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the firm

A legal sector publication brought to you by Moore and Smalley Chartered Accountants and Business Advisors

Squeeze out from the credit crunch...

On 5 November 2008, the Law Gazette reported a spike in law firm closures. Looking back, month on month, September 2008 had the highest number of firms closing since January 2005. 375 firms closed, which was nearly 40% higher than the September average for the previous three years.

So how big an impact has the economic downturn had on legal firms?

Statistics aside, it has become obvious that law firms have been hit immediately and directly by the drop off in the housing market. Residential conveyancing firms are closing, or departments being severely downsized. Staff, and in some instances, partners, are being laid off.

There are still firms undertaking commercial property work, with the economic slowdown not producing such a sudden halt in workload. But as building developers begin to close commercial sites, and businesses take the decisions to hold off from investing in new property, then this area is also becoming quiet.

Some solicitors are buoyant, claiming that the problems in the economy are catalysts for marriage and relationship breakups so that matrimonial and family law should get busier over the coming months, with post Christmas being a traditional peak in new cases.

Other lawyers take a keen interest in weather forecasts, knowing that a cold snap also tends to bring in new work for the probate section.

But what should you be doing to stay ahead of the credit crunch?

Each distinct business will have issues that are relevant only to them, but many legal practices will be facing similar problems over the coming months. These basically fall into three sectors: income, expenditure, and cash flow.

Income is key to the survival of the firm. If work is drying up in some sectors then where else can new work be generated from? A focussed business development plan will help to concentrate resources into those areas where most benefit can be derived in terms of new work referrals. Consider cross-selling opportunities, intermediary contacts, but most of all consider what your clients need and how you can add value to potential clients.

Think about how your staff and partners are working, and in what ways you can operate more efficiently. This may include your use of IT. Look at your statistics on productivity and make sure all fee earners have a realistic target of chargeable (good, billable) time to log each week. Use your support staff better to free up time to allow fee earners to generate those fees.

Where you can issue interim fee notes to clients, do so. Keep a close eye on work in progress and hours logged into the system to make sure that it is recoverable and fully billable. If it is not, then make sure that provision is made against it, so that it is not taken into account when reviewing management information giving a distorted view of potential future billings.

Make sure that when clients have been billed that debt collection is prioritised. If you are holding client monies, then do not wait for the full 14 day rule to kick in before transferring the funds to office account.

Expenditure must be controlled, so that any drop in income is matched by a proportionate cut in costs.

The quickest but the hardest cost cutting exercise is redundancies. Many practices have already undertaken this process, having understood the urgency in making significant reductions in the cost structure, some in direct response to falling income levels. Firms must take a realistic view of their pool of staff (and partners) to ensure that they are not spending more in wage costs than is being returned in fee income. Traditionally law firms expect a fee earner to be able to generate three times their salary.

Some practice expenses are easier to control than others, so we would expect to see a fall in entertaining spend (but remember your business development plan); training may be put on hold (but consider retraining staff); IT equipment may be retained for a year or two longer than was originally planned; the planned refurbishment of the office may be put on hold. But there may be simple ways to cut costs like comparing quotes from PI insurers, phone and IT system suppliers, before accepting the renewal fee.

In some cases, the back office function, or part of it, could be outsourced. There are numerous secretarial services, book-keeping services, payroll bureau, archiving firms, costs draughtsmen, marketing and HR advisors available which may be more cost effective than employing someone in-house to undertake these duties or using a fee earner to do them.

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Squeeze out from the credit crunch… continued

But of course, it is always **cash flow**, or the lack of it, that pushes a firm out of business.

If you are managing your business so that all fee earners are fully occupied on work that is fully billable, your bills of costs are raised quickly, debts are recovered without delay, expenses are controlled, credit periods taken so that invoices are not paid early, staff costs have been reduced to the minimum operational, partner drawings have been scaled back then cash flow should be easy to maintain. However, most businesses will struggle with some (but hopefully not all) of the above.

Think about how your business is financed. How much fixed capital are the partners expected to contribute? How much is borrowed from the bank? Is this on short term overdraft or on long term loan? Are there other finance arrangements, say to cover asset purchases, or to pay PII? What is your lock-up?

You must have a cash flow projection that details your expected income and expenditure from the business, as well as the commitments to make repayments of loans and other finance arrangements, pay partner drawings, pay VAT and PAYE, and don't forget that come 31 January there will be a tax bill to pay for each partner too. This cash flow projection should be at the top of every management team meeting agenda, and should be kept under constant review, being updated for all changes in circumstance as they arise.

Keep close to your Bank Manager, and make sure that they are aware of your cash flow requirements well in advance. Monitor your banking covenants, so that nothing comes as a surprise. If you think you may need it, consider other sources of finance. They may not come as cheap, but could well be a short term consideration.

If there is a choice between an undertaking an activity that generates profit or cash – choose cash.

If you need help with any of the issues raised in this article, please call Karen Hain on 01772 821021.

Law management section; benchmarking survey 2007

In our last edition of The Firm we looked in depth at what the results of the 2007 benchmarking survey tell us about figures for firms of varying sizes.

There were a number of interesting findings, including:

- The number of Practice Managers in general has increased
- More firms are achieving Lexcel
- A significant number of firms are now Limited Liability Partnerships (LLP's)
- Appraisal systems have become increasingly prevalent in firms
- The majority of firms share profits equally or on a lock-step basis

We also considered what the survey can tell us about the income and expenditure of firms. We found that firms were increasing the average number of fee-earners per equity partner, for example. The rising cost of employing fee-earners and support staff has been one of the key factors behind firms increasing the number of fee-earners per equity partner, in order to maintain and even increase profit levels.

Profitability and working capital

In this edition we will be looking at the changes in profitability and working capital of firms.

Profitability

As we saw in the last issue, income per fee-earner has risen by around 6.7% since last year and 3% and 8% in the previous two years. As we also revealed, there was an 8.8% increase in the employment cost of fee-earners and a 20% increase in the cost of support staff. Profit per partner has increased by 18.4% because of a 25% increase in gearing over the last year despite these sizeable cost increases.

The first table below shows net profitability as a percentage of total income for all firms taking part in the survey. The median figure this year is 24.5% which is very close to the traditional figure which is always mentioned of 25%. Last year the equivalent figure was 27.4% but last year there were far more sole practitioners in the survey. Sole practitioners usually bill only modestly but have a lower cost base so might be expected to achieve a higher margin. It is interesting to see the upper quartile result for sole practitioners of 45.1%. The median upper quartile figures for all firms was 32.4%. A margin of 33% has long been regarded as a measure of success or efficiency for a firm.

Profit as a percentage of total income by size of firm

Size of Firm	Lower Quartile (%)	Median (%)	Upper Quartile (%)
1	17.0	32.1	45.1
2-4	13.5	22.1	29.0
5-10	17.1	26.5	32.7
11-25	19.8	24.5	32.5
Over 25	21.3	21.4	25.5
All	17.6	24.5	32.4

When the figures are looked at by region (see the table below) it can be seen that most of the regions are grouped reasonably tightly together. The median margin is unusually low in the North West at 21.4% and unusually higher in Wales at 34.0%.

Profit as a percentage of total income by region

Region	Lower Quartile (%)	Median (%)	Upper Quartile (%)
Eastern	19.8	24.5	31.9
Gtr London	20.3	28.4	37.8
Midlands	16.8	26.2	32.4
North East	22.4	25.3	31.3
North West	**15.5**	**21.4**	**27.3**
South East	17.4	25.7	32.9
South West	12.9	21.4	26.9
Wales	31.8	34.1	44.4
All	17.6	24.5	32.4

When we consider the profits of equity partners, the survey shows a median profit for individual partners of £137,954, which is an 18.4% increase on the previous year.

Looking at the regional variance, perhaps unsurprisingly the Greater London median is the highest at £263,883 with the next highest being the Midlands at £155,960 and the lowest being the North West at £115,206. The overall median was £137,954 so greater London and the Midlands were 91% and 13% up on the median while the North West was 16% down on the median.

The below table shows the position for partners in firms with more than 30% legal aid work.

Profit per partner – legal aid firms

	Lower Quartile (£)	Median (£)	Upper Quartile (£)
Legal aid firms	77,000	100,264	160,987
All other firms	100,264	139,105	189,973

Legal aid partners are generating profits that are 28% lower than the median for other firms. It has been interesting to see how some years the legal aid firms are more profitable and some years less profitable. It is probably due to the smaller number of firms in the survey who still derive over 30% of their fee income from legal aid.

Notional Salary

It is not easy to arrive at a figure for a partner's notional salary that has a universal application because profits vary according to size of practice, location and type of work. Previous reports used a notional salary calculated on the basis of 60% of profit per partner. Using median figures, this varies with the size of firm. For firms with five to 10 partners, where the profit per partner is £138,687, the notional salary will be £83,000 (rounding to the nearest £1000). The figure of 60% allows a sufficient margin to take into account fluctuations in profits and the need to retain some profit in the firm for future investment.

Working capital management

We shall now look at how firms manage their working capital to determine how effective they are in turning paper profits into cash. The measure of this is the length of time a firm takes between recording an hour and collecting the money. Two benchmarks are used for measuring this. Firstly, the average number of days between carrying out the work and invoicing, and secondly, the interval between invoicing and cash collection. The first is called WIP days and the second is called debtor days.

The total of these two figures is in the firm's 'lock-up' – in other words, the amount of time that money due to the firm is 'locked up' in working capital. The median figure for participating firms is 145 days up from 131 in 2006 and down from 154 in 2005. In other words, nearly five months' income is locked up in work in progress and debtors. This is illustrated in the below table.

Total lock-up by size of firm

Size of Firm	Lower Quartile (days)	Median (days)	Upper Quartile (days)
1	88	124	163
2-4	105	139	183
5-10	107	147	190
11-25	129	159	175
Over 25	32	89	146
All	107	145	177

The general trend – that larger firms tend to be slower than smaller firms in billing and cash collection, as noted in previous reports is not repeated this year.

It is not surprising to find a considerable difference between different types of work. Residential conveyancing has low lock-up (67 days) because it has a short duration and cash is received at completion while personal injury and clinical negligence (269 days) has greater lock-up because matters can last longer before it is practice to raise a bill and there can be a delay between the bill being issued and cash being received.

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New rules for Self Invested Personal Pensions (SIPPs)

A SIPP is simply a personal pension plan but with wider investment powers and the ability to borrow against the fund for further SIPP investments. The maximum borrowings that can be made are 50% of the schemes assets. A very common usage of this facility is for the purchase of commercial property, typically by owner managed business', to trade from. For example if your fund was worth £200,000, it could borrow a further £100,000 thus enabling the pension scheme to buy a property worth £300,000.

The SIPP can then charge a rent for use of the commercial property and this is a legitimate business expense. Once any borrowings have been repaid, the rental income will accumulate within the SIPP with no tax liability and, together with any future pension contributions, can be put in other investments, including possibly funding additional commercial property purchases. When the commercial property is eventually sold there is no liability to capital gains tax.

It is important to remember that commercial property held within a SIPP is treated the same as any other pension scheme asset and is subject to the same rules that apply to personal pensions. Assets held within pension schemes are technically owned by the pension scheme and not a company/individual and are therefore 'ring fenced' for the purposes of creditors.

New rules effective from 1st October 2008 mean that over 6 million people with Protected Rights pension funds can at last move them into SIPPs. Protected Rights funds are the funds that build up from the rebates of National Insurance contributions for opting out of the state second pension scheme, formerly known as SERPS (State earnings related pension scheme). Until now such funds have not been allowed to be used in a SIPP. It is estimated that over £100 billion is held in such funds averaging £16,500 each although if you have been contracted out since you were first allowed to in 1988 your Protected Rights fund could now be worth over £50,000.

It is also possible to group together a number of SIPPs to purchase more expensive property e.g. partners in a solicitors practice to purchase their business premises. Alternatively, a joint purchase of property can be made by SIPP monies and companies or individuals although there are additional costs for this. So if you have an old Protected Rights plan amongst your policies now might be a good time to review it.

Another change in the rules regarding SIPPS and personal pensions concerns the age at which you can draw your benefits. At present this is 50 but from April 2010 this is going to increase to 55. This means that if you are currently aged 50 you could start drawing your pension benefits now but if you do not draw them before April 2010 you would then not be able to draw them until 2013.

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Annaul partner's seminar update

In the last edition we informed you of our up-coming seminar. In light of the recent economic crisis, we felt it more beneficial to take a breather from everything and put the date back until early 2009 when we can benefit from a clearer understanding of the way the economy is heading. We will be including updates on our website shortly to inform of a more definite time for our annual seminar.

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