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the firm

MOORE & SMALLEY
CHARTERED ACCOUNTANTS AND BUSINESS ADVISORS

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Welcome

To the first edition of 'The Firm' for 2007. Following the 'bedding in' of UITF 40 rules on revenue recognition, we have in this edition moved away from that thorny issue, and considered another very topical matter, mergers and acquisitions of practices.

As our 'Legal MarketWatch' (Page 2) shows, the number of firms in the UK is shrinking as practices consolidate through mergers and acquisitions. As this issue becomes increasingly topical, it is important that mergers and acquisitions are managed effectively to minimise issues, and my colleague Rob Kenmare, our Corporate Finance Director, considers how to go about doing this (Page 3).

However, if you still require advice, guidance or even a second opinion on UITF 40, I would urge you to contact me to arrange this sooner rather than later, as issues tackled now will have less impact than if they are only discovered in the next few years.

I hope you find the newsletter helpful and informative, and should you wish to suggest any topics for future editions, please contact Mark Brennan on 01772 821021.

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Law Society welcomes "much improved" Legal Services Bill

In the last edition we covered the Law Society's opposition to the draft Legal Services Bill. Since then, the Bill proper was announced in the Queen's Speech and then published in November 2006. The Bill has been largely welcomed by the Law Society, who feel that a number of their key concerns with the draft Bill have been taken into account.

Fiona Woolf, the President of the Law Society, believes the Legal Services Bill is 'much improved' from the draft Bill, which was considered by the Joint Committee of both Houses of Parliament in the summer:

"The Law Society has consistently supported the principles of the Bill – separation of representation from regulation in the professional bodies; light-touch oversight from an independent Legal Services Board; creating a new body to handle all consumer complaints about lawyers; and enabling new ways of delivering services to the public to be developed.

"The draft Bill failed to incorporate these principles satisfactorily, and risked creating a micro-managing Legal Services Board which would undermine the independence of the legal profession from Government. We are pleased that the Government has accepted a number of the Joint Committee's recommendations and has listened to some of what the Law Society and other stakeholders have said. The result is a much improved Bill."

"But there are still a number of important issues where amendments are needed. The Bill should ensure: that the process for appointing to the Legal Services Board is genuinely independent of Government; that the Legal Services Board works in partnership with approved regulators using its powers only where there is a risk of serious regulatory failure; that the system for regulating new business vehicles (ABSs) takes proper account of the potential impact of any new providers on access to justice and that the Government pays a fair share of the costs of the Legal Services Board. We will raise our detailed concerns on these issues with parliamentarians during the passage of the Bill."

The Legal Services Bill

The Legal Services Bill essentially implements the main recommendations from Sir David Clementi's 2004 report on the regulation of legal services, which recommended that:

- Existing professional bodies should continue to carry lead responsibility for regulation of legal services, rather than being replaced by a monolithic direct regulator along the lines of the Financial Services Authority.
- Professional bodies which held both regulatory and representative responsibilities should be required to separate the two roles.
- An over-arching Legal Services Board should be created to provide consistent oversight of the frontline regulators, in place of the incomplete patchwork of supervision arrangements which currently exist.
- All consumer complaints against lawyers should in future be dealt with by a new body, the Office for Legal Complaints, wholly separate from the professional bodies.
- New Alternative Business Structures (ABS's) - involving partnerships between lawyers and non-lawyers, and the possibility of external ownership of law firms - should be permitted to provide legal services to the public.

Legal MarketWatch: Future market changes drive consolidation strategies

Readers of the regional press cannot fail to have noticed that the North West legal services market is currently in a state of flux. The merger of Preston-based Napthens and Blackburn-based Roscoes in November created a 21-partner practice with a significant corporate arm. This was swiftly followed by the merger of Ricksons (with offices in Preston, Manchester, and Leeds) with DWF in January, which has seen the latter become one of the region's largest firms, with an annual fee income of £51m. Finally, February's announcement that Preston-based Marsdens and Rawsthorns are to merge has seen the North West legal sector change dramatically in a short space of time. The signs on both a local and national scale, are that such mergers and acquisitions will become increasingly prevalent.

The Law Society reports that over the last eight years, the number of private practices in the UK has dwindled by more than 10%, with the decline showing no sign of stopping. Even accounting for retirements and bankruptcies, it still appears that the sector is going through a significant reorganisation period.

1. Number of UK Law Society accredited private practices 1998 - 2006

Year	Number of firms
1998 - 1999	9,983
1999 - 2000	9,770
2000 - 2001	9,251
2001 - 2002	9,231
2002 - 2003	9,198
2003 - 2004	9,211
2004 - 2005	9,081
2005 - 2006	8,926

Source: Law Society - Annual statistical reports 2006, 2005, 2004

The ownership make-up of these practices also makes for interesting reading. It suggests that the 1-4 partner model is becoming increasingly common. This could be a response to larger firms limiting the number of new equity partners in order to preserve profit-per-partner. Increasing use of non-equity partnerships and performance-based reward structures may actually be forcing increasing numbers of lawyers to 'go it alone', or form small partnerships.

2. % of UK Law Society accredited firms by number of partners (As at 31 July 2006)

Number of partners	% of Firms 2006	% of Firms 2005	% of Firms 2004
Sole practitioners	46.3%	45.9%	45.3%
2-4 Partners	40.7%	40.0%	39.7%
5-10 Partners	8.9%	9.3%	9.8%
11-25 Partners	2.8%	3.3%	3.6%
26+ Partners	1.3%	1.4%	1.5%

Source: Law Society - Annual statistical report 2006

However, were these smaller firms to become successful, they would undoubtedly attract the attention of large and medium-sized practices who are looking to grow rapidly through an acquisition strategy.

The North West Market

Within the North West, the picture is a little different. Again the number of private practices is on the decline, suggesting the type of consolidation we have seen in recent months is part of an overall trend.

3. Number of North West based Law Society accredited private practices 2003 - 2006

Year	Number of firms
2003 - 2004	1,096
2004 - 2005	1,082
2005 - 2006	1,064

Source: Law Society - Annual statistical reports 2006, 2005, 2004

However, the ownership make-up is significantly different for North West practices with a much larger 'middle market' of 2-10 partner practices, and smaller numbers of large firms and sole practitioners. This could suggest that the prospect of starting as a sole practitioner is much less attractive in the North West than in other regions.

4. % of North West based Law Society accredited firms by number of partners (As at February 2006)

Number of partners	% of Firms 2006	% of Firms 2005	% of Firms 2004
Sole practitioners	39.3%	38.2%	38.6%
2-4 Partners	45.1%	45.6%	44.7%
5-10 Partners	12.2%	12.3%	12.1%
11-25 Partners	2.5%	3.0%	3.5%
26+ Partners	0.8%	1.1%	1.1%

Source: Law Society - Annual statistical report 2006

There are fewer 'big players' in the local market, and this may be seen as an opportunity for practices with 5 or more partners to grow through mergers and acquisitions, subject to finding other like-minded firms that share their aspirations.

Future trends: Regulatory changes threaten smaller practices

One of the key drivers that will undoubtedly have a major effect on both the local and the national market is the two key pieces of current legislation facing the legal services sector, namely the changes to the legal aid system, and the Legal Services Bill.

The proposed changes to the procurement of legal aid could have a substantial impact on smaller firms, who will have to bear the costs of transition to the new regime and operating within a reformed environment against larger firms with more access to resources. These firms also have the most to lose, as they are far more reliant on legal aid work.

5. % of total fee income from legal aid work by size of firm 2003

Size of Firm	% of legal aid fee income
Single Solicitor	11%
2-5 Solicitors	29%
6-12 Solicitors	27%
13-40 Solicitors	11%
41-170 Solicitors	4%

Source: Law Society – Solicitor's firm survey 2003

Firms with between two and twelve solicitors are reliant on legal aid work to bring in over a quarter of their annual fee income, so if they are unable to adapt to the new arrangements, they face a bleak future.

The Legal Services Bill (see Page 1 for more details) will allow non-legal entities and individuals to own legal companies, theoretically opening the way for supermarkets to offer legal services along the same lines as they now offer insurance and banking products. Consequently, smaller firms could face being 'priced out' of an increasingly competitive market. Larger firms, on the other hand, could suddenly find that they have more ways of accessing finance than ever before, funding even more expansion through mergers and acquisitions.

Under the microscope – the importance of Due Diligence

As mergers and acquisitions are becoming increasingly commonplace in the market generally, and the North West specifically in recent months, it seems increasingly pertinent to consider how the parties to a deal can determine whether the deal is the right one. Not all mergers and acquisitions are successful, particularly if careful thought and planning do not go into the process.

Due diligence is the process by which a buyer or merger partner gets a clear picture of the business that they are buying or merging with. If you were buying a car or a house, you would need to know as much as possible about the product prior to committing to the purchase, and buying a business is no different.

Some of the issues that should be investigated as part of the due diligence process are:

- **Financial due diligence** – looking at the target's figures and books to look for commercial and financial risk areas and their potential impacts.
- **Taxation due diligence** – take into account any tax issues affecting the vendor or the transaction, and any opportunities to reduce your own tax burden post-investment.
- **Management due diligence** – assessing the existing management structure and management team of the vendor to identify whether they are capable of adding value in the post-deal period.
- **Commercial due diligence** – reviewing the projected profits of the vendor and the strength of the markets in which they currently operate.

Doing the right type of due diligence could be the difference between taking on a millstone around your neck, or a financial goldmine, but doing due diligence properly requires more than a few financial checks done in-house. You should appoint experienced advisors who can take an objective third-party view of the potential deal and determine the key areas of investigation in order to minimise risk.

Rob Kenmare is Moore and Smalley's Corporate Finance Director, and joined the firm from Ernst and Young's Manchester Mergers and Acquisitions team in 2004. His team advise businesses in a wide variety of sectors on disposals, mergers and acquisitions, accessing finance, due diligence and succession planning. For more information, contact Rob on 01772 821021 or e-mail him at rak@mooreandsmalley.co.uk.

Law Society launches 'What Price Justice?' campaign

The Law Society has launched the 'What Price Justice?' campaign to persuade the government to guarantee an adequately funded legal aid system ensuring quality representation and access to justice for all. It follows the government's proposed reform of the legal aid system, begun by the Carter Review.

Following the Special General Meeting (SGM) at the Law Society on 17th January, Andrew Holroyd, Law Society Vice President said:

"Today's SGM highlights the strength of feeling among solicitors about the current legal aid reforms. The Law Society wants the same result as all the solicitors who attended the meeting – to secure a sustainable future for legal aid and to protect vulnerable clients. The Society will continue to fight for that objective with all urgency.

"We continue to lobby intensively to secure a viable future for legal aid. The current proposals threaten an already economically fragile sector and so access to justice. We are working on behalf of legal aid solicitors to find a workable solution, but the current proposals are far from that."

The Law Society has commissioned legal and economic advice from relevant experts to improve understanding of the likely impact of the proposals on the sector. MPs have been given a detailed briefing on the threat to the future of the legal aid system in advance of a debate in Westminster Hall. During that debate, MPs expressed concern at the lack of opportunity for parliamentary scrutiny of the proposals.

For more information on the Law Society legal aid campaign, and to lend your support, go to http://www.whatpricejustice.lawsociety.org.uk/.

RICS report highlights cooling in house price inflation

House price inflation has cooled following the November interest rate rise, says the RICS UK housing market survey published on 16th January 2007. House prices rose for the fourteenth consecutive month in December but the pace of increase eased back to August levels.

The pace of increase remains strong, above the long run average of 21%, but this is the first real evidence that the November rate rise has started to take some of the heat out of the market.

Although the market experienced its first slowdown since 2004, it remains firm, sustained by a booming city economy and a strong financial services sector.

House price rises in the North have accelerated, whilst in the North West, prices increased at the fastest pace since September, driven by increasing numbers of buyers coupled with less property available for sale.

RICS spokesman Ian Perry comments:

"Interest rate rises have started to cool the housing market and last week's rise will have a further impact in the coming months, but the market remains strong.

"However, the rate rise will do nothing to aid home owners struggling with affordability conditions with more repossessions looming on the horizon.

"As we move further into the new year, consumers will begin to tighten their belts as finances come under pressure but rising wages and employment will continue to boost the economy and RICS expects interest rates to finish at 5.5% by year end."

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