AUDIT • TAX • ADVISORY

Legal Benchmarking

Annual Report 2018

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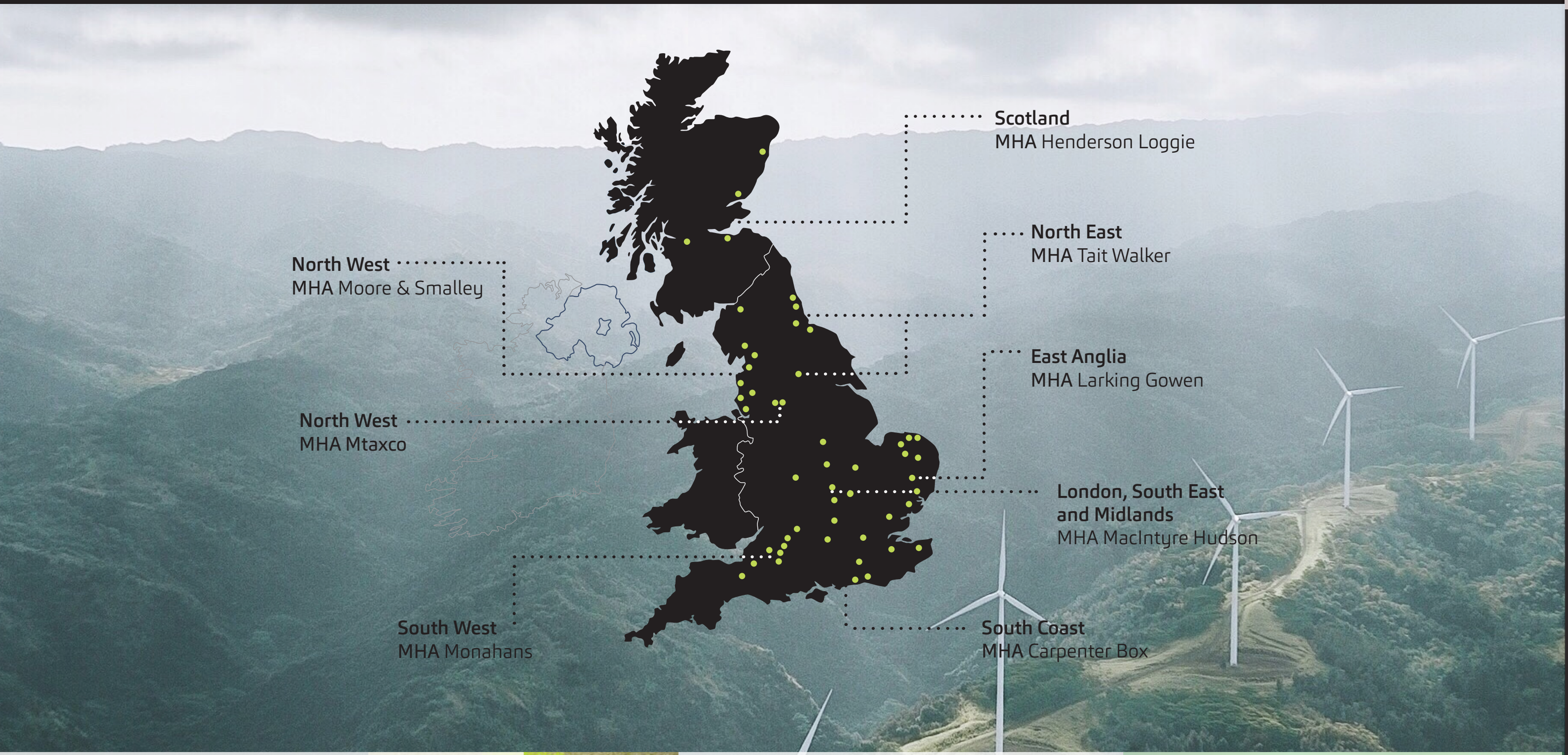
About MHA

MHA is an association of progressive and respected accountancy and business advisory firms with members across England, Scotland and Wales. Our member firms provide both national expertise and local insight to their clients. MHA members assist clients with their needs wherever they are in the UK, as well as globally through our membership of Baker Tilly International, which has a network of trusted advisors covering 145 terrirtories worldwide.

Our Sector Approach:

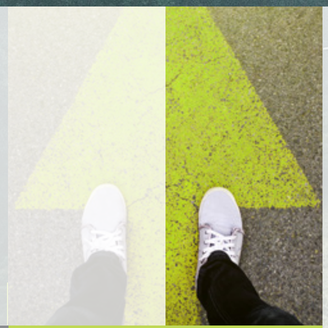
MHA allows clients to benefit from our in depth sector knowledge, which adds value to the specialist services that we can provide in accountancy, audit, tax, regulatory and expert business advice. Professional Practices is a key sector for MHA.

We act for over 400 professional practices, including over 200 legal firms. We are committed to assisting both our clients and the sector as a whole and this report is just one of the tools we use to give our clients insight into issues affecting the sector, to give them a head start when it comes to mitigating risks and exploiting opportunities.



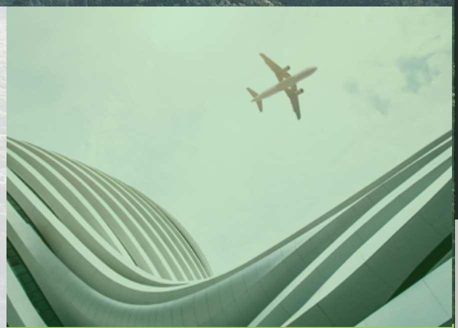
National Reach

50+
Offices nationwide



International Reach

125
Member firms in 145 territories



8
Independent accountancy firms

Combined turnover of
£143m

10th
Largest network in the world by combined revenue

US$3.6bn
Combined member firm revenues

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Introduction

Karen Hain
MHA Moore & Smalley
Head of the Professional Practices Group at MHA

Welcome to our sixth MHA legal benchmarking report which looks at results generated over 2017

Thanks once again to my colleagues across the country for sharing their daily experience of working with legal practices, so that we can share key themes in this report.

My thoughts in considering the results from 2017 are what do we expect to see as a 'new normal' for the legal sector?

After a number of years of steady growth in fee income, in 2017 we saw a fall in fees billed across all sized practices. Smaller firms have recorded a reduction of between 1% and 5%.

Some of these businesses have been personal injury law specialists and the dramatic impact of small claims limits have finally taken hold. The cases signed up before the changes were imposed have been running off and have not been replaced with matters generating the same fee levels. New types of litigation work, such as holiday claims, have been stopped in their tracks by Government legislation. Other new work types, like pension mis-selling, are still in progress and had not yet generated significant fees in 2017.

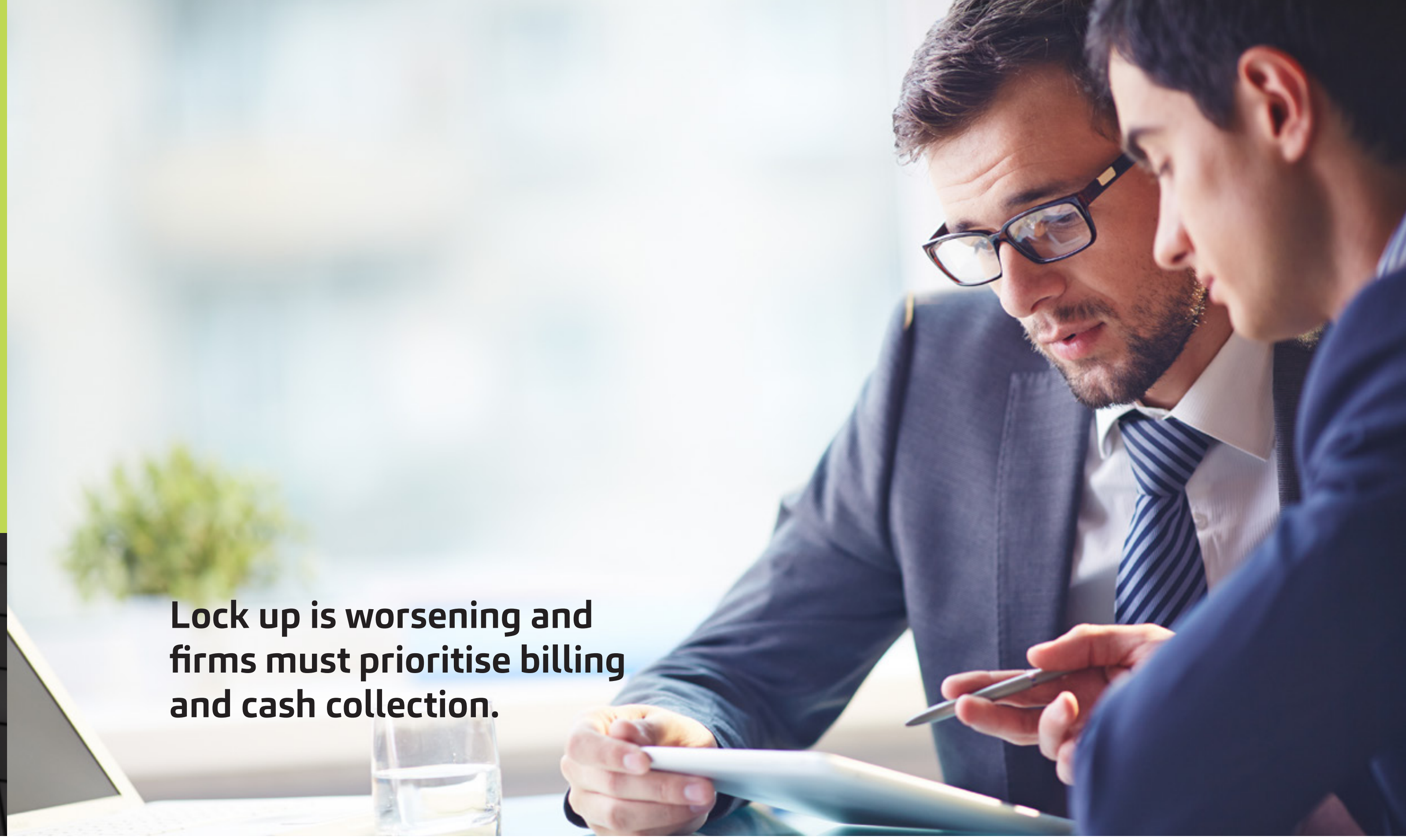
Smaller practices have seen even more competition from online sources. This has been prevalent in residential conveyancing matters, with traditional high street practices suffering from a fall in new matter openings.

The impact of fixed fees has also been a factor in the drop in income in 2017. Price competition is a regular occurrence in smaller firms, with them often having to reduce quotations to win work at a fixed fee. As fixed fees become a 'new normal', firms need to have the financial data at their fingertips to accurately price up work with profits built in.

Efficiency will need to be a key planning theme for 2018, so that all work completed is done following the quickest and most accurate procedures, by the lowest costing individual. This will help to bolster profits which have also taken a negative hit in 2017.

Net profit percentages in the past were always aimed at 33%. However, over recent years it has become clear that the 'new normal' is more like 25% net profit. Some of the sizes of firms in our review have hit this benchmark, albeit having seen a reduction in profitability from previous years.

An interesting change has occurred in the staffing of legal practices. In 2017 we saw a change in the staffing mix. There are fewer senior fee earners, more paralegal levels and more support staff compared to prior years. Administrative duties are being passed from fee earning staff to support staff. Paralegals are picking up more of the work from qualified fee earners. One reason for this change has been the difficulty in recruiting experienced qualified fee earners, at a salary package that firms can afford. If there are no recruits, then firms have looked at alternative options to keep up with client service.



The reducing number of experienced fee earners is also one of the reasons why fee income has dropped. Once again we can assume that a 'new normal' will be senior fee earners being replaced by paralegals and other support staff. We have yet to see what the impact of this change in staff mix will have on profits, but we would expect to see increases in 2018.

Looking now to the changes taking place in the management and ownership function, we have seen more non-lawyers coming into management teams. Firms have accepted that they can operate effectively with an ex banker or other financial professional at the helm, steering along a more commercial business plan than may have been in place traditionally.

We have in prior reports discussed the issue of succession planning in legal practices and in 2017 we have seen fewer equity partner numbers once more. Senior fee earners have, as predicted, opted out of the route into equity, preferring instead to take a high remuneration package with no risk attached, which is the case with equity ownership. Those ongoing equity partners are having to leave more of their undrawn profits in the business to assist cash flow and in some cases had to introduce more capital funding, as banks are now reducing their interest in the sector.

These equity partners are demanding higher return for their risk. Our expectations for the future are that equity partner numbers reduce further, so that a smaller number of partners share profits to give a better return on their investment in the practice; and because high paid fee earners do not want to give up employment security for a partnership position. It is disappointing to see that lock up is worsening and firms must prioritise billing and cash collection. These processes must become second nature to fee earners, they should be involved alongside a credit control function, as they are the main and regular client contacts.

As the gulf between the results of the smallest firms in our review compared to the largest firms grows even more, we can only expect to see fewer small firms in the sector in the future. Many of the traditional high street firms have partners coming close to retirement, and this is driving the merger discussions of many.

Smaller practices have seen even more competition from online sources.

Firms need to have the financial data at their fingertips to accurately price up work with profits built in

Income

After three years of strong growth, we have seen income drop across the profession. The benefits of mergers and a strong economy were seen in previous years, particularly for larger firms of 11 partners or more.

David Smith
MHA Henderson Loggie

2017 has been characterised with a reduction in merger activity, uncertainty in the market partly arising from political uncertainty and the retirement of equity partners. Lower margin work in personal injury and public funded matters have been hit again with reducing fees and drop off in new instructions. Clients are increasingly prepared to shop around for more competitive pricing and fixed fees.

Comparative Levels of Fee Income

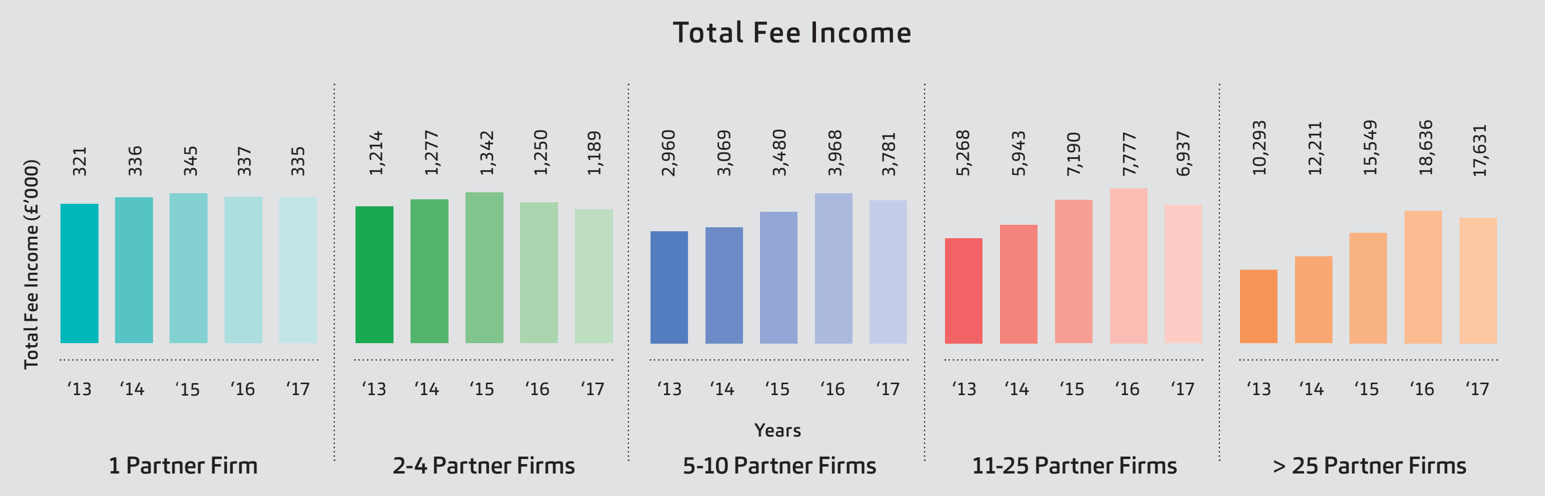
A drop in income has been seen across the board, with the sole trader practices seeing the smallest fall of 1%. Mid-tier firms of 11-25 partners saw the largest reduction in fee income, of 11% compared to 2016. All other categories saw income reduce by 5%.

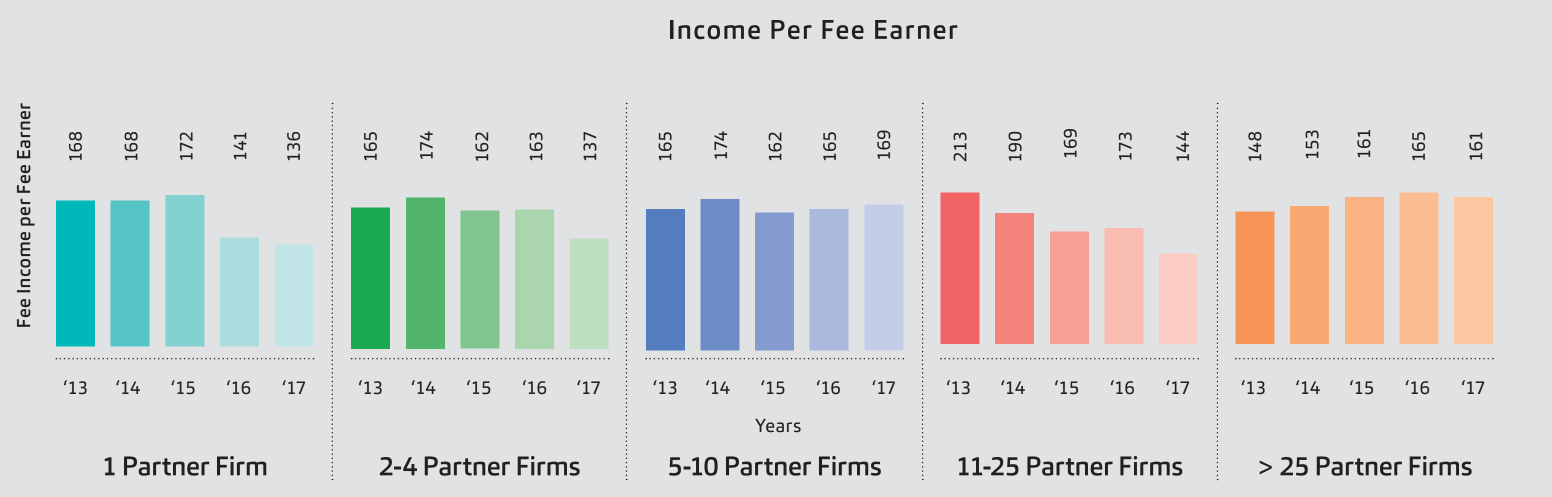
In years without growth from merger activity, renewed focus is required on profitable organic growth.

> " In years without growth from merger activity, renewed focus is required on profitable organic growth "

As the graph shows, the gap between turnover levels of the different sizes of firms is consistent with previous years, despite the reductions in income.

If we check what has happened to lock up in 2017, we can see that work in progress is rising. It is taking longer to raise fee notes and this has negatively impacted on fee income.





Income Per Fee Earner

Income per fee earners mirrors the movements in overall firms' turnover. Other than practices with 5–10 partners (2.4% increase to £169,000), all firms have seen a reduction in income per fee earners. Income per fee earner ranges from £136,000£144,000 for firms other than 5-10 partner firms and >25 partner firms.

The number of fee earners to partners has stayed consistent compared to last year, so the overall fall in income has come as fee earners bill less on average than they did in 2016.

Income Per Equity Partner

Reductions in fee income per equity partners were witnessed at all sizes of firm, except firms with 11-25 partners. In this specific category, there has been an increase in income per equity partner from £591,000 to £746,000, however income per partner has reduced from £486,000 to £406,000. The number of partners to equity partners has reduced by 40% which signifies a shift in ownership during the period.

In other categories, the number of partners to equity partners has increased as equity partners have retired, being replaced by non-equity partners. The target fee income per equity partner remains in the region of £350,000+ for sole practitioners; £500,000+ for 2-4 partner firms; £750,000+ for practices with more than 5 partners; and £1m+ for the larger practices of more than 25 partners.

Despite overall falling fee levels, the ratios of fee earners to partners and to equity partners has been at least maintained and generally shows an increasing trend. This demonstrates that firms continue to invest in their teams to seek growth and for succession planning. We would hope to see that these members of staff start to fill the gap in fee income that has been seen across 2017 results.

To ensure this investment leads to profitable growth in the coming years, firms must look to build high performing businesses and should consider the following questions:

- Does your firm have the key capabilities needed, such as strategies for talent management and empowering leadership?
- Is your firm regularly communicating with clients to be aware of their changing needs?
- Does your firm have good processes for managing scope creep in assignments?
- Are the fixed fee pricing calculators correct?
- Are you keeping track of matter recoveries to see which jobs are profitable?
- How good is the referral process to maintain the pipeline of work?

Profitability

A key indicator of performance is the profitability of the firm. This measure not only allows firms to assess themselves against competitors and their previous years' results, but is one of the main questions that our clients ask us.

Charlie Eve
MHA Carpenter Box

" How much profit have we made and how does that compare to the previous year? "

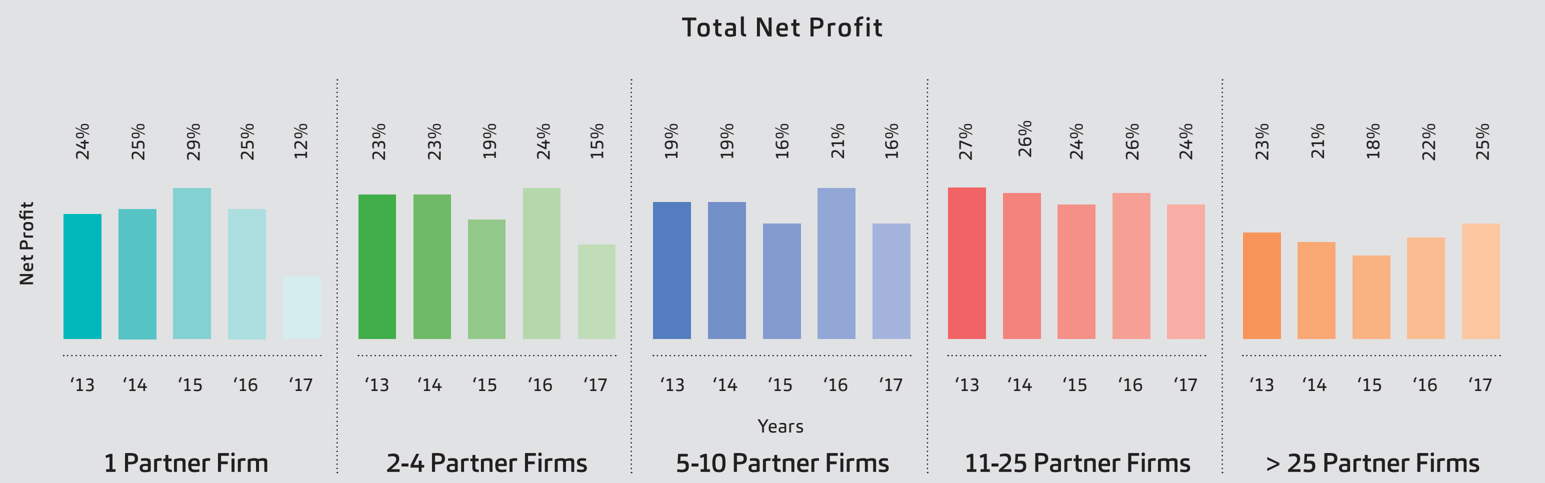
My answer this year will be delivered with a sense of trepidation, but also a dose of reality. The cost of employment in professional practices is rising at a disproportionate rate to fees and this is impacting on the profit of the equity partners (PEP). The PEP has fallen for each of the firm size categories we benchmark and this is a worrying trend.

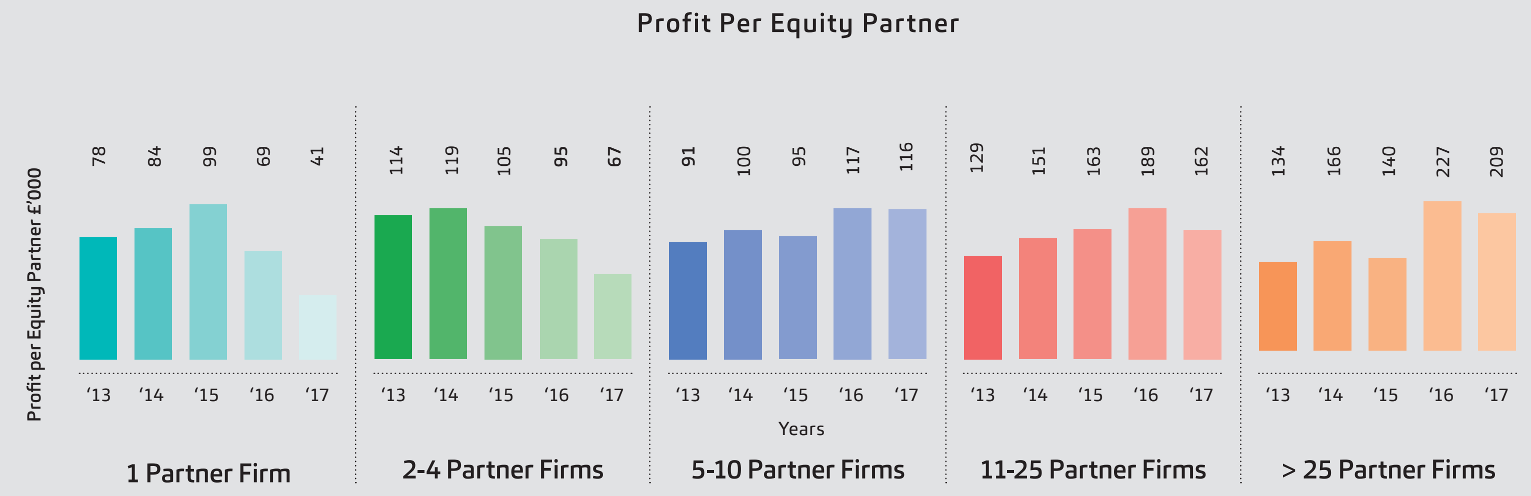
Hard Market for the Smallest Firms

The sole practitioner's profits have fallen by 40% in 2017 to £41,000. At what point is this profit level unsustainable for the lone partner? In a number of cases, their fee earners are earning more than the equity partner.

This profit level is nearly 60% lower than the heady heights of 2015 when partner profits were close to £100,000. This level of profits is the lowest since we started our benchmarking statistics five years ago. The smaller firms are now starting to struggle in a market where the trend seems to be leading to larger firms dominating the market place.

The cost of employment in professional practices is rising at a disproportionate rate to fees and this is impacting on the profit of the equity partners (PEP).





Larger Firms Invest Profit in Ownership Changes

There has been a reduction in PEP for the 11-25 and 25+ partner firms of 13% and 8% respectively, however, the profit levels stay markedly higher than the smaller partner firms. The reduction in this profit seems to be a result of not only a fall in income, but also a shift in the ownership of the firms, with larger fee earners remaining as salaried partners rather than moving into equity positions. There appears to be a cultural change with fewer up and coming partners pushing for equity ownership, preferring instead to draw higher salaries without the financial risks attached.

Net Profit Percentages Tumble

As illustrated by the PEP falling for most sizes of practices, the net profit percentages have tumbled for all sizes of firms except the largest. It would appear that the wage demands of the non equity partner fee earners of the smaller firms, coupled by those fee earners producing lower fees than in the previous year, has led to the dramatic fall in net profit percentages. The sole partner firm's net profit percentage has fallen to a mere 12% and 2-4 partner firms reducing to 15%.

Not surprisingly, with profits so low for the smaller firms, they have strictly managed their other spending, with practice expenses being at similar or lower levels to previous years.

5-10 partner firms have not kept their expenditure under the same control as the smaller firms and this has impacted on the net profit percentages falling back to the levels of 2016. the larger practices of more than 25 partners.

Firms of the Future

There is a growing gap between the profitability of the smaller firms and the larger firms. This is illustrated with the stark difference between PEP for firms up to 10 partners in size, to those above. We are also starting to see a trend where the smaller firm's equity partners, as a ratio to salaried partners, is falling. Salaried partners do not want the additional risk and responsibility of ownership for a share of diminishing profit levels.

This profit gap is likely to continue the trend of larger firms consolidating the smaller firms. We expect there to be fewer smaller firms in the market place and the larger firms will continue to grow both organically and by acquisition.

The sole partner firm's net profit percentage has fallen to a mere 12% and 2-4 partner firms reducing to 15%.

There is a growing gap between the profitability of the smaller firms and the larger firms.

Employment Costs

Salary costs have been steadily rising year-on-year as a percentage of income, from

57% five years ago to **68%** this year.

Based on 2-4 partner firms

Jon Woolston
MHA Larking Gowen

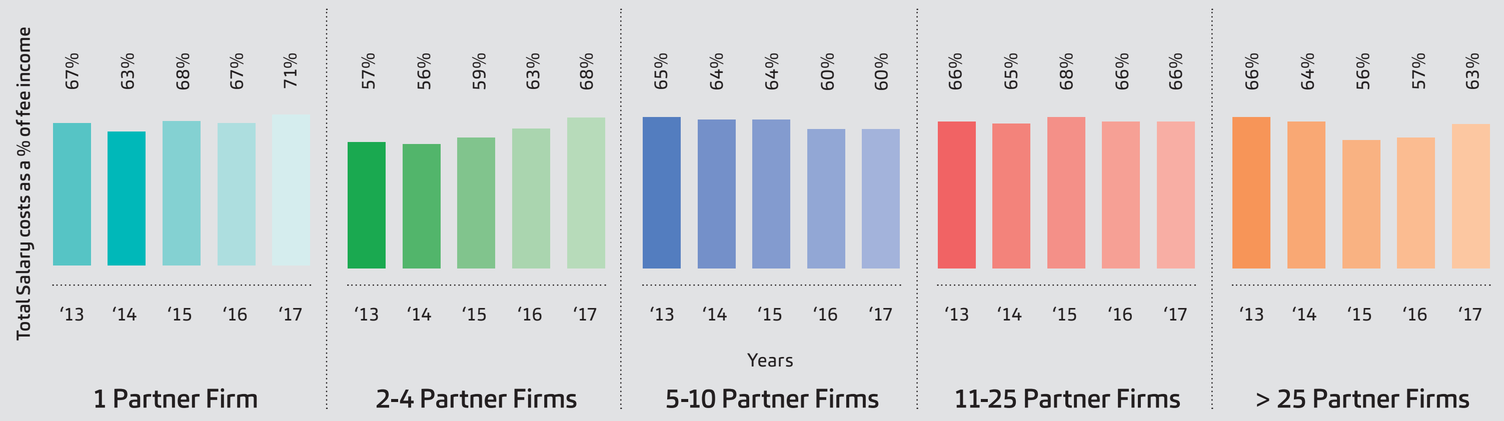
Equity partners are now having to contribute more capital funding; last year a partner was contributing an average of £215,000, whereas this year each partner is retaining an average of £248,000 in the business.

Employment costs as a percentage of fee income have either increased or remained stable for all firm sizes. The cost of employment will continue to rise with increased pension costs, following the auto-enrolment contribution increases and expected inflation rises. Unfortunately, this was also accompanied with all firms suffering a larger fall in income, with the resultant fall in overall net profit.

The Cost of 'Going Solo'

Sole practitioners experienced an overall increase of just over 3% in salaries as a percentage of fee income, from 67.4% to 70.6% (including notional partner salaries), moving further away from the old benchmark of spending one third of income on salaries. Whilst the increase this year and over the past five years has been greater in firms of other sizes, the salary costs remain the highest as a percentage of income in sole practitioner firms. Employee numbers have remained consistent, however the proportion of fee earners to overall staff in sole practitioner firms increased this year, as did the ratio of fee earners to equity partners

Total Salary Costs: % Of Income



Successor Shortage?

Small firms of 2-4 partners saw an overall increase of 5% in salary costs as a percentage of income. This continues to be the trend revealed over the past 5 years, with salary costs steadily rising year-on-year as a percentage of income, from 57% five years ago to 68% this year. Total employee numbers remained broadly consistent, but an increase in the percentage of fee earners to equity partners points to the continuing struggle for smaller firms to find and appoint successors in the equity ownership group.

Staff Mix

Mid-sized firms of between 5 and 25 partners saw salary costs as a percentage of fee income stay consistent, comparing the results to last year with 5-10 partner firms spending 60% of their income on employment costs and 11-25 partners firms spending 66%, for both years. Considering that the fall in income for firms between these sizes has been significant, this consistency in employment costs is represented by a mix of factors. These are likely to include the promotion of higher-paid fee earners to partners and the appointment of lower-paid fee earning staff. Whereas total employee numbers marginally decreased in firms of 5-10 partners, the firms of 11-25 partners saw a 10% increase in the number of employees, and a reduction in the ratio of fee earners to equity partners from 5.0 to 4.6.

This reveals that the mix of fee earners to administration staff has changed, such that more of the routine work which would have been undertaken by a fee earner in the past is now being undertaken by lower-paid support staff. A corresponding increase in IT costs as a percentage of overall income provides such employees with the necessary tools to accomplish these tasks.

Equity Shared Amongst Fewer

The largest firms (more than 25 partners) revealed an overall increase in total staff numbers by 7.5%, a decrease in the proportion of fee earning staff to total employees of 3%, where support staff are being recruited to pick up tasks previously completed by fee earners. We have seen a sharp increase in the ratio of fee earners to equity partners to 6.9, following four years where it was broadly static at 5.2. The combination of these factors reveals that the largest firms are rationalising the numbers of their equity partners and replacing senior partners with well paid fee earners. This is further supported as equity partners are now having to contribute more capital funding to accommodate the reduction; last year a partner was contributing an average of £215,000, whereas this year each partner is retaining an average of £248,000 in the business.

Firms of 11-25 partners saw a 10% increase in the number of employees.

Practice Expenses

The fee income of each category of practice has reduced.

Mark Brunton
MHA Tait Walker

When comparing practice expenses as a percentage of fee income, it is important to remember that in 2017, the fee income of each category of practice has reduced. It could therefore be considered surprising that overall practice expenses as a percentage of fee income has also fallen. The biggest reductions were found in the smallest and the very large practices.

Premises

Premises costs as a percentage of fee income was broadly consistent in 2017, when compared to 2016. It ranged from 5.9% to 9.3% in 2017, compared to 5.8% to 9.5% in 2016. The rental element of this cost ranged from 3.3% to 6% in 2017 compared to 3.3% to 5.8% in 2016. The largest percentage costs in both years were practices with in excess of 25 partners, due to larger “flag ship” offices or city centre offices. The lowest percentage premises costs remained in 2-4 partner practices where practices are likely remaining static in one office location.

IT

IT costs remained broadly the same as a percentage of fee income from 2016 to 2017. The costs ranged from 1.6% to 2.2% in 2017 compared to 1.7% to 2.3% in 2016, with larger practices, 11-25 and over 25 partner practices at the upper end of the scale. There is still pressure to embrace technology and increase IT spend, therefore it remains surprising that the IT spend is relatively modest compared to other professional practices. We would also expect to see some increase in charge per user as most IT software suppliers move to a unitary licence fee.

Marketing

Overall marketing costs as a percentage of fee income increased in 2017. It ranged from 0.4% to 2.9% in both 2017 and 2016. Sole practitioners are spending proportionately less than others and 11-25 partner practices are investing the most in marketing. There are modest increases in the proportionate marketing spend during 2017 amongst 5-10 partner and over 25 partner practices, as practices attempted to reverse reducing fee income.

Professional Indemnity Insurance

For the first time in a number of years, 2017 shows professional indemnity insurance (PII) fall as a percentage of fee income. This reduction is found in all sizes of practices. In 2016 the range as a percentage was 2.5% to 6.5% and this has fallen in 2017 to 2.1% to 5.5%. This fall is due to a softening of the PII market and brokers managing to obtain improved terms, with some of these running over 18 month insurance periods. The higher risk is still perceived to be sole practitioners, which pay a proportionately higher premium, whereas the larger practices, which have better compliance systems and governance are perceived to be of lower risk.

There is still pressure to embrace technology and increase IT spend, therefore it remains surprising that the IT spend is relatively modest compared to other professional practices.

SBad Debts

2017 has continued the trend of 2016 that 2-4 partner practices are suffering the highest proportionate bad debt costs. For this size of firm, it has risen to 3.3% of income in 2017 from 2.7% in 2016, which equates to an average expense of nearly £40,000. This is likely to be due to these firms not having a dedicated credit control function and a high proportion of partner time being chargeable. Larger practices with over 25 partners have bad debts remaining at 1% of fee income, whereas sole practitioners have had their best year, only suffering a 0.5% bad debt rate.

Books and Library

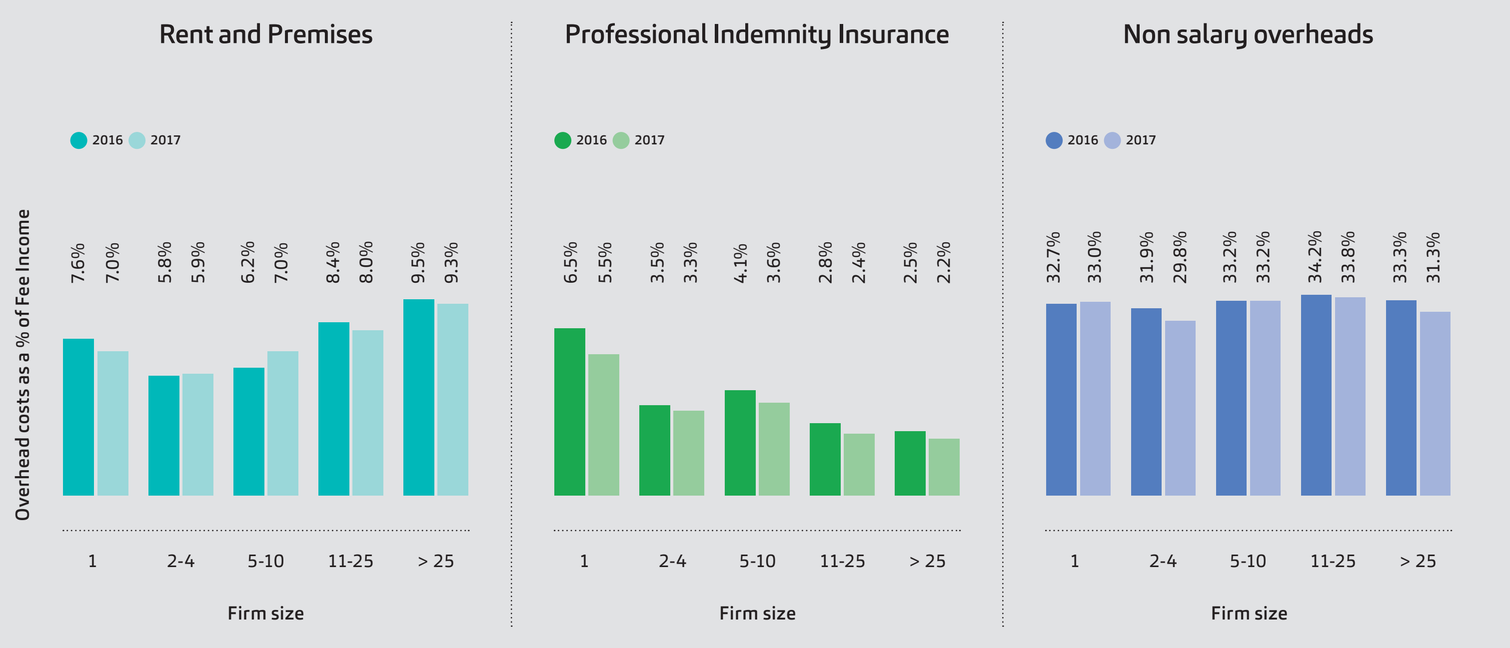
This is a relatively small expense category, but a necessary one as legal practices must maintain a reference library, virtually or paper based, to keep up to date with legislation changes. Overall the costs as a percentage of fee income remained consistent with the previous year. The cost ranged from 0.4% to 1.4% in both years, with 11-25 partner practices incurring the highest percentage spend in both years. Practices continue to take advantage of online solutions, which prove most cost efficient.

Non Salary Overheads

Traditionally, the business model for a professional practice has been to incur one third spend on salary, one third on overhead expenses, leaving one third of fee income as profit. This model changes depending on the size of the practice and there has been a trend of increasing employment costs, resulting in profit margins reducing. Over the previous few years of benchmarking, we have seen that the new normal level of expected net profit is around 25%.

The general trend of expenses as a percentage of fee income reducing in 2017, is reflected in an overall reduction in the percentage of non salary overheads, which range from 29.8% to 33.8%. This is a result of actively managing costs down during the year, which could be seen as especially important with fee income reducing in 2017.

Practices continue to take advantage of online solutions, which prove most cost efficient.



What Drives Profit and Financial Stability?

Our survey shows that while larger firms generally take longer to bill, smaller firms are taking longer to collect debts.

Simon Tombs
MHA Monahans

Achieving increased profit and financial stability in a highly competitive market is a challenge that has been facing law firms for many years. Little or no growth in the sector, together with increased competition from outside of the profession and increasingly demanding clients, means that firms without an understanding of the drivers of profitability are unlikely to be successful.

Control of WIP and Debtors

Time management is key and firms need to be billing a higher percentage of worked hours. Non-billable tasks need to be carried out by support staff or a greater reliance placed on software. Staff are invaluable here in identifying inefficiencies and making improvements.

The most successful firms are also becoming more efficient at billing. Discipline is needed throughout the firm to ensure that time is entered and that bills are raised promptly to ensure that clients see the value of the work that has been done. Firms also need to consider if their bills are being paid. Successful firms are introducing strategies such as direct debit payment options and timely communication is a must with late payers. Our survey shows that while larger firms generally take longer to bill, smaller firms are taking longer to collect debts.

Strategies to Increase Fee

All firms are striving to increase spend per client, but the firms that are delivering the best profits are in possession of up to date management information and understand which of their clients create a profit and which ones do not.

They are continually looking for opportunities by maintaining an ongoing dialogue with their clients to build and improve these relationships. These firms also target clients with recurring work, which is much more cost effective than continually seeking out new clients.

The most successful firms are also becoming more efficient at billing.

The results of our survey have shown that firms of all sizes have continued to keep a tight control of their overheads.

Cost Control – Overheads and Variable Expenses

The results of our survey have shown that firms of all sizes have continued to keep a tight control of their overheads. The most profitable firms have seen savings in rent, PII and non-salary overheads, which has then impacted on net profit percentages.

The biggest variable cost of all firms has always been their staff costs. For a number of years now, the most profitable firms in the survey have shown an increasing ratio of fee earners to partners.

The optimum staffing structure is critical. Generally the more fee earners per partner the better the profit. Staff retention is also a key factor.

Firms invest so much in finding and training their staff that losing them after a few years can be very costly. All of the firms that we surveyed showed an increase in salary costs, but only the 5-10 partner firms mitigated this rise by increasing fee income at the same rate.

Moving Forward

The key to success is going to be firms gaining a full understanding of the true value of the services that they provide and passing this understanding on to their clients. Firms that actively monitor the cost of providing the service, bill enough in a timely fashion and ensure that they collect fees while controlling expenses, will achieve the profits and financial stability that is desirable.

Finance and Funding

With the results of our survey showing an overall decrease in income levels and profitability, the level of funding available to firms is even more crucial. It is the level of available finance in a firm that will allow it to remain viable, successful and agile enough to adapt to the current climate.

Kate Arnott
MHA MacIntyre Hudson

27%
2017

11%
2016

Equity funding as % of fee income

The need for managing the balance between external funding and capital effectively has never been more important.

Reduced External Funding Levels

Total external funding per equity partner has decreased significantly in 2017, ranging from £42,000 in the smallest firms to £228,000 in the largest, compared with £156,000 to £506,000 last year. While this may seem to be a positive move reducing external finance, it has most likely been driven in part by bankers putting pressure on firms to reduce the overall lending.

Bank borrowings have fallen significantly in all firms except sole practitioners, who tend to fully guarantee all bank borrowing in their own names. Bank borrowings per equity partner range from £19,000 to £112,000 (in the largest practices), compared to a range of £21,000 to £228,000 last year.

Practices have had to look for additional finance streams outside of their traditional banking facilities, partly to replace the fall in bank funding and partly to plug the gap that equity partners are unable or unwilling to contribute to. Purchases of new assets tend to come with a finance option, and more short term finance companies are being utilised to fund the payment of large one-off expenses, such as professional indemnity insurance. Due to there being a greater funding need over the year, we have seen the average percentage of external funding to equity partner funding increase across all sizes of firms.

Strategies to Increase Fee

All firms are striving to increase spend per client, but the firms that are delivering the best profits are in possession of up to date management information and understand which of their clients create a profit and which ones do not.

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Total Funding Per Equity Partner

£42,000
in the smallest firms

£228,000
in the largest firms

Increasing Reliance on Equity Partners

The lower level of external finance has been mopped up by partners drawing less from the practice. In all sized firms except the sole practitioners, the amount of equity partner capital plus undrawn profits has risen over the last year. The range of partner own finance invested, per equity partner, ranges from £64,000 in 2-4 partner practices up to £336,000 in the largest.

Although the total funding per equity partner has decreased across the board, the actual capital invested in the year has varied depending on the size of the firm. Both the largest firms and the 5-10 partner firms saw increased levels of fixed capital being invested by their equity partners.

The reductions in fee income in 2017 have meant that equity capital as a percentage of fee income has risen drastically to concerning levels, the downturn in income and profitability has left the firms in our survey with an average of fixed equity capital at 27% of fee income, compared to just 11% last year.

Whilst there is no ideal level of capital to suit all firms; long term strategy, profitability, capital commitments and lock up can all affect the optimum capital level. This drastic increase of equity funding as a percentage of fee income shows a continued fall in return on capital for law firms across the board.

Long Term Debt

Traditionally, law firms have raised funding from partner capital injections, bank loans and finance leases. Increasingly there is much more of a corporate outlook, especially in the larger firms, and there is a move away from short term loan financing and bank overdrafts to an acceptance that longer-term borrowings are par for the course.

With ever increasing scrutiny on the financial stability of law firms, requirements to invest in IT infrastructure, the need to remain cutting edge, and increased salary costs, firms are looking to more structured debt as a way of funding their businesses.

The current environment for law firms is difficult. It is vital to plan and monitor cash flow and funding requirements accurately, both in the short term with a rolling quarterly cash flow, to an annual projection of cash needs. It is more common to see longer term planning over 5 years so that strategic factors can be built in, covering matters such as partner retirements. The need for managing the balance between external funding and capital effectively has never been more important.

Lock Up

In the largest firms an improvement of 1 day in lock up would release

£19,000

of cash.

What is Lock Up?

The working capital of a law firm is made up of the costs that accumulate whilst work is undertaken for a client, before it can be billed, plus the time it takes the client to pay the bill. As a consequence, the practice 'lock up' represents work in progress (unbilled time and disbursements) and in debtors (bills issued but not yet paid).

The significance of lock up is heightened by the fact that firms must pay their major cost, being staff, at the end of each month and most overheads must be paid within 30-45 days. Lock up is defined in days and if matters rest in work in progress for 60 days and then the client takes a further 45 days to pay the bill, the total lock up is 105 days.

Why is Lock up Important?

If lock up is 105 days and staff and overheads are paid within 30 days, you can see there is a 75 day gap. The greater the value of 'lock up' the greater is the funding gap required to meet staff costs and practice overheads. This funding gap can be met by increasing the capital introduced by equity partners, by restricting the ability of partners to make drawings from the business or by seeking a working capital facility (loan or overdraft) from a bank or other funder.

The result of our survey demonstrates that whilst in previous years lock up was reducing across most firms, in the last two years there has been a worrying increase across all firms except those with 11-25 partners. This suggests that this is an area of practice management that needs urgent review.

In our review, we have seen lock up days increasing from an average of 3 days to 17 days, except in 11-25 partner practices who have worked hard to reduce lock up by 27 days.

In a practice, for every £1m of turnover, an increase in lock up by 15 days will result in a further £41,100 tied up in unbilled time or unpaid bills. For a practice of £5m turnover, the increase in lock up would be £205,500 and for a practice of £15m turnover the increase will be £616,500.

In a mid sized practice with 11 partners this could represent nearly £75,000 per partner. These are significant additional funding requirements whatever the size of the practice.

Our review has seen a huge spread in the amounts of lock up per equity partner, from £70,000 per partner in the sole practitioner firms, to £225,000 in 11-25 partner firms, topping out at £415k in the largest firms. In the largest firms an improvement of 1 day in lock up would release £19,000 of cash.

Smaller practices bill more regularly but take longer to collect the debts, whereas larger firms take longer to bill but then have better credit control in collecting the debts.

> "Firms have been managing overhead costs but not lock up"

> "Collective responsibility but independent credit control"

What are the Challenges to Address?

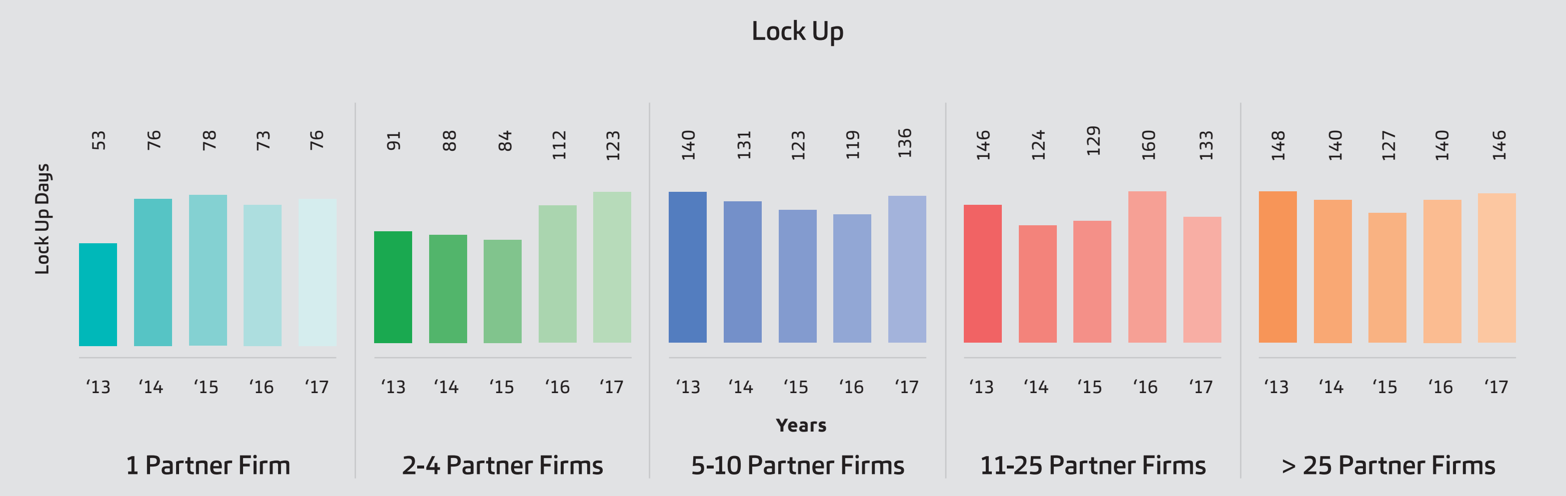
There are a number of catalysts that put pressure on lock up:

- Growing practices will have increasing lock up and funding requirements. However, if lock up is not adequately controlled, the issue magnifies as the practice grows. Indeed, our survey has shown increasing lock up despite a reduction in turnover for most practices. This puts extra pressure on funding.
- New fee earners may see their role as just getting in new work, whereas billing the work and collecting the debt is just as crucial.
- Our survey demonstrates that smaller practices bill more regularly but take longer to collect the debts, whereas larger firms take longer to bill but then have better credit control in collecting the debts. The key is to get the balance right.
- Our survey also suggests that attention was focused on managing lock up after the last recession (cash is king), but that this focus may have slipped in the last two years.
- Changes in the economy can also have a significant impact on lock up with clients more reluctant to pay on time. Therefore, getting the management right before the economy tightens again will be essential.

What can be Done?

The key issues to consider in managing lock up are:

- All fee earners must have a responsibility to manage the lock up within their own client service portfolio and must understand the impact of increasing lock up on the practice funding.
- Consider opportunities to agree with the client to raise bills on account as work progresses.
- Set billing targets for each fee earner to meet on a monthly basis and make this a discussion topic in partner meetings.
- Ensure bills are agreed with the client to avoid any delays in payment due to dispute.
- Monitor overall lock up by fee earner and department to ensure trends are understood. We have seen practices move into litigation and medical negligence work as they believe these areas are more profitable. However, they have also realised that these areas of work can have a greater level of lock up and therefore require adequate funding.
- Consider establishing an internal credit control function that takes the burden of chasing debts away from fee earners. Whilst fee earners must take responsibility for their own lock up, client relationships often make the fee earner more likely to allow longer credit than a credit control department would.



Conclusion

Karen Hain
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Practices Sector Head

I hope that you have found this report interesting, and I wonder if some of the key themes that have arisen are resonating with your firm?

As always, the starting point of any business plan is detailing where you are now and the strengths and weaknesses that your firm have identified.

You can then plot where you want to take your firm to, with the opportunities and threats to consider along the way. My MHA colleagues are all experienced in business planning so can assist your firm to generate the "how" part of this planning cycle. Clearly there have been changes already taking place with staffing structures. Perhaps one of the 2018 thoughts needs to be how to improve efficiency in your firm, because small positive changes result in better profits.

Please make sure that improving lock up is also on the agenda. Firms fail due to lack of cash flow. We have already seen more partner capital being injected into firms, but there will be a limit that equity partners want to put on this. Invest some time in reviewing your billing procedures and cash collection, because shaving a few days off your lock up period will mean immediate cash generation.

When reading reports like this, it is sometimes just calming to understand that the issues facing your firm are an issue for others too. Perhaps the problem does not seem so serious when recognising that other practices are discussing them too. If your firm is struggling to get to the bottom of how you might change your results, then go back to the underlying statistics – the numbers never lie!

My MHA colleagues across the country have many years of experience in dealing with legal practices and can assist and guide you through your planned changes. Please do not hesitate in contacting your local team.

To find out more about the accountancy and business advisory services MHA **Monahans** can offer, please contact

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