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Legal Benchmarking

Annual Report 2020

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Welcome to the 8th MHA legal benchmarking report considering 2019 results from across the country.

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

Many legal practices have seen increased demand for services during 2019, even with the underlying economic uncertainty in the country. Long threatened reforms to legal services are still not in place, and so we are not seeing any significant changes to individual sectors.

We have continued to see consolidations of law firms with the most popular size of practice to merge being those between 2 and 10 partners. These tend to be the size where due diligence is easier to conclude, procedures are easier to amalgamate and staff do not find cultural changes so dramatic to force resignation. There is still not a great deal of cash changing hands in these consolidations, with limited payment being seen for goodwill.

Key themes arising from statistics

Apart from the smallest practices, profits per equity partner are improving. Overhead control is one factor but the main driver is that the ratio of fee earners to partners has increased.

The number of fee earners and partners have both increased in 2019. Trainee recruitment is up, and there has been a trend for assistants to move from a full support function to actually completing part of the service for clients.

Senior fee earners are being promoted to partner, in a bid to fix succession plans and to retain important individuals. These new partners are not always being asked to contribute personal funding into the practice as the firm looks at funding streams from banks and other finance offerings.

Firms have built up their capacity to grow and we are now seeing increases in fee income alongside the increased fee earner head count and expense. However, the increase in fees are not transferring directly into higher profits. This is because many of the new staff are not fully chargeable on profitable client work, or are at much lower chargeable rates, being junior staff. This is an investment period for many firms.

Premises costs are continuing to grow, with no real move to employee agile working being seen in short terms plans.

Where we have seen improvements in lock up, there has been a corresponding reduction in the amount of partner funds held in that practice. Challenger banks have been more active in the market place and bank funding has increased, as a proportion of total funding, on average over the year.

I hope you find the report useful and are able to use some of the calls to action as checklists against your own business plans.

Contents

Key Findings

1 Partner Firms

£8k
Equity Partner capital invest down £8k

£27k
Bank borrowing up £27k

14%
Number of Fee Earning staff up 14%

2%
Net profit down 2%

2-4 Partner Firms

£100k
Lock up improved by £100k

3%
Fee Earners billing 3% more

4%
Net profit up 4%

£14k
Profit per Equity Partner up £14k

5-10 Partner Firms

£143k
Lock up worsened by £143k

10%
Fee Earning staff up 10%

12%
Income per Fee Earner down 12% to £149k

11-25 Partner Firms

12%
Fees billed up 12%

14%
Income per Fee Earner down 14% to £122k

£4k
Profit per Equity Partner down by £4k

>25 Partner Firms

£55k
Equity Partner capital down by £55k each

70k
Total funding down £70k per Equity Partner

22%
Fees up 22%

£23k
Profit per Equity Partner up £23k

Income

The results of our 2019 review highlight trends being seen across the legal sector and key strategies being implemented consistently by many firms.

David Smith
MHA Henderson Loggie

Growing fee income trend

In 4 of the 5 size categories, total fee income has grown compared to 2018.

Sole trader practices and 5-10 partner firms saw modest growth in fee income of 2.9% and 1.7% respectively. The larger practices, with 11-25 partners achieved 12% income growth, while firms with more than 25 partners saw significant income growth of 22.4%.

Only 2-4 partner firms on average continued their trend in recent years of falling income.

	Fee earner numbers	Partner numbers	Equity partner numbers
1	Static	Static	Static
2-4	Falling	Static	Rising
5-10	Rising	Static	Static
11-25	Rising	Rising	Rising
>25	Rising	Rising	Rising

Increasing numbers of fee earners and partners

Income growth was mirrored by growth, on the whole, in numbers of fee earners, partners and equity partners, as summarised in the above table.

Total Fee Income
(£'000)

	1	2-4	5-10	11-25	>25
'19	387	1,052	4,201	7,780	20,849
'18	376	1,165	4,132	6,948	17,040
'17	335	1,189	3,781	6,937	17,631
'16	337	1,250	3,968	7,777	18,636
'15	345	1,342	3,480	7,190	15,549

A key question posed in our 2019 review was whether firms were too lean to grow. During the past year, increases in fee earner and equity partner numbers have built capacity for growth.

Our review highlights the trend of senior fee earning employees moving up to partnership and partners moving up to equity partner status. Correspondingly, fee earner numbers have risen. This increase is at a more junior level, with these staff not as qualified, experienced and not as highly remunerated.

Promoting senior fee earners to partnership is a defensive strategy for the retention of good people and reflects the current, very difficult recruitment market. Bringing in more fee earners at lower levels is a strategy for growth in the medium term.

Income per fee earner – falling ratio

The short-term consequence of these strategies is a fall in income per fee earner. The more junior fee earners have lower fee targets and are not generating the same levels of income as their more senior colleagues.

Income per fee earner for sole trader practices of £121,000 was down 19.3%; for 5-10 partner firms £149,000 was down 12.3%; 11-25 partners of £122,000 was a fall of 14.1%; and more than 25 partner firms figure of £134,000 was a drop of 5.6% compared to 2018. 2-4 partner firms saw an increase in income per fee earner of 6.6% compared to 2018, but the 2019 figure of £129,000 remained below the income levels of earlier years i.e. 2013 through to 2017.

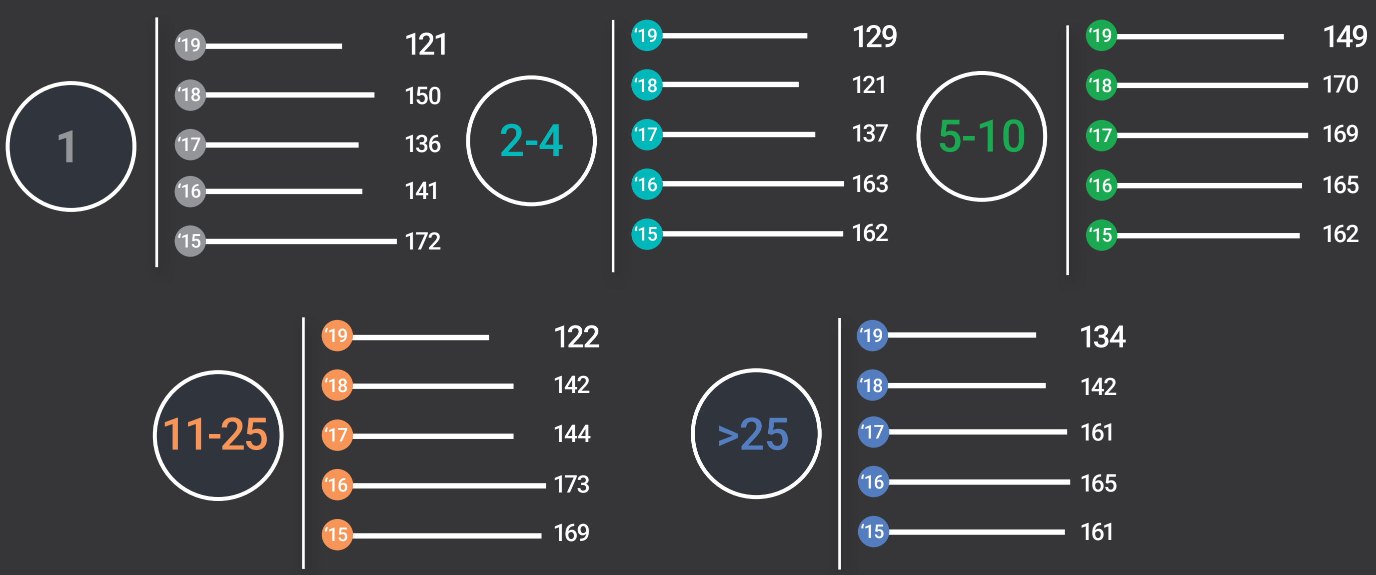
For all three size categories showing increased equity partner numbers (2-4 partner; 11-25 partner; and more than 25 partner firms), there has been a respective drop in the income per equity partner ratio, as the total firm income is shared across more equity partners.

A cautionary note for sole trader practices and 5-10 partner firms: These firms have experienced growth in income whilst encountering significant falls in the income per fee earner ratio. Fee growth has been achieved through equity partners stepping in to fill gaps and while that may maintain current profitability, it will not be sustainable in the long term.

Call to action

1. Growth in income per fee earner is key to creating improved, sustainable profitability, which will only come from building the capabilities of more junior fee earners.
2. With senior staff promotions to partnership, consider what leadership development and mentoring is in place for their continued progress.
3. Consider agile and remote working policies as part of your recruitment and retention strategies and how they will interconnect with plans to grow your fee income per fee earner.

Income per Fee Earner
(£'000)



What Drives Profitability?

Understanding the change in profit share from one year to another is a key measure looked at by Equity Partners (EP's) to determine whether the year has been a successful one.

Charlie Eve
MHA Carpenter Box

Improvement on the previous year but is it good enough?

The EP's in the 2-4 partner firms will be happy to see a 17.5% increase in average profit share. However, their profit share of £94,000 is still £1,000 less than that achieved in 2016, and £11,000 less than in 2015. 2-4 partner firms have found the last few years very difficult. These firms appear to have tried a new tactic of reducing fee earner numbers. The removal of some high earning employees has reduced turnover but has had a positive impact on equity partner profit.

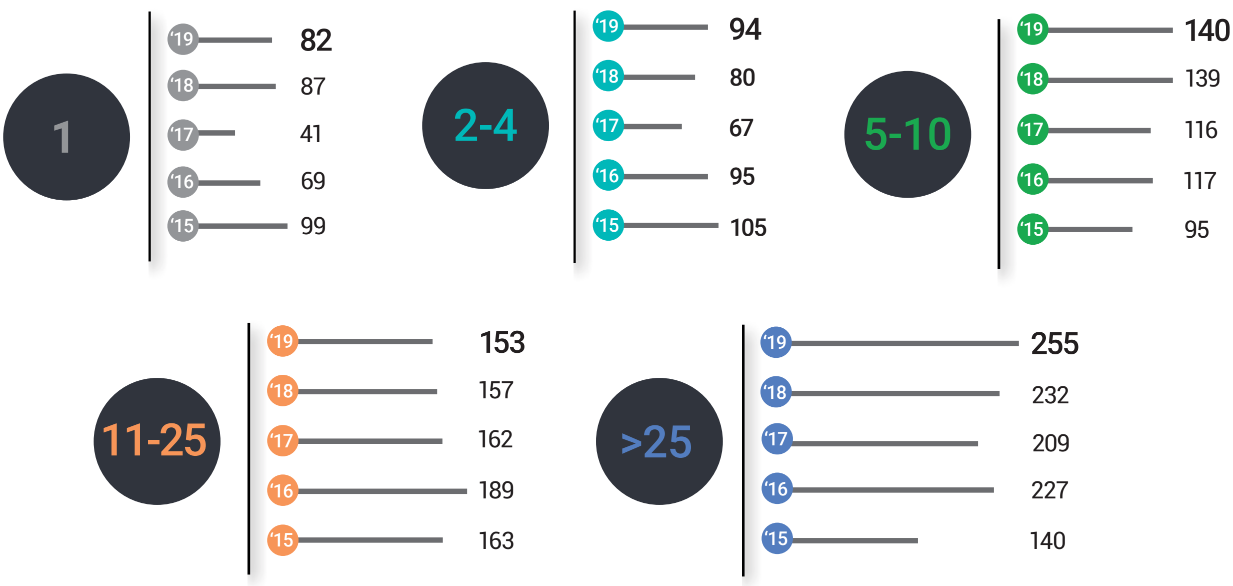
The profit divide

There is a real divide between the size of practice and the Profit per Equity Partner (PEP) that are achieved. Bigger seems to certainly be better with regards to profitability.

Where a practice has 1 to 4 EP's, its Average Annual Profit (AAP) for the last two years is £86,000. Where the practice has 5 to 25 EP's the AAP for the last two years is £147,000, but for the practices with greater than 25 EP's the AAP for the last two years is £244,000.

This profit divide seems to fuel the regular discussion in the market regarding the continued consolidation of smaller firms into larger firms.

Profit per Equity Partner
(£'000)



Are you valuing your work properly?

The net profit as a percentage of turnover statistic is incredibly important for legal firms, showing whether the work that is being carried out is actually profitable. The standard net profit benchmark to aim at is 25% or more. Only the firms with 11 or more partners seem to be achieving this target.

In the market place there seems to be a constant challenge where partners are battling to agree fees with clients. It is easy to increase fees by selling your services at a low fee level, but you will not make any profit by doing so and it appears that the smaller firms are finding it harder to charge fee levels that counter their increasing costs.

Old time is less profitable

Old work in progress is hard to bill. The perception of value from the client is at its highest on the production of the work, so firms should ensure all fee notes are produced and issued when the job completes. Smaller firms, especially, need to make sure invoices are raised on a timely basis to get maximum costs charged. This will help to push up net profit percentages.

What work is profitable?

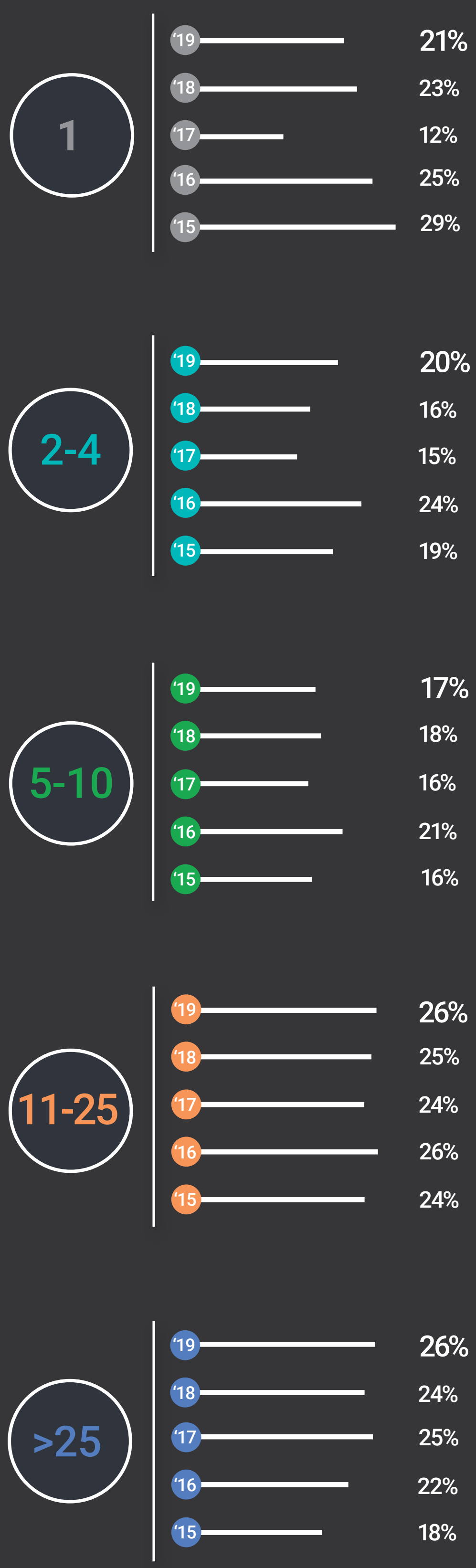
Firms' accounting records are all now electronic and as a result, there is a significant amount of data available to analyse. A review should be completed to understand which are the profitable matters. Are they all the same type of matter? If so, maybe the marketing of the firm should concentrate on this type of work. Is it the same fee earners? If so, what do those fee earners do differently and how can other fee earners learn from them? Concentrating on profitable work will push up the net profit margin and in turn the profit to share between equity partners.

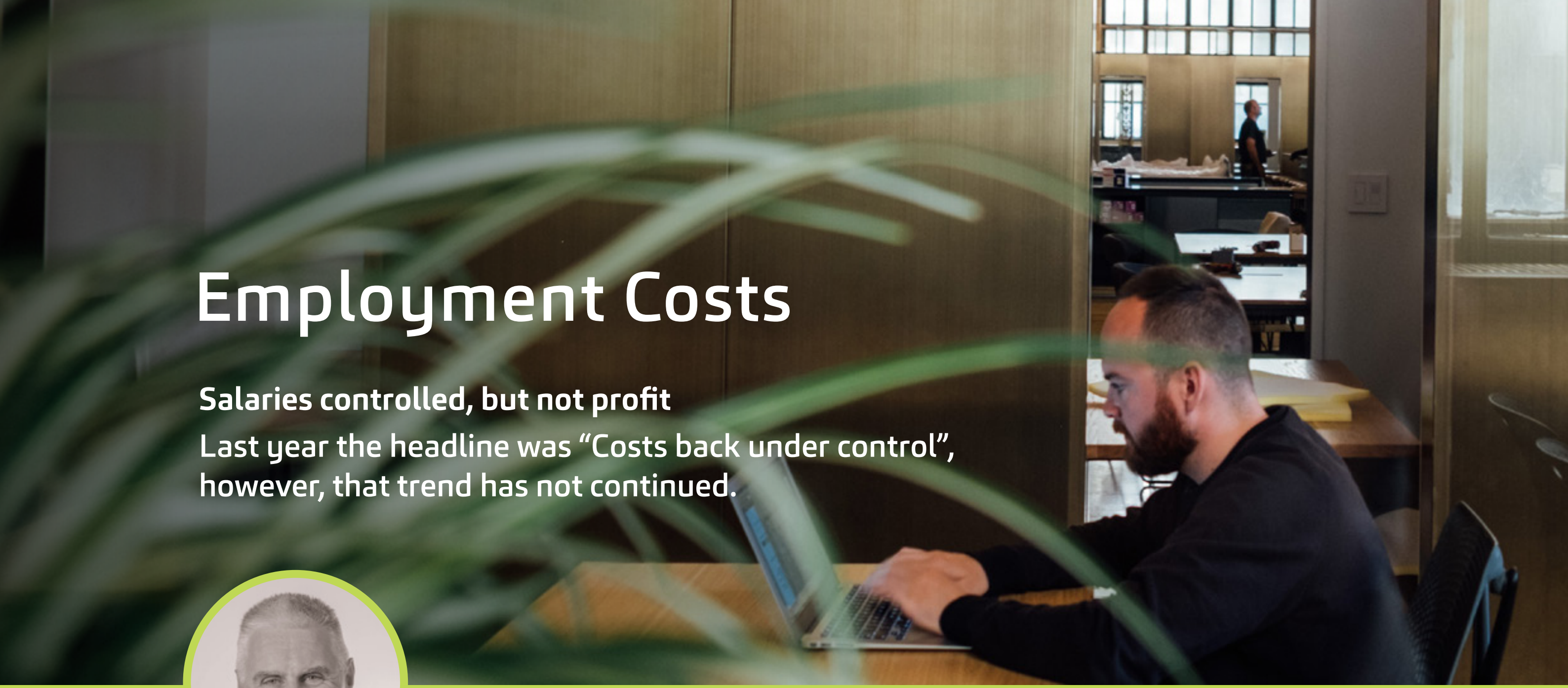
Call to action

1. Review bill recovery rates to see which matter types are earning profits.
2. Consider how this profit review impacts on marketing plans.
3. Check billing procedures to ensure there is a prompt to prepare the bill on completion of the matter.
4. Consider if consolidating into a larger firm to share overheads would grow profits at a faster rate?

Net Profit

%





Employment Costs

Salaries controlled, but not profit

Last year the headline was "Costs back under control", however, that trend has not continued.

Jon Woolston
MHA Larking Gowen

Profit is sanity

Increases in wage costs, particularly for fee earners may not be a bad thing if the cost is matched by an equivalent increase in charging rate, which is recovered from the client through better billing. Every £1 charged should have an element of profit, so increasing salaries of fee earners should lead to an increase in profits!

However, the converse applies. Wage costs with no increase in revenue equals lower profit. Even worse, wage costs stay static, but fees reduce. That is why we assess salary as a proportion of income. A 72% proportion of salaries to fees (as seen in 1 partner firms), leaves only 28% available for all other overheads and proprietor profit. For most firms, that is an unsustainable level.

11-25 partner firms are not far behind, with a trendline that is even more significantly upward, Those firms need to look to reverse this trend. Our report suggests that this worsening is due to the fall in revenue per fee earner (which is covered in the section on income) but with a general national increase in wages, in 2020 it is likely to become more than just a revenue issue.

Firms with 2-4 partners seem to have had their rise last year and have brought things under more control, but there is still a way to go. Whilst it has levelled off for 5-10 partner firms, the mid-tier firms have had this under control for some time and, at 56%, they are much healthier.

Fee earner salaries controlled

The table of average fee earner spend is very noteworthy.

This table shows two things. Firstly, there is no obvious loss of control of fee earner salaries, and secondly, there is a tightening of the spread of salaries over the sizes of firms. To only have a £5,000 spread over the whole average in 2019 is quite remarkable.

Ratio of fee earners to the whole firm

The other area worth considering is how the proportion of fee earners to the rest of the firm is moving.

As ever, the larger firms score well in this category, but every single size of firm shows an improvement. For years, support teams have become increasingly chargeable, but is this now enhanced by using better and/or more intelligent computer systems. Given the movement in other factors, it is key that this trend continues.

Total Salary Cost Per Fee Earner (£'000)

	2016	2017	2018	2019
1	76	87	93	87
2-4	87	86	85	87
5-10	100	88	94	83
11-25	102	89	83	83
>25	91	95	89	82

% of Fee Earning Staff

	2016	2017	2018	2019
1	34%	37%	36%	50%
2-4	43%	39%	45%	46%
5-10	41%	41%	42%	52%
11-25	57%	53%	55%	56%
>25	61%	58%	54%	63%

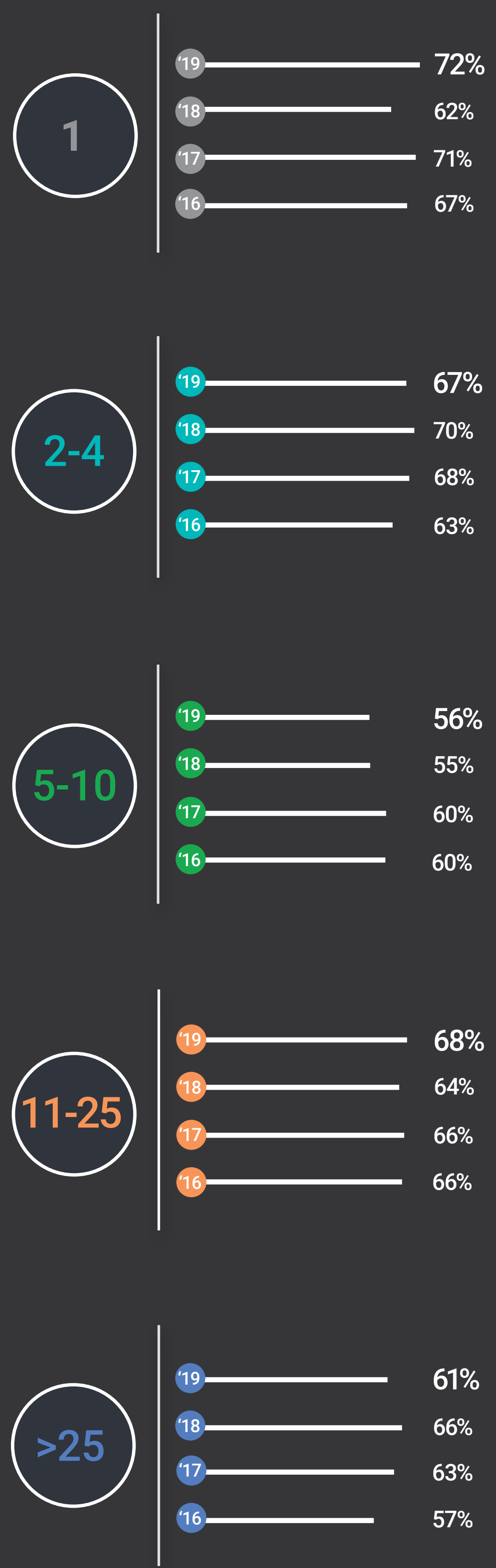
A 72% proportion of salaries to fees, leaves only 28% available for all other overheads and proprietor profit.

> 2020 is going to be an important year for most law firms as they balance salary cost against revenue. No law firm will want to lose quality people, and a good area to start making improvements is to implement flexible working which can produce positive results for the firm, not just the employees.

Call to action

1. Review overall employment cost reduction through payroll management such as salary sacrifice.
2. Consider flexible working and employee wellbeing schemes which may offer a solution to the law firm as well as its people.
3. Consider the improving trend of reducing the number of non-chargeable staff.
4. Make sure that your costing systems to generate fees fully include the complete costs of employing your staff.

Total Salary Costs
% of fee income



Practice Expenses

Mark Brunton
MHA Tait Walker

Throughout 2019, most practices, on average, were able to reduce their overhead spend as a percentage of fee income. Only sole practitioners have seen a significant increase in expenditure compared to income.

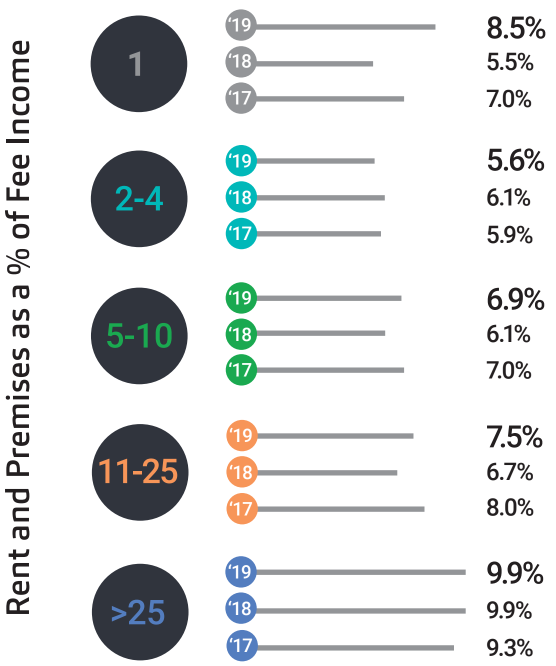
Premises

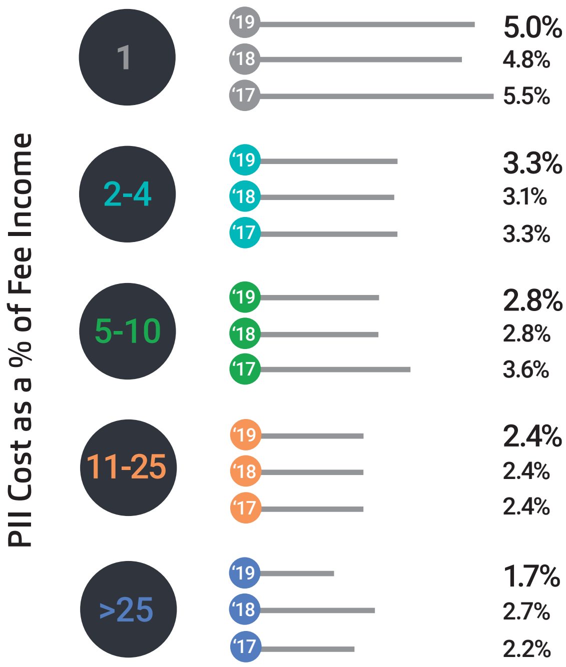
The cost of premises as a percentage of fee income was broadly consistent with 2018. It ranged from 5.6%-9.9% in 2019, compared to 5.5%-9.9% in 2018. The rental element of this cost ranged from 2.9%-7.3% in 2019 compared to 3.2%-6.3% in 2018. Sole practitioners demonstrated the largest increase in premises costs, increasing to 8.5% from 5.5% in 2018.

Annual rent reviews are more difficult to cover with smaller levels of fee income. The largest percentage costs remain for practices with more than 25 partners, generally preferring city centre offices with higher rent and service charges.

IT

The range of spend on IT costs as a percentage of income narrowed slightly in 2019 to 1%-2.7% compared to 1%-3.3% in 2018. Firms of all sizes remain under pressure to keep up with the latest IT solutions to ensure they maintain secure and robust systems and also to enable staff to work more flexibly. The lack of significant increase in % spend on IT may be masking an overall reticence in investing for the future with changing working practices.





Marketing

The range of marketing costs as a percentage of income between different practice sizes widened from 1.2%-2.5% in 2018 to 1.3%-3.2% in 2019. The largest increase in marketing spend as a percentage of fee income was seen in sole partner practices, where there has been an emphasis on growing fee income.

Professional Indemnity Insurance (PII)

The reduction in spend on PII has continued in 2019 for the largest, over 25 partner practices. In 2019, the range as a percentage of fee income was 1.7%-5% compared to 2.4%-4.8% in 2018. Only the smallest, one partner practices and the 2-4 partner practices found PII increased as a percentage of fee income from 4.8% to 5% and 3.1% to 3.3% respectively. The higher risk is still perceived to be sole partner and 2-4 partner practices, which pay proportionately higher premiums than all other sizes of practice. The largest practices saw a proportionate reduction from 2.7% in 2018 to 1.7% in 2019.

Bad debts

In 2019, practices of all sizes saw a reduction in bad debts as a percentage of fee income. This year it has been the 5-10 partner firms which have been affected the most by bad debts, with 1.2% of fee income going bad. This equates to an average cost of nearly £50,000 or between £5,000 to £10,000 per equity partner. Debtor days also increased in this firm size indicating that there is a slow down in billing collection, possibly increasing the risk of a bad debt.

Non salary overheads

The general trend of expenses as a percentage of fee income was a reduction in 2019 across all practice sizes, except sole practitioners. As a percentage of fee income, non salary overheads range from 20.8%-29.3% in 2019, compared to 23.5%-34.8% in 2018. Sole practitioners saw their non salary overheads increase to 28.6% in 2019 compared to 23.5% in 2018.

Call to action

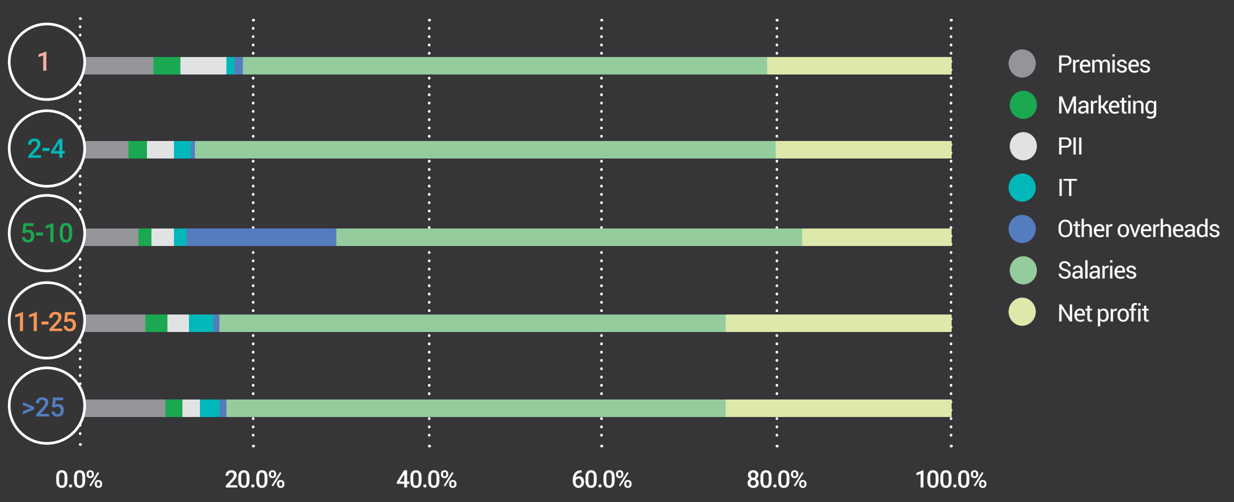
1. Consider allowing employees to make use of modern IT solutions to work remotely, freeing up the need for larger office spaces and potentially reducing high rental and service charge costs.

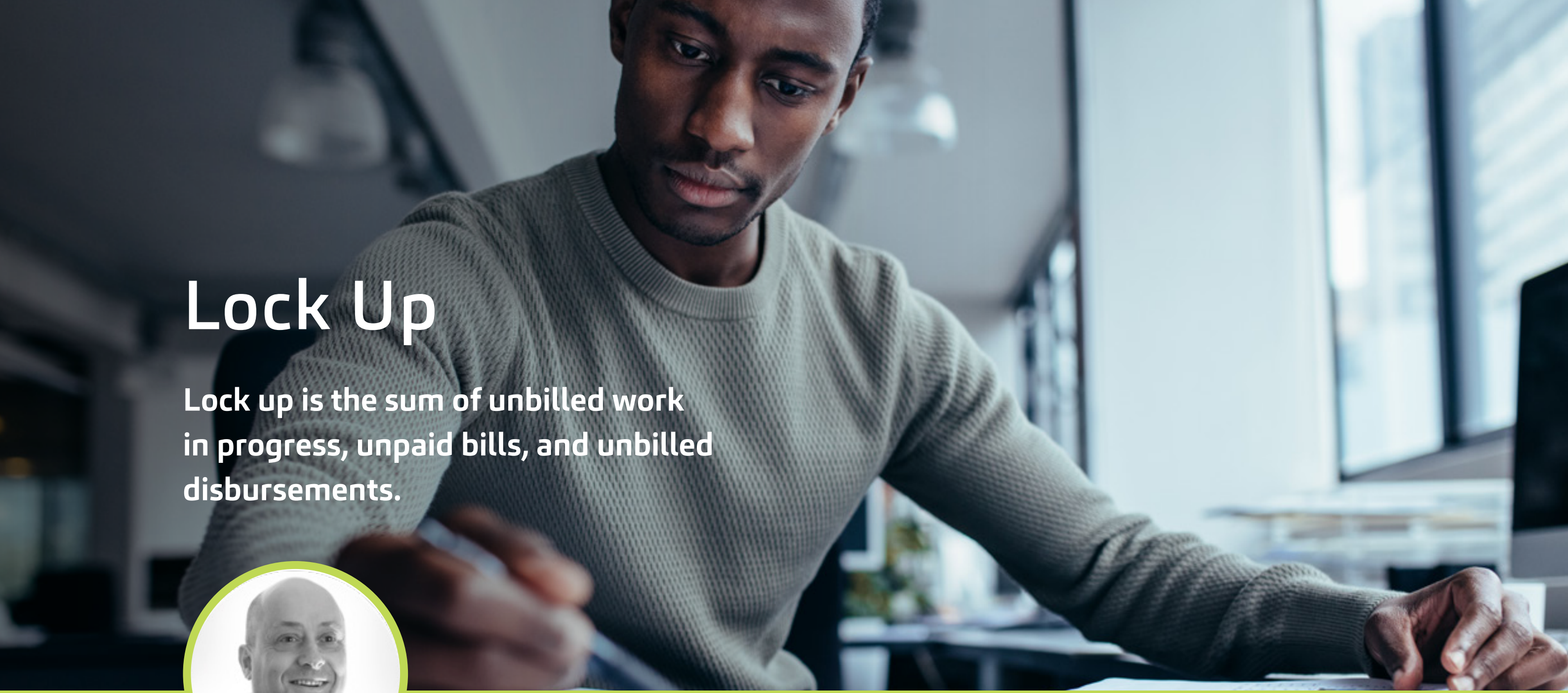
2. Review marketing costs against new wins and ensure that the marketing plan is focussed in the right areas.

3. Review the risk register and ensure that all risks are identified and properly mitigated in order to keep PII costs down.

4. Continue to evolve online libraries to keep costs down and also to ensure all solicitors are using the same, up to date legislation.

2019 Expenditure and Profit





Lock Up

Lock up is the sum of unbilled work in progress, unpaid bills, and unbilled disbursements.

Simon Tombs
MHA Monahans

Cash will always be king in business and therefore the amount locked up in debtors and work in progress will always be of concern to partners. It is all about cashflow management.

Why is it important?

At the risk of stating the obvious, you can't turn the work you have done into "cash" unless you bill it and receive the monies. The higher your lock up levels, by definition, the less efficient your process is and the more likely you are to require external funding or have cashflow problems. Poor cashflow is a major factor in the failure of firms.

There is a direct correlation between improvements in lock up and the required working capital committed by partners reducing.

If a firm can generate cash via lock up then it has more choice over investment strategies, than if it has to then consider financing options.

The results

Our review shows that 2-4 partner firms, after 4 years of rising levels, have tightened control of lock up and decreased the level to 110 days, back to 2016 levels. This is mainly due to debt collection being brought under control to around a 6 week level.

Lock Up Days

	'19	'18	'17
1	63	65	76
2-4	110	130	123
5-10	142	132	136
11-25	129	128	133
>25	136	146	146

The worst performers in the review are the 5-10 partner firms that have seen a 10 day increase to 142 days, which implies some lack of control in the process overall. Those firms with 25 partners or more have seen a reduction by 10 days to 136 days but this still equates to a massive £363,000 per Equity Partner.

Sole practitioner firms still remain by far at the lowest level (63 days), largely as the majority of billing and debt collection is undertaken by the fee earners and they have closer relationships with their clients.

With the exception of 2-4 partner practices, firms have seen a small decrease, or a relatively static level of lock up, which is encouraging as there are still vast improvements to be made, while relatively small change in the economic environment or taking your eye off your procedures could see lock up increasing again.

Many firms target 100 days lock up, which if achieved would release cash of:

£483,000
in 5-10 partner firms

£618,000
in 11-25 partner firms

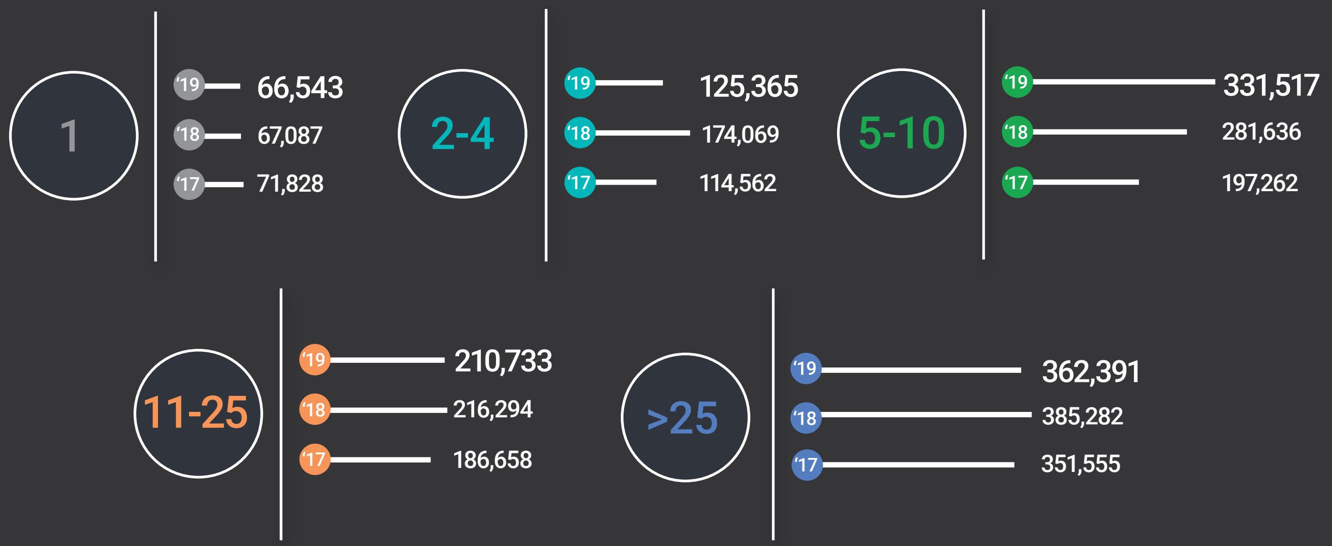
£2,056,000
in more than 25 partner firms

Not insubstantial amounts!

Call to action

1. Ensure all staff understand the commercial reality, that they need to invoice and collect monies promptly.
2. Agree the billing protocol, payment terms and preferably the amount, with the client at the outset as the easiest narrative to write on a bill is "Fee as agreed."
3. Make invoices payable on presentation. By giving 30 days credit you are immediately increasing your lock up by that amount.
4. Make it easy for clients to pay and consider implementing a Direct Debit system. Ensure you can take credit cards and other forms of electronic payment.
5. Make your client relationship manager the person responsible for debt collection, as they are closest to the client.

Lock Up per Equity Partner
(£)



Finance and Funding

Total Funding per Equity Partner

£31k in 2-4 partner firms

£77k in 5-10 partner firms

Equity Partner Funding as a % of Fee Income

2019	2018	2017
10%	18%	27%

Kate Arnott
MHA MacIntyre Hudson

Achieving the optimum level of funding in a law firm should enable that firm to mitigate risk, effectively manage cash flow and flourish and grow to achieve its long term goals.

Overall funding

Our review saw total funding per equity partner remain static or decrease in the majority of firms, continuing the overall trend from last year. Only the smallest firms saw an increase in total funding with a significant increase from £25,000 to £48,000.

The most dramatic reduction was seen in the firms with over 25 partners, decreasing from £139,000 in 2018 to only £70,000 in 2019.

In or out?

Funding from external sources continued to reduce in the largest firms, following the pattern set over recent years, with a reduction from 32% to 18% in 2019, the lowest level in four years.

All other firms saw increases in bank borrowings and in the percentage of total funding from external sources. Many firms are using the current economic climate to renegotiate, and frequently increase facilities with their existing providers on favourable terms with interest rates and fees remaining static at worse.

All sizes of firm in our review showed a decrease in the actual capital invested in the year, likely to be a reflection of both the continued reticence of senior fee earners to make the jump up to partner and also having more junior partners in place with lower levels of required capital.

Equity Partner Capital Invested (£)

Partners	'19	'18	'17
1	13,504	21,254	16,624
2-4	14,800	17,849	11,789
5-10	39,022	77,547	96,298
11-25	72,450	89,142	84,072
>25	115,625	170,018	247,821

> Financing is no longer required simply to pay distributions to partners, firms need to have agile funding solutions in place to ensure they are well placed to take advantage of any market opportunities and to be able to adapt to the ever changing economic conditions.

What does the future hold?

Law firms are seeing ever increasing demands on their finances, such as investment in IT and technology, the need to retain and motivate key staff and investing in work places of the future, whilst still maintaining the expected return to partners.

Call to action

1. Consider reviewing your existing facilities to ensure you have the most favourable terms available.
2. Investigate the possibility of using alternative sources for funding as there are increasing numbers of specialised law firm financiers now competing.
3. Review your current cash flow forecasts – are they adequate and accurate?
4. Do the forecasts include all possible projected costs, outgoing partner payouts, early retirements, investment in infrastructure?
5. Consider the future objectives of your firm, and the related funding required to achieve those goals; are you looking to acquire fees, expand into new markets?

Total Funding per Equity Partner

(£)

	'19	'18	'17
1	47,922	25,911	41,590
2-4	30,945	36,217	45,856
5-10	76,771	84,230	74,820
11-25	48,316	47,369	91,036
>25	69,555	139,183	227,766

IT and Infrastructure

Compared to the legal and accountancy professions, Information Technology (IT) is the new kid on the block, yet most practices would now struggle to function without it.

Gavin Davis
MHA MacIntyre Hudson

There will always be examples of senior partners insisting on working with mountains of case files on their desks, but as younger tech-savvy professionals advance through the ranks, this is, fortunately, becoming less common.

Like the accountancy and medical professions, Robotic Process Automation (RPA) and Artificial Intelligence (AI) are predicted to have a major impact on the legal profession and could eliminate most paralegal and legal research positions within the next decade. There is even some discussion that in the future, it could do much of the work of judges and lawyers!

But within your organisation, who decides what technology you need, what will work and fit the culture?

It is not uncommon for a partner to be responsible for IT. We call them "The Quasi IT Director." If they have a technical background, then this works well, although frequently it is just another responsibility that must be allocated to someone who may only fulfil half of the requirement of the role. Although they will understand what the firm wants, they may not know what it needs or how it can be delivered and will turn to their IT team for advice.

For many practices, IT is just one consolidated team of technical geeks who have long hair and eat pizza. "The IT Crowd" did us no favours, but it was considered accurate at the time, and for some smaller businesses and professional practices, this is still the case. Often, they are the go-to people for a problem with anything with a plug on, and although they can keep everything running, they generally do not have the necessary experience to advise on strategic matters.

Support vs development

Fortunately, IT is also maturing fast and is more structured and commoditised. Forward thinking practices that have recognised this will have divided IT into the two principal domains often called support and development. There is still a grey area between the two, but as explained later, it is crucial to keep them divided.

The IT support team look after the day-to-day IT systems, ensuring that they are functioning correctly and that everyone can work as expected. Typically, first-line support will help with password resets and routine issues and escalate to the more experienced second line team as required. Second-line support also conducts proactive maintenance and ensure that the back-office systems are secure and running correctly. Third-line support usually consists of highly experienced engineers that get involved in high priority issues, but also assist with the design and the delivery of projects, as explained below.

The development team work closely with the organisation to investigate and deliver new technology projects, although they are very rarely the stakeholders. A team would usually consist of business analysts, project managers and technology architects; although some roles are interchangeable, and some may wear two hats. The third line engineer would also be part of the team and would be consulted as well as being involved in the delivery of the projects.

> Having key-person dependencies puts the organisation at risk since the knowledge is rarely documented or shared.

You are probably thinking, that sounds like a lot of staff to manage my IT, and you would be right. That is why so many organisations consolidate roles to perhaps one or two staff. But this often leads to problems and can give IT a bad name. When support staff are involved in the delivery of projects, it is not uncommon for projects to run late or become rushed, causing problems later. Support staff priority is “support”, so any issues that come along will cause project delivery delays.

Key person dependency

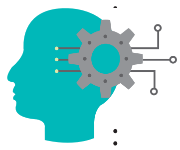
Technology is vast and growing exponentially. You cannot expect one or two people to understand everything about all your systems, keep them secure, running efficiently, and at the same time, monitor emerging trends and deliver new projects. There will of course be some that say we have someone who does all of that and more; and that itself is a problem. Having key-person dependencies puts the organisation at risk since the knowledge is rarely documented or shared.

How should you manage IT?

So how should a legal practice manage its IT? Most importantly, it would help if you had somebody that understands the practice, the IT, and how they work together. For many organisations, this is the role of an IT Director, but for the smaller legal practice, this is an overhead that they can ill afford. A mistake often made is that the practice will seek advice from a local IT company. Although their advice is usually sound, it is frequently found to be limited to a small range of technologies of which they have knowledge and often, a commercial agenda. The preferred approach is to engage an independent consultant who works with you to understand the business and produce a coherent IT strategy and delivery roadmap. This can sometimes be a one-off project, but regular engagement will ensure delivery, a much greater understanding of the business and the ability to respond quickly to market changes or technology trends.

What next?

Professional service organisations are becoming more dependant on IT and to remain competitive, they need professional technology advice. This will ensure that they have the right systems and IT staff to support the practice, but also understand the technological trends in the sector and how to adopt them.



Buying or merging with another law firm?

Professional Indemnity Insurance considerations……Proceed with care.

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Consolidation continues at pace across the legal services market. Some firms are looking at merger opportunities to grow their practice, others are looking to be acquired as a way to exit the profession.

A further group want to rid themselves of management responsibility, join another firm, and get back to fee earning and "the law". For those firms that are looking to buy, merge or otherwise acquire a firm it is important to proceed with care. The potential impact on your Professional Indemnity Insurance (PII) should be a major consideration.

Successor practice or run-off cover?

The rules regarding succession for law firms are complex and we would always recommend you seek guidance from a broker specialising in solicitors' PII.

Some of the more important issues to keep in mind are as follows:

1 If you do not want to become a successor practice, then a fail-safe solution is for the firm you are acquiring to purchase run-off cover – even if you assist them to fund this. It is critical to ensure that the premium for the run-off is paid before the merger for this arrangement to be effective.

2 **If no run-off cover is arranged, your firm will become successor practice if:**

a) you acquire the practice of a sole practitioner and the sole practitioner joins your firm;

b) a partnership ceases and the majority of the partners join your firm as principals;

c) you acquire an incorporated firm and either the LLP or the limited company becomes a principal;

d) you acquire the majority of partners from a partnership in the expectation that their old firm will continue, but the remaining partner(s) shut the door on the day that the other partners join you.

3 If you are acquiring principals or files from an LLP or incorporated practice that is ceasing and you want to avoid becoming a successor, then it is critical that you do not do anything that could be considered "holding out" unless run-off has been purchased prior to the cessation. "Holding out" occurs where there is some reference to "having taken a firm over". This is another complex area that firms need to consider carefully and everyone in the firm needs to be fully briefed on the issue.

4 You can have more than one successor to a firm, for example where a two partner firm splits and the partners move to two different firms. In that case there will be two successors to the whole of the firm – they will each be 50% liable for all claims.

5 Once a successor practice, always a successor practice. If the merger does not work out and you agree to go your separate ways, you cannot rewrite history.

Due diligence

Before you make a decision on whether to proceed with the purchase or acquisition of another practice, due diligence is critical.

The following list suggests some of the more important areas to investigate:

a) Previously completed PII proposal forms
Providing these have been completed accurately in the past, these forms will help you understand how the firm has represented their business to insurers. Your insurer will also want to see them.

b) Claims history
This is absolutely critical. Remember, the claims record of a prior practice will become part of your claims record upon succession. If there are any sizeable payments or reserves, then get chapter and verse on the background to the claim. Talk to your broker about the potential impact the merger of the claims history could have on your premium.

c) Complaints history
This will inform you regarding the culture that exists in the firm. In addition to the nature of the complaints, consider how the firm responds in each situation. Is their approach to clients compatible with yours?

d) SRA/Disciplinary issues
A firm's most recent insurance proposal form will generally provide you with a good overview of any SRA or other disciplinary related matters.

e) SRA Accounts Rules compliance
As well as the disciplinary aspects of accounts compliance, it is important to note that in some circumstances the SRA may assert that an acquiring firm is responsible for shortages on the prior firm's client account.

f) Risk management
Undertake a comprehensive review of risk management within the firm, including related systems and processes. Is the firm's risk management culture compatible with your own?

g) Areas of practice
Make sure you understand the areas of practice that the firm undertakes and the percentage split by gross fees. If they undertake work you do not engage in, then you need to consider whether the knowledge and experience exists within your firm to supervise this work.

h) Finances
A poor financial position will often be a catalyst for a firm looking for opportunities to merge or be acquired. Ask for the accounts and understand what the pressures are.

i) Partners/Associates/Staff
Are you going to inherit any HR issues? Are there potential redundancies? It is important to identify this and take appropriate advice as early as possible in the process. Decisions here need to be based on sound business sense and not sentiment.

j) Details of prior practices
Take care to identify whether the firm you are acquiring is itself a successor to any other practice. If it is, then you should make enquiries regarding the due diligence that was undertaken prior to the succession and obtain the claims history for that practice prior to merger if it falls within the last 10 years.

k) IT systems
It is important to understand the compatibility, or otherwise, of IT systems. What will be the challenges and cost of integration and how quickly can this realistically be achieved?

l) Impact on your PII
If you are going to be the successor practice or assume additional contractual liabilities, ensure that you have communicated with your broker at a very early stage to ascertain the view of your current insurer. You certainly need to know if an acquisition is going to be a "show stopper" from their perspective.

Integration

Never under-estimate the time, cost and energy that will be expended integrating with another firm. In terms of best practice we suggest the following:

1. Ensure that there is a clear vision for the new firm and that this is communicated to all staff in advance of the merger.
2. Identify what you need to do pre and post-merger including combining or transferring systems, training and social integration. Make sure you have a clear plan that you share with others in the firm as appropriate.
3. An increased focus on risk awareness and supervision during the integration phase will pay dividends and identify areas where extra work is required.
4. Leadership is important at all levels, but especially from those at the top. Be cautious and always take advice from your insurance broker.

2020 Legal benchmarking conclusion and thank you

Karen Hain
MHA Moore & Smalley

Head of the Professional Practices Group at MHA

I would like to thank my MHA colleagues from each region for their support to collate, analyse and interpret the data that is generated from our review of law firm financial results and activity in 2019.

Two of the standing issues over the last few years has been the need to invest in IT and the expectation that consolidations in the sector will continue. We have therefore included two new sections this year looking at IT and infrastructure and law firm mergers. Gavin Davis leads the MHA technology advisory services and I am grateful that he has shared his thoughts. Many thanks to Jenny Screech at Howden UK Group Limited for writing the article on law firm mergers and acquisitions from the professional indemnity angle, which I am sure you will find of interest.

> We have once again included a set of actions that you may wish to consider alongside your current business planning.

Income can be improved further with a real attempt to sell the value of the service that you provide for your clients.

Continue with your training programmes to retain valuable staff and allow them to grow in experience and billing capability. Staff are critical to your success so you will need to keep up to date with trends, both in terms of payscales, but possibly almost as important now are the additional benefits, flexibility, wellbeing and agile working that younger staff demand.

Flexible and agile working may be part of the plan to recruit and retain staff, and to reduce spend on premises costs, but it will come with an additional IT cost. It is difficult to generate a medium term plan for IT, as it simply changes so fast. But most investment in IT processes, before too long, see a positive impact on billing. Firms refusing to invest in IT will simply be left by the wayside.

PII premiums are also expected to increase in 2020. With the cost base rising, it is more important than ever to understand which types of work that you undertake generate the best profits for you.

As ever, you will then need to understand how you will manage lock up in the coming years and where you need to make procedural changes to reduce the period of time that you have cash tied up in unbilled work in progress or clients unpaid fees. If you are planning to invest, then how will you fund that?

My MHA colleagues are available to share advice and experience across a wide range of issues impacting on legal practices. Please contact your local team for specialist support.

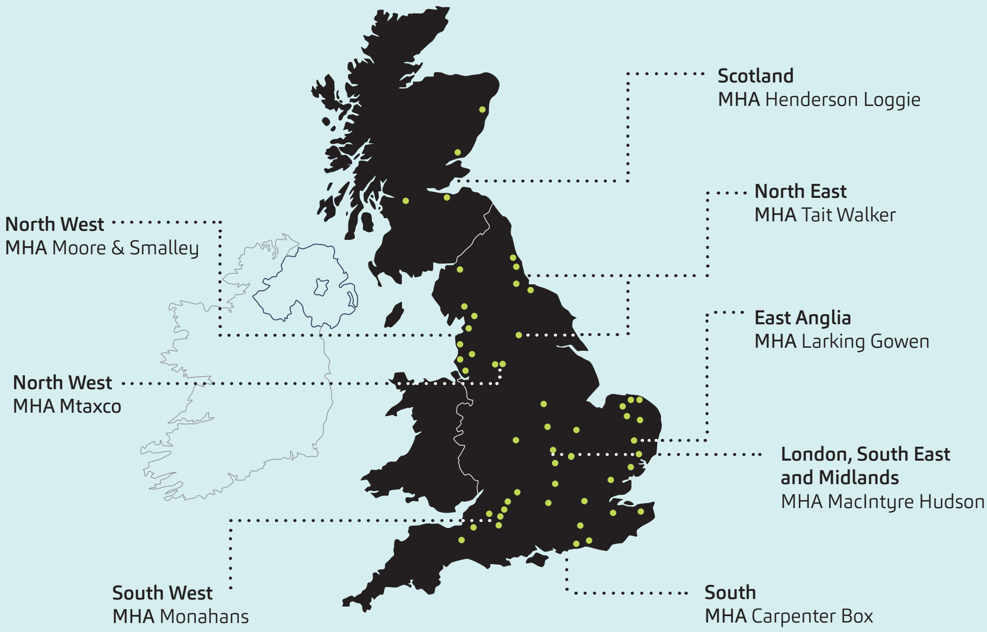
About MHA

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 146 territories worldwide.

Our Sector Approach:

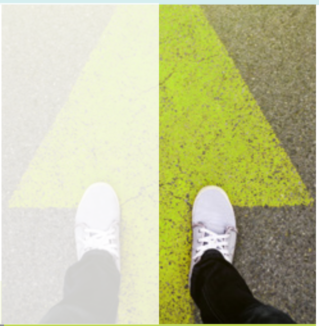
MHA allows clients to benefit from our in depth sector knowledge, which adds value to the specialist services that we can provide in accountancy, audit, tax, regulatory and expert business advice. Professional Practices is a key sector for MHA.

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

742
Offices in 146 territories

8
Independent accountancy firms

Combined turnover of
£143m

10th
Largest network in the world by combined revenue

US$3.9bn
Combined member firm revenues

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

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