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Legal Sector Breakfast Briefing

Wednesday 15 January 2014

Financial Stability

This briefing qualifies for 1 hour CPD – Authorisation Ref: EKQ/ARWA





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Legal Sector Breakfast Briefing

Welcome

David Hannon

Managing Partner, iFS, Clydesdale Bank



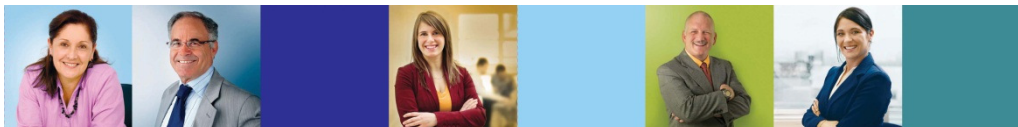


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Legal Sector Breakfast Briefing

Wednesday 15 January 2014

| | |
|---------|----------------------------------|
| | |
| 8.00am | - Arrival and breakfast |
| 8.30am | - Welcome |
| 8.35am | - Briefing – Financial Stability |
| 9.30am | - Q & A |
| 10.00am | - Close |



Legal sector update

Financial stability

Andy Poole

Legal Sector Director

Armstrong Watson



Benchmarks

| | 2010 | 2011 | 2012 |
|---------------------------------|------|------|------|
| Fee income per fee earner | | | |
| Profit per equity partner | | | |
| Break even point per fee earner | | | |
| WIP days | | | |
| Debtor days | | | |
| Borrowings per equity partner | | | |

Source: LMS Financial Benchmarking Surveys



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Driving cash flow and profitability to ensure financial stability

Agenda

- SRA risk indicators
- Key performance indicators
- Benchmarks
- Financial analysis, reporting and forecasting
- Key points to improve cash flow and profitability



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SRA Risk Indicators

Samantha Barrass, SRA Executive Director:

“Unlike the banks, failing law firms won’t be bailed out by the tax payer. Instead, any costly interventions necessary to safeguard clients will be met by all of you here today; firms run responsibly, diligently and effectively picking up the tab for those that aren’t”



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SRA Indicators of financial instability

Key Indicators

- Drawings exceeding profits
- Borrowing exceeding net assets
- Borrowing over a certain level

Impact Assessment

- RAG rating
 - Red - Two or more indicators
 - Amber – One indicator
 - Green – No indicators
- Impact score



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SRA Risk Indicators

Samantha Barrass, SRA Executive Director:

“What we are seeing is how well the firm is run, their ability to spot and manage early warning signs, their financial management, their approach to risk taking and their willingness to engage and co-operate with us having a major bearing on whether they succeed or fail”



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SRA Indicators of financial instability

“Bad behaviours”

- Payments made to partners irrespective of cash in the bank
- All net profits drawn with no reserve pot retained
- Short term borrowings to fund partners' tax
- VAT received used as cash received, resulting in borrowings to fund VAT due to HMRC
- Heavy dependence on high overdraft borrowings
- Partners capital injection is 100% borrowed
- Partners out of touch with office account bank balances
- “Problem, what problem?”



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SRA Indicators of financial instability

“Good behaviours”

- Drawings are linked to cash collection targets and do not exceed net profits
- Provision is made to fund partners' tax from income received
- A capital element is retained from profit, and a capital reserve account built up
- Premises costs are contained
- All partners regularly receive full financial information including office account bank balances
- Profitability levels are tested and unprofitable work is dropped



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SRA Risk Indicators

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Spot and manage early warning signs

| "Bad behaviours" | Result | Cause | Driver |
|---|--------|-------|--------|
| Payments made to partners irrespective of cash in the bank | | | |
| All net profits drawn with no reserve pot retained | | | |
| Short term borrowings to fund partners' tax | | | |
| VAT received used as cash received, resulting in borrowings to fund VAT due to HMRC | | | |
| Heavy dependence on high overdraft borrowings | | | |
| Partners capital injection is 100% borrowed | | | |
| Partners out of touch with office account bank balances | | | |
| "Problem, what problem?" | | | |



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Spot and manage early warning signs

Key performance indicators

- Average fee income per fee earner by department
- Gross profit percentage by department
- Utilisation percentage by fee earner
- Recovery rates by fee earner
- Debtor days by department
- WIP days by department
- Lock up days by department



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Benchmarks

Fee income

Chargeable hours per fee earner per annum

| | Hours |
|----------------|-------|
| All firm sizes | 1,068 |
| Small | 1,115 |
| Large | 958 |

Source: Armstrong Watson benchmarking database



Benchmarks

Profitability

Recovered rate per hour

£/Hour

All firm sizes

136

Small

119

Large

151

Source: Armstrong Watson benchmarking database



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Benchmarks

Profitability

Net profit percentage

%

All firm sizes

30

Small

29

Large

36

Source: Armstrong Watson benchmarking database



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Benchmarks

Profitability

Profit per equity partner

€

All firm sizes

91,000

Small

78,000

Large

139,000

Source: Armstrong Watson benchmarking database



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Impact

How to increase profitability

| | |
|---------------------------|-------|
| Gearing | 2.5 |
| Hours | 1,068 |
| Recovered rate/hour | 136 |
| Profit margin | 30% |
| Profit per equity partner | |



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Impact

How to increase profitability

What would the profit per equity partners be if the recovery rate increases by 10%?

| | |
|---------------------------|-------|
| Gearing | 2.5 |
| Hours | 1,068 |
| Recovered rate/hour | 150 |
| Profit margin | 30% |
| Profit per equity partner | |



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Impact

How to increase profitability

What would the profit per equity partner be if the hours and recovery rate both increase by 10%?

| | |
|---------------------------|-------|
| Gearing | 2.5 |
| Hours | 1,175 |
| Recovered rate/hour | 150 |
| Profit margin | 30% |
| Profit per equity partner | |



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Impact

Case study: summary

- Increase any of the factors by 10% and the profit per equity partner will increase by 10%
- Increase all by 10% and profit per equity partner increases by over 40%
- Key = utilisation and recovery



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Benchmarks

Cash flow

WIP days

Days

All firm sizes

99

Small

85

Large

124

Source: Armstrong Watson benchmarking database



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Benchmarks

Cash flow

Debtor days

Days

All firm sizes

68

Small

58

Large

99

Source: Armstrong Watson benchmarking database



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Impact

Case study: how to increase your bank balances

| | Target | AW |
|-------------|------------|------------|
| Fee income | £1,000,000 | £1,000,000 |
| Overdraft | £(200,000) | £(200,000) |
| WIP days | 54 | 99 |
| Debtor days | 50 | 68 |



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Impact

Case study: how to increase your bank balances

- What would bank balance be if the WIP days and debtor days reduced to target?

| | | | |
|-------------|---------|---|---------------------|
| WIP days | 99 – 54 | = | 45 days improvement |
| Debtor days | 68 – 50 | = | 18 days improvement |
| | | | 63 |



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Impact

Case study: summary

- Billing one day earlier reduces your overdraft by $1/365 \times \text{fee income}$
- Collecting debts one day earlier reduces your overdraft by $1/365 \times \text{fee income}$
- Key = WIP days and debtor days



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Financial analysis, reporting and forecasting

Reporting

- Base on KPIs
- Easy to understand
- Relevant to the firm and decisions to be made by the firm
- Relevant to the individuals
 - what they can control
- Assess and reward people based on
 - what they can control
 - what they can measure
 - what is important to the firm



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Financial analysis, reporting and forecasting

Forecasting

- Base on KPIs
- By department
- Three year forecast updated annually
 - Integrated profit and loss, balance sheet and cash flow
 - Cash flow is the result of the interaction between the profit and loss account and the balance sheet
- Three month rolling cash flow



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Key points to improve cash flow and profitability

- Base on KPIs

Utilisation

- Time record in all departments – as matters progress
- Time sheets to be submitted by a certain time point
- Set minimum time to be on all timesheets
- Person responsible for checking timesheets have been submitted
- Heads of department to monitor utilisation rates for their department and justify to the partners or make appropriate decisions
- Monitor fee earner fee income multiples of salary



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Key points to improve cash flow and profitability

- Base on KPIs

Recovery

- Record all time
- Monthly review by fee earner of recoverable WIP
- Write off irrecoverable WIP monthly
- Bill promptly on completion
- Monitor recoveries on each bill or on a monthly basis by fee earner
- Partner approval for all under-recoveries of more than 10%
- Partner approval for any direct WIP write-offs
- Stop acting in unprofitable work types
- Stop acting for unprofitable clients
- Use of cost draftsmen
- Abort fees



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Key points to improve cash flow and profitability

- Base on KPIs

WIP days

- Time record in all departments – as matters progress
- Weekly review by fee earner of recoverable WIP
- Write off irrecoverable WIP monthly
- Bill on account
- Bill promptly on completion
- Ensure all associated WIP is written off when a bill is raised
- Concentrate in two areas
 - Log jam
 - Easy wins
- Accounts department to review aged WIP prints



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Key points to improve cash flow and profitability

- Base on KPIs

Debtor days

- Payments on account
- Bill on account
- Bill promptly on completion
- Automatic transfers from the client account?
- Daily reviews for amounts to transfer from the client account
- Transfers for disbursements
- Unpaid professional disbursements
- Don't wait for client approval!
- Empowered credit control
- Credit control to review aged debtors
- Stop work!



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Questions

- What questions do you have?



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Summary

Key points

- Small changes can have a big difference
- Four factors to concentrate on:
 - Utilisation
 - Recovery
 - WIP days
 - Debtor days
- Use KPIs to drive the firm in the right direction



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Conclusion

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