The Armstrong Watson Legal Sector Benchmark

Annual Report for 2013

February 2014

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ArmstrongWatson®
Accountants & Financial Advisers
A track record of providing solutions to the legal profession

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Commentary

We have prepared this report using information from the law firms we advise. We supply a bespoke individual report to all of our legal sector clients as part of our normal accounts service when discussing their annual accounts. Those individual discussions allow us to take more of a strategic stance with our legal clients.

We currently act for approximately 50 law firms. This document is the annual report summarising the results of all of those individual practices. The results cover firms of all sizes up to 30 partners, mostly located in the North of England. Where possible the results have been analysed by practice size.

The highlights from this report are as follows:-

- The average fee income per equity partner was £286,000 which is 33% higher than in 2012.
- The average fee income per fee earner was £112,000 which is 15% higher than in 2012.
- The average net profit per equity partner was £75,000 which represents 26% of fee income. Law firms with 11+ partners performed above this benchmark with average net profit per partner of £131,000.
- Overheads have remained at a similar level to the previous year with the exception of PI insurance. Surprisingly, PI insurance as a percentage of fee income has reduced by 2%. This is a result of increases in fee income than decreases in insurance premiums.
- On average there are 2 fee earners for every equity partner. Firms with 11+ partners show a higher ratio nearer to 3 fee earners for every equity partner.
- Staff costs have reduced by between 1% and 3% as a proportion of fee income.
- The number of staff per equity partner has increased from 4 people to 5 people.
- The number of support staff has remained broadly the same as the previous year at 1.2 per fee earner.
- Equity partner charge out rates have increased by a couple of percentage points for law firms with 1-10 partners. Law firms with 11+ partners show an uplift to equity partner charge out rates of 5%.
- Salaried partner charge out rates have also increased by 9%. Associate, assistant and trainee charge out rates have remained broadly the same as the previous year.
- The average time taken to bill work in progress has reduced from 99 days to 92 days. The average time taken to collect debts has increased from 69 days to 72 days.
- The average partner's capital account has increased by 19% from £91,000 to £108,000.

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In general, 2013 showed growth in fee income and profits are showing signs of improvement. However, that is not necessarily being reflected in cash. Working capital continues to be a significant concern for many firms, especially those that are highly geared. Firms need to continue to monitor their work in progress days and debtor days and take proactive steps to reduce these where possible.

We are in the process of extending our benchmarking database to include the law firm clients of a select number of other accountancy firms with a specialism in acting for lawyers. That will be on a completely anonymous basis and should increase the number of firms in next year's database to approximately 150.

If you are interested in seeing how your firm compares with the benchmarks in this report or want to investigate variances with your own firm's performance then please contact me.

Andy Poole

Andy Poole

Legal Sector Director

Armstrong Watson are a top 30 UK accountancy firm with 15 offices throughout Northern England and Southern Scotland.

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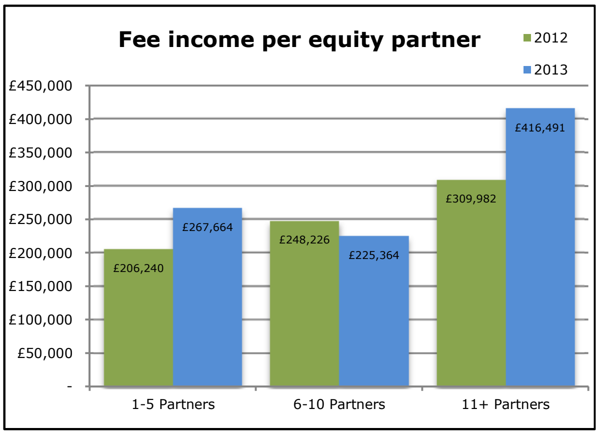
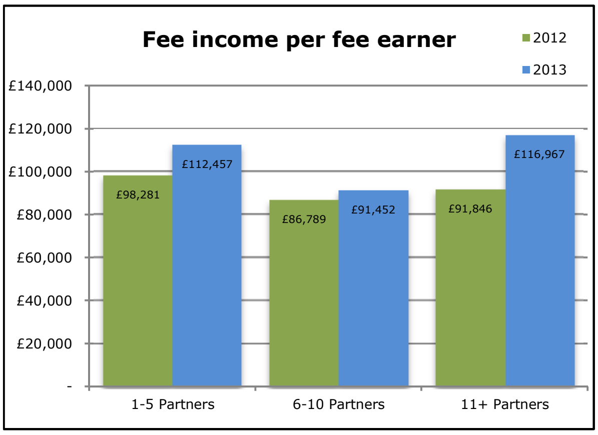
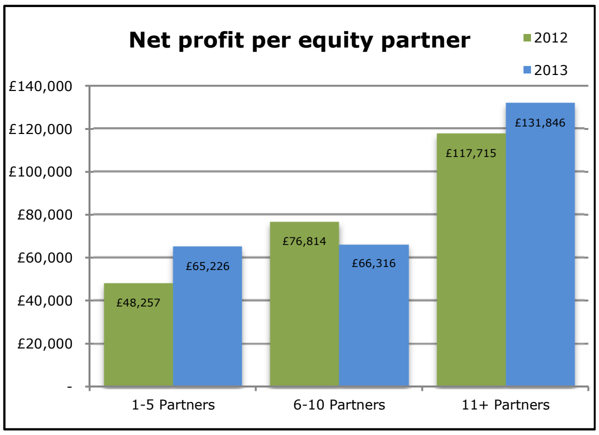
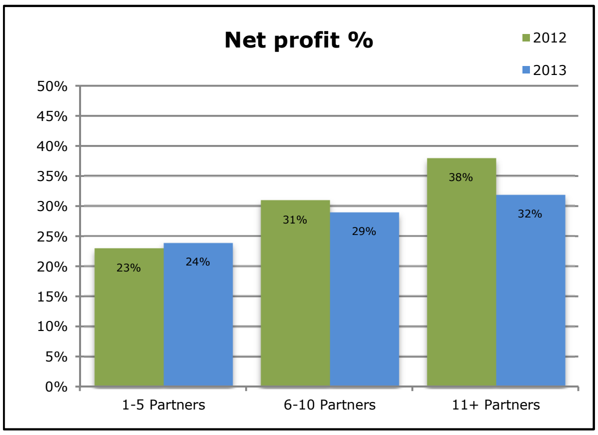
1. Fee income and profits







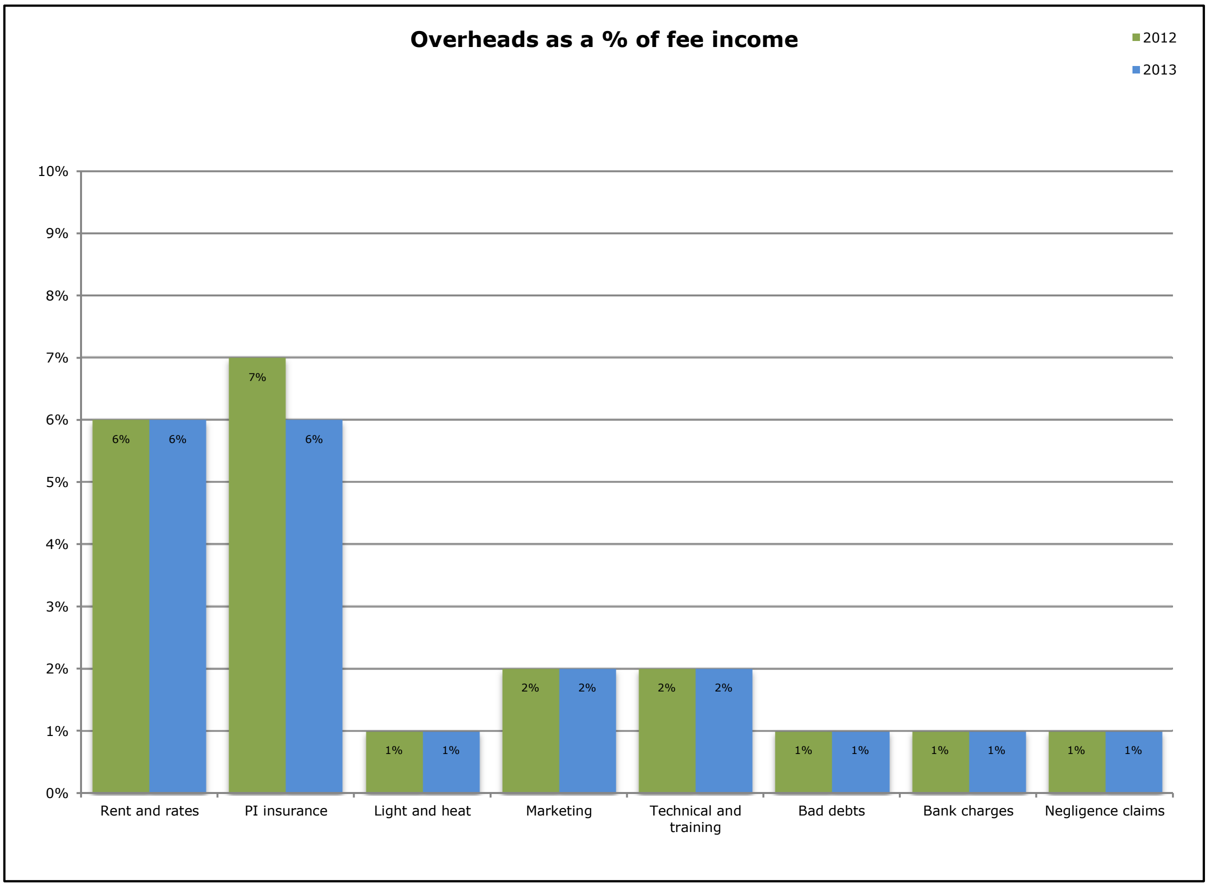


Fee income per equity partner has increased from 2012 to 2013 for law firms with 1-5 partners and law firms with 11+ partners. However, firms with 6-10 partners show a decline in fee income per equity partner. This may be due to the number of restructures occurring in this size of law firm with exiting partners and new partners distorting the proportion of profits available per equity partner. Despite this, the average fee income per equity partner for all firm sizes has increased in total by 33% from 2012 to 2013.

The level of fee income per fee earner shows an increase for all firm sizes with the average being an increase of 15% from 2012 to 2013. This shows how firms have focussed on increasing productivity and efficiency; use of technology; and particularly the property market picking up.

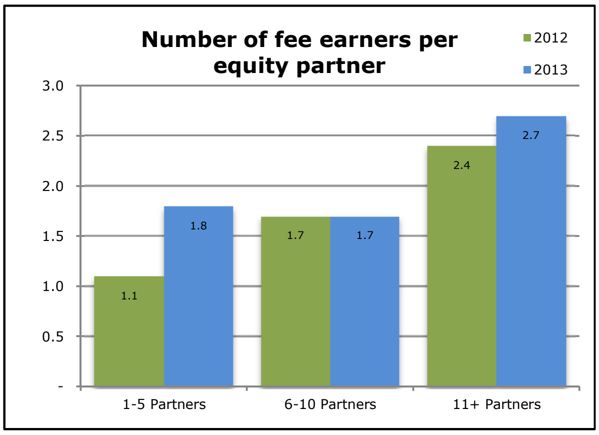
The average net profit per equity partner has increased significantly from 2012 to 2013. However, this is largely due to profits being suppressed during 2012 and the level of profits per partner for firms with 1-10 partners are still at an historic low. Law firms with 11+ partners show strong profits with a net profit percentage of 32%. This is particularly pleasing given the number of changes in the legal sector and the difficult economic climate.

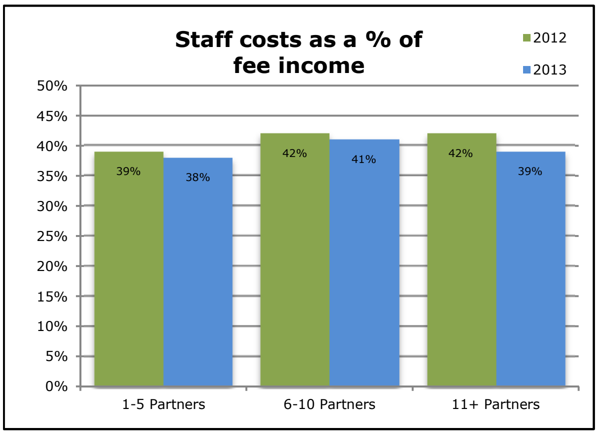
2. Overheads as a % of fee income

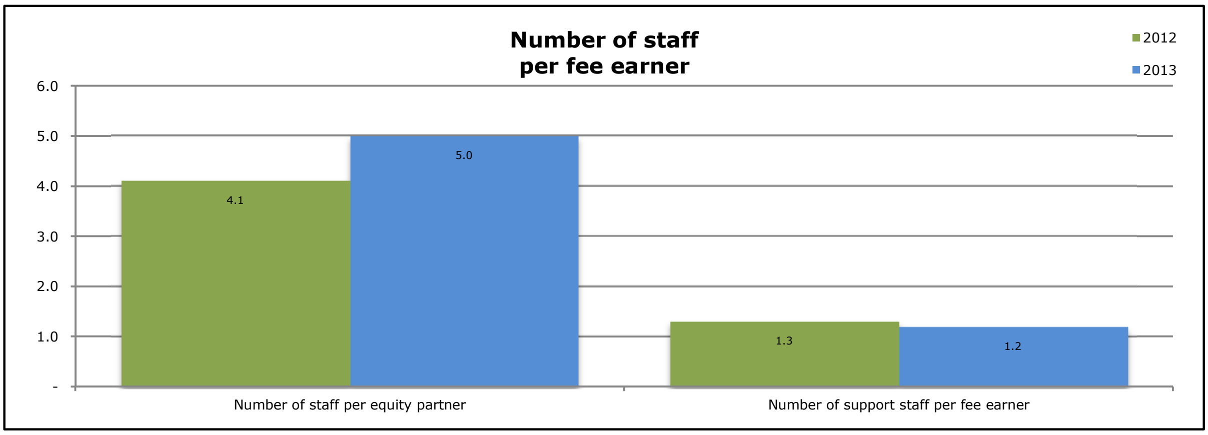


Overheads as a percentage of fee income have been rounded to the nearest percentage point. People costs are covered separately in the next section. Controlling overheads is particularly important when there is pressure on the levels of fees due to new entrants in the legal sector. The consistency from 2012 to 2013 shows how overheads are being closely monitored and controlled by law firms. PI insurance reduced from 2012 to 2013, however, we would expect this overhead to increase during 2014 due to the difficulties firms have experienced when obtaining cover in the last renewal period.

3. People





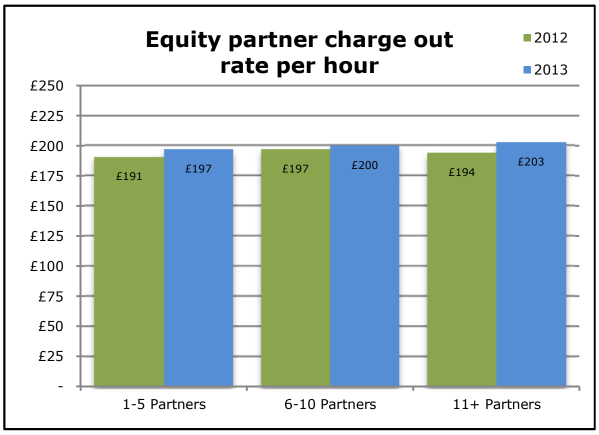


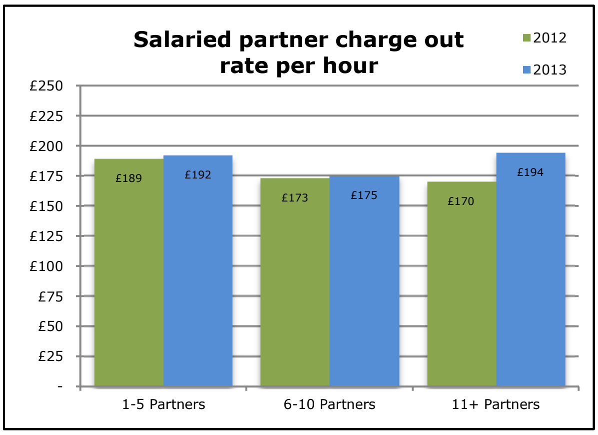
On average there are 2 fee earners for every equity partner across all firm sizes. Firms with 11+ partners show a higher ratio nearer to 3 fee earners for every equity partner. For law firms with 1-5 partners, this ratio has increased from 1 person to nearly 2 people when comparing 2013 with the previous year. The number of changes in the legal sector market and partners exiting practices has increased the rate of change in this ratio for firms of this size.

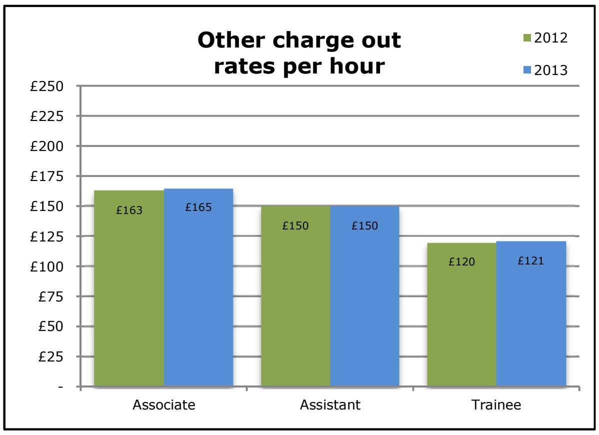
Staff costs as a percentage of fee income has reduced by between 1% and 3% across all firm sizes. For some firms this will reflect redundancies, for others this reflects an increase in fee income without a proportionate increase in staff costs due to spare capacity that was being carried for the previous few years.

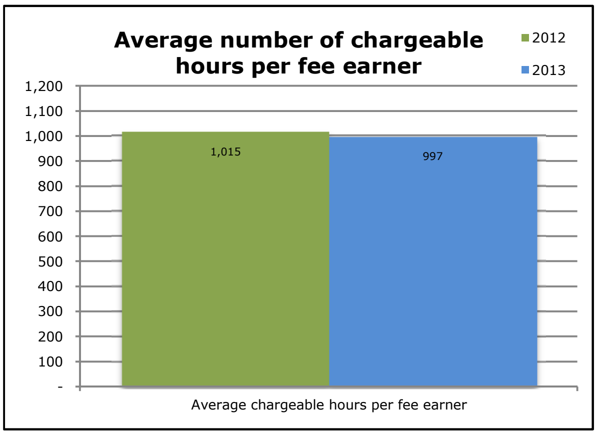
The number of staff per equity partner has increased on average from 4 people to 5 people. Where the number of partners has reduced and staffing levels have remained the same this leads to an increase in this ratio. In addition, many firms are employing paralegals to improve efficiency and allow fee earners to focus on achieving higher levels of fees. The number of support staff per fee earner has remained broadly the same over the past two years.

4. Charge out rates









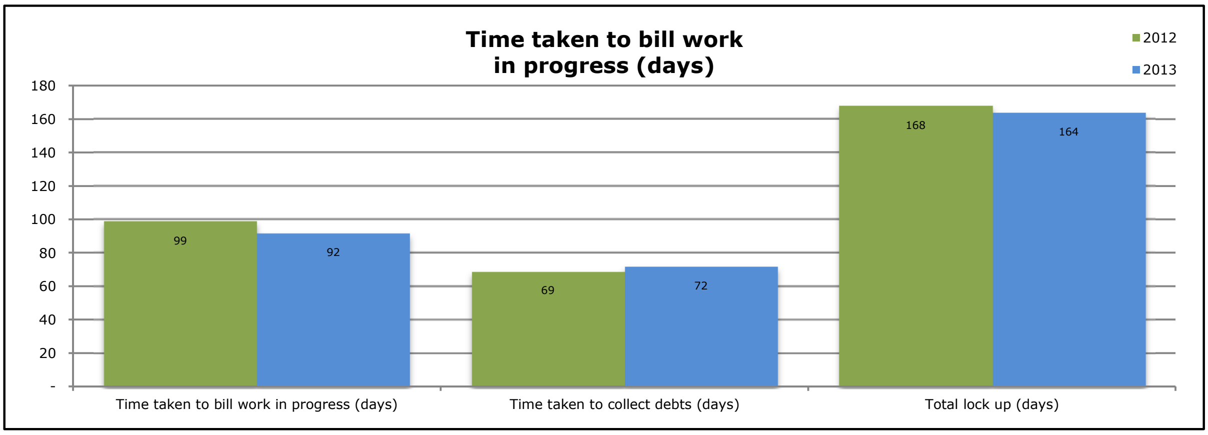
The equity partner charge out rates have increased across all firm sizes from 2012 to 2013. This increase is in line with inflation for firms with 1 -10 partners. Law firms with 11+ partners have shown the greatest increase with an overall uplift in equity partner charge out rates of 5%.

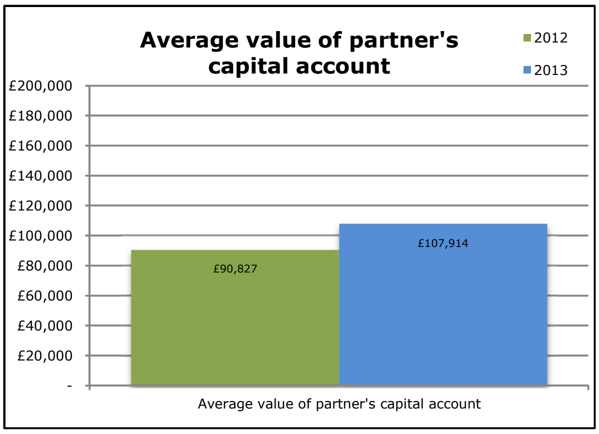
Salaried partner charge out rates show a significant increase for firms with 1-5 partners and 11+ partners. For firms with 6-10 partners, these rates have remained broadly static.

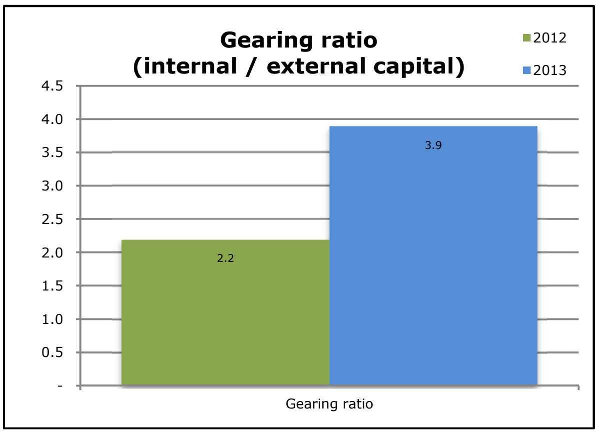
Associate, Assistant and Trainee charge out rates show very little movement across all firm sizes.

The average number of chargeable hours per fee earner has reduced by 2%. At an average charge out rate of £167 per hour, this represents a potential reduction in fee income of £3,000 per fee earner. However, given that the average level of fee income per fee earner has increased across all firm sizes, it would appear that this reduction in chargeable time reflects time spent developing new business and working more efficiently with the available chargeable hours. It also suggests that as fee earners become busier, they act more efficiently, recovery rates increase and write offs decrease. That is unless there is an element of under-recording of time.

5. Working capital







The average time taken to bill work in progress has reduced from 99 days to 92 days when compared with the previous year. This shows that law firms are endeavouring to raise fees more promptly to reduce their working capital requirements. It also reflects a change in the mix of work types as residential conveyancing has picked up as a percentage of most firm's fee income.

Unsurprisingly, the number of days taken to collect debts has increased from 69 days to 72 days when compared with previous years. Collecting debts from clients continues to cause difficulties as individuals and businesses look to stretch credit terms wherever possible.

The lock up days, which is the total of the time taken to bill and the time taken to collect debts, has reduced by 4 days to 164 days when compared with the previous year. Based on an average fee income of £250,000 per equity partner, this represents a working capital commitment of £112,000 per equity partner. This is significant, especially for firms that are aiming to grow. Proactive steps need to be taken to implement controls and new systems to reduce this requirement.

The average value of an equity partner’s capital account has increased by 19% from the previous year. This may be due to a number of factors; changes in the partnership structure with new and exiting partners, a reduction in drawings levels, retention of reserves needed for working capital or refinancing of the practice. The gearing ratio of law firms has increased from 2.2 to 3.9 when compared with the previous year. This is a result of a lack of cash preventing partners from drawing as much as they would like, thus increasing capital accounts. The banks have not been as keen to lend and so the ratio of the amount the partners invest compared to the amount they borrow has increased. It should be noted that this ratio doesn’t reflect “off balance sheet” finance, where partners have taken on personal debt to inject into the practice or as a part of a refinancing package.