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MANAGING FINANCIAL PERFORMANCE

"HOW TO GET A LONG TERM RETURN FROM A SALE OF YOUR LAW FIRM"?

UNDERTAKING BUSINESS VALUATIONS

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AN INTERVIEW WITH... BILL GUTHRIE OF GLENESK

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WELCOME

Welcome to the Spring 2023 edition of The LAW, the specialist publication for the legal profession from the legal sector team at Armstrong Watson.

As last quarter, concerns remain around the wider economy and the potential impact on law firms. Although most firms are still operating profitably and cash generatively (due in some cases to the increased interest rates), concerns still remain as to the future impact on law firms, particularly from transaction volumes.

We have written an article for the Law Society, in the January 2023 edition of their Managing for Success publication, containing top tips for managing law firms through potentially troubled times. That article is reproduced here with their kind permission.

This edition also includes:

- The current difficulties in obtaining partnership capital loans
- How to make a return after selling your law firm
- How to value a business, particularly with reference to dispute resolution and matrimonial matters
- An overview of the potential future accounting changes that may impact law firms

Specialists are available from all of our 18 offices, to provide pro-active support and advice to lawyers in compliance and business improvement matters. This publication is designed to allow us to share our collective experience in acting for lawyers throughout the UK.

To find out more on any of the above, including how we can work with you to help you and your clients, please do get in touch with me.

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MANAGING FINANCIAL PERFORMANCE

This is the first part of our published article in Practical Law, the full article can be found at www.practicallaw.com

Scope of this note

Managing a business and driving its finance performance is important in any sector. However, particularly for law firms and solicitors authorised by the *Solicitors Regulation Authority* (SRA) there are two further complications that make it even more important:

- Paragraph 2 of the *SRA Code of Conduct for Firms* is clear: you should seek to run the finances of your firm correctly and if you are at risk of insolvency, you should manage the downturn appropriately.
- Solicitors by their nature are not always naturally "numbers people" and many are self-taught in the world of finance. Accordingly, it can be harder to find the time to dedicate to it.

This note will help busy practitioners focus on what they can and should be doing to manage a firm's financial performance in an efficient manner.

The three building blocks

Assets: why a "healthy balance sheet" is important

Any conversation about financial performance starts with financial stability and therefore the balance sheet. This document shows all of the assets of the firm less its liabilities to give the "shareholders' funds". (A note on terminology: some firms may be limited liability partnerships, some limited companies and some traditional partnerships or sole practitioners. All the concepts in this note are identical regardless of entity. For ease therefore this note uses the limited company terminology throughout.) Accordingly, those with more assets than liabilities result in a positive figure and may be considered to be "healthy". Those with more liabilities than assets have a technically insolvent balance sheet. However, it does not necessarily follow that those entities with more liabilities than assets (and therefore negative shareholders' funds) are at risk of actual insolvency. It is possible that they are in a growth phase and if the liabilities in question are repayable over a very long time (for example, a long-term bank loan) then there could be no issue.

Having a healthy level of assets is important for several reasons. Many outside agencies (notably credit reference agencies and by extension any finance providers) consider this a key test similar to an individual applying for a mortgage, that is, is the ratio of loan to assets reasonable. Moreover, having positive net assets implies that you have spare cash (or cash-like items) which in turn means you have options on how to spend those items; whether in investment or in returning cash to the owners.

The key element of the balance sheet for law firms is the work in progress figure. This represents all the time spent on files that is yet to be billed, but that also meets the criteria for revenue recognition. These criteria can be complex (see section 23 of *Financial Reporting Standard 102*) but is often colloquially paraphrased as "am I virtually certain of this revenue?". Crucially this does not have to be 100% certain, but firms must have a reasonable expectation. Therefore, firms must make a judgement about which work is genuinely going to be billed versus that which might be written off, subject to a provision or subject to future challenge (for example, assessed for costs, or contingent on winning the case). However, cash is preferrable to WIP, so the best answer is to get the item billed (and therefore paid) quickly.

Law firm owners (unlike owners of other businesses) have more flexibility in adjusting their asset position as they can be more or less lenient in any provisions they place against work in progress. Care must be taken to still follow the above accounting standard but also to not get too carried away and over provide. Law firm owners should think carefully about taking on new liabilities and the extent to which it would have an adverse impact on total net assets.

Profits: why a good margin is important

In relation to profit, two metrics are important: gross and net margin. Gross margin is the % ratio of turnover to directly attributable costs whereas net margin is the % ratio of turnover to all costs (other than taxation). So, if we have sold a £100 item but it cost us £50 to make it then our gross margin is 50%, if there was a further £25 of other overheads then our net margin becomes 25%. Our ultimate profit in this example is now £25 and (still ignoring taxation) that is the amount that would be available for distribution to the owners of the business.

Looking at the profit and loss (P&L) through the prism of ratios help us look for "like for like" movements. For example, if we open a new office our revenues and profits will probably both go up in absolute terms, but if the margins do not go up then that implies the new office is not as profitable as the old ones.

The obvious flaw, from a law firm's perspective, in the above example is that it may not cost anything to make the sale (which is quite different from a manufacturer or retailer). Accordingly, many law firms might report their gross margin as 100%. However, this is a misnomer: wages of fee earners, their directly attributable costs (practising certificates, licence for software and so on) can all be thought of as cost of sale to create a gross margin. This leads to a different mindset: every sale has a cost attached to it. For law firms, every time you open a file there is a notional cost of professional indemnity insurance (PII), or wages to service that file and of software licences to provide templates and precedents. With this mindset we can step away from the concept of billing being in hourly rates, but being in value added and costs incurred, which might still ultimately be expressed in hourly rates, but is not simple a function of the time and wages of the fee earner involved.

Traditionally, firm owners would talk of the rule of thirds: 33% for the staff, 33% for overheads and 33% for the owners. Although this logic is a little old fashioned (current benchmarks differ but tend towards showing staff as closer to 40% and so gross and net margins in practice are now lower than the "third rule"), it is a starting point. If your gross margin is lower than 67% and your net margin lower than 33% then can you work out why: what is it that you are spending more than most on? Or is your revenue not keeping pace with other costs, in which case it may be time to increase your standard fees or look at where time is being written off without being billed.

Cash: why it is the most important of the three building blocks

Cash can be something quite distinct from the assets and the profits. For example, if a firm buys a new laptop, its fixed assets go up (it has a new asset) and it profits barely move (as the P&L is only charged for the depreciation on the asset) but they have paid for a new asset and so their cash will go down (and so overall net assets will be unaffected). This explains one of many reasons why profits can be much higher than cash and so the amount theoretically available for distribution to the owners of the firm is, in practice, curtailed by how much cash is available to distribute to them.

A lack of cash will make a firm go bankrupt. Of all the items to monitor, this is the key one. Most businesses will use a 13-week rolling cashflow forecast. This time period is popular as it is considered to be:

- Far enough forward that if you are projecting any cashflow issues you still have time to fix them.
- Conversely, not so far in the future that any prediction is so highly caveated as to be useless.

Many firms struggle to accurately predict cash inflows due to the variability in timing of matters finalising. While acknowledging the difficulty, that should not necessarily prevent giving the firm's "best guess".

The other foible related to cashflow and law firms is the client account. Clearly there are obligations in respect to client money, but noting those, if the matter is properly billable and an appropriate notification of costs has been delivered to the client then this is actually an advantage for law firms. There should be minimal (if any) bad debts compared to other sectors as most (if not all) money should be on account in the client account and (subject to the caveats of the *SRA Accounts Rules*) available for immediate payment to the firm.

Monitor this regularly and with honest appraisals of when cash inflows and outflows will occur. If the firm foresees a problem, then it needs to take steps to close the gap; either by advancing cash flow (that is, completing matters quicker), reducing upcoming expenditure or, in more extreme examples, applying for working capital loans

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"HOW TO GET A LONG TERM RETURN FROM A SALE OF YOUR LAW FIRM"?

Selling your Law Firm will be one of the biggest decisions you ever make. Once you have reached that point you are moving into a new phase where the asset that produced your income may now be providing you with a lump sum of capital (or a series of lump sums).

Having focussed so much of your time and energy on your firm, and then the sale of your firm, you now need to ensure that you are able to make that capital work for you. There is an important step between agreeing and completing the sale, and being able to pursue the next phase of your life.

For those wanting invest or for those where it is suitable to invest, that step is having a comprehensive investment strategy to enable you to fund your next life phase, and that can be a daunting prospect, especially if you have been used to controlling your assets yourself.

Big decisions should be made over a period of time and accompanied with expert advice. In the meantime, you need to find a safe place for your money until you are ready to invest it. The good news is that interest rates have rapidly increased since the start of the 2022, with the most notable indicator being the base rate which has increased from 0.10% to 3.5% since December 2021. (www.bankofengland.co.uk/monetary-policy/the-interest-rate-bank-rate)

With so many different banks and building societies offering products – each with its own unique terms and conditions - it can be quite challenging to know the best home for your hard-earned cash.

There are 321 banks authorised to accept deposits in the UK and 43 building societies, however these won't all appear on a comparison website. These numbers continue to grow, as new specialist lenders enter the market. The most recent entrant being Middlesbrough-based GB Bank, which is focussed on property development finance. Such banks may be unknown names to you, but typically they can offer higher rates than the better-known banks in the market. It's also worth noting the benefits of the Financial Services Compensation Scheme, which protects eligible deposits up to £85,000 per person or entity per banking licence. This can help you to manage your risk by keeping within the protection limits but earning much higher returns too.

The rates are starting to settle at a new norm. For individuals, rates are around 3% on Instant Access, 4.36% on 1-year fixed terms and are just shy of 5% on 5-year fixed terms. Businesses and charities can earn up to 2.36% on Instant Access, 4.31% on a 1-year fixed term and 4.9% on a 5-year fixed term. The returns from shopping around have never been greater.

At Armstrong Watson we work in close partnership with the UK's leading cash management provider and in doing so, we can provide access to the widest range of savings products on offer from Instant Access accounts through to 5 year deposit account, providing solutions for all types of savers including individuals, directors, trustees and pension holders too. This means we can help generate the highest returns possible, as well as the greatest level of diversification for peace of mind.

Our Financial Planning Consultants will work closely with you to identify your cash needs and we'll assist in opening your new savings accounts. This will involve us submitting applications to your chosen providers and providing you with the instructions you need to transfer your money into your new accounts. Your money will remain under your sole instruction at all times, and you'll have direct legal relationships with each provider, meaning there are no hidden charges or middle-men involved.

At Armstrong Watson our objective is to be with you throughout the whole financial journey, a cash management service fits in between the expert corporate finance and tax advice available when structing your firm's sale to and our expert financial planning and wealth management service that will support your long term financial needs.

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UNDERTAKING BUSINESS VALUATIONS

Anyone involved in business valuations will likely know the often cited definition of value as 'the present value of future cashflows'. While the concept of a discounted cashflow valuation is great in theory, it's just too complex for most SMEs and so, as with many things in life, we look for a simplified approach or rule of thumb that is broadly right (rather than precisely wrong).

If one were to look at a sample of SME valuation reports, it would be easy to come away with the impression that, in many cases, one such rule is 3 to 5 times earnings. Too simple? Possibly.

Taking that notion further, it is possible to identify the post-transaction multiples achieved on previous real-world business deals. It is even possible to do this for businesses of different sizes, industries, locations, or even a combination of these, to come up with a valuation which fits the bill.

It is important, however, to remember several key points when preparing any valuation:

- **one size doesn't necessarily fit all;**
- **value is a concept that changes from one moment to the next based on circumstances; and**
- **the results of any valuation will often be the basis for life-changing outcomes for the parties involved.**

As a result, it is important not to over-simplify or to rely on rules of thumb which, while convenient, and perhaps safe, do not explain to the parties involved why their expectations are different from the valuation undertaken.

Let us consider a couple of examples of why earnings or multiples for a particular valuation might not conform to a simple rule.

Timing

During an economic crisis, such as the recent pandemic, reduced activity levels have a dramatic effect on earnings and may leave some businesses running on reserves, surviving only by drawing down on profits retained in previous years.

Prior to the crisis, they were profitable, healthy businesses. In all probability, assuming they can survive the crisis, they will return to being their previous selves.

The question for someone valuing a business during such a time is whether the company will have sufficient reserves to survive until normal activity is restored. In this case, it will be necessary to consider the rate of cash-burn as well as the depth and likely duration of any depressed activity.

The valuation then becomes a binary choice between either business failure (and a potential break-up valuation) or the restoration of business as usual but with lower reserves going forward; not easy to express as 3, 4 or 5 times earnings, whatever they might be.

The timing of the valuation might give rise to diametrically opposed valuations depending on the valuer's views of the most appropriate basis for their calculations.

What is known at the date of the valuation?

Take our current low growth, high inflation, high-interest rate environment, coming as it does on the back of a decade which was very different. For many, the current economic conditions have not been experienced during their working life time.

Nowadays, businesses are having to replace expiring funding lines with higher cost debt. Supply chain issues and cost inflation are changing expectations of future gross margins and the ability for companies to pass on higher costs without sacrificing bottom line could be in question. These are some of the factors which make estimates of future earnings, based on historical accounting information more difficult.

One way for a putative buyer to take account of these uncertainties is to reflect the uncertainty over future earnings by reducing the multiple, which, of course, then deviates from any historical comparisons one might obtain by looking at past real-world transactions.

Without some kind of thought out analysis and consideration, current valuations can easily be significantly different from those based on previous experience.

Summary

As with many things in life, one can implement process to a point, but it was Bob Dylan who wrote The times they are a changin' . And when they do, it is probably good practice to review our 'usual' ways of doing things, to check whether these are still appropriate and, sometimes, we need to modify, update and or change these.

Of course, it has to be said, sometimes the answer is actually 3 to 5 times earnings, but the real question is do we know why?

Matthew Geale heads our Forensic Service Line, regularly undertaking business valuations, working alongside lawyers on a whole range of matters including dispute resolution, matrimonial and court appointed expert witness.

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PARTNERSHIP CAPITAL LOANS

Professional practices looking to bring in new partners to the firm are finding it increasingly difficult to obtain the financial support from mainstream banks to support their succession planning. Previously bank appetite for supporting such transactions was strong, with loans, often interest only over a term of up to 20 years, provided to the individual buying into the firm and an undertaking provided by the firm to the bank. These were often seen as quick and easy opportunities for banks to provide additional lending to their client base and were readily available from all high street banks.

However, more recently, a lot of the banks have moved away from offering this to law firms, particularly at the smaller end of the Business Banking criteria – typically less than £10-£15m turnover, dependent on the bank – meaning that these businesses are often left unable to obtain funds through traditional methods.

There are still some banks providing the traditional offering, which is typically reserved for existing clients and not something that they can offer on a standalone basis for new customers. This means that a firm, and often the individual buying into the firm, are required to move their entire banking arrangements in order to find a suitable lender. This can obviously be timely and disruptive to firms but there are little alternatives if the firm wishes to obtain the funding required under traditional structures.

Alternative providers are available, however over a typically shorter term of a maximum of 7 years, with Capital and Interest payments expected to be made, putting increased cashflow pressures on the individual and firm. These lenders are typically unsecured or require a personal guarantee from the individual as well as an undertaking from the firm.

The advice to firms looking at their succession planning is to approach their existing provider as early as possible in the process to identify if they are able to support the firm with these requirements. Ultimately when starting up, firms may wish to ensure that their bank of choice has the capability to support them with this potential requirement later down the line, rather than have the pain of switching provider after several years, or decades, of trading.

We can help to source funding for partnership capital loans if you would like support in this area.

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MANAGING YOUR BUSINESS THROUGH UNSTABLE ECONOMIC TIMES

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Douglas Russell and Sally Jones, at Law Society partner Armstong Watson LLP, give their advice on how to manage your firm through difficult economic times.

The words of the popular Billy Ocean song seem particularly apt right now: "When the going gets tough, the tough get going".

Just as we all hoped that the worst effects of the coronavirus (COVID-19) pandemic were behind us, a new lengthy set of challenges have presented themselves, like war in Ukraine and a cost of living crisis. What, therefore, are the key areas that managers of legal businesses should be considering to mitigate these risks to the business?

Combating inflation and maintaining profit margins

It may be difficult to maintain planned organic growth trajectories within firms over the next few years, so with higher costs of salaries and other costs, such as energy and professional indemnity insurance (PII), adequate re-pricing of services will be necessary to maintain or grow the bottom line.

These factors may suppress demand for legal services from both businesses and consumers, with economic growth rates unlikely to return to previous levels until after the predicted two-year recession. It might be tempting to maintain, or even reduce, pricing to gain market share, but that could be more problematic in the longer term, and firms should stay robust on pricing and brave enough to increase their fees in line with specific inflationary pressures. Otherwise, the bottom line will suffer, either by standing still or reducing in real terms.

Maintaining recovery rates and seeking out efficiencies in operational processes will also help protect or grow the bottom line. Lean process reviews are something that we have carried out with many firms. There may be some easy wins around the use of existing technology or the introduction of new software that could improve efficiencies as well as produce better management information for business decision-making.

Reviewing travel and marketing spend, to weed out unnecessary or low-return expenditures, will also help to protect the bottom line. Many firms will have made some permanent changes to such areas of spending during the pandemic, including utilising Microsoft Teams and/or Zoom for meetings, where previously the cost of travel, as well as the time incurred in that travel, were lost.

...continued

Potential cost savings

A detailed line-by-line review of the firm's direct costs and overheads may lead to some cost-saving initiatives that could be relatively easy to implement. If there is any "fat" within those costs, then this is the ideal time to start trimming that away without of course cutting into the necessary "muscle" which underpins the effective and efficient running of the firm. This could include:

- Increasing the number of trainees taken on, to re-balance how the work is done and improve the salary cost to fees ratio. Good training and career development of those trainees can also future proof the staff resources in the business through mutually beneficial retention.

- Printing and postage costs should be reviewed as more use of email and electronic document signatures should be preventing the need for the printing and sending of paper documents. Internal policies should be applied around printing needs, encouraging printing on both sides of the paper and specifically limiting colour printing which is substantially more expensive.

- Consider reducing the number of office locations or looking at more cost-effective alternatives

- Centralising as many internal functions as possible to achieve economies of scale

- Consider outsourcing some internal functions to achieve cost savings, as well as taking admin responsibilities away from fee earners.

- Some degree of hybrid working and hot desking may allow the firm to reduce the overall footprint of offices, or if expanding, prevent an immediate need to move to larger premises

- Consider a new range of key performance indicators (KPIs) that may be more geared to cost control and encouraging cost savings

Careful cost control, combined with appropriate pricing for services, will go a long way to protecting the real terms value of the bottom line even if growth proves difficult in the next two years. A good financial and management information system, producing prompt and accurate financial reporting, is vital as a monitoring and early warning system. If this is difficult within the structure of your firm, consider outsourcing that function.

Diversifying income streams

Reliance on just a few key service lines, or a few large clients, could prove problematic over the next two years. Consider whether expanding the range of services you provide and moving closer to a full-service offering that may make you more attractive to a broader range of clients – or even up-selling to existing clients.

It may also be possible to balance income streams by offering a mix of services that are counter-cyclical, leading to more profitable opportunities and smoother cash flow throughout the year.

Profitable top-line growth may prove to be challenging over the next two years, but anything achieved should flow to the bottom line.

Addressing unprofitable income streams

You may have some services that are running at a loss. The obvious answer would be to charge more commercially for that work, but that may not be possible. The departmental profitability may be because the staff engaged in that department are just not busy enough, or simply that historic work methodology is now outdated and the work process could be done differently or by using trained but lower grades of staff, while diverting more experienced or skilled staff to more profitable work. Ask yourself whether that problematic workstream be outsourced or referred to other firms in return for more lucrative return referrals.

Cash is king

It may be a cliché, but in addition to protecting profit margins, including control of key costs, it has become even more important to maintain a higher level of cash resources, so as to have a suitable contingency fund. There will be some bumps in the road for us all over the coming years, and with the rising costs of borrowing, an adequate working capital reserve is essential.

This could be achieved by partners or directors retaining more of the profits in the business for a temporary period to boost cash reserves. There may also be an opportunity to improve the lock up within the firm e.g., by billing more regularly/promptly and by strengthening credit terms and credit control processes. This is critical to monitor, especially if clients seem to be taking longer to pay than previously.

Cash flow forecasting on a rolling 12-week basis will be an essential tool in monitoring the adequacy of cash reserves and measuring against the annual cash flow targets. Some contingency planning based on some adverse sensitivities or "stress testing" is also useful to predict worst case scenarios.

Firms that are planning to expand or are seeing increasing levels of business should be careful about growing too quickly. Often referred to as "over trading," a sudden burst of growth may put significant pressure on existing working capital facilities, as well as putting additional pressure on existing teams if recruitment cannot be achieved quickly enough.

Your culture – staff retention and recruitment

The current trend when it comes to salaries is unsustainable for most firms, however, the positive news is that existing staff, as well as potential candidates, for the most part, are not purely driven by money. Instead, they want to know more about who you are and what you do, so they can make a fair assessment of whether the fit is right. This should put culture as the single most important aspect of any recruitment strategy.

Getting your culture right can also help with retention; high numbers of employees in professional services firms score things like flexibility and progression as more valuable to them than salary. This is not to say that salary is unimportant, as it most certainly is, however getting culture right is proving to be far more impactful with people.

Once you have the right culture in place, think about how you can best demonstrate that culture to people outside the organisation. As an example, when you choose to interview a candidate, we would encourage you to invite that person into the office as opposed to going to Microsoft Teams or Zoom as default. As we all know, candidates and businesses alike have become used to conducting interviews virtually, mainly as it is seen as a more convenient way to meet someone. For a candidate this is almost certainly true, however, it is also far more difficult to get a feel for a firm's culture virtually. Where candidates can't come into the office to interview, invite them in for a tour so they can get a real feel for the place.

Think about the make-up of your interview panels as well. Are the people talking to candidates the best cultural representatives of your firm and are they clear on what the culture of your firm is?

Make sure that you also reference your culture in the conversation with candidates, and that the message is consistent. This above all else will help you differentiate from your competitors, which in turn will help you recruit the right people for your firm.

In summary

The circumstances for every firm will be different in planning for the next few years, and the economic downturn may present opportunities for some. In previous recessions, it is clear that the "survival of the fittest" has proved true. Planning is vital now to ensure that your firm is in good shape to take those opportunities when, as it will, the economic recovery builds momentum.

Douglas and Sally represent the legal sector at top 30 UK accounting firm, Armstrong Watson LLP. They are part of Armstrong Watson's specialist legal sector team advising law firms throughout the UK on strategic, structural and other business improvement issues. Further information can be found at www.armstrongwatson.co.uk/legalsector

This article was first published in the Law Society's Managing for Success magazine and is reproduced here with their kind permission.

Armstrong Watson LLP is working in partnership with the Law Society for the provision of accountancy services to law firms.

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THE LAW | SPRING 2023

FRS 102 – WHAT ARE THE PROPOSED CHANGES?

FRS 102, the Financial Reporting Standard applicable in the UK and the Republic of Ireland is evolving. The changes on the horizon are likely to be significant.

What are the proposed changes to FRS 102 and how will they impact law firms?

FRS 102 is subject to periodic review, with a significant review every five years alongside a three-yearly review in the intervening period. The latest version of this, Financial Reporting Exposure Draft 82 (or "FRED 82" as it is catchily known) was published in December 2022.

One of the proposed key changes is a new model for revenue recognition, using the 5 step model of IFRS 15. The aim is to provide greater consistency of revenue recognition for users of financial statements and a clearer process for preparers to apply. In the legal sector, this will help users like private equity consolidators assess the underlying earnings and recurring revenues of legal practices.

This is a fundamental change, as revenue recognition is a key part of the financial statement preparation process. Revenue is one of, if not the, largest figure in the financial statements. It is a highly sensitive figure which is important in many ways; determining entity size, employee/partner bonuses and entity valuation figures. Views are being sought and will be taken into account when FRS 102 comes to be updated.

Final amendments will be made following the end of the consultation in April 2023. These may be published in Q3 2023. An implementation period is proposed with an effective date of accounting periods commencing 1 Jan 2025, i.e., for 31 December 2025 year ends. Although this date is subject to consultation too!

What will this mean in practice for Revenue Recognition?

Firstly, it is useful to outline the five steps required in determining revenue recognition:

1. Identify the contracts with the customer

Key considerations include whether a modification to terms of existing contracts results in the creation of a new contract, for instance, if new performance obligations (major scope changes or revisions to terms) are added.

2. Identify separate performance obligations in the contract

This can involve the "unbundling" of a contract. For instance, the conveyancing process could be deemed as consisting of separate processes relating to right to title, issues of planning, exchange and completion and registry of title.

3. Determine the contract price

Fundamentally, the transaction price will be the most likely value that the entity expects to be entitled to in exchange for the promised goods or services supplied under a contract. This requires consideration of variable consideration (for instance for rebates or incentives, although not likely relevant to the legal sector) and adjustments for financing components (for instance if cash is paid in arrears or advance).

4. Allocate the contract price to the different performance obligations

Here, the individual selling price of the goods and services is allocated to the individual performance obligations. Consideration is paid to the allocation of variable considerations which are linked to specific performance obligations if certain conditions are met

5. Recognise revenue when performance obligations are fulfilled

The key point here is that the point of revenue recognition is the point when the performance obligation is satisfied. Revenue can be recognised in two ways – at a point in time or over time.

How will a move to the IFRS 15 method affect law firms?

A move to the IFRS 15 method of determining revenue recognition will potentially have changes to the timing and profile of revenue recognition for law firms. The IFRS model is far more prescriptive than the current FRS 102.

What will law firms need to consider, should the proposed changes be accepted?

Do engagement letters provide firms with an enforceable right to be paid for work completed to date? If this right is not present, then it is possible that revenue cannot be recognised until the point in time the matter is completed, rather than being recognised over time as is the norm for professional services fees.

Are the systems in place sufficient for identifying separate performance obligations and the amount of the contract price to be allocated to each?

Provided revenue can be recognised over time, IFRS 15 permits the use of inputs to measure completion. For legal firms, the inputs will likely be the hours spent per matter. IFRS 15 however explicitly prohibits including administrative or contract set-up activities in the measurement of inputs. Is your firm's time recording policy and system set up to identify and exclude such items?

Are systems in place that will record the stage of completion of each contractual obligation?

Contingent fees will need considering. Where contingent fees relate to similar matters and firms have access to enough historical data, firms have used this data to estimate the percentage of contingent WIP that will become revenue. Examples of this are firms that deal with large volumes of personal injury claims. Firms will need to consider carefully whether this method of recognising revenue in relation to contingent fee matters complies with the requirements of IFRS 15.

In summary, the process of determining revenue recognition is to become far more prescriptive in the near future. With the changes to FRS 102 largely following IFRS 15, there is scope to determine in advance whether your entity's revenue recognition will be affected. Action can be taken to review the content of engagement letters where these do not give the entity the right to be paid for work completed to date.

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AN INTERVIEW WITH...

Andy Poole interviews renowned transformation consultant for the legal sector, Bill Guthrie of Glenesk.

Andy Poole interviews Bill to explore his thoughts on what law firms should be focusing on to improve their businesses, and in particular how and why:

1. What types of law firms do you tend to work with?

In Legal Services, our typical client would be PE owned or be one of the larger ABS consumer firms. They tend to be the segment of the market most focussed on investing in performance over the medium term. That said, we also offer support to smaller regional firms who make use of our team on an occasional basis to help develop strategy and provide skills and structure to support its implementation.

2. What are the key areas that law firms should be focusing on?

That's a big question but I'll start by pointing out a view on what they shouldn't be focussed on. I think that firms can sometimes be overly focussed on external market conditions. I've seen a few firms become unstuck because they bet on changes in the conveyancing and small claims market that didn't materialise. It's really difficult to predict the future and we rarely do so accurately; I can't remember anyone predicting COVID for example, but it certainly had an impact! What I note, is that regardless of practice area, those firms that are focussed on being great at client acquisition alongside effective and efficient service tend to outperform, whatever the market conditions.

The firms that we've worked with have all had a very detailed view of fee-earner time and billable versus non-billable activity. What we've found though is that the most useful way of understanding fee earner activity is to study how much of it is split between progressing client matters and how much is lost to the series of client, third party and internal updates, chasing and searching for information and dealing with complaints that fill the typical working day. These often provide a significant opportunity to free up time that can be used limit the need for new hires or manage growth without additional cost.

There seem to be a lot of firms that fared comparatively well through lockdown but are now facing rapidly increasing staff costs and PII premiums. Again, the response in a price constrained market is to take a fresh look at how effectively and efficiently client matters are delivered to protect margins and mitigate cost increases.

We are also witnessing increasing delays in the civil justice system, which is beyond the control of firms, but cash-cycles can still be improved by looking for the missed opportunities to progress cases faster that are within our control.

3. How do you know that, and how do you assess what individual firms should focus on in their particular circumstances?

So I should point out that we are not advisors to the sector; our approach is to deliver rigorously evidence-based change. Wherever we work we always start with an in depth evidence-based review of a known problem area or a firm wide evaluation to identify the biggest opportunities to improve cost, cash, customer service and operational risks.

We don't have anything like the market wide understanding or reach that Armstrong Watson has; we only work with a handful of clients after all, but we do understand our clients' performance, opportunities, and barriers to implementation in detail and we do see common themes emerging from our work.

We also undertake market reviews from time to time which can be found on our website for those interested in the evidence base on topical sector issues and I'm drawing on my knowledge from all those sources in my comments.

4. Other than appointing you (or Armstrong Watson!), if there was one quick win that you think law firms could benefit from, what would it be?

My stock answer to that is that you should really analyse the value drivers in the firm first to understand where the biggest and easiest opportunity to improve profitability is and then follow the evidence to the root-cause to identify what changes will move the dial.

If I had to make a bet though on a quick change to a firm we didn't know that would reliably improve financial performance with minimal effort, then I'd focus on making a marginal improvement in the conversion of enquiries to new work. The simplest way to do this is to identify the most effective call-handler or fee-earner who manages this work and ask them to review how the less well performing members of the team manage enquiries.

If you codify the learning that results and mentor the rest of the team based on the insight gained, you should see an improvement in the volume of new business quickly and at no additional cost. I've seen that opportunity to some degree in every firm we've worked with to date.

BILL GUTHRIE
DIRECTOR OF GLENESK

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