The Law Society's Law Management Section

Financial Benchmarking Survey 2020

The Law Society

In association with Hazlewoods LLP

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DRIVING LIFELONG PROSPERITY

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Foreword

I am delighted to write the introduction for the 2020 Law Management Section Financial Benchmarking Survey.

The year, 214 firms participated, making the LMS Survey one of the largest of its kind in England and Wales.

The combined turnover of firms involved amounts to almost £1.2bn. We can confidently say that the LMS Financial Benchmarking Survey continues to increase in importance as a valuable tool for all law firm managers, enabling them to benchmark results against a wide range of other law firms.

The team behind the survey have worked to improve the layout and formulation of the results. The design is aimed at making the survey user-friendly and easy to understand. Many of the charts contain results over two years.

I would strongly encourage firms who are not members of LMS to look at our website and consider joining the section; and for those LMS member firms who have not yet joined in the survey, hopefully next year you will be encouraged enough to do so, making the results stronger than ever.

A huge thank you to Andy Harris and everyone at the accountancy practice Hazlewoods, for their hard work in pulling together and compiling all of the survey results. Thanks also to Andrew Otterburn for his efforts throughout the year, and to Clive Black, Helen Lee and Steve King at the Law Society for their invaluable assistance.

More thanks also go to Lloyds Bank Commercial Banking for their sponsorship of the survey, and to Darren Cable from Lloyds for his support and encouragement.

Final thanks go to all who have taken the time to participate in the survey, which makes the report possible.

I hope that you find this year's survey useful in improving the profitability of your practice. Please keep a look out for the survey later in the year, so that you can include your statistics in next year's report.

Ann Harrison
Chair, Law Management Section Executive Committee
Chairwoman, Stephensons Solicitors LLP
March 2020

About the Law Management Section

The Law Management Section (LMS) is the community for partners, leaders and practice managers in legal businesses. Established in 1998, the Section provides law firm managers with support, advice and opportunities to network and share best practice with peers.

It provides practical guidance, information and support on the full range of practice management disciplines, including HR, finance, marketing, IT, business development, client care, quality and risk.

The comprehensive range of services and benefits includes:

- *Managing for Success* quarterly magazine;
- regular *Law Management* e-newsletter;
- website featuring news and events, members-only discussion forum, downloadable documents, secure payment facility and suggested links;
- national and regional CPD-accredited events programme covering all management disciplines;
- the *LMS Financial Benchmarking Survey*;
- toolkits on internet policies, mergers, legal aid, risk management, HR and business development;
- networking opportunities;
- representation on the Council of the Law Society; and
- discounts on a range of events, texts and training packages.

Membership is open to solicitors; those concerned or involved in the management of a legal practice / department (whether as HR, IT or marketing manager); or those habitually or frequently involved in the supply of services to legal practices which relate to the financing or management of such practices.

New Corporate Membership

Individual membership costs £199, but why not take advantage of even greater savings with our new corporate membership deal? For only £399 your firm can nominate up to six staff members, who can all enjoy the individual benefits of being a Law Management Section member.

For more information, visit

www.lawsociety.org.uk/lawmanagement
email: MSadmin@lawsociety.org.uk
telephone: 0207 320 5804

About Hazlewoods LLP

The *LMS Financial Benchmarking Survey* is written and produced by the Legal Team of Hazlewoods LLP.

Hazlewoods is a Top 30 accountancy practice with a niche specialism in advising the legal profession. We have worked with law firms since 1992, and we have a dedicated team of 30 individuals who focus only on this.

We are retained by over 150 law firms countrywide on a recurring basis, and advise at least 30 others each year on projects such as practice strategy, new practice start-ups, mergers and acquisitions, structure advice and implementation, external equity investment, breaking away from larger firms and dealings with the SRA. The scope of our service goes far beyond the normal compliance-based services provided by the majority of other accountancy practices, and we have a tremendous range of contacts in the sector. See more at **www.hazlewoods.co.uk/sectors/legal-accountants.aspx**

This is the 11th year that we have compiled the LMS Financial Benchmarking Survey. Over this period, our experience and understanding of the sector have enabled us to develop and constantly refine the questionnaires and interpret the results.

Should you have questions about anything at all in it, we would be delighted to hear from you (**legal@hazlewoods.co.uk**)

We would like to thank all law firms that took the time to complete and return the questionnaires, and we hope that you find the report both interesting and useful in your firm.

About Lloyds Bank Commercial Banking

We are delighted to once again sponsor the Annual LMS Financial Benchmarking Survey, providing vital benchmarking data for law firms. It is the most in-depth of its kind, and an invaluable tool for law firm owners and managers to understand best practice and to make the right business decisions.

We work closely with solicitors to provide funding and support that meets the specific needs of your business. Our specialist managers are Lexcel-trained; understand practice management standards; and know the opportunities and threats that face the profession. They are also trained in the SRA Accounts Rules to ensure we complete the housekeeping processes correctly.

In 2019, we were voted 'Bank of the Year' by Finance Directors in the FDs' Excellence Awards for the 15th consecutive year. Our 'through the cycle' approach to lending has allowed us to continue to support viable firms through difficult times. From 2018 to 2020, we are supporting businesses to start up and grow with a £6billion increase in net lending to SME and Mid-Market businesses, and as part of Lloyds Banking Group we have recently pledged to help reduce the carbon emissions we finance by more than 50% by 2030.

Darren Cable
UK Head of Legal
Lloyds Bank Commercial Banking
www.lloydsbank.com/solicitors

Introduction

Members of the Law Society's Law Management Section (LMS) are represented in law firms across England and Wales. For the past 19 years, the LMS has produced the annual LMS Financial Benchmarking Survey with the active participation of that membership, and the recent growth in support from the wider legal practice community. The survey is widely regarded as one of the leading annual health check reports for smaller and mid-sized practices.

This report is unique in providing detailed accounting and business metrics collected directly from over 200 solicitor firms across England Wales, allowing those firms and others – particularly from the mid-market – to benchmark their performance against peers and to an extent over time.

214 law firms from across England and Wales, concentrated in the mid-market, with a combined turnover of almost £1.2billion have taken part in this year's survey. We anticipate that most of the participants' income will relate to domestic work.

For reference, in 2018-19, total domestic turnover for all firms in England and Wales was £25.5billion, although over half of this amount was earned by the 100 largest firms, which are not the subject of this survey.

As in previous years, all participants provided two years' data, i.e. the most recent accounting period and the previous one, which has allowed us to compare two years' results on a true like for like basis.

Many of the charts throughout this report include the results for two accounting years. Most charts include three figures for each turnover band; the lower quartile, median and upper quartile. The results for 2019 are shown as columns and numbers, and the like-for-like results for 2018 are shown as a dash, i.e. - .

Participants are analysed in more detail in the following section.

In a small number of instances, either participants were not able to provide us with full comparative data, or the population size was insufficient to allow the findings to be statistically valid. Where necessary, we have taken account of this in the charts shown and statistics quoted. In general, we have provided results for categories where at least 30 practices responded to the survey.

We consider that the response rates that we have seen for this voluntary survey are very good, compared to other financial surveys of professional firms. There was a good participation amongst mid-sized and larger firms, but an under-representation of smaller firms, and we do not survey the very largest firms (many of which are global operations). The overall results should not be taken as being representative of the profession as a whole. The sample is self-selecting, and this may introduce bias into the results in a manner that is not directly quantifiable.

For ease, throughout this report we refer to the owners of the practices as Equity Partners.

Participants

214 law firms from across England and Wales, comprising 16,000 partners and employees, took part in this year's survey. The fee income of all participants totals £1.17bn - an average of £5.5m per practice - and combined net profits of £258m.

Once again, we have categorised firms based on turnover. The turnover bands and the number of participants in each band are shown in the table below.

The total number of practices in England and Wales in each band is also shown.

Turnover band	Total number of practices	Number of participating practices	%
Up to £2million	8,974	75	0.8%
£2million to under £5million	690	68	9.9%
£5million to under £10million	256	41	16.0%
£10million to under £35million	184	29	15.8%
£35million+	122	1	-
No turnover data available	94	-	-
Total	**10,320**	**214**	**2.1%**

There was a good participation amongst firms with a turnover greater than £5million, and an under-participation of firms with turnover below £2million.

The locations of the participants are as follows:

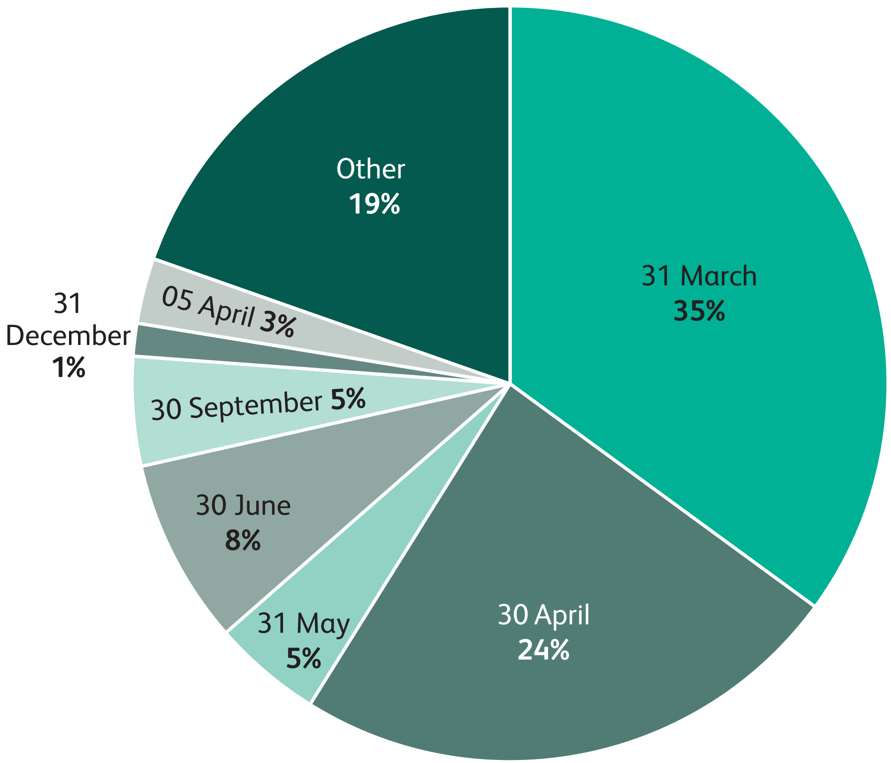
Region	Number of participating practices
Eastern	8
Greater London	41
Midlands	40
North East	11
North West	16
South East	35
South West	43
Wales	8
Yorkshire	12
Total	**214**

79% of participants traded as either an LLP or limited company. This is significantly higher than, and in different proportions to, the percentages for the legal sector as a whole – according to SRA statistics, 48% of law firms were operating as a limited company, and 15% were operating as an LLP at 31 December 2019. These statistics, and more, can be viewed here:
www.sra.org.uk/sra/how-we-work/reports/statistics/regulated-community-statistics/

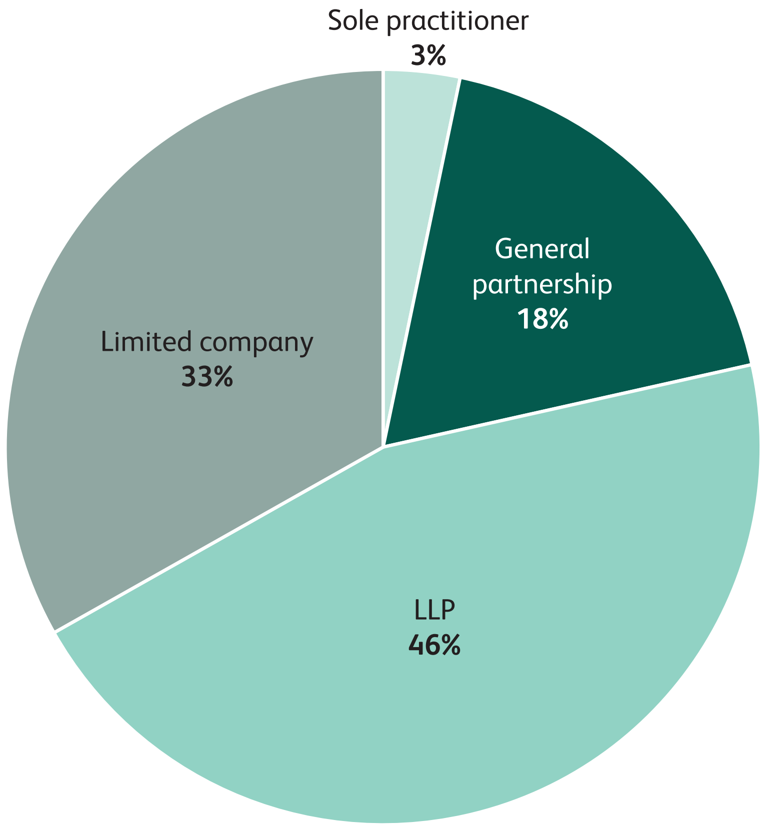
This difference between the survey participants and the sector as a whole reflects the fact that a greater proportion of mid-sized firms have taken part this year – the majority of the Top 200 law firms are either an LLP or limited company.

The SRA's statistics show that the number of limited companies has increased by 369 in the last two years, with very little change in the total number of firms.

Financial year end of participating practices



Structure of participating practices



1. Using benchmarking information to improve your performance

On the whole, the findings from this year's survey are very positive. Fees are up, staff and partner numbers are up too, and WIP and debtor balances are down. Firms are also feeling confident about the future, with a predicted 4% fee growth for the 2019/20 financial year.

However, there are indications that some firms are struggling. Pressure to raise salaries has resulted in firms' overheads growing more quickly than fees, leading to the first reduction in net profits per partner that we have seen for quite some time.

This needs to be addressed quickly, as future investment in a firm and its people is only possible if fees and profits are growing. Benchmarking information can be very helping in identifying key areas for improvement.

Fee earner breakeven point

By combining some of our findings throughout this report we are able to calculate the expected breakeven point for a fee earner. This is the fees a firm must generate per fee earner before any profit contribution is earned. As illustrated in the table on the right, this is substantially more than simply the median cost of a fee earner.

	2019 £	**2018** £
Median fee earner cost, including notional salaries for equity partners (Figure 4.4)	52,027	51,516
Median support staff cost per fee earner (Figure 4.9)	21,697	21,429
	73,724	72,945
Median non-salary overheads per fee earner (Figure 5.9)	35,655	35,665
Breakeven point per fee earner	**£109,379**	**£108,610**

Working on an average of say 1,100 chargeable hours per annum per fee earner, or 220 chargeable days per annum, this equates to the following:

	2019 £	**2018** £
Cost per hour	£99.44	£98.74
Cost per day	£497.18	£493.68

In Figure 3.6 we see that the median fee income per fee earner in 2019 was £122,487, and this figure has changed very little over the past 10 years. This means that just under 90% of fees earned by a fee earner are used to cover their costs. Looking at it another way, if a firm has a 31 December year end, on average it takes until 22 November for a fee earner to earn sufficient fees to cover his or her total costs for the year, and for the practice to reach 'super-profits'.

These figures assume an average of five chargeable hours per day, but in reality, fee earners in many firms do not record anywhere near 1,100 chargeable hours per annum.

Areas to focus on

Sections 4 (Employment costs) and 5 (Profitability) include some pointers on key overheads, such as fee earner costs, support staff costs and accommodation costs, and these may help to identify areas for potential savings.

However, we expect the breakeven point to continue to increase. Salary costs are generally only going one way, and overheads in many practices have already been cut back as far as possible.

Section 3 (Fee income) is therefore the key section for practices looking to increase profitability.

Fee earner performance

Fee income is driven by a combination of chargeable hours recorded (productivity) multiplied by a recovery rate. The greater the productivity and recovery, the higher the income. For example, let's assume a practice with 20 fee earners, all with an hourly chargeout rate of £175. Fee earners record an average of 1,100 chargeable hours each per year, and recover (i.e. bill) 80% of the recorded WIP value, resulting in total fee income of:

20 x £175 x 1,100 x 80% = £3.08million

If the fee earners are able to increase the recovery rate by just 1%, annual fee income and profitability will increase by £38,500.

If the fee earners can improve productivity by 1%, then this gives a £30,800 increase in turnover and profitability. A 1% improvement in productivity represents just one additional 6-minute unit per fee earner per day.

A 1% improvement in both productivity and recovery increases income and profits by almost £70,000.

Time recording

In our experience, fee earners in many practices do not fully time record. This is often the case where the work is fixed fee, for example in residential conveyancing. Even where fee earners do time record, it is rare to see fee earners recording more than four chargeable hours per day.

If you do not know how long it takes a job to do, how will you be able to tell if it is profitable and therefore worth doing at all? If fee earners are making the decision to not record all of the time they have taken on a matter, you also risk a further reduction being made at the point of billing, or "double discounting". The fact that it is felt not all time can be recorded suggests that work might not be being performed at the right level, further training is required, or there are undue pressures from management.

Capturing all time spent on a client matter, for all work types, is essential, not only to allow you to charge your clients a commercial fee, but also to ensure that work is being carried out efficiently and at the right level. Fee earners should be provided with targets for both productivity and recovery, which can then be monitored, and the process of recording time and billing should be made as simple as possible.

Coming up with a suitable productivity/chargeable hours target for each grade of fee earner can be difficult. Generally speaking, we would expect more senior people, with non-fee earning responsibilities, to have a reduced productivity target, whereas more junior people with no other responsibilities at all could be looking at a target of upwards of 1,200 or 1,300 hours. This may sound like a lot, but even after allowing for holidays, sickness and other absences, it amounts to less than six chargeable hours per day.

Once you arrive at a target level of productivity and recovery, this should allow you to calculate target fees per fee earner, and for the practice as a whole, and compare them to our findings in section 3. Ideally, you should be aiming to be in the upper quartile for your turnover band, which will hopefully move you into the upper quartile in section 5 (Profitability).

Fee earner gearing

As we explain in sections 3 and 5, fee earner gearing also impacts on fee income and profitability. Generally speaking, the higher the ratio of fee earners to equity partners, the greater the fee income, and the higher the net profit, provided of course that fee earners are busy. However, high gearing ratios are not suitable for all work types, particularly those requiring greater levels of supervision and experience.

Management information

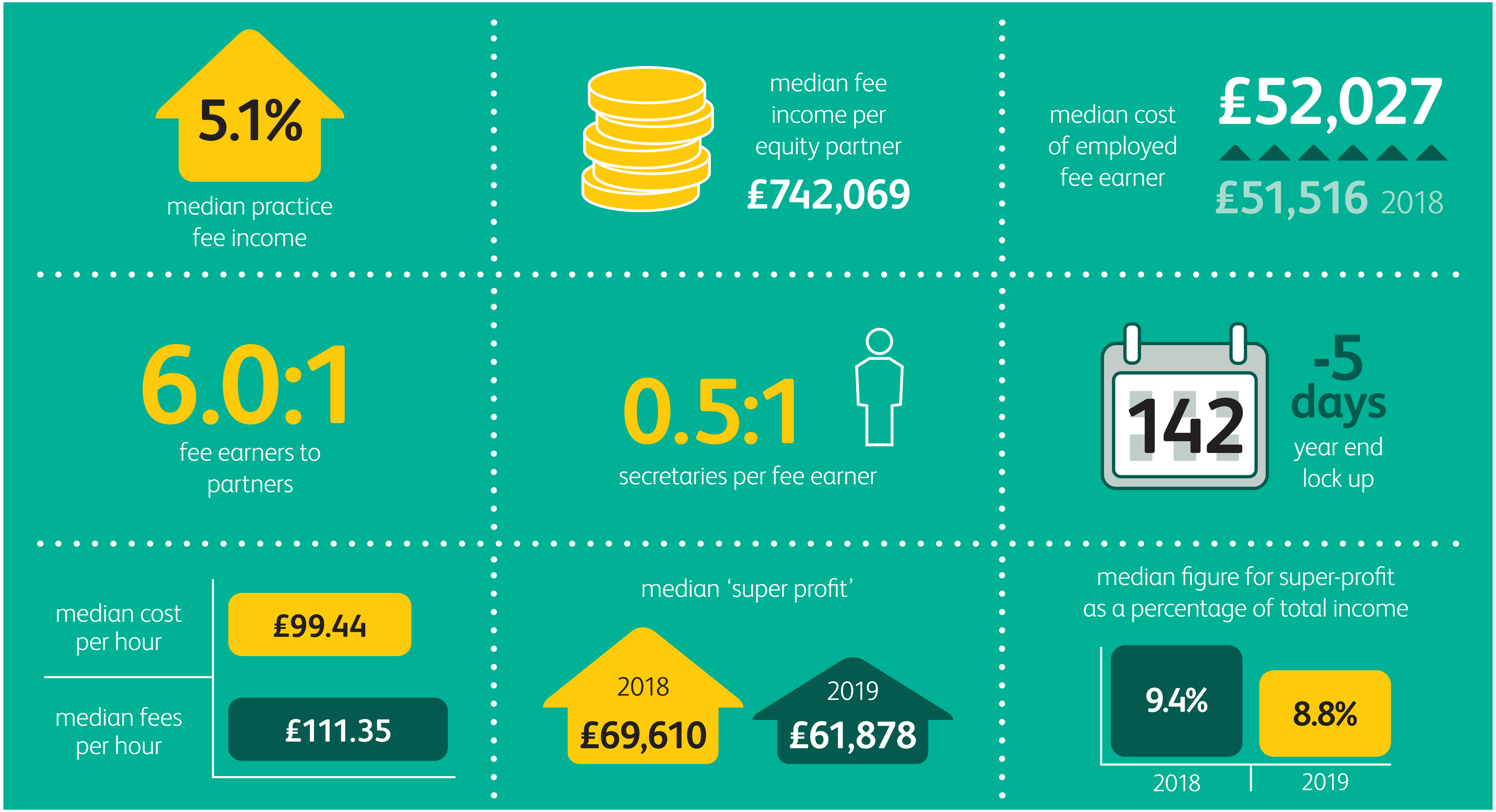
Monitoring the performance of individual fee earners and the firm as a whole is only possible if you have accurate and reliable management information (MI). In our experience, many firms struggle to extract useful data from their practice management software, either because they do not know how or because their software has very poor functionality and reporting.

Many firms are unaware that there are inexpensive reporting tools available at the moment, including many that come with Microsoft Office, that can transform the production of monthly management information, take just minutes to update, are easy to understand, and can output key performance indicators in real time. These can make a huge difference to a firm, and enable partners to monitor fee earner targets, cash flow and working capital.

If you already have good MI, consider sharing it with all fee earners. In our experience, the potential upsides from doing this usually outweigh any potential drawbacks.

2. Summary of findings

Key headlines in this year's survey (explanations for all of these will follow later):



- Median practice fee income increased by 5.1%. Most work types have seen an increase.
- Median fee income per equity partner of £742,069 (2018: £683,394).
- The median cost of a fee earner, including fixed share partners and notional salaries for equity partners, was £52,027 per fee earner, compared to £51,516 in 2018.
- The ratio of fee earners to equity partners has increased to 6.0 to 1.
- The median spend on support staff, including secretaries, reception, HR and accounts, was £21,697 per fee earner, compared to £21,429 in 2018.
- The median spend on non-salary overheads per fee earner was £35,655 compared with £35,665 in 2018, and as a proportion of fee income, non-salary overheads dropped slightly, to 30.0%.
- Total year end lock up days (WIP and debtors combined) fell by 5 days to 142 days.
- Median equity partner capital (combined total of capital account, current account and tax reserves) rose by 12.2% to £219,691.
- The median hourly cost of a fee earner (based on 1,100 chargeable hours per year) is £99.44, compared to median hourly fees per fee earner of £111.35.

Median net profit per equity partner (before notional salary) for participating practices has dropped from £161,653 in 2018 to £155,897 this year – a fall of 3.7%.

When we adjust the net profit figure to include a cost for equity partners, and also notional interest on partner capital, the median ‘super-profit’ for the year was £61,878 compared to £69,610 in 2018. A sixth of participants reported a ‘super-loss’ for the year.

3. Fee income

We start our analysis by reviewing income growth. We have measured income performance by equity partner, by individual fee earner and by specialism. We reveal the effects on revenue from changing the gearing in a practice; that is the ratio of fee earners to equity partners. We also look to see how income and gearing can vary by specialism.

Most of the charts throughout this and later sections include the results for two accounting years, and the results are analysed into turnover bands. Most charts include three figures for each turnover band; the lower quartile, median and upper quartile. The results for 2019 are shown as columns and numbers, and the results for 2018 are shown as a dash, i.e. - . The dashes show the like-for-like 2018 results for the participants in this year's survey, so may not correlate with the findings in the 2019 survey.

Key points are:

- 70% of the participants in the survey reported year-on-year fee growth in 2019, with almost 30% seeing growth of over 10%. Smaller practices in the survey saw a wider range of fee change than other turnover groups, as shown in Figure 3.1, possibly due to the fact that a modest increase in £ terms can represent a large proportion of overall fees for those practices.
- This is the tenth consecutive year that we have reported a median fee increase, although it should be noted that the composition of the sample across those ten years will have varied. Across the last five years we have reported an average median increase of 5.16%, so when compared against RPI inflation (currently at 2.2%), many participants have experienced strong growth in real terms.
- Participants reported a median fee income per equity partner of £742,069 compared to £683,394 in 2018 – an increase of 8.6% - although smaller firms in the survey generally saw much lower results.
- In general, most work types are experiencing growth, although for many firms this has slowed significantly in recent months.

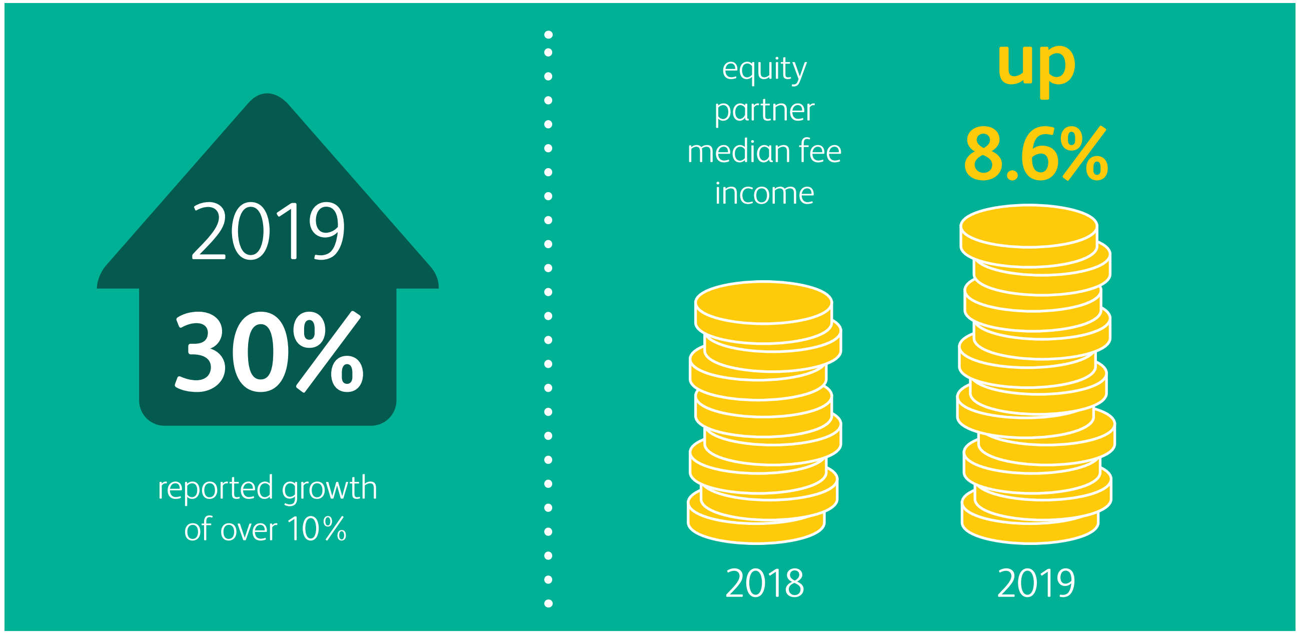


Figure 3.1: Change in fee income compared to previous year's fee income (%)

Figure 3.2: Median changes in fee income over the last 11 years (%)

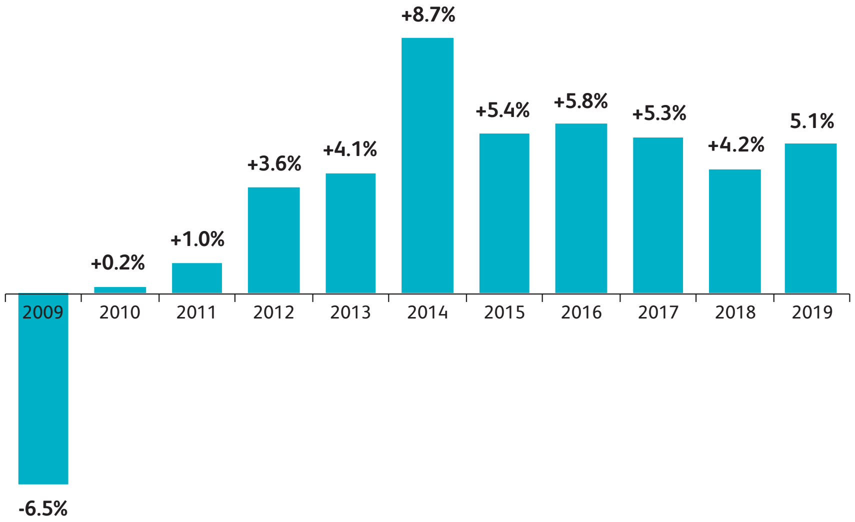
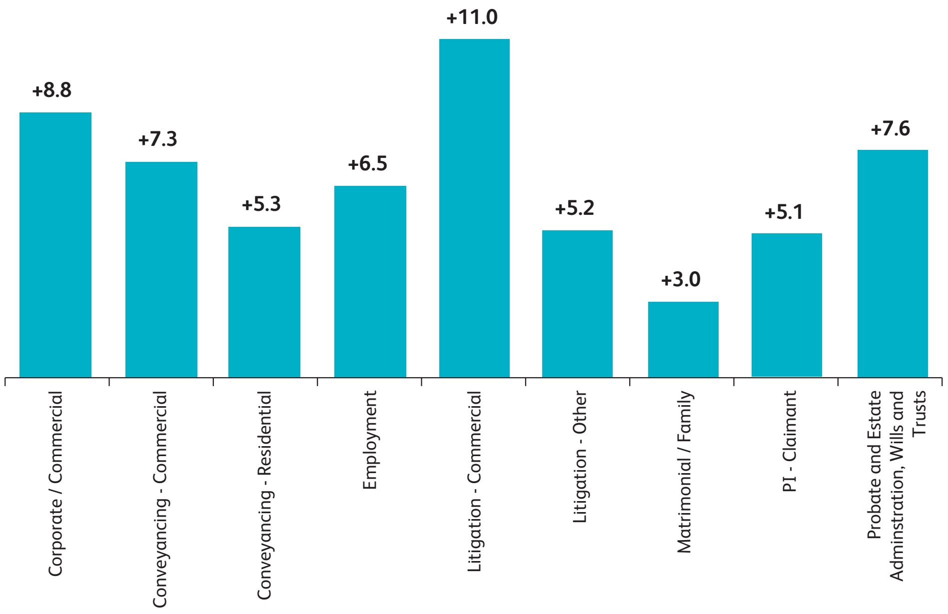


Figure 3.3: Change in fee income compared to previous year's fee income by specialism (%) (median figure only)



Equity partner performance

The majority of participants in the survey reported minimal change to the number of partners between 2018, and 2019. The total number of equity partners increased by just 1.7%, from 1,207 to 1,227.

For most firms, the growth shown in Figure 3.1 has resulted from increased fee income per equity partner, rather than an increase in partner numbers. Most turnover groups saw a rise in fee income per equity partner, with a median growth of 8.6%.

Figure 3.4: Fee income per equity partner (£'000)

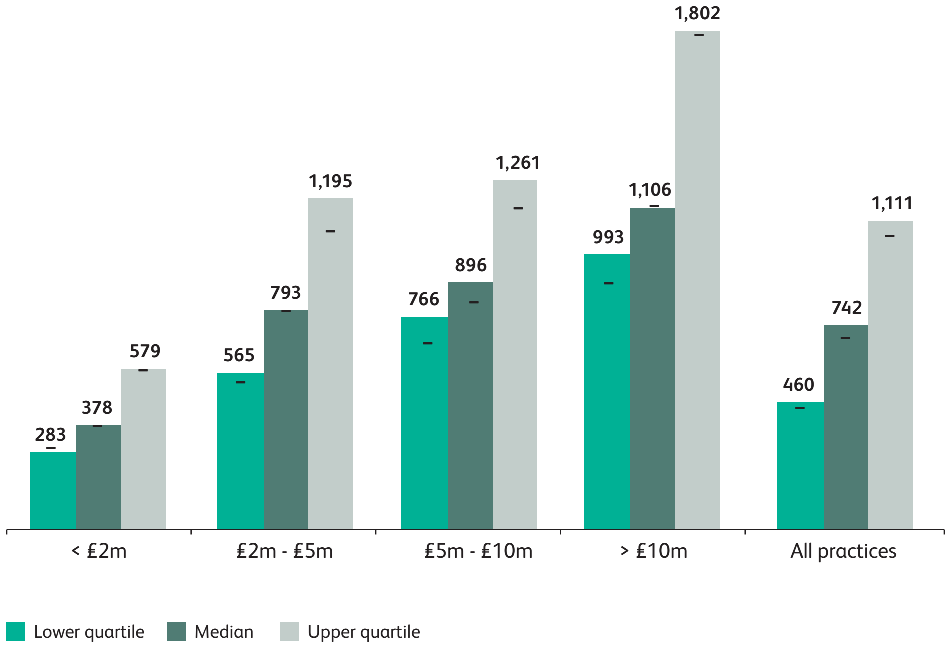
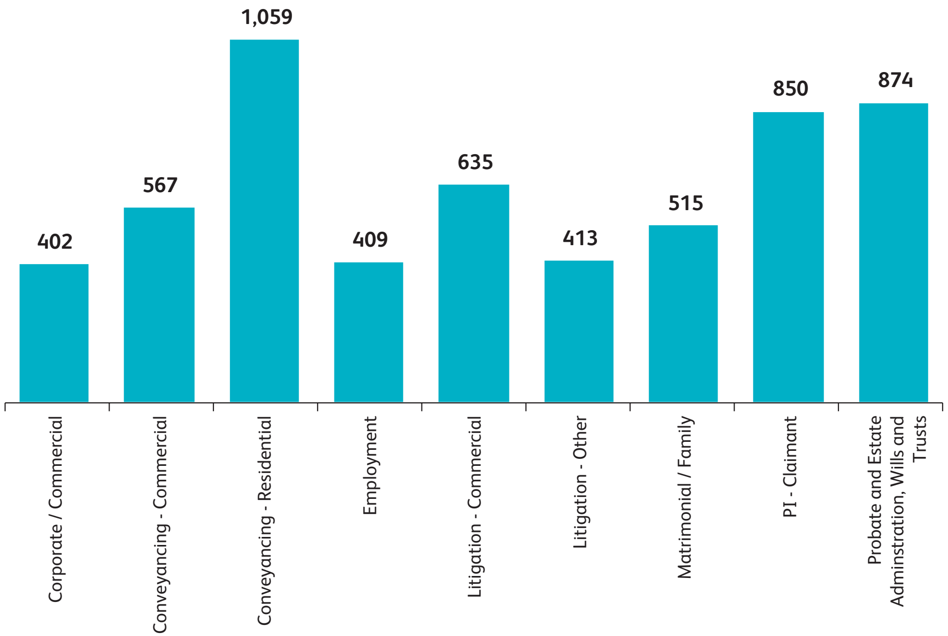


Figure 3.5: Fee income per equity partner by specialism (£'000) (median figure only)



Income by individual fee earner

Key points here are as follows:

- The total number of fee earners for participating firms was 8,919, compared to 8,520 in those same firms in 2018, a 4.7% increase.
- Average fees per fee earner were £122,487, compared to £121,920 in 2018, an increase of just 0.5%. Back in 2009, when we first carried out the LMS survey, the median was £114,326, so fee growth has been minimal over the past 10 years.
- The growth in the number of fee earners is positive news, as it demonstrates that partners in most firms are optimistic about the future. The increase in average fees per fee earner is also positive news, although the median increase is well below the current RPI inflation rate, and firms in the largest turnover group will be very concerned to see a median reduction of 7.3%. A reduction in fees per fee earner could suggest that new joiners are taking a long time to bed in, or that work is being performed at the wrong level.
- Fees per fee earner is a key issue for all firms to focus on, and alongside this there needs to be close monitoring of productivity and recovery rates. Some commentators in the sector argue that time recording is unnecessary, particularly as most clients expect a fixed fee nowadays, but our view is that if fee earners are not fully time recording then it is very difficult to know whether work is being carried out efficiently and profitably.
- Increasing numbers of firms are giving their fee earners training on issues such as pricing and lock-up management, and we have seen some very positive results from this.
- Lots of firms pay bonuses to their staff to reward strong performance, and these can work well if done properly. However, we would caution against introducing bonus arrangements that encourage poor behaviours, such as delaying billing or not delegating work to team members. Also, where targets are based on fee income, it is important to look at fees billed and paid, rather than simply fees billed.

Figure 3.6: Fee income per fee earner (£'000)

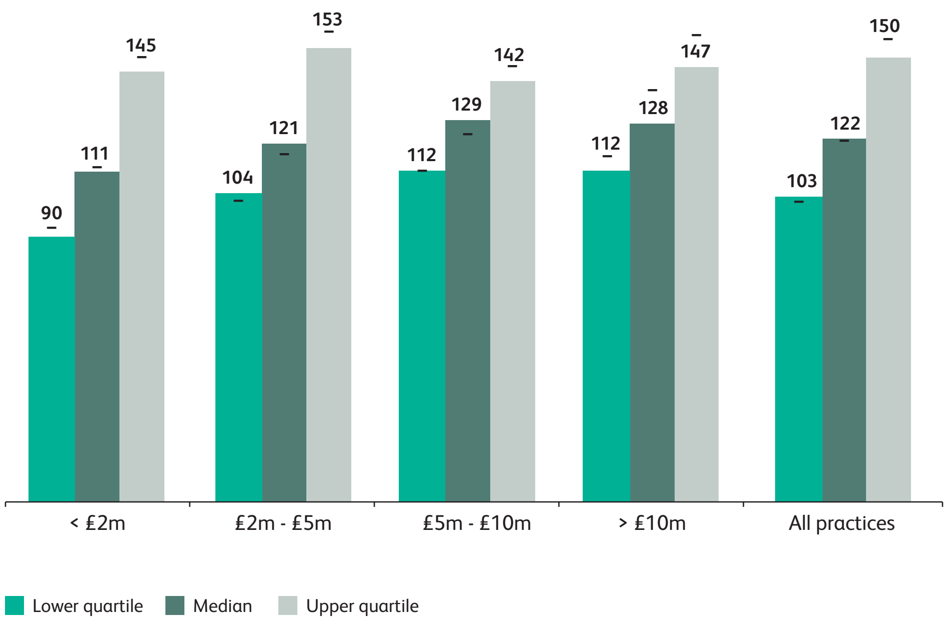
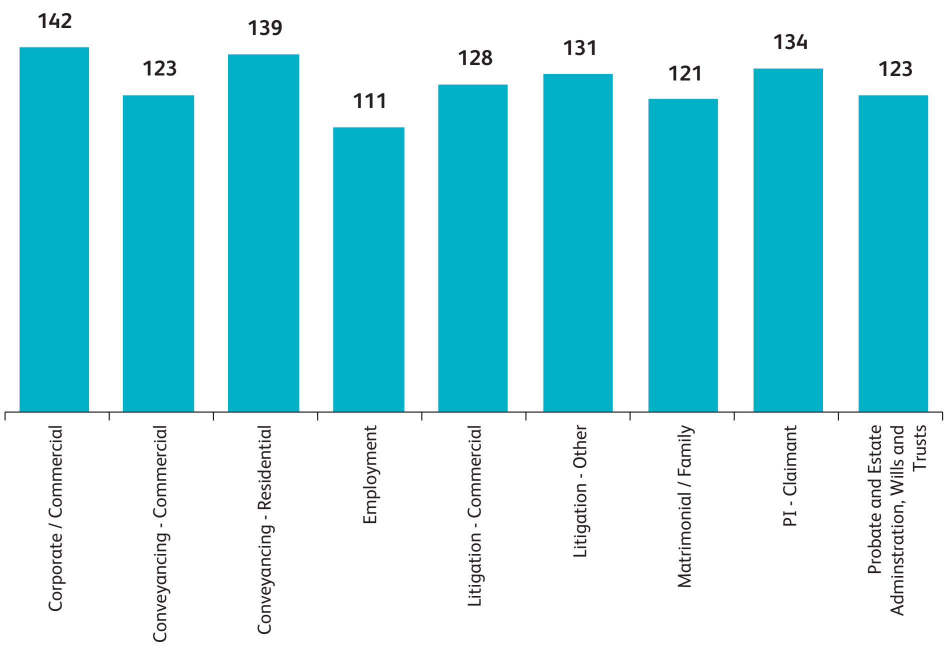


Figure 3.7: Fee income per fee earner by specialism (£'000) (median figure only)



Fee earner gearing

Fee earner gearing (the ratio of fee earners to equity partners) is a key indicator, not only as an absolute measure, but also as a trend over time. In improving economic conditions, the ratio of fee earners to equity partners tends to increase as firms grow, with the opposite happening in times of recession.

This is certainly true in our surveys. Back in 2009, the median ratio was 4:1, and the general economic climate then was fairly bleak. Since then, we have seen a steady rise in fee income, and the gearing ratio has gradually crept up to 6.0:1. It is this increase that has led to the rise in fees per equity partner that we saw in figure 3.4.

In our calculations we have included equity partners in the number of fee earners (unless they are non-lawyer managers). For example, if a firm comprises two equity partners and three other fee earners then the ratio is 2.5:1 (i.e. five divided by two).

As shown on the chart at figure 3.9, fee earner gearing can vary quite significantly by work type. Residential conveyancing and personal injury claimant teams in particular often have a higher than average ratio, whereas the ratio tends to be lower in areas such as employment and litigation.

Figure 3.8: Number of fee earners per equity partner

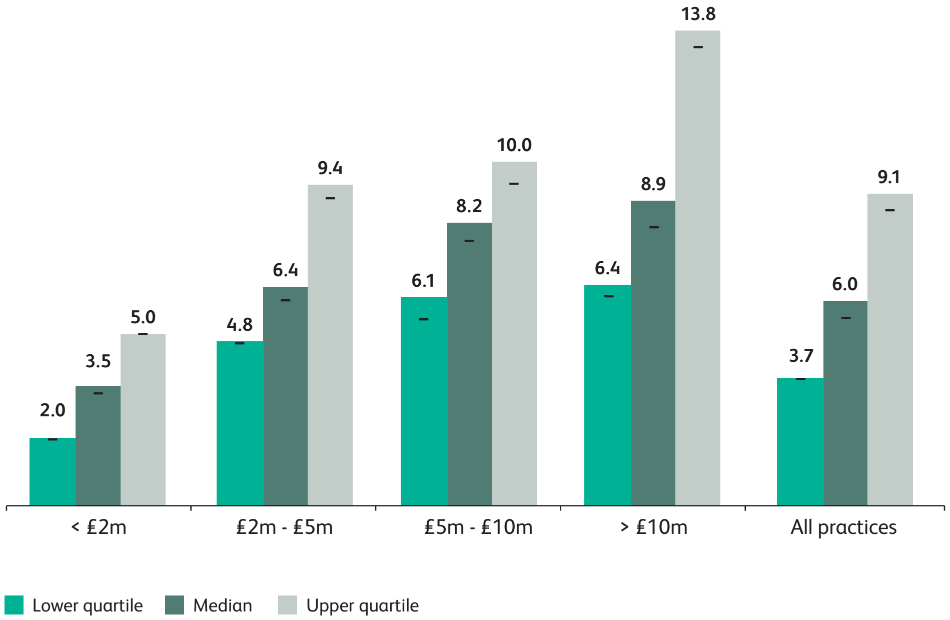
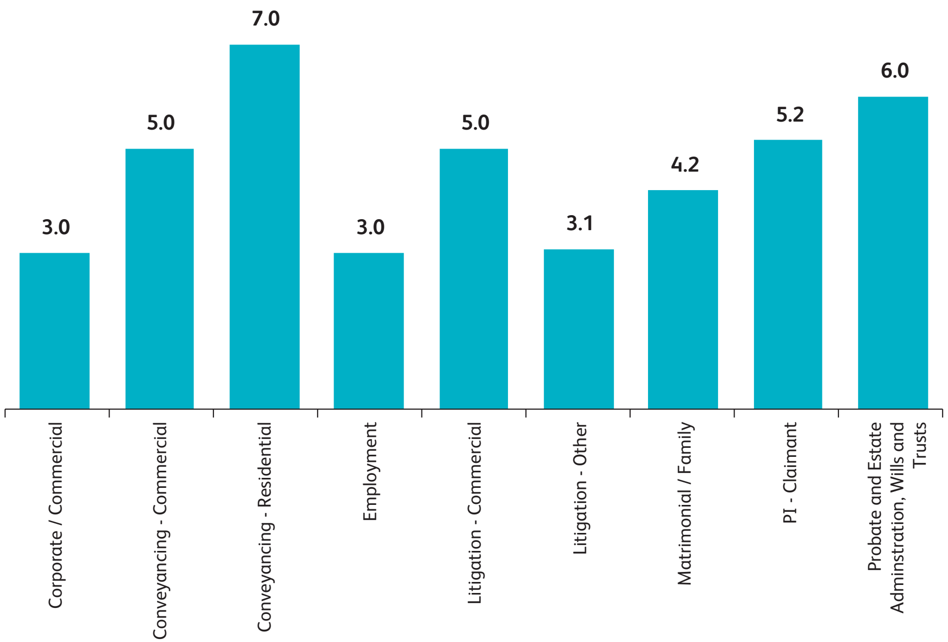


Figure 3.9: Number of fee earners per equity partner by specialism (median figure only)



Fee earners

People represent the primary cost of all law firms. The total costs are broken down into three principal categories:

- Equity partners
- Fee earners
- Support staff

Figure 4.1 compares the total cost of these people against fee income. This includes notional salaries for equity partners, which we have set at a level of the highest employed fee earner's salary for the size of practice, plus 15%, to reflect Employer's NIC and pension contributions.

The median 2019 total is 61.1%, compared to 60.3% in 2018, giving a median gross margin/contribution of 38.9%. The slight drop in margin indicates that fee earner costs have risen ahead of the increase in fee income, which will be a concern to many firms.

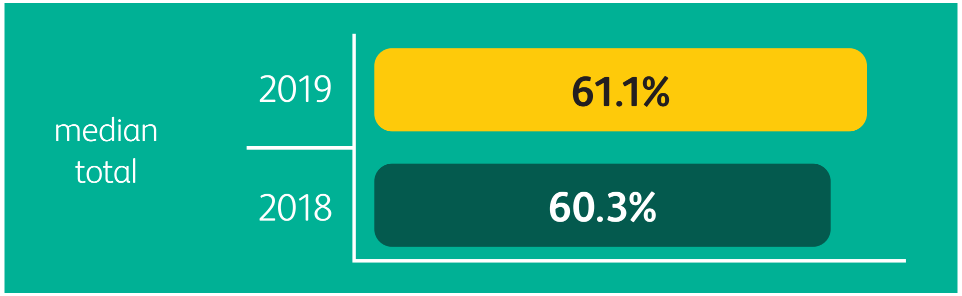


Figure 4.1: Total salary costs, including notional salaries, as a percentage of fee income (%)

Employment costs – employed fee earners

Having established the contribution margin, we can now look in more detail at how much firms are actually spending on their employees. In Figure 4.2 we include salaries, fixed share partners, consultants, temporary staff and all usual payroll and pension costs. However, no redundancy or recruitment costs are included here, or any notional salaries for equity partners.

Key findings are:

- Expenditure on fee earners as a percentage of fee income is consistent for most firms, across all turnover bands.
- The median cost of an employed fee earner increased by 1.5%, from £44,116 in 2018 to £44,788.
- Part of this increase will have resulted from the increased level of employer pension contributions payable under pensions auto-enrolment, but the driving factor here is that recruitment and staff retention remain very challenging for most firms, increasing pressure to increase salary levels.
- Not all firms have seen an increase in fee earner costs. Some firms provide career development opportunities to support staff, by making at least some of their work chargeable.
- The average fee earner cost is not consistent across all turnover bands, and as you might expect, rises in line with firm size. Firms with the highest fee income are generally employing more expensive staff, as shown by the notional salaries detailed in section 5.

Figure 4.2: Expenditure on employed fee earners as a percentage of fee income (%)

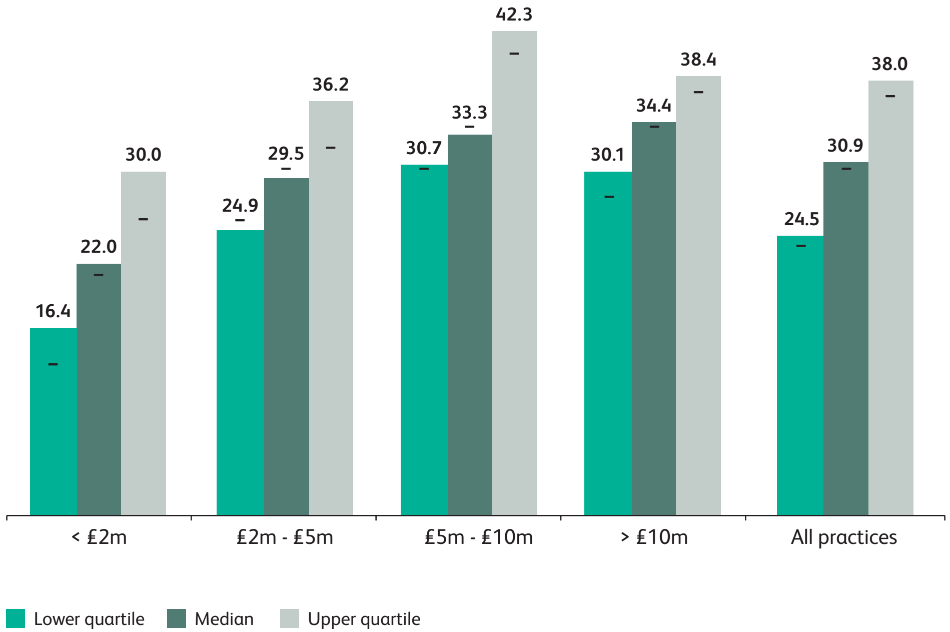
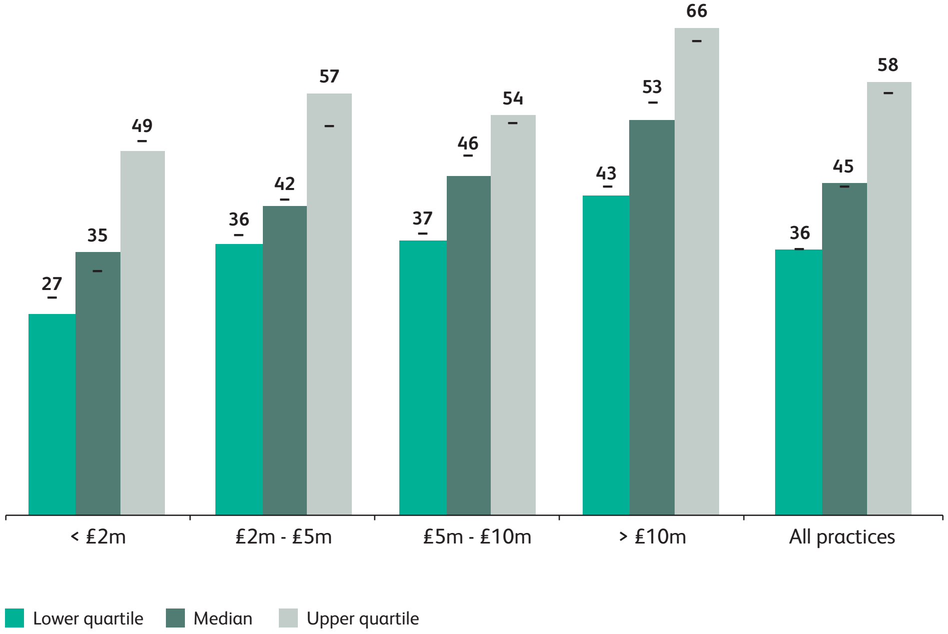


Figure 4.3: Cost per employed fee earner (excluding notional salaries for equity partners) (£'000)



Employment costs – all fee earners, including equity partners

Building on the results in Figure 4.3, we now show the cost per fee earner, including a notional salary cost for equity partners. This graph shows the "true" cost of a fee earner, combining employee salaries, fixed share partners, consultants, temporary staff and normal payroll and pension costs, and a notional cost for the equity partners.

Notional salaries are based on the highest fee earner salary for the turnover band, plus an extra 15%, partly to reflect the costs that would have been incurred if the equity partners had been employed.

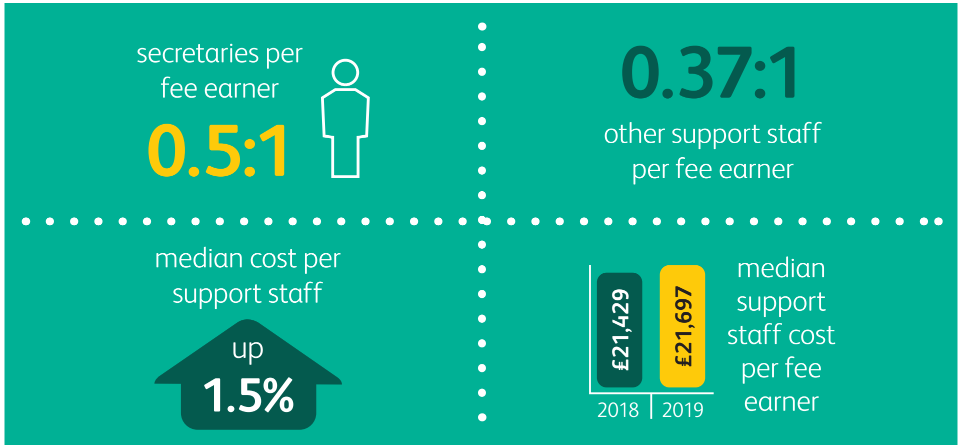
When equity partners are included, the median 'true' cost of a fee earner increases to £52,027, up slightly from £51,516 in 2018.

Notional salary rates are shown on Figure 5.4. The median notional salary across all turnover bands is £86,000, although notional salaries for the larger firms in the survey are considerably higher than this.

Figure 4.4: Cost per fee earner (including notional salaries for equity partners) (£'000)

Employment costs - support staff

In terms of actual head count on a full-time equivalent basis, the total number of people employed in a non-fee earning capacity by participants in our survey was 7,159 in 2019, compared to 6,964 in 2018. That's a rise of 2.8%.



Within that total we looked in more detail at their specific roles and identified the following statistics:

- The number of secretaries per fee earner fell very slightly, from 0.51 to 1 to 0.5 to 1. If we look back ten years ago, the same ratio was 0.77 secretaries per fee earner, so 50% higher than we see now.
- The number of other support staff per fee earner (accounts, administration, marketing, receptionists, IT, etc.) remained static at 0.37 to 1.
- The median cost per member of support staff (including secretaries) rose from £22,719 in 2018 to £23,051. In addition, the median support staff cost per fee earner, including secretarial support, was £21,697 in 2019, compared to £21,429 in 2018 – an increase of 1.3%.
- These two combined have pushed the median spend on support staff up from 16.7% to 17.3% of fee income. In other words, support staff costs have also risen ahead of the increase in fee income.

Figure 4.5: Expenditure on support staff as a percentage of fee income (%)

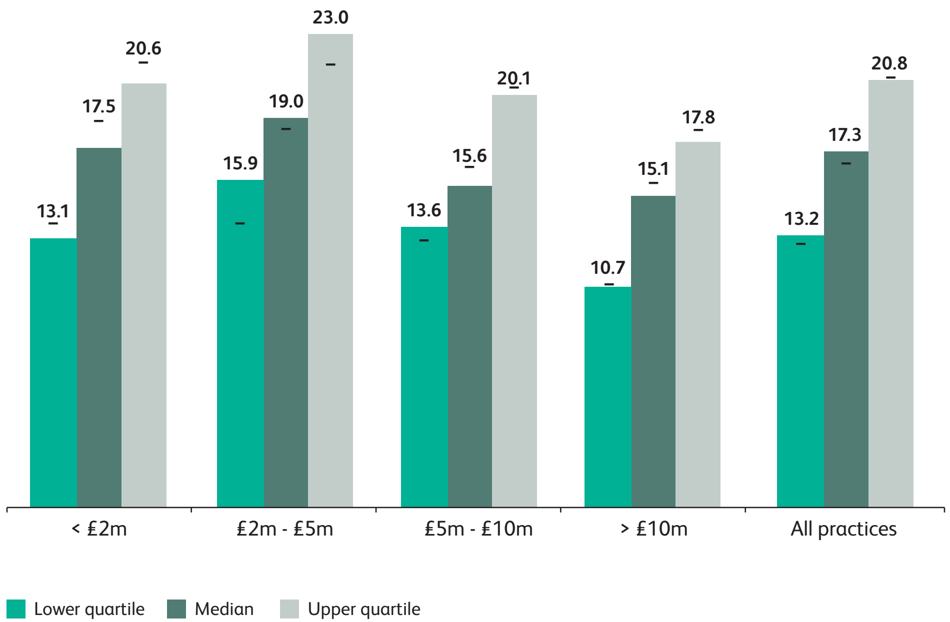


Figure 4.6: Cost per support staff member (£'000)

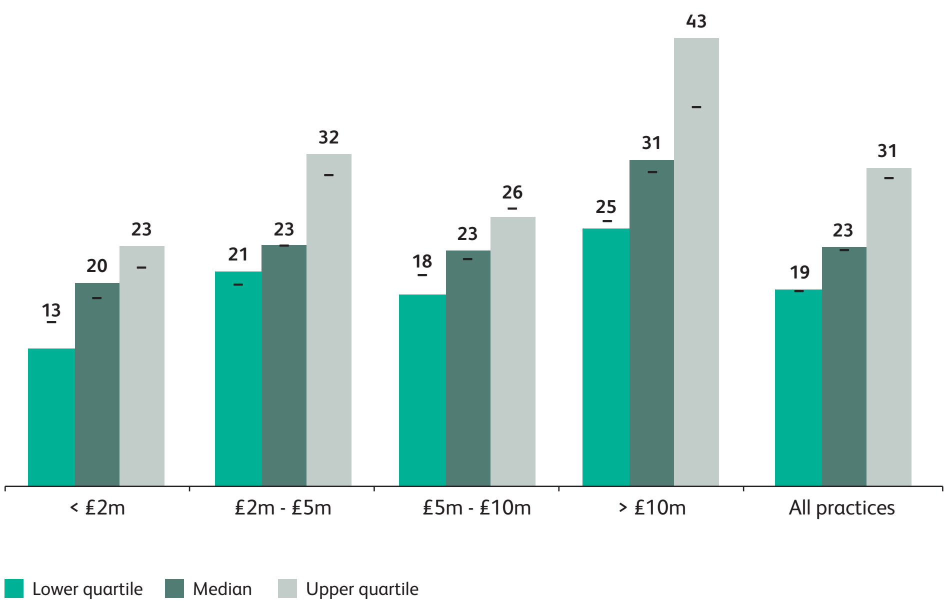


Figure 4.7: Number of secretaries per fee earner

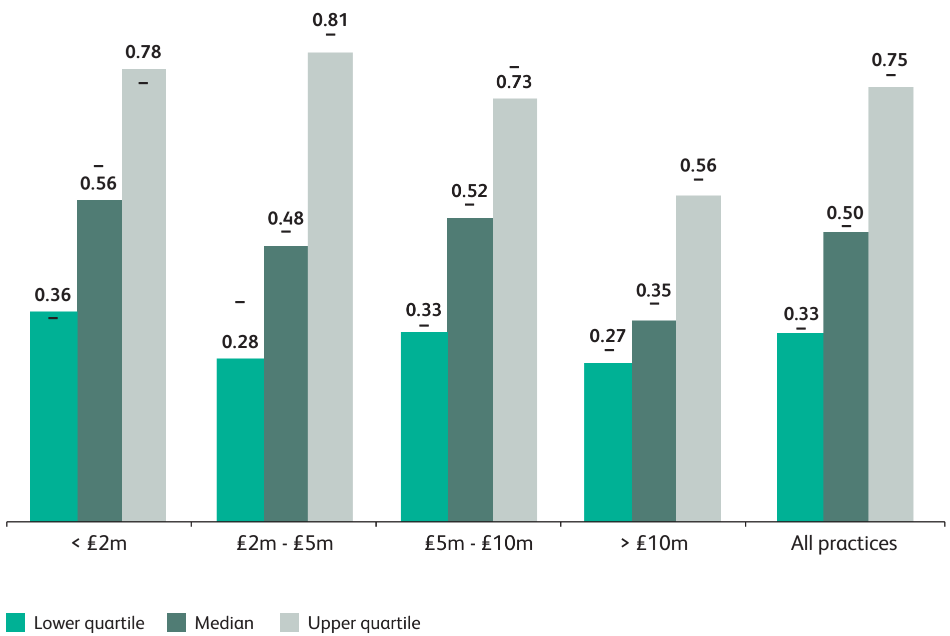


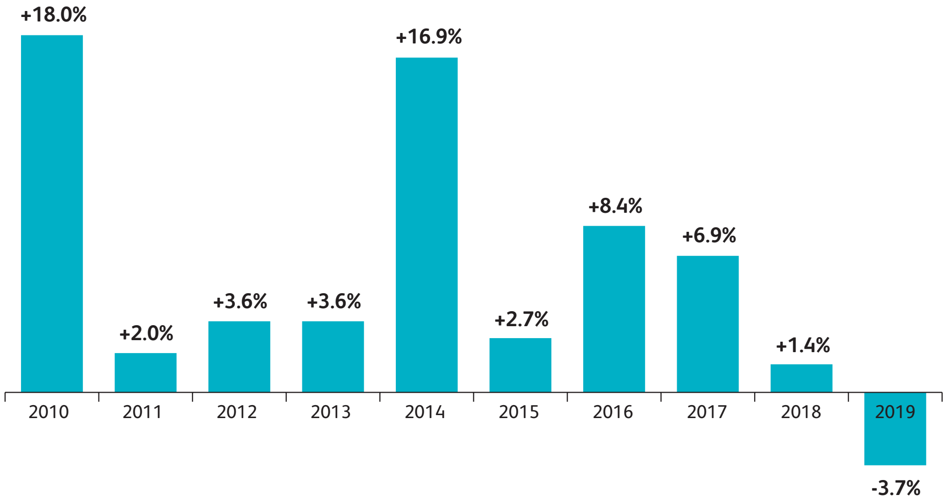
Figure 4.8: Number of other support staff per fee earner

Figure 4.9: Cost of support staff per fee earner (£'000)

5. Profitability

The reported median profit per equity partner (PEP) for participating firms has fallen for the first time since 2010, as shown in the graph below. Median profit per equity partner fell to £155,897 from £161,823 in 2018. Again, it should be noted that the composition of the sample across those ten years will have varied.

Median changes in PEP (%)

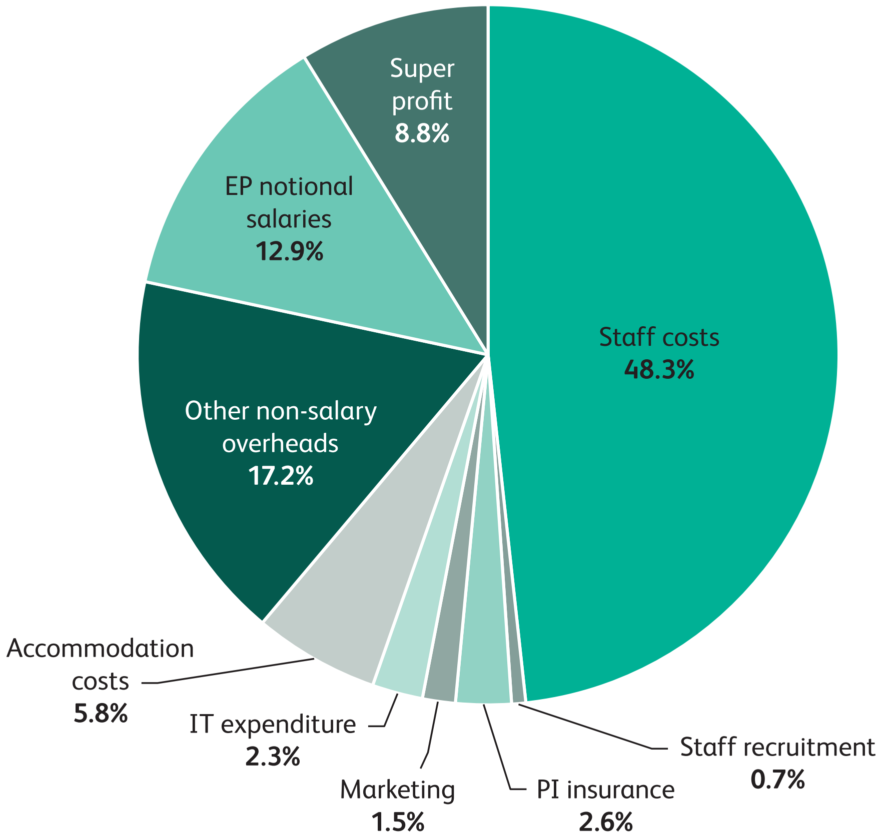


In addition, the net profit margin has also fallen, from a median of 22.0% to 21.7%, mainly as a result of the increasing staff costs that we saw in section 4. The reduced margin is particularly pronounced in the smallest and largest firms in the survey.

Almost a third of fee income is spent on non-salary overheads. The median amount per fee earner is £35,655, compared to £35,665 in 2018. We have looked in detail at expenditure on specific costs such as professional indemnity insurance cover, marketing and accommodation costs. When expressed as a proportion of income, there has been a drop from 31% in 2018 to 30% in 2019. Practices are continuing to focus on fixed costs, and seem resistant to price increases.

For many years, the general rule of thumb for staff costs, non-salary overheads and profit compared to income was 33%:33%:33%, but this ratio is no longer appropriate for the majority of firms, mainly as a result of increasing staff costs. If we combine the findings in sections 3, 4 and 5 of this survey, we arrive at the proportions shown on the following pie chart.

Overheads and profitability as a proportion of fee income (median results only)



In a bid to reduce overheads costs and improve productivity, some firms have begun outsourcing key functions:

- A quarter of participants either fully or partially outsourced their secretarial, typing and document production function.
- 31% of participants had fully outsourced their payroll function, either to specialist payroll bureaus or their accountants, and a quarter had partially outsourced it.
- A fifth of firms had partially outsourced their reception and telephone answering, although just 2% had fully moved to a dedicated bureau.
- Just 8% of participants had partially or fully outsourced their cashiering/bookkeeping function, with most preferring to keep their accounting function in-house.
- Three quarters of participants told us that they used external marketing support, for help with issues such as website and social media content.
- Almost 90% of participants either fully or partially outsourced their IT support and maintenance functions, and three quarters outsourced their IT servers and cloud-based storage to some extent.

Figure 5.1: Profit per equity partner (£'000)

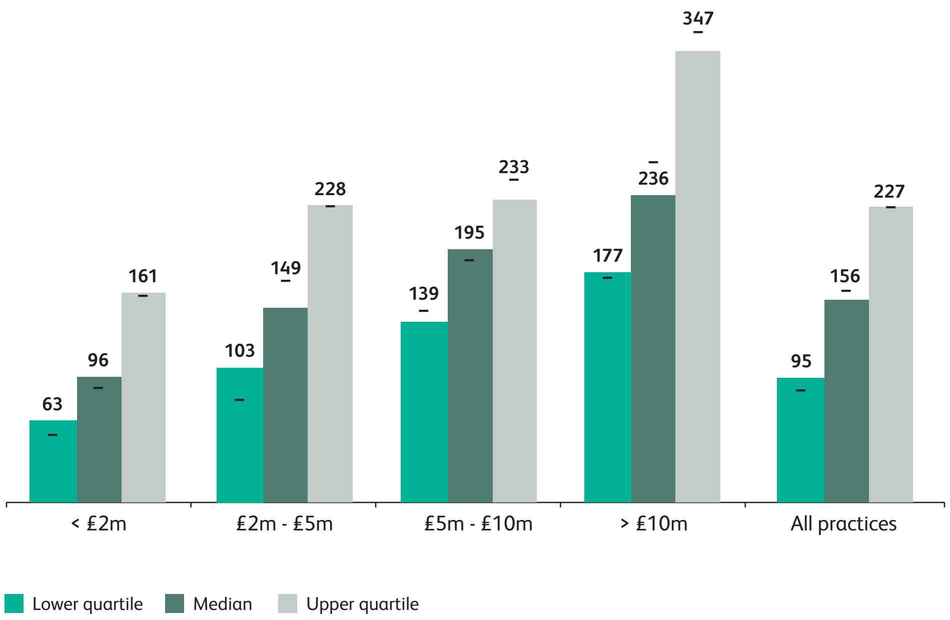


Figure 5.2: Profit per fee earner (£'000)

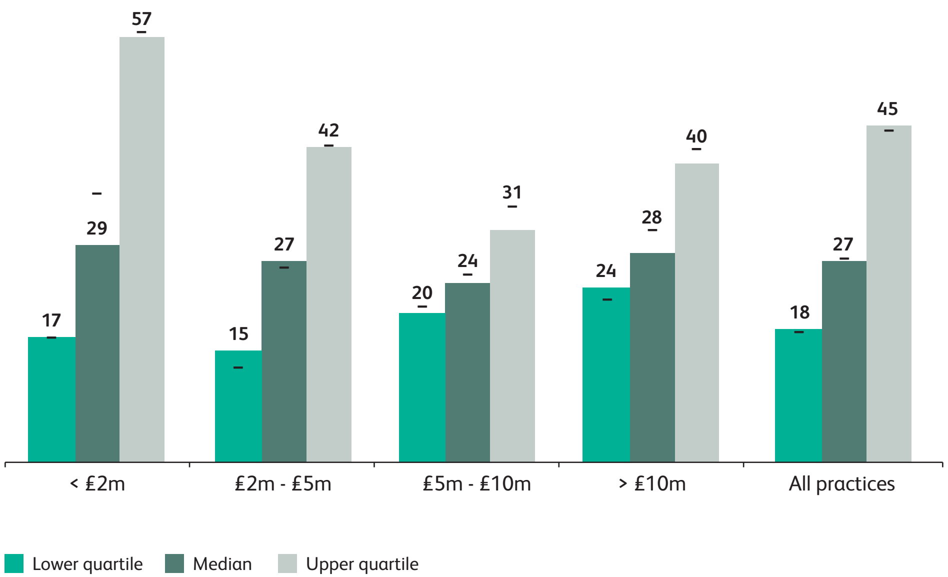
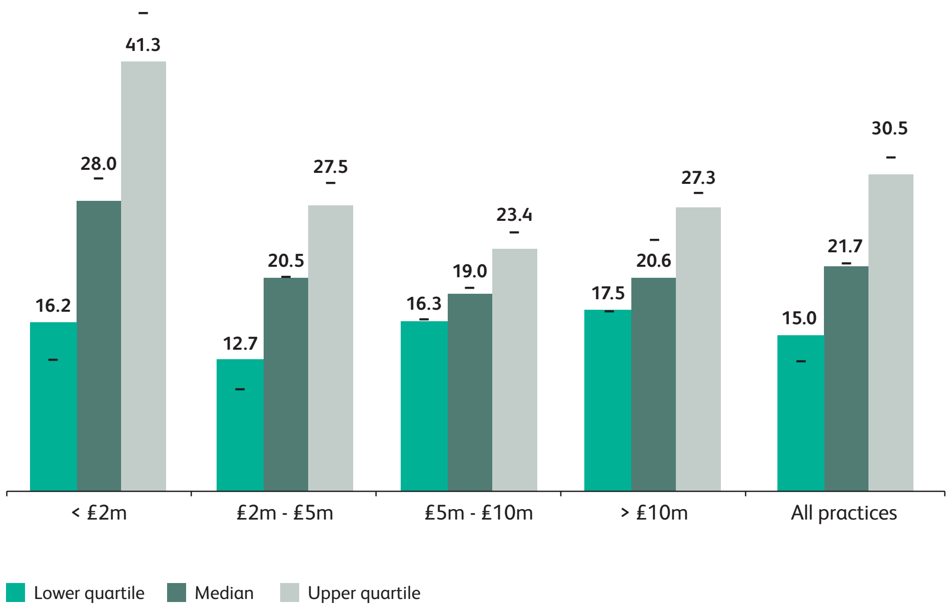


Figure 5.3: Profit as a percentage of total income (%)



Profitability – return on investment, i.e. super-profit

As law firm owners, equity partners expect to be rewarded for the salary equivalent for work that they do, and they also require a return for the capital invested in the practice and an additional "super-profit" for the risk and liabilities of running the practice. We refer to these as notional salary, notional interest and super-profit.

As noted in section 4, equity partner notional salaries have been calculated based on firms' highest fee earner salary plus an extra 15%.

Notional interest is set at 3% of partner capital/company reserves.

Super-profits are simply the net profit less notional salaries and notional interest.

In Figure 5.4 we show the "super-profit" per equity partner. In 2019, the median 'super profit' was £61,878, compared to £69,610 in 2018 - a reduction of 11.1%. Again, this has mainly resulted from all staff costs (including notional salaries) increasing ahead of fee income.

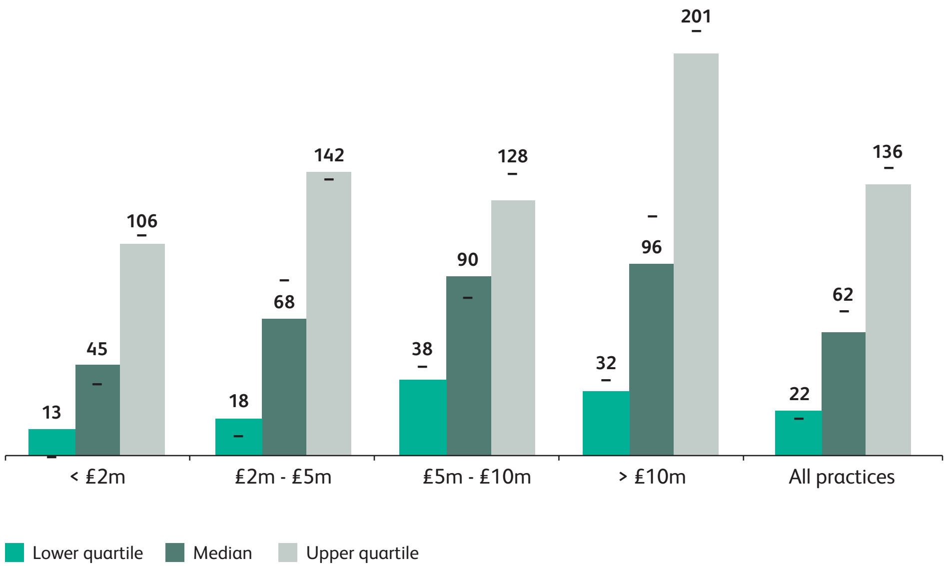
The median figure for super-profit as a percentage of total income has fallen, from 9.4% last year to 8.8% in 2019.

The notional salaries used for each size of firm are shown below the Figure on the right. As we noted in section 4, the larger the firm, the higher the notional salary. Mid-sized firms have been forced to pay higher salaries, in order to both retain and attract senior fee earners.

Super-profits per fee earner have reduced, to a median of £11,481 in 2019 compared to £11,696 in 2018.

Finally, 17% of firms in our survey reported a super loss, suggesting that partners in those firms could have earned more by being employed somewhere else. This is better than we saw last year though, when a quarter of firms saw a super loss.

Figure 5.4: Super-profit per equity partner (£'000)



Notional salaries

2019	51	81	98	129	86
2018	50	81	97	128	83

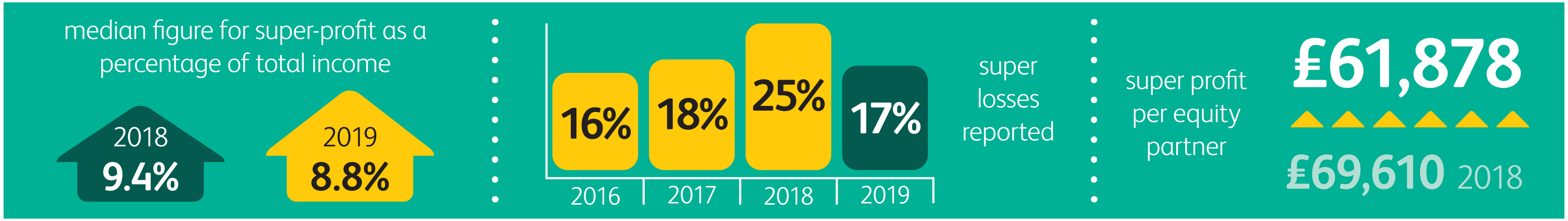


Figure 5.5: Super-profit per fee earner (£'000)

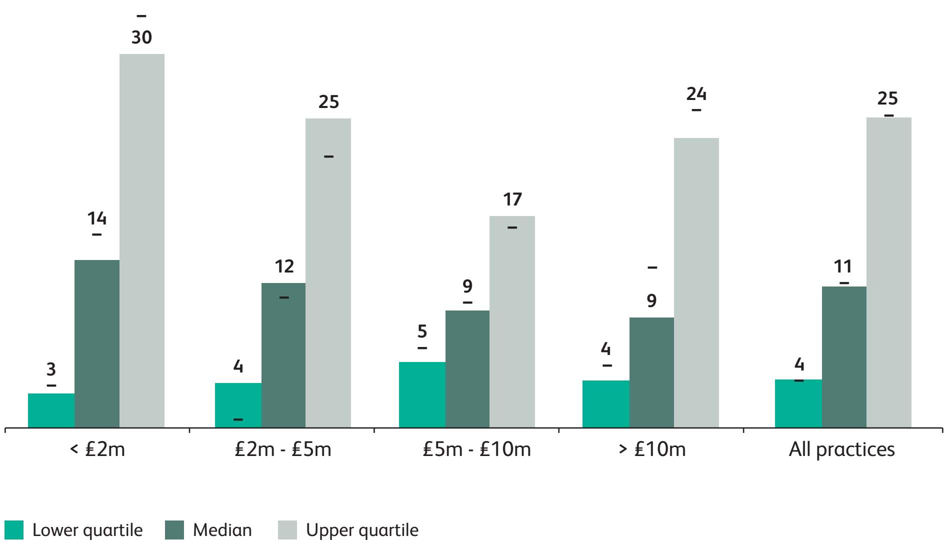
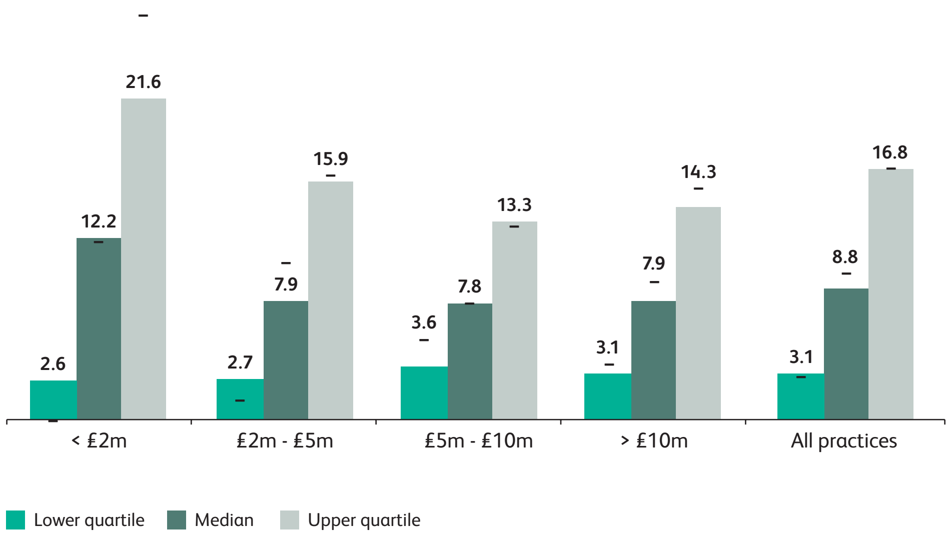


Figure 5.6: Super-profit as a percentage of total income (%)



Return on capital employed (ROCE)

ROCE is a measure of the returns made by a firm on the resources available to it. For a law firm, ROCE is measured in terms of super-profits as a percentage of partner capital in a partnership or LLP, or retained profits in a limited company. We use super-profit, as this takes account of notional salaries for partners, and also notional interest on partners' capital.

The results show a median ROCE of 31.6% for 2019. ROCE is higher in the smaller firms in the survey, mainly due to the fact that partner balances in those firms are typically lower than we see in larger firms, as explained in section 8.

Firms looking to attract new partners will be more successful with higher levels of ROCE. Potential investors or acquirers will pay more when a practice is achieving ROCE in line with the best performers in their size category.

Figure 5.7: Return on Capital Employed (super-profit as a percentage of partner capital) (%)

Non salary overheads

The graphs over the next few pages reveal that practices have continued to work hard to control their overheads, with non-salary overheads either falling or remaining consistent across all size of practice.

The professional indemnity insurance costs shown in figure 5.10 are based on firms' renewals from 2018, so are one year out of date. In 2019 we saw a hardening market, with some insurers departing from the solicitors primary PII market, and premiums increased for many firms, particularly for the excess layer/top up cover, where increases of 100% or more were not uncommon.

For the first time, we asked participants how much they spent on staff recruitment, and the findings are shown in figure 5.13. The median spend across firms of all sizes was very similar, at 0.7% of fee income.

Figure 5.8: Non-salary overheads as a percentage of fee income (%)

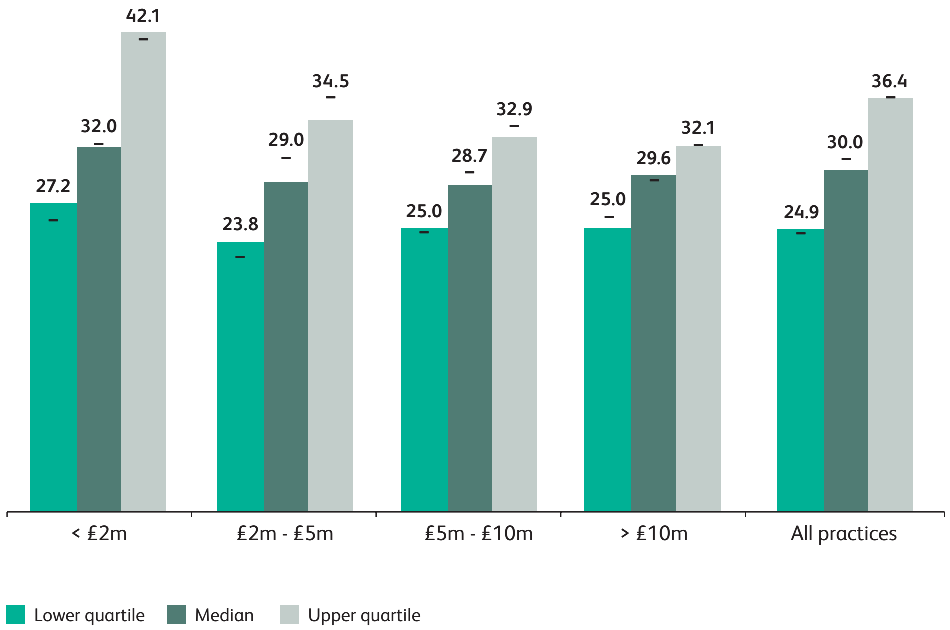


Figure 5.9: Non-salary overheads per fee earner (£'000)

Figure 5.10: PI insurance premium expenditure as a percentage of fee income (%)

Figure 5.11: Marketing expenditure (including staff costs) as a percentage of fee income (%)

Figure 5.12: IT expenditure (including IT support, IT consultants and cloud-based storage) as a percentage of fee income (%)

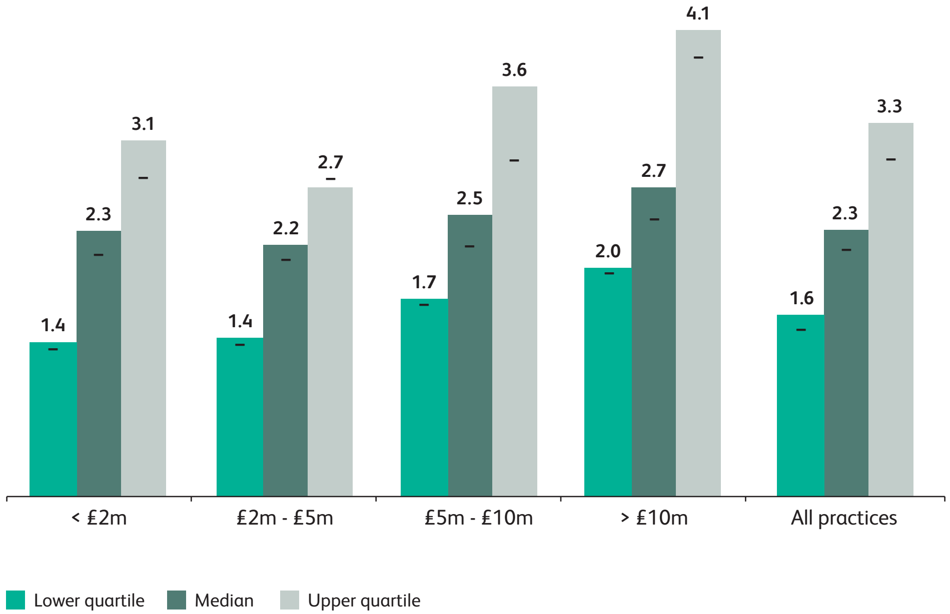
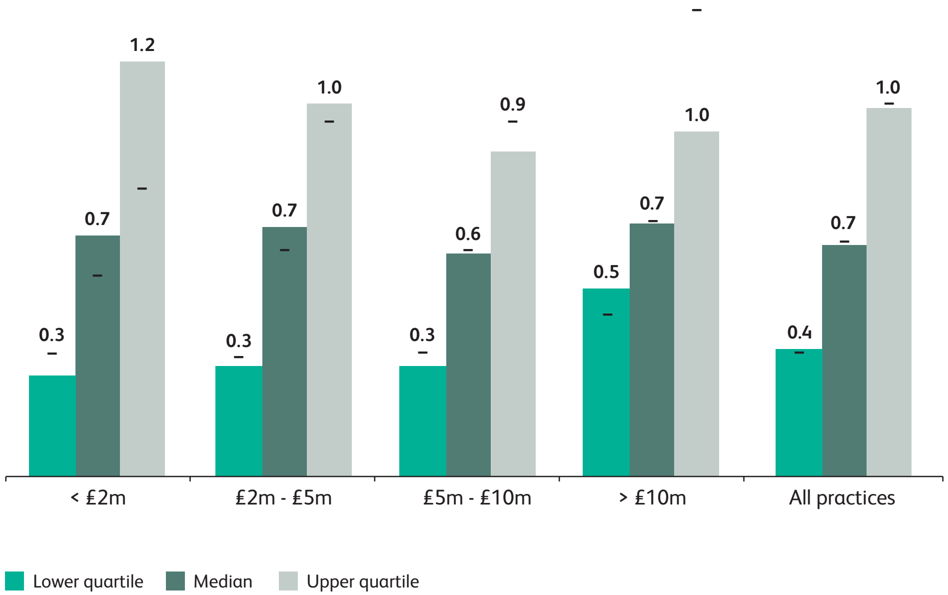


Figure 5.13: Staff recruitment costs (external or in-house) as a percentage of fee income (%)



Accommodation costs

After staff-related costs, accommodation costs are usually the next largest expense for any law firm. The results here show a median spend on accommodation costs of 5.8% of fee income, in line with the previous year.

Many firms are paying considerably more than this though, either due to prime locations (e.g. those in city centres or brand new offices), as a result of surplus office space, or both.

The cost of providing car parking spaces for staff is also increasing. Increased flexible working can help here, but it is not an option for lots of firms.

A few firms in the survey pay a reduced rent on their premises, either because the property is owned by the principals or former principals of the firm, or because they have managed to negotiate reduced rent with their landlords. Where this is the case, those firms have provided us with a current market rental value, so that the results shown are as if on a third-party basis.

Figure 5.14: Accommodation costs as a percentage of fee income (%)

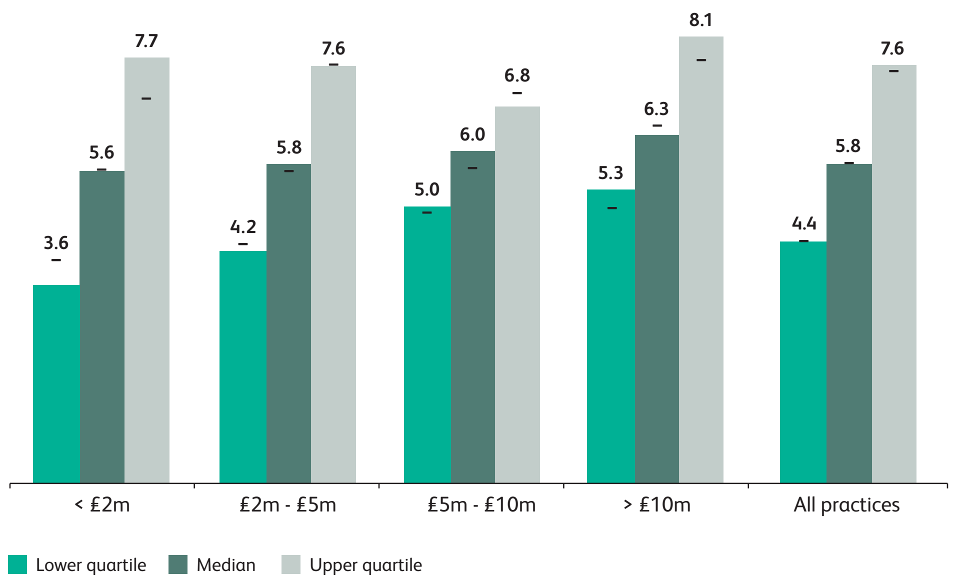


Figure 5.15: Premises rental payments as a percentage of fee income (%)

Figure 5.16: Other premises costs (rates, light and heat and maintenance) as a percentage of fee income (%)

Characteristics of profitable firms

In this section we examine the characteristics of the firms that achieved above-average levels of profitability in this year's survey and compare them against the same characteristics of the firms that achieved lower than average levels of profitability. We have focused on four key areas:

- Fee earner gearing;
- Fee income per equity partner;
- Total salary costs, including notional salaries for equity partners;
- Non-salary overheads.

The figures shown in the following charts have been calculated by separating all participants into two groups: those with net profit per partner above the median shown in Figure 5.1, and those with net profit per partner below the median, in each turnover band. We then reanalyzed these two groups, to calculate new median figures.

The four Figures in this section show two bars for each turnover band. The bars on the left are the figures for the firms with above-average levels of profitability, and the bars on the right are for the firms with lower than average levels of profitability.

Figure 6.1: Fee earner gearing (median figure only)

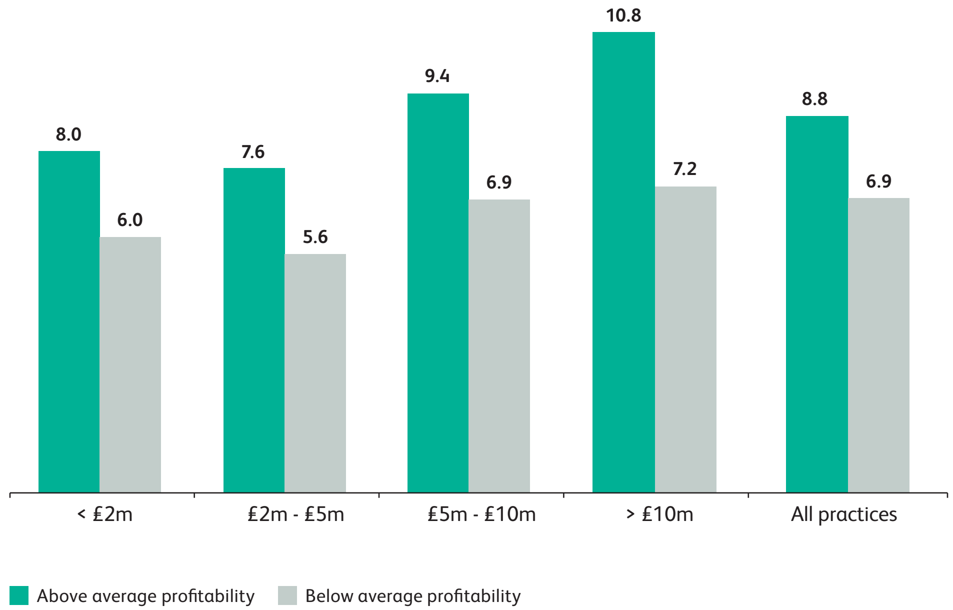


Figure 6.2: Fee income per equity partner (£'000) (median figure only)

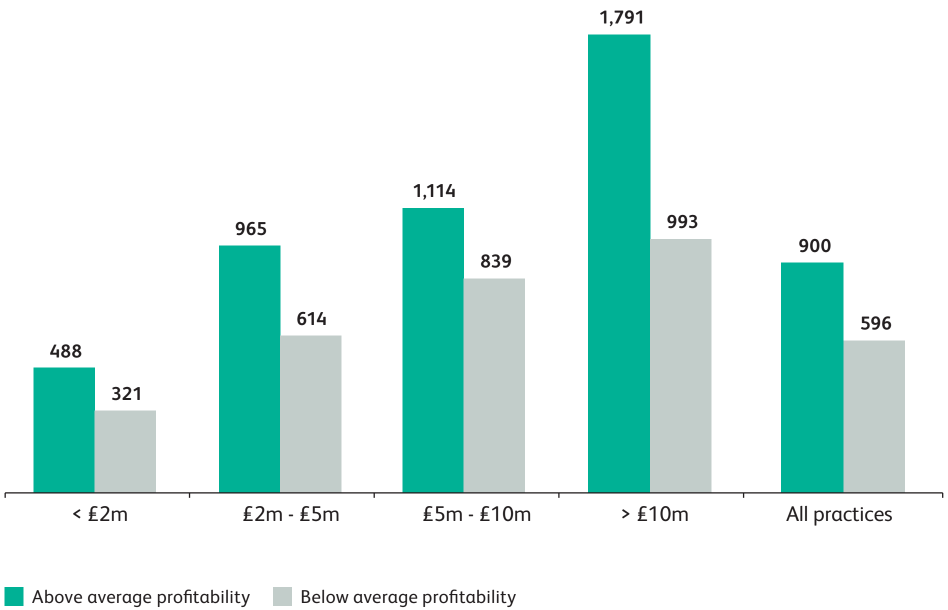
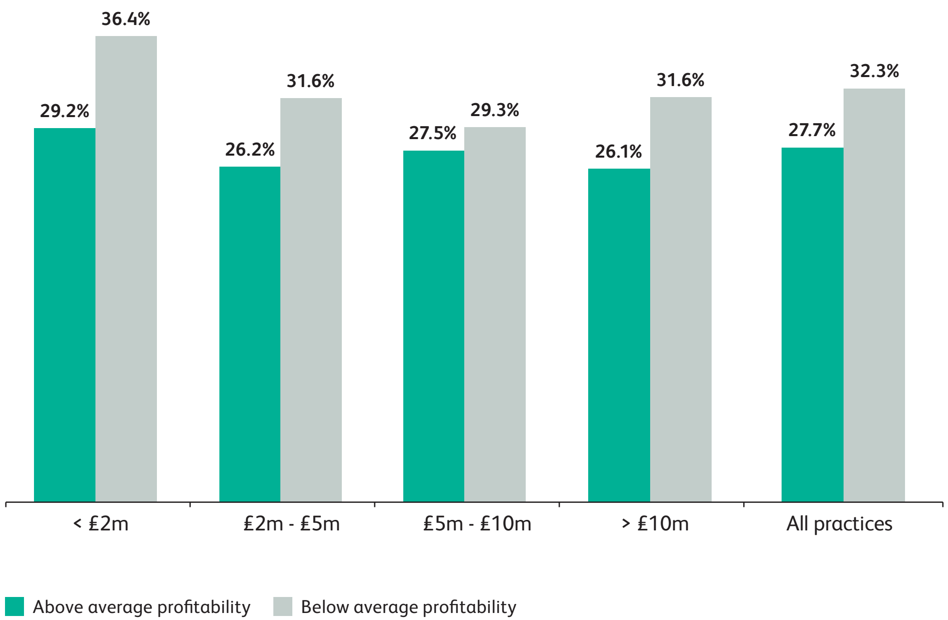


Figure 6.3: Total salary costs, including notional salaries, as a percentage of fee income (median figure only)

Figure 6.4: Non-salary overheads as a percentage of fee income (median figure only)



7. Working Capital

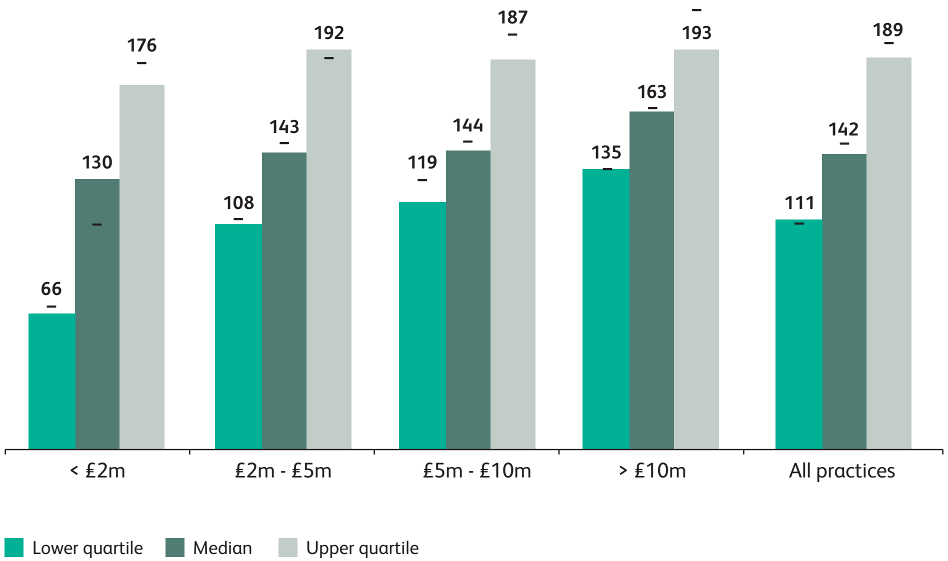
It is always difficult to conclude on trends on working capital management in a survey of law firms, as lock up (work in progress and debtors combined) varies so dramatically in differing areas of law.

However, the median number of days lock up has fallen by about 3% between 2018 and 2019, and we have seen reductions in both WIP and debtor days, both of which are good news. We must remember that our data is collected for balances at the year-end date only, which may not be reflective of a full twelve-month period.

Even a small reduction in lock up can make a significant difference to cash flow. For a firm with turnover of £5m, a one-week reduction in lock up would free up £100k of cash.

As a matter of general good procedure, firms need to ensure that they continue to focus on reducing lock up where at all possible, as high lock up can not only lead to adverse cash flow issues but often also leads to increased bad debt exposure too.

Figure 7.1: Total lock up (days)

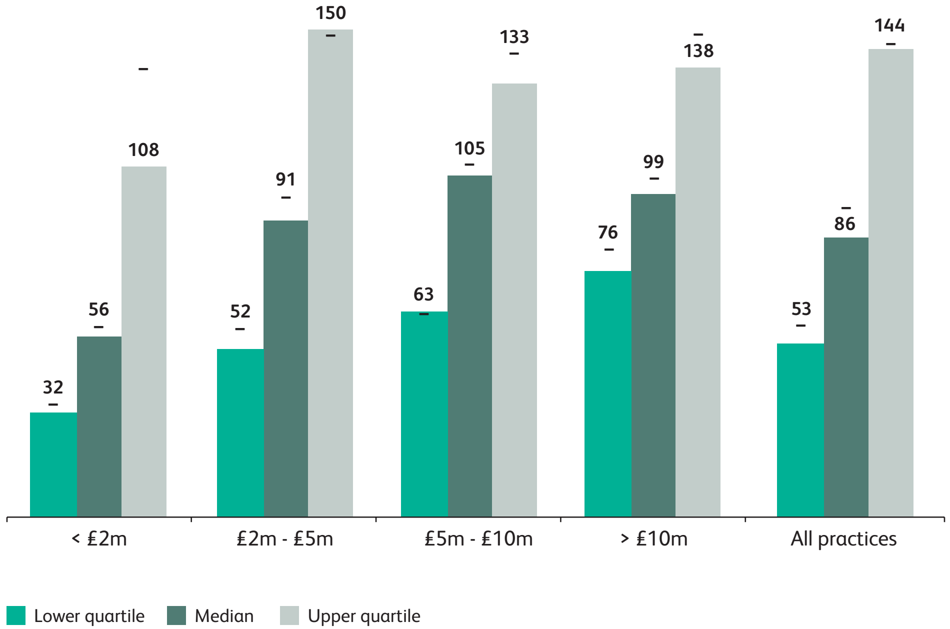


WIP days

WIP days have been calculated based on total WIP per participants' time records, as opposed to the figure included in their accounts, as for many practices the figure in the accounts does not include large amounts of contingent WIP.

The survey shows a reduction in WIP days across all of the turnover bands, with a median of 86 days, compared to 93 days in 2018.

Figure 7.2: WIP days (days)



Debtor days

As per last year, the survey shows very little change in debtor days between 2018 and 2019, with a reduction from 45 to 43 days. Our own experience is one where:

- Fee earner training on managing lock-up can make a huge difference.
- Increased effort continues to be directed at pre-billing client communication and cash collection, resulting in fairly quick realisation of current invoices.
- Small changes to standard practice, such as raising bills as soon as the work is complete, can make a big difference to how soon you get paid. Moving away from billing at month-end to billing across the month can also result in clients paying a full month earlier.
- Many practices continue to carry large amounts of unbilled disbursements, and often do not ask for money on account of them, even in areas where you would have thought it was straightforward for them to do so, e.g. property work.
- It can often be helpful to remove fee earners from the credit control function entirely. Fee earners generally do not like having difficult conversations with clients, and appointing a dedicated credit controller can allow balances to be chased sooner and more effectively, and will allow fee earners to focus on fee earning.

The SRA introduced new Accounts Rules in November 2019. Under the new Rules, some firms are able to hold money received on account of fees and disbursements in their office account, even if the work has not been carried out, which could make a huge difference to cashflow. Also, firms that hold money on account of disbursements in their client account now need to raise an invoice or send written notification of costs before they can reimburse themselves for any disbursements paid from office account. Under the previous Rules, a bill was not required for disbursements.

It will be interesting to see how these changes impact on debtor days in next year's survey.

Figure 7.3: Debtor days (days)

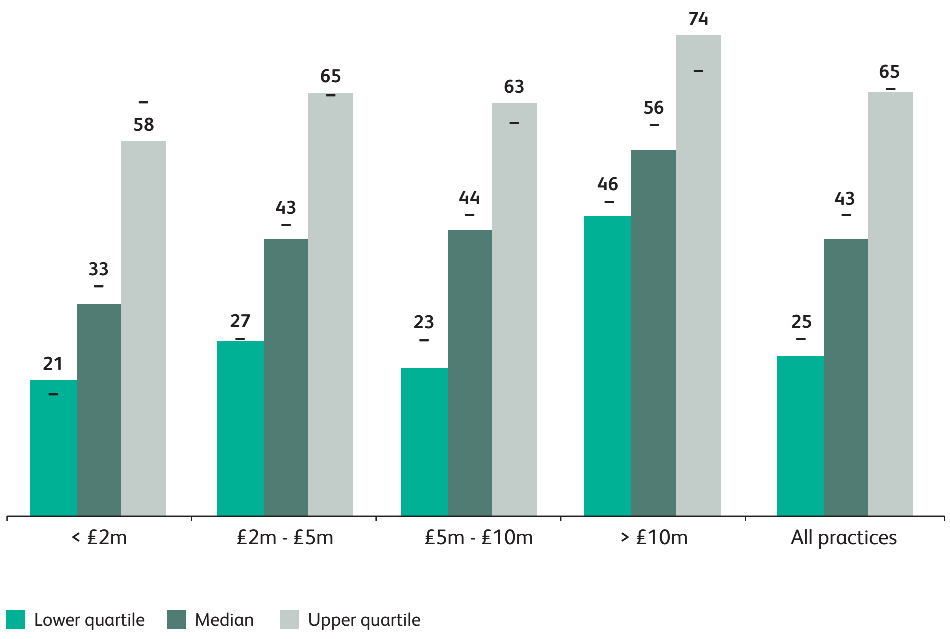
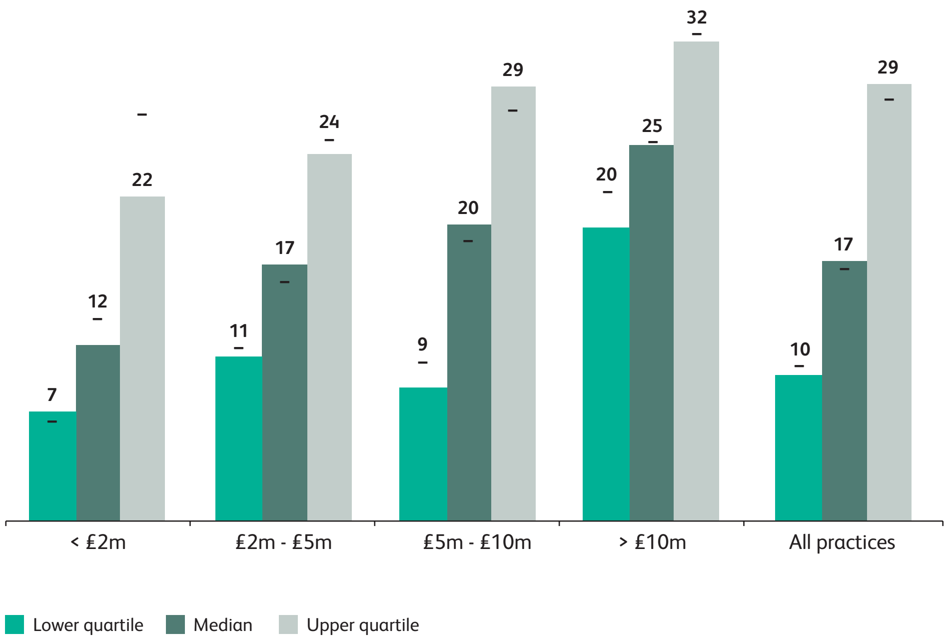


Figure 7.4: Debtors per fee earner (£'000)



Working capital – equity partner funding

Equity partner capital in a partnership or LLP is the total combination of capital account, current account and tax reserves. In a limited company, capital comprises share capital and retained profits.

The participants in this year's survey reported a median 12.2% increase in partner capital in 2019, which reverses the drop that we saw in 2018.

The median balance has risen from £195,684 in 2018 to £219,691.

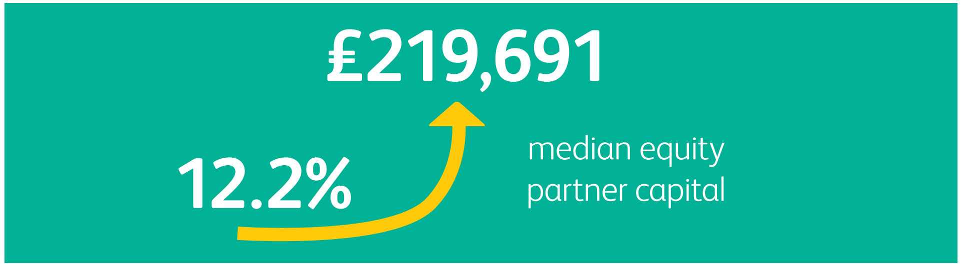
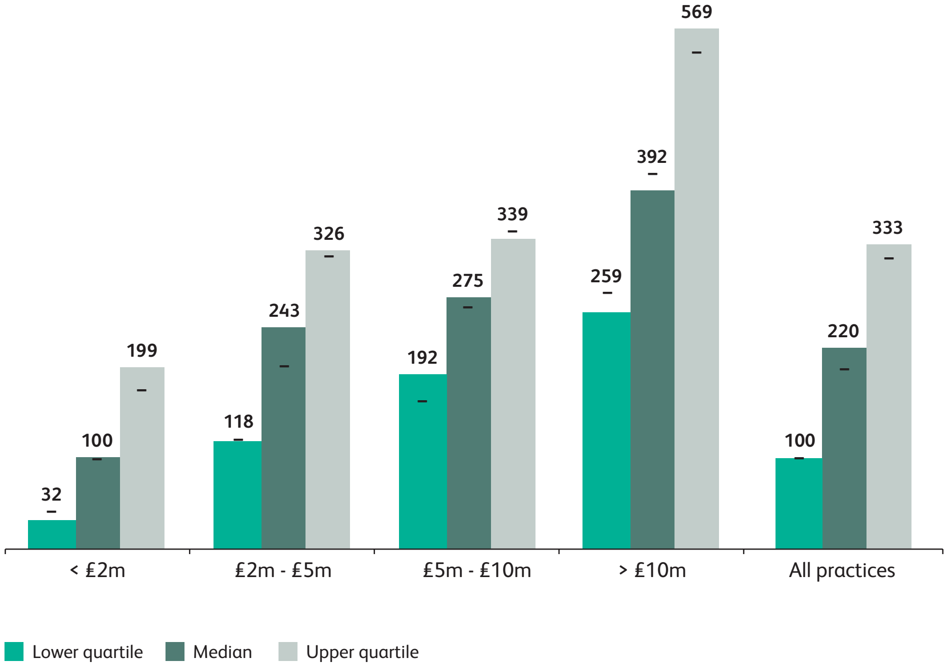


Figure 7.5: Partners' account balances per equity partner (£'000)



Bank and other borrowings

Just over two thirds of participants reported a positive office account balance at their most recent accounting date. The median office account balance across all participants was £89,000, with all turnover bands reporting a positive median balance.

Fewer than one in five participants reported that they operated with no overdraft or borrowings at all. For those firms that had bank borrowings and/or a bank overdraft, the median amount per equity partner was £58,550.

Approximately a third of the participants had non-bank borrowings such as hire purchase or finance agreements. The median amount per equity partner was £26,679.

Finally, just 20% of firms told us that they use secondary funding to finance payments such as the firm's VAT, partners' tax bills, etc.

On the whole, these findings are encouraging. However, it is important to bear in mind that these are very much a snapshot of the position at participants' accounting dates, and may not be reflective of the position over a 12-month period.

Figure 7.6: Year-end office account bank balance (£'000)

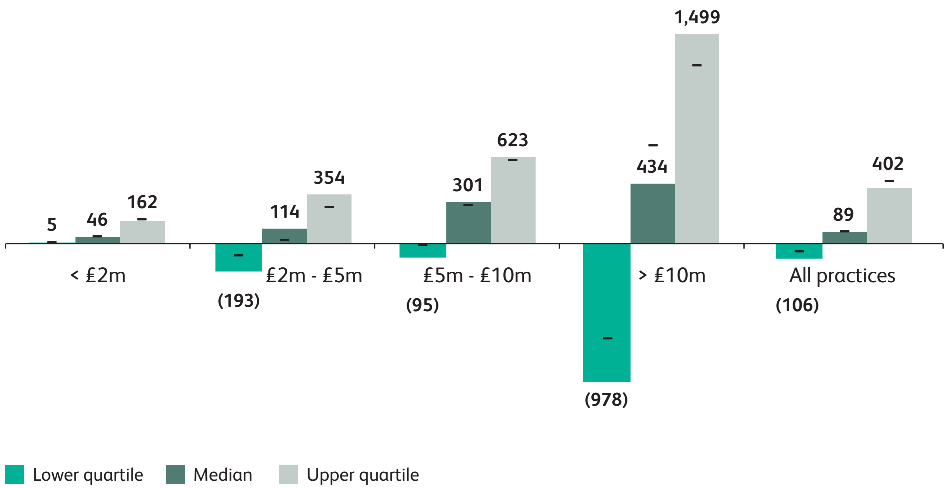


Figure 7.7: Bank borrowings per equity partner (£'000)

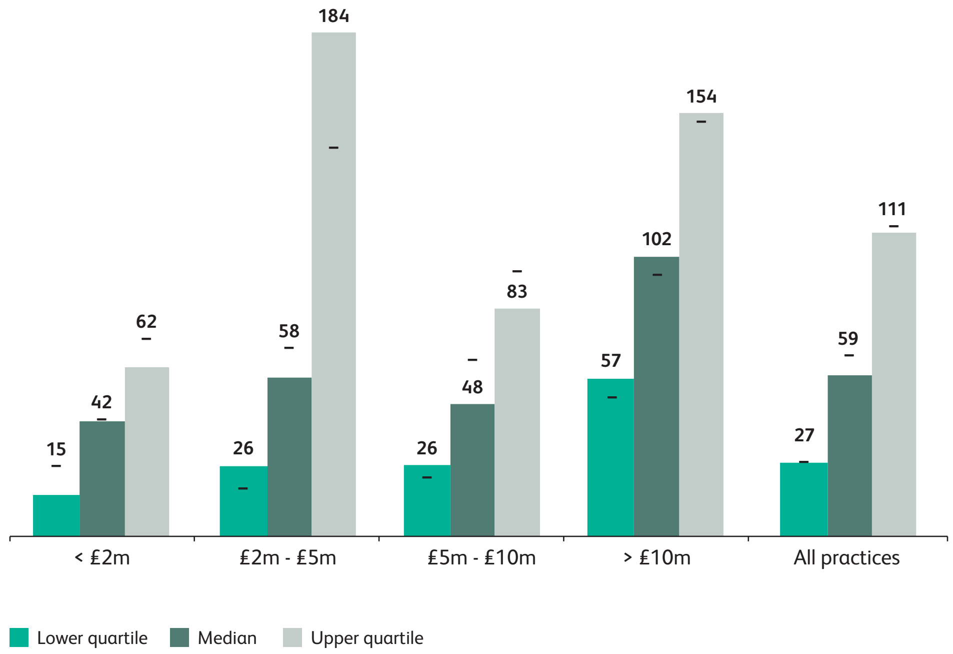
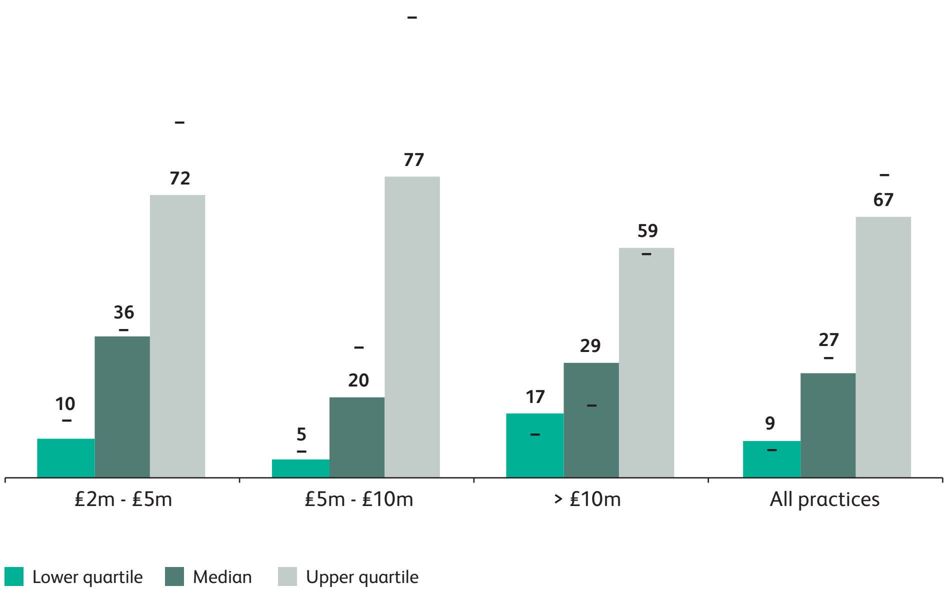


Figure 7.8: Other borrowings per equity partner (£'000)



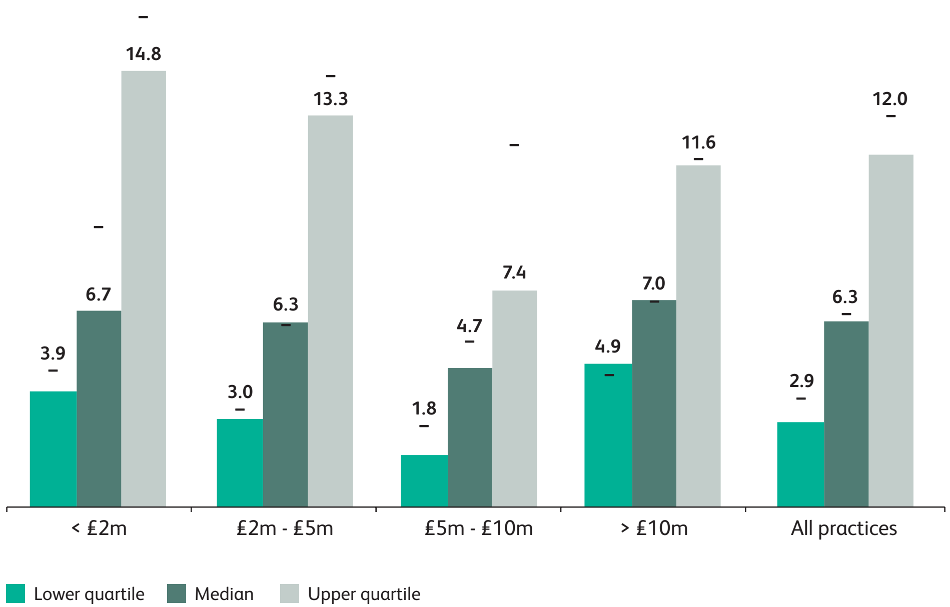
Banks' attitude to lending

Banks continue to view the legal sector positively overall, although there is an increasing reluctance to lend to firms specialising in areas such as personal injury or clinical negligence work, where very high levels of WIP and disbursements often result in corresponding high levels of debt.

As per last year, we have seen considerable levels of new lending, secured by a debenture over the firm's assets only, where performance and debt to equity ratios support it. We are also seeing increasing pressure on some firms to bring overdraft levels down, or convert all or some of the balance to debt.

Many banks pay close attention to the ratio of borrowings to fee income when assessing ability to make repayments, and it is pleasing to see a median of 6.3% for the firms in the survey, compared to 6.5% a year ago.

Figure 7.9: Bank borrowings as a percentage of fee income (%)



Financial stability 8.

In 2015, the SRA began risk-assessing law firms based on selected figures from their annual accounts. The three warning indicators identified by the SRA were:

- Drawings in excess of profits.
- Borrowings in excess of net assets, i.e. net liabilities.
- Borrowings over a certain (undefined) level.

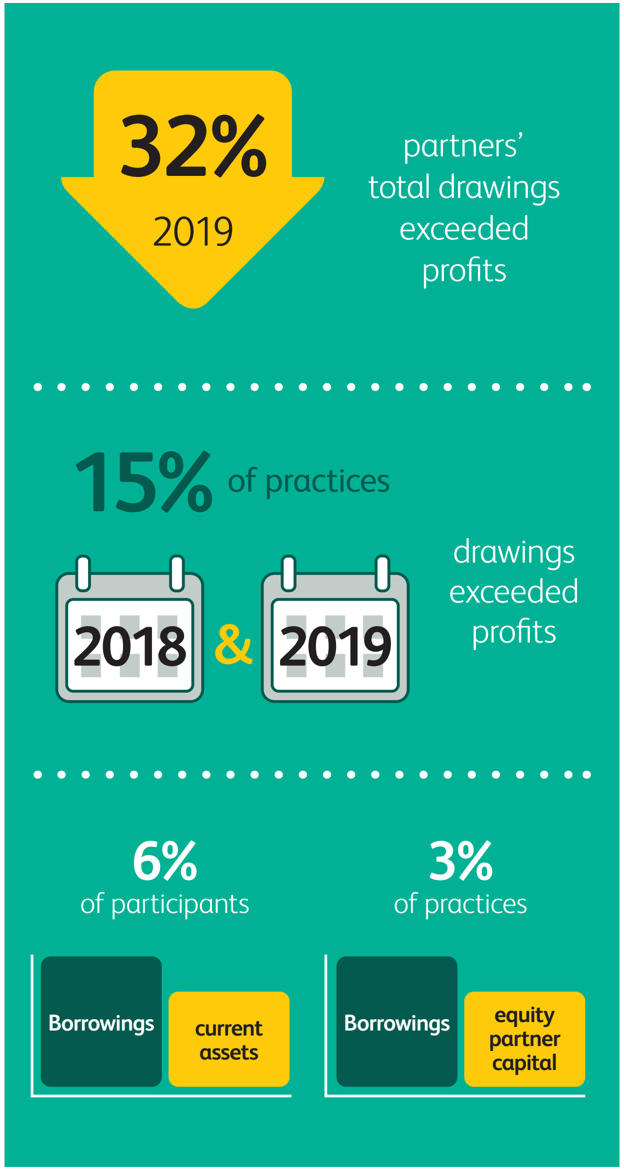
Based on these indicators, firms were assessed as red, amber or green, resulting in differing levels of supervision from the SRA. For example, red rated firms received intensive supervision from the SRA, were required to provide the SRA with regular management information and contingency plans, and were told to obtain professional insolvency advice.

Over the past few years, the SRA have moved their attention to other matters, and the majority of the firms that were initially assessed as red and amber are no longer required to provide the SRA with any financial information, and have little contact with them.

There is little doubt that the indicators used by the SRA were sensible, and the focus on financial stability encouraged partners in many firms to take action.

Every year since 2015 we have analysed the information provided by participants to see how they fared. This year's findings are as follows:

- In 2015 and 2016, partners' total drawings (including income tax) exceeded profits for a quarter of participants. In 2017, this increased to 30%, and the upward trend continued in 2018, with partners in 36% of practices taking drawing in excess of profits. The figure has fallen back slightly in 2019, to 32%. As we have noted in previous years, sometimes this is no more than a timing difference, i.e. when partners decide to withdraw profits, so is not necessarily a cause for concern.
- Of more concern is that in each of the last four years we have found that partners in 15% of practices had taken drawings in excess of profits for two consecutive years. This is less likely to have arisen from timing differences.
- Borrowings exceeded current assets (WIP and debtors combined) for just 6% of participants, compared to 8% last year. Borrowings exceeded equity partner capital for 3% of firms this year, slightly up on last year.



9. The short term future

Every year, we ask participants for their fee predictions for the next 12 months. Last year, firms predicted a median growth in fee income for 2018/19 of 3.2%, so a little way below the actual median growth of 5.1%. The median growth prediction for 2019/20 is 3.9%, with larger firms in the survey feeling notably more optimistic than smaller firms.

The upper quartile predicted growth of up to 8.9%, whilst the lower quartile predicted a fee reduction of 1.2%.

Figure 9.1: Predicted change in fees for 2019/20 as a percentage of this year's fees (%)