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Small Firms

Howard Hackney

# Maximising profitability

# Introduction

# Howard Hackney

Howard left Grant Thornton UK LLP in 2008 where he had been a partner for over 25 years to establish his own boutique practice. During his time at Grant Thornton he was head of professional practices for the North West and head of family businesses for the UK. At Grant Thornton he had a variety of roles including office Managing Partner, North West regional marketing partner and membership of the partners appointments panel. Howard specialises in advising mid market professional practices and family businesses. In 2002 he won the CBI's national award as "Best Business Adviser“.

Howard's focus is providing "special projects" advice to firms with up to 20 partners. His experience extends from highly profitable sole practitioners to advising 3 of the top 100 law firms. Recent assignments have included sales of law firms, partnership disputes, fund raising, LLP and ltd company conversion, ABS conversions and acquisitions.

howard hackney LLP

www.howardhackney.co.uk

www.mosaicma.co.uk

# Agenda

- Ask an accountant what 2+2 makes
- Applies to profit
- But old saying
  - Turnover is vanity
  - Profit is sanity
  - Cash is reality
- Look at each in turn
- Questions & comment throughout

# SRA –viability indicators

- Drawings in excess of profits
- Borrowings in excess of net assets
- Heavy dependence on high overdraft borrowing
- Inability to measure or control financial performance
- Over dominant senior/managing partner
- Lack of transparency of financial performance
- Narrow focus on single type of work
- Weak billing & cash collection processes

# Questions for you

- How many partners in your firm?
- What is your position in the firm?
- Do you have more than one office?

# Strategic issues

# The business models

- Process-driven, standardised, computerised, cost-sensitive, high-leverage – "factory"
  - susceptible to incorporation & 'corporate' structure & culture
  - Limited company structure?
- Collegiate - expertise, quality, relationship, low-leverage
  - preferring the 'traditional' partnership and collegiality
  - LLP structure?
- Niche

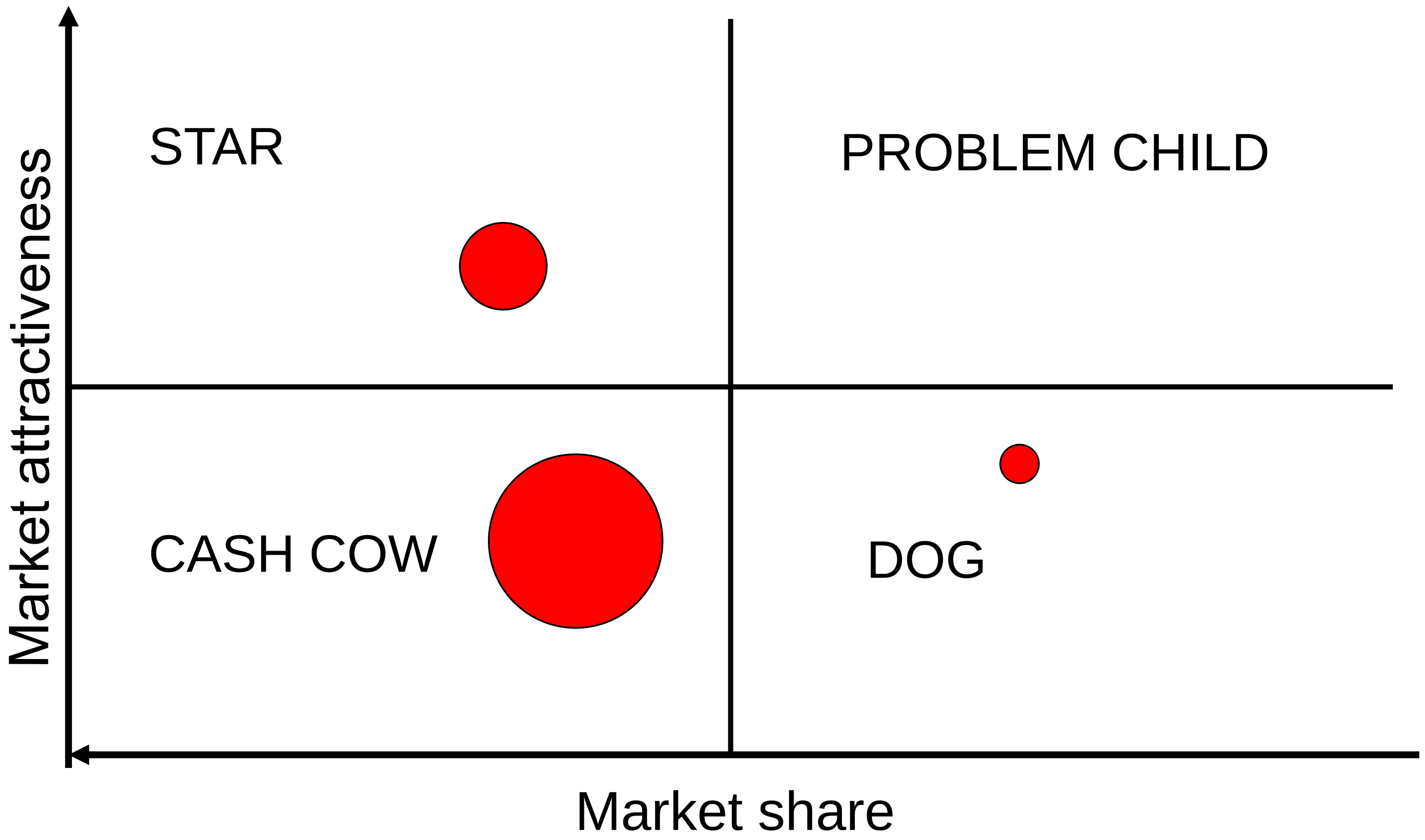
# Strategic issues to address

- Size
- Geographic location
- Desired profitability
- Which clients / sectors
- Many others but these should address them

# Tools

- Old Hat??? BUT
- SWOT analysis – aid to thinking
- Boston Matrix
- Facilitator
  - Provides independence
  - Resource to "make it happen"
  - May need individual interviews to unlock  issues

# Boston Matrix



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# Question for you

- Are you process driven or collegiate or a mixture?

# Questions?

# Understanding profit

# P&L account

| | |
|---|---|
| Fee Income | 900,000 |
| Fee earners employment costs | (450,000) |
| Gross Profit | 450,000 |
| *Gross profit %* | *50%* |
| Overheads | (100,000) |
| Net profit | 350,000 |

# But what about partners?

| | | |
|---|---|---|
| Fee Income | 900,000 | 900,000 |
| Equity partners notional salaries | 0 | (100,000) |
| Fee earners employment costs | (450,000) | (450,000) |
| Gross Profit | 450,000 | 350,000 |
| *Gross profit %* | *50%* | *39%* |
| Overheads | (100,000) | (100,000) |
| Net profit | 350,000 | 250,000 |
| Equity partners notional salaries | 0 | 100,000 |
| Net profit for division | 350,000 | 350,000 |

And Rent??

# Cash or fees?

| | |
|---|---|
| Cash received | 825,000 |
| Opening debtors | (50,000) |
| Closing debtors | 125,000 |
| Fee income | 900,000 |

# What about WIP?

- Accrued income – where contractual right to income e.g. billable on time recorded basis even if no invoice
- Accrued income valued at selling price
- WIP – valued at cost
- But contingent often not included for tax purposes

- If drawings based on fee income – can be a problem

# WIP impact

| | | | | |
|---|---|---|---|---|
| Cash received | **825,000** | **800,000** | **780,000** | **630,000** |
| Opening debtors | (50,000) | (50,000) | (50,000) | (50,000) |
| Closing debtors | 125,000 | 125,000 | 125,000 | 125,000 |
| Opening accrued income | | (25,000) | (25,000) | (25,000) |
| Closing accrued income | | 50,000 | 50,000 | 50,000 |
| Opening WIP | | | (60,000) | (60,000) |
| Closing WIP | | | 80,000 | 80,000 |
| Opening contingent WIP | | | | (200,000) |
| Closing contingent WIP | | | | 350,000 |
| Fee income | **900,000** | **900,000** | **900,000** | **900,000** |

# Question for you

- Are you confident that you have an accurate value for WIP month on month??

# Increasing profit

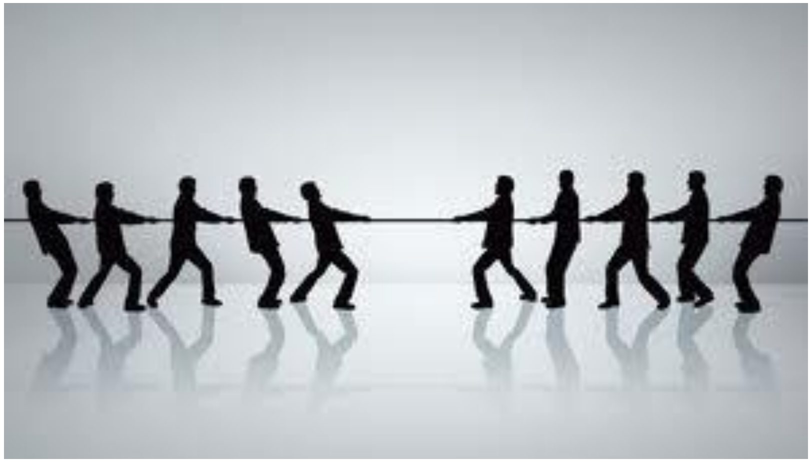
# It's easy!!

- Increase fee income
- Decrease costs

- Reduce the partners?
- Collect the cash

# But is it? – opposing forces

- growth v lock up/cash collected
- utilisation v recovery
- growth v profitability
- departmental rivalry
- making it happen



# The office model 1

| | Available hours | Billable Hours | Unbillable Hours | Charge rate £ | Available £ | Billable £ |
|---|---|---|---|---|---|---|
| Partner | 2,000 | 1,000 | 1,000 | 250 | 500,000 | 250,000 |
| Associate 1 | 2,000 | 1,200 | 800 | 200 | 400,000 | 240,000 |
| Associate 2 | 2,000 | 1,200 | 800 | 175 | 350,000 | 210,000 |
| Associate 3 | 2,000 | 1,200 | 800 | 160 | 320,000 | 192,000 |
| Other | 2,000 | 1,200 | 800 | 100 | 200,000 | 120,000 |
| | 10,000 | 5,800 | 4,200 | | 1,770,000 | 1,012,000 |
| Unrecovered time | | | | | | (112,000) |
| Billed | | | | | | 900,000 |
| Less salaries and overheads | | | | | | (550,000) |
| Profit | | | | | | 350,000 |
| | | | | | | |
| Recovery % | | | | 900 \ 1,012 | | 89% |
| Productivity % | | | | 1,012 \ 1,770 | | 57% |

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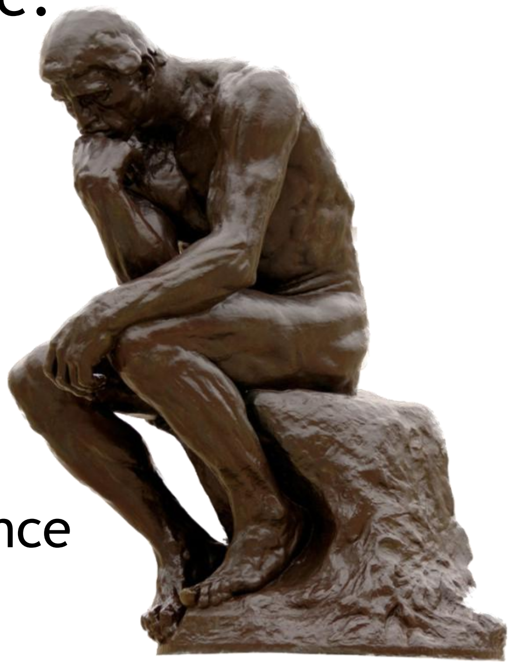
# The office model 2

| | Available hours | Billable Hours | Unbillable Hours | Charge rate £ | Available £ | Billable £ |
|---|---|---|---|---|---|---|
| Partner | 2,000 | 1,000 | 1,000 | 250 | 500,000 | 250,000 |
| Associate 1 | 2,000 | 1,500 | 500 | 200 | 400,000 | 300,000 |
| Associate 2 | 2,000 | 1,500 | 500 | 175 | 350,000 | 262,500 |
| Associate 3 | 2,000 | 1,500 | 500 | 160 | 320,000 | 240,000 |
| Other | 2,000 | 1,500 | 500 | 100 | 200,000 | 150,000 |
| | 10,000 | 7,000 | 3,000 | | 1,770,000 | 1,202,500 |
| Unrecovered time | | | | | | (152,500) |
| Billed | | | | | | 1,050,000 |
| Less salaries and overheads | | | | | | (550,000) |
| Profit | | | | | | 500,000 |
| | | | | | | |
| Recovery % | | | | 1,050 \ 1,203 | | 87% |
| Productivity % | | | | 1,203 \ 1,770 | | 68% |

# Thoughts

- Zero based budgeting – at start of year – “rightsize”
- Time on clock more likely to be billed
- Charge out rates – base on market – balance:
  - On clock more likely to be billed
  - Credibility of the rates
- But we work on fixed fees:
  - Just as important to record
  - Practice management tool
  - Measure of individual & departmental performance
  - Ability to direct resources at right level
  - Choice of type of work



# Benchmark data

(for budget setting)

# Benchmarks

- From LMS 2013 inter firm comparison
- 165 firms of which 142 with 2 to 25 partners
- Increase in fee income from 2012 - 4.1%
- Sweet spot is 11-25 partners
- Health warning
  - Notional salaries of £48k - £70k per EP
  - Which firms take part?

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# Fee income

| | Median | Lower | Upper |
|---|---|---|---|
| Fees per equity partner £'000s | | | |
| All firms | 550 | 370 | 867 |
| 11-25 partners | 638 | 485 | 897 |
| PI | 730 | | |
| Conveyancing | 408 | | |
| Criminal | 153 | | |
| Trusts | 105 | | |
| Fees per fee earner £'000s | | | |
| All firms | 117 | 101 | 139 |
| 11-25 partners | 123 | 105 | 140 |
| Fee earner gearing | | | |
| All firms | 4.7 | 3.1 | 6.7 |
| 11-25 partners | 5.0 | 3.9 | 6.5 |
| PI | 4.0 | | |

# Employment costs & expenses

| | Median | Lower | Upper |
|---|---|---|---|
| Employment costs £'000s | | | |
| Fee earner | 48 | 41 | 55 |
| Support staff | 21 | 18 | 26 |
| Costs per hour £ | 97 | | |
| People costs as % of fee income | 59.6% | 50.4% | 64.7% |
| Marketing as % of fee income | 2.2% | 1.4% | 3.1% |
| IT as a % of fee income | 1.6% | 1.1% | 2.5% |

# Profit

| | Median | Lower | Upper |
|---|---|---|---|
| Profit per EP £'000s | | | |
| All firms | 121 | 80 | 185 |
| 2-4 | 99 | 65 | 214 |
| 11-25 | 132 | 104 | 172 |
| >25 | 146 | 109 | 208 |
| Profit per FE £'000s | | | |
| All firms | 25 | 18 | 42 |
| 2-4 | 26 | 16 | 51 |
| 11-25 | 23 | 16 | 38 |
| >25 | 31 | 26 | 38 |
| Profit % of fee income | 22.3% | 15.5% | 30.5% |

# Funding

| | Median | Lower | Upper |
|---|---|---|---|
| Lock up days | | | |
| All firms | 177 | 137 | 250 |
| Residential conveyancing | 88 | | |
| Family & matrimonial | 153 | | |
| Probate | 137 | | |
| Med Neg | 466 | | |
| Capital per EP £'000s | 158 | 82 | 261 |
| Borrowing per EP £'000s | 46 | 16 | 101 |

# Making it happen

(Relentless hard work & attention to detail)

# KPIs

- Billing
- Work done (chargeable hours)
- Recovery
- Productivity
- Lock up

- By partner
- By fee earner
- By department

- Month & year to date
- Against budget (& previous year)

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# Making it happen

- Client focussed
  - Payment on account
  - Terms of business
  - Credit control procedures
  - Interest charges for late payment
  - Agree payment profiles
  - Credit checks and credit limits
- Fee earner focussed
  - Approach to daily work management
  - Behaviour influence
  - PRP & bonus scheme
  - KPI’s allocated to individuals
- Partner focussed
  - Link drawings to cash collected
  - Profit sharing adjustments
  - Additional capital

# Making it happen

- sharing information & explaining it
- hearts & mind
  - link to target setting/appraisal
  - incentivisation
  - leading by example
  - people need to have a grasp of numbers
- reporting lines
- identifying the players to keep and bind in
- and the underperformers
- individual action plans

# Making it happen

- fee earner responsibility
- mind set/no exceptions
- prompt billing
  - billing throughout the month
  - on account billing / disbursements
- delivery of bills
- transfer of funds from client account
- daily cash reports

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# Questions for you

- Does your firm operate a time recording system
- For those who do, do you get helpful information from it?

# Questions?

# Funding

# Relevance

- Fewer partners = better PEP
- Fewer partners = more funding required per partner
- Control of lock up important

# Lock up

- Funds tied up in debtors and WIP
- Needs to be funded by partner cash or the bank
- Increasing lock up = less available to partners and/or more needed from the bank
- Growing practices are likely to need more funding:
  - Meet salaries and O/Hs that are paid before fees received
  - Credit control may slip
  - Growth may come from being price competitive = lower profits
- Typically measured in number of days

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# Lock up calculation

| | |
|---|---|
| Fee income | 1,500,000 |
| | |
| WIP | 80,000 |
| Accrued income | 50,000 |
| Debtors from clients | 125,000 |
| Disbursement debtors | 50,000 |
| | 305,000 |
| | |
| In days | 74 |

BUT it is not that simple!!

# Lock up calculation

| | | |
|---|---|---|
| Fee income | 1,500,000 | 1,500,000 |
| | | |
| Contingent WIP | 0 | 350,000 |
| WIP | 80,000 | 80,000 |
| Accrued income | 50,000 | 50,000 |
| Debtors from clients | 125,000 | 125,000 |
| Disbursement debtors | 50,000 | 50,000 |
| | 305,000 | 655,000 |
| | | |
| In days | 74 | 159 |

# Gearing

- The ratio of external funding (bank) to partner capital
- Primarily a banking issue
- Is also a partner risk issue
- Banks rarely lend > one:one

# Gearing calculation

| | |
|---|---:|
| Fixed assets | 15,000 |
| Current assets | |
| WIP | 80,000 |
| Accrued income | 50,000 |
| Debtors from clients | 125,000 |
| Disbursement debtors | 50,000 |
| | 305,000 |
| Current liabilities | |
| Trade creditors | 10,000 |
| Bank borrowing | **100,000** |
| | 110,000 |
| Net current assets | 195,000 |
| Net assets | 210,000 |
| | |
| Partner capital | **210,000** |

BUT it is not that simple!!

# Gearing calculation

| | | | |
|---|---|---|---|
| Fixed assets | 15,000 | 15,000 | 15,000 |
| Current assets | | | |
| Contingent WIP | 0 | 350,000 | 350,000 |
| WIP | 80,000 | 80,000 | 80,000 |
| Accrued income | 50,000 | 50,000 | 50,000 |
| Debtors from clients | 125,000 | 125,000 | 125,000 |
| Disbursement debtors | 50,000 | 50,000 | 50,000 |
| | 305,000 | 655,000 | 655,000 |
| Current liabilities | | | |
| Trade creditors | 10,000 | 10,000 | 10,000 |
| Bank borrowing | **100,000** | **100,000** | **300,000** |
| | 110,000 | 110,000 | 310,000 |
| Net current assets | 195,000 | 545,000 | 345,000 |
| Net assets | 210,000 | 560,000 | 360,000 |
| | | | |
| Partner capital | **210,000** | **560,000** | **360,000** |

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# Bank criteria


- Gearing – 1:1
- Security - varies but 30% to 50% debtors & WIP
- Debt to fee income < 40%
- Personal Guarantees??!! – try to limit and avoid joint and several and supported
- Interest cover – at least 2 times but less used
- Others but vary from bank to bank

# The numbers

| | | Security value 1 | Security value 2 |
|---|---|---|---|
| Fixed assets | 15,000 | 0 | 0 |
| Current assets | | | |
| Contingent WIP | 350,000 | 105,000 | 175,000 |
| WIP | 80,000 | 24,000 | 40,000 |
| Accrued income | 50,000 | 25,000 | 25,000 |
| Debtors from clients | 125,000 | 62,500 | 62,500 |
| Disbursement debtors | 50,000 | 25,000 | 25,000 |
| | 655,000 | | |
| Current liabilities | | | |
| Trade creditors | 10,000 | | |
| Bank borrowing | **300,000** | | |
| | 310,000 | | |
| Net current assets | 345,000 | | |
| Net assets | 360,000 | | |
| Partner capital | **360,000** | | |
| Fee income | 1,500,000 | | |
| Debt to fee income | 20% | 241,500 | 327,500 |

# War stories

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# A sample

- Partner drawings linked to cash collected
- Time recording introduced – increase in profits
- Staff bonus scheme linked to SMART financial objectives
- Split banking for partners & the firm
- Buy out achieved with no increase in bank exposure

# Questions?

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