The Law Society's Leadership and Management Section

Financial Benchmarking Survey 2023

The Law Society

In association with Hazlewoods LLP

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Foreword

In tough economic times the resilience of law firms shines though, although we need to remember these findings pre-date the cost-of-living crisis, the UK's political contortions of 2022 in terms of multiple Prime Ministers and of course the impact of the war in the Ukraine. The results reflect the property boom of 2021 and the challenges in the service economy during 2021/2022 financial year. Resilience is though a good sign, knowing as we do that firms are currently steering through the on-going choppy waters.

Firms reviewing this year's FBS might like to consider the growth in fee income, the 10-day reduction in lockup and the median equity capital trends. These three give a great insight into fee income, collection, and capital needs: all of which will be useful to help plan ahead.

The benchmarking aspect should help those who took part to be more profitable again. For those who did not take part, looking at the trends can help with their planning and of course taking part next time would ease the use of the data as every firm who participates gets a personalised summary to help them with business planning using their own data.

Paul Bennett
Chair, Law Management Section Executive Committee
February 2023

About the Law Leadership, Management and Operations Section

Formerly known as the Law Management Section, the group has newly changed its name to the Law Leadership, Management and Operations Section (or in short - Leadership and Management Section). The change is part of our ambitious strategy for strengthening and growing this community.

The Law Leadership, Management and Operations Section is the community for partners, leaders and practice managers in legal businesses. Established in 1998, the Section provides guidance on best practice and innovation to law leaders, managers and operational staff. The Section delivers essential practical knowledge, focusing on legal practice management and challenges, including: operations, people, finance, business development, client care quality and regulation.

The comprehensive range of services and benefits includes:

- *Managing for Success* quarterly magazine;
- *Law Leadership, Management and Operations* e-newsletter bi-monthly;
- dedicated member-only portal featuring relevant resources, including topical news updates and on-demand event recordings;
- online events on practical tips and advice;
- the *Leadership and Management Financial Benchmarking Survey;*
- the *Leadership and Management Quarterly Pulse Survey* – real-time insights on key metrics four times a year;
- networking opportunities;
- 20% discount on Law Society publications
- discounted registration to on a range of other Law Society events (a variety of in-person and virtual)
- Opportunity to share your expertise/ raise my profile within the community by contributing to the Section's programme of activities

Save the date: New Future of Work Conference, taking place in September/October 2023.

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

Benefit from Corporate Membership

Individual membership costs £199, but why not take advantage of even greater savings with our corporate membership deal? For only £399 your firm can nominate up to six staff members (and £60 for additional people), who can all enjoy the individual benefits of being a Law Leadership, Management and Operations Section member.

For more information, visit:
communities.lawsociety.org.uk/leadership-and-management
email: MSadmin@lawsociety.org.uk
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Sarah Moore
Membership Engagement Manager, The Law Society

Sarah works with the Law Society's Law Leadership, Management and Operations Committee to plan and deliver the Member offering, identifying key areas of concern for the membership and providing practical guidance and know-how through a variety of resources, including events, online classrooms, editorial content and a quarterly magazine. For any feedback in relation to the Section offering and suggestions or ideas around future content or speakers for events, please contact leadershipandmanagement@lawsociety.org.uk.

About Hazlewoods LLP

The *Leadership and Management Section 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 37 individuals, all working closely together, who focus only on this.

We are retained by over 200 law firms countrywide on a recurring basis, and advise at least 40 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**

This is the 14th year that we have compiled the Leadership and Management Section 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

Business and Commercial Banking at Lloyds Bank

Lloyds Bank is delighted to again sponsor the annual LMS Financial Benchmarking Survey, which provides vital benchmarking data for law firms. It is an invaluable tool for law firm owners, partners and managers to understand best practice and to might the right business decisions.

We work closely with solicitors to provide funding and support that meets the specific needs of your business. Our specialist Relationship Managers are Lexcel trained, understand practice management standards, and the opportunities and threats that face the profession. They are also trained in the SRA Accounts Rules. We have a range of support available to you, from funding professional indemnity insurance to providing card payment solutions. We also support firms to bring in new partners through partner capital loans, and to manage client money through a range of secure accounts.

As businesses continue to navigate an uncertain economic climate and ongoing pressures on costs our dedicated and Relationship Managers work with their clients to provide a range of financial and non-financial support measures. We are committed to being by the side of our business customers, supporting them through this year and beyond.

Becci Wicks
UK Head of Legal, SME & Mid Corporate
Lloyds Bank Commercial Banking
www.lloydsbank.com/solicitors

LLOYDS BANK

Introduction

Members of the Law Society's Leadership and Management Section are represented in law firms across England and Wales. For over 20 years, the Leadership and Management Section has produced the annual Leadership and Management Section 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 solicitor firms across England and Wales, allowing those firms and others – particularly from the mid-market – to benchmark their performance against peers and over time.

The 2023 survey was carried out between July and October 2022, when society was recovering from the COVID-19 pandemic. As detailed in the following section, the majority of participants have either a 31 March or 30 April accounting date, and therefore the entirety of their comparative results for 2021 will have been impacted by COVID-19.

155 law firms from across England and Wales have taken part, and are concentrated in the mid-market, with a combined turnover of £1.1billion. We anticipate that most of the participants' income relates to domestic work. For reference, in 2019-20 total domestic turnover for all firms in England and Wales was £27.2billion, 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 2022 are shown as columns and numbers, and the like-for-like results for 2021 are shown as a dash, i.e. - .

Participants are analysed in more detail in the following section.

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. In order to allow the findings to be statistically valid, we have only provided full results for categories where at least 30 firms participated in the survey.

Although we have a particularly strong representation from mid-sized firms this year, as detailed in the following section, fewer than 30 participants were in the £10million to £35million turnover band, and therefore the charts and statistics quoted throughout this report only reflect the median figures for those firms.

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

Participants

155 law firms from across England and Wales took part in this year's survey, comprising almost 13,000 partners and employees. The fee income of all participants totals £1.1billion - an average of £7.1million per practice - and combined net profits of £277million.

As in previous years, 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 firms in England and Wales in each band is also shown.

Turnover band	Total number of practices	Number of participating firms	%
Up to £2million	8474	43	0.5
£2 million to under £5 million	714	43	6.0
£5 million to under £10 million	258	42	16.3
£10 million to under £35 million	188	24	12.8
£35 million+	145	3	2.1
Total	**9779**	**155**	**1.6**

There was a good proportionate participation amongst firms with a turnover greater than £5million. There was a lower proportionate participation from firms with turnover below £2million, but this is due to the number of smaller firms, with the majority of firms being in the smaller band.

As shown in the chart on page 7, the majority of participants had either a 31 March, 5 April or 30 April accounting date. It is worth noting therefore that, from the 2023/24 tax year onwards, self-employed individuals and partners will be taxed on a tax year basis, rather than an accounting year basis, i.e. individuals will pay tax on profits arising in each tax year, regardless of their firm's accounting date. This will affect sole practitioners, partnerships and LLPs that do not prepare their accounts to either 31 March or 5 April. Limited companies are not affected.

To make the preparation of personal tax returns easier, we anticipate that many firms will move their accounting dates to 31 March or 5 April, to tie in with the tax year. Firms will need to be careful that they do this at the correct time in order to avoid missing out on the ability to spread any accelerated tax bills resulting from the changes over up to five years.

The locations of the participants are as follows:

Region	Number of participating practices
Eastern	11
Greater London	16
Midlands	28
North East	5
North West	19
South East	23
South West	40
Wales	5
Yorkshire	8
Total	**155**

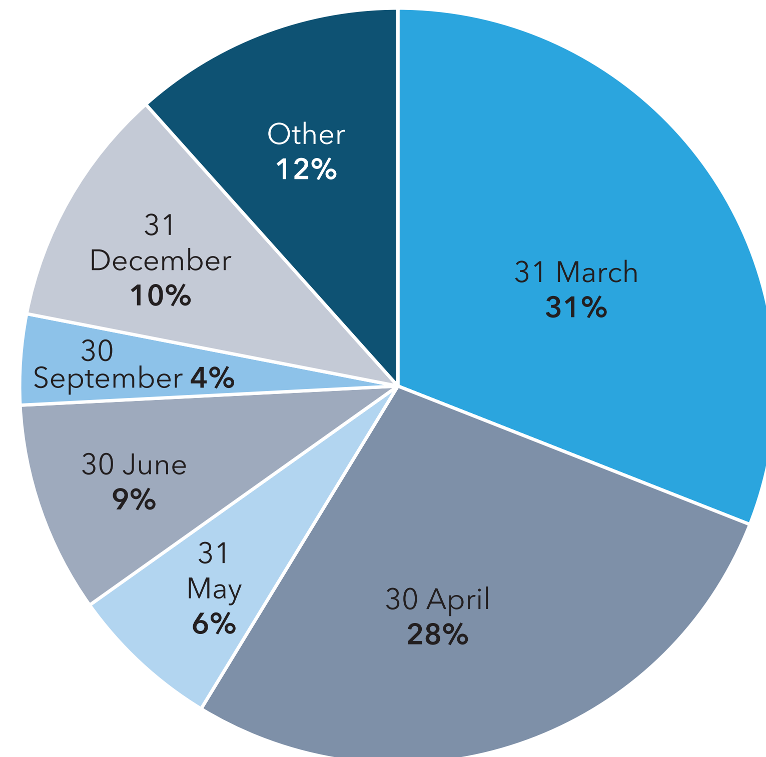
93% of participants traded as either a Limited Liability Partnership (LLP) or limited company. The remaining participants were unincorporated partnerships or sole practitioners. This is in different proportions to the percentages for the legal sector as a whole. According to SRA statistics, 54% of law firms were operating as a limited company, and 16% were operating as an LLP at 31 December 2022. These statistics, and more, can be viewed here: **www.sra.org.uk/sra/research-report/regulated-community-statistics/**

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

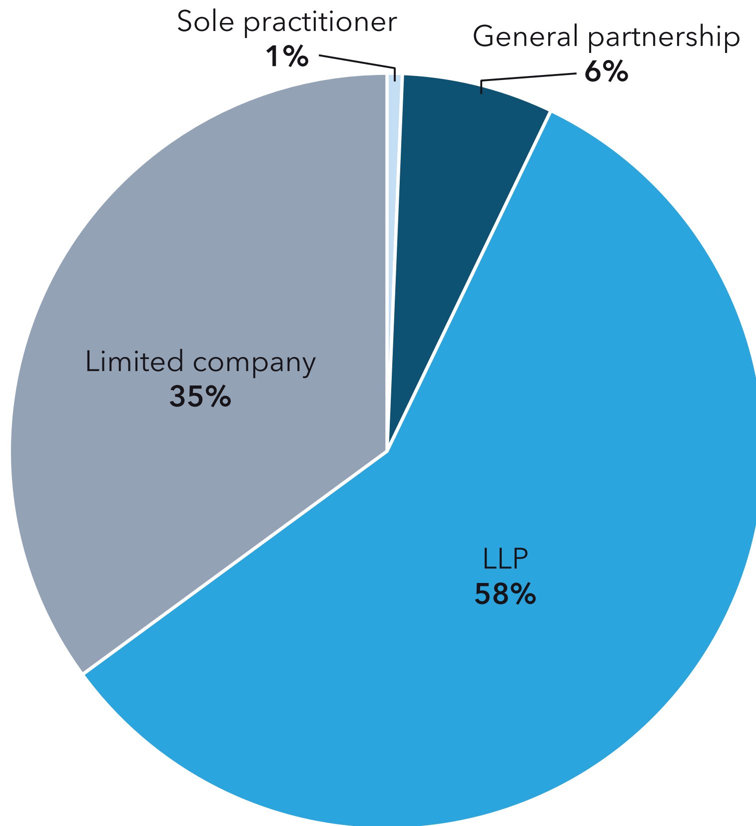
The SRA's statistics also show that the number of limited companies has increased by 159 in the last two years, whilst the total number of firms of all types has fallen by 434 over the same period.

With the rate of corporation tax set to increase to 25% for companies with annual profits over £250,000, and the marginal rate of income tax on personal dividend income increasing by 1.25% from 6 April 2022, it will be interesting to see if limited company status remains as popular in the coming years.

Financial year end of participating practices



Structure of participating practices



Looking back

We explored the impact of the Covid-19 pandemic on law firms' finances in detail in last year's survey. Despite the many challenges placed on firms throughout the pandemic, the overall picture was that many firms that took part in last year's survey saw stronger than expected performance in their 2020/21 financial years.

Overall profitability increased for the majority of firms in last year's survey, driven by a combination of the following:

- Increased fee income across all regions of England and Wales, and in most work types too. Firms specialising in residential conveyancing and employment fared particularly well.
- Salary costs as a percentage of fee income fell, due to a number of factors, including staff being furloughed during the period, delays in awarding pay reviews and promotions, and fees per fee earner rising by more than the increase in salaries.
- Non-salary overheads as a proportion of fee income also fell. In particular, we saw reductions in marketing, accommodation and other premises costs (light, heat, repairs, etc), and with staff working from home, other overheads such as printing, stationery and postage also fell for many firms.

Last year's findings showed a median increase in profit per equity partner of almost 40% - the largest jump in profitability that we had seen in 13 years of producing and writing the survey. For many firms in last year's survey, profit per equity partner and super-profit per equity partner were the highest they had ever been, and our experience was that this was the case for the majority of law firms.

Cash flow was also very strong in many firms. Almost three quarters of firms in last year's survey had borrowed monies through either of the BBILS or CBILS, and in many cases had not used the money months afterwards, preferring to hold onto it 'just in case'.

A return to normality

As life returned to something approaching normality, our experience was that most firms continued to see strong financial performance into 2022, as workflow remained strong in most areas. However, firms faced a series of new challenges, most notably increasing pressure to raise staff salaries in order to retain and attract good quality staff, and many saw large increases in their professional indemnity insurance premiums. There are mixed views on the benefits of agile working, but it is clear that in some cases there has been a negative impact on productivity.

As we will see in this survey, these challenges have impacted on net margins and profitability. However, it is important to remember that we are comparing profitability in 2022 against very strong profitability in 2021, and therefore despite the drop in overall performance, the majority of firms that took part in the survey have performed very well once again.

Looking forward

As noted above, the majority of firms that took part in this year's survey have either a 31 March or 30 April financial year end. As a result, our findings do not reflect many of the challenges currently facing firms, including record high inflation, increased bank base rates, record energy prices and high wages growth. We will discover the impact of all of these in next year's survey.

As we have said before, key to meeting these challenges is getting the most from staff, providing the best possible client service efficiently, and charging for it accordingly.

Fee earner breakeven point

By combining our findings throughout this report we are able to calculate the expected breakeven point for a fee earner. This is defined as the fees a firm must generate per fee earner before any profit (sometimes also referred to as fee earner contribution) is earned. As illustrated below, this is substantially more than simply the median cost of a fee earner.

	2022 £	2021 £
Median fee earner cost, including notional salaries for equity partners (Figure 5.5)	60,551	56,997
Median support staff cost per fee earner (Figure 5.10)	22,609	23,661
	83,160	80,658
Median non-salary overheads per fee earner (Figure 6.9)	39,469	37,108
Breakeven point per fee earner	**£122,629**	**£117,766**

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:

	2022 £	2021 £
Cost per hour	£111.48	£107.06
Cost per day	£557.40	£535.30

In Figure 4.5 we see that the median fee income per fee earner in 2022 was £138,925, which equates to £126.30 per hour based on 1,100 chargeable hour per annum. This means that just over 88% of fees earned by a fee earner are used to cover their costs. Looking at it another way, if a firm has a 31 March year end, on average it takes until 16 February for a fee earner to earn sufficient fees to cover his or her total costs for the year, and for the practice to start earning 'super-profits' for the partners.

These figures assume an average of five chargeable hours per day, but as we see at Figure 4.8, the median number of actual chargeable hours recorded by fee earners in many firms is well below 1,100 chargeable hours per annum.

Areas to focus on

Sections 5 (Employment costs) and 6 (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. UK inflation is currently running at over 10%, which is putting huge pressure on firms to increase salary rates, particularly as working from home means that it is much easier for staff to move to another firm for more money. Alongside this, high energy costs are pushing utility bills and other overheads upwards at an alarming rate.

Section 4 (Fee income) is therefore the key section for firms looking to increase profitability.

Fee earner performance

Fee income is driven by a combination of fee earner numbers per partner (fee earner gearing), chargeable hours recorded (productivity) and the amount billed and received for each of those hours recorded (recovery rate).

While fee earner gearing is an important metric when the industry is growing, COVID-19 has meant that firms have had to look much more closely at fee earners' capacity for chargeable work and the availability of that work. Put simply however, the greater the productivity and recovery of fee earners, the higher the income.

For example, let's assume a firm with 20 fee earners, all with an hourly chargeout rate of £195. 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 £195 x 1,100 x 80% = £3.43million

If the fee earners are able to increase the recovery rate by just 1%, annual fee income and profitability will increase by £42,900.

A 1% improvement in productivity represents just one additional (and chargeable) 6-minute unit per fee earner per day.

A 1% improvement in both productivity and recovery increases income and profits by almost £80,000.

Time recording

In our experience, fee earners in many firms do not fully time record. This is often the case where the work is fixed fee, for example in residential conveyancing.

We frequently see firms adopting a policy whereby fee earners are only required to record chargeable time and/or there is no minimum on the number of hours that must be recorded each day, which can result in a lack of accountability for non-chargeable time, and this can also have a negative impact on overall time recording.

Where fee earners do fully time record, it is fairly common to see fee earners recording somewhere around four or five chargeable hours per day, and sometimes lower than this.

This raises an important question: if you do not know how long it takes to do a job, because your fee earners do not record their time, how will you be able to tell if it is profitable and therefore worth doing at all or whether individual fee earners are working efficiently? 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" and, while this will make an individual fee earner's recoverability statistics look good, it will damage underlying profitability.

Furthermore, without a full time recording policy that is monitored and enforced, it is difficult to properly establish what 'capacity' looks like, and so working towards an appropriate level for fee earner gearing becomes difficult too.

In these situations, firms need to consider why time is not being fully recorded. Is it because work is being pushed down too much and fee earners feel out of their depth, or is there a deeper cultural point that needs to be addressed, with staff members feeling under pressure to charge less time to a particular matter?

Capturing all time spent on a client matter, for all work types, is essential, as too is capturing non chargeable time. 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. Where fee earners are seen as 'rain makers', their use of business development time should also form part of the monitoring process.

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 should be looking at an above average target of upwards of, say, 1,200 or 1,300 hours. In some cases, where matter volumes are high, and the nature of work is more routine / transactional, this could go even higher. 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, as well as for the firm as a whole, and compare them to our findings in section 4. 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 6 (Profitability).

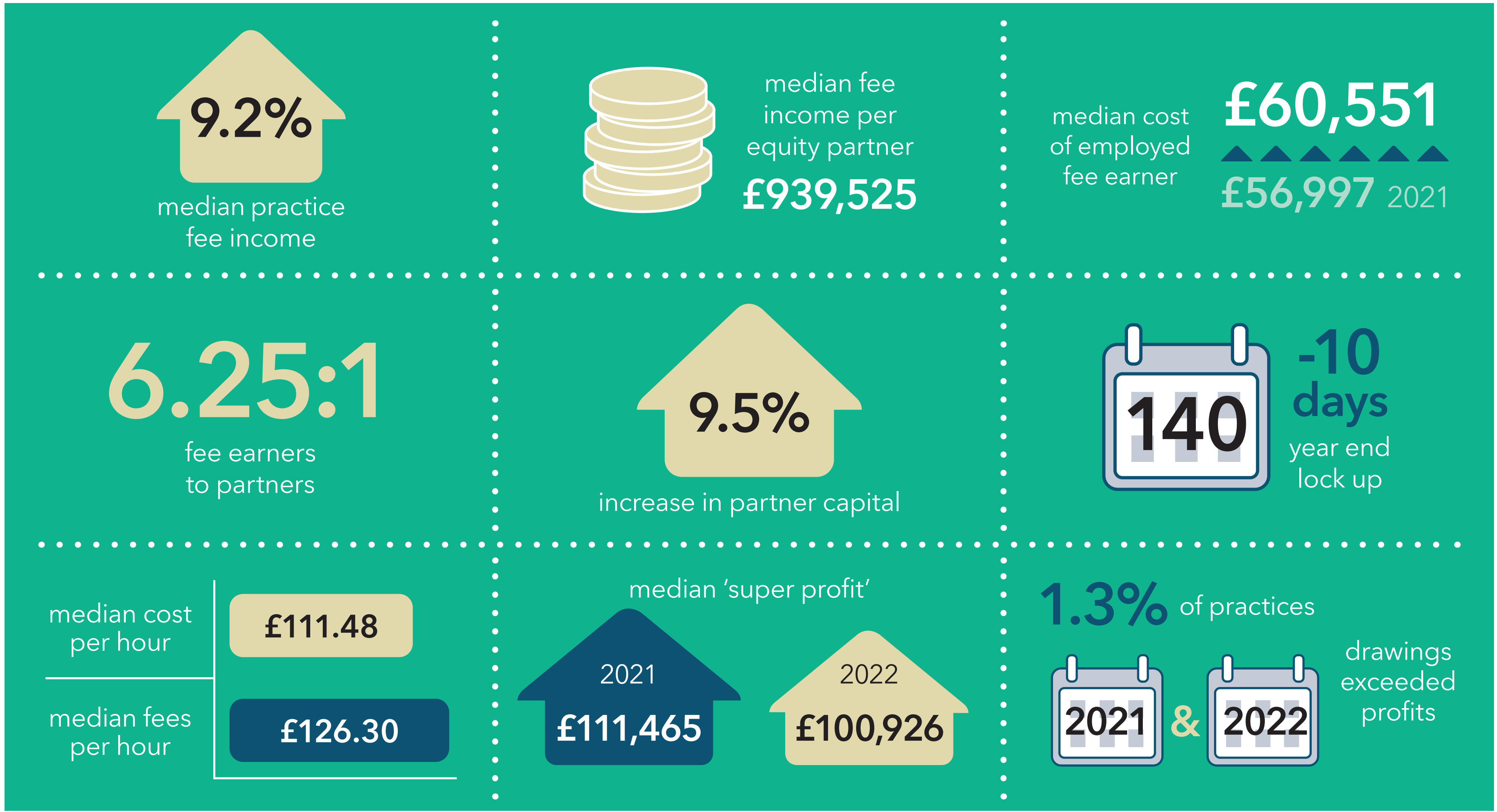
Management information

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 poor functionality and reporting.

Firms should use good quality MI to measure, and track, a small number of meaningful key performance indicators (KPIs). While there is no 'one size fits all' approach to measuring success in a business, and KPIs will commonly measure both financial and non-financial factors, there are common themes that will allow firms to benchmark themselves against their peers, and that is what this report explores.

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. Individuals who understand how they can have a positive impact on a firm's performance will often adapt their behaviours accordingly, and may feel that they have a greater personal investment in the business.

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



- Median practice fee income increased by 9.2%.
- Median fee income per equity partner of £939,525 (2021: £891,693).
- The median cost of a fee earner, including fixed share partners and notional salaries for equity partners, was £60,551 per fee earner, compared to £56,997 in 2021.
- The ratio of fee earners to equity partners increased slightly to 6.25 : 1
- The median number of chargeable hours per fee earner was 841, down 2.5% on 2021.
- The median spend on support staff, including secretaries, reception, HR, finance and other back office functions, was £22,609 per fee earner, compared to £23,661 in 2021.
- The median spend on non-salary overheads per fee earner was £39,469 compared with £37,108 in 2021, and as a proportion of fee income, non-salary overheads increased slightly, to 27.6%.
- Total year end lock-up days (WIP and debtors combined) dropped from 150 days to 140 days.
- Median equity partner capital (combined total of capital account, current account and tax reserves in a partnership, or retained profits and directors' loan accounts in a limited company) rose by 9.5% to £302,338 per partner.
- The median hourly cost of a fee earner (based on 1,100 chargeable hours per year) was £111.48, compared to median hourly fees per fee earner of £126.30.

Median net profit per equity partner (before deducting notional salaries for partners) firms fell by 1.8%, from £203,577 in 2021 to £199,846 in 2022.

When we adjust the net profit figure to include a notional salary cost for equity partners, and also notional interest on partner capital, the median 'super-profit' for the year was £100,926 compared to £111,465 in 2021.

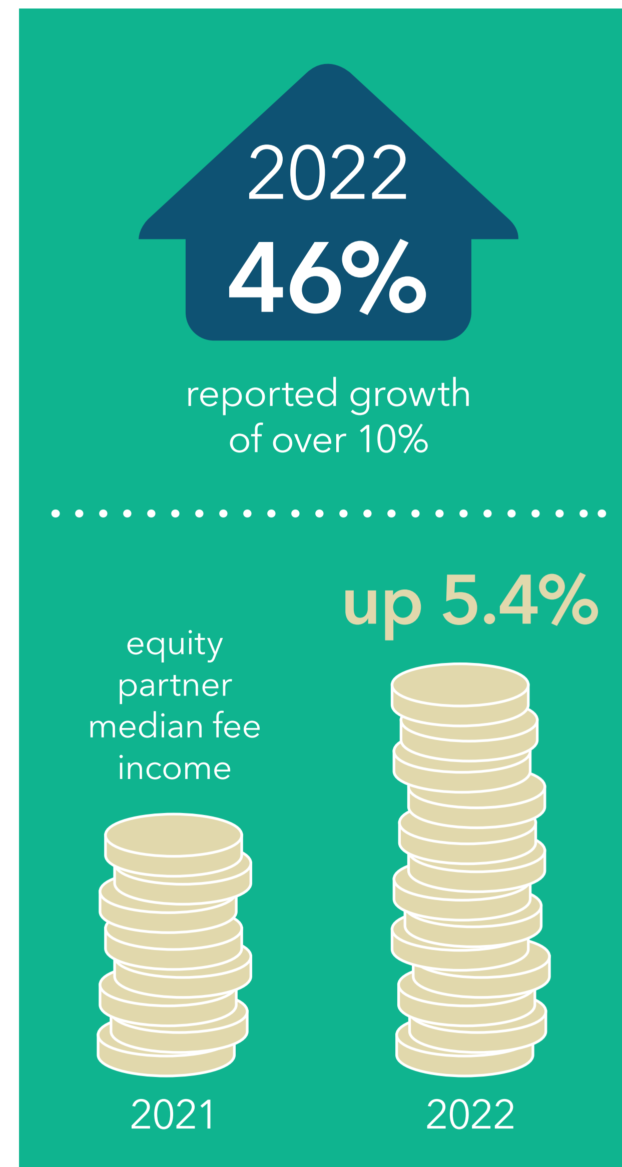
As in previous years, we start our detailed analysis by reviewing income growth. We have measured income performance by equity partner and by individual fee earner. We reveal the effects on revenue from changing the gearing in a practice; that is the ratio of fee earners to equity partners.

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 2022 are shown as columns and numbers, and the results for 2021 are shown as a dash, i.e. - . The dashes show the like-for-like 2021 results for the participants in this year's survey, so may not correlate exactly with the findings from last year's survey.

As there were fewer than 30 participants in the greater than £10million turnover band, we have only included the median results for those firms in all of the charts in this report.

Key points are:

- 75% of the participants in the survey reported year-on-year fee growth in 2022, with 46% 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 4.1, 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 13th consecutive year that we have reported a median fee increase, although it should be noted that the composition of the sample across those 13 years will have varied. The last time we saw a general reduction in fees was in 2009, when firms were struggling with the impact of the global recession of the time.
- Participants reported a median fee income per equity partner of £939,525 compared to £891,693 in 2021 – an increase of 5.4% - although smaller firms in the survey generally saw lower results.
- Firms across all regions of England and Wales reported a median increase in fee income, and most work specialisms did too, particularly residential conveyancing and commercial property, which saw median rises of 17% and 12% respectively. In our experience, most conveyancing firms increased their fee rates several times in the last couple of years, and have not reduced them since.



4. Fee income

Figure 4.1: Change in fee income compared to previous year's fee income (%)

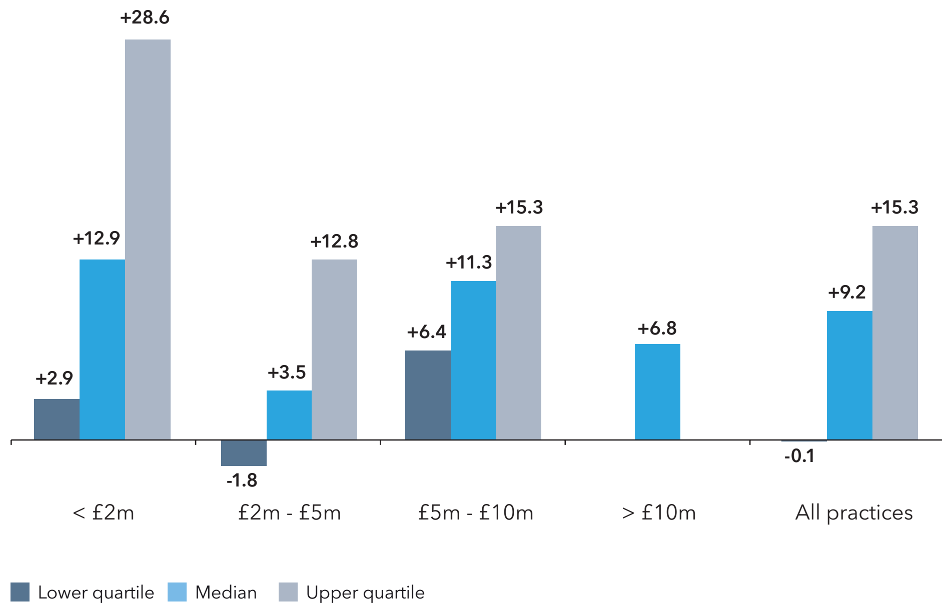


Figure 4.2: Median changes in fee income over the last 14 years (%)

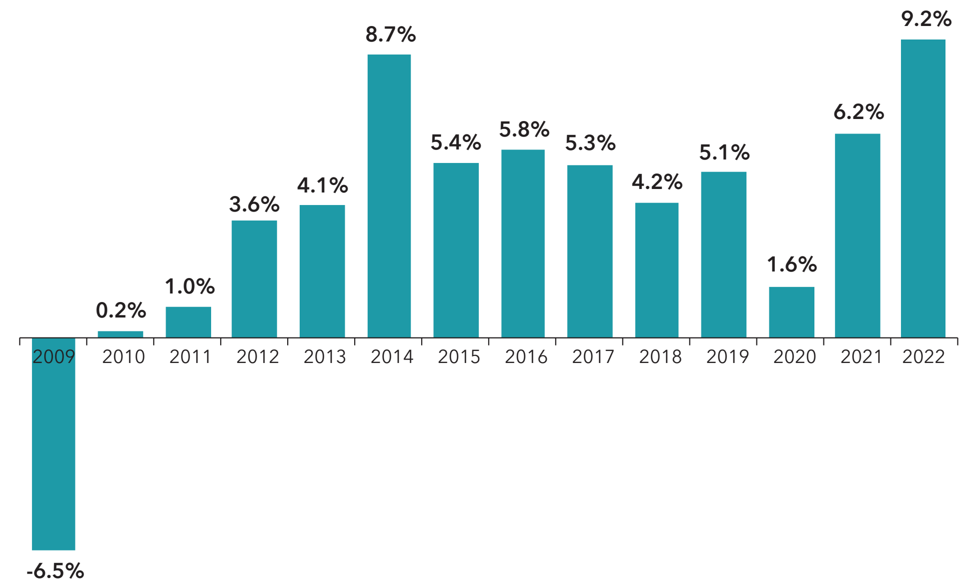
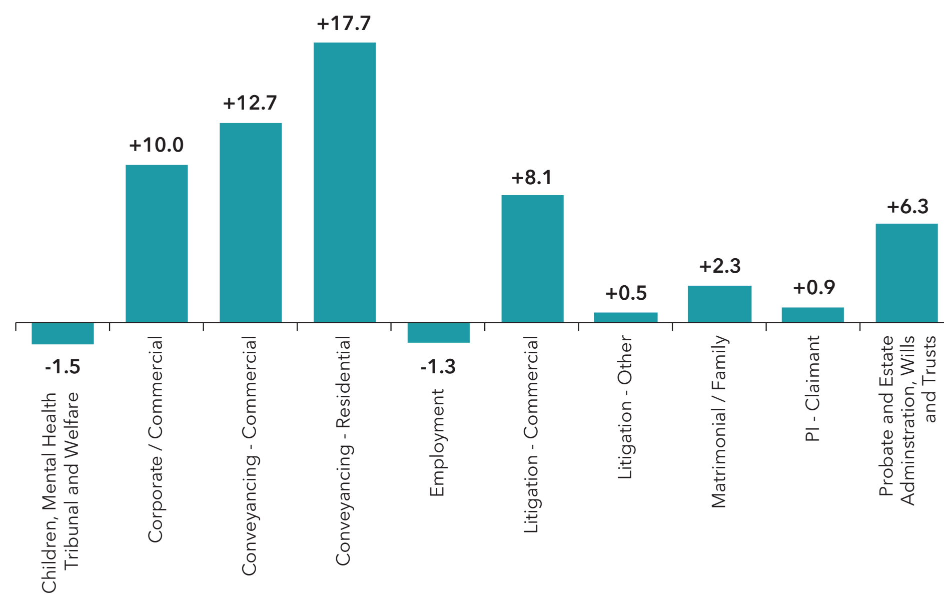


Figure 4.3: Change in fee income compared to previous year's fee income by specialism (%) (median figure only)

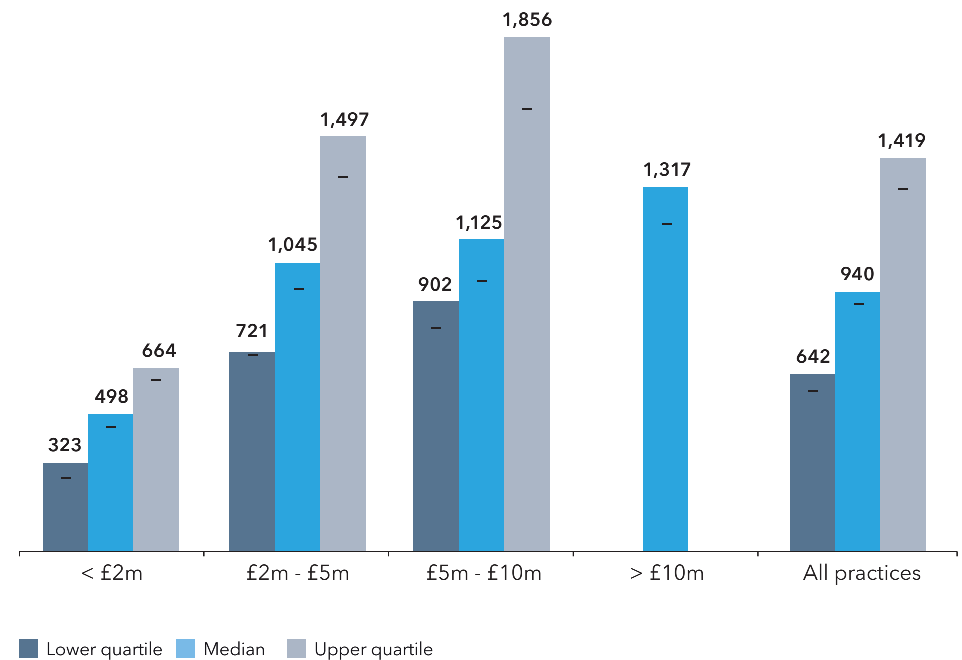


Equity partner performance

The majority of participants in the survey reported minimal change to the number of partners between 2021 and 2022.

For most firms, the growth shown in Figure 4.1 has resulted from increased fee income per equity partner, rather than a reduction in partner numbers. All turnover groups saw a rise in fee income per equity partner, with a median growth of 5.4%.

Figure 4.4: Fee income per equity partner (£'000)



Income by individual fee earner

Key points here are as follows:

- The total number of fee earners for participating firms was 7,342 compared to 7,109 in those same firms in 2021.
- Average fees per fee earner were £138,925, compared to £130,533 in 2021 - an increase of 6.4%. Firms across all turnover bands saw an increase, which is very positive.
- Despite the positive picture, 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 as discussed previously. Our view is that if fee earners are not fully recording both chargeable and non-chargeable time, then it is very difficult to know whether work is being carried out efficiently and profitably, or what real fee earning capacity looks like.
- Participants in this year's survey reported a median of 841 chargeable hours recorded per fee earner in 2022, slightly down on 863 in 2021. These findings are surprising, given that many firms tell us that staff recruitment is a huge challenge for them at the moment, leading to high workloads for existing staff.
- 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, both from an income generation and cash management perspective.

Figure 4.5: Fee income per fee earner (£'000)

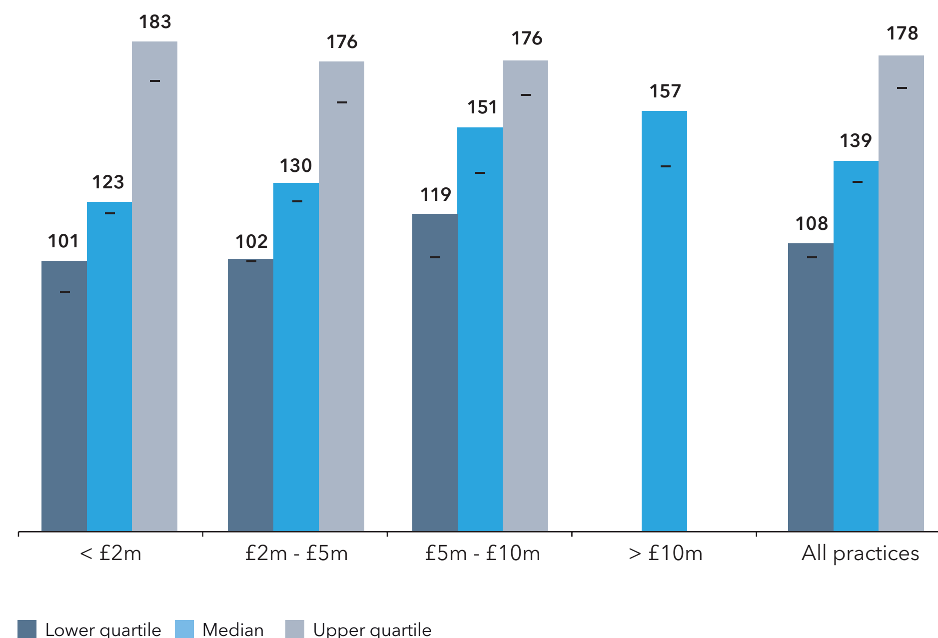
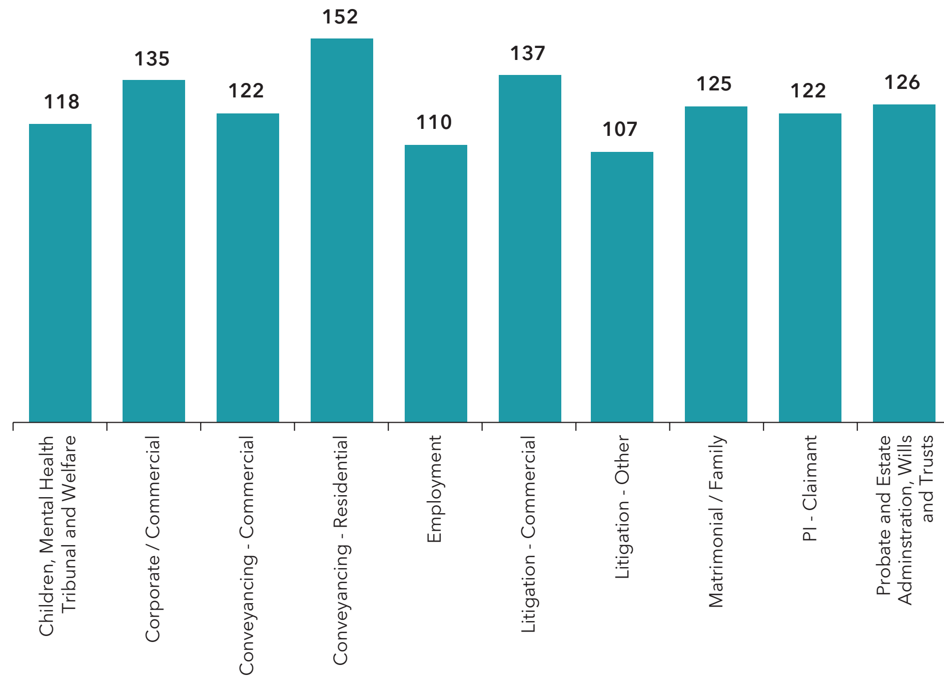


Figure 4.6: Fee income per fee earner by specialism (£'000) (median figure only)



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 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).

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, when Hazlewoods first carried out the survey, the median ratio was 4:1, and the general economic climate then was challenging. Since then, we have seen a steady rise in fee income, and the gearing ratio gradually crept up to 6.0:1 immediately prior to the pandemic. We have seen another rise this year, to a median of 6.25 fee earners per equity partner.

Another factor to be aware of is that fee earner gearing can vary between different departments in the same firm, and we tend to see higher gearing in teams such as residential conveyancing and high volume personal injury work, and lower gearing in more specialised technical teams, such as complex litigation and corporate work, which generally require a larger amount of senior fee earner involvement.

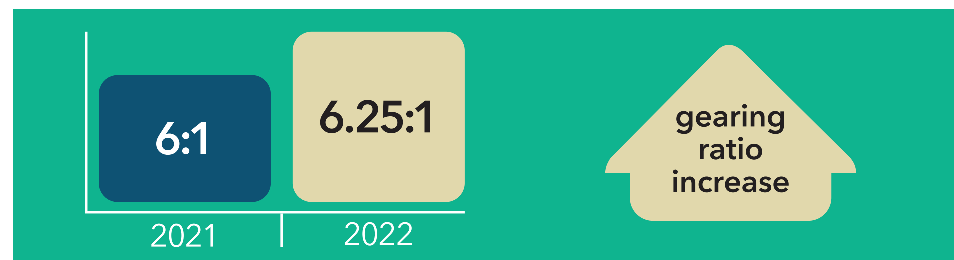
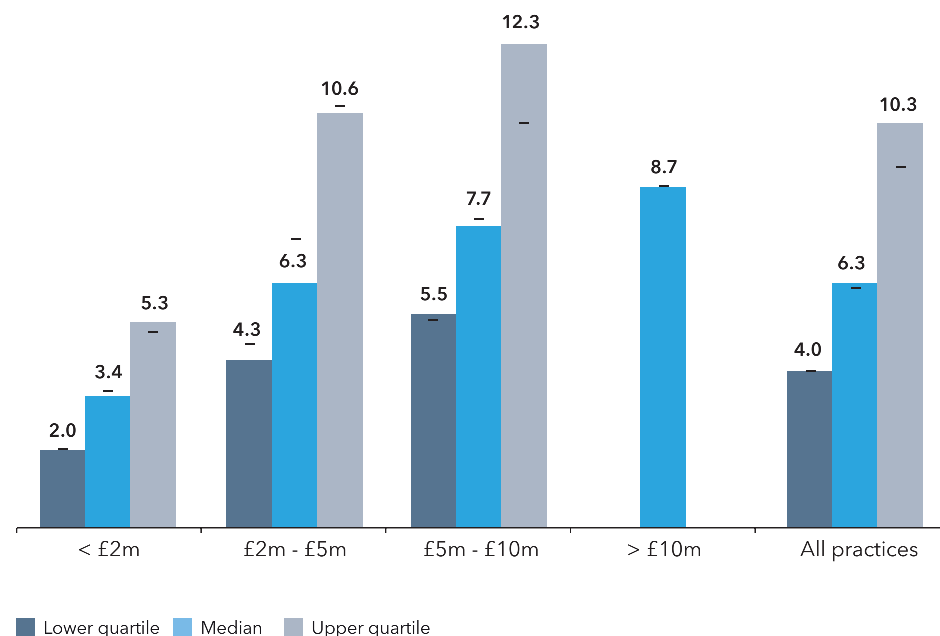


Figure 4.7: Number of fee earners per equity partner



Chargeable hours

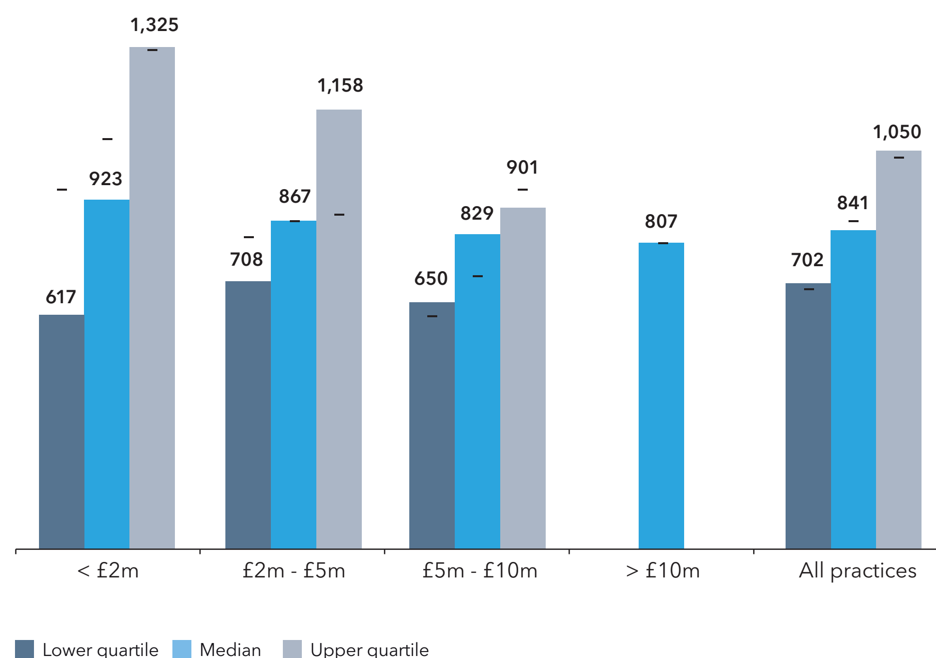
As explained in section 2, productivity (i.e. the amount of chargeable time recorded) has a direct impact on fee income and profitability, as every additional chargeable unit that can be recorded and billed goes straight to the bottom line. For the first time, we asked participating firms for the total number of chargeable hours recorded by all of their fee earners (including partners), and the findings are shown at Figure 4.8.

The findings are likely to be a surprise to many firms, as the general rule of thumb used by many firms is that fee earners should be charging at least 1,000 or 1,100 chargeable hours per year.

An overall reduction in the median number of chargeable hours, from 863 in 2021 to 841 in 2022, is concerning, and supports the growing evidence that working from home is not always as beneficial to the firm as it is to the individual. In our experience, more and more firms are calling their staff back to the office for at least some of the week.

When you consider that a full time fee earner working say 35 hours per week has a capacity of 1,600 chargeable hours per year, after allowing for holidays, sickness and training, it is difficult to understand how the actual median can be so low. As noted in section 2, we would expect more senior people with non-fee earning responsibilities to have reduced productivity, but more junior people with no other responsibilities at all should be looking at upwards of 1,200 or 1,300 hours.

Figure 4.8: Chargeable hours recorded per fee earner



People represent not just the greatest asset for law firms, but also the primary cost. The total costs are broken down into three principal categories:

- Equity partners
- Fee earners
- Support staff

Figure 5.1 compares the total cost of all of these people against fee income. This includes notional salaries for equity partners, which we have once again set at the same level of the median highest employed fee earner's salary for the size of practice, plus 15%, to reflect Employer's NIC and employer pension contributions.

The median 2022 total is 58.9%, compared to 58.5% in 2021, giving a median gross margin/contribution of 41.1% (2020: 41.5%). This slight drop in margin indicates that fee earner costs have risen by more than the growth in fee income that we saw in the previous section.

79% of participants reported that they had furloughed members of staff for a time during their 2021 financial years, and as a result, claimed grants under the Coronavirus Job Retention Scheme (furlough money). 33% of firms also claimed furlough money during their 2022 financial years, although the amounts were significantly smaller.

The analysis at Figure 5.1 does not take into account furlough money receipts. Figure 5.2 shows the same information as in Figure 5.1, except that we have deducted furlough grant income from the total staff costs when comparing staff costs to fee income. The total furlough money claimed by participants was £20million during their 2021 financial year and £750,000 during their 2022 financial year.

The average amount claimed by participating firms in 2021 was £159,000, falling to £14,000 in 2022. As shown in Figure 5.2, claims in 2021 reduced the median total employment cost in 2021 to 57% of income, but there was minimal impact in 2022.

As noted in previous years, a key challenge facing all law firms is the need to attract and retain high quality staff. This, and the recent increases in cost of living, mean that firms have felt under greater pressure to increase salaries, and some firms have brought forward pay reviews to help address this.

In our experience, very few firms have so far elected to make one-off lump sum payments to staff, choosing instead to focus on their overall remuneration packages, including options such as staff bonuses, increased levels of employer pension contributions, improved holiday entitlements and the introduction of other benefits such as health cover.

Unless firms are able to increase their hourly chargeout rates and fees to clients in line with rising staff costs, we expect employment costs as a percentage of fee income to increase again in next year's survey.

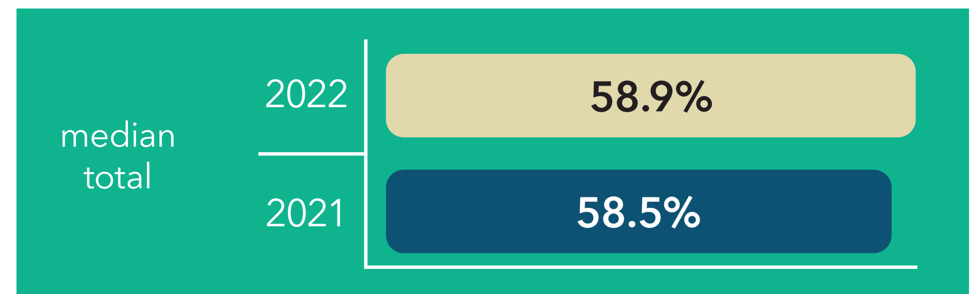


Figure 5.1: Total salary costs, including notional salaries, as a percentage of fee income (%)

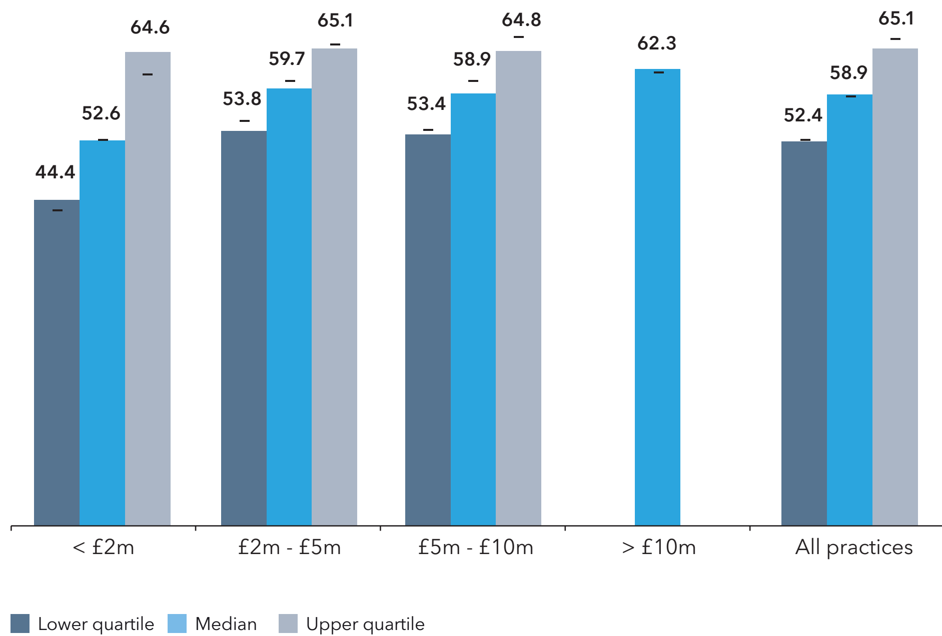
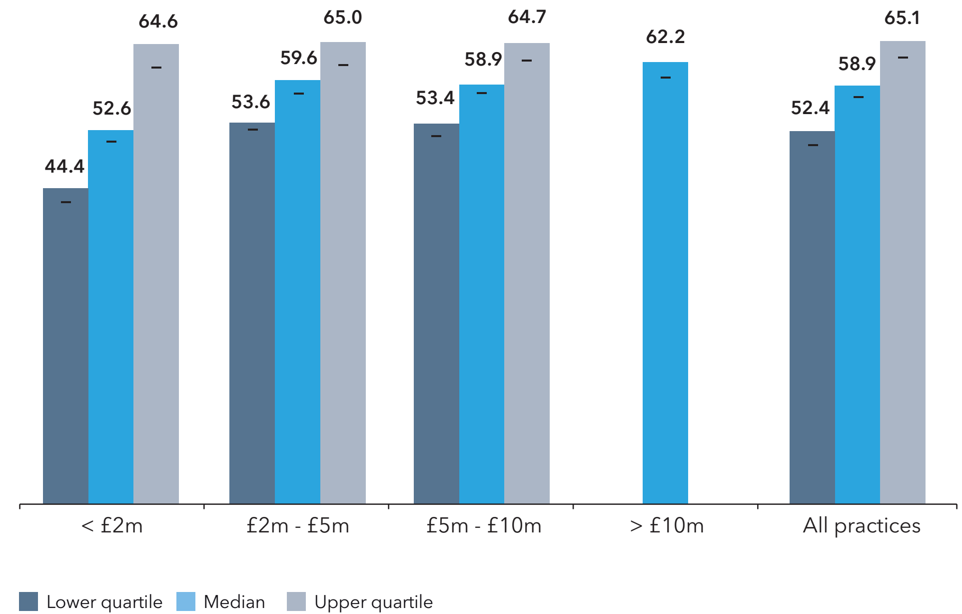


Figure 5.2: Total salary costs, including notional salaries, less furlough grants received, as a percentage of fee income (%)



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 5.3 we include salaries, fixed share partners, consultants, temporary staff and all usual payroll and pension costs for fee earning staff. However, no redundancy or recruitment costs are included here, nor any notional salaries for equity partners. We have also not taken account of any furlough monies received.

In terms of actual head count on a full-time equivalent basis, the total number of people employed in a fee earning capacity across all participants in our survey, excluding equity partners, was 7,342 in 2022, compared to 7,109 in 2021 – an increase of 233 people (3.2%).

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 rose by 5.8%, from £50,586 in 2021 to £53,541.
- 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 6.

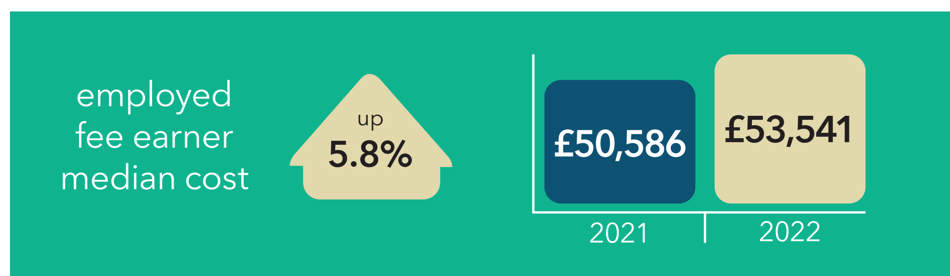


Figure 5.3: Expenditure on employed fee earners as a percentage of fee income (%)

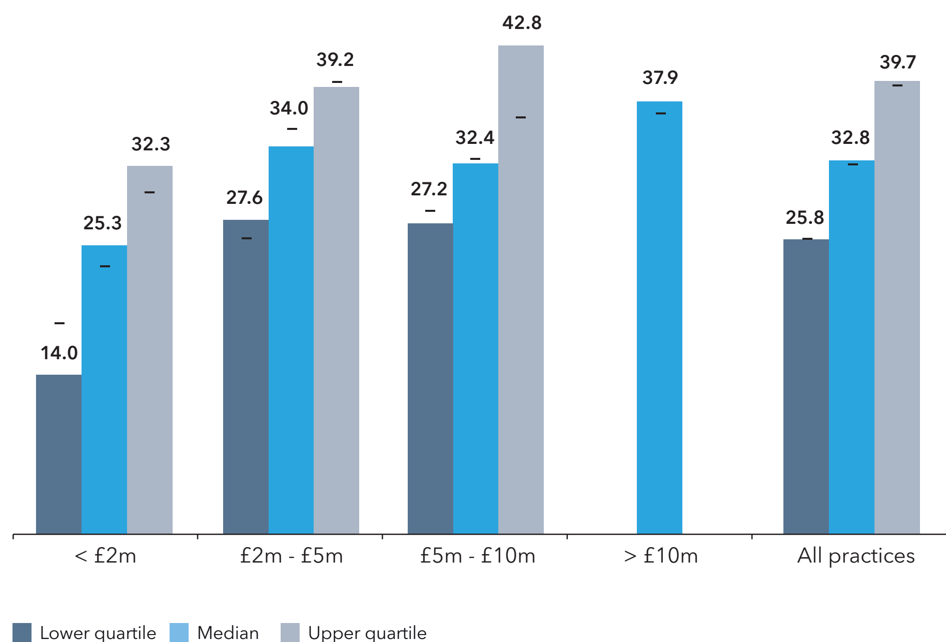
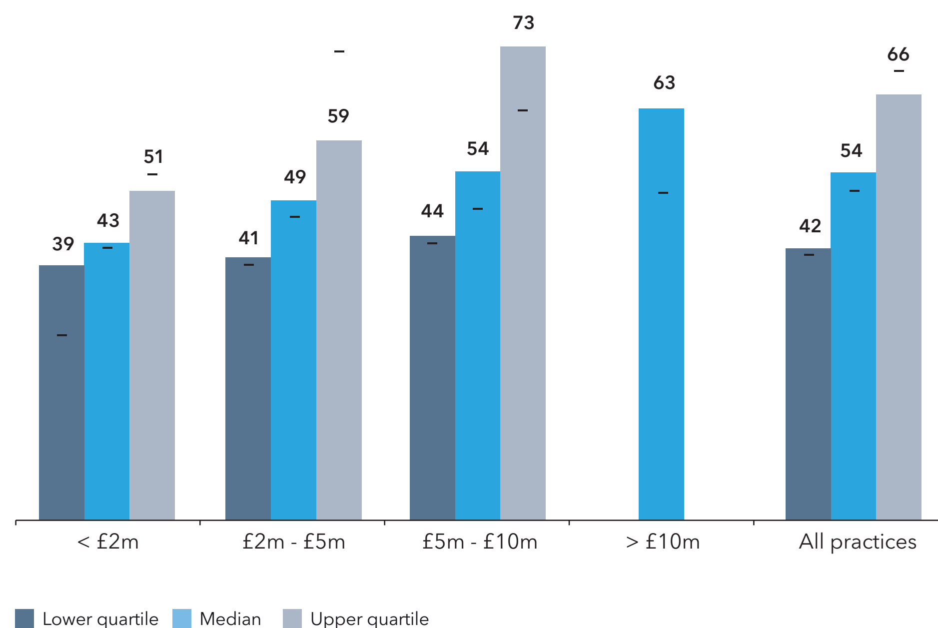


Figure 5.4: Cost per employed fee earner (excluding notional salaries for equity partners) (£'000)



Employment costs – all fee earners, including equity partners

Building on the results in Figure 5.4, 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' profit shares, consultants, temporary staff and normal payroll and pension costs, and a notional cost for the equity partners.

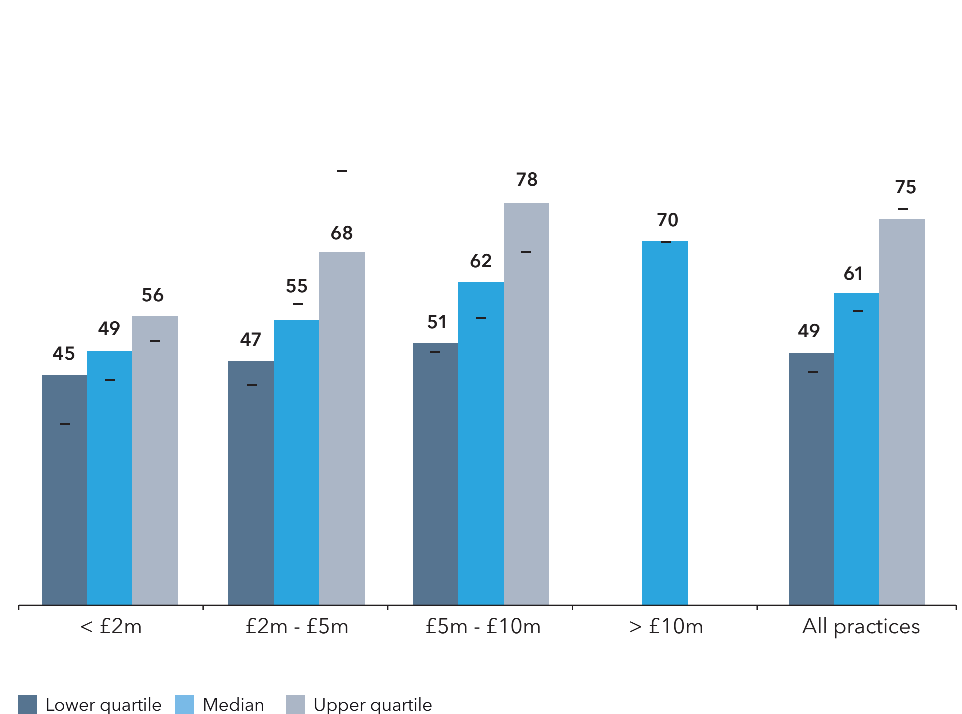
Notional salaries are based on the highest fee earner salary for the turnover band, plus an extra 15%, to reflect the additional costs that would have been incurred if the equity partners had been employed, such as employer's NIC and pension contributions.

When equity partners are included, the median 'true' cost of a fee earner increases to £60,551, up 6.2% from £56,997 in 2021.

Notional salary rates are shown on Figure 6.4. The median notional salary across all turnover bands is £87,000, although as with other staff costs, notional salaries vary depending on the size of the firm.

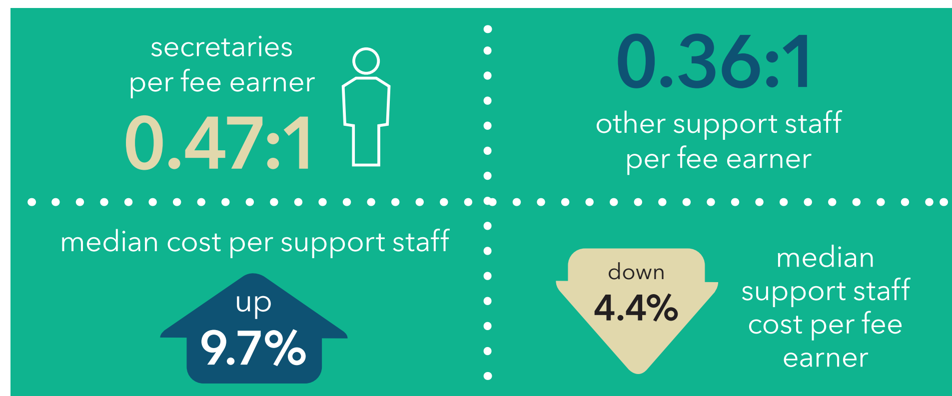
The median notional salary increased by 2.2% in 2022, with similar increases across all turnover bands.

Figure 5.5: 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 across all participants in our survey was 5,594 in 2022, compared to 5,480 in 2021 – an increase of 114 people (2.1%).



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, to 0.47 : 1
- The number of other support staff per fee earner (accounts, administration, marketing, receptionists, IT, etc.) remained static, at 0.36 : 1.
- The median cost per member of support staff (including secretaries) rose from £24,582 in 2021 to £26,963. However, the median support staff cost per fee earner, including secretarial support, was £22,609 in 2022, compared to £23,661 in 2021, due to the combination of increased fee earner gearing and reduction in reliance on secretarial support.
- This, combined with increasing fee income, have reduced the median spend on support staff, from 17.0% to 15.8% of fee income.

Figure 5.6: Expenditure on support staff as a percentage of fee income (%)

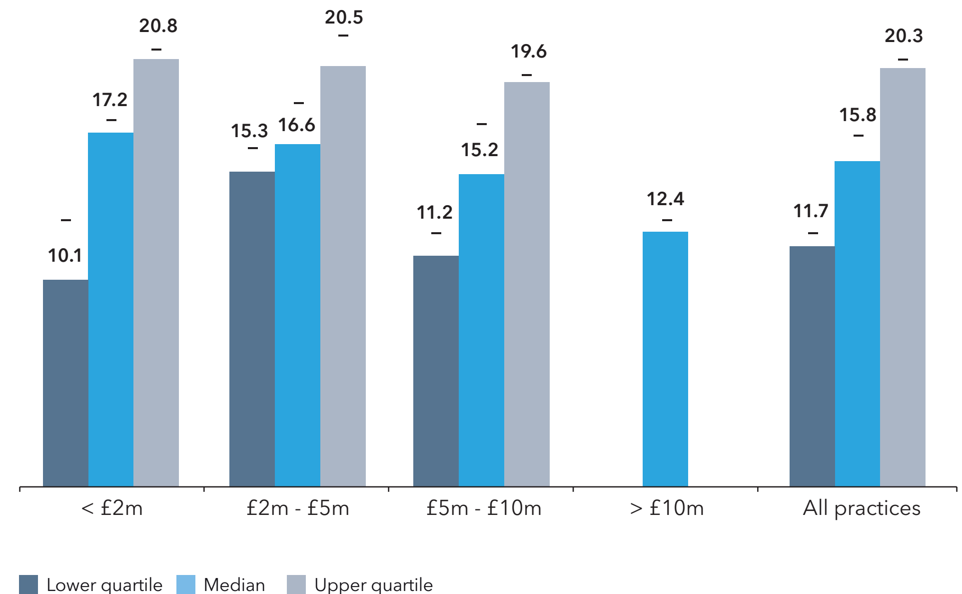


Figure 5.7: Cost per support staff member (£'000)

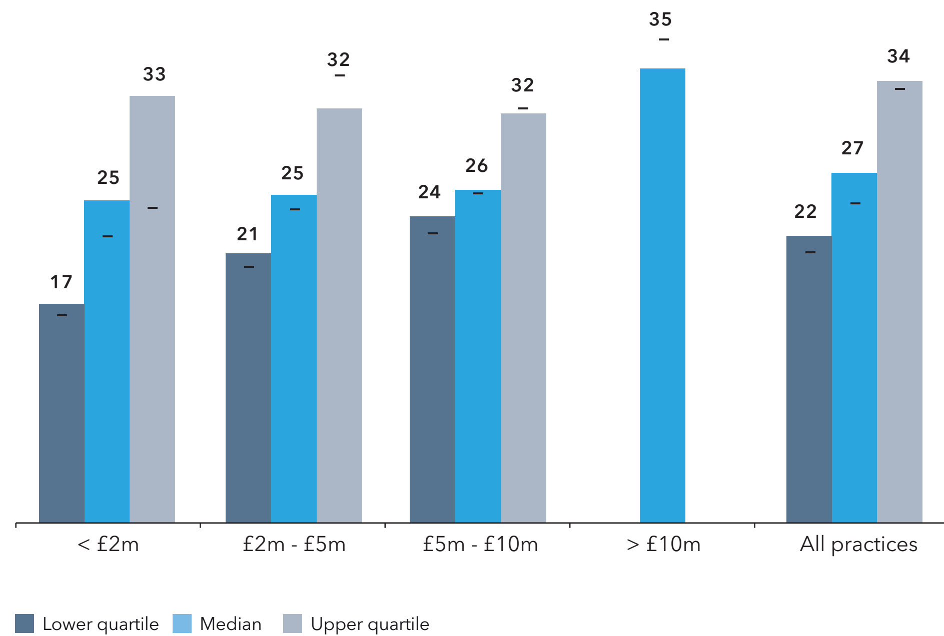


Figure 5.8: Number of secretaries per fee earner

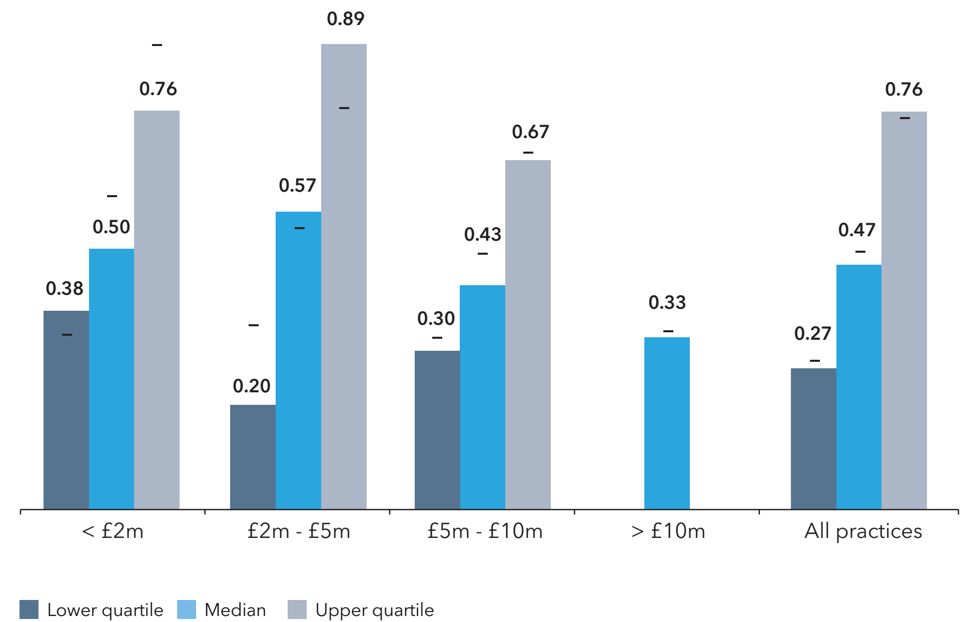


Figure 5.9: Number of other support staff per fee earner

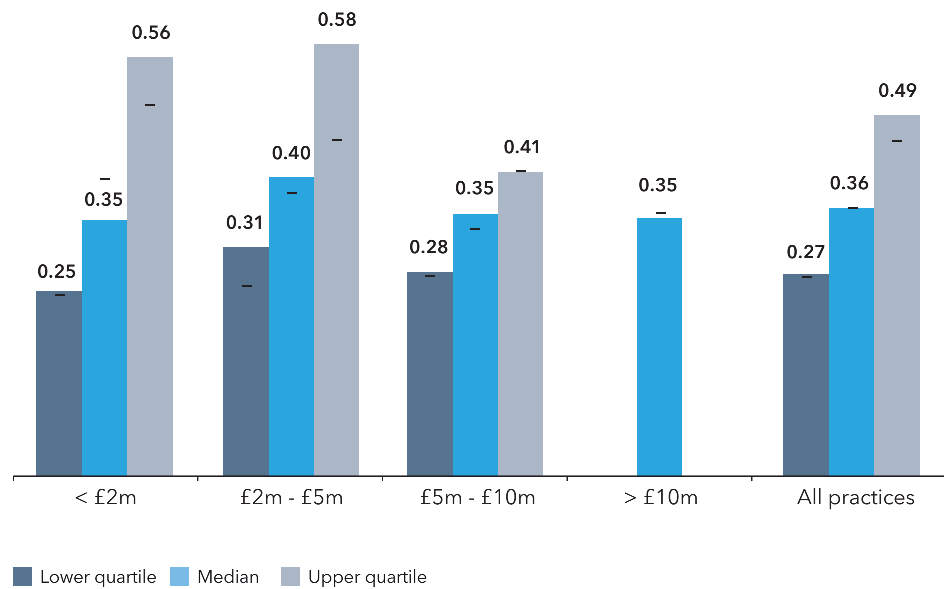


Figure 5.10: Cost of support staff per fee earner (£'000)

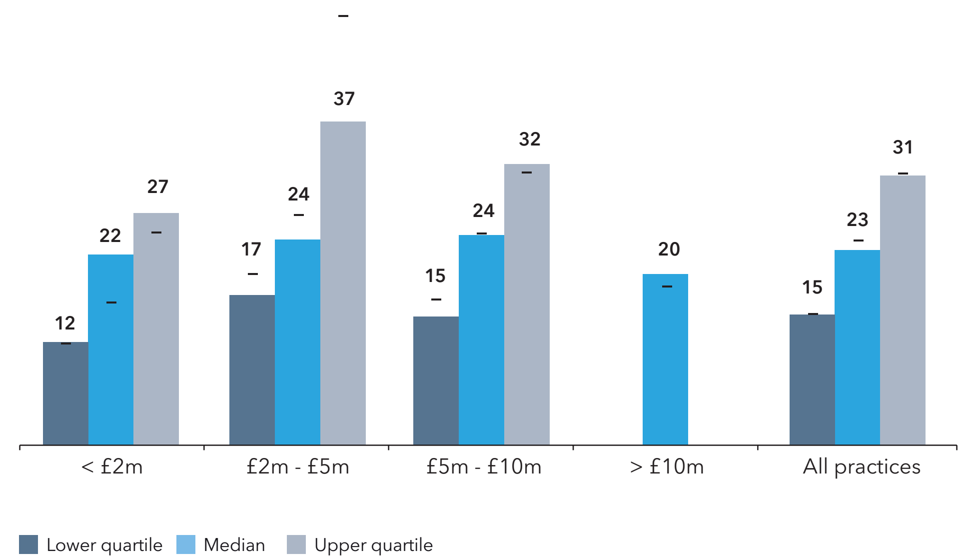
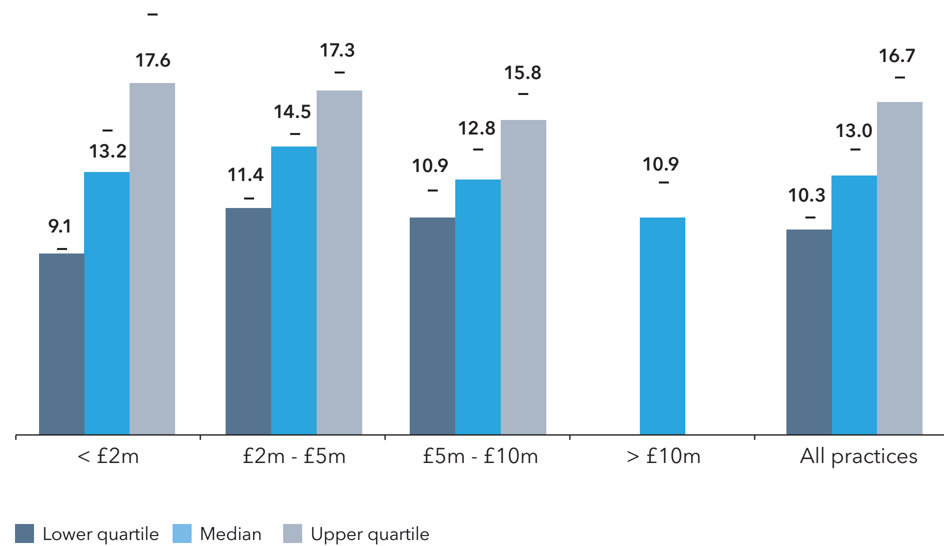


Figure 5.11: Total FTE headcount per £1million of fee income



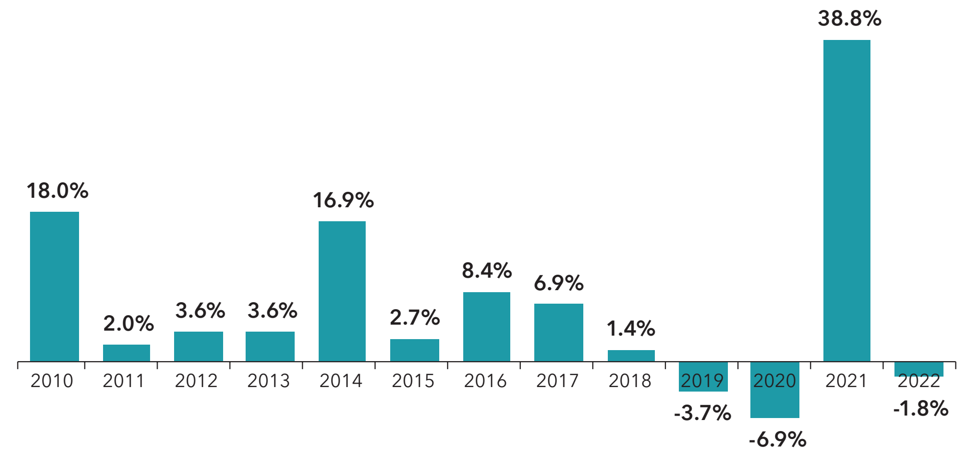
6. Profitability

Last year, we reported that a combination of increased fee income, furlough grants and other grant income, and a reduction in staff and other overhead costs, had resulted in increased (and in some cases, record) profitability for three quarters of survey participants. Prior to that (and prior to the Covid-19 pandemic), profit per equity (PEP) had fallen for two consecutive years, mainly as a result of falling net profit margins, following large increases in staff costs.

This year's findings return to the pre-Covid trend, with median profit per equity partner falling from £203,577 to £199,846 – a drop of 1.8%. Whilst on the face of it, this may appear to be bad news, it is important to remember that firms' 2021 results were extremely strong, and therefore a median 1.8% reduction in profitability should not take away from the fact that many firms once again performed very strongly, with profits well above pre-Covid levels.

The chart below summarises median changes in profit per equity partner as reported in our last 13 surveys. Whilst the composition of the sample will have varied each year, it provides a useful reminder of how firms have fared in that time.

Median changes in PEP (%)



In addition, the net profit margin has also fallen, from a median of 24.4% to 21.7%, with firms of all sizes seeing similar reductions.

Over a quarter of fee income was spent on non-salary overheads, with a median cost per fee earner, ignoring the impact of furlough income, of £39,469, compared to £37,108 in 2021. We have looked in further detail at the breakdown of this expenditure, and in particular specific costs such as professional indemnity insurance cover, marketing, accommodation costs, staff recruitment and external staff training.

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. Whilst this is mainly due to increasing staff costs, current high energy costs are pushing non-salary overheads upwards.

If we combine the findings in sections 4, 5 and 6 of this survey, we arrive at the proportions shown on the following pie chart.

As noted earlier in this report, firms need to focus on generating more fees from fee earners, either by improving productivity, increasing fee rates, or both, otherwise the Super-Profit slice in the pie chart is going to be squeezed even further.

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

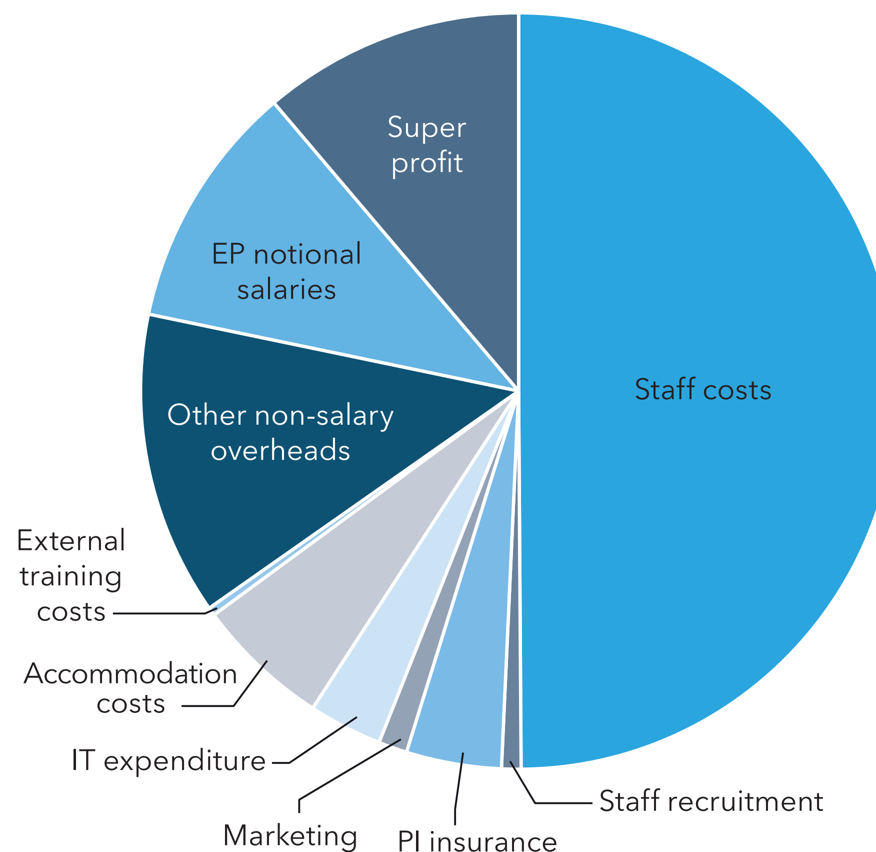


Figure 6.1: Profit per equity partner (£'000)

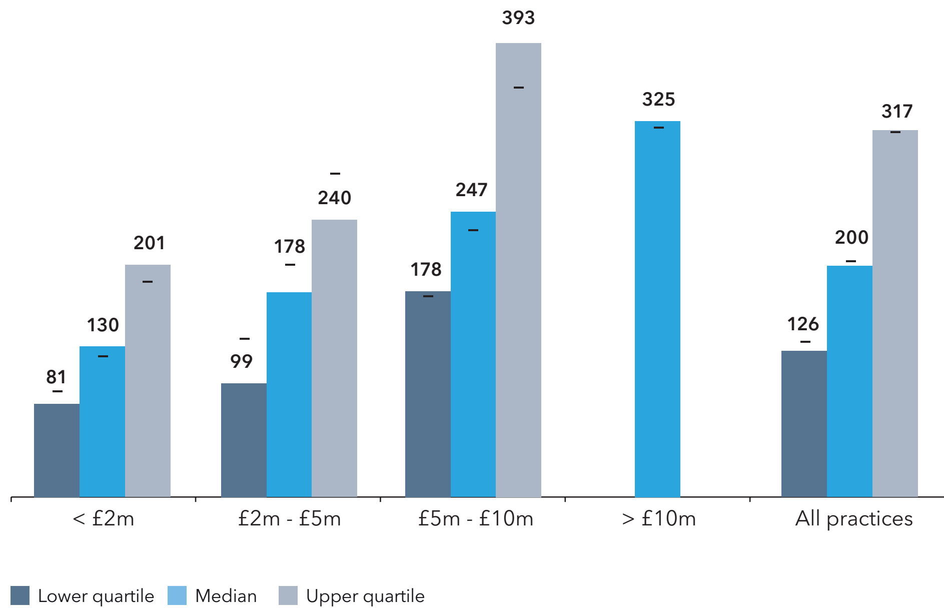


Figure 6.2: Profit per fee earner (£'000)

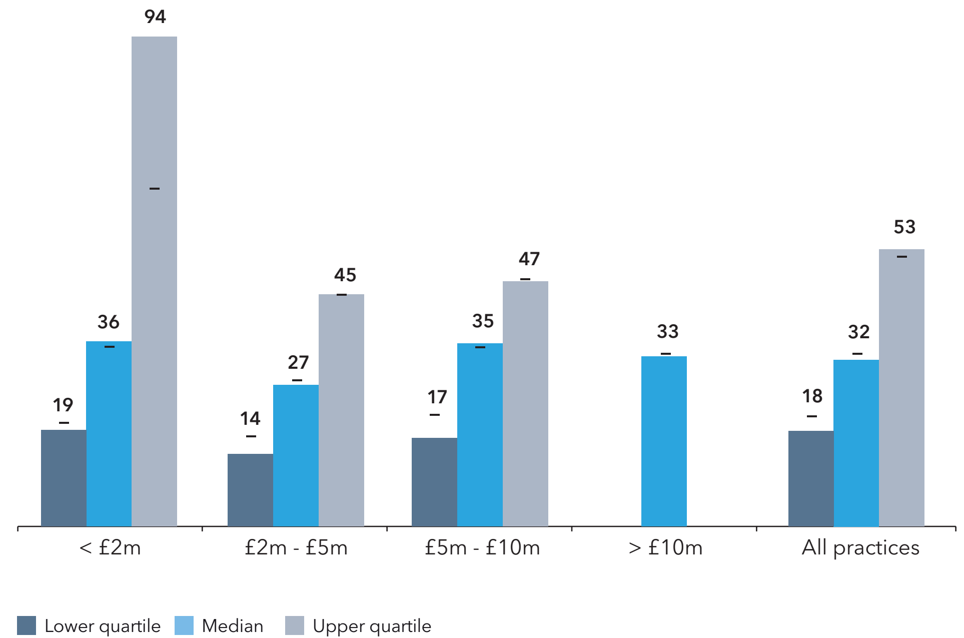
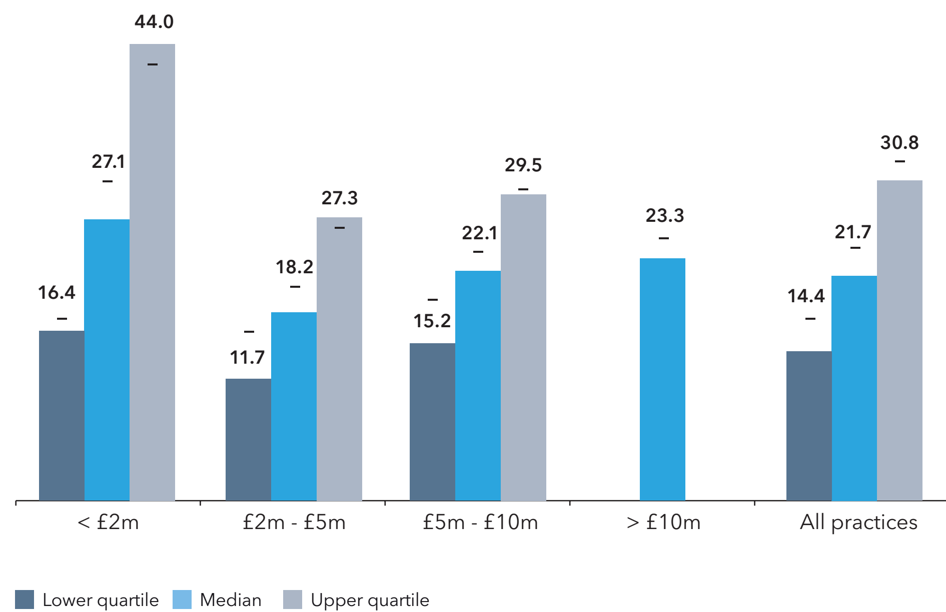


Figure 6.3: Profit as a percentage of total income (%)



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

As law firm owners, equity partners expect to be rewarded with a 'salary' equivalent for the work that they do. They also expect a return for their capital invested in the practice and an additional "super-profit" for the additional risk that they face through being business owners rather than employees. We refer to these three layers of remuneration as notional salary, notional interest and super-profit.

As noted in section 5, equity partner notional salaries have been calculated based on firms' highest fee earner salary plus an extra 15% to reflect the incidental costs of employment such as employer's NIC and pension contributions.

Notional interest has once again been set at 3% of partner capital/company reserves, given that bank base rates will have been much lower than current levels throughout the financial year being reported by participating firms.

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

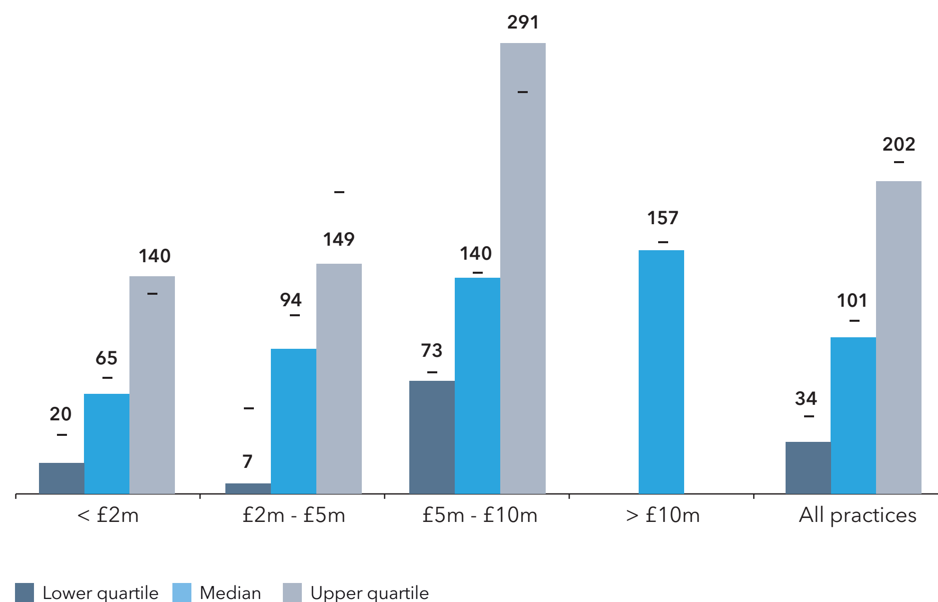
In Figure 6.4 we show the "super-profit" per equity partner. In 2022, the median 'super-profit' was £100,926, compared to £111,465 in 2021, which is to be expected given the drop in PEP that we saw in Figure 6.1. Firms in all turnover bands have seen a drop in super-profit.

Again, it is important to remember that, whilst super-profits have fallen, they are well above pre-Covid levels.

We also noted that super-profits per fee earner have fallen, from a median of £18,339 in 2021 to £15,890.

13% of firms in our survey reported a super-loss, suggesting that partners in those firms could (in theory) have earned more by being employed somewhere else.

Figure 6.4: Super-profit per equity partner (£'000)



Notional salaries (£'000)

	< £2m	£2m - £5m	£5m - £10m	> £10m	All practices
2022	58	83	96	153	87
2021	49	78	89	148	85

Figure 6.5: Super-profit per fee earner (£'000)

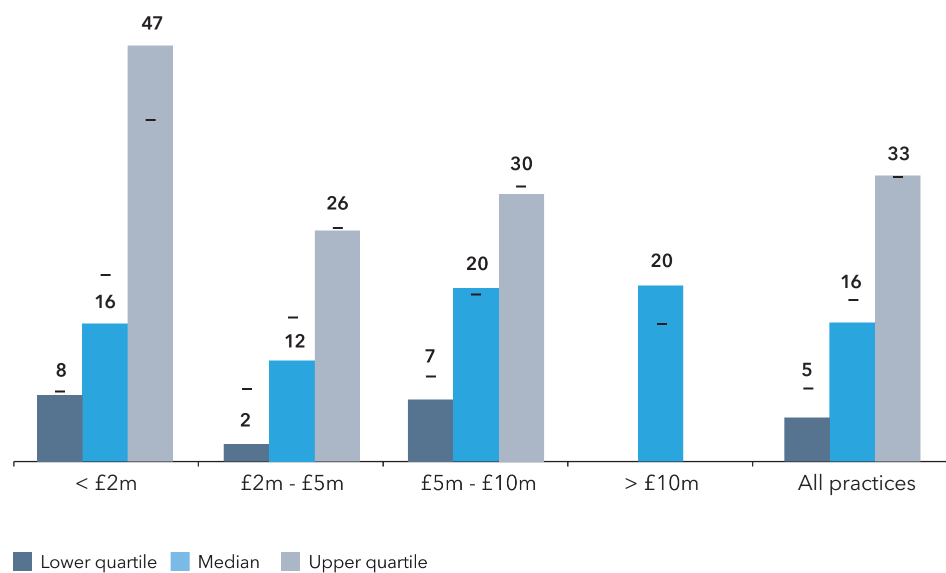
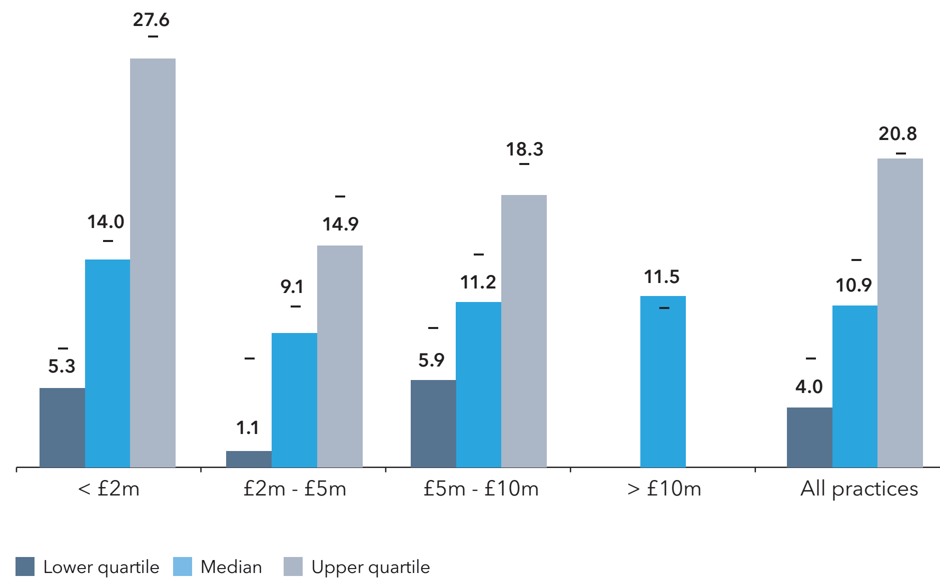


Figure 6.6: Super-profit as a percentage of total income (%)



Return on capital employed (ROCE)

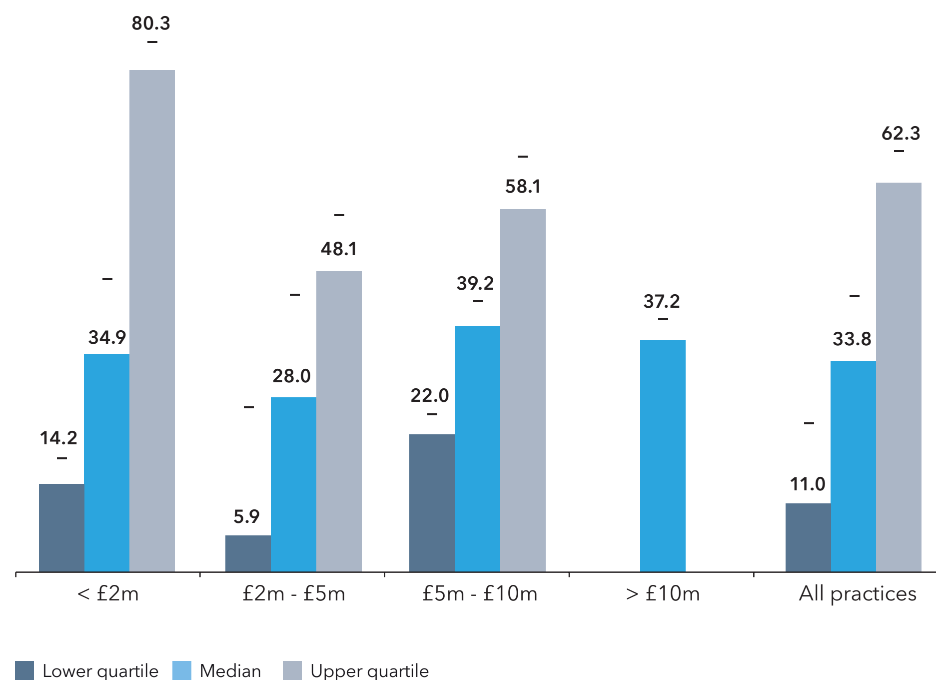
ROCE is a measure of the returns made by a firm on the resources available to it. For a law firm, ROCE is measured in terms of super-profits as a percentage of partner capital in a partnership or LLP, or retained profits and share capital in a limited company.

In the context of the returns made to the owners of a law firm, we use super-profit, as this takes account of notional salaries for partners, and also notional interest on partners' capital and so is representative of the reward to the partners for the risk they take in being owners of the business.

The results show a median ROCE of 33.8% for 2022, compared to 44.0% in 2021. Naturally, firms looking to attract new partners will be more successful with higher levels of ROCE and the range of returns between the lower performers and the higher performing firms is apparent.

In an industry climate where M&A activity is on the increase, ROCE is a key measure, as potential investors or acquirers will pay more when a practice is achieving ROCE in line with the best performers in their size category.

Figure 6.7: Return on Capital Employed (super-profit as a percentage of partner capital) (%)



Non-salary overheads

The charts over the next few pages show that firms have worked hard to control their overheads. Overall, non-salary overheads have remained fairly consistent, across all turnover bands.

As shown on the historical analysis, it is interesting to note a steady reduction in the amounts spent on marketing, perhaps reflecting a move towards often less expensive online and social-media based activities.

There have been some exceptions though, particularly in professional indemnity insurance costs, where we saw significantly increased premiums for many firms. Rises of between 10% and 30% for primary cover were commonplace, with even higher increases for top-up cover.

We have also seen an increase in IT spend, partly driven by investment to allow staff to work effectively from home, and recruitment spend is on the rise, as firms look to build fee earner numbers.

Median spend on non-salary overheads (as a % of fee income)

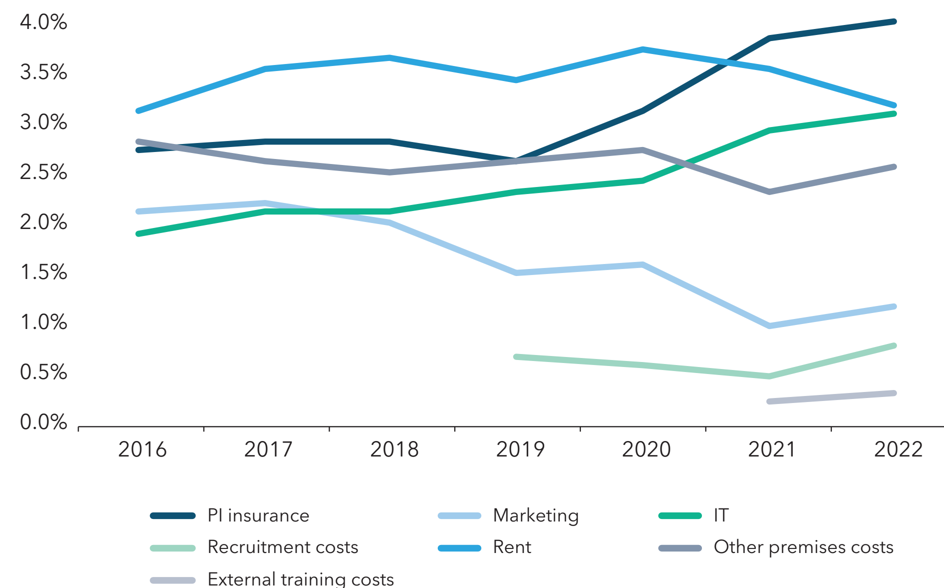


Figure 6.8: Non-salary overheads as a percentage of fee income (%)

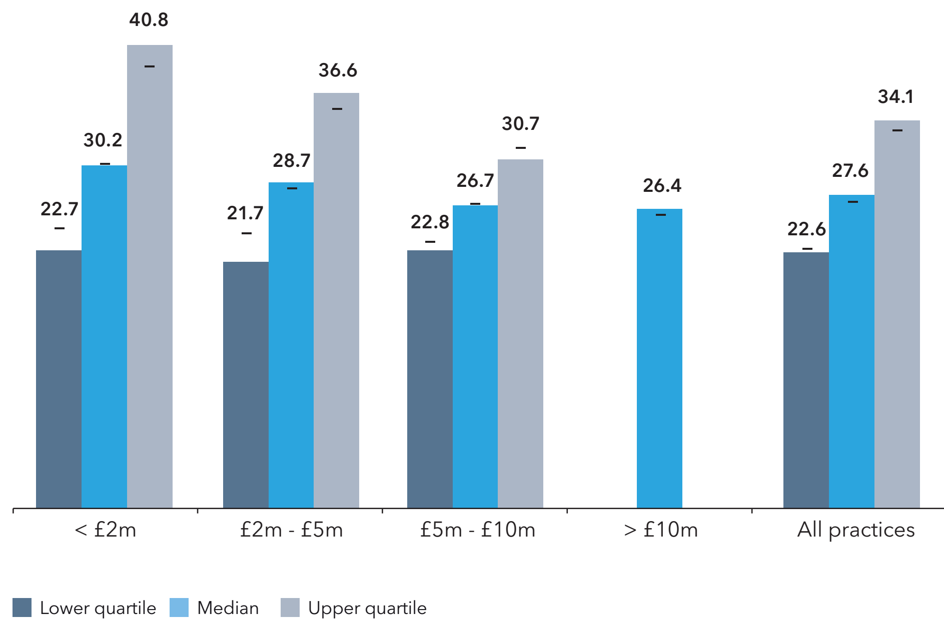


Figure 6.9: Non-salary overheads per fee earner (£'000)

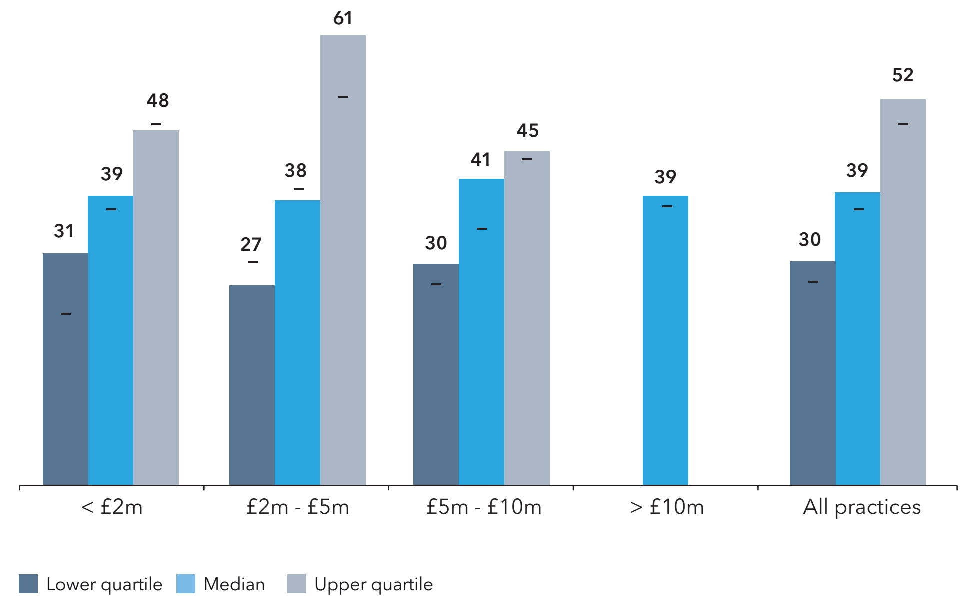


Figure 6.10: PI insurance premium expenditure as a percentage of fee income (%)

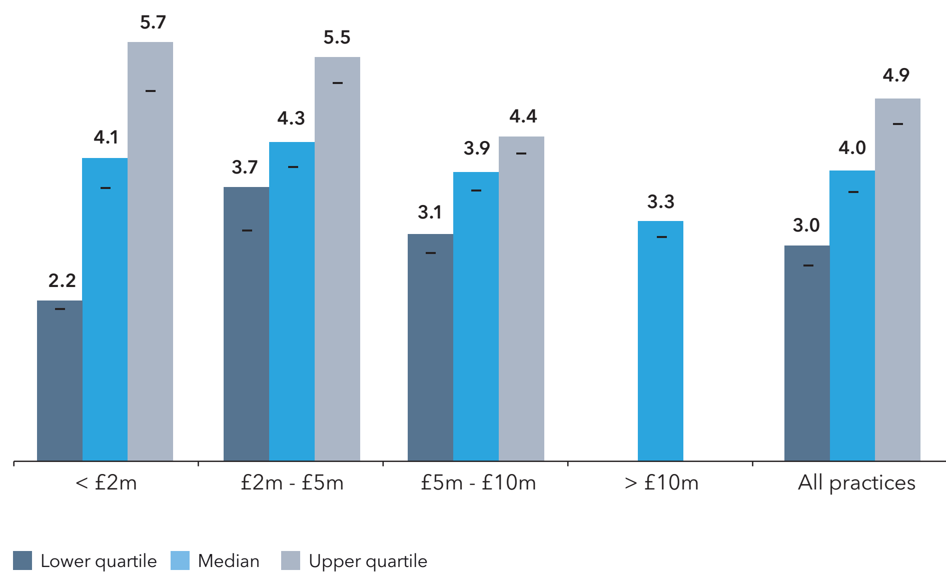


Figure 6.11: Marketing expenditure (including staff costs) as a percentage of fee income (%)

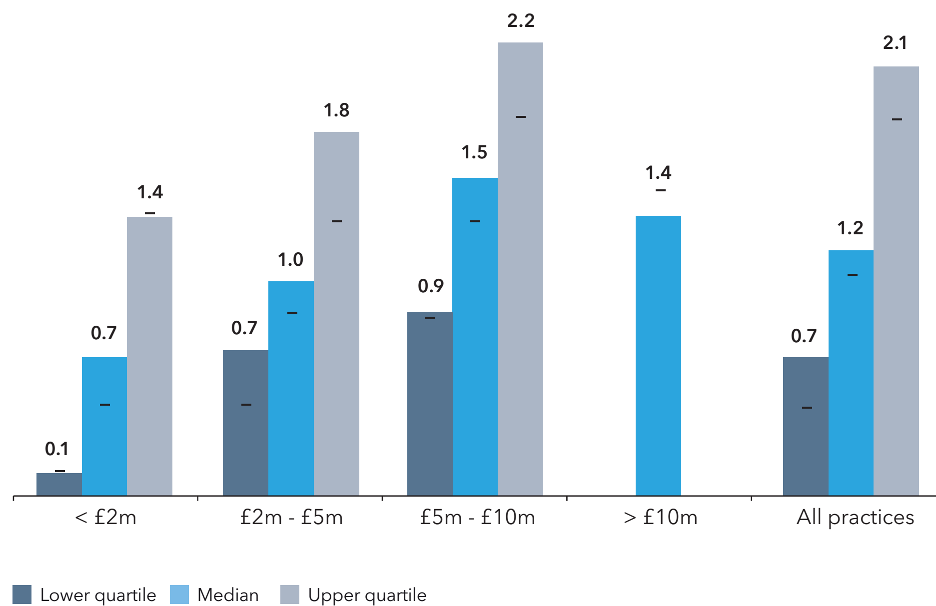


Figure 6.12: IT expenditure (including IT support, IT consultants and cloud-based storage) as a percentage of fee income (%)

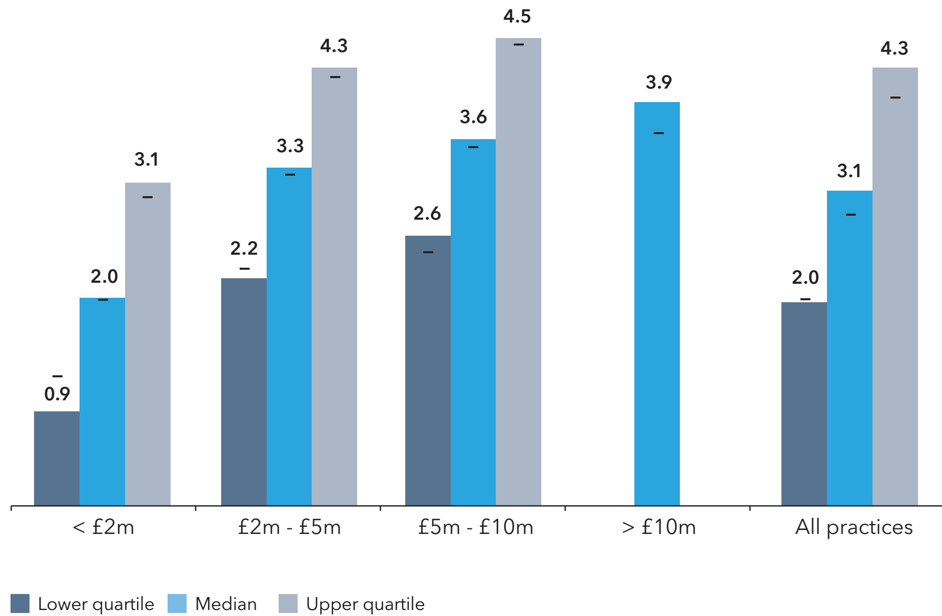


Figure 6.13: Staff recruitment costs (external or in-house) as a percentage of fee income (%)

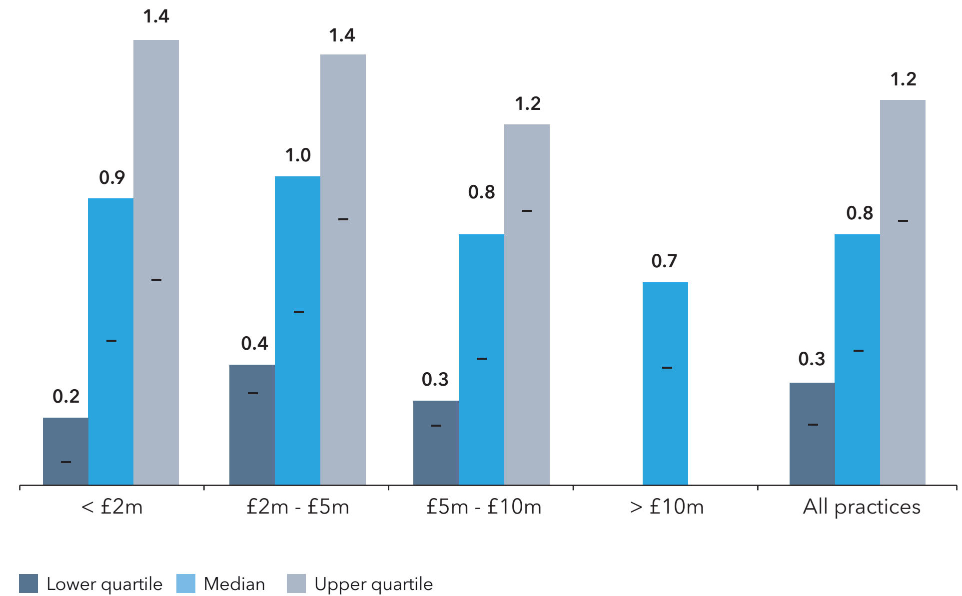
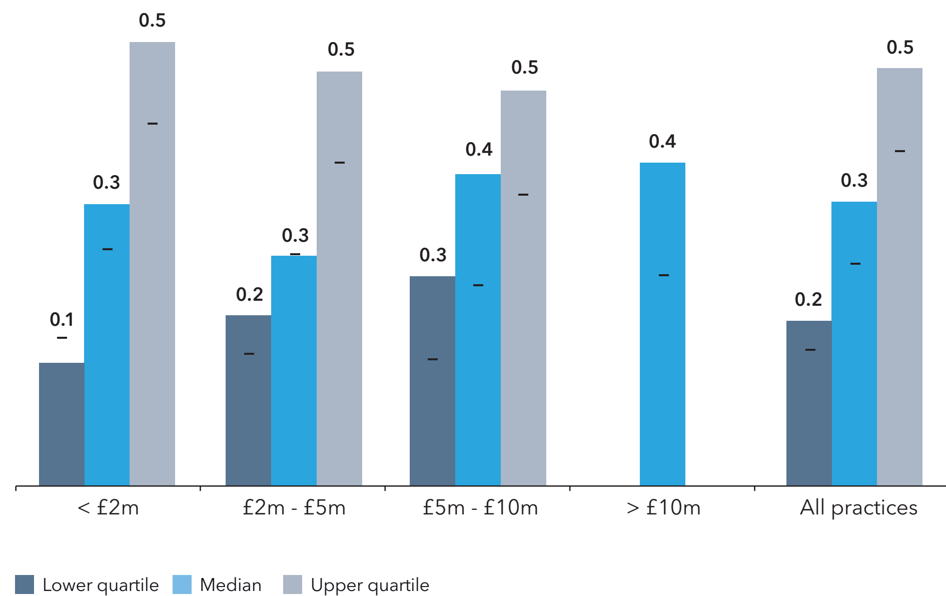


Figure 6.14: External training costs as a percentage of fee income (%) income (%)



Accommodation costs

After staff-related costs, accommodation costs are usually the next largest expense for any law firm. Accommodation costs typically consist of rent, rates, office insurances and office running costs such as day to day utilities.

The results here show a median spend on accommodation costs of 5.6% of fee income, down slightly from 5.7% in 2021.

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 comparable across the board.

The pandemic forced all firms to take urgent action to enable staff to work effectively from home, with many investing in IT equipment and in some cases furniture too. Our experience is that most firms have adopted a hybrid approach to working practices, with a combination of some time in the office and some time working from home.

There are mixed views on how this has impacted on firms' use of existing office space, with some firms wishing to scale back as much as possible, whilst others are looking to use their offices in different ways, to make them nicer places to be for the staff that are there.

In any case, for now, many firms will find that they are tied into lease agreements that extend beyond the pandemic, and so the true cost savings of remote working may not be fully unlocked for a number of years.

As you might expect, with more staff returning to the office, other premises costs such as light, heat and maintenance increased for the majority of firms in the survey, as shown in Figure 6.17. Following the recent increases in energy prices, we expect other premises costs to rise significantly in next year's survey.

Figure 6.15: Accommodation costs as a percentage of fee income (%)

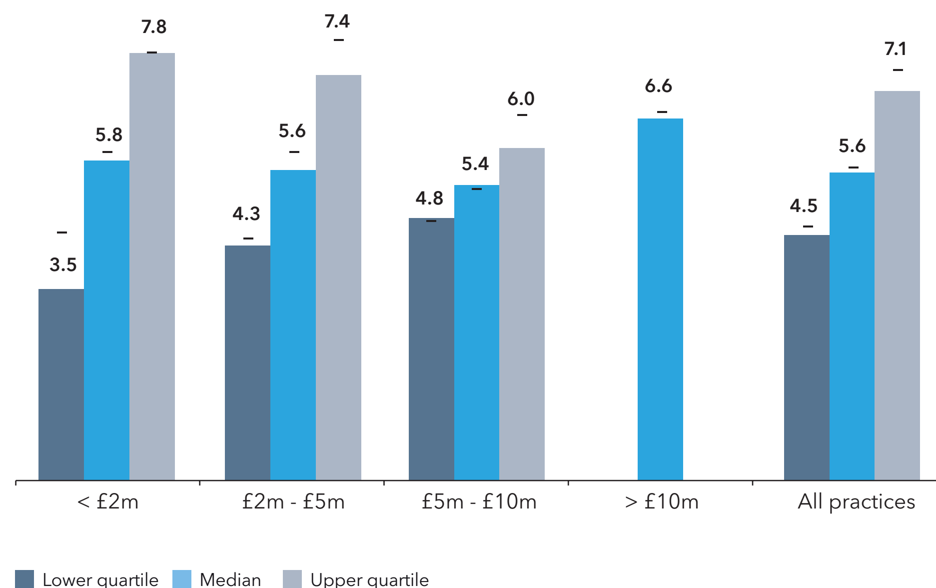


Figure 6.16: Premises rental payments as a percentage of fee income (%)

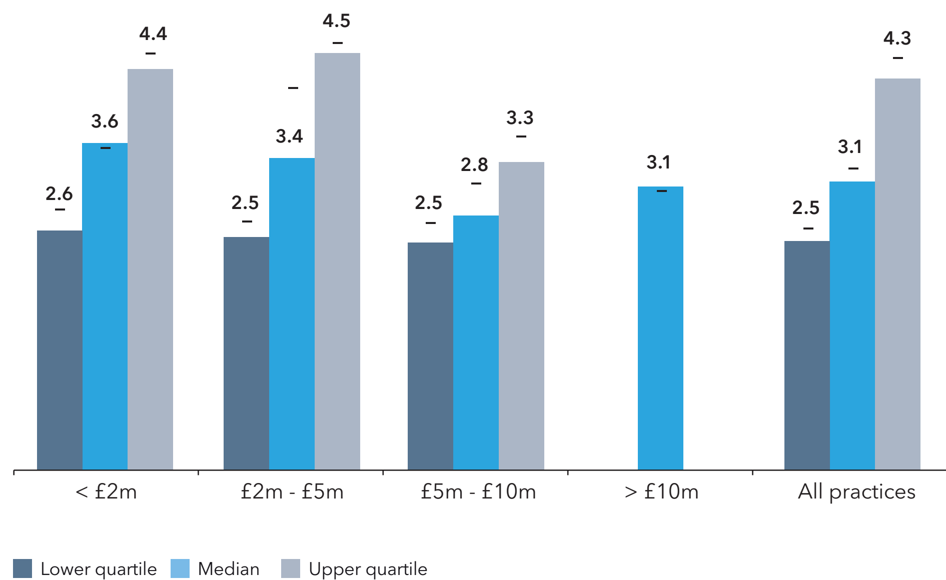
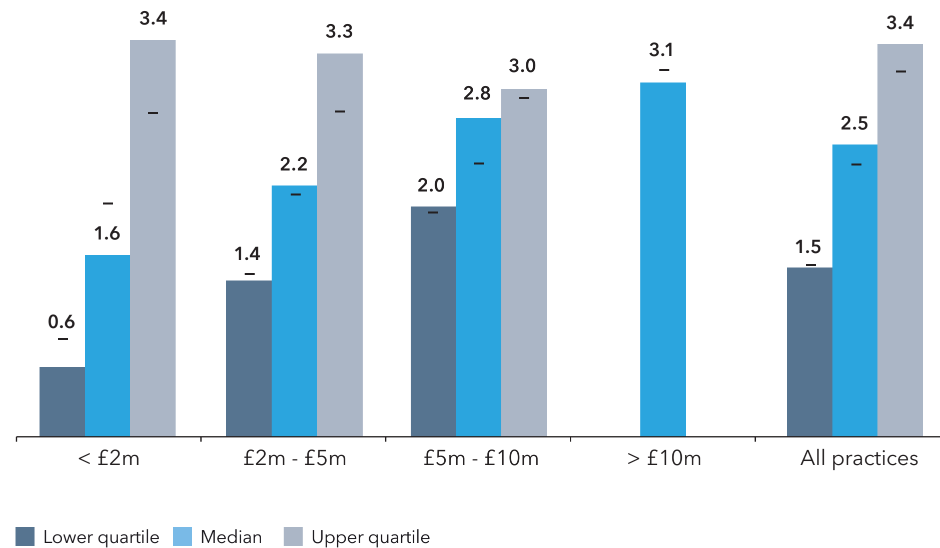


Figure 6.17: Other premises costs (rates, light and heat and maintenance) as a percentage of fee income (%)



7. 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 six key areas:

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

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 6.1, and those with net profit per partner below the median, in each turnover band. We then reanalysed these two groups, to calculate new median figures, so that we can more easily represent what a well performing firm looks like relative to a firm that is underperforming.

The six charts 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.

Arguably, lock up days do not affect overall profitability. However, it is interesting to note that the more profitable firms in our survey generally have lower lock up (WIP and debtors), perhaps as a result of stronger financial processes.

Figure 7.1: Fee earner gearing (median figure only)

Figure 7.2: Fee income per equity partner (£'000) (median figure only)

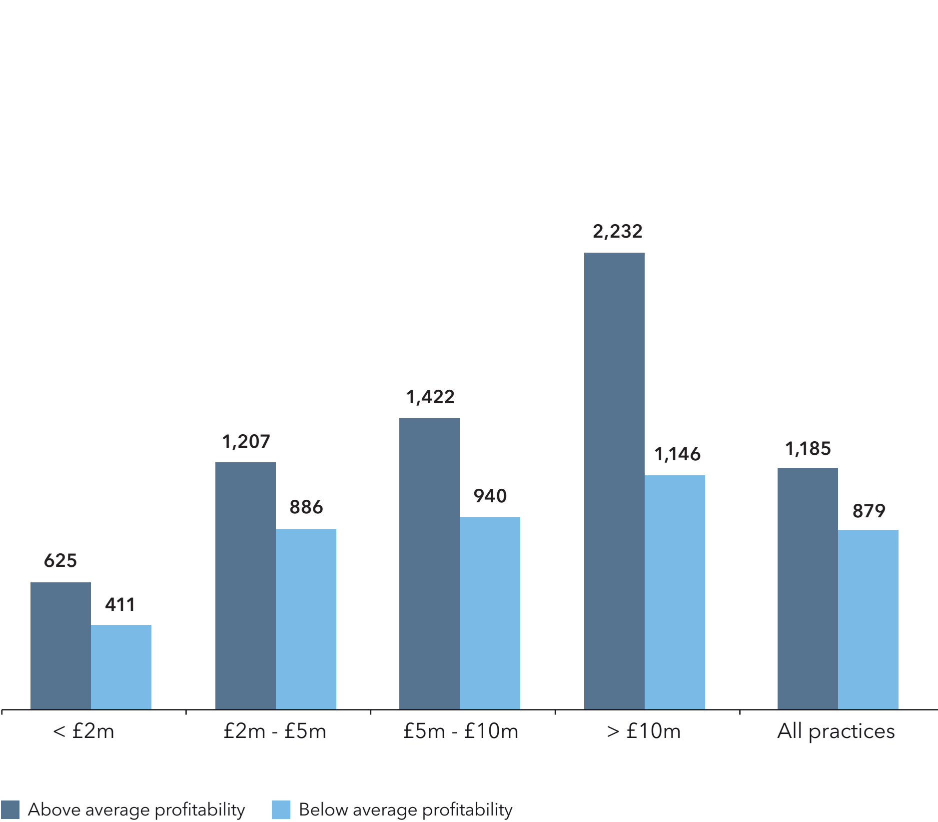


Figure 7.3: Fee income per fee earner (£'000) (median figure only)

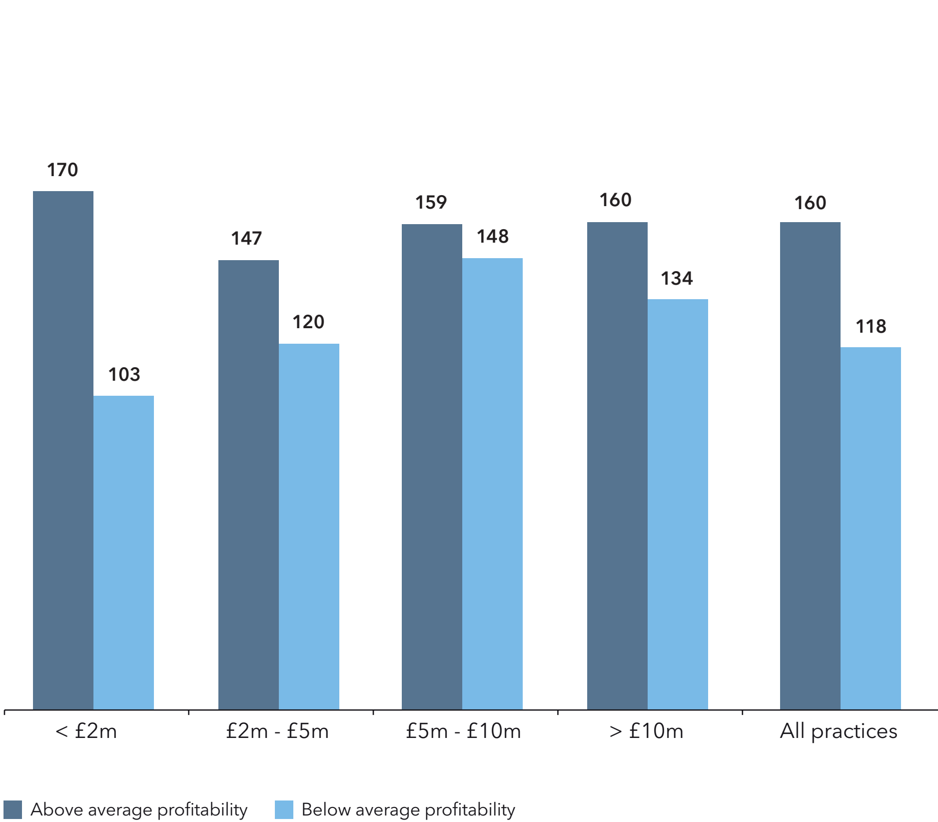
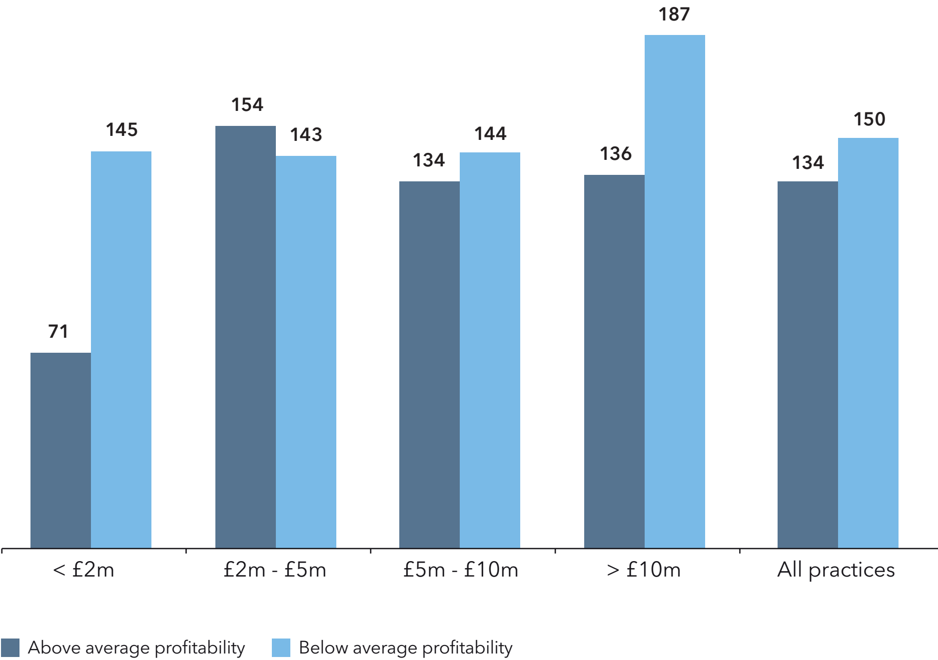


Figure 7.4: Total salary costs, including notional salaries, as a percentage of fee income (median figure only)

Figure 7.5: Non-salary overheads as a percentage of fee income (median figure only)

Figure 7.6: Total lock up days (median figure only)



8. Working Capital

It is always challenging 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.

This is particularly true this year, where some firms in the survey will have had their 2021 financial year ends during one of the COVID-19 lockdowns, and others will not. The early stages of lockdown were characterised by firms and clients alike pushing particularly hard to progress matters in the pipeline and convert time worked into bills as quickly as possible.

This year, the median number of days combined lock up has fallen from 150 in 2021 to 140 days in 2022. Both WIP days and debtor days have also fallen.

A 10 day reduction in lock up is good news. For a firm with turnover of £5m, a 10 day permanent reduction in lock up will free up £140k of cash. For many firms, that can make the difference between operating close to their overdraft limit and operating with no overdraft at all.

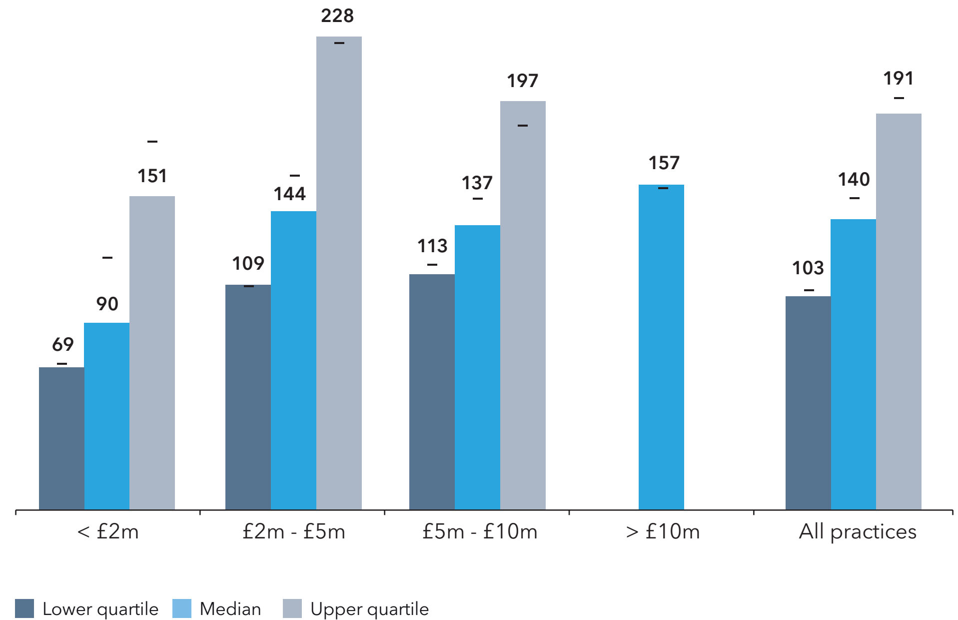
Regardless of the ongoing challenges facing firms, and as a matter of general good procedure, firms need to ensure that they continue to focus on reducing lock up where at all possible, as high lock up can not only lead to adverse cash flow issues but often also leads to increased bad debt exposure too.

140

-10 days year end lock up

2022 7% days lock up

Figure 8.1: Total lock up (days)



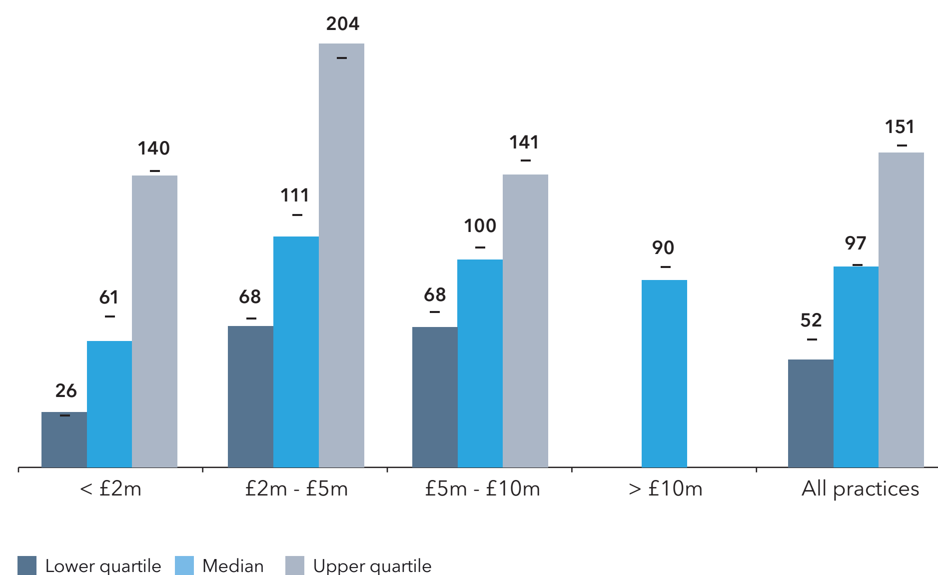
WIP days

Work in progress (WIP) days have been calculated based on total WIP per participants' time records, as opposed to the figure included in their year end accounts, as, for many firms, the figure in these accounts does not include large amounts of contingent WIP.

We typically see firms that operate conditional fee agreements carrying large amount of contingent WIP that is not reflected in their year-end accounts, and it is just as important for those firms to be able to monitor that WIP as it is for firms that raise interim bills as matters progress

While firms tend to focus on credit control as the primary tool to manage lock up, good financial hygiene starts at an earlier stage than chasing debts, and the best performing firms have robust polices that ensure that all time is captured properly, in a timely manner, and that time is billed as soon as the work is complete (and the client is still happy), rather than waiting until the month or quarter end.

Figure 8.2: WIP days



Debtor days

Debtor days have seen a drop of over 10% this year, from 35 days to 31 days. This is good news, and demonstrates that firms have been keeping a close eye on debtor days to keep exposure to potential bad debts to a minimum. As we have noted in previous years:

- Fee earner training on managing lock-up can make a huge difference.
- Small changes to standard practice, such as raising bills as soon as the work is complete, or raising more frequent interim bills where the work type allows, 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. A client who is happy with the outcome of a case may well pay more quickly if they receive the bill promptly. For those clients that are not as happy, prompt billing gives everybody the opportunity to resolve the matter while knowledge is still fresh.
- Many firms continue to carry large amounts of unbilled disbursements, and often do not ask for money on account of them, even in areas where it should be straightforward for them to do so (e.g. property work). Too many firms continue to extend unnecessary free credit to clients by funding disbursements from the office account rather than using the client's own money.
- 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, as well as taking a lot of the emotion out of the process, and will allow fee earners to focus on fee earning. However, any policy should allow some degree of flexibility, and in some cases, it is the fee earner who is better positioned to negotiate a favourable outcome.

Figure 8.3: Debtor days

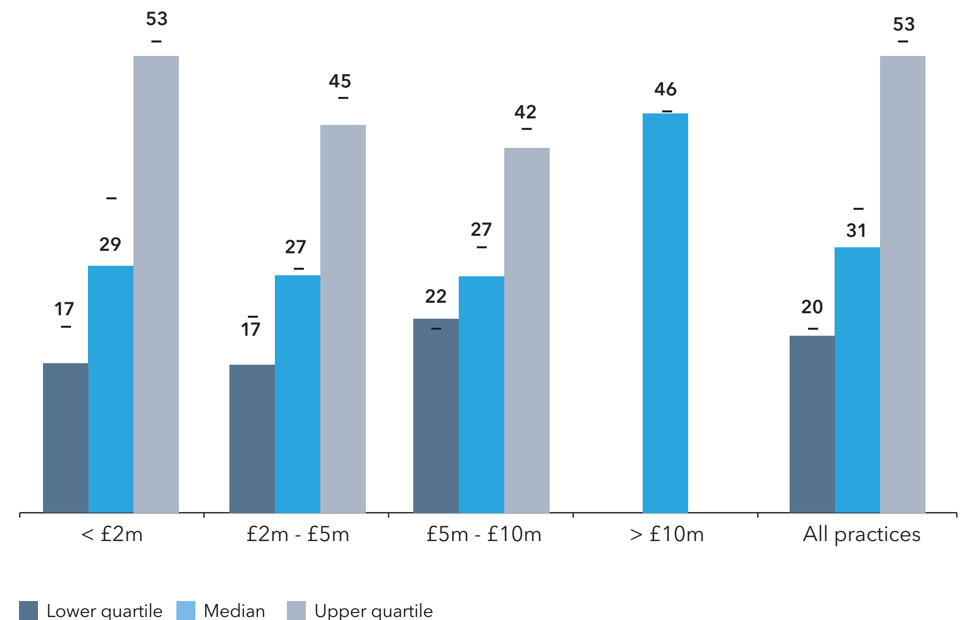
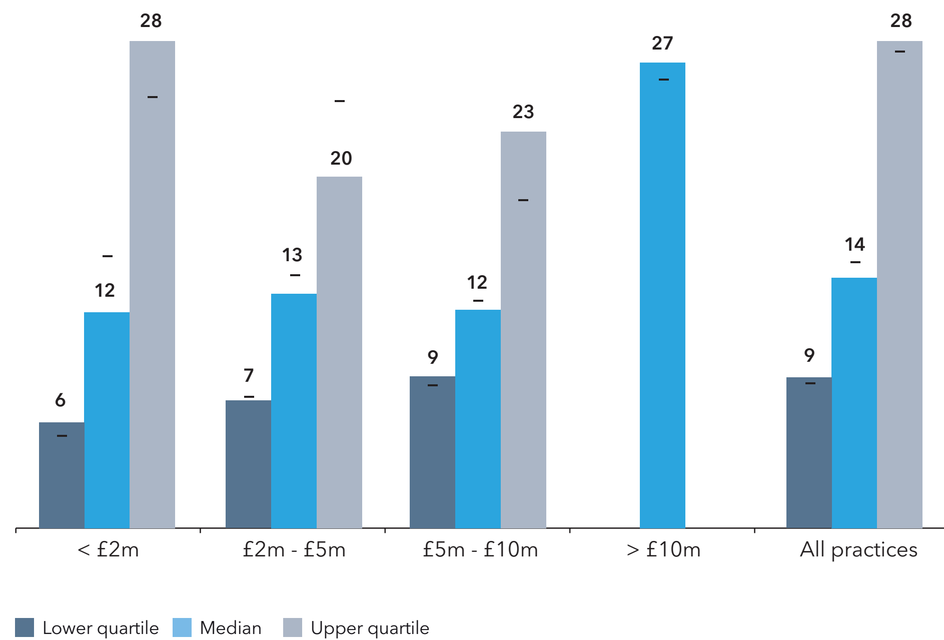


Figure 8.4: Debtors per fee earner (£'000)



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, retained profits and any directors' loan accounts.

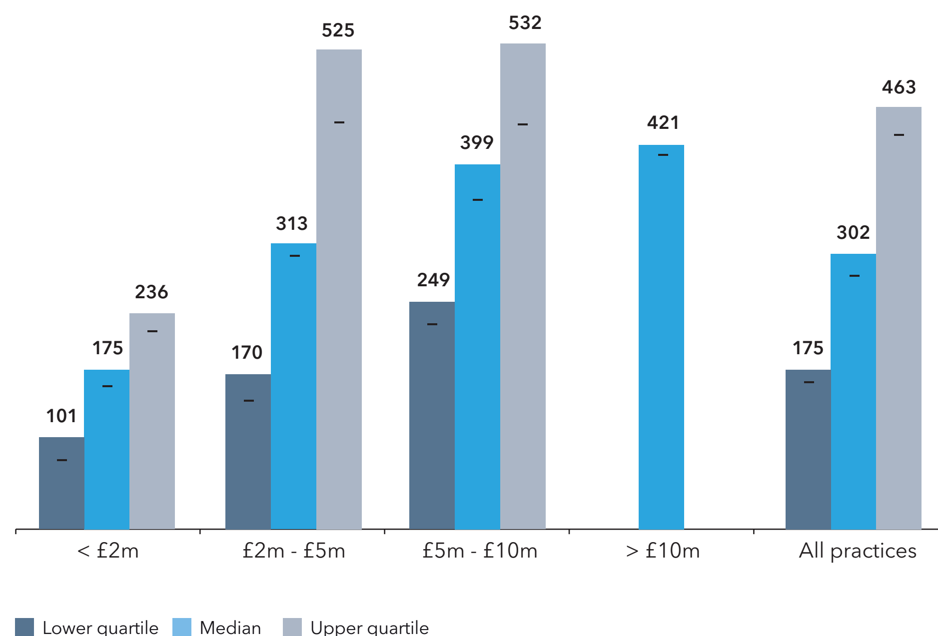
The participants in this year's survey reported a median 9.5% increase in individual partner capital in 2022, with a median of £302,338. As you might expect, partner capital increases in line with the size of firm.

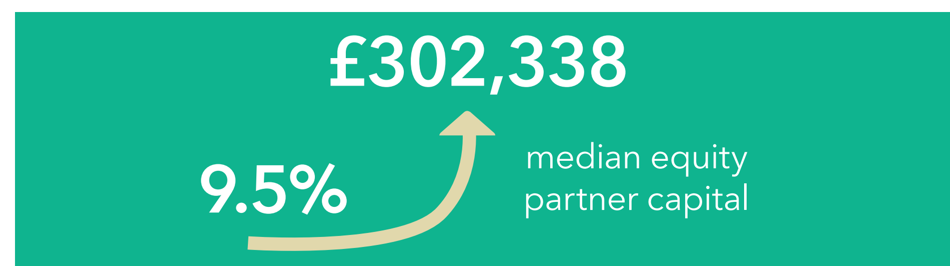
As noted earlier in this report, from the 2023/24 tax year, all self-employed individuals and partners will in future be taxed on a tax year basis, rather than an accounting year basis, i.e. individuals will pay tax on profits arising in each tax year, regardless of the firm's accounting date. The changes are set to come into effect from April 2023, with a transitional period in the 2023/24 tax year. Limited companies are unaffected.

For most firms, the changes will not involve ultimately paying more tax – rather it is an acceleration of tax payments. Whilst it will be possible to spread the accelerated tax over up to five years, firms will need to manage cashflow to prepare for the changes. Managing lock-up is key to this, and the tips listed earlier in this section can help.

We would also recommend that firms consider introducing partner tax reserves into their accounts if they do not already have them, as this can help ensure that partners do not overdraw profits, leaving themselves short.

Figure 8.5: Partners' account balances per equity partner (£'000)





Bank and other borrowings

81% of participants reported a positive office account balance at their most recent accounting date., although the figure for the same firms a year earlier was 91%. Last year, we reported that almost three quarters of participating firms had borrowed money through either BBILS or CBILS, and at the time, many were still holding on to the money 'just in case'. Since then, many firms have either repaid the loan or (more often) used it to fund working capital, viewing the loans as cheap debt in comparison to traditional funding options.

The median office account balance across all participants was £295,000, down from £437,000 in 2021, with all turnover bands reporting a positive median balance.

Almost a quarter of participants reported that they operated with no overdraft or bank debts at all. For those firms that had bank borrowings and/or a bank overdraft, the median amount per equity partner was £83,333.

Finally, 21% of firms told us that they used secondary funding to finance payments such as the firm's VAT, partners' tax bills and annual practicing certificate renewals.

Figure 8.6: Year-end office account bank balance (£'000)

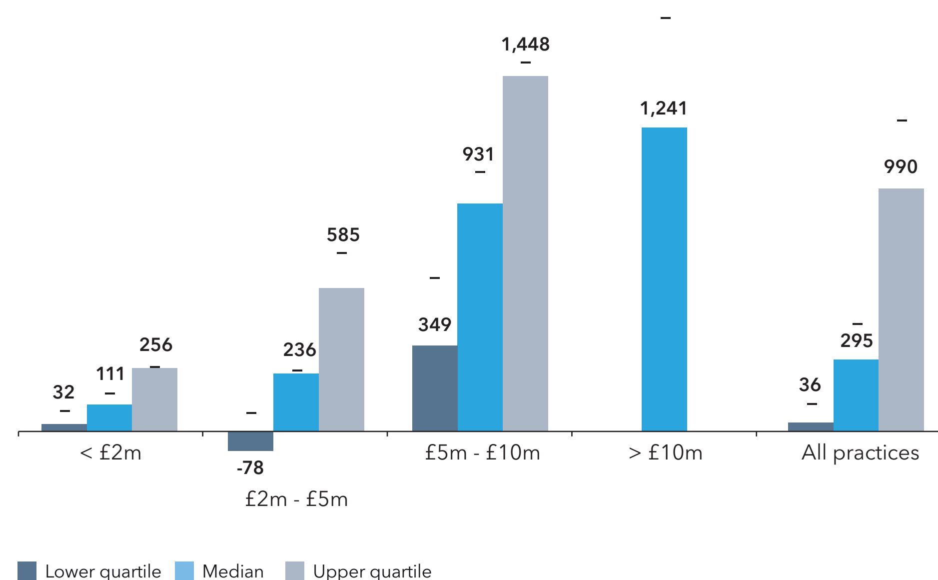


Figure 8.7: Bank borrowings per equity partner (£'000)

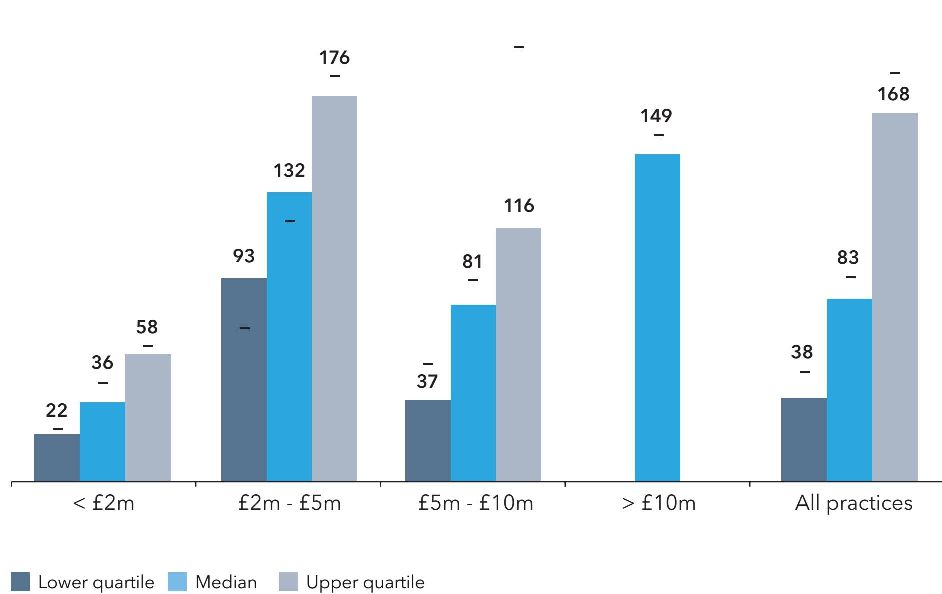
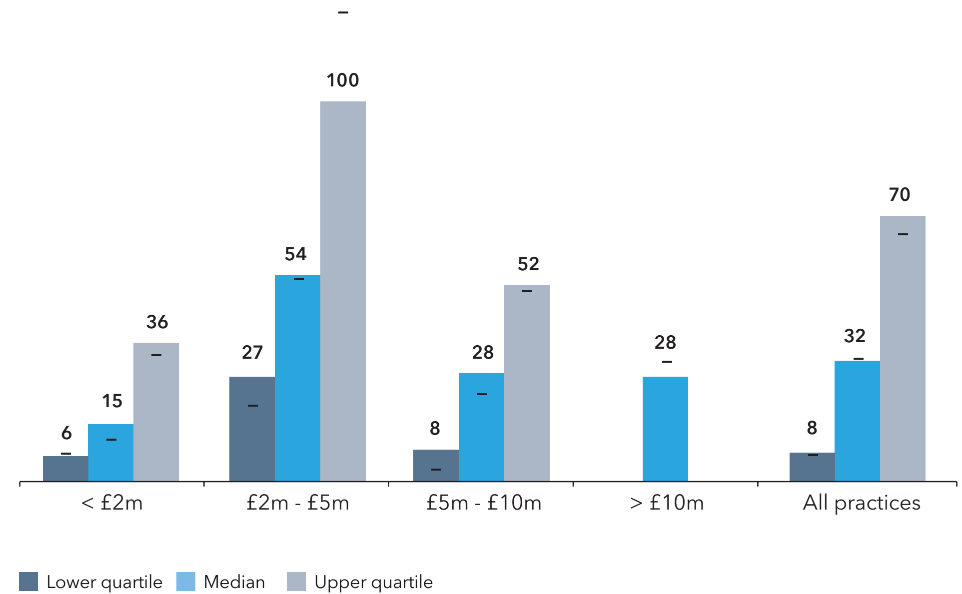


Figure 8.8: Other borrowings per equity partner (£'000)



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 where very high levels of WIP and disbursements often result in corresponding high levels of external working capital funding.

Whilst most banks have lending options for incoming partners in a partnership or LLP, there are currently very few options for people wishing to buy into a limited company.

Some banks have been hit quite badly by high profile firm collapses in recent years, and those experiences have had a lasting impact on some banks' appetite to lend, especially where a large proportion of borrowings are secured against contingent WIP.

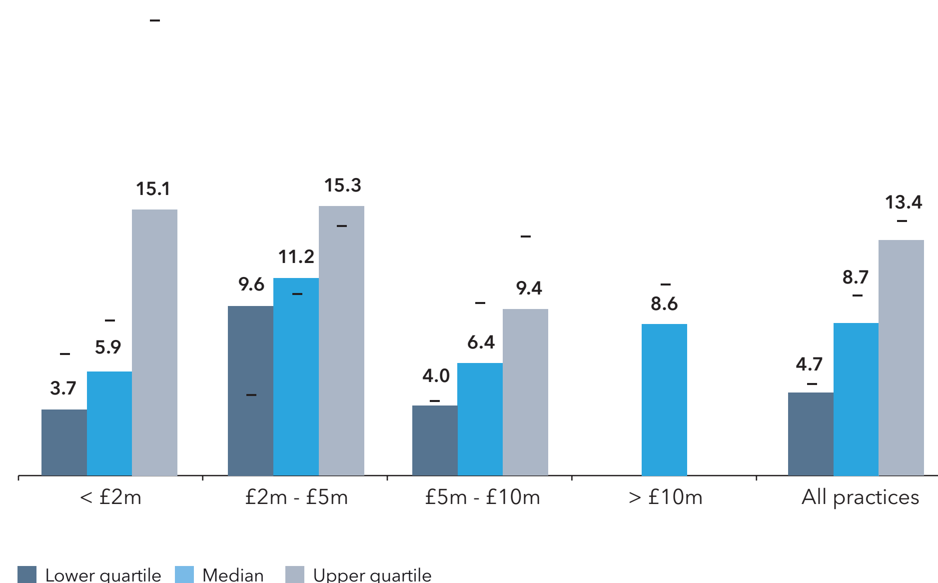
There have been other recent developments that are likely to impact on banks' attitudes to lending:

- From 1 December 2020, HMRC's status as a preferential creditor was restored, which means that when a company goes into liquidation owing money to HMRC, HMRC takes priority over other creditors for certain outstanding taxes. These taxes are those which have been 'paid' by employees and customers through the business, such as PAYE, VAT and employee NIC. The age of these tax debts does not matter, and all outstanding arrears will be given preferential status.
- As noted earlier, many law firms have borrowed through BBILS or CBILS, either from their main bank or a secondary lender. As a result, the ratio of borrowings to partner capital in those firms will have risen sharply.

Both of these factors could mean that lenders will become more reluctant to lend on an unsecured or floating charge basis, as the chances of recovering funds on a liquidation will be reduced.

Many banks pay close attention to the ratio of borrowings to fee income when assessing a firm's ability to make repayments, and will be concerned to see an increase for the firms in the survey, with a median of 8.7% compared to 10.2% in 2021.

Figure 8.9: Bank borrowings as a percentage of fee income (%)



9. Financial stability

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:

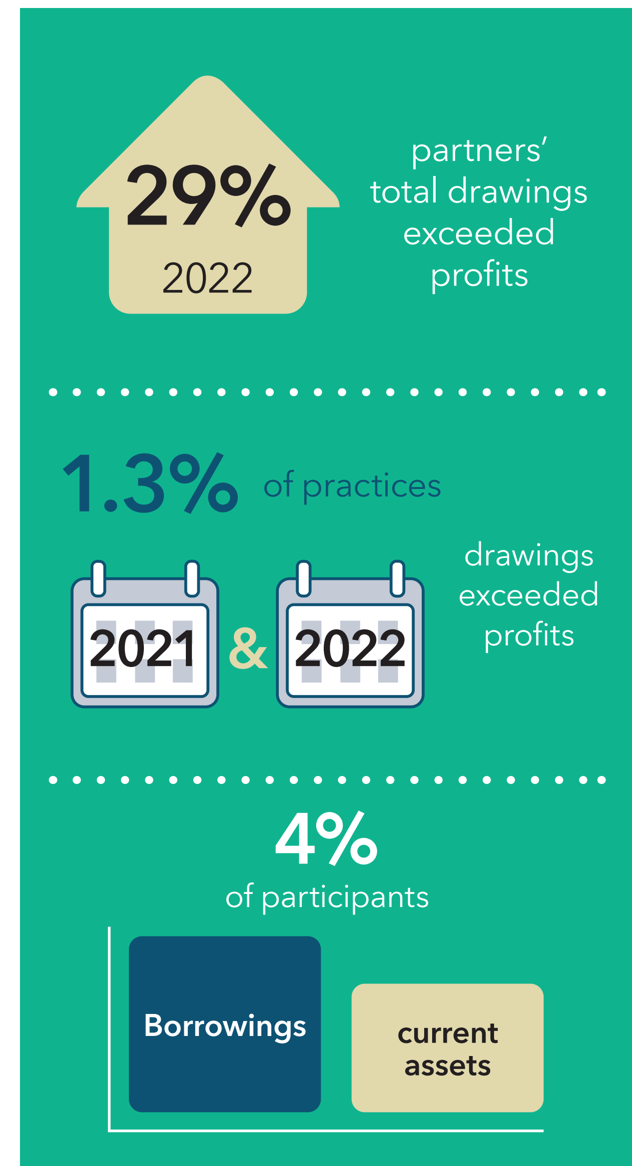
- Drawings in excess of profits.
- Borrowings in excess of net assets, i.e. net liabilities.
- Borrowings over a certain (undefined) level.

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.

In recent 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.

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

- In 2021, just 7% of participants in this year's survey had taken drawings in excess of profits. However, in 2022, this increased to 29% of participants. Just two firms reported that they had taken drawings in excess of profits in both 2021 and 2022. As we have noted in previous years, sometimes this is no more than a timing difference driven by when partners decide to withdraw profits and is more pronounced in firms that carry a large amount of contingent WIP.
- Borrowings exceeded current assets (WIP and debtors combined) for just 4% of participants.
- Finally, none of the firms in this year's survey had borrowings in excess of total partner capital, and total partner capital had increased in 61% of firms.



The short term future – fee predictions

10.

Survey participants were asked for their projected fee income for the current 2023 financial year. Confidence was fairly high across firms in all turnover bands, with a median growth prediction for 2022/23 of 3.5%. The upper quartile are predicting growth of 10.1%, whereas the lower quartile are predicting a 2.5% reduction in fees.

Following recent increases in bank base rates, we have begun to see a return to the days of earning substantial amounts of interest on client monies. Nowadays, many firms have placed the top slice of client money into SRA-compliant term deposit accounts in a bid to earn more interest, and we are even seeing the return of overnight treasury accounts.

We would also recommend that firms review their interest policies, as a de minimis limit of £50 or more is commonplace nowadays.

Figure 10.1: Predicted fee growth for the 2022/23 financial year (%)