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UK Law Firm Accounts

Accounting treatment may seem a dry issue, but it can impact on law firm performance by at least 20 per cent.

In a lockstep firm, it may produce anomalies between different generations of partners. But how comparable are the figures between firms and in respect of different years for the same firm?

What follows is the top 10 issues that can have a major impact on law firm reported profitability and, as such, can affect reported figures. Any partner should know how these factors impact on their firm. For any lateral hire,it is an essential part of the due diligence process.

- How is the firm accounting for its property costs? Are rent free periods being accounted for upfront or amortised over the length of the lease? Does any landlord contribution to fit-out have any impact on future rent levels, and how is it being applied? Is any provision for dilapidations needed and how is surplus space being accounted for? How are relocation costs being expensed? Taking rent-free benefits upfront can have a dramatic impact on law firm profitability, as rent alone accounts for at least 10 per cent of a firm's cost base. However, if this benefit comes at the price of taking additional space, a longer lease or a higher rent later, this may produce substantial unfairness between groups of partners at a later date.

- On what basis are the earnings of other offices converted into sterling? If a year-end exchange rate is used this may distort performance. In this year's figures, using year-end rates for euro-denominated offices will have inflated performance by around 15 per cent. Using an average exchange rate for the year will substantially reduce this uplift and is probably more prudent.

  Remember that exchange rates go down as well as up. Also, your eurozone partners will be unimpressed by the sterling increase in profits which, for them, results in reduced euro drawings.

- How realistic is the value of the work in progress (WIP)? Most firms agree a cost base of their WIP with the Inland Revenue and use this for their accounts. But with so many deals not proceeding, how realistic is the WIP valuation, especially given that everything that could be billed will have been billed by the financial year-end?

- Bad debts are usually an insignificant exposure for law firms, but with so many redundancies in the City the person to whom the bill was sent may no longer be there. Is the firm being rigorous in discounting bills over, say, three or six months old?

- Traditionally, a firm was funded by partner capital, often borrowed individually by partners. Now a myriad of financing techniques are used, including bond issues. The cost of borrowing by the firm will generally appear as a pre-profit item, whereas the cost of borrowing by a partner will generally be post-profit.

  Although interest rates are currently low, on capital of £250,000 this will impact on reported partner earnings by around £10,000.

- What depreciation policy is used and is it appropriate? Although depreciation for tax purposes is a benchmark, what is the real life and residual value of IT equipment, office furniture and office fit-out? Should certain expenses be expensed rather than capitalised?

- We know the havoc the pensions crisis has inflicted on corporate UK, but how has that been accounted for in the firm? Most firms have or will have had a staff final salary scheme at some stage. Is it still open? When was the last full valuation and how is any deficit to be funded?

- Partners are increasingly being ‘let go’. How is the termination package, which may include a short-term annuity or pension, being accounted for and funded?

- Are all professional indemnity (PI) claims properly provided for? This may seem an odd question, as few claims are likely to exceed the level of their PI cover; however, most policies have various levels of deductibles which may be significant.

- What is the effective tax rate that the partners pay? For UK partners you may think the top rate of tax is 40 per cent. However, many business expenses may not be tax deductible. Furthermore, the tax and accounting treatment of an item may not (for perfectly legitimate reasons) be consistent. Accordingly, it is not unusual for partners in a UK firm to have an effective top rate of tax of around 45 per cent.

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