

# RECOGNISING INCOME AND VALUING GOODWILL IN LAW FIRMS

DASLS PRACTICE MANAGEMENT CONFERENCE

NOVEMBER 2019



# OVERVIEW OF NEXT 45 MINUTES.....

- History of “WIP” recognition
- Time recording & Valuation
- Practical issues
- Valuation of the law firm / Goodwill

# HISTORY OF WIP RECOGNITION IN LAW FIRMS

- Pre 1999 – Cash basis
- Post 1999 Cash basis removed (WIP recognised)
- Post 2005 (Pre UITF 40) (Accrued income recognised) – spreading rules
- Post 2015 (FRS 102) – adjusted to interpretation of CFA recognition

Interaction with Goodwill?.....

## A COMMON CONVERSATION IN OCTOBER AND NOVEMBER.....

- **Andrew:** “Hi – How are the halve year results looking to September 2019”
- **Managing partner:** “Excellent we seem to be bucking the trend from talking to other firms; we are ahead of budget and last year; so looks like are on track for current account pay-outs in November!”
- **Managing partner** “We’ve done £5million and are £500,000 ahead of our budget fees of £4.5million for the first 6 months!”
- **Andrew:** “That’s great news. Are you ahead of fees issued and earned income?”
- **Managing partner:** “Sorry what do you mean?”
- **Andrew:** “Are you looking at earned income, including movements in WIP since the last year end, or just fees issued?”



## A COMMON CONVERSATION IN OCTOBER AND NOVEMBER.....

- **Managing partner:** “Gosh no; we only look at WIP and value it at the year end for you; hang on I’ll check”
- **Managing partner:** “Great news Andrew; we have reduced our WIP by nearly £1.4million since the last year end; explains why cash is looking healthy!”
- **Andrew** “Your right that is good news cash wise”
- **Andrew** “If you think about profits however this is not so good; you normally recognise about 80% of your WIP in your accounts; if WIP is down £1.4million then your earned income is actually the fees issued of £4.5million less 80% of £1.4million; so you have earned income of about £3.9million.
- **Andrew** “Assuming you didn’t budget for a WIP reduction I think that means you are under budget by around £600,000”

## A COMMON CONVERSATION IN OCTOBER AND NOVEMBER.....

- **Andrew:** “Assuming I’m right its probably worth having a look at fee earner productivity and projecting cash flow for the rest of the year as this is likely to deteriorate; especially with the significant January tax bill following the excellent results in April 2018”

- **Managing partner:** “.....”



- **Andrew:** “You still there?”

# RECORDING AND VALUATION

- Why are we recording time?
  - Charging clients
  - **Costing matters**
  - **Future pricing**
  - **Performance review / process management**
  - **Measuring profitability**
  
- Important aspects of recording:-
  - Capturing all matter related time
  - Capturing non matter related time?
  - Recording on a timely basis
  - Writing off when irrecoverable and reviewing old matters
  - All fee earners time recording? All teams?





# RECORDING AND VALUATION

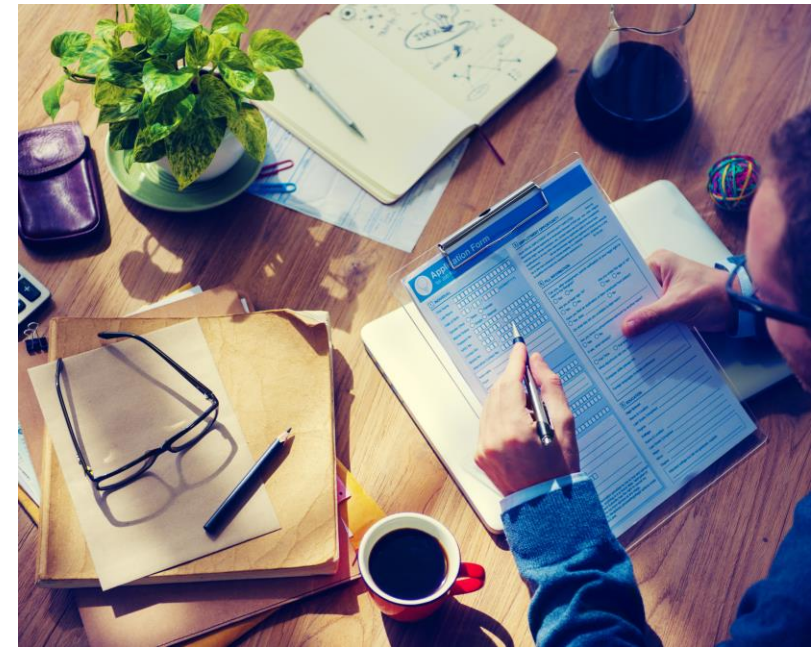
- Valuation adjustments for accounting
  - Fee earner review of matters
  - Recovery rate adjustments
  - Age profiled reductions
  - Bad debt provisions
  - Cost to bill provisions
  - Commercial value adjustments on early matters
- Common outcomes as a percentage of PMS Value?
  - Overall (typical firm)
  - Dominance of work types (e.g. CFA / private client / Litigation / Commercial)





# RECORDING AND VALUATION

- Valuation problems / common approaches
  - PI / Medical negligence – CFA matters
  - Highly homogenous matters
    - Residential conveyancing
    - Employment (employee matters)
  - Contingent commercial / commercial property work



# RECORDING AND VALUATION

## **Why would we want to record unbilled time at less than commercial value (subject to accounting standards)**

- Defer income tax
- Control income tax rates between years

## **Why would we want to record unbilled time at commercial value (subject to accounting standards)?**

- Equity between incoming and retiring partners
- Reliability of financial performance measures (year end and in year)
- Ensure better investment and financial decisions are made in the business

## **What might we do where accounting valuation methodologies do not provide a fair commercial value?**

- Allocate profits that are different to the accounts!
- Consider pre and post retirement adjustments to profit sharing
- Consider interaction with “goodwill” models on retirement – annuities and retirement schemes

## VALUE OF A FIRM?

How could you value a law firm and where does unbilled time valuation impact on a valuation?

**VALUE = NET ASSETS OF BUSINES AT FAIR VALUE + GOODWILL**

**GOODWILL = NET MAINTAINABLE EARNINGS X MULTIPLE**

# NET ASSETS AT FAIR VALUE - EXAMPLE

	Firm A £'000	Firm B Notes £'000
Partners	20	27
Average investment	250	250
Net Assets	5,000	6,750

Fair value adjustments:-

Dilapidations	(275)		No policy of providing for dilapidations/reinstatement
Former partner annuities	(150)		Unfunded in balance sheet
Onerous property lease	(250)		Remainig 5 years; no sublet expected; £50k p.a.
Deferred tax	(75)	(450)	Neither firm provides
CFA WIP		2,000	No value included for CFA WIP
Net Assets at fair value	<u>4,250</u>	<u>8,300</u>	
Average investment (FV)	<u>213</u>	<u>307</u>	



# MAINTAINABLE EARNINGS

Adjustments to profit for factors such as:-

- Notional salaries
- Notional rent
- Non arms length transactions
  - Private motor and domestic expenses
  - Employed relatives
- Undervaluation of unbilled time
- Overvalued fee and disbursement debtors
- Omission of liabilities



# MAINTAINABLE EARNING- EXAMPLE

	Firm A £'000	Firm B Notes £'000
Partners	20	27
PEP	225	222
Net Profits	4,500	6,000

Notional Salaries	(2,400)	(3,015)	£120k per full equity, in firm B 5 are at 75% equity
Notional rent		(120)	B owns freehold worth £2m no debt; return assumed 6%
Employed spouses	(150)		A employs some spouses at overvalue
Private motor		250	B suffers P&L charge for all private motor costs; A mileage
Unbilled time		400	B gives no value to any CFA unbilled time in accounts
Maintainable earnings	<u>1,950</u>	<u>3,515</u>	
Super PEP	<u>98</u>	<u>130</u>	



# MULTIPLES

- “Widget manufacturer” vs professional services
- Likely range for a law firm
- Aspects that may impact level:-
  - Stability of profits / cash generation
  - Succession planning
  - Nature of firm
  - Management structure
  - Composition of income / future prospects
  - Any sector specific IP or brand
- Arms length vs “specific purchasers”



# VALUATION?

	Firm A £'000	Firm B £'000
Partners	20	27
PEP	225	222
Average investment	250	250

## MULTIPLE 1

Net Assets at fair value	4,250	8,300
Goodwill	1,950	3,515
	<u>6,200</u>	<u>11,815</u>

Per Partner	310	438
<i>Gain</i>	<u>60</u>	<u>188</u>

## MULTIPLE 1.5

Net Assets at fair value	4,250	8,300
Goodwill	2,925	5,273
	<u>7,175</u>	<u>13,573</u>

Per Partner	359	503
<i>Gain</i>	<u>109</u>	<u>253</u>

## MULTIPLE 2

Net Assets at fair value	4,250	8,300
Goodwill	3,900	7,030
	<u>8,150</u>	<u>15,330</u>

Per Partner	408	568
<i>Gain</i>	<u>158</u>	<u>318</u>

## CLOSING THOUGHTS

- Accurate, complete and reliable time recording provides help to:-
  - Price future work
  - Monitoring performance of the business and individuals
  - Provide information to improve future profits
- Reflecting an accurate value in the year end accounts for unbilled time is important for:-
  - Ensuring equity between partners from year to year
  - Helping the firm make the right investment and strategic decisions
- Commercial value of unbilled time can in some cases exceed the value that firms (can) or want to record in their accounts. In some circumstances firms may want to consider how this value is captured for the appropriate group of partners at any time.
- The valuation of unbilled time can significantly impact on the valuation of a firm in terms of goodwill or simply capital value. This can be an important consideration in aspects such as:-
  - Incoming partner arrangements
  - Mergers
  - Third party sales or investments



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