

Stop the clock?

A research report on fees and value
in legal services

Welcome

A lot has been written recently on the subject of law firm fees as in-house counsel come under greater pressure than ever to reduce costs and demonstrate value to their management teams.

The issue of fees goes to the very heart of the relationship between commercial law firms and those organisations with in-house legal teams. Most in-house counsel recognise that simply focusing on reducing fee rates is only a short-term gain. The real opportunity is to move away from a traditional adviser–client relationship and develop a true partnership based on a mutual understanding about quality, risk sharing and value creation, as well as competitive billing.

A partnership approach completely changes the conversation compared to an adviser-client relationship. Talking about clients as ‘partners’ tests the approach of law firms like nothing else. Likewise for in-house counsel when, for example, a law firm says it would like to get closer to a board. A partnering approach would help close the divide which is often articulated, that law firms are focused on process and in-house counsel on results. On both sides, there are complaints of short-termism but long term equity in relationships needs significant thought-based investment.

Getting to a partnership model may take time. So, as a first step in a major new initiative, C&I Group and BDO Stoy Hayward have teamed-up to conduct independent research which should help us all to understand better the needs, views and experiences of in-house counsel in relation to fees and value, and to be a catalyst for a more forward looking dialogue in this area.

We are excited by the findings. There is a role for hourly rates, fixed and capped fees, value based billing and other structures. The challenge is learning when to use these various methods, developing accepted standards around their usage and capturing the value which legal services bring to organisations. We hope this report will facilitate positive on-going conversations between private practice and in-house counsel which helps to influence and inform the debate on this topic.

We would like to thank Rethinking Legal Services for organising round-table discussions, which formed an important part of this research. Special thanks are due to all the members of private practice and in-house counsel who have already contributed to the research, in particular the members of the C&I Fees Focus Group. We urge both in-house departments and law firms to share their views, experience and suggestions – this debate can only be shaped with your input. For more information please contact Christine Smith at the C&I Group (0161 480 2918 or christine@cigroup.org.uk).

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Paying by the hour

Concern about the level of fees charged by law firms is nothing new. Put two in-house counsel in a room together and talk will soon turn to the question of bills. But recently, the level of concern has increased significantly.

With hourly fee rates at their highest levels ever, especially in the City of London, many in-house counsel say the bills they receive from law firms bear little relation to the value of the services provided. At the same time, in-house counsel are coming under significant pressure from within their own organisations to cut the cost of legal advice. Clearly, these two trends are in direct conflict with each other.

In the short term, in-house counsel are having to juggle their budgets in order to access the legal services they need with the funds at their disposal. But in the long term, many are keen to engineer a new way of working with law firms, where bills and value are more closely aligned.

82% in-house counsel believe hourly billing provides no incentive for firms to be efficient

The C&I Group established a focus group to explore law firm charging and teamed up with BDO Stoy Hayward to commission this research. The study included a survey of almost 200 leading in-house counsel, a programme of round-table discussions – attended by both in-house counsel and law firms – and a series of interviews. This programme sought to identify some of the new and innovative approaches that are emerging.

“In-house counsel continue to become increasingly sophisticated buyers,” says Deepak Malhotra, General Counsel, Western Europe and Corporate Legal at the brewer InBev, who also leads the C&I Group Fees Focus Group. There is no ‘one size fits all’ approach to buying legal services, “but the in-house counsel involved in this project are keen to examine current billing practices, to see what best practice does exist, and then to share it. There is no easy answer in delivering ‘win-win’ change to fees and billing methods, and much of what exists works well. However, there is a growing sense of urgency for new charging models, greater dialogue on value and more innovative practices.”

The potential benefits are clear. Computer networking giant Cisco, for example, recently negotiated a 10 per cent cost reduction with one US law firm it uses by talking about how the two could cut costs by working together better. “We’re not trying to destroy their business model,” says Richard Given, a legal director at the company, “but rather we want to find new ways to align interests between lawyers and clients so that there are mutual incentives for efficiency.”

The review showed that the firm was billing for time that required no legal expertise, such as proofreading documents or chasing people for information. The two parties agreed that Cisco would do more of this work in future – enough of it to enable the law firm to commit to the 10 per cent cut with confidence, Cisco put in place a service level agreement: if Cisco doesn’t perform the work it has promised to do, it will have to compensate the firm.

More widely, believes Mr Given, linking costs to value will require a change of attitude by law firms. To maximise their own profits, they should take into account the changing needs of customers, in the understanding that as their customers prosper, so will they. “The firms will then be successful because of their customers, not despite them,” he says. “For some, that change in attitude may be like turning around an oil tanker,” he adds ruefully.

Research programme

This report is based on a three-stage research programme. We surveyed members of the C&I Group nationally, and received 171 completed questionnaires. Of the respondents, 43 per cent belonged to an organisation that had an annual turnover of over £1bn, 24 per cent had turnover of between £101m and £499m whereas just over one in ten earned between £500m and £999m. There was a balance of large and small legal departments, with 39 per cent employing more than ten staff and a similar proportion employing less than five. We also held a series of focus groups and round-table discussions with leading in-house counsel and law firms, and carried out a series of in-depth interviews with survey respondents.

But the burden of change doesn't fall solely on the firms, believes Mr Given. In-house counsel must change their ways, too. "The biggest challenge with value-based billing, and the source of resistance to it is that the clients can be useless at it," he says. "They don't understand that in order to make value billing work you both have to buy into it and you both have to behave." Often, he says, in-house counsel try to keep the work inside their own team, but then realise they can't do it and throw it to the law firm with little preparation and poor instructions. The result, he believes, is that both in-house counsel and firm resort to hourly billing, as there is no time or real basis to discuss an alternative.

Indeed, our research shows just how ingrained the hourly billing model is, notwithstanding the development of alternative billing structures. Hourly billing accounted for two-thirds of the total annual legal spend of our survey respondents; most had commissioned at least some legal work on this basis in the preceding 12 months. Nearly half of the respondents were dissatisfied with hourly bills and were clear about the reasons why (see figures below).

Respondents did say hourly billing had some strengths. Half of them believed it was simple and measurable. It also enabled them to compare the costs of different legal firms and helped them to break their bills down into clear component parts. To a lesser extent, it provided a degree of transparency. But one in ten in-house counsel said hourly billing had no strengths at all, and most were ready to be impressed by an alternative.

In the meantime, the in-house counsel at our focus groups talked about how they had, or were, turning to smaller or regional firms as a way of keeping costs down. "The people in

my business are saying they do not want to pay more for going to 'a name,'" said one. Another put it this way: "Someone once said to me I would never be fired for going to a magic circle law firm, but that attitude is starting to change." In the regions, they found excellent service from City-trained lawyers, but at a much lower cost.

10% in-house counsel believe hourly billing has no strengths at all

Some organisations are bringing their procurement departments to the negotiating table, believing this will help them to get better value for money. At computer company Dell, procurement function processes have affected legal purchasing for years, but there is now a much higher level of engagement from the procurement function on new legal supplier sourcing. Procurement team involvement is now mandatory on higher spend relationships, with only a few limited exceptions, says in-house counsel Bruce Macmillan.

Mr Macmillan is the EMEA liaison between the legal and non production procurement functions and has been closely involved in the development of some of procurement's processes. He says that this approach can work well. Legal still negotiates and agrees its budget with the finance function and the business management, but the procurement department is there to help to ensure that the suppliers with whom the legal team spend represent a reasonable use of the company's resources.

Figure 1: Strengths of hourly billing model

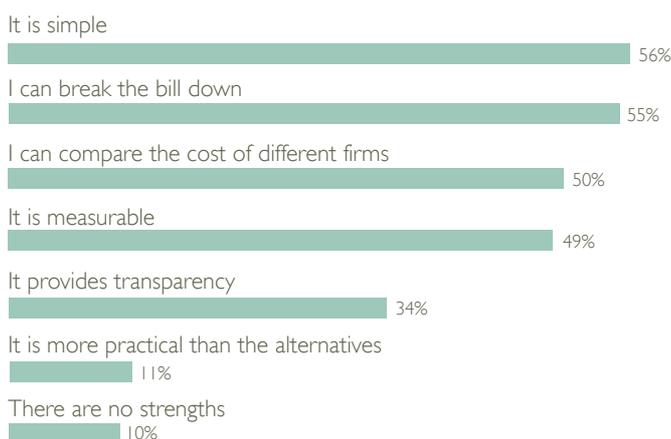
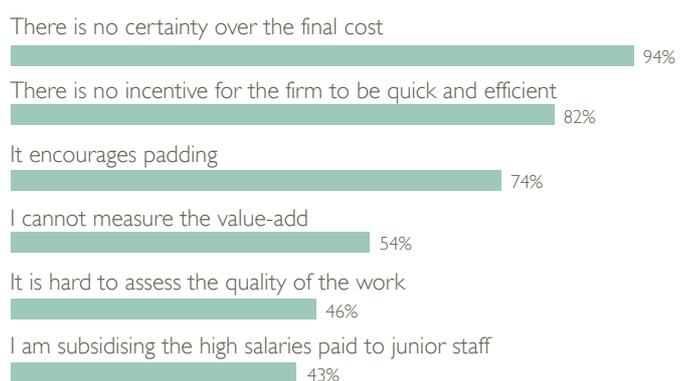


Figure 2: Weaknesses of hourly billing model



“The procurement function helps me to define what is best value (but not always cheapest) and helps the business to understand impartially the value that I’m getting,” says Mr Macmillan. It can also force any variance from best value – in terms of fees or billing practices – to be justified. Law firms have to justify their practices not only in comparison with rivals, but also a range of other consulting service providers, such as accountants, as these form part of procurement’s benchmarking data.

“[To deliver value, law firms should] provide accurate estimates, accurate daily rates and clear billing narratives, with no silly extraneous items and no surprises. [Anything else]...burns up good relationship capital.”

One result is that Dell asks some law firms to bill on a daily or half-daily rate rather than by the hour, for some of their work. This can offer better value and also means that “the bills look more familiar in terms of structure and content to people who are more used to dealing with other kinds of adviser,” he says. This scrutiny by finance and procurement teams also raises the bar that suppliers need to get over in terms of billing practice.

“One of the biggest pieces of value a law firm can deliver for me is to provide accurate estimates, accurate daily rates and clear billing narratives, with no silly extraneous items and no surprises – they need to get their paperwork right first time.” Anything else wastes time and, for Mr Macmillan, “burns up good relationship capital with the procurement and finance people upon whom I’m reliant for getting things resolved quickly.”

Figure 3: Billing methods used

	In-house counsel using this method ¹	Proportion of annual legal costs (users only) ²	Level of satisfaction ³
Hourly rate	97%	68%	2.61
Fixed fee	66%	31%	3.96
Success/conditional fee	13%	16%	3.76
Capped fee	42%	20%	3.8
Value-based fee	10%	13%	3.65

Notes: ¹ In last 12 months. ² Legal costs of those firms using each method. ³ Measured as a mean, where 1 = strongly disagree and 5 = strongly agree.

Trying alternatives

There are, of course, alternatives to hourly billing. Two out of three in-house counsel have engaged a law firm on a fixed-fee basis, and two out of five have used capped fees. When used, these billing models accounted for 31 per cent and 20 per cent of legal spend respectively. Conditional fees were used by 13 per cent of in-house counsel, accounting for 16 per cent of their legal spend.

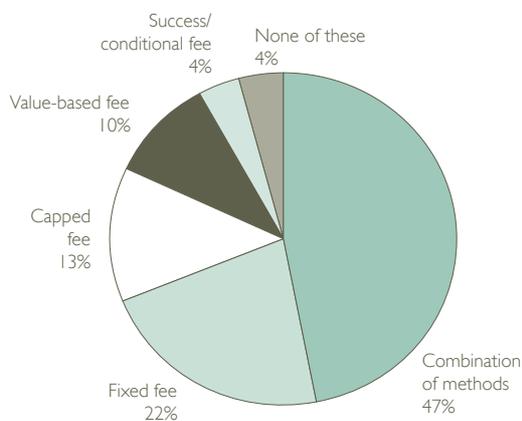
Are these alternatives more popular than hourly billing? Partly. On a scale of one to five, fixed fees achieved the highest satisfaction level (3.96), with capped fees close behind (3.8). Both levels are higher than the satisfaction rating for hourly billing, but neither statistic is a resounding endorsement.

In fact, the survey showed that in-house counsel do not want to replace hourly billing with any single alternative. The most popular stand-alone method – fixed fees – was ranked as the best substitute by only one-fifth of respondents. Of those in-house counsel that had used fixed fees, only one in four would choose it as the single alternative. Likewise, capped fees or value-based fees were chosen by just one in ten. “Hourly fees remain easier,” said one in-house counsel. “There’s not one solution that can be adapted to all types of work.”

47% in-house counsel want a mix of fixed, conditional, capped and value-based fees

Instead, there was more enthusiasm for firms to offer a flexible menu of billing options so that in-house counsel could then agree the mix that best suits the assignment. Just under half (47 per cent) said this kind of offering – one combining fixed fees, success/conditional fees, capped fees and value-based fees – would best meet their needs; but that percentage is hardly a ringing endorsement, either. In practice, in-house counsel often defaulted to hourly billing because they needed to move quickly.

Figure 4: Which alternative billing method is best?



So what is the best way forward? It's clear that many in-house counsel are concerned about the value they receive for the fees they pay. Some have used alternatives to hourly billing to see if a different charging model can align fees more closely with value, but experiences have been mixed. Perhaps the answer lies elsewhere?

One route many in-house counsel adopt is to challenge the bill when it arrives – as one participant in our research put it, “to negotiate value after the event”. Some in-house counsel are happy to have this kind of discussion with their legal advisers. Mark Harvey, in-house counsel at Help the Aged, says he typically works this way, receiving an hours-based bill from a firm and then asking what they actually propose to charge. “We’ll agree something at the end,” he says. Does that make for an awkward relationship? Apparently not. “It’s not haggling, it’s negotiating.” Mr Harvey says he is generally happy with the value he receives, and focuses on quality of service more than anything else.

Help the Aged, of course, is a charity, and as such has financial – and perhaps moral – leverage when asking for a fee discount. Les Todd, in-house counsel at Newcastle Building Society, would rather establish a clearer link between fees and value from the start. “I do not like receiving quotes which turn out to be totally unrealistic,” says Mr Todd. “In certain circumstances the quote may be exceeded, but I do not accept this as a fait

accompli, and generally find that constructive discussions need to take place to ascertain whether the increase is justified.”

Understanding value

Any negotiation over value, whether entered into when the bill arrives or when the work is assigned, begs the question: what is value? The majority of survey respondents and interview participants want a better link between fees and value, but their understanding of what value means in this context varies.

Broadly speaking, in-house counsel identified two ways of thinking about value. Some talked in terms of value for money. They wanted law firms to stop charging for costs that, in their view, added no value. One respondent complained about a firm that charged for travel time when its office was just a fifteen-minute walk away. A value-focused relationship is one, in his view, where he could phone up a lawyer to discuss an issue quickly and not be charged for it.

Other in-house counsel talked about value in a broader sense. They felt there was often no necessary link between the time a law firm spent on an assignment and the value of that work to the client. The effect of this can cut two ways.

Sometimes a firm might run up a large volume of billable time on an assignment such that the final fee far exceeds the value of that work to the client’s business. Other times, the opposite may happen: the firm provides highly valuable advice, but can only bill for a small amount of time.

“We [in-house counsel and private practice] need to understand what value means to one another before we can measure it.”

Defining value is not easy. “Value is ultimately about meeting the needs and expectations of customers (i.e. in-house counsel),” says Deepak Malhotra of InBev and the C&I Group. “But it is a two-way process and we should also recognise that billing and its correlation to value is just one aspect. Often, fees and value are linked to the quality of instructions. When in-house counsel and private practice needs are more closely aligned with one another, there is a better platform to build mutual value. We need to understand what value means to one another before we can measure it.”

“Law firms find it difficult to contemplate charging less than they would on hourly rates, and they find it difficult to explore the corollary of that – which is that sometimes they would be able to charge more.”

Of course, this difficulty is not unique to the legal services market; it affects every professional or consulting service. But our research suggests that the legal sector does not deal with it particularly well. “Law firms find it difficult to contemplate charging less than they would on hourly rates, and they find it difficult to explore the corollary of that – which is that sometimes they would be able to charge more,” says Richard Tapp, Company Secretary and Director of Legal Services at Carillion plc. “Until you’ve sorted out the first aspect of that, you will have difficulty dealing with the second.”

A solid majority of in-house counsel in our survey (68 per cent) said they would be willing to pay higher fees for valuable work if they were charged less for lower-value work. Only 4 per cent disagreed strongly with that idea. Value-based billing does not suit every kind of legal work however, as many of our research participants pointed out. “Value-based billing is by definition subjective,” says Rosalyn Breedy, in-house counsel at Sand Aire, a financial services firm. “It is therefore potentially open to exploitation by the client and/or law firm, particularly if expectations aren’t managed well in advance and the purchased process is not delivered in line with the agreement.”

68% **in-house counsel would pay higher fees for high-value work if they were charged less for lower-value work**

Nevertheless, the suggestion from our research is this: if law firms are willing to try a value-based approach, many in-house counsel would be receptive. Indeed, 65 per cent said they would like to discuss the possibility of value-based billing with the law firms they use. This point was reiterated – and amplified – during the focus group meetings, round-table discussions and interviews.

In order to create a closer alignment between fees and value, in-house counsel see a need for greater shared understanding of what ‘value’ actually is. Some law firms are keen to embrace change and many have been proactive in reaching out to their clients to discuss fees and innovative ways of charging.

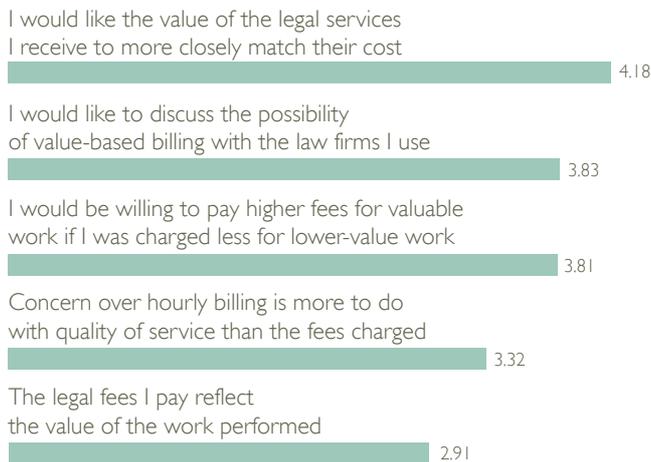
But there is a problem here. If in-house counsel and law firms are to explore a new approach to billing, they will have to do so in a climate of trust and for some of the in-house counsel in our survey, that trust is lacking. “I am concerned that a large number of law firms focus purely on chargeable hours and not on providing the service the client wants at an economical rate,” said one survey respondent. “They do not seem to understand that we are in business and have significant pricing issues ourselves.”

Another respondent addressed the same issue: “Law firms are currently disconnected from the commercial realities,” said the in-house counsel. “Almost all commercial organisations are required to make year-on-year cost savings – apart from law firms, apparently.”

“Making sure expectations are met takes work on both sides. As a client, you have to be clear and help the law firm to understand your business.”

Other in-house counsel have managed to create better relationships with the law firms they use. “Hourly billing is difficult, but that is where the value of having a good relationship comes in,” says Maxine Chow, in-house counsel at LGC, a company that provides scientific analysis. “If they understand your business, they will also understand what you really thought was the right value for the work, so it’s much easier to have that conversation about value without falling out.”

Ms Chow works hard to develop good relationships with law firms, but says that most of what she does is just common sense. “It’s about having a good client partner who communicates well with you and understands your business, your constraints and your goals,” she says. “But this is a two-way relationship, in which both parties have to be candid and realistic about what they want, how long it will take, who will do it, and what it will cost. Making sure your expectations are met takes work on both sides,” says Ms Chow. “As a client, you have to be clear and help the law firm to understand your business.”

Figure 5: Perceived value of the work provided

Note: Satisfaction is measured as a mean, where 1 = strongly disagree and 5 = strongly agree.

When the relationship with a law firm has broken down, billing is only one of the reasons, she believes. “Really it will have been because we were not impressed by the service we received or we were not well understood by the people we worked with. If their bills were cheaper, would I still go back to them? No.”

When Ms Chow does have an issue over a bill, it is usually because her expectations have not been well managed. This point is reflected in our survey findings. Nearly all (92 per cent) of the respondents in our survey asked a law firm to provide an estimate before starting work, but fewer than one in four said that the estimates they received were “usually in line” with the final cost. The majority (68 per cent) said that the final cost was only “sometimes in line” with the original estimate. Close to one in ten indicated that this never happened. Eight out of ten of the bills that missed the estimate were at least 10 per cent higher than the expected figure.

10% in-house counsel believe legal bills never meet their estimates – they are usually higher

On the face of it, this is an area of much concern and one which needs real improvement. Against a backdrop of in-house counsel needing to provide detailed and accurate estimates internally for budget purposes, law firms’ inability to stick within

estimates is potentially damaging for the relationship and can affect levels of trust. Much of this comes back to communication; the scope of work does change and estimates may therefore need to be revised, but this should be done after open and timely communication and not in retrospect.

Seeking improvements

In-house counsel are keen to make existing billing models work better; our research shows. They want to develop best-practice guidance on billing areas such as estimation methodologies and post-invoice fee negotiations, perhaps importing ideas from wider procurement approaches and learning from the experiences of their peers. This will enable them to have a more open and robust discussion with law firms about rates, fees and value.

Insurance company manager Thomas Miller, for example, is trialling an e-billing system, as part of a focused effort to better manage its multimillion pound legal budget. Under the system, which is widely used in the United States, law firms submit their bills in a standard format with a code assigned to every cost. That makes it easier to analyse a bill and to compare costs between firms, Mark Holford, Group Director of Service at the company explains. “The whole thing becomes a far more transparent activity,” he says. “It’s better than receiving a pile of paper that you then need to wade through and understand.”

“That’s the bigger prize – to make sure we get value for the money we spend overall, and that we get more certainty over the outcome than we have today.”

Mr Holford plans to use billing data with discretion to begin with, as the company has long-standing relationships with the law firms it uses. But over time, he will use it to challenge major issues. The company does already negotiate down bills that it thinks are too high, “but it can be a bit hit and miss, because we don’t always know whether we are challenging the right things in the right way,” says Mr Holford. He believes E-billing will improve that.

But reducing unnecessary billing is not the main reason for investing in the system. “The real long-term goal for us is to make sure that the right amount of money is being spent on each law suit,” he says. “I don’t think traditionally either we or the law firms have focused enough on the balance between

the fees and limiting the amount of money that we are liable to pay out. That's the bigger prize – to make sure we get value for the money we spend overall, and that we get more certainty over the outcome than we have today."

Mr Holford hopes the system will lead to a "no surprises" culture, where the company can better estimate its legal costs and the claims themselves. That's an outcome many of the in-house counsel in our research would like to achieve.

65% in-house counsel want to discuss value-based billing with the law firms they use

In the meantime, Mr Given from Cisco says hourly billing will become even less attractive as in-house counsel become more sophisticated. While 20 years ago in-house counsel were just a conduit for private practice lawyers to deliver the real legal services, they are now a key part of the executive team. "We are a cost centre," he says, "and are expected to be as efficient as anyone else."

There will always be some firms working on an hourly basis, says Mr Given, but over time "the business model will change and firms will focus more on adding value". If billing does move onto that more subjective basis, how will in-house counsel decide what they ought to pay? "It's also the other way around," he says. "It's

for law firms to work out what their USP is and to put a value on it. I'm not going to say it will be easy, but it will be increasingly hard to ignore as an issue – it's not going to go away."

Next steps

This research report highlights the imperative for in-house counsel and law firms to develop a holistic, partnership-driven approach to fees. The report aims to be an important step in providing clarity on the needs, views and experiences of in-house counsel in relation to fees and related issues, such as value.

Our goal is to continue this evolving process of constructive dialogue, bringing together in-house counsel and law firms to work together to produce a practical toolkit which can help shape a different, and mutually beneficial dialogue on fees, billing and value. To this end, we have already held two round-table discussions, attended by both in-house counsel and law firms, at which the findings of this report were discussed in an open and constructive manner.

We are planning to host and run other events during the rest of 2007 and the early part of next year. Please look out for these events, as your active support and participation is crucial to shaping the discussion. To help us to continue to integrate the thinking of both in-house counsel and law firms into the work of the fees focus group, we urge both parts of the legal profession to send comments on this report or the issue of fees in general to Christine Smith at the C&I Group (0161 480 2918 or christine@cigroup.org.uk). Please submit any comments before 16 November 2007.

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