The Law Society

The Law Society

Consolidated report and financial statements

31 December 2006

The Law Society

Report and financial statements

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Report from the president and the chief executives

President's report

I took up the role of president at the mid-point of the year covered by this report, in July 2006. Before that, I had been working closely with my predecessor as president, Kevin Martin, and with the then chief executive Janet Paraskeva, and with the Council to get the Society into shape for the challenges of a rapidly evolving legal services market in a fast changing world. That work culminated in the establishment in January 2006 of the functionally independent Solicitors Regulation Authority and Legal Complaints Service, each with its own chief executive.

My chief concern during 2006 was to ensure that the Legal Services Bill should lay the foundations for legal practice in coming years in a way that truly supports innovation and the continued global competitiveness of the legal sector in England and Wales. That work has continued into 2007 as the Bill has made progress through Parliament. I am proud that we have been so instrumental in shaping the Bill and protecting the independence of the legal profession from the perennial assaults of politicians.

Looking inwards, I was also delighted to welcome our new chief executive Desmond Hudson, who has taken on the task of reshaping the representative Law Society in line with the wishes of the profession and Council. He and his team have made an excellent start, and I hope that you are already seeing the effects of that. The programme of change will last for some time yet and we will keep in close touch with our members to make sure that it stays on the right track.

As president, my role in that work has been to spend as much time as I can meeting solicitors and talking to them about what they need the Society to do for them. I've focussed on larger firms, the home of a large proportion of our membership and a sector that has in the past felt itself to be distant from its representative body. I've been delighted and challenged by the response I received and I am putting in place measures to ensure the work continues following the end of my presidency in July 2007.

2006 saw a new beginning for the Law Society. We are more closely engaged with our members than ever before. We understand better the environment that you are working within and the support that you need from your professional body. It has been a privilege to be at the helm of one of the country's great institutions at such a critical moment of change and to lead such an energetic and diverse profession.

I am disappointed to have to report an error in the collection of contributions to the Compensation Fund for the year 2006/07. Fuller details appear in these reports and also in the Compensation Fund accounts and we are determined to learn lessons from this.

2007 is proving no less demanding and I will take this opportunity to wish my successor, Andrew Holroyd, as lively and successful a year as I have spent as president.

Fiona Woolf

President

Report from the president and the chief executives (continued)

The Law Society

A changing Society

2006 was a year of fundamental change for the Law Society and a turning point in its 150 year history. On 1 January, the independent bodies to which the Council has delegated its regulatory and complaints handling responsibilities took on their new roles after some months running in shadow form. The separation of these responsibilities from the Society's work representing solicitors is a step that should give confidence to our members and to the users of the services they provide. It has created much more transparency and clarity.

Solicitors can be confident that the Law Society can now work to protect their interests without compromise, that we can focus more sharply on helping them in the development of their careers and practices and that we have a freer hand to promote the profession to the public. My team and I intend to do precisely that and the resources and management of the Law Society are being focused to that end.

Equally, the public can be confident that the regulation of solicitors by the Solicitors Regulation Authority (SRA) and the handling of consumer complaints by the Legal Complaints Service (LCS) take place outside the framework of representation and are overseen by independent boards with complete operational freedom. Our provision of financial resources and technology is being re-shaped to enable them to be effective and efficient in serving the public interest.

This separation was put in train by my predecessor as chief executive, Janet Paraskeva, working with the office holder team of the time and the Council. It has put the Society in a strong position in preparation for the Legal Services Act, which is still making its progress through Parliament as I write. We believe that the arrangements we have in place will be able to continue with the agreement of the future Legal Services Board. This will provide stability and continuity for our profession at a time of change.

Undoubtedly the most exciting and challenging consequence of the new structure of the Society from my perspective is that our members' expectations of us have changed. In early 2006 around 20,000 solicitors responded to our Have Your Say survey about the future role of the representative Law Society. Such a high level of participation itself sends a message about the Society's importance to members, but the main message was also absolutely clear: Above all, solicitors want their professional body to put its energy into representing their interests to their regulators and to government. The Society has an impressive track record in that respect, but we have also been working hard to develop the services and support that the profession also told us it wanted us to deliver. Those services will be coming on stream in the second half of 2007.

Managing our resources

When I joined the Law Society in September 2006, towards the end of the period of this report, a great deal of the initial ground work for establishing the modern representative Law Society had been done. Since then I have been striving to ensure that we become a more efficient organisation. The Society's representative work is funded by a small part of the practising certificate (PC) fee but also from profits that we make from commercial activity. We have to make the best possible use of that money. I have set my managers the task of spending the Society's money as carefully as if it were their own.

Report from the president and the chief executives (continued)

I have been examining closely our use of human, physical and financial resources and began in 2006 to make changes to staffing levels and methods of working in order to control our costs more effectively. Sadly, reductions in staffing have resulted.

We have consolidated our London-based staff into the building that we own at 113 and 114 Chancery Lane, resulting in considerable long-term savings and are ending leases on offices in the English regions while continuing to deliver support regionally.

In addition, I am introducing a more rigorous approach to financial management, including more detailed in-year reviews of progress against business plans and budgets to make sure that we are delivering effectively and within our financial targets and to be certain that we are getting the best possible outcomes from the resources that we have. We need across the Society enhanced management information to assist the decision-making process as we continue to evolve. This work will be helped by enhanced individual performance management from directors downwards.

After a number of years of growth in the PC fee to fund improved regulatory services to members and the public, we are now working hard with the SRA and LCS to control costs across the board to keep the financial burden on the profession as low as possible. Where it is more efficient, support services are provided centrally by the Law Society to the SRA and LCS in areas such as finance, IT and human resources. The cost of the PC fee for 2006/07 was reduced and early indications are that we can achieve a freeze in the PC fee for the year 2007/08. As you will see from the financial summary below, this has been achieved at the same time as a significant reduction in our pension liabilities (a challenge that we share with many other employers) and a strengthening of our balance sheet. During 2007, I will be reviewing our future strategy on the pensions liability and the benefits of establishing medium-term financial targets.

The following financial summary of the income and expenditure in 2006 covers the entire Law Society group which now comprises the Law Society, the Solicitors Regulation Authority and the Legal Complaints Service.

Consolidated income and expenditure

Income increased by £18.9 million or 17.4%. This is mainly due to the increase in the PC fee income from £86.8 million in 2005 to £104.7 million in 2006 and **investment & interest income** grew from £3.7 million in 2005 to £10.0 million in 2006 resulting from improved management of cash flow and changed arrangements for investment of reserves.

The increase in **expenditure** (from £118.0 million in 2005 to £118.9 million in 2006), was limited to 1.4%. Both years, however, included an additional contribution of £4 million to the pension scheme. £25 million was paid in to the pension scheme both in 2005 and 2006 from SIF surplus.

Consolidated balance sheet

Accumulated funds stood at £29.4 million as at 31 December 2006 compared to £2.8 million as at 31 December 2005 due to the increased surplus in the year. **Pension liability** (FRS 17) was reduced by £24 million as a result of payments of £29 million paid into the pension scheme and represents a satisfactory strengthening of our balance sheet.

Report from the president and the chief executives (continued)

Risk management

A complete review of risk management and control processes in all three arms of the Law Society is under way at the time of writing. The management of risk at the group level across the Law Society and within each arm will become an integral part of our management approach.

Supporting solicitors

We are laying the foundations for a modern representative body which is closer to its members than ever before. The work of supporting solicitors can only be achieved in close partnership with individual members of the profession, local law societies and other practitioner associations. I and the wider management team will continue to work with the profession's elected representatives on the Council and with representatives of practitioner associations to build that modern representative body. We will work to increase yet further our communications with individual members to guarantee the relevance of everything that we do. To that end we are developing an online engagement strategy allied to improved IT infrastructure.

This is a time of great change, the start of a clearer and more proactive role as an advocate for our members, the building and development of new services and a re-fashioning of our organisation. For the staff this is also a difficult time. What has been achieved has been achieved by them. What will be achieved will be built on their skill and commitment. I thank them for their help.

Compensation Fund

Prompt action was taken following the discovery after the close of the financial year that contributions collected from members for the year 2006/7 were in some cases calculated incorrectly. The reduction in contribution rate agreed by Council was not applied in all instances. The amount over collected is £3.5m and this will be refunded to members, with interest, by the Solicitors Regulation Authority.

Working with my colleagues in the Solicitors Regulation Authority and with the involvement of the Society's Audit Committee we are urgently reviewing these matters to ensure lessons are learnt and repetition avoided.

Building a modern representative organisation also requires openness on the part of the Society to which I am committed. Should you have any questions about any aspect of this report and accounts, please put them to me at desmond.hudson@lawsociety.org.uk.

Desmond Hudson

Chief executive

The Law Society

Solicitors Regulation Authority (SRA)

Development and performance in 2006

The SRA Board's strategy was finalised in September 2006, following public consultation. It sets out the SRA's purpose, principles and key objectives. In addition, the SRA developed an Architect's Plan to show its key features and the main gaps between its current position and its objectives. In the first half of 2006 the SRA also carried out a Regulation Audit, a substantial piece of work which identified gaps in the Authority's capability to deliver regulation functions efficiently and effectively. Following the audit, a programme of efficiency improvements commenced, the majority of which will be delivered in 2007. To drive efficiency savings, the SRA has decided to finance its improvement agenda using a flat budget.

Principal risks and uncertainties

A number of strategic risks, and mitigation of them, have been identified by the SRA and are listed below:

1. Lack of organisational resources, capacity, capability or skills to give transparency of processes and performance

1.1. A new senior management team (SMT) structure for the SRA has been defined and is being implemented.

1.2. Key performance indicators are as follows:

- SMT in place March 2007.
- Change Programme Office established, March 2007.
- Eight new directorates in place, April 2007.
- New performance measures to be agreed for each directorate by summer 2007.
- Finance and HR staff to be embedded within SRA by summer 2007.
- New budgetary control systems to be in place by summer 2007.
- Development plans delivered within approved budget.

2. Inadequate regulatory mechanisms undermine confidence in SRA's ability to regulate profession

2.1. Key performance indicators are as follows:

- Business processes rationalised during roll-out of new IT system (begins 2007, continues 2008).
- Rationalisation of character and suitability criteria, modernisation of decision-taking, and modernisation of adjudication implemented following consultations in spring 2007.
- New regulatory powers secured in Legal Services Bill during 2007.
- Board agrees and publishes quality assurance strategy in summer 2007.

Report from the president and the chief executives (continued)

Business strategies in 2007

The focus of activities in 2007, and the target for deployment of resources, is on reducing the gaps identified in the Architect's Plan between the situation in 2006 and the desired end state. The main areas for delivery are as follows:

- Concentration of policy development on the regulation of organisations, and on continuing quality assurance of solicitors.
- Rationalisation of decision-making across the SRA, with simplification of processes to avoid duplication, delay and unnecessary expense.
- Overhauling existing business processes, and the introduction of a new IT system.
- Disentangling of the system of overhead allocation and central services.
- Restructuring of the SRA staff organisation to help it deliver objectives.
- Delivery of efficiency improvements.
- Rebranding the SRA and a communication strategy to enable people inside and outside the organisation to understand the SRA's role and independence.

IT strategy

The SRA intends to introduce a new IT system to enable it to work from a single, reliable database, and to improve both public and management information. £4.86 million was included in the 2007 budget – to enable the SRA to improve its database information, to improve its analysis of information and to improve its management information – though approval for this spend has been deferred by the Law Society. Work on the implementation strategy will begin with an external implementation partner in April 2007. Implementation of the project will extend well into 2008.

Compensation Fund

At the beginning of June it was discovered that contributions to the Compensation Fund collected for the year 2006/7 were incorrect. Due to an administrative error, some solicitors had not received the benefit of the reduction in contribution set for that year by Council when it met in July 2006. The individual sums over-collected were either £100 or £50. We have identified that about 36,000 individuals have been affected by this and the amount over collected is £3.5m. As soon as the error was identified, I issued a public apology, and in consultation with the Society's Audit Committee and the Law Society initiated an action plan with the objective of promptly refunding the overpayment plus interest during July 2007. The SRA will work with the Audit Committee and in consultation with the Law Society to review the causes of the error, to improve the control of the Compensation Fund, and to put in place measures to minimise the risk of a recurrence. Work already started by the SRA to improve the management of the Fund will feed into this review.

Antony Townsend

Chief executive

Solicitors Regulation Authority

Report from the president and the chief executives (continued)

Legal Complaints Services (LCS)

Development and performance in 2006

The Legal Complaints Service underwent significant strategic change during 2006 in order to improve performance. It recruited additional capacity to enable it to reduce backlogs, and set up a team to focus on closing the oldest files. Processes were improved and streamlined. Consequently, the Legal Complaints Service achieved all its timeliness targets for the year ending March 2007. Only four files were in excess of 15 months old. Backlogs were significantly reduced.

LCS has been busy in many other ways:

- Work undertaken during 2006 allowed it to rebrand in January 2007;
- IT development work throughout 2006 delivered a new stand-alone website in January 2007;
- Work began on a management restructure and a new internal governance structure for LCS;
- A meeting was held with key stakeholders to begin work on the Improvement Agenda – a three year strategic plan.

This work will begin to reap rewards from 2007 onwards.

Principal risks and uncertainties

The major risk for LCS is failing to perform to the standard required by the external regulator, the LSCC, and then the resulting threat of a fine. Whilst all of the timeliness targets and the planning targets have been met, the results of the quality audit will not be known until May at the earliest. The LSCC will not reach a final decision as to whether to fine until July.

The Board of the Legal Complaints Service has established an audit and risk sub-committee to identify any areas of risk specifically arising. LCS is committed to introducing better financial governance systems to recognise that the Law Society has now split into three distinct parts. It is also introducing formal risk management processes, and will be appointing an individual with specific responsibility for programme assurance and risk.

LCS is also keen to demonstrate its consumer focus. During the year, LCS has investigated the possibility of publishing solicitors' complaints records. No decision will be made on this until early 2008, as legal advice is currently being taken, and our options investigated. A large element of complaints work has involved complaints from former miners who have legitimate complaints regarding inappropriate deductions from their settlements. LCS is currently investigating contacting former miners to raise awareness of its services, as it is recognised that there are many former miners who may have a legitimate complaint but are unaware of their right to seek redress.

Business strategies for 2007

The Board has a three-year Improvement Agenda. The Agenda has three strategic objectives – improving our services at LCS, informing consumers, and raising standards in the legal profession through sharing information.

Report from the president and the chief executives (continued)

Targets for our performance each year are agreed with the Legal Services Complaints Commissioner, and an annual complaints handling plan is produced. This plan concentrates on setting timeliness and quality standards for our delivery. We have agreed that by March 2008, there should be no files in excess of twelve months old, and 67% of our files will be closed within three months. LCS is committed to improving quality over the next 12 months.

IT strategy

LCS began the replacement of its core system during 2006. The new system for complaints handling, Visual Files, is planned to be rolled out at the end of August 2007.

Deborah Evans

Chief executive

Legal Complaints Service

Council's report and statement of the Council's responsibilities

The Law Society's role

Historically, the Law Society has combined responsibilities for both regulating and representing solicitors in England and Wales. Although the Law Society remains a single legal entity, it separated the governance of its regulatory and representative functions in January 2006. The representative Law Society is responsible for the promotion of the interests of the profession, and for promoting law reform; the Solicitors Regulation Authority has substantive responsibility for the regulation of solicitors; and the Legal Complaints Service has substantive responsibility for dealing with consumer complaints. Each of the three organisations has its own chief executive.

The Council of the Law Society is an elected body of solicitors. The solicitor and lay members of the Board of the Solicitors Regulation Authority and of the Board of the Legal Complaints Service were appointed in accordance with best practice for public appointments ('Nolan principles'). No-one may be a member of the Council and of the regulatory boards at the same time.

The term 'the Law Society' therefore applies in a legal sense to the totality of the three organisations, and in a functional sense to the representative organisation.

The Combined Code

The Society is incorporated by Royal Charter. Although this means that the Combined Code on Corporate Governance does not apply, the Society is committed to the principles of corporate governance.

Some of the Combined Code's provisions are not directly applicable, because the Society is not a listed company. The following paragraphs explain the Society's approach in relation to the Combined Code's main sections, and the areas of non-compliance.

Strategic management

The Society's governing body is the Council. The Council maintains strategic oversight but delegates most corporate functions to the Corporate Governance Board ('the Board'). In practical terms, for the purposes of the Combined Code, the Board is the nearest equivalent of a plc board of directors.

The Council's responsibilities are derived from statute and the Society's Charter, Bye-Laws and General Regulations. The Charter and Bye-Laws reserve certain matters to the annual general meeting of Law Society members.

There are 100 places on the Council. Members are elected for a four year term, which is renewable. There is no direct equivalent of non-executive directors. The Council's Remuneration Committee has five members, of whom two are non-Council members; the Audit Committee has nine members; seven are non-Council members, of whom four are not solicitors. The chairs of these committees are non-Council members.

The boards of the Legal Complaints Service and Solicitors Regulation Authority are not represented on the Corporate Governance Board or on the other committees of the Council but attend meetings for items of business relevant to them.

Council's report and statement of the Council's responsibilities (continued)

Induction is provided for Council members. Members of the Board and the Audit Committee regularly review risk management issues.

Regulation and complaints handling

The Society has separated the governance of its regulatory and representative functions by establishing a Regulation Board and a Consumer Complaints Board which, since January 2006, have had substantive responsibility for regulation and consumer complaints respectively, in so far as this can be lawfully delegated by the Council. The Consumer Complaints Board has a majority of lay members, while the Regulation Board has a solicitor majority, with significant lay membership.

From January 2007, these boards were renamed the Board of the Solicitors Regulation Authority (SRA) and the Board of the Legal Complaints Service (LCS). The SRA is the identity given to the Society's regulatory functions; the LCS was formerly the Consumer Complaints Service.

As explained in the office holders' report below, following the Legal Services Bill which is expected to receive Royal Assent in June 2007, complaints handling will in future become the responsibility of a separate body, the Office for Legal Complaints (OLC). The Society's intention is that LCS staff will be the subject of a TUPE transfer to the OLC. Post-legislation the Society will be the approved regulator responsible to a new Legal Services Board for the performance of its regulatory functions by the SRA.

Representation

In 2006 the Law Society conducted a major consultation with the profession on the future of the Society's representative and membership service functions. New governance and business arrangements will flow from the consultation and the business planning process.

Solicitors Disciplinary Tribunal

The Society also provides the funding for the Solicitors Disciplinary Tribunal (SDT), a statutory tribunal whose primary function is to adjudicate upon allegations of professional misconduct or breaches of professional rules by solicitors. The SDT is constitutionally and operationally independent of the Law Society, although its administration is funded by the Society and its staff are Law Society employees who are seconded to the Tribunal. The Tribunal's members are appointed by the Master of the Rolls.

Office holders

The Society has three office holders: the president, vice president and deputy vice president. They hold office for one year at a time. Each year, the Council elects the deputy vice president (DVP); the previous year's DVP becomes vice president and the vice president becomes president. The hand-over takes place at the AGM in July.

Council's report and statement of the Council's responsibilities (continued)

The office holders are the Society's main ambassadors, and represent the Society at home and abroad. The president is a full-time appointment. The president chairs the Council. The vice president and the treasurer co-chair the Board ('treasurer' was a title customarily given to the chair of the former Finance & Resources Board, and has been retained for the board member who has primary responsibility for financial matters).

Chairs of the regulatory boards

The two regulatory boards each have a chair. The chair of the Board of the Solicitors Regulation Authority is Peter Williamson. The chair of the Board of the Legal Complaints Service is Shamit Saggar.

Chief executives

In 2006, Janet Paraskeva left the Society. Three new chief executives were appointed: Antony Townsend to lead the SRA, Deborah Evans to lead the LCS and Desmond Hudson to lead the Law Society.

The chief executives are responsible for implementing policy, for the management of staff and for ensuring that the Society, the SRA and the LCS operate effectively and efficiently. Each chief executive is responsible for a budget approved by the Council.

The Board

The Council formed the Corporate Governance Board on 1 January 2006. Most of the members of the former Main Board and the Finance & Resources Board as at 31 December 2005 are now members of the Board.

The Board is responsible for the preparation of financial statements which give a true and fair view of the group's position at the end of the financial year and of any surplus or deficit. In preparing the financial statements for 2006, the Board has:

- selected suitable accounting policies and then applied them consistently;
- made judgements and estimates that are reasonable and prudent;
- stated whether applicable accounting standards have been followed; and
- prepared the financial statements on the going concern basis.

During 2006 the Board was responsible for ensuring that proper accounting records were kept. The Board was also responsible for the system of internal control, for safeguarding the assets of the group and for taking reasonable steps for the prevention and detection of fraud. The Board regularly reviewed risk management issues.

The directors of the companies whose accounts are consolidated with those of the Society are similarly required to prepare accurate financial statements, keep proper accounting records and safeguard the companies' assets.

The consolidated financial statements include the Society and its subsidiaries (together the 'group').

Council's report and statement of the Council's responsibilities (continued)

Remuneration

In 2006 payments were made to:

- the office holders or their firms or employers;
- the chairs and members of the regulatory boards.

Council members received expenses only.

In 2006, the chairs of the Remuneration Committee and Audit Committee also received payment.

The Remuneration Committee advises on compensation to the office holders, and Council, board and committee chairs and members; it approves the remuneration arrangements for the chief executives and senior managers.

Accountability and audit

The relevant Combined Code provisions are met, except that there are no interim or price-sensitive reports to include in the assessment of the Society's financial position. There is an organisational structure with defined roles for the Corporate Governance Board and the Audit Committee.

Auditors

A resolution to appoint BDO Stoy Hayward LLP as the Society's auditors for the 2006 accounts was approved at the July 2006 annual general meeting.

Following a recommendation from the audit committee, the Board has adopted a policy in relation to the provision of non-audit services by the auditors, with the objective of ensuring that the provision of such services does not impair the external auditor's independence or objectivity. This includes, *inter alia*, assessing all relationships with the audit firm, including their partners and staff; assessing the nature and level of fees for non-audit services in relation to the audit fee; obtaining confirmation of independence from the auditors; and ensuring the appropriateness of the firm as providers for non-audit services.

The split between audit and non-audit fees for the year under review is disclosed in note 6. The non-audit fees were principally paid in respect of accountancy services provided before they were appointed as external auditors and are considered by the audit committee not to affect the auditors' independence or objectivity.

Audit Committee

The members of the Audit Committee are listed on page 20. The Committee met seven times in 2006. Its terms of reference are consistent with the Combined Code, as far as is possible given the Society's management structure and governance. They include responsibility for the review of internal control and the overseeing of action required as a result of matters raised by the external auditors. The Committee also reviews the plans and monitors the progress of the Internal Audit Unit. The Council will consider the Committee's terms of reference when the governance structures for the future Law Society have been settled.

For 2006 an annual review of internal control has been undertaken. The Internal Control Statement resulting from this review appears below.

Council's report and statement of the Council's responsibilities (continued)

Internal control

The Society recognises the value of the internal control principle in the Combined Code, and adheres voluntarily to it. In doing so, the Society acknowledges that internal control systems are designed to manage rather than eliminate the risk of failure to achieve business objectives, and can only provide reasonable assurance against material misstatement or loss. The preceding paragraphs explain how the Society's structures relate to the main provisions of the Combined Code.

The Council gave specific responsibility for internal control to the Corporate Governance Board, although all boards have risk management responsibilities. The Corporate Governance Board was therefore primarily responsible for reviewing the effectiveness of the Society's system of internal control in 2006.

Throughout the year, the Board received regular progress reports on the achievement of strategic objectives and any related financial implications and control issues. The Board received updates on the strategic risk register and associated action plans, which are being completely revised as a consequence of the reorganisation of the Society. The new strategic register will be integrated with those which the Regulation and Consumer Complaints Boards began to develop in 2006.

The Council approves revenue and capital budgets annually. The Council and the Corporate Governance Board have approved the budgets for 2007 and these are subject to continuing review by the chief executives in terms of actual performance against plan.

The Audit Committee also regularly monitored risk and control issues. The Scrutiny Committee reviewed the exercise of delegated powers by the Board and its subsidiary boards. The Remuneration Committee approved the remuneration arrangements for the chief executives and senior managers, and advised on compensation to the office holders, chairs and members of committees, Council members and members of the regulatory boards.

The Internal Audit Unit carried out its annual assurance review for 2006. The Corporate Governance Board did not do its own control review, but did review its performance for 2006, and partly as a result is proposing significant changes to its role and remit. It is nevertheless satisfied that it has received sufficient information from all of the sources above to have monitored the effectiveness of the Society's system of internal controls, and set in train changes where required by the reorganisation of the Society. These include restarting the process of embedding risk management within and across the new businesses in the Society.

Although the Society is not bound by the Combined Code, it complies with its provisions wherever that is practical. There are structural differences between the Society and a company which mean that the Society is unable to comply with certain clauses. Accordingly the Society discloses that, of the Combined Code provisions that are directly relevant, the following are those with which it may not comply:

Council's report and statement of the Council's responsibilities (continued)

Internal Control (continued)

Clause		Comment
A.1	The Board	
A.1.3	The chairman should hold meetings with the non-executive directors without the executives present. Led by the senior independent director, the non-executive directors should meet without the chairman present at least annually to appraise the chairman's performance (as described in A.6.1) and on such other occasions as are deemed appropriate.	The Society has no comparable mechanism to non-executive directors. The Code envisages non-executive directors as having a key role in the corporate sector, in checking any excesses of executive directors. The Society has an entirely different model of governance, based upon a framework of regulations and strategic overview by the Council. It is these which are designed to provide a check on the executive.
A.1.4	Where directors have concerns which cannot be resolved about the running of the company or a proposed action, they should ensure that their concerns are recorded in the board minutes. On resignation, a non-executive director should provide a written statement to the chairman, for circulation to the board, if they have any such concerns.	The Society has no comparable mechanism. However, so far as Council members are concerned, the Society has a website where they can communicate with one another easily and are free to express views, which they do. They can also submit Council members' motions to Council which no-one can prevent being on the agenda and thus formally recorded.
A.3	Board balance	
A.3.2	Except for smaller companies[1], at least half the board, excluding the chairman should comprise non-executive directors determined by the board to be independent. A smaller company should have at least two independent non-executive directors.	See under A.1.3 above.

[1] A smaller company is one that is below the FTSE 350 throughout the year immediately prior to the reporting year.

Council's report and statement of the Council's responsibilities (continued)

Internal Control (continued)

Clause		Comment
A.3.3	The board should appoint one of the independent non-executive directors to be the senior independent director. The senior independent director should be available to shareholders if they have concerns which contact through the normal channels of chairman, chief executive or finance director has failed to resolve or for which such contact is inappropriate.	See under A.1.3 above
C.2	Internal control	
C.2.1	The board should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so. The review should cover all *material* controls, including financial, operational and compliance controls and risk management systems.	An annual review of internal control is undertaken by Internal Audit, and reported to the Audit Committee and Corporate Governance Board. The Corporate Governance Board did not do its own assessment for 2006, as it is engaged on a strategic review of its role and responsibilities. The Regulation Board oversaw a business process review in 2006, as a result of which the SRA's management structure was revised. The necessary changes are taking place during the first half of 2007. One product will be a risk register. The Consumer Complaints Board began to install mechanisms for risk management in 2006, which will be used to produce a register in 2007.

Statement of going concern

The Council's opinion is that the Society will have sufficient resources to meet its liabilities as they fall due over the 12 months from the date of signing the accounts. As a result, the Council has satisfied itself that the Society is a going concern.

Office holders' report

Legal Services Bill

The Government introduced a Legal Services Bill on the regulation of legal services in the House of Lords, on 27 November 2006. The Bill could receive Royal Assent around July 2007. It aims to establish:

- Legal Services Board (LSB). This new legal regulator will supervise the Law Society, Bar Council and all regulators of legal services. Regulatory functions would be delegated to the approved regulators subject to their competence and governance arrangements, especially in the separation of regulation from representation. Subject to legislation, it seems likely that the LSB will be established by 2011;
- Office for Legal Complaints. This would be a single independent body to handle consumer complaints against all providers of regulated legal services, probably from 2010. Any discipline and conduct issues about solicitors would continue to be dealt with by the Law Society; and
- Alternative Business Structures (ABSs). These structures would enable lawyers from different professional backgrounds, for example solicitors and barristers, to work together, and would permit non-lawyers to become involved in the management and ownership of legal practices. The Law Society believes that it is well-placed to regulate ABSs, through the SRA.

Once passed, the Bill will have a significant impact on the Society's structure and future regulatory role. Under the Bill, the Society will be the approved regulator. The Society will have to demonstrate competence as a regulator and that it can separate its regulatory and representative functions satisfactorily. The Council has taken significant steps to achieve that separation by establishing new governance structures. The Solicitors Regulation Authority and the Legal Complaints Service will have a direct relationship with the Legal Services Board, which is expected to be established in shadow form to begin with. The Society will also have a direct relationship with the LSB. In the longer term, the LCS will be succeeded by the Office for Legal Complaints. The Council has taken the decision in principle that regulatory functions should in due course be devolved, along with the regulatory operations, to a wholly owned subsidiary company, provisionally known as 'Reg Co'. No formal steps have yet been taken towards establishing this subsidiary, which is the subject of continuing discussion.

Operationally, staff across the three organisations remain for the present employees of the Society and common services such as facilities, IT and finance are shared. The government has announced that its preferred site for the OLC is the West Midlands, which offers the possibility that the expertise and experience of the LSC's staff will be retained through a transfer of undertakings.

The Society has the statutory power to levy a practising certificate fee, under order of the Master of the Rolls with the concurrence of the Lord Chancellor and the Lord Chief Justice. The Bill retains provision for the Society's public interest and international activities to be funded through the practising certificate fee.

Office holders' report (continued)

Legal Services Complaints Commissioner

The Government set up the Legal Services Complaints Commissioner (LSCC) in October 2004. The LSCC has the power under section 52 of the Access to Justice Act 1999 to require the Law Society to provide information on how it deals with complaints, to make recommendations about the complaints system, to set targets for complaints handling, and to require the Society to submit a plan for improved complaints handling. In addition, the LSCC has the power to levy a penalty on the Society if it fails to deliver an adequate plan or fails in the delivery of that plan of up to the lower of £1 million or 1% of turnover.

In May 2006, the LSCC announced that she would be levying a penalty of £250,000 on the Society because it had submitted a plan for securing improvements to its complaints handling services during 1 April 2006 to 31 March 2007 which she found inadequate. In July 2006, the LSCC agreed with the Society a new plan for the year, and reduced the fine by £30,000.

The LSCC also found that the Society had failed to handle complaints in accordance with its plan for 1 April 2005 to 31 March 2006, but did not levy a penalty.

The LSCC has acknowledged the significant improvements in the quality and timeliness of the Society's complaints handling.

Law Society Pension Scheme

The Law Society provides a final salary pension scheme for employees who joined before 1 January 2005; for staff joining after that date, the Society contributes to a defined contribution stakeholder pension scheme.

The final salary scheme had a FRS (financial reporting standard) 17 deficit of £12.4m at 31 December 2006.

On 1 June 2005, the trustees of the Law Society Pension Scheme issued a formal demand to the Society for a £50 million payment into the scheme by the end of December 2005.

In September 2005, the Council agreed that, upon the coming into force of the necessary amendments to the Solicitors Indemnity Rules 1987 that the Society would require that £25 million of the Solicitors Indemnity Fund be released to the Society to be applied towards the demand made by Law Society Pension Scheme under Clause 3(1) of the Deed of Trust governing the Law Society Pension Scheme. This sum was paid over to the Pension Scheme in October 2005.

The Council also decided that, to the extent that there were any funds remaining in the Solicitors Indemnity Fund which were surplus to indemnity requirements at the relevant time, the Society would after 1 October 2006 but before 31 December 2006 further require, under the Solicitors Indemnity Rules 2005, that up to a further £25 million be released to the Society and will be applied by 31 December 2006 towards the demand made by Law Society Pension Scheme. This sum was paid in December 2006.

In addition, the Society will be making a series of top-up payments to the scheme of £4 million per year for the next five years. This is intended to remove the balance of the scheme deficit over a 10-year period, taking into account the trustees' investment strategy. The first £4 million was paid in December 2005 and the second payment in December 2006.

Office holders' report (continued)

Professional Indemnity Insurance

Solicitors Indemnity Fund (SIF) administers the Society's professional indemnity business.

Quasi-subsidiary

In July 2005 the Council of the Law Society directed that up to £50 million be transferred to the Law Society from SIF over a two-year period. The changes to the Solicitors Indemnity Fund rules to allow this transfer came into effect on 1 October 2005. As the Law Society had access to the benefits of SIF from this date, SIF is now a quasi-subsidiary. SIF has been consolidated into the accounts of the Law Society using the acquisition method of accounting.

It is considered to be a discontinued activity as it is now in run-off.

SIF's financial position as at 31 December 2006 shows an accumulated surplus of £3 million. Professional indemnity is 'long tail' by nature and estimates suggest that a small number of claims may still need to be dealt with for 10 years or more. Therefore any release of surplus could only be dealt with over a period of many years.

SIF's board entered into an Adverse Loss Development Programme (ALDP) underwritten by a leading international reinsurer. This programme provides cover from 1 October 2004 for all the Fund's future claim liabilities up to £205 million. The Fund meets the first £90 million of this programme, the balance being paid by the reinsurer. The effect of this programme allows for a number of uncertainties to be removed, thereby crystallising future surpluses earlier than expected.

The Law Society established a working party to determine how any surplus from the Fund should be dealt with. The Solicitors' Indemnity Rules have always provided that all or any part of the Fund not needed for providing indemnity to the profession should be released to the Law Society, but only after the end of what proves to be the final indemnity year.

The Rules have now been amended following a decision taken by the Council of the Law Society on 13 July 2005 to refund the shortfall contributions paid by the profession in the 2001/2 and 2002/3 indemnity periods. These contributions equate to approximately £25 million each (£50 million in total). All remaining surplus is to be dealt with as directed by the Council of the Law Society.

The first shortfall contribution refund in respect of the collection made in the 2001/2 financial year was made to the profession by 30 September 2006, with the second refund in respect of the collection made in the 2002/3 financial year to be paid by September 2007.

In October 2005 the Council of the Law Society directed the Fund to pay £25 million of the surplus to the Law Society under Rule 11 of the Solicitors' Indemnity Rules 2005. A further £25 million was paid over in December 2006.

In negotiating the ALDP, the Fund was also able to secure post six-year run-off cover for firms that have ceased without successor since 1 September 2000. This will not replace the first six years' run-off cover that firms need to acquire from their qualifying insurers. The cover will be made available for a block period of ten years to commence in September 2007. This will provide continuing run-off protection at no additional cost to those ceased practices beyond the initial six years' protection provided since the open market scheme came into effect on 1 September 2000.

Quasi-subsidiary (continued)

The Fund continues to provide ongoing run-off protection to firms that ceased prior to 31 August 2000.

All the above necessitated a further review of the investment portfolio with the Board preferring a strategy based on gilts providing a matching portfolio to the remaining liabilities of the Fund. These liabilities relate predominantly to the £90 million excess payable for future costs of administering the Fund to conclusion. The Board took a decision in late 2004 to exit all equity related investments by 30 September 2005. The balance of the investments was converted to short term deposits to meet the surplus refunds and the payment to the Law Society.

Retirement Benefit Scheme

The Law Society established a Retirement Benefits Scheme in 1957 to take advantage of the prevailing tax regime. In return for contributions, which could be paid as frequently or infrequently as members wished, the Scheme provided retirement benefits by way of guaranteed deferred annuities to solicitors who chose to join.

The Society did not provide these benefits directly: in respect of the guaranteed deferred annuity section of the scheme, policies were entered into with four different life offices (which over time, as a result of mergers and acquisitions were reduced to two: Norwich Union and Guardian). In 1969, a new arrangement was established under the Scheme, with M&G (which subsequently was taken over by Prudential) providing unit-linked retirement annuities.

Since July 2006, the Society has been in discussions with the insurers for both parts of the Scheme. The insurers have been advised that the Society intends (subject to Council's approval) to withdraw from the Scheme which, under the terms of the trust deed, will result in the Scheme's termination. The Law Society's remaining duties as trustee will then be to ensure that arrangements are made for the provision of suitable equivalent retirement annuities for members, and that members are not placed in a less advantageous position than at present.

Communication with Scheme members has been given high priority. A letter was sent to members, advising that the Society is assessing its continued involvement with the Scheme, and that they would be informed of any changes. Members will have sufficient opportunity to take independent advice before the Scheme comes to an end.

In December 2006, the Council authorised the Law Society to take such steps as are necessary to terminate the Law Society Retirement Benefits Scheme. Following that decision, it is expected that the Scheme will be wound up by June 2007.

Board members' attendance records in 2006

The Combined Code requires presentation of the attendance record of the board of directors. Attendance of Council members at Council meetings is recorded in the minutes, and available to members of the Society on request. Given the Council's size, the records are not shown here.

The attendance records for the Corporate Governance Board and the Audit Committee are overleaf.

The Board's membership from 1 January 2006 to 31 December 2006 was:

Office holders' report (continued)

Board members' attendance records in 2006 (continued)

Kevin Martin	(president until 14 July 2006)
Fiona Woolf	(president from 14 July 2006, having been vice president)
Andrew Holroyd	(vice president from 14 July 2006, having been deputy vice president)
Paul Marsh	(deputy vice president from 14 July 2006)
Robin ap Cynan	(resigned 26 May 2006)
Andrew Caplen	
Helen Davies	
Nigel Day	(appointed 10 July 2006)
Philip Hamer	(treasurer)
Bob Heslett	
Alexandra Marks	
Sue Nelson	
John Pickup	(resigned 8 February 2006)
Rodney Warren	(resigned 20 April 2007)
Janet Paraskeva	(chief executive until 31 August 2006)
Desmond Hudson	(chief executive from 1 September 2006)
Evlynne Gilvarry (non-voting)	(director of representation and law reform)
Frances Low (non-voting)	(director of legal services)
Bruce Minty (non-voting)	(director of finance & resources until 23 February 2007)
Russell Wallman (non-voting)	(director of strategic policy)

Linda Lee was appointed to the Corporate Governance Board on 12 April 2007 and Bill Bilimoria was appointed interim group finance director from 26 February 2007.

The membership of the Audit Committee from 1 January 2006 to 31 December 2006 was as follows:

Stephen Brooker	(chair)
Richard Bagley	(retired 31 August 2006)
Sue Carter#	
Stuart Collins	
Michael Lawson	
Geoffrey Mitchell	
Kevin Mortell	(resigned 28 September 2006)
Murray Ross	(from 5 October 2006)
Michael Singleton#	

#Council members of the Audit Committee. The remainder are independent members.

Office holders' report (continued)

Board members' attendance records in 2006 (continued)

The membership of the Remuneration Committee from 1 January 2006 to 31 December 2006 was:

Sally Irvine (chair until 1 February 2006)

Shaun Tyson (chair from 1 February 2006)

Philip Hamer+

David Taylor+ (appointed 29 March 2006)

Ronald Fox

+ Council members of the Remuneration Committee.

Attendance records

Corporate Governance Board	14 meetings	**Audit Committee**	7 meetings
Total number of meetings in 2006			
Kevin Martin	6 (7)		
Fiona Woolf	13	Stephen Brooker	7
Andrew Holroyd	14	Richard Bagley	4 (5)
Paul Marsh	3 (7)	Sue Carter	7
Andrew Caplen	8 (12)	Stuart Collins	7
Robin ap Cynan	3 (5)	Michael Lawson	5
Helen Davies	10	Geoffrey Mitchell	5
Nigel Day	7 (7)	Kevin Mortell	5 (6)
Michael Franks	12	Murray Ross	1 (1)
Philip Hamer	14	Michael Singleton	7
Bob Heslett	10		
Alexandra Marks	12		
Sue Nelson	12		
John Pickup	1 (2)		
Rodney Warren	10		
Janet Paraskeva	8 (8)		
Desmond Hudson	6 (6)		

Remuneration Committee	7 meetings
Sally Irvine	1 (1)
Shaun Tyson	6 (6)
Philip Hamer	7
Ronnie Fox	7
David Taylor	5 (5)

Office holders' report (continued)

Attendance records (continued)

The numbers in brackets denote the maximum number of meetings a person could have attended, allowing for the period during which he/she was a board or committee member, if less than the full year under review.

The Law Society chief executives (Janet Paraskeva until 31 August, Desmond Hudson thereafter) have been included as they were or are voting members. Non-voting senior manager members have not been included.

Compensation fund overpayments

Since the year end, it has been discovered that the Compensation Fund had collected some categories of annual contributions from firms during the year ended 31 December 2006 at a higher rate than that determined by the Council of the Law Society. The amount overcollected is £3.5m, which will be refunded to the payers, with interest, by the Solicitors Regulation Authority.

The administrative error meant that about 36,000 solicitors were overcharged for the year 2006/07. Some were charged a £500 contribution rather than £400 and others were charged £250 rather than £200.

The matter has been reported to the Audit Committee, which will be supervising a review to see why the mistake occurred and why it was not identified sooner. The Law Society and the Solicitors Regulation Authority will put measures in place to minimise any risk of recurrence.

Approved by the Corporate Governance Board of the Law Society on behalf of the Council of the Law Society and signed on behalf of the Law Society on 18 July 2007.

F Woolf — Fiona Woolf — PRESIDENT

P Hamer — TREASURER

Independent auditors' report to the members of the Law Society (the 'Society')

We have audited the consolidated financial statements of the Law Society and its subsidiary entities, as listed in note 1 to the accounts, ('the Group') for the year ended 31 December 2006 which comprise the consolidated income and expenditure account, consolidated statement of total recognised gains and losses, consolidated balance sheet, consolidated cash flow statement, notes to the consolidated cash flow statement and the related notes. The financial statements have been prepared under the accounting policies set out therein.

Respective responsibilities of the Council and auditors

As described in the statement of Council's responsibilities, the Council, through the Corporate Governance Board, is responsible for the preparation of the annual report and financial statements in accordance with United Kingdom accounting standards (United Kingdom Generally Accepted Accounting Practice).

Our responsibility is to audit the financial statements in accordance with International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view in accordance with the relevant reporting framework and whether the information given in the Council's report is consistent with those financial statements. We also report to you if, in our opinion, the Society has not kept proper accounting records or if we have not received all the information and explanations we require for our audit.

We read the Council's report, office holders' report and chief executives' reports and consider the implications for our report if we become aware of any apparent misstatements within them.

Our report has been prepared pursuant to the requirements of the bye-laws of the Society and for no other purpose. Our audit work has been undertaken so that we might state to the Society's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Society and the Society's members as a body, for this report and we hereby expressly disclaim any and all such liability.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the Corporate Governance Board in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Group's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In our opinion

- the financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the Group's affairs as at 31 December 2006, and of its surplus for the year then ended; and
- the information given in the Council's report is consistent with the financial statements.

BDO Stoy Hayward LLP

BDO STOY HAYWARD LLP

Chartered Accountants

London

19 June 2007

Consolidated income and expenditure account: Year ended 31 December 2006

	Notes	Continuing operations 2006 £'000	Discontinued operations 2006 £'000	Total 2006 £'000	Restated 2005 £'000
Income					
Practising certificates and other fees	3	104,667	-	104,667	86,836
Other income	5	22,576	-	22,576	21,525
		127,243	-	127,243	108,361
Expenditure					
Administration expenses	6	110,507	-	110,507	110,323
Establishment expenses	6	8,321	-	8,321	7,535
Donation to the Law Society Bursary Fund	6	100	-	100	135
		118,928	-	118,928	117,993
Investment income and interest	4	2,856	7,094	9,950	3,719
Surplus/(deficit) arising on professional indemnity insurance operations	12	-	1,855	1,855	(1,778)
Negative goodwill released in respect of professional indemnity operations	9	-	10,275	10,275	30,315
Surplus for the financial year	18	11,171	19,224	30,395	22,624

Discontinued operations relate solely to the activities of the Solicitors Indemnity Fund (SIF).

The Law Society

Consolidated statement of total recognised gains and losses

	2006 £'000	Restated 2005 £'000
Surplus for financial year	30,395	22,624
Actuarial loss recognised in the pension schemes	(4,023)	(21,102)
Unrealised gains on investments	246	1,451
Total recognised gains and losses relating to the year	26,618	2,973
Prior year adjustment – funded scheme	-	(44,841)
Prior year adjustment – unfunded scheme	-	(900)
Total gains/(losses) recognised since last Annual report	26,618	(42,768)

The Law Society

Consolidated balance sheet: 31 December 2006

	Notes	2006 £'000	2005 £'000
ASSETS			
Negative goodwill	9	-	(10,275)
Tangible assets	10	38,693	56,770
Investments	11	78,276	129,143
Reinsurers' share of claims provision	16	15,751	33,984
Current assets:			
Inventories		243	298
Receivables and prepayments	14	7,861	14,279
Cash and cash equivalents		102,171	86,791
TOTAL ASSETS		242,995	310,990
LIABILITIES			
Current liabilities:			
Creditors	15	(134,616)	(159,560)
Gross claims provisions	16	(62,520)	(106,386)
Provision for other liabilities and charges	17	(3,144)	(4,981)
TOTAL LIABILITIES		(200,280)	(270,927)
Total net assets excluding pension liability		42,715	40,063
Pension liability – unfunded		(975)	(980)
Pension liability – funded	21	(12,363)	(36,324)
Total net assets including pension liability		29,377	2,759
Represented by:			
Accumulated Fund	18	29,377	2,759

The financial statements were approved by the Corporate Governance Board of the Law Society on 15 June 2007.

Signed on behalf of the Council of the Law Society on 18 July 2007.

F Woolf Fiona Woolf PRESIDENT

P Hamer TREASURER

Consolidated cash flow statement: Year ended 31 December 2006

	Notes	2006 £'000	2005 £'000
Net cash outflow from operating activities	I	(44,372)	(10,930)
Returns on investments and servicing of finance	II	2,856	1,634
Taxation		1,136	(964)
Capital expenditure and financial investment	II	6,463	(5,778)
Acquisitions and disposals	II	-	689
Cash outflow before management of liquid resources and financing	III	(33,917)	(15,349)
Management of liquid resources	IV	33,602	15,309
Decrease in cash in the year	III	(315)	(40)

Consolidated cash flow statement: Year ended 31 December 2006 (Continued)

Reconciliation of net cash flow to movement in net funds

	Notes	2006 £'000	2005 £'000
Decrease in cash in the year	III	(315)	(40)
Cash outflow from changes in liquid resources		(33,602)	(15,309)
Change in net funds resulting from cash flows		(33,917)	(15,349)
Deposit accounts and other investments acquired with quasi subsidiary		-	163,531
Net losses on investments		(1,570)	(379)
Movement in net funds		(35,487)	147,803
Net funds at 1 January		215,934	68,131
Net funds at 31 December		180,447	215,934

Notes to the consolidated cash flow statement: Year ended 31 December 2006

I Reconciliation of surplus/(deficit) for the year to net cash (outflow)/ inflow from operating activities

	2006 £'000	Restated 2005 £'000
Surplus for the year	30,395	22,624
Depreciation charges	10,613	10,971
Movement in provision for professional indemnity insurance run-off costs	(667)	(287)
Decrease in professional indemnity insurance claims incurred net of reinsurance	(25,634)	(8,731)
(Profit)/loss on disposal of tangible fixed assets	(5,335)	1,643
Investment income received	(7)	(7)
Bank deposit interest received	(2,849)	(1,627)
Tax charge	449	869
Increase in stocks	55	(14)
Decrease in debtors	6,773	1,750
(Decrease)/increase in creditors	(19,868)	4,666
(Decrease)/Increase in fees in advance	(1,848)	18,313
(Decrease) in pension fund liabilities	(27,990)	(32,614)
Net realised losses on investments	1,816	1,829
Release of negative goodwill	(10,275)	(30,315)
Net cash outflow from operating activities	(44,372)	(10,930)

II Analysis of cash flows for headings netted in the cash flow statement

	2006 £'000	2005 £'000
Returns on investments and servicing of finance		
Bank deposit interest received	2,849	1,627
Investment income received	7	7
Net cash inflow from returns on investments and servicing of finance	2,856	1,634
Capital expenditure and financial investment		
Purchase of tangible fixed assets	(3,690)	(5,778)
Sale of fixed assets	10,153	-
Net cash outflow from capital expenditure and financial investment	6,463	(5,778)
Acquisitions and disposals		
Cash acquired with quasi subsidiary	-	689
Net cash acquired from acquisitions and disposals	-	689

Notes to the consolidated cash flow statement: Year ended 31 December 2006 (continued)

III Analysis of net funds

	At 1 January 2006 £'000	Cash flow £'000	Other non-cash items £'000	At 31 December 2006 £'000
Cash in hand and at bank	5,291	(315)	-	4,976
Cash held in deposit	81,500	15,695	-	97,195
Cash investments	77,793	(26,797)	-	50,996
Other investments	51,350	(22,500)	(1,570)	27,280
	215,934	(33,917)	(1,570)	180,447

Other non cash items consists of £(1,816) net realised losses on value of investments and £246 net unrealised gains on investments.

IV Management of liquid resources

	2006 £'000	2005 £'000
Cash withdrawn from deposit accounts	33,602	15,309

Notes to the accounts: Year ended 31 December 2006

1. Accounting policies

The financial statements have been prepared in accordance with applicable United Kingdom accounting standards but not in accordance with the full requirements of the Companies Act 1985. The particular accounting policies adopted are described below and these have been applied consistently in the current and prior year.

The financial statements are prepared under the historical cost convention with the exception of valuation of investments and claims provisions (see below).

Basis of preparation

Following the decision of the Council of the Law Society in June 1999 to move to market insurance, the professional indemnity insurance operations went into run-off on 1 September 2000. On 4 October 2005 the Solicitors Indemnity Fund (SIF) became a quasi subsidiary of the Law Society due to a change in solicitors indemnity fund rules. The professional indemnity insurance operations have ceased and are therefore treated as discontinued activities. Under FRS3 it is also necessary to provide for all future anticipated administration costs, which are referred to as run-off costs.

Accrued interest has been re-classified in the balance sheet to other debtors which is considered a more appropriate classification. This has not had any impact on the results.

Change in accounting policies

Unrealised gains on investments held by SIF are now included in the statement of total recognised gains and losses. This has resulted in the prior year surplus for the year figures being reduced by £1,451,000 but has had no effect on net assets at 31 December 2006.

Basis of consolidation

Consolidated entities

The consolidated financial statements include the financial statements of the Law Society, together with those of The Law Society Services Limited, The Law Society Property Services Limited, Solicitors' Indemnity Fund, The Law Society Pension Scheme Limited, Law Society (Hardware Rental Services) Limited and Law Society (Software Licensing Services) Limited, which are wholly owned by the Law Society.

The Society's 51% holding in Solicitors' Professional Indemnity Limited (SPIL #2), a dormant company, is included in the consolidated accounts of the Society.

Non-consolidated entities

A review was undertaken in November 2005 (and agreed at January 2006 Corporate Governance Board meeting) to consider if consolidation was appropriate. It was agreed that the following entities should not be consolidated into the financial statements of the Law Society: Compensation Fund, Stannard Bequest Fund, The Law Society Retirement Benefits Scheme, The Cheviot Trust, The Law Society Trustees Limited, The Law Society Charity, The Law Society Pension Scheme and the Assigned Risks Pool.

These entities are not consolidated in the consolidated Society financial statements because the Law Society does not exercise control over these entities.

Notes to the accounts (continued)

Liquid resources

For the purposes of the cash flow statement, liquid resources are defined as current asset investments and short term deposits.

Practising certificates

Fees received in respect of practising certificates for the practising year which commences on 1 November are apportioned over the practising certificate period to which they relate. No credit has been taken for fees due but not received at the balance sheet date, since there is no certainty that these will be paid.

Examination fees and Legal Practice Course fees

Examination fees are accounted for in the year in which the examination is held. Legal Practice Course fees are apportioned over the period of the course to which they relate.

Admission, annual enrolment, registration and transfer of training contracts

These fees are accounted for on a cash received basis.

Students' enrolment fees

These fees are payable on registration and are apportioned over the period to which they relate.

Taxation

Full provision is made for taxation payable on activities during the year. The Law Society is only liable for taxation on its investment income and gains and obtains no tax relief for its overhead expenditure, which is regarded as being incurred for the benefit of members whose fees are correspondingly not taxed. Tax relief is obtained on annual payments made under deed of covenant and Gift Aid. Its subsidiaries, The Law Society Services Limited and The Law Society Property Services Limited, are liable for corporation tax on their profits.

Deferred taxation

Deferred taxation is recognised in respect of all timing differences (except those noted as exceptions in the accounting standard) that have originated but not reversed at the balance sheet date where transactions or events that result in an obligation to pay more, or a right to pay less, tax in the future have occurred at the balance sheet date. Deferred tax assets are recognised only to the extent that it is more likely than not that there will be taxable profits from which the future reversal of the underlying timing differences can be deducted.

Depreciation of fixed assets

Tangible fixed assets are stated at cost net of depreciation and any provision for impairment.

Depreciation is provided on a straight-line basis to write off the cost less estimated residual value over the periods indicated below:

(i) In respect of freehold property which has been split into various component parts with each category being depreciated over its useful economic life as follows, or straight line over 50 years:

Building structure	50 years
Internal finishes	15 years

Notes to the accounts (continued)

Depreciation of fixed assets (continued)

Services and fittings	25 years
External works	35 years

Costs of repairs and maintenance are charged against revenue in the year in which they are incurred.

(ii) In respect of leasehold property and improvements:

Premiums paid – over the period to the next open market rent review

Improvements – over ten years or the period of the lease if shorter

(iii) In respect of equipment and furniture:

Motor vehicles: over five years

Equipment and furniture: over ten/five/four years

(iv) In respect of computers and hardware:

Mainframe, mini computers, servers and operating software: over five years

Software associated with the Society's customer relationship management and web systems is being written off over five years from the point at which the relevant software is first used.

All other computing equipment and software: over three/four years.

All additions to the library are now written off in the year of purchase.

No depreciation is charged on freehold land.

Goodwill

Goodwill arising on an acquisition of a subsidiary undertaking is the difference between the fair value of the consideration paid and the fair value of the assets and liabilities acquired. Negative goodwill has arisen on the acquisition of Solicitors Indemnity Fund, as no consideration was paid for monetary and non-monetary assets. Upon disposal of the relevant assets, this negative goodwill has been written off to reserves, through the Consolidated Income and Expenditure Account.

Valuation of investments

All investments, which relate to professional indemnity insurance activities, comprise deposit accounts and fixed interest stocks held by Merrill Lynch on behalf of SIF. Fixed interest stocks are valued at their mid-market value at the balance sheet date. As these funds are held to meet long term liabilities, they are classified as fixed asset investments.

Investment income

Interest on government stocks, bonds and deposits has been accounted for on an accruals basis. All other investment income has been taken into account on the basis of the due date.

Inventories

Inventories are valued at the lower of cost and net realisable value.

Notes to the accounts (continued)

Contributions

Professional Indemnity Insurance contributions are accounted for on the accruals basis.

Claims paid

Professional Indemnity Insurance claims are accounted for as and when payment is authorised. They include the cost of panel solicitors and the cost of internal claims handling staff, including an appropriate share of overheads.

Claims provisions

Estimation techniques are used to determine the Gross Claim Provision of Professional Indemnity Insurance activities which represent the estimated outstanding liabilities relating to all indemnity years.

Ultimate claim settlements are estimated by the use of statistical projections of historical data, together with case by case reviews of notified losses, and are based on information available at the time the estimates are made. There is uncertainty as to the quantum of the ultimate settlement of the liabilities which is inherent in the process of estimating such that, in the normal course of events, unforeseen or unexpected future developments cause the ultimate cost of settling the outstanding liabilities to differ from that currently estimated. Any differences between provisions and subsequent settlements are dealt with in later accounting periods. Claims provisions include the estimated costs of panel solicitors and of internal claims handling staff, including an appropriate share of overheads.

Claims provisions are discounted to take account of future investment income which will be earned on the assets held for meeting claims. It is considered appropriate to discount claims provisions because contributions to the Fund were determined after taking account of future investment income. The discount is calculated using the rate of interest which corresponds to the Fund's estimated long term rate of investment return and an estimate of the time to settlement based on the historic trend.

The gross claim provision has been calculated in accordance with the insurance SORP.

Lease transactions

Rentals under operating leases are charged to the income and expenditure account in equal annual amounts over the lease term.

Development costs

Software development expenditure is capitalised if it is separately identifiable, it is reasonably certain that the development will be successful and, on completion, it will provide a material benefit to the Society.

Pension costs

The Council of the Law Society decided to close the old Law Society pension scheme to new members from 1 January 2005. From that date, a new pension scheme has been set up whereby staff who entered employment on or after 1 January 2005, and staff who entered employment before then but had not joined the old scheme within 12 months of commencing employment became eligible to join the new scheme, which will be a defined contribution (money purchase) scheme.

The Law Society makes contributions towards the new scheme, which will be double the individual employee's contribution up to maximum of 7% of basic salary.

Notes to the accounts (continued)

A separate defined contribution pension scheme is also available to staff involved in the professional indemnity insurance operations.

For defined benefit schemes, the amounts charged to the income and expenditure account are the current service costs and gains and losses on settlements and curtailments. Past service costs are recognised immediately in the income and expenditure account if the benefits have vested. If the benefits have not vested immediately, the costs are recognised over the period until vesting occurs. The interest cost and the expected return on assets are shown as a net amount of other finance costs or credits. Actuarial gains and losses are recognised immediately in the statement of total recognised gains and losses.

Pension – funded

Defined benefit schemes are funded, with the assets of the scheme held separately from those of the group, in separate trustee-administered funds. Pension scheme assets are measured at market value and liabilities are measured on an actuarial basis using the projected unit method and discounted at a rate equivalent to the current rate of return on a high-quality corporate bond of equivalent currency and term to the scheme liabilities. The actuarial valuations are obtained triennially and are updated at each balance sheet date. The resulting defined benefit asset or liability, net of the related deferred tax, is presented separately after other net assets on the face of the balance sheet.

Pension – unfunded

The unfunded scheme (also referred to as ex-gratia or top-up scheme) was implemented by the Law Society in the 1980s when inflation was running very high. Under the scheme the Society agreed to top up/increase pensioners' payments to account for the erosion of the value of pensions.

A monthly payment is made by the Society to Legal and General (L&G) and L&G in turn pay this money to the pensioners. The amounts payable are reviewed regularly by Cheviot and 'valued' each year by a qualified actuary. Any change in value of the scheme is charged to the Society and included in the financial statements.

For defined contribution schemes the amount charged to the income and expenditure statement in respect of pension costs and other post-retirement benefits is the contribution payable in the year. Differences between contributions payable in the year and contributions actually paid are shown as either accruals or prepayments in the balance sheet.

Notes to the accounts (continued)

2. Segmental analysis

	Income		Surplus/(deficit) for the financial year		Net assets / (liabilities)	
				restated		
	2006 £'000	2005 £'000	2006 £'000	2005 £'000	2006 £'000	2005 £'000
Analysis by class of business						
Law Society activities	130,099	109,995	11,171	(7,998)	26,377	(4,313)
Professional indemnity operations	-	-	19,224	30,622	3,000	7,072
	130,099	109,995	30,395	22,624	29,377	2,759

3. Practising certificates and other fees

	2006 £'000	2005 £'000
Practising certificates	100,065	82,213
Examination and Legal Practice Course fees	2,017	2,042
Admission fees	708	729
Student enrolment fees	885	806
Annual enrolment fees	452	425
Registration and transfer of training contracts	540	621
	104,667	86,836

4. Investment income and interest

	2006 £'000	2005 £'000
Bank deposit interest	2,849	1,627
Investment income	7	7
Equities	-	90
Fixed interest and deposits	6,249	1,941
Interest on payments into court	845	54
	9,950	3,719

Notes to the accounts (continued)

5. Other income

	2006 £'000	2005 £'000
Gazette income from advertisements	9,035	9,002
Publications and products	1,772	1,698
Courses and functions	1,068	854
National conference	187	860
Recruitment service	-	96
Library	131	151
Rents receivable	484	329
Royalty income	813	743
Grant income	762	624
Catering	400	394
Foreign lawyer registration	1,750	1,500
Special interest sections income	898	770
Family Law Panel fees	216	234
Countrywide legal indemnity	436	424
Personal Injury Panel	144	160
Authorisation of Course Providers	526	620
Business services to solicitors	843	863
Other subscriptions	203	116
Section 12 waiver fee	207	116
Incorporated practice rules fee	223	146
Lexcel assessment fees	179	133
Limited liability partnership fee	245	167
Cost Directions income	494	403
CRB enquiry fee	197	41
Rights of audience	196	198
Other panel fees	254	213
Sundry income	913	670
	22,576	21,525

Grant income includes £273,610 (2005: £174,083) from the European Commission, £339,445 (2005: £326,919) from the Department for Constitutional Affairs, £52,289 (2005: £7,112) from the Foreign Commonwealth Office, and £27,632 (2005: £6,465) from the British Embassy in Libya.

Notes to the accounts (continued)

6. Analysis of expenditure

		2006 £'000	2005 £'000
Administration expenses			
Employment costs:	wages and salaries	49,974	47,302
	social security costs	3,990	4,183
	other pension costs	9,402	4,764
	other costs	5,493	4,785
Recoveries of administration expenses from the Compensation Fund		(11,804)	(11,638)
Other recoveries		(127)	(97)
		56,928	49,299
Gazette – printing paper and postage		2,671	2,711
Other printing and stationery		1,856	1,947
Other postage and telephone		2,389	2,470
Computer charges		5,393	5,934
Office holders' expenses		336	343
Council and committee expenses		1,015	1,261
Staff travelling and other expenses		2,204	2,551
Legal fees		4,654	8,274
Auditors' remuneration		100	151
Other professional fees		9,455	8,661
Operating lease costs		869	921
General administration expenses		5,101	6,272
Loss on disposal of fixed assets		939	1,643
Depreciation – equipment and furniture and computer hardware		9,368	9,963
Value Added Tax irrecoverable		4,907	5,846
Financial services – application and registration fees		255	263
Legal Services Complaints Commission		1,036	1,350
Solicitors' Disciplinary Tribunal expenses		122	86
Taxation		909	377
		110,507	110,323
Establishment expenses			
Rent, rates, heating, cleaning and insurances		4,072	3,435
Operating lease costs		1,607	1,716
Repairs and alterations		1,303	1,235
Employment costs:	wages and salaries	608	602
	social security costs	51	45
	other pension costs	110	102
Depreciation – property		947	973
		8,698	8,108
Recoveries of establishment expenses from the Compensation Fund		(377)	(573)
		8,321	7,535

Notes to the accounts (continued)

In addition to their remuneration, the auditors, BDO Stoy Hayward LLP were also paid £55,000 (2005: Deloitte & Touche LLP £1,556,000) in respect of the following matters.

Non audit fees	**2006 £'000**	**2005 £'000**
Tax services:		
compliance services	-	31
advisory services	10	48
Other services:		
project management & implementation services	-	1,435
IT outsourcing/strategy	15	39
SIF Consolidation re 2005 accounts	30	-
other services not covered above	-	3
	55	1,556

Tax advisory services include work in relation to VAT advice and assistance, and income tax advice and assistance given during the year.

This additional remuneration is included in other professional fees and legal fees.

Donation to The Law Society Bursary Fund

The Law Society Education and Training Department made a Gift Aid donation of £100,000 (2005: £135,000) to the Law Society Bursary Fund for the benefit of students.

7. Compensation, remuneration and staff numbers

Office holders

Compensation for the year was payable in respect of the office holders as follows:

	2006 £	**2005 £**
President	93,795	91,668
Vice president	46,898	45,834
Deputy vice president	23,450	22,917

From 1 September 2006 the annual compensation payable was increased in respect of office holders as follows:

	£
President	94,418
Vice president	47,209
Deputy vice president	23,605

Notes to the accounts (continued)

Senior managers

The Society's senior managers (the staff members on the Corporate Governance Board) received total emoluments, including pension contributions, of £2,572,000 for the year to 31 December 2006 (2005: £1,677,000).

The highest paid member was the previous chief executive who received emoluments including pension contributions of £821,000 (2005: £338,000).

All management team members are members of the Law Society final salary pension scheme in both the current and prior years, except the chief executive who is a member of a private stakeholder scheme - a defined contribution scheme.

Solicitors Regulation Authority

The chair of the SRA Board was paid £71,000 in fees in 2006. Board members were each paid £4,800 for service on the board, with payments of £400 a day for additional duties.

The SRA's senior managers received total emoluments, including pension contributions, of £573,000 for the year to 31 December 2006. There is no direct comparison for 2005. The highest paid member was the director of regulation compliance who received emoluments including pension contributions of £174,000. This figure includes basic salary of £119,000 and pension contribution of £32,000 including employer's contributions. The CEO of SRA commenced employment on 01/06/06, and is not listed as the highest paid member of staff as a full year's salary was not paid to him.

All the SRA's managers are members of the Law Society final salary pension scheme in both the current and prior years, except the chief executive who is a member of the Law Society stakeholder scheme - a defined contribution scheme.

Legal Complaints Service

The chair of the LCS Board was paid £71,000 in fees in 2006. Board members were each paid £4,800 for service on the board, with payments of £400 a day for additional duties.

The LCS's senior managers received total emoluments, including pension contributions, of £119,000 for the year to 31 December 2006. There is no direct comparison for 2005. The highest paid member was the chief executive who received emoluments including pension contributions of £60,000. This figure includes basic salary of £53,000 and pension contribution of £3,000 including employer's contributions. This covers the period of employment from the commencement date of 1 July 2006.

All the LCS's managers are members of the Law Society final salary pension scheme in both the current and prior years, except the chief executive who is a member of the Law Society stakeholder scheme - a defined contribution scheme.

Staff numbers (full-time equivalents)

The average number of persons employed by the Society for the year ending 31 December 2006 was 1,349 (2005: 1,374).

Notes to the accounts (continued)

8. Tax on profit on ordinary activities

Analysis of tax charge on ordinary activities.

	2006 £'000	2005 £'000
UK corporation tax at 22%/30% (2005: 22%/30%) based on profit for the period	6,185	1,444
Adjustment in respect of prior years	68	(183)
	6,253	1,261
Deferred tax:		
Timing differences, origination and reversal	(1,170)	(394)
	5,083	867

Factors affecting tax charge for the current period.

The tax assessed for the period is higher than that resulting from applying the standard rate of corporation tax in the UK 30% (2005: 30%). The differences are explained below:

	2006 £	2005 £
Profit from ordinary activities before tax and excluding mutual activities	22,160	3,330
Tax @ 30%	6,648	999
Adjustments to Tax:		
Reduced rate (22%) paid by SIF	(1,576)	(180)
Expenses not deductible for tax purposes	162	59
Capital allowances in excess of depreciation	(16)	-
Marginal Relief	(9)	(7)
Mark to Market transitional adjustment	1,184	395
Adjustment of tax value for sale of fixed assets	(234)	-
Unutilised losses carried forward	15	205
Dividends received and interest not taxable	-	(20)
Other timing differences	11	(7)
Prior period adjustment	68	(183)
Tax charge	6,253	1,261

Notes to the accounts (continued)

9. Negative goodwill

	£'000
Cost	
At 1 January 2006	40,590
Disposal	(40,590)
At 31 December 2006	-
Amortisation	
At 1 January 2006	30,315
Disposal	(30,315)
At 31 December 2006	-
Net book value	
At 31 December 2006	-
At 31 December 2005	10,275

Negative goodwill at 31 December 2005 represents the fair value of land and buildings acquired on the acquisition of Solicitors Indemnity Fund Limited. The land and buildings were sold in 2006 and the goodwill credited to the income and expenditure account during the year.

Notes to the accounts (continued)

10. Tangible assets

	Freehold land and buildings £'000	Leasehold property & improve-ments £'000	Equipment and furniture £'000	Computers and hardware £'000	Total £'000
Cost					
At 1 January 2006	40,817	541	16,401	55,460	113,219
Acquisitions	-	18	2,034	1,637	3,689
Disposals	(13,384)	(103)	(4,401)	(15,158)	(33,046)
At 31 December 2006	27,433	456	14,034	41,939	83,862
Accumulated depreciation					
At 1 January 2006	9,980	298	10,547	35,624	56,449
Charge for the year	944	118	1,513	8,038	10,613
Disposals	(2,276)	(58)	(4,401)	(15,158)	(21,893)
At 31 December 2006	8,648	358	7,659	28,504	45,169
Net book value					
At 31 December 2006	18,785	98	6,375	13,435	38,693
At 31 December 2005	30,837	243	5,854	19,836	56,770

Freehold land and buildings are periodically valued. The total open market value at the last valuation in 2006 was £29,650,000.

The Library collection, which has a net book value of £nil (2005: £nil) is shown within equipment and furniture. It is periodically valued for insurance purposes. The last valuation in 2006 totalled £3,424,800.

11. Investments

	Value 2006 £'000	Value 2005 £'000
Fixed interest stocks	27,280	51,350
Deposits	50,996	77,793
	78,276	129,143

Notes to the accounts (continued)

12. Subsidiary and other undertakings

The Society had the following subsidiary undertakings. They are all incorporated in Great Britain and operate in England and Wales.

	Nature of business	Issued share capital	Percentage of Ownership
The Law Society Services Limited	Trade and services	£100	100%
The Law Society Property Services Limited	Property holding company (company will be dissolved in 2007)	£100	100%
The Law Society Trustees Limited	Charity trustee	Limited by guarantee	100%
The Law Society Pension Scheme Limited	Pension trustee	Limited by guarantee	100%
Law Society (Hardware Rental Services) Limited	Lease rental (company dissolved 9 January 2007)		100%
Law Society (Software Licensing Services) Limited	Lease rental (company dissolved 19 December 2006)		100%
Queens Counsel Appointment Limited	Services and Support	Limited by guarantee	50%
Solicitors Indemnity Fund Limited	Professional Indemnity Insurance	Limited by guarantee	100%
Solicitors Indemnity Fund	Professional Indemnity Insurance	Fund	100%
Solicitors Indemnity Fund Operations Limited	Professional indemnity insurance	£100	100%

The Law Society Pension Scheme Limited, Law Society (Hardware Rental Services) Limited and Law Society (Software Licensing Services) Limited and Queens Counsel Appointment Limited have no, or minimal, assets or liabilities.

The Solicitors' Indemnity Fund Limited (SIF) is considered to be a quasi-subsidiary (see note 1) under the terms of financial reporting standard 5 (FRS 5) and its assets and liabilities are consolidated in these financial statements.

Notes to the accounts (continued)

12. Subsidiary and other undertakings (continued)

SIF summarised financial statements for SIF

	2006 £'000	(post acquisition) 3 month period ended 31 December 2005 £'000
Revenue account		
Gross claims paid	(17,795)	(8,827)
Reinsurance recoveries	72	657
Decrease in gross provision for reclaims	43,866	13,654
(Decrease)/increase in amount recoverable from reinsurers	(18,233)	(4,923)
Reinsurance premiums recoverable	160	-
Decrease in insurance claims incurred net of reinsurance	8,070	561
Investment return	5,443	1,684
Administration expenses	(163)	6
Profit on sale of assets	6,274	-
Contributions refunds	73	(3)
Tax (charge)/credit	(4,166)	(490)
Surplus after tax	15,531	1,758

There are no other recognised gains or losses for the year.

The surplus shown above is recognised in the primary statements are:

Notes to the accounts (continued)

SIF summarised financial statements for SIF (continued)

	2006 £'000	3 month period ended 31 December 2005 (restated) £'000
Investment income and interest	7,094	2,085
Surplus arising on professional indemnity insurance operations	1,855	(1,778)
Statement of total recognised gains and losses:		
Unrealised gains	246	1,451
	9,195	1,758
Profit on sale of assets not recognised as fair valued at date of acquisition	6,336	0
	15,531	1,758

Notes to the accounts (continued)

SIF summarised financial statements for SIF (continued)

Administrative expenses are broken down as follows:

	2006 £'000	3 month period ended 31 December 2005 £'000
Staff	2,278	851
Premises	427	147
Computer	547	150
Legal and professional	232	39
Audit	58	62
Insurance	208	54
Depreciation	180	35
Other operating costs	220	68
Total operating expenditure in the period	4,150	1,406
Less cost of internal claims-handling staff, including share of overheads	(3,320)	(1,125)
Administrative expenditure in the period	830	281
Movement in provision for run-off costs (note 16)	(667)	(287)
(Credit)/charge to revenue account in the period	163	(6)

The provision for run-off costs represents future anticipated administration costs as set out in the accounting policies. The cost of internal claims handling staff, including an appropriate share of overheads has been included in claims paid as described in the accounting policies.

Notes to the accounts (continued)

SIF summarised financial statements for SIF (continued)
Balance sheet

	2006 £'000	(Post-acquisition) 31 December 2005 £'000
Assets		
Investments	78,276	129,143
Reinsurers' share of claims provision	15,751	33,984
Debtors	3,274	7,505
Fixed assets	416	4,019
Bank balances	4,855	3,491
Total assets	102,572	178,142
Liabilities		
Gross claims provision	62,520	106,386
Provision for other liabilities and charges	3,144	4,981
Creditors	33,908	55,764
Total liabilities	99,572	167,131
Net assets	3,000	11,011

Cashflow statement

	2006 £'000	(Post-acquisition) 3 months ended 31 December 2005 £'000
Net cash flow from operating activities	(25,475)	(31,207)
Cash expenditure	(22,458)	-
Net cash outflows	(47,933)	(31,207)

Notes to the accounts (continued)

13. Joint ventures

a) SPIL

On 25 April 2000 the Society entered into a joint venture agreement with St. Paul Holdings Limited. In accordance with this agreement, a joint venture company, Solicitors Professional Indemnity Limited – SPIL#1 (the 'joint venture Company'), was set up for the following purposes: to arrange the provision of compulsory professional indemnity insurance to solicitors in private practice in England and Wales under the new open market arrangements; to act as marketing, claims handling and underwriting agent of St Paul International Insurance Company Limited in respect of solicitors' professional indemnity insurance; and to provide run-off and related services to the Solicitors Indemnity Fund.

During the year ended 31 December 2002, St Paul Holdings Limited transferred its shareholding to St Paul Co Inc who subsequently transferred it to St. Paul London Limited.

The Law Society owned 51 'A' shares and St Paul owned 49 'B' shares in SPIL#1.

The agreement with St Paul was terminated on 30 September 2004.

The Law Society was approached by St Paul with an offer to enter a new joint venture agreement but under this agreement St Paul would not manage and administer the run-off of SIF.

The carve-out of the management of the run off of SIF was achieved by the shares in SPIL#1 being transferred from each of the Law Society and St Pauls to Solicitors Indemnity Fund Limited on 1 October 2004. The Law Society gave no warranties or indemnities in respect of the 'A' shares and received £51 from SIF Limited in consideration for the transfer.

The Law Society entered into a number of agreements relating to SPIL#2 on 1 October 2004. The arrangements largely mirror the agreements which were in place on the previous joint venture, but crucially, the difference between SPIL#1 and SPIL#2 is that SPIL#2 will not operate and will remain effectively dormant unless and until St Paul group fails to offer quotations for compulsory professional indemnity insurance to the profession (trigger event).

b) Queen's Counsel Appointment Limited (QCAL)

A joint venture company with the Bar Council, Queen's Counsel Appointment (limited by guarantee and not having a share capital) was incorporated on 13 April 2005. The main purpose is to support and facilitate the process for the selection and appointment of Queen's Counsel (or King's Counsel), and to support the independent Selection Panel charged with the conduct of that process, and thereby to assist the process in serving the public interest by offering a fair and transparent means of identifying excellence in advocacy in the higher courts.

The loan outstanding from QCAL at 31 December 2006 was £117,000.

Notes to the accounts (continued)

14. Receivables and prepayments

	2006 £'000	2005 £'000
Trade debtors	2,591	2,879
Compensation Fund	-	391
Other Law Society affiliated entities	257	329
Other debtors	1,440	1,754
Prepayments	1,517	1,587
Corporation tax recoverable	460	107
Excess of loss insurance recoveries	-	119
Claims recoveries receivable	13	5
Accrued income	608	946
Reinsurance premiums recoverable	544	5,340
Claims recoverable under master policies	37	49
VAT	394	773
	7,861	14,279

15. Creditors

	2006 £'000	2005 £'000
Amounts due to suppliers	12,810	16,323
Other creditors including taxation and social security	2,086	1,220
Fees received in advance	84,405	86,253
Compensation Fund	689	-
Accrued expenses	1,535	844
Contributions refundable	25,767	50,223
Stop loss insurance recoveries payable	132	132
Excess of loss insurance recoveries payable	492	492
Income tax	6,152	3,804
Claims payable	479	195
Claims payable under master policy	69	74
	134,616	159,560

Included in other creditors are balances of £1,364,000 (2005 £1,299,000) in respect of PAYE and National Insurance.

16. Claims provision

	2006 Gross £'000	2006 Reinsurance £'000	2006 Net £'000	2005 Net £'000
Total provision	67,735	(17,687)	50,048	76,955
Discount adjustment	(5,215)	1,936	(3,279)	(4,553)
Provision at discounted value	62,520	(15,751)	46,769	72,402
Provision brought forward	106,386	(33,984)	72,402	81,133
Release of the provision to income and expenditure account	(43,866)	18,233	(25,633)	(8,731)

The professional indemnity insurance claims provisions have been discounted using the long term discount rate of investment return of 3% (2005: 3%)

17. Provisions for liabilities and charges

	Provision for run-off costs £'000	Provision for deferred tax £'000	Total £'000
As at 1 January 2006	3,874	1,107	4,981
Charges	-	-	-
Released in year	(667)	(1,170)	(1,837)
As at 31 December 2006	3,207	(63)	3,144

Provision for deferred tax is made up as follows:

	2006 £'000	2005 £'000
Mark to Market transitional adjustment	-	1,184
Other timing differences	(63)	(77)
	(63)	1,107

The provision for run-off costs represents future anticipated administration costs in respect of the professional indemnity insurance operations. The cost of the internal claims-handling staff, including an appropriate share of overheads, has been included in claims paid, as described in the accounting policies note.

Notes to the accounts (continued)

18. Accumulated fund

	Accumulated fund £'000 2006	Restated Accumulated fund £'000 2005
Consolidated		
At 1 January 2006 as previously stated	2,759	45,527
Prior year adjustment (FRS 17)		
- funded scheme	-	(44,841)
- unfunded scheme	-	(900)
At 1 January 2005 as restated	2,759	(214)
Surplus/(loss) for the financial year	30,395	22,624
Actuarial loss recognised in the pension schemes	(4,023)	(21,102)
Realised gains/loss on investments	246	1,451
At 31 December 2006	29,377	2,759
The Law Society		
At 1 January 2006	(7,359)	42,000
Prior-year adjustment (FRS 17)		
- funded scheme	-	(44,841)
- unfunded scheme	-	(900)
At 1 January 2006 as restated	(7,359)	(3,741)
Surplus for the financial year	35,185	17,484
Actuarial loss recognised in the pension schemes	(4,023)	(21,102)
Law Society Property Services Ltd Intercompany adjustment	(553)	-
At 31 December 2006	23,250	(7,359)

19. Operating lease commitments

The Society's commitments for rental payments under operating leases payable during the year to 31 December 2006 are as follows:

	Land and buildings		Other operating leases	
	2006 £'000	2005 £'000	2006 £'000	2005 £'000
Leases expiring between two and five years	409	397	869	921

Notes to the accounts (continued)

20. Capital commitments

The LSC and CGB have approved a spend of £2.3 million on a new IT system for the casework management. In 2006, £0.8 million was spent, leaving a capital commitment of £1.5 million in 2007. The supplier of the system is Visual Files. The system is likely to be fully implemented in August 2007.

21. Pension commitments

The Society operates a pension scheme (the 'Scheme') providing benefits based upon final pensionable salary. The Council of the Law Society decided to close the old Law Society pension scheme to new members from 1 January 2005. The assets of the Scheme are held separately from those of the Society in a trustee administered scheme, The Law Society Pension Scheme. These assets are invested and managed as follows:

UK equities	Barclays Global Investors (BGI)
	Scottish Widows Investment Partnership (SWIP)
	Lindsell Train
Overseas equities	Bank of Ireland (until July 2006)
	AllianceBernstein (Alliance)
Fixed Interest Bonds	BlackRock (formerly Merrill Lynch).

The total pension cost for the year was £10,584,000 (2005: £9,358,000).

The deficit decreased from £36.3 million to £12.4 million (see page 55). The Law Society has made a commitment to the Pension scheme to pay special contributions of £4 million per year for the next three years.

Other pensions

The Society also operates a defined contribution scheme providing benefits based on the amounts paid into the scheme and the performance of the investments.

The scheme incurred costs of £463,000 during the year (2005: £133,000).

There were no outstanding prepaid or accrued contributions at the year end.

A separate defined contribution pension scheme is available to staff involved in the professional indemnity insurance operations. The scheme incurred costs of £163,000 during the year (2005: £53,000). There were no outstanding prepaid or accrued contributions at the year end (2005: £nil).

The chief executive of the Law Society is a member of a private stakeholder scheme - a defined contribution scheme. The scheme incurred costs of £2,200 during the year (2005: nil). There were £1,100 outstanding accrued contributions at the year end (2005: £nil).

FRS Retirement benefits

The Scheme is subject to triennial valuation by a qualified independent actuary.

The full actuarial valuation of the Scheme was carried out as at 31 December 2006 by a qualified, independent actuary. The scheme is closed to new entrants, under the projected unit method the current service cost will increase as the members of the scheme approach retirement.

Notes to the accounts (continued)

21. Pension commitments (continued)

The assets in the scheme and the expected rates of return at 31 December were:

	2006		2005		2004	
	Long term rate of return expected	Value £'000	Long term rate of return expected	Value £'000	Long term rate of return expected	Value £'000
Equities	7.6%	98,222	7.1%	58,136	7.8%	44,188
Bonds	4.6%	86,297	4.1%	79,955	4.8%	40,327
Total market value of assets		184,519		138,091		84,515
Present value of Scheme liabilities		(196,882)		(174,415)		(129,356)
Deficit in the scheme and net pension liability		(12,363)		(36,324)		(44,841)

Notes to the accounts (continued)

The figures shown above were calculated on the basis of the following assumptions.

	2006	2005	2004
Discount rate	4.9%	4.8%	5.3%
Rate of increase in salaries	4.7%	4.2%	4.85%
Rate of increase in deferred pensions	3.0%	2.7%	2.85%
Rate of increase in pensions in payment (for pensions accrued before 1 November 2002)	5.0%	5.0%	5.0%
Rate of increase in pensions in payment (for pensions accrued after 1 November 2002)	3.0%	2.7%	2.85%
Inflation assumption	3.0%	2.7%	2.85%

Analysis of the movements in the scheme deficit during the year

	2006 £'000	2005 £'000
Opening deficit in the scheme and net pension liability	(36,324)	(44,841)
Current service cost	(9,025)	(7,664)
Normal contributions	10,583	9,824
One off contribution	25,000	25,000
Annual contribution	4,000	4,000
Past service cost	(1,665)	(373)
Other finance income	(909)	(1,168)
Actuarial (loss) / gain	(4,023)	(21,102)
Closing deficit in the scheme and net pension liability	(12,363)	(36,324)

Amounts that have been included within the financial statements for the year ended 31 December 2006 are as follows:

Amounts included within operating profit

	2006 £'000	2005 £'000
Current service cost	9,025	7,664
Past service cost	1,665	373
Total operating charge	10,690	8,037

Notes to the accounts (continued)

Amounts included as net finance return

	2006 £'000	2005 £'000
Expected return on scheme assets	7,625	5,861
Interest on scheme liabilities	(8,534)	(7,029)
Net return	(909)	(1,168)

Analysis of the actuarial (loss)/gain in the statement of total recognised gains and losses

	2006 £'000	2005 £'000	2004 £'000	2003 £'000	2002 £'000
Actuarial return less expected return on pension scheme assets					
Amount (£'000)	1,489	10,006	3,524	3,221	(10,315)
Percentage of scheme assets	1%	7%	4%	5%	(18%)
Experience (losses)/gains/arising on the scheme liabilities					
Amount (£'000)	(2,407)	(4,018)	1,184	3,065	(4,383)
Percentage of net present value of scheme liabilities	(1%)	(2%)	1%	3%	(5%)
Changes in assumptions underlying the present value of the scheme liabilities	(3,105)	(27,090)	(4,161)	(12,384)	(12,276)
Total actuarial (losses)/gains recognised in the statement of total recognised gains and losses					
Amount (£'000)	(4,023)	(21,102)	547	(6,098)	(26,974)
Percentage of the present value of scheme liabilities	(2%)	(12%)	0%	(5%)	(29%)

FRS17 disclosures

In December 2006 amendments were made to FRS17 regarding required disclosures. The amendments will be mandatory for the Law Society for the year ending 31 December 2008. The Corporate Governance Board and the Audit Committee will consider the early adoption in the Society's accounts for the year ending 2007.

Notes to the accounts (continued)

22. Monies held as a consequence of the intervention process

The Law Society is trustee of funds vested in it as a result of intervention into a firm of solicitors and is responsible for ensuring that the funds are properly accounted for and distributed appropriately. These cash balances are referred to as the Statutory Trust Accounts (STAs). The Fund is able properly to recover from those cash balances grants it has made provided certain procedures are followed.

The work performed by the Solicitors Regulation Authority to reconcile STAs and the Fund and assess the overall position is well progressed. An application to the Chancery Division of the High Court for guidance on how to deal with STAs was filed in January 2005. Judgement was handed down on 14 March 2006. Investigative work to trace beneficiaries continues and has been reasonably successful particularly with intact accounts, and payments have been made. A targeted advertising campaign is ongoing to identify other potential beneficiaries, so far with limited results.

The High Court on 14 March 2006 determined that the Statutory Trusts held by the Law Society are subject to public law rather than the private law of trusts. It also determined that the Law Society has power to determine who is beneficially entitled to the funds taken in trust as a consequence of intervention pursuant to public law principles in a bona fide, rational and reasonable way, and taking note of private law trust principles. The Society will determine from its investigations a 'best list' of beneficial owners.

This means that in cases where the Compensation Fund has made payments the recovery of grants pursuant rights of subrogation may now be exercised. This will be done over time on a case-by-case basis and it is difficult to estimate the likely total but it will probably exceed £15 million. Interim distributions are possible where the amount due to the Compensation Fund is established and sufficient can be retained to meet the maximum of any claims from other beneficiaries. After a long period of inability to make distributions on the basis of legal advice, interim and final distributions are now underway.

The judgment also allows the Law Society to recover costs incurred from the STA in determining beneficial entitlement and making distribution. The Society has indicated that it will only do this from un-distributable balances.

At 31 December 2006, £55.9million (2005: £55.7 million) was held by the Law Society as statutory trustee and comprised designated deposit accounts, office deposit accounts and the current account. The rightful beneficiary of these monies is often not known, and in some cases may never be known. The Compensation Fund may have a legal entitlement to some of these monies.

This contingent asset, being the unknown amount that may be remitted from the STAs to the Compensation Fund, has been excluded from the Fund's statement of assets and liabilities.

23. Related party transactions

Four lay members of the Council received payments of £3,000 each in 2005. There were no lay members in 2006.

The Law Society paid £54,345 (2005: £17,957) excluding VAT to Council members in respect of royalties received, assessors' fees, training, professional fees and consulting.

Notes to the accounts (continued)

Payments totalling £10,000 + are listed below:

- Rodney Warren £25,500 *
- Robert Brown £17,625
- Denis Cameron £16,155

* plus VAT: payment to Mr Warren's firm

Solicitors Indemnity Fund (SIF) paid £2,000 (2005: £6,000) to the chair for activities undertaken.

24. Council members' expenses

In addition to expense costs of attending meetings, annual expense allowance may be claimed in respect of incidental expenses, which Council members and their firms have incurred on behalf of the Society.

The rates may be claimed as follows:

All chairs of the boards, committees and sub-committees covered by the allowance	£3,000
Chair of the Solicitors Disciplinary Tribunal	£3,000
Other Council members	£1,000
Other Committee members and members of the Solicitors' Disciplinary Tribunal	£500

25. Litigation

The Law Society has a very robust process of reviewing and managing high profile litigation matters relating to the representative function, Solicitors Regulatory Authority, Legal Complaints Service and Solicitors Disciplinary Tribunal. The Law Society considers that there are no major litigations which require disclosure in the financial statements.

26. Contingent liability

The Law Society received a letter dated 12 June 2007 from Zahida Manzoor, Legal Services Complaints Commissioner, which states that the Law Society has not handled complaints in accordance with its plan, however, it is allowing the Law Society the opportunity to make representations before a final decision is made and also on the possibility of levying a penalty and, if so, in what sum. All this is to be agreed by 5 July 2007. The LCS and SRA intend to make representations to convince the Commissioner that the Law Society has handled cases substantially in accordance with the plan.

