

Trust to get it right...

We discuss how to make trusts work for your clients

Cash flow management for law firms

We share some tips for improving cash flow in your law firm and alternative sources of finance

Merger, is it the way to go?

We investigate why law firms are looking to merge and the process that involves

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Welcome to the Winter 2013/14 edition of The LAW, the specialist publication for the legal profession from the legal sector team at Armstrong Watson.

Specialists are available from all of our 15 offices to provide pro-active support

and advice to lawyers in compliance and business improvement matters. This publication is designed to allow us to share our collective experience in acting for lawyers throughout the UK.

I also keep our law firm clients up to date with more immediate developments in the legal profession via Twitter. If you would like to follow me, I'm @AW_AndyPoole

Recent developments include the SRA publishing its revised Risk Outlook as well as papers on cloud computing and financial difficulty.

Please contact me if you would like to discuss how we might be able to help to improve your practice, or if you would like any further information on anything referred to in this publication.

Andy Poole
Legal Sector Director

In this edition:

Merger, is it the way to go?

David Richmond discusses how to make a merger go smoothly.

david.richmond@armstrongwatson.co.uk

The Armstrong Watson valuations faculty

Douglas Russell highlights the services provided by our own valuations faculty and introduces the team.

douglas.russell@armstrongwatson.co.uk

Challenging times ahead

Melvin Leech updates us on the accounting standard changes to UK GAAP from 1 January 2015.

melvin.leech@armstrongwatson.co.uk

Cash flow management and alternative sources of finance

Andy Poole shares some tips for improving cash flow in your law firm.

andy.poole@armstrongwatson.co.uk

Trust to get it right

Bob Wheatcroft advises how to make trusts work for your clients.

bob.wheatcroft@armstrongwatson.co.uk

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Merger, is it the way to go?

David Richmond, Partner

In the current climate, talk of law firm mergers is all around.

The issues facing the legal profession are considerable; retirement, succession, The Legal Services Act, legal aid reform, personal injury reform, regulatory reform and difficult trading conditions. The list is long and to many lawyers, daunting.

This has led to many discussions in the board rooms of law firms over the direction a firm is going and future plans.

Eventually, the discussions lead to talks of mergers.

The first thing to stress is that whatever course of action is taken, it has to be planned, well thought out, considered and done for the right reasons, otherwise the old adage "out of the frying pan and into the fire" rings true.

Before considering the options, the practice needs to take a close look at itself; its strengths, weaknesses, opportunities and threats. Often this is easier done by an independent third party, as it is sometimes difficult to see what your strengths and weaknesses are when you are looking from within. It also has the benefit of taking away individual personalities; there is nothing better than a big ego to get in the way of a sound, sensible commercial decision.

Once the merger route has been agreed upon, targets need to be identified. These targets will enable further growth within specific sectors, the enhancement of specialisms or the offering of complimentary services. In addition they will enable the business to grow, move forward and continue to compete in an ever increasingly difficult and challenging marketplace.

At this stage, keep your options open, talk to more than

one potential merger partner, consider the options and review the possibilities. It is imperative to be honest with the potential merger partner and address the deal breakers at an early stage. It's better to get the issues out in the open at an early stage rather than them becoming deal breakers further into the process.

Draw up a shortlist, speak informally, then have the conversation "we want to expand by merger ... would that be of interest to you?" Share your vision with the potential merger partner, what's in it for both parties.

Time and skill is then required to assess the situation. Is it worth continuing the discussion? Do the two practices fit? Is there a willingness to merge? Does the merger make financial sense? What structure should be adopted?

If there is a positive outcome to these questions, then move to due diligence, exchange questionnaires and talk about the price, then it's deal done, shake hands and off you go!

Communicate the deal with staff and clients, highlighting the positives and benefits of the merger.

Then the hard work starts! There will be difficulties, differences of opinions and the unexpected, but they should not derail what appears to be a sound commercial decision.

So that's it, merger – Is it the way to go?
– It could be!

We're here to help throughout the process. Armstrong Watson has a dedicated Legal Sector team, backed by experienced partners and staff throughout the firm. We are able to offer help, assistance and support throughout the merger process to ensure a positive outcome.

Introducing...

The Armstrong Watson Valuations Faculty

Armstrong Watson has a number of skilled individuals with experience in carrying out a variety of types of valuations. Early in 2012 we decided to form our Valuations Faculty with a view to promoting our services to our chosen markets; sharing best practice; and ensuring consistency of approach across our various offices.

Experience tells us that legal firms benefit from engaging with us in a variety of valuation circumstances, leading to optimal results for themselves and for their clients. There are a number of examples of types of valuation work that we regularly engage in on behalf of our own clients or after receiving instructions from our contacts in the Legal Sector:-

1. Practice Valuations

We are increasingly being asked to assist law firms with the valuation of goodwill in their practices, with particular reference to incoming and outgoing partners; in merger/acquisition scenarios; and with structural changes to law firms. The legal market place is changing and evolving at a rapid rate and our experience in the sector allows a pragmatic and realistic view to be taken on practice valuations.

2. Dispute Resolution

We are often appointed as arbiters or expert witnesses where there is a dispute on the valuation of goodwill; shareholdings or indeed an entire business. This could be in relation to a partnership dispute within a legal practice itself, or in relation to a dispute between business owners or shareholders in any business sector.

3. Litigation Support

In our role as expert witnesses, we are often engaged in cases where court proceedings are underway and we can add value in our role as valuation experts, often aiding the early settlement of cases following our input. Again, this can cover a wide range of valuation circumstances covering partnership or shareholder disputes; matrimonial cases; and price adjustments to corporate transactions following a claim under sale/purchase agreements.

4. Fiscal Valuations

We receive frequent instructions to carry out valuations of shares and goodwill for a variety of reasons, including those for Inheritance Tax, Capital Gains Tax and income tax purposes. Our experience in dealing with HMRC, will normally result in an optimal position being negotiated for our clients and for our legal connections that instruct us on behalf of their clients.

5. Corporate Valuations

Our Corporate Finance Team assist many clients in a pre-sale phase by way of considering a realistic value for their business, and then with aiding price negotiations with a potential purchaser. Our team also receive instructions in valuing target businesses where our clients are in acquisition mode, again to assist with negotiations.

Any of our team will be delighted to talk with you about any specific valuation circumstances that you may be involved in, so please feel free to contact us to discuss anything we may be able to help you with.

The Team



Douglas Russell, Partner

- Head of our Valuations Faculty with wide experience in business and share valuations as well as expert witness valuations for litigation support and matrimonial cases.

Based in our Dumfries office

T: 01387 955955

E: douglas.russell@armstrongwatson.co.uk



Richard Rankin, Partner

- Corporate Finance specialist with wide experience in company valuations.

Based in our Kendal Office

T: 01539 942030

E: richard.rankin@armstrongwatson.co.uk



Andy Poole, Legal Sector Director

- Legal Sector specialist with wide experience in valuing legal practices.

Covers all of our offices, primarily Carlisle and Leeds

T: 07828 857830

E: andy.poole@armstrongwatson.co.uk



David Robinson, Tax Consultant

- Tax specialist with wide experience of fiscal valuations for CGT, IHT and income tax purposes.

Based in our Carlisle Office

T: 01228 690200

E: david.robinson@armstrongwatson.co.uk



Alison Watts, Partner

- Corporate Finance specialist with wide experience in company valuations as well as expert witness valuations for litigation support and matrimonial cases.

Based in our Carlisle Office

T: 01228 690200

E: alison.watts@armstrongwatson.co.uk



Steven Holmes, Tax Consultant

- Tax specialist with wide experience of fiscal valuations for CGT, IHT and income tax purposes.

Based in our Leeds Office

T: 0113 211 1300

E: steven.holmes@armstrongwatson.co.uk

Cash flow management and alternative sources of finance

Andy Poole



A pre-requisite of any successful law firm, is the ability to mitigate economic and regulatory fluctuations from impacting their cash flow. Prudent, pro-active cash flow management provides protection for the future and enables firms to remain fluid, avoiding unpredictable spikes.

Although firms can seek protection at particular pinch points, banks are not always the most appropriate source of finance when it comes to balancing the books, and in many cases they are not willing lenders, particularly if the pinch points are unexpected. Initiatives to help the banks to lend, whilst maintaining a long term view on their own risk and internal balance sheets have included the Funding for Lending and the Enterprise Finance Guarantee schemes. Even with such initiatives, many in the legal sector have struggled to access finance at a time when it has been badly needed.

John Clarke, Sales Manager for Key Accounts at Syscap has noted that: "Many firms have become too dependent on their overdrafts, and are struggling to the point where merger, sales or even closure seems like the only viable option. The reasons for this are two-fold; firstly, the banks have realised their lending risk and will not provide unlimited credit facilities and secondly, the banks are now more likely to impose a restricted number of days allowance once a business has breached its overdraft limit before further action is taken".

So what alternatives are there? A good working relationship with your bank is essential, so any alternative needs to be something that the bank sees the logic in, as part of an all round funding package. In many cases, it is appropriate to mix sources of finance, so that for example an

overdraft is maintained for the core working capital requirements, and additional funding is taken for the short term pinch points. It may be that the professional finance market could provide that additional funding.

A professional finance loan can offer perfunctory and secure barriers against cash spikes and enable firms to create a stable on-going cash flow position. Solutions can be long-term or short-term and repayments can be made over a number of months or a number of years, depending upon the particular circumstances and the required solution. If you look at the table for Legal Firm "A", and the graph below, you can see how funding can positively impact a law firm's cash flow. Clarke continues to say that "The additional headroom when compared to a fixed overdraft limit can reduce associated risk". Syscap have provided the following table and graphical analysis to support Clarke's thoughts.

Legal Firm "A"			
21 Income Generators - 7 Equity - 4 Salaried - 20 Fee earners	£5.7m Turnover - 10 Years trading - London & south coast office - 77 areas of law - Client since 2011	Current Facilities - Bankers: Allied Irish - £200k OD limit	Potential Funding Requirements - VAT £300k - TAX £195k - PI £250k - PC £40k



Clarke explains: "Demonstrated in the graph above, the blue line shows what Legal Firm "A" would look like with a professional finance loan and the red line shows what the

overdraft position would look like if Legal Firm "A" implemented an additional funding solution. The light blue shading illustrates that with the additional cash into the business, the firm has the ability to create headroom to prepare for fluctuations and to support growth".

This is a fairly simplistic example, although it does demonstrate that packaged in line with an overdraft facility, it could take pressure away from the banks, and potentially allow for the overdraft to be reduced.

The key to any package of funding solutions is to be aware of future requirements well in advance. Any last minute finance requests to either the banks or the professional finance market are likely to be viewed in a dim light. Firms need to have an accurate forecasting system in order to predict the cash flow requirements, and the servicing of any finance provided. Forecasting hints:

- Three year period with automatic integration of the cash flow with the profit and loss account and balance sheet – update annually and adopt variance and sensitivity analysis
- Separate analysis of each income stream, i.e. each work type – different work types will have different working capital requirements e.g. conveyancing v personal injury
- Reflect changes in work in progress, rather than assuming that WIP will be constant and simply looking at fee income and debtors
- Adopt an additional more accurate shorter term forecast model that simply looks at cash flow over say a 13 week period - as each week is completed, add another week so that you're always looking 3 months ahead and are therefore aware of pinch points

Challenging times ahead

Melvin Leech



Accounting standards have been overhauled and UK GAAP is changing. The mandatory adoption date is accounting periods beginning on or after 1 January 2015, although earlier adoption is permitted. There is a new standard (FRS102) and an updated version of the FRSSE 2015. These replace all existing accounting standards and guidelines.

You may think that this does not affect you, or it is a long way in the future. However the changes that are coming may affect your reported profits, tax charges and distributable reserves sooner than you think. The comparative figures in any accounts will need to be on the new basis, which means a balance sheet as at 1 January 2014 for the earliest mandatory set of accounts.

The main changes are...

Goodwill

Currently under Financial Reporting Standards (FRS's) and the Financial Reporting Standard for Smaller Entities 2008 (FRSSE 2008) there is a general default maximum amortisation period for writing off the value of goodwill over no more than 20 years.

Under the new standards this has been shortened to 5 years.

Where there are no reliable estimates to prove a longer useful economic life, the

effect of the change will be to increase the amortisation charges against profits, which will lower profits available for distribution. In many cases, particularly for law firm partnerships, this amortisation charge is not allowable for tax.

Lower profits may affect banking covenants, bonus agreements and partner/ shareholder expectations. These may need advance discussions with the relevant organisations.

Revaluations

There are also a few issues around the revaluations of properties and investment properties.

Presently any revaluation gains and losses go into a separate revaluation reserve on the balance sheet. Nothing is charged to the profit and loss account until the reserve has been extinguished.

Under the new standard, revaluation gains and losses on investment properties will all go directly into the profit and loss account. This may have a dramatic effect on the accounting profit or loss for the period depending on the magnitude of the revaluation. A second change affecting revaluations is that of deferred tax. Presently deferred tax is not accounted for on revaluations. The tax charge occurs when the item is sold.

This changes under the new standards and deferred tax

is accounted for in full on all revaluations. This may have an immediate effect on distributable reserves or profits where the revaluation reserve has been utilised to offset higher depreciation charges or used to issue further shares.

Lease Incentives

At present any lease incentive received for entering into a lease, for example a rent free period, is spread over the period to the first break clause.

Under the new standards the lease incentive would be spread over the period of the lease regardless of any break clauses. Transition rules mean that any existing lease could continue under the old rules but new ones would have to be on the new basis. This means that the profit effect will be spread over a longer period and can have a major impact where previously there were long leases with short break clauses.

Conclusion

Although these changes may appear to be minor and may appear to be some time away, all of the issues raised here need to be considered on how they affect your business, not something that should be left to the last minute.

Trust to get it right

Bob Wheatcroft



The need to get it right

The modern trust is a flexible animal. It is frequently established as part of a tax planning exercise but does of course have other uses too. Whatever the reason for the establishment of the trust, it is important to get it right.

Of course, solicitors prepare the deeds and the wills that are usually the founding documents of trusts. Readers will be aware of the difficulties that can arise there.

Getting the initial paperwork right is not, unfortunately, the end of the matter. The trust has to be administered properly in accordance with the deed or will as well as the relevant trust legislation. Additionally, the tax obligations have to be dealt with in accordance with ever changing statutory obligations and HMRC attitudes.

When things go wrong

That is often the undoing of busy professionals who focus on the advisory part of the job and leave what seems to be more routine tasks to other more junior people within the office. When things go wrong that can be a very expensive mistake – often leading to angry clients and big PI claims. Non-tax problems can include such matters as failing to take proper investment advice or to keep rented property properly insured – accidents do happen! Keeping track of important events like a key beneficiary birthday or 10 year trust anniversary is also vitally important. You need tight systems to ensure that such irregular dates are picked up. Missing the event not only often causes tax issues in itself but also means that tax planning opportunities are missed.

A solution

Many firms of solicitors will offer trusteeship services to their clients but those who don't might want to consider using Armstrong Watson's own trustee company. A trustee company offers a solution to the continuity problems arising with changes in partners who are acting as trustees, as well as providing a solid basis for ensuring that trust matters are properly controlled by individuals who understand the requirements.

At Armstrong Watson we have become heavily involved in the administration of trusts. In part this has arisen through the number of trusts created as a result of our own tax advice, but we also administer a large number of trusts where we have had little or no initial involvement. In particular we prepare the tax returns and, where required, financial statements for an increasing number of trusts.

Working with you

We have been delighted to accept instructions from firms of solicitors to take over some or all of the administrative aspects of their own client trust portfolio. These services are sometimes provided in a direct engagement with the trustees but, in a number of cases, the solicitor is our client and their relationship with the underlying client is unchanged. Whilst we do offer tax planning services ourselves, we also recognise that where other advisors are engaged by trustees, then our role is likely to be restricted accordingly.

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