the law

Armstrong Watson's specialist publication for the legal profession

Autumn 2017

Appropriate Management Information

For law firms to operate effectively

Research & Development

Unexpected tax relief for law firms

National Minimum and National Living Wage - and the law

Pension Planning -

For directors of practices trading as limited companies

SRA Accounts Rules -

What makes a breach material?

An interview with...

Richard Beech, Commercial Director of Riliance

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Welcome

Welcome to the Autumn 2017 edition of The LAW, the specialist publication for the legal profession from the legal sector team at Armstrong Watson.

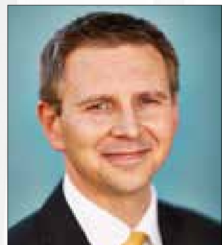
In this edition, we focus on:

- Appropriate management information and reporting for law firms in order to make appropriate strategic decisions – our views as a follow up from the interview in the last edition with Graham Moore of Katchr
- Potential Research & Development tax claims for law firms – perhaps something you hadn't even considered was possible!
- Updates on the national minimum wage
- Pension planning for directors of law firms that operate as limited companies
- A reminder of COFA duties and helpful hints on when to report or not

As noted in Karen Lightfoot's article on COFA duties, the SRA Accounts Rules are to change in Autumn 2018 – a key part of the COFA's responsibilities will be to ensure that everybody within a law firm is trained on those changes – **now is the time to contact us to arrange for Armstrong Watson to provide that bespoke training in house at your law firm.**

Specialists are available from all of our 16 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.

Please contact me if you would like to discuss how we can help you, or if you would like any further information on anything referred to in this publication.



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The Law Society has exclusively endorsed Armstrong Watson for the provision of the following services to law firms throughout the North of England:

- Strategy Planning Workshops
- Business Plans
- Benchmarking
- Mergers & Acquisitions of Law Firms
- Law Firm Valuations
- Forecasts
- Raising Finance
- Lock-up Reviews
- Pro-active Tax Planning
- Tax Compliance
- Audits
- Accounts Rules Reporting
- Accounts Preparation
- LLP conversions
- Incorporations
- ABS Applications

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Craig Foxcroft
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Appropriate Management Information for Law Firms

In the spring issue of The LAW we spoke to Graham Moore, Managing Director of Katchr about management information for mid-sized UK law firms. We now take a closer look at the things to consider when looking at the output from your finance function. We are often asked what and how much management information do we need? There is no right answer to this as each business is different; it really does depend on your size, your structure and your strategic objectives.

The first port of call when considering what information you need should be for you to determine where you want to be and how you are going to get there. Once you have a strategy and a plan of how you are going to get there, the big ongoing question you should be asking is what do you need to give people to monitor the implementation of that plan?

Whatever business structure you operate, you will require a mix of statutory and non-statutory information. Statutory information includes the likes of VAT returns and client account bank reconciliations. However no business is likely to succeed on compliance alone. To go further you need to put more in! Success, like life, is a delicate balancing act of moderation, after all law professionals didn't choose to study accountancy so why would they need the volume of information an accountant would crave?

You may have a management team made up of some or all of the partners. You will need to consider how much information you provide to this management team and how regularly. If you have split your firm by work type and the responsibility is delegated to a team leader or department head, you would expect them to receive information on their team on a more regular basis then the people to whom that department head is accountable. Taking that logic to the next step these department heads should not consider themselves baby sitters and therefore the fee earners for whom they are responsible should be given the opportunity to manage their own matters, so they need relevant information also. That said, it really does depend on what support is available to those fee earners in managing their portfolios and their experience. For example, if the firm has a credit control department responsible for the collection of debts, the fee earners may feel disengaged from that process when in fact they have the greatest opportunity to influence that process long before any fee has even been raised.

We would expect that the information provided to any person in any business should be relevant to the role they play in the business. But raw information is unlikely to be appropriate. If someone were to communicate to you that you raised £5,000 of fees last week how would you feel? Whereas if someone were to say you raised £5,000 of fees last week against a target of £7,000 but your fees raised in the year to date are £45,000 against a budgeted target for the year to date of £40,000. The second communication gives you much more information about performance. This is a simple example of how we can take an isolated piece of information and give a much greater insight into one aspect of fee earner performance.

As with any business in the professional services industry, as people orientated business we are always looking to measure people's performance. Indeed these measures may actually be used to reward staff. If a person were a machine we would be looking at its output and efficiency. Continuing that theme, a fee earner's efficiency in law is generally judged by how effectively they use their time and how much of that time is recovered. Management information should therefore be based on those efficiency measures. The output of the fee earner is also not just the quality of the fee produced i.e. how long it takes to receive the payment, but also how long it takes to produce that fee, and information should also be available to measure that.

Various regulatory bodies are keen to promote open pricing for clients which is not only a massive headache if we get it wrong but also a massive opportunity if we get it right. Measurement of relevant factors should help with that also.

In summary we echo the three principles that management information should be built on:

- Keep it focused with the use of KPIs;
- Highlight exceptions and link to targets; and
- Do not overwhelm people with detail.

If you'd like to know more about how we are able to assist you with your management information, how to better align management information with your business strategy or even how to use this information to motivate and reward, please get in touch with one of the Legal Sector team.

Research and Development Tax Relief and the Digitalised Economy-

opportunities for more sectors than you might expect!

As the economy becomes increasingly reliant on digital technology, we are seeing a change in the typical market sectors claiming research and development ("R&D") tax relief.

When R&D tax relief was first introduced it was mainly claimed by companies involved in pure research type sectors and some other sectors, such as manufacturing and computer software. Gradually, as people have realised there is a much wider scope to make a claim, there has been an increase in claims from companies who previously did not think they were eligible. The tax relief is marketed heavily at the moment and with this increased awareness, the popularity and take up of the tax relief has grown and grown. Coinciding with this, over the last year or so we have seen a rise in claims from even less obvious sectors such as law firms.

The reason for the increase in claims from law firms is typically because they are using advanced digital technology to improve their business performance.

The first stumbling block for law firms is that the tax relief can only be claimed by companies, as more firms incorporate, they unlock the ability to claim the tax relief. Typically firms are incorporating for other reasons, not even considering R&D tax relief.

For readers that aren't aware, the tax relief is given by way of a corporation tax super deduction.

Companies receive a 130% super deduction on qualifying costs, effectively 230% tax relief.

This equates to a tax saving of approximately 25p for every £1 spent on the R&D project. The amount 'spent' is subjective to quite specific rules relating to certain cost categories. The relief is for companies that 'seek to advance science or technology through the resolution of scientific or technological uncertainty'.

This sounds like a grandiose statement, but in layman's terms if a company is:

1. Doing something no else has done before, or doing something someone else has done before, but in an appreciably new way, AND
2. They weren't sure how to do it.

Then they should be discussing a R&D tax relief claim with someone.

When undertaking a software project it is important to consider that the advance must be in respect of overall knowledge in computer software, not just the company's own state of knowledge. However, interestingly, combining standard computer software technologies can be R&D if the software developers can't readily deduce how the separate components should be combined to have the intended function.

One of the first R&D tax relief court cases B E Studios involved computer software, which helpfully set certain parameters for what can and can't be included in a claim.

Numerous law firms are embarking on significant software projects that fit the criteria for R&D tax relief without knowing it. However the significant tax saving can often prove to be a nice (and often unexpected) bonus.

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National Minimum and National Living Wage - and the law

Compliance is a word often associated with payroll as when legislation isn't complied with the consequences are often painful for the business pocket. The National Minimum Wage (NMW) and the National Living Wage (NLW) are both hot topics at the moment.

HMRC are the regulators and/or enforcers of these bits of legislation and the introduction of naming and shaming of employers who flout the law demonstrates how high on HMRC's compliance agenda they are.

Whilst I fully support coming down hard on those who deliberately do not comply, I cannot support the government when employers just do not realise this legislation applies. I don't mean through ignorance and/or excuses, but genuinely not knowing what you don't know.

I have been in payroll for 20 plus years and remember NMW legislation coming into force, reading night after night what this was going to mean for payroll professionals and employers.

So imagine my surprise when a client of Armstrong Watson, who does their own payroll processing received a massive penalty from HMRC for non-compliance. Let me paint the picture, with slight alterations to the story to protect our client.

You have an employee compliment of three; two men and one woman. All of whom earn £10 per hour. One of the male employees sells his house and is looking for somewhere to rent. The owner of the business, who isn't directly involved with the business comes to his rescue and offers him a discounted rate for a house in the town (discounted as an employee). Problem solved or so you would think.....

None of the employees have the need for work based accommodation, so none is offered. This employee, with his partner has taken out a private rental agreement for a property not connected with the business or his job. And yet when HMRC carry out a NMW/NLW compliance audit the employer is advised he has breached the NMW regulations! Why, well because the accommodation rental agreement is with a person connected to the company (the owner in this case) and therefore the cost of the accommodation rental amount should have been taken into account.

Without going into the exact numbers, the penalty was going to be significant. I then got involved. Never having had the need to understand this part of the legislation, albeit I was fully aware of work related accommodation and NMW, I couldn't believe what GOV.UK was saying.

After negotiation, the case was resolved with a much reduced penalty as the non-compliance was not deliberate avoidance, but it didn't end there. You may recall earlier I said one female and two male employees. As this individual's hourly rate has now had to increase to take account of the accommodation costs, so do all the employees to ensure equal pay; a very costly rescue one might say!

So employers and employment lawyers be warned; this is a moving target so really important to keep up to date. The link to the guidance/regulations I refer to can be found at https://www.gov.uk/national-minimum-wage-accommodation/accommodation-charges and we can help with reviews and advice in your particular circumstances.

Pension Planning

For directors of practices trading as limited companies

In my experience in dealing with the legal sector, it is increasingly common for practices to be incorporating or considering incorporation. Following our Spring 2017 edition of The LAW in which my colleague Emil McKenzie outlined the significant changes in pension annual allowances, I now follow that up with an outline of the potential advantages and disadvantages open to directors of limited companies, as opposed to partnerships, LLPs and sole traders.

Pension annual allowances are not negotiable and are a fixed amount, but there are circumstances which provide company directors with more flexible pension planning opportunities.

How much and who can contribute

Being a director of a limited company opens up the possibility of the legal practice making a pension contribution directly into your own personal pension. The practice can theoretically contribute any amount, provided that it is commensurate with your role and overall remuneration.

The individual cannot receive contributions that exceed the Annual Allowance of £40,000, but can carry forward unused annual allowance from the three previous tax years, subject to specific rules.

Theoretically, if three years of carry forward is available the practice could contribute £120,000 as a one off to the individual's pension and a further £40,000 for the current tax year and £40,000 each year thereafter.

What benefits does a director derive from this?

- If the practice contributes to a pension on your behalf, you will not incur an Income Tax liability on the pension contribution. It is a tax efficient way of extracting your funds from the company.
- As an example, you could take £10,000 salary, £30,000 dividend and £40,000 pension contribution to make a package of £80,000.
- This will accelerate your pension provision, building an investment in a tax free environment outside of your estate.

What benefits would the practice derive?

- The practice can effectively claim Corporation Tax relief on the gross pension contribution – it is treated as a legitimate business expense (the director will not receive tax relief on the contribution, but subject to the above will not be taxed on it either).
- In the example above, a contribution of £160,000 would attract a tax saving of £32,000 based upon corporation tax of 20%. The saving will reduce proportionately as if the rate of Corporation Tax reduces.

What are the drawbacks and risks?

Depending upon the director's earnings, the Tapered Annual Allowance may apply.

What this means in practice is that if you draw any combination of salary and dividends that exceeds the Threshold Income of £110,000 per annum, or your remuneration (including pension contributions from all sources) exceeds the Adjusted Income threshold of £150,000 per annum, your Annual Allowance will reduce by £1 for every £2 earned above £150,000. So an individual with a total remuneration package of £210,000 or more would only be able to contribute £10,000 per annum to their pension arrangements.

On the other hand, those earning more than £100,000 can use personal (not company) pension contributions to restore some or all of their Personal Allowance. For each £2 earned in excess of £100,000 the Personal Allowance is reduced by £1 (so someone earning £122,000 would lose the £11,000 Personal Allowance), but personal pension contributions are deducted from the income figure, so a £20,000 contribution would restore £10,000 of Personal Allowance.

An example

It is often the case when a legal practice incorporates that it will convert the capital accounts and the 'goodwill' of the partners into a director's loan account with the new company. After any initial capital gains tax on the goodwill transfer, this effectively means that each director has a pot of money upon which they can draw down an income free from taxation in the initial years. When allied to a Dividend Allowance of £5,000 per annum, and for those who retain it, the personal income tax allowance of £11,500, this creates the opportunity for significant tax free income.

Controlling the income stream also means that triggering the Tapered Annual Allowance can be avoided, meaning that the director retains a full pension Annual Allowance of £40,000.

If little or nothing has been paid into a pension in the preceding three tax years prior to incorporation, there could be capacity to carry forward up to £120,000, and use the current year allowance of £40,000 which in turn could create Corporation Tax savings of up to £32,000.

Once the money is in the pension scheme, each director could then implement their own investment strategy.

Alternatively, the directors could pool their funds and use them to invest in commercial property, including the premises occupied by the legal practice, as outlined in my article in the Spring 2016 edition of The LAW.

Pension planning is a complex topic and specific advice should be sought prior to implementing any of the above.

Our financial planning and legal sector teams work closely together with incorporating law firms in order to generate efficient outcomes.

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SRA Accounts Rules

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What makes a breach material? Should I report to the SRA?

Since November 2015, the form of your Accountants Report has changed, as has what is now reported to the SRA. As mentioned in my previous article in The Spring 2017 edition of The LAW, it used to be quite straightforward when deciding if a qualified report should be submitted – often one breach and the accountant was encouraged to report it.

Under the current system, the SRA now only require us as accountants to report if we consider the breach to be material, loss to a client and/or considered to be systemic. So why the change?

The general consensus is that this change has occurred because the SRA believe that the COFA should be identifying the material breaches and reporting these to the SRA as they occur, as opposed to being reported by the accountant up to six months after the firm's year end. The SRA believes that a firm should have ensured that the necessary policies and procedures are in place so that the risk of inherent or systemic weaknesses is low and therefore by default the risk of a material breach is also low.

The SRA state in their guidance that all material breaches should be reported promptly – although there is no definition of 'promptly', the Accounts Rules would imply that this is within 24 hours! - and that the COFA should not await until the completion of any internal investigation. However, the guidance does not definitively state what is a material breach. So what should a COFA be doing in order to ensure that they meet their responsibilities and to identify any material breaches? Firstly you need to understand what would be judged to be a material breach – this is the area that is most open to interpretation and judgement.

Guidance note xi to Rule 8 of the Authorisation Rules suggests that the following four factors should be taken into account when assessing whether something is material.

These are:

1. The detriment, or risk of detriment, to clients;
2. The extent of any risk of loss of confidence in the firm or in the provision of legal services;
3. The scale of the issue;
4. The overall impact on the firm, its clients and/or third parties – think of how would the reputation of the firm fare if something was reported in the local press?

The Guidance note also implies that the COFA should always bear in mind that a material breach does not have to cause a loss of money to a client – a recurring pattern of breaches in regard to one fee earner, one department etc. could indicate systemic and/or inherent weaknesses within the controls. To give you an example, the most common recurring pattern we now see as reporting accountants are breaches of Rule 14.3 and 14.4 – residual balances. These rules have been in place now since July 2008 – yet nearly ten years after the residual balance changes, it does not yet appear that firms have robust enough procedures in place to deal with residual balances. On a daily basis we see breaches of these rules on matters which may only be two/three years old. Fundamentally this could also be viewed as a loss to a client.

So what should a COFA be doing to ensure that they are meeting their responsibilities? The underlying premise is that the COFA is responsible for maintaining compliance with both the financial and risk management systems. There are no set or hard and fast rules to ensure this – the guidance is in the form of a sub-note to rule 8 and should be viewed as a common sense approach.

There are several things that should be undertaken on a periodic basis – we would recommend that the majority of these should be done on a monthly basis.

These include:

1. Carry out regular checks on the accounting systems – but not necessarily at the month-end date as by default everyone always ensures it is correct at the 30th of June but maybe not at the 22nd June!
2. Review the matter listing – do not just look at balances – look at names – are there any suspense or miscellaneous clients?
3. Undertake and document file and ledger reviews – vary these between different departments and different fee earners. Where breaches are noted, ensure these are logged and promptly remedied (Rule 7.1 of the SRAAR Account Rules 2011 specifically states this). Even if you do not find any breaches, document the files reviewed!
4. Have an open dialogue with your cashiers – where do they believe there are issues? They see the ledgers and files every day and interact with the fee earners.
5. Run regular training programmes and updates for all fee earners. The rules are constantly being reinterpreted and new guidance being issued – just because something was acceptable five years ago does not mean it is acceptable now. The prime example of this is the reinterpretation of Rule 14.5 ... banking facilities!
6. Review your breaches register periodically – you need to ensure it is in a format by which you can spot any recurring patterns.

So how can we help?

The SRA Accounts Rules are due to have a further significant change in Autumn 2018. We already know the changes that will come into force and are being engaged by firms to train all of their cashiers and fee earners so that they are ahead of the game – COFAs will need to ensure that the people within their firms are properly trained and ready for the new regime.

We can talk to your COFA, helping you to design checklists for accounts compliance checks, monthly checks and file reviews.

We host COFA forums in various locations – contact us if you would like to join.

We provide formal training on the SRA Accounts Rules – now is the time to arrange for us to provide training in-house at your firm.

An interview with ...

Richard Beech, Commercial Director of Riliance, specialists in risk and compliance software, outsourced services and training

1. What are the key regulatory challenges that law firms are facing today?

I think the key regulatory challenges that firms face will be complying with regulatory changes and new regulations being introduced over the next 12 months.

Many firms are still getting to grips with the 4th Money Laundering Directive. The new AML regulations may require a different approach to CDD and AML risk management, especially as there is more onus on solicitors to evaluate their own risk and act accordingly.

GDPR is coming into force in May next year, and it remains the biggest regulatory challenge faced not just by law firms, but by businesses overall. The GDPR changes are focused on strengthening and protecting data subject's rights. As solicitors hold sensitive data, the changes required under GDPR could be far reaching covering systems, processes, training, documentation, supply chains and information security to name but a few. Firms should be focusing on GDPR compliance now so that they are not caught out in May next year.

Overall, as regulation continues to move towards principle based and outcome focused, new regulations can be either an opportunity or a burden. The regulatory changes give firms more scope to use their judgement in understanding the risks they face and plan accordingly which can lead to more efficient compliance frameworks. They could also create an ever-extending set of checklists and tick boxes that may not be effective.

2. What are the key non-regulatory challenges that law firms are facing today?

Data management and information security continue to be an increasing challenge faced by law firms. Data breaches can cause huge damage to firms through fines & sanctions, loss of revenue, and reputational damage. Information Security should be an ongoing focus for law firms.

Market forces are also challenging for some areas of the legal market. Uncertainty over Brexit, changing buying behaviours, and client expectation of lower costs and higher quality can all put firms under pressure. Client requirements, such as IT due diligence, supplier questionnaires and annual audits/accreditations can create an additional workload and if not managed correctly can lead to large pieces of work becoming unprofitable or, if firms can't meet client demands, lost entirely.

3. What options are available for law firms when looking to overcome those issues?

Having access to a network of similar firms or advisers that you can talk to and gain insight from can help you navigate your way across the changing risk and compliance landscape. We have seen a rise in our clients calling us with AML, Risk Management and GDPR queries, in addition to increased attendance at roundtable events and seminars. Being able to discuss any aspect of risk and compliance with advisors or peer firms can clarify matters and help identify the best approach to the new regulations.

Alongside the knowledge of what you need to do to comply with the new regulations is how you manage them in practice. Effective systems and processes are crucial to managing all areas of risk and compliance. Firms initially used the Riliance platform for their SRA compliance, however, the scope has widened to general risk management, managing quality marks, evidencing compliance with wider regulations and tracking/managing client requirements. Having systems in place to track, manage and report on all areas of a risk and compliance framework will put firms in good stead for the changes ahead, both regulatory and commercial.

4. How can working with legal sector specialists help law firms?

Specialists like Armstrong Watson and Riliance work with firms facing challenges like these every day, and that wider market understanding can be invaluable to you. Having a partner with specialist risk and compliance knowledge and expert staff will help you manage these changes, which helps you get on with running and growing your firm, and gives you the peace of mind that you are compliant where it counts.

Richard Beech
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