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The Law Society

# theLaw

Armstrong Watson's specialist publication for the legal profession

Winter 2017/18

The benefits of developing management information for law firm owners

Making Tax Digital

Heads up on what law firms and your clients need to prepare for

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Joe Reeve, Managing Director of Words4Business and LegalRSS

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# Welcome

Welcome to the Winter 2017/18 edition of The LAW, the specialist publication for the legal profession from the legal sector team at Armstrong Watson.

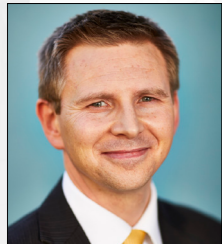
Specialists are available from all of our 16 offices to provide proactive support and advice to lawyers in compliance and business improvement matters. This publication is designed to allow us to share our collective experience in acting for lawyers throughout the UK.

As ever, we focus on ways to improve your business and your advice to your clients, including:

- How forward thinking law firms work with Armstrong Watson on understanding and then taking strategic action based on accurate and meaningful management information
- Changes for you to be aware of in advising your education clients
- The need to protect your law firm business
- The steps you need to be aware of ahead of more regular reporting to HMRC

During 2017, we were engaged on new instructions by, on average, two law firms every week. Thank you for working with Armstrong Watson as your accountants and best wishes for 2018.

To find out more on any of the above, including how we can work with you to help you and your clients, please do get in touch with me.



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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:

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## Circumstances in which business protection may be beneficial for law firms

Being a Director or Partner in a legal practice goes hand in hand with numerous forms of risk, and risk assessment is a constant for professional practices. Primary concerns are health & safety, fire, employer's liability, public and professional liability but for many practices the list goes well beyond those. You are legally obliged to insure against perils such as insuring premises and the cars driven by your teams, but what happens when one of your key people is diagnosed with a critical illness or is lost as a result of premature death?

### Business ownership

If one of your co-partners/directors were to pass away it is likely in most cases that the surviving business proprietors would wish to retain control of their deceased colleague's share of the business, but equally probable that their surviving spouse or family would wish to realise the cash value of their spouse/partner's share of the business.

This could easily run into hundreds of thousands of pounds, creating the need to find a significant amount of capital in a short space of time. Option one is to have sufficient capital set aside, but this is probably not realistic. Option two is to borrow from the bank, but they may be less willing to lend knowing you're a fee earner down and taking on more debt.

### Business debt

Most commonly this is viewed as bank debt, which may indeed be the case, but what if the bank calls the debt in on the change in circumstances?

To compound the issue, for limited companies, Directors' Loan Accounts (DLAs) are a business debt and they become repayable on death.

Consider an example, where the business incorporated in recent years, perhaps combining goodwill and capital accounts into a DLA to allow maximum tax efficiency over future remuneration. In this instance, a DLA of £1m would provide a great deal of financial flexibility, but it also creates a debt of £1m owed to the director's family by the practice on their death.

For many practices finding £1m at short notice may not be financially viable, but living without the lost money may not be viable for the surviving family.

It is also worth noting that a DLA forms part of your personal estate for the purposes of Inheritance Tax.

### Key person fee loss

Based on the most recent Armstrong Watson Legal Sector Benchmarking report, the average fee earner (in a 1-30 partner firm) earns just over £125k per annum of fees.

The Law Management Section financial benchmarking survey report of September 2017 highlights that 'if a practice has a 31st December year end, on average it takes until 22 November for a fee earner to earn sufficient fees to cover his or her total costs for the year'.

Without beginning to consider the costs of recruitment or locum cover, on average there is a loss of £125,000 per practice on death of a fee earner and a potential lag time of over 11 months for a new fee earner to be in profit.

### The solution

Some legal practices may have sufficient cash reserves and/or access to borrowings to cover such eventualities, but many will not and it may be prudent to consider insuring the lives of those driving the business to avoid placing the practice in jeopardy should the sudden loss of a key person arise.

It is imperative to review the life insurance and critical illness insurance provision for directors, partners and fee earners with regularity, to ensure that the risks posed by worst case scenarios are provided for.

Changes in business structure and legislation also mean that protection needs to be reviewed and updated on an ongoing business as your practice and its people evolve.

Life insurance is likely to form part of the solution, so knowing the correct structure, policy owner(s), lives assured, sum assured and potential need for a trust is dependant upon the circumstances of your practice and the individuals within it.

We work together combining the knowledge of our specialist Legal Sector and Financial Planning teams to build bespoke solutions to the risks identified for your practice. Contact me should you require a review of your particular circumstances.

# Making Tax Digital

## Heads up on what law firm businesses and your clients need to prepare for

Following intense lobbying from the accountancy profession and other industry bodies, the originally proposed start date for Making Tax Digital (MTD) has been delayed. The General Election also delayed the introduction of the legislation.

We have now had the Finance Bill with details of how HMRC intend to implement MTD and encouragingly it seems that the Government has taken heed of the concerns and delayed the start date for most businesses even further. However, changes to the way VAT returns are to be submitted are now on the horizon:

### From April 2018

There will be voluntary pilot schemes:

- VAT registered businesses can report quarterly data to HMRC using MTD compatible software and will have to maintain digital records to provide an audit trail to support the figures filed.
- Other businesses and individuals, e.g. businesses with turnover under the VAT threshold or property landlords, can submit tax return information on a quarterly basis.

### From April 2019

VAT registered businesses – including companies and LLPs - will be required to submit VAT information using MTD compatible software. We are still awaiting guidance from HMRC as to what precisely they mean by digital records, and in particular whether spreadsheets are an acceptable way to keep records.

The first VAT quarter starting on or after 1st April 2019 is the first return that needs submitting under the new system. As most VAT registered businesses already submit quarterly VAT returns online, this should not be a major change, but software upgrades may be needed. The deadline for filing the MTD for VAT submission remains five weeks after the end of the VAT quarter.

Businesses who are voluntarily VAT registered, e.g. those with turnover under the VAT threshold (currently £85,000), will not be required to make MTD reports.

Also from 2019 other businesses will be able to submit quarterly information to HMRC - business income and expenses or property rentals for example – on a voluntary basis.

### From April 2020

This is the earliest date that all taxpayers will be required to submit regular information to HMRC for income tax purposes. For most businesses this will mean quarterly submissions, but more frequent returns can be made, e.g. where monthly VAT returns are prepared. HMRC has committed not to do this until it is satisfied that the software and systems can be shown to work.

The original plan was that partnerships would have to make a minimum of five submissions each year. In most cases this will be four returns during the year to coincide with VAT returns and a final submission after the end of the year once the accounts have been prepared. HMRC has said that the in-year submissions do not need to be full accounts, i.e. they do not need to include work in progress, stock, bad debts, capital allowances, etc. This means the final taxable profit could be massively different to the figures submitted in-year.

HMRC has been keen to stress that the payment dates for tax will not change when MTD is implemented. This means that the figures declared on the in-year returns, including the allocation between partners, does not matter too much. However, it would not be too much of a surprise if quarterly payments were introduced in the future.

### What about Companies?

VAT registered companies are included in the changes described above and will need to submit returns using MTD compatible software. We are awaiting a HMRC consultation document as to how MTD will be implemented for Corporation Tax purposes. It is safe to say that this will not be until April 2020 at the earliest.

### The end of tax returns?

All the information submitted via HMRC will appear on an individual's Personal Tax Account, together with PAYE and other data already collected by HMRC. Once other miscellaneous information has been entered, a person's tax liability for the year can be calculated without the need to submit a tax return. This is a "work in progress" and HMRC has not set a timetable for the phasing out of tax returns.

### Ways to make your life easier

In order to be able to provide much more regular financial information to HMRC, firms will need to ensure that their internal accounting function permits that. Many of the new accounting software suites have been developed with this in mind, and one that we work with in particular, Xero, now has links to legal sector practice management systems and case management systems. Through Xero, Armstrong Watson is now the largest cloud accountant in the UK and we have recently been named as Xero Cloud Accounting Partner of the Year 2017.

<http://www.armstrongwatson.co.uk/blog/2017/10/xero-cloud-accounting-partner-year-2017>

If you have any queries, or would like to start planning for your MTD regular submissions, please contact me.



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# Governance requirements for the education sector.

## Do the boards of your education clients demonstrate effective governance?

The new Governance Handbook issued by the Department of Education in January 2017 is a vital resource for governors as it clarifies the roles and responsibilities of those governing schools as well as capturing the legal responsibilities of school boards.

The strengths and resolve of governing bodies are certainly being tested in the current climate with financial uncertainty over future funding, the reduction in school buildings and maintenance programmes, and political influences looking to shape the future of the sector. All of this results in governors needing to formulate strategies that only use the current resources available at their disposal. With skill-sets and experience levels varying on boards, it is important that governors have access to the latest key guidance and information to help their decision making.

This article covers the changes introduced by the new handbook. The handbook now defines six key features which should run through the skills, knowledge and the culture of our governing bodies which can lead to proactive demonstrations of effective governance.

**Effective governance** – the handbook clarifies that the function of a board is to ‘hold executive leaders to account for the educational performance of a school, its pupils and development of staff’. Governors create the strategic vision of an organisation in terms of the standards of attainment to be achieved, the culture of a school, and the performance standards for staff, but they may choose to delegate certain tasks to the executive team for implementation.

**Strategic leadership** - Governors must ensure that they challenge poor management decisions and performance and also encourage strategies to drive improvements and raise those key standards. Strong leadership also connects with parents and the wider community, taking their views and knowledge into consideration. Well supported schools always look to strengthen links between those governing the school, the parental community and local stakeholders.

**Accountability** – enhancing the financial management of schools must be a key focus for governors, to provide

reassurance to stakeholders that strong robust financial systems and controls are in place, reducing risk of mismanagement and to ensure that resources are being expended appropriately and in line with regularity. The handbook provides specific guidance on establishing and monitoring policies in respect of transactions with related parties. Serious reputational damage to schools can occur when irregular transactions involving connected parties are publicised. Governors must therefore ensure that decisions involving related parties are managed effectively through:

- the identification of potential related parties
- assessing and documenting associated risks
- documenting the decisions resulting in approval/rejection of the transactions
- whilst also following their normal procurement procedures

**People** – the handbook covers the new requirements for all individuals who govern schools to hold a Disclosure and Barring Service (DBS) check. Without such checks being in place, then an individual will be disqualified from joining or continuing to serve on any board/committee. New advice is also provided on conducting informed elections which encourage more parents to assist and support boards. This will help to ensure that boards remain accessible and connected with the local community and to ensure a variety of perspectives is given. New guidance also encourages a comprehensive Code of Conduct for boards to adapt and adhere to, which also supports information within the public domain. In addition there needs to be a clear understanding of information to be displayed on the school’s website which must be accurate, factual and relevant for it to be a useful resource to any user.

**Structure** – the definition of a member and their role within the organisation is further clarified within the guidance on how a school appoints a member and what their role constitutes. It is important that members do not overstep their responsibilities or undermine the governance of school boards.

The handbook provides a clear distinction between the role of a governor and that of a member. Another key governance tool is a school’s Scheme of Delegation. The handbook specifies that the Scheme of Delegation must now be publicised and must include key features including the authority levels for procurement and payments, details of committees and any specific functions for those committees, delegated responsibilities and those undertaken by the board alone, parental engagements, and describing the relationship between the executive team and those in charge of governance.

**Compliance** – the new handbook consolidates the legal responsibilities of the board in terms of both charity and company law. More guidance will be forthcoming in future months in respect of safeguarding as this area has been subject of a major review and overhaul. One member of the Trust board must take responsibility for the school’s safeguarding arrangements. This area can be particularly challenging given that governors are not active participants within the school on a daily basis and the complexity and sometimes delicate nature of events in this area. The governor in charge must be knowledgeable about the legal issues and operational aspects for implementing the policies within the school. All governors have a responsibility to ensure that they promote the welfare of pupils and are accountable for the effective child protection policies in place and that they adhere to local and national guidance. The handbook very much looks towards ‘prevention’ in its guidance and encourages all board members to undertake training in this vital area.

The handbook although prepared for a school scenario enhances key aspects of good governance which could be adapted by other not for profit organisations, being suitable as a reference tool. The role of a school governor continues to evolve, whether they are a strategist, finance specialist, legal expert or educational consultant, and with more pressures being placed on this voluntary role is it any wonder that recruitment is proving difficult in some areas of the country?

Contact me for further information on how we can help you with your education sector clients.



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# The benefits of developing your management information for law firm owners

In recent editions of The LAW we have looked at what management information your law firm should consider. In this issue I will look at what we can do to work with you on your firm's management information and illustrate the significant benefits that can be obtained by small improvements in Key Performance Indicators ("KPIs").

We are engaged by law firms to review and implement management information reporting procedures and also act as outsourced FDs to law firms.

Earlier editions noted that management information should be built on three key principles:

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

In reviewing a firm's existing management information as well as considering its fit with the above principles we also consider how the information is presented. As everyone looks at things from a slightly different perspective, we look to ensure that the information includes a higher level summary or overview together with additional detail for those that require it. As well as presenting the results for the period and year to date, the summary should include some context. This context is usually in the form of the results for the same period last year to allow like for like comparison as well as the budgeted position. Regardless of the accounting system used, the objective should be to provide management, and crucially also individual fee earners, with information on a timely basis in a clear format to allow them to make informed strategic decisions. Clarity in the information used can bring clarity to the strategy of the firm.

What is expected to happen in the remainder of the year is often more important than what has already happened. Do we have an adjusted budget or cashflow that shows what we expect to receive and pay out.

Can we identify pinch points in cash flow?

The use of focussed KPIs will allow progress of the firm against its strategy. These KPIs should also be measured against targets. The targets should also form part of the strategy of the firm and be set by fee earners and department taking account of work type and mix, past performance and sector benchmarks. If the wider strategy of the firm was, for example, to reduce lock up by 30 days it may be unrealistic to set that as a target in year one and to do so may be demotivating. Targets should therefore be set in such a way to get everyone on board. It may be necessary to step the targets, to reduce lock up by 10 days in the initial six months and then review the targets going forward. One of the keys is to then monitor such KPIs on an ongoing basis. Once appropriate KPIs are introduced, targets set and monitoring/coaching introduced, the KPIs can also be used to reward staff performance.

This is another area we are able to advise and guide law firms wishing to motivate their staff - the key asset in any service business. We introduce schemes linking the reward and remuneration of staff and fee earners to their performance against the focused KPIs, which in turn are linked to the firm's objectives and strategy.

We therefore believe management information is more than just the information used by the management of the business. The fee earners should be provided with management information on their own performance on a regular basis against their targets.

We have seen success in building individual scorecards and team or department scorecards that are used by the individuals and also by department heads in monitoring the performance of their team. Incorporating a traffic light system to allow them to easily identify areas of strong or weak performance will help to focus decision making. Department heads can then report to the managing director, partner or the management board on an informed basis.

We have a track record of implementing the procedures outlined above for law firms either as a standalone engagement, or as part of an outsourced FD role. This benefits the law firms as a result of focussed management and staff making appropriate day to day decisions based on relevant information.

The following examples illustrate how KPIs can have positive impacts on the profitability and bank balance of your firm.

## EXAMPLE 1

If a firm has 3 fee earners, each of whom record and bill 1,000 hours a year at an average recovered rate of £150 per hour, and the firm also has a net profit margin of 30%.

**This would give a net profit of:**

$$3 \times 1,000 \text{ hrs} \times £150/\text{hr} \times 30\% = \text{£135,000}$$

If we increase the recovery rate by 10% the profit rises by 10%:

$$3 \times 1,000 \text{ hrs} \times £165/\text{hr} \times 30\% = \text{£148,500}$$

So if one of the fee earners is an equity partner and the other two salaried fee earners, increasing one of these factors increases the profit per equity partner by 10%. If we increase the recovery rate and billed hours by 10% the profit rises by 20%:

$$3 \times 1,100 \text{ hrs} \times £165/\text{hr} \times 30\% = \text{£163,350.}$$

A 10% increase in recovered hours of 100 hours in a year is less than half an hour a day for the full time fee earner. The key measures here are utilisation and recovery.

## EXAMPLE 2

Let's take a firm with fee income of £1,000,000 and an overdraft of £200,000. They have total lock up days of 150 days, made up of WIP days of 90 days and debtors days of 60 days.

If the firm were to reduce these measures to best practice of 45 days for WIP and 30 days for debtors, the cash improvement would be  $£1,000,000 / 365 \times 75 \text{ days} = \text{£205,480}$ . This improvement would turn a £200,000 overdraft into a positive bank balance.



For illustrative purposes, this is an extreme example. Bringing the change to a more realistic level if WIP days are improved by 30 days, i.e. raising an invoice 30 days earlier, this alone could improve the cash position of the firm by  $£1,000,000 / 365 \times 30 = \text{£82,191}$ .

The key measures in this example are the components of lock up: WIP days and debtors days.

KPIs can be powerful if you are monitoring the right things for your strategy and are able to make small improvements to them they can have significant impacts on the financials of your firm.

The Armstrong Watson Legal Sector team specialise in providing services to the legal profession. To learn more about how we are able to assist you and your firm getting the best out of your people and fulfilling your strategic aims, or to explore the possibility of engaging Armstrong Watson as outsourced FD's for your firm, please contact me.



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## Directors and annual payrolls – the first impacts of making tax digital

Over the last couple of months the legal sector team at Armstrong Watson has received a number of queries from Directors with regard to their eligibility for statutory entitlements such as free child care and statutory maternity pay (SMP).

In a limited company structure, Directors will often decide to pay themselves their salary once a year through their annual payroll. This is particularly true in small companies without other non-director employees.

Annual payrolls for directors are a well established practice for all limited companies, not just those in the legal sector. They allow increased flexibility for remuneration planning in owner managed companies, as well as being beneficial in terms of generating cost and administration savings as the whole payroll process is only performed once a year.

However, the recent move to digital tax accounts for all individuals is presenting some disadvantages to that annual method.

In order to qualify for certain statutory entitlements, such as SMP (paid via the employer), or Maternity Allowance (paid directly by the government), HMRC will need to know that the required level of earnings has been met by the individual. In addition, the nature of the calculations mean that regular earnings will often be required. Similar rules apply for adoption and paternity/shared parental pay and leave arrangements, as well as the thirty hours of free childcare.

If an annual payroll is being used for a director, HMRC will either not see any earnings for the year until after the payroll has been processed, or if an annual payroll is processed at the start of a tax year, depending on the timing of the claim, it will not see regular earnings throughout the year.

Annual payrolls therefore now cause a potential issue for a number of Directors, in that they do not qualify for the entitlements despite both being employed and having sufficient earnings - albeit on an annual basis.

As annual payrolls for directors are a well established practice of which HMRC are aware, our Director of Payroll Services, Karen Thomson has spoken with HMRC for their thoughts. From those discussions with HMRC, there doesn't appear to be a suitable way of advising HMRC of any potential earnings during the year if an annual payroll is adopted. An estimate of earnings can be made through your personal digital tax account, but it isn't clear whether this method will, or can, link through to the entitlements information.

Based on the above, Directors now essentially have two choices: keep paying themselves annually but accept they may not qualify for benefits or entitlements should the need arise, or pay themselves on a more regular basis. The actual annual earnings will be the same on both bases.

We would advise that if your company already processes a regular payroll as you have additional non-director employees, you should add yourself to the regular payroll (monthly/weekly etc.). Providing that regular payroll marks you as a Director, the normal annual National Insurance reconciliation will still take place.

If your limited company does not currently process a regular payroll, then you should consider the need to set one up, and to begin to process the salary on a more regular monthly basis. This may result in both additional time and monetary costs to the company, although the issue with statutory entitlements would be eased.

Being included on the regular payroll for the company does remove some of the flexibility regarding remuneration planning, in that a salary level is being determined early in the year, before any results of the company can be considered.

We will continue to look into the different options and advise accordingly in future, as the digital world continues to move at a very fast pace.

## An interview with ...

Joe Reevy, Managing Director of Words4Business and LegalRSS, specialist providers of B2C content and content distribution to the legal profession since 1999.

### 1. A lot of firms espouse a 'content strategy' – what are the key issues in getting a content strategy right?

There are a lot - see The Seven Content Mistakes that Almost All Law Firms Make (<http://snip.ly/0tf3h>). The main mistake is to try to impress people with their expertise. If your target is in-house legal, fine - otherwise, not. In most cases, expertise is a given as soon as you have the brass plaque. The firms that win are those that:

- make themselves seem approachable - this is about writing plain English and making the content resonate with readers
- are up to date - being the fifth firm to tell somebody about something is pointless
- are really thinking about issues and potential issues from the client's point of view.

The focus should be relentlessly on the client, not the firm. There is no point in spending megabucks to drive people to your site or subscribe to an e-newsletter and then them be disappointed with the offering found there.

The other big mistake firms make is to assume that people visit sites and read the content of a number of firms in detail. Almost NO-ONE does this. What is important about content is that it is there, not that it is read (sorry!). This does NOT mean you can be shoddy, as simple grammatical errors will be a big turn-off for many, but does mean that the emphasis should be on controlling cost and having a balance of material, not lots of case references and long words.

### 2. It is often said that differentiation is the biggest problem for professional firms. How does that relate to the pursuit of content strategy?

Law firms tend to have a very 'cookie cutter' approach to differentiation. My own view as an ex-partner is that true differentiation is darned near impossible unless you have a small niche. I'd spend instead on out-distributing my competitors and leveraging my contacts and clients. However the one REAL differentiator in my mind is the firm that is genuinely proactive: a claim often made, very rarely achieved. That is all about spending time thinking about clients, their issues and their futures.

### 3. What is the most effective tool in content marketing?

Our clients report to us that targeted e-mail/e-newsletters give by a mile the best return on investment, but it is crucial to target the messages at the audience. E-communications must be valuable in order to be read and acted upon. That said, just delivering e-newsletters to former clients is also a great way to keep them reminded that your firm is there and ready to act. I am very often shocked by how little firms do to keep clients once the file is closed. How ready they are, in effect, to go through the expense of acquiring a new client rather than the much less expensive process of retaining and leveraging what they have. Interestingly, PAPER e-newsletters also show very high long-term rates of return on investment – probably because they have permanence.

### 4. What are your views on social media?

This depends entirely on the market targeted. However, for those targeting commercial businesses, LinkedIn is without peer. It now generates 60% of our business leads and leads to invitations directly to 'top table' meetings. Build your LinkedIn network! The 'light' social media such as Twitter and Facebook are decent routes to market for private client work. However, they are swamped and the more firms that pile in, the more important it is to be savvy on how you use them. It is also important for firms to think about whose brand they are building (and at what cost) when staff are using social media.

The great news is that all of the above can be done cheaply and quickly using the right software. It is perfectly feasible for a firm with a £20k BD budget, and two hours a week of time allotted to content management and distribution, to compete effectively against one with a £200k BD budget and full-time marketing team. The tech is there. It is easy. It is powerful.

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