the Law

Armstrong Watson's specialist publication for the legal profession

Spring 2017

Spring Budget 2017
A review of the first and final spring budget

Important changes to pension annual allowances
Maximising pension payments based on Carry Forward rules

New SRAAR regime
Karen Lightfoot gives you some helpful tips on the new SRA Accounts Rules

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Graham Moore, Managing Director of Katchr

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Welcome

Welcome to the Spring 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:

- The recent budget
- The complex but important area of pension contributions
- The new SRA Accounts Rules Regime
- Changes resulting from the new LLP SORP

We also introduce our new forensic team, with a case study to demonstrate how we help law firms and their clients

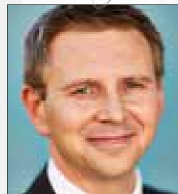
Due to increased requests for help from law firms, I'm delighted to announce that:

- Rosy Rourke has been promoted from Legal Sector Manager to Legal Sector Director
- Tom Blandford has been recruited as a Legal Sector Director
- Craig Foxcroft has joined our specialist team full-time as Legal Sector Manager

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.

Andy Poole



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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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Budget 2017 Review

I suppose it was inevitable that in the year of two budgets, and this final Spring budget occurring before article 50 is triggered, that there would be very few changes. In fact just one week after the budget, the fallout from the Class 4 National Insurance increase has led to the Government doing a U-turn, cancelling the planned increase from April 2018 for this parliament. But this does leave some interesting questions as the Government commits to a review of the differences between employees, the self-employed/partners and those operating through a corporate entity.

Dealing firstly with the changes introduced in the budget, the dividend allowance would be regarded as the most surprising. This allowance, which was only introduced last April by this Government, is simply seen as too generous, when combined with the savings allowance, the increases in personal allowance and the higher rate threshold. There is no doubt that, before the introduction of the dividend tax, remuneration planning was focused on trading through a corporate entity and drawing at least a part of your remuneration in the form of dividends.

The dividend tax changed this somewhat but it was still possible to draw your personal allowance, the £5,000 dividend allowance and then an interest charge, which would be covered by the savings allowance. Therefore, with this in mind the Chancellor has reduced this £5,000 to £2,000 from April 2018. This will obviously affect some of the remuneration planning that has become embedded over the last few years but there will still be benefits in spreading your remuneration over different income classes.

The Chancellor did also increase both the personal allowance to £11,500 and the higher rate threshold to £45,000 from April 2017 and this marks a further step towards his planned thresholds of £12,500 and £50,000 respectively.

The Chancellor had argued that since the reform of state pensions, which saw both the employed and self-employed/partners receiving the same level of pension, that there was no reason why the rates of National Insurance between these two groups should be different. The rise suggested in the Budget of 1% per year, over two years, would have impacted on those practices that are not corporate entities; however, given that they are planning to scrap the Class 2 National Insurance from April 2018 they perhaps felt that this would mask the increase. Anyway, now that this increase will not take place, until at least the budget of 2020, following any election, the Government has announced a consultation on the differences between those that offer their services through (1) a trading structure, be that sole trader, a partnership (including LLP) or a company and (2) those who are employed directly by the firm.

From a tax perspective there are many differences between the two, particularly around the deductibility of expenses and, of course national insurance. These are perhaps in sharpest focus in LLPs where the 2014 salaried member changes meant that firms had to consider whether members were either employed or self-employed with different tax treatments applying to both. This new consultation will aim to try to address some of those differences. Presumably it will not suggest changes in tax rates to 'level the playing field', but instead focus on those main areas of fundamental difference and perhaps how taxpayers are classified to ensure the correct treatment. This is likely to mean that many law firms may need to further review the distinction between employment and self employment in the future.

It is likely that there will be further changes to the tax system when we have the Autumn budget especially as the position with Brexit will be slightly clearer. The chancellor will then understand whether his 'war chest' will be needed to support the economy or whether growth is stronger than predicted. However, any review is likely to lead to further changes which, in the current climate, is the last thing businesses need as they learn to adapt.

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Important changes to pension annual allowances

The current Annual Allowance is set at £40,000 and this limits the amount that can be paid into a pension each year and still receive tax relief. Exceeding the Annual Allowance in a year would result in no tax relief being allowed and a tax charge on the excess.

Those who haven't used their full Annual Allowance in this or any of the previous three tax years may be able to pay in more than the Annual Allowance under the Carry Forward rules.

Carry Forward has become important, particularly for higher earners, who have been gradually restricted by the amount of tax relief they can claim on their pension contributions.

Carry Forward rules

Carry Forward allows you to contribute in excess of £40,000 and obtain tax relief on the full amount, but there are restrictions that apply.

To qualify for Carry Forward, you must:

- Have a valid pension scheme in place for each year from which you are carrying forward, even if you haven't paid to it; and
- Have earnings at least equal to the amount that you are paying. For example, if you wanted to make a contribution of £100,000 then you must have earnings of at least £100,000 this tax year.

Carry Forward limits

The maximum amount you can carry forward depends on how much Annual Allowance you have available in each of the last three tax years. You must also first use up the Annual Allowance for the current tax year then go back to the earliest year. When working this out, don't forget to include any pension contributions you have made personally, payments made by your employer and any pension benefits you may have built up in a defined benefit/final salary pension scheme.

Tax year (6th April – 5th April)	Annual Allowance
2014/15	£40,000
2015/16 *	£40,000
2016/17	£40,000
2017/18	£40,000

* This is split into two mini tax years, where individuals may have an Annual Allowance of £80,000.

An example

The table below provides an example of how Carry Forward rules work in principle, but does not constitute the basis of a recommendation. Professional advice is strongly recommended to assess your individual situation.

Tax year	Annual Allowance limit	Overall pension payments	Amount available to carry forward
2014/15	£40,000	£40,000	£0
2015/16	£40,000	£20,000	£20,000
2016/17	£40,000	£20,000	£20,000

The table assumes a standard Annual Allowance for the 2015/16 tax year. Assuming post 6 April 2017 figures, a person could make an additional £40,000 payment using Carry Forward, on top of the current Annual Allowance of £40,000.

The Government automatically adds 20% tax relief to your payments and any extra relief is claimed back through self assessment tax returns. Whilst speculation continues to mount on the future of tax relief, currently higher rate taxpayers are able to claim an extra 20% and additional rate taxpayers 25%.

Are you affected by the Tapered Annual Allowance?

Higher earners may find that their Annual Allowance is reduced dependent upon their income. Those with Threshold Income above £110,000 and Adjusted Income above £150,000 will have their Annual Allowance reduced by £1 for every £2 of income in excess of this figure, until it reaches £10,000.

This is called the Tapered Annual Allowance and was introduced on 6 April 2016.

What is Threshold Income?

Broadly speaking, Threshold Income is your total taxable income, inclusive of any salary or bonus sacrificed for pension contributions on or after 9 July 2015, less any personal pension contributions and allowable reliefs.

What is Adjusted Income?

This is your total taxable income (as above), plus any employer pension contributions.

Final steps

If you have more than one pension, or have been a member of a final salary scheme, the amount you can contribute into pensions may be limited and obtaining information about your contribution history could take time.

Pensions offer a valuable means of saving for retirement, but you can't normally access the money saved until a minimum age of 55 (rising to 57 from 2028). Up to 25% of each payment withdrawn is paid tax free and the remainder is taxed at your marginal rate of income tax in the year it is drawn.

To discuss your own arrangements or those of your clients please contact me on 0113 2211300 or by email.

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New SRAAR regime - what to report and not

Helpful tips on the new SRA Accounts Rules from the 'coalface' and how you should be benefitting from a change in approach from your accountants.

Many years ago when I first started undertaking SRA audits, as an accountant, I found they could be complicated and I had to learn a whole new language - 'lawyer-speak' - however unlike other audits which relied on systems, controls and materiality, the actual decision making process on what to report on these types of audits was quite straightforward – if it was a breach, report it!

For example, if you took more than 14 days to transfer money from client to office to pay your bill (and yes we would actually sit and count the days!), you breached Rule 17.3 and we reported you, even if we only found one occurrence. There was very little room for discussion, in fact the standing joke used to be that we had not done our job properly if we did not find at least one breach and that the SRA would be more concerned if we did not report you.

However back in 2013, this all began to change and we saw the SRA beginning to move the 'goalposts' in regard to your annual SRA audit. The first of these steps was the introduction of the COFA – in its simplest terms the COFA is your annual audit but he or she would be there every day checking up on you and ensuring compliance. The thinking behind this being that any SRA-regulated firm would have the systems in place which were designed to ensure compliance with the Rules. Therefore the need for the Accountants Report would no longer be required as the COFA would have identified the breaches. Understandably, this met with some resistance from the legal profession.

The SRA effectively went back to the drawing board on this and in June/July 2015 they introduced a whole new remit on how we should approach your annual SRA audit.

The biggest impact was the removal of Rule 39. I liked Rule 39; it was prescriptive in its wording, it told me exactly what I had to test, check and what information you had to provide to me – yes it meant I had to go into an attic and hunt through boxes of papers for chits, review numerous correspondence files (and yes you could always guarantee that we would pick that one file you really did not want us to review or could not find), and we would go into panic mode if your bank reconciliation was £1 out (even if it corrected itself) etc.

Rule 39 died on 31 October 2015 and was replaced eventually by Rule 43.A – the wording of the new Rule is replicated below.

The accountant should exercise his or her professional judgement in determining the work required for the firm they are instructed to obtain the report on in order to assess risks to client money arising from compliance with these rules. This should cover the work that the accountant considers is appropriate to enable completion of the report required by the SRA at the date the report is commissioned.

So what did this mean? From the SRA perspective, it meant that they only wanted us to report to them if we found material breaches, loss to client (regardless of the amount) and/or where there were indicators of inherent weaknesses and /or lack of controls in your systems.

From an auditor's point of view, Rule 43A has meant we have had to have a complete re-think on how we approach your audit. Material breaches and losses to clients are easier to approach and report.

The difficulties arise in how do we identify inherent weaknesses and lack of controls which could lead to a loss of client money.

To some extent we could review the work performed by the COFA and review their breach register. This would provide us with some indicators of whether there is a specific area where a pattern of breaches was occurring but this would mean we could then only draw conclusions from work undertaken by someone else. The emphasis in Rule 43A is and always will be on us using 'our professional judgement'. We can only judge if we have all the facts and understand how you as a firm operate.

In practice we have completely changed the way in which we undertake SRA Accounts Rules reporting assignments. We now revert back to a traditional audit in which we would be required to firstly document your system in the way you thought it worked and then we test it to ensure it works in this way. From this work, we can then use our judgement to conclude if there are firstly any weaknesses or control issues and then to assess if these are either serious or moderate. This then impacts on the remainder of our testing, to what extent we will look at specific areas and whether we need to qualify your report. We continue to look at the bank reconciliations and we review a number of correspondence files as these still provide us the most comfort.

In nine out of ten cases, it is the file reviews which still throw up the breaches. If we identify breaches, we will then assess if these are systemic and/or if there is a loss to client.

So what has this meant for your annual SRA audit – hopefully you should have noted that we spend more time sitting down with you discussing with you your procedures and hopefully coming to the same conclusions as your COFA. From a compliance point of view, you should be noticing that there are fewer reportable breaches.

More importantly, we have completely revamped our Management Letters so that they are far more meaningful and actually contain summaries of your own systems in flowcharts. We can use this to provide recommendations – don't forget we see many varying systems and can draw on our experiences to be able to recommend where you could improve, introduce or tighten up a control.

If your reporting accountant has not changed their approach, or are not providing you with details on your own systems with suggested improvements, perhaps they are not as up to date with the new regime as they should be.

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Timing is everything...

In October 2016, I left RSM and joined Armstrong Watson to set up and lead their new forensic accounting service line. I have been joined by three members of my former team: Liesel Annible (director), who is insolvency trained and specialises in crime and fraud work, Claire Prideaux (manager) and Liam Whittleston (assistant manager).

Shortly after we joined, I was contacted by a solicitor who had a particularly tricky case - a difficult Claimant, a sizeable Schedule of Loss but not much in the way of documentation. She knew her client was on the hook and wanted to resolve this quickly, but understandably did not want to over pay. She asked us to have a look through the papers and then came to our offices for a brainstorming meeting. By combining her legal brain and our financial knowledge, we came up with a strategy. We prepared a sensible valuation of the claim, based on what information was available, and assisted her in: a) making a Part 36 offer based on our valuation; b) simultaneously making a 'time bomb offer', i.e. an offer greater than the Part 36, but only open for acceptance for a limited period of 30 days; and c) preparing an extensive disclosure list of the further information and documentation required to properly consider the claim, should it not settle. We waited... and the matter settled before the expiry of the time bomb period of 30 days.

We are often brought in at the last moment, when a matter hasn't settled, is careering toward a Court date or as a last minute thought. While we can still help you, the above example serves as a good illustration of how we, by working more closely with you, can provide a more effective service and add value to both you and your clients.

In the example above, our early involvement not only helped achieve a commercial settlement, ensured the solicitor had a happy client but also restricted our costs.

Most accountants just get involved when a report is needed. We can help in a variety of other ways too. For example, discussing with you varying strategies for dealing with that problematic claim or party, detailing what financial disclosure is required to properly consider a claim, reviewing the Schedule of Loss or other expert's report and providing a strengths and weaknesses assessment, pinpointing if there is a financial 'Achilles heel' and working with you to assess at what level a Part 36 offer could be made, or help by contributing our thoughts as to the competiveness of an offer.

This is our preferred way of working with you. They say that timing is everything... and, by complementing your skills with our financial understanding and experience, we can add value to you and your clients.

If you would like to find out more about how we are able to assist you in dealing with claims, please get in touch.

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Changes to accounting for law firms that practice as LLPs

Both the new Statement of Recommended Practice (SORP) in respect of LLPs and its related statutory instrument (SI 2016/575) are now published and are in effect for accounting periods starting on or after 1 January 2016 (early adoption is however permitted).

A copy of the SORP is available at www.ccab.org.uk/documents/FinalSORP26012017.pdf

In many respects this is nothing new and it simply brings LLPs into line with the reporting regime that Limited companies adopted in 2015. It means that LLPs are now able to take advantage of many of the size exemptions brought in under FRS 105 (Micro entities).

However, and especially for smaller entities, the micro/small/medium/large distinction is important as it drives reporting requirements.

Unfortunately there is not the space here to cover every exemption conferred by having a smaller status. However, as a general rule, the smaller the entity the less onerous the reporting requirements; for example, micro & small entities do not have to publish a cashflow statement, whereas only micro entities can omit disclosure in respect of loans and debts due to members.

For groups which include companies and LLPs, it is helpful that the size thresholds for LLPs are now aligned to the size thresholds that determine the same classification for a company which will help to avoid different disclosures in the accounts of sister entities.

Size and reporting requirements	**Micro** Two of: Turnover not more than £632,000 Balance sheet total (fixed assets plus current assets) not more than £316,000 Not more than ten employees	**Small** Two of: Turnover not more than £10.2m Balance sheet total (fixed assets plus current assets) not more than £5.1m Not more than an average number of 50 employees	**Other** Not micro or small
FRS 105 only	Yes	-	-
Section 1 A of FRS 102, paragraphs 63 and 64 of the LLP SORP and recognition and measurement requirements of LLP SORP	Yes	Yes	-
FRS 102 and all requirements of the LLP SORP	Yes	Yes	Yes
FRS 101	Yes (qualifying entities only)	Yes (qualifying entities only)	Yes (qualifying entities only)
IFRS	Yes	Yes	Yes

Small LLPs

An LLP is small when it meets two of the criteria. The SORP requires that small LLPs comply with the disclosure requirements of Section 1A Small Entities in FRS 102 rather than the disclosure requirements of the SORP. In respect of the recognition and measurement of amounts in the financial statements, these will be based on full FRS 102.

It is still a legal requirement that a small LLP prepares financial statements that give a true and fair view. Professional judgement will be needed to consider whether any additional disclosures, over and above those contained in Section 1A, will be required to achieve that. Therefore, depending on the individual facts and circumstances, some, or all, of the disclosures in the SORP and the rest of FRS 102 may be needed in order to give a true and fair view.

The most significant of these is how loans and other debts due to members rank in relation to other unsecured creditors (paragraphs 63 and 64 of the SORP).

Such a disclosure is considered to be needed for all LLPs, regardless of the fact that the LLP may be small, in order that the financial statements give a true and fair view.

The LLP SORP mandates this disclosure because LLPs do not have any of the capital maintenance provisions which apply to companies.

Small LLPs are also encouraged, rather than mandated, to include a reconciliation of movements in members' other interests, outlined in paragraph 59 of the SORP, and illustrated overleaf.

Micro-entity LLPs

An LLP qualifies to be classed as a micro-entity if it is not in a business that is precluded from applying the framework (e.g. a financial institution) and the LLPs financial statements are not subsequently consolidated in with those of a parent – groups are not allowed to adopt FRS 105.

An LLP qualifies as a micro-entity LLP if it can meet two of the criteria above.

Micro-LLPs applying FRS 105 are scoped out of the requirements of the LLP SORP and hence must only prepare financial statements in accordance with FRS 105.

This is because the LLP SORP complements the requirements of FRS 102 not FRS 105. As there are fundamental differences between the two standards, the regulators took the decision to prohibit micro-LLPs from applying the provisions within the LLP SORP.

As a result of this prohibition, where a micro-LLP enters into a transaction that is not dealt with in FRS 105, it must develop an accounting policy in line with the Concepts and Pervasive Principles outlined in Section 2 of the standard.

Example reconciliation of members' interests	Equity Members other interests				Debt Loans and other debts due to members less any amounts due from members in debtors			Total members' interests
	Members' capital (classified as equity)	Revaluation reserve	Other Reserves	Total	Members' capital (classified as debt)	Other amounts	Total	TOTAL
Amounts due to members						X	X	
Amounts due from members						(X)	(X)	
Balance at start of period	X	X	X	X	X	X	X	X
Members' remuneration charged as an expense (including employment and retirement benefit costs)						X	X	X
Profit/(loss) for the financial year available for discretionary division among members			X	X				X
Members' interests after profit/(loss) for the year	X	X	X	X	X	X	X	X
Other division of profits			(X)	(X)		X	X	
Surplus arising on revaluation of fixed assets		X		X	X		X	X
Introduced by members	X			X	X		X	X
Repayments of capital	(X)			(X)	(X)		(X)	(X)
Repayments of debt (including members capital classified as a liability)					(X)		(X)	(X)
Drawings						(X)	(X)	(X)
Other movements	X	X	X	X	X		X	X
Amounts due to members					X	X	X	
Amounts due from members						(X)	(X)	
Balance at end of period	X	X	X	X	X	X	X	X

Statement of changes in equity

Paragraph 59A has been inserted into the January 2017 SORP which says that a statement of changes in equity need not be prepared if the LLP has no equity. This was not explicit in previous versions of the SORP. Where a statement of changes in equity is not included on the basis that the LLP does not have any equity (and is not replaced as a primary statement by the reconciliation of members' interests), a statement must be made on either the face of one of the other primary statements, or in the notes to the accounts, that the LLP does not have equity and hence a statement of changes in equity is not given.

Conclusion

Smaller LLPs can now adopt a variety of disclosure exemptions that have previously only been allowed by smaller companies, including (for micro LLPs) the provisions of FRS 105, for many will make this reporting much less onerous. There are, however, still differences between the reporting regime for LLPs as compared to companies. The most significant of these is how loans and other debts due to members rank in relation to other unsecured creditors.

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An interview with ...

Graham Moore, Managing Director of Katchr, specialists in business intelligence and management information for mid-sized UK law firms.

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

All of the key challenges we see for law firms derive from the need to operate in an increasingly competitive commercial market.

Issues such as increased competition from new entrants, pressures on price, regulatory changes are all symptoms of the fact that delivery of legal services is now a business, not just a professional service.

Managing this doesn't come naturally to lawyers so probably the number one challenge I see is building an appropriate management team for the firm with the right combination of commercial management skills. Real expertise, not just functional capability, is needed in areas such as Marketing, IT, HR, Project Management, Operations and Finance and management of such a diverse collection of people as a business leader is not something taught at law school.

2. How do law firms make strategic management decisions in light of those challenges?

Good strategic decisions can only be made by using all the available information. That requires the expertise outlined above, but those experts need to be supported with hard data. Yes, there are also "soft" management concerns such as culture, professional standards, attitude to risk, but without good data to inform decisions, they are ultimately just guesses.

3. What management information should law firms monitor?

There are two different types of management information needed by any law firm. The first is monitoring of performance, in all areas, against agreed targets. Those targets should have been derived directly from the firm's objectives and the strategies to achieve those objectives. Unfortunately targets in my experience are too often based on past actuals or blind hope rather than an analysis of what is needed to achieve goals.

For most firms, strategy includes winning new business in defined areas and gaining repeat business from existing clients. However, good management information on performance against target in these areas is surprisingly rare in my experience.

The second type of management information is deep analysis of the why. When exceptions to performance expectations are experienced, or alternative strategies are being considered, the management information needed is more about achieving deep insight into the firm and becomes analysis not just monitoring. Investigating why a particular team has suddenly started to fall behind target, or determine which is the most appropriate service to invest in for growth are questions that will never be fully answered with a standard set of month-end management reports. That is where the need to carry out ad-hoc analysis using fast and flexible access to a wide range of data becomes important.

4. How should that be communicated to people within firms?

In our experience, communication of management information within law firms has traditionally been very poor. The recipients of most of the information are lawyers, people who chose to train in law (not accountancy) because they liked logic and words. However most of the information they are presented with is prepared by accountants who live, sleep (and probably dream) spreadsheets. I'm not saying that lawyers can't understand tables of figures, but I am saying that most lawyers are not inclined to spend their time reading tables of figures.

Instead, communication should be built around three principles:

- **Keep it focussed**

  Focus on key measures: just because something can be measured, doesn't mean it should be.

- **Highlight exceptions**

  Use systems to generate alerts when action is required. Don't just assume that giving someone a report will change their behaviour.

- **Don't overwhelm people with detail**

  Present summary information graphically, but still provide the ability to drill down to detail for those who really want to.

All of this can be achieved through the use of a well-designed management information system using dashboard-style displays, with each display being tailored to the specific needs of a given role within the firm.

At Katchr we help law firms achieve this using our law-firm specific technology and years of experience in this sector.

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