SPRING 2024

the law

Working with The Law Society

Armstrong Watson's specialist publication for the legal profession

IN THIS EDITION...

PLUS...

ArmstrongWatson®
Accountants, Business & Financial Advisers

A track record of providing solutions to the legal profession

IN THIS EDITION...

Exclusively working in partnership with the Law Society for the provision of the following services to law firms.

Working with The Law Society

- 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

WELCOME

Welcome to the Spring 2024 edition of The LAW, the specialist publication for the legal profession from the legal sector team at Armstrong Watson.

As M&A activity is picking back up at pace in the legal sector, this edition focuses on options for how to go about a disposal and how to get ready for one. It also covers the Employee Ownership Trust (EOT) option that more firms are looking towards as an alternative to an external disposal.

Subject matter includes:

- Initial considerations for selling a law firm
- Top tips for how to go about a law firm sale
- EOTs
- Risks within business

We also include articles on compliance, including roles of key people and the thorny topic of banking facilities. We close with an interview with Victoria Ritchie of HSBC on funding options for law firms.

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.

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.

Andy Poole

Andy Poole
Legal Sector Partner
@AW_AndyPoole
andy.poole@armstrongwatson.co.uk

INITIAL CONSIDERATIONS FOR LAW FIRM CLOSURE, SALE OR MERGER PART 2

This is the second part of our published article in Practical Law, the full article can be found at www.practicallaw.com

Market the firm to targeted potential acquirers

Marketing law firms for sale is different to marketing general businesses. Confidentiality during the process is far more important, since if staff or clients become aware of a potential disposal of the firm they may become alarmed, perhaps fearful of future redundancy, and decide to leave the firm. This can be a particular concern in relation to any key individuals. For this reason, the mass marketing often used for other commercial businesses (involving flyers circulated as widely as possible) does not work for law firms.

Best practice is therefore to:

- Consider the types of firms that may be suitable acquirers for the firm. Identifying these firms and potentially building relationships with them may also help lay good foundations for the rest of the merger discussions and smooth the overall disposal process.
- Compile a shortlist of preferred potential acquirers. Factors which might make a firm a good potential acquirer might include compatibility of location, work type, size, client base or culture.
- Engage a corporate finance professional with specific expertise in the legal sector to make no-name approaches to those firms to see if they might be interested.
- Put appropriate non-disclosure agreements (NDAs) in place with any interested potential acquirers through this intermediary, before the name of the selling firm is disclosed, along with high level financial information.

  The parties should be mindful that the SRA has published important guidance on the use of NDAs by law firms, and ensure that any NDA prepared for the transaction complies with it (see SRA: Warning notice: Use of non-disclosure agreements and SRA: NDA warning notice, now updated (3 December 2020).
- If the acquirer is interested, arrange initial meetings to focus on gauging the cultural fit (rather than commercial or financial matters). It is important to find an acquirer that aligns with the firm's culture and values to make any merger work in the long term. Discussing this early on will either provide the parties with the confidence to proceed to the more costly and onerous stages of the pre-contractual investigations and discussions or, if the fit is not right, to end discussions amicably before expending any further resources.

Prepare for pre-contractual due diligence

Once the firm has been marketed and a preferred acquirer has been agreed in principle, the parties will want to find out about each other in more detail, to ensure that they are happy that their firms are compatible before they proceed.

Often, the selling firm will conduct its own due diligence on the potential acquirer, but this is generally far less detailed and involved than the due diligence that the acquirer will conduct into the selling firm.

Aside from commercial issues, the acquirer will want to know what risks and benefits the firm poses for its wider business, and the firm should be prepared for very detailed enquiries.

Accounting records and management information

A potential acquirer will not want to rely on broad brush statements from the firm, but will want to be confident of factual performance information. Being able to provide timely, accurate and informative accounting records and management information will help ensure that an acquirer has more confidence in the firm, that it is sound and well run, and will be more interested in proceeding to completion. This may also enhance the perceived value of the firm and therefore the acquisition price.

Consider investing in employing appropriately qualified and experienced accounting professionals (if it does not have these in-house) and in accounting software, or outsourcing to legal sector specialist accountants where necessary, to develop and maintain appropriate accounting methods and reporting which can later be used to respond to due diligence requests.

Future business plan and forecasts

Acquirers will want to know that the firm has a solid business strategy and plan for the future of its business, informed by appropriate forecasts of how it expects that plan to unfold.

The firm should:

- Prepare and regularly update its strategy, business plan and forecasts.
- Ideally forecast not just profits for the next year (as many firms do), but prepare fully integrated profit, cash and balance sheet forecasts for at least a three-year period.
- Review the forecasts and prepare to respond to due diligence enquiries on this point. This may also help the firm to be more successful in the meantime, which may itself increase the acquisition interest in and value of the firm.

Professional indemnity insurance (PII) and claims history

A potential acquirer will be acutely interested in the firm's professional indemnity insurance (PII) and claims history, often requesting records and information going back for six years or more.

Firms with a poor claims record (sometimes called distressed claims history) will usually be less attractive to acquirers, both because it suggests the firm may present an increased financial, resourcing and reputational risk to the acquirer going forward (in that its people and practices may present a risk of more claims in future) and because, as a result, its acquisition may prejudice the acquirer's post-merger PII premiums.

PII and claims due diligence

To enable the firm to demonstrate sound management and its proactive approach to risk both to acquirers and to its own PII insurers in the meantime, it should do the following:

- Identify any trends in the firm's claims history and what the causes of those claims have been, and any issues that insurers have raised in response to the firm's past insurance application.
- Take action to address the issues identified.
- Carefully document the measures taken and any benefits that result (for example, reduced frequency of claims after the measures were introduced).

Successor practices and run-off PII cover

- Consider with the acquirer whether it should become a successor practice to the firm, taking on responsibility for any ongoing and future claims that arise out of its pre-merger work.
- If the acquirer does not become a successor practice, the firm will need to obtain run-off PII, to cover any claims that may emerge against the firm in respect of its historical pre-sale work in the six years following closure of the firm on completion of the sale. The firm's current PII insurers will be obliged to provide this run-off cover under the SRA Minimum Terms and Conditions of Professional Indemnity Insurance (annexed to the SRA Indemnity Insurance Rules). However, the premium required can be extremely expensive.

Most sellers of a law firm would prefer an acquirer to become a successor practice because of the cost of run-off cover. That is more likely to happen if the firm can demonstrate that it has a good PII and claims record and good risk management processes.

Contact Andy Poole if you would like assistance with any of the topics raised in this series of articles.

andy.poole@armstrongwatson.co.uk

PROVISION OF BANKING FACILITIES

Back in March 2023, the Solicitors Regulation Authority issued a warning notice regarding the improper use of a client account as a banking facility. Although we are now into the new year, it is important for firms to remember their obligations in this respect.

The SRA Accounts Rules rule that relates to banking facilities is Rule 3.3 – "You must not use a client account to provide banking facilities to clients or third parties. Payments into, and transfers or withdrawals from a client account must be in respect of the delivery by you of regulated services."

Below we summarise the warning notice to provide clarity and provide some tips on how to avoid breaching Rule 3.3.

Why should banking facilities not be provided?

Many years ago, it was decided by the Solicitors Disciplinary Tribunal that it is not a proper part of a solicitor's everyday business to operate a banking facility, whether they are clients of the firm or not.

The courts have also confirmed that operating a banking facility is objectionable, and, as you are not regulated as a bank, you should not provide such facilities and improper use of a client account has been stated in case law.

What is expected from you?

The expectations and obligations can be exhaustive; we have highlighted a few below:

You must only receive funds into your client account where there is a proper connection between receipt of the funds and the delivery by you of regulated services.

You should discuss with your clients at the outset of the retainer how their money will be dealt with.

You need to think carefully about whether there is any justification for money to pass through your client account when it could be simply paid directly.

You should always ask why you are being asked to make a payment or why the client cannot make or receive the payment directly themselves. The client's convenience is not a legitimate reason for holding client monies.

At the conclusion of a matter, you should only return client monies directly to the client, not to a third party or even a person/entity linked to the client.

You have a separate obligation under Rule 2.5 to return client money to the client or third party promptly, as soon as there is no longer any proper reason for you to hold those funds.

You must remain alert to any unusual or suspicious factors such as concern about the source of funds or what you are asked to do with them.

Examples

1. A firm is instructed to provide specialist tax advice in relation to the payment of SDLT on a property which has been bought by the client. The firm did not act in the purchase but the client wants to forward the tax payable to the firm with a view to the firm paying the sum on their behalf.

<u>SRA view:</u> This is likely to be a breach of rule 3.3 if there is no reason for the firm to hold monies.

Simply having a retainer with the client is not sufficient reason to accept the money - the firm must be satisfied that there is a proper and justifiable reason why the money should pass through their client account rather than be paid direct by the client. In this case, the firm's retainer was limited to providing stand-alone legal advice. The firm did not act in the purchase and there is no obvious reason for them to receive the money rather than the client paying direct.

2. A firm is acting for a husband and wife in connection with the sale of the former matrimonial home. The clients are in the process of a divorce and separate firms act for each of them in respect of their financial affairs. The sale of the property has completed but the net proceeds of sale have not been distributed as the parties have not yet reached an agreement as to the division of the sale proceeds.

<u>SRA view:</u> In a joint retainer a firm cannot pay out any of the net proceeds of sale without the joint agreement of both clients. If the firm is unable to obtain their joint instructions then they must continue to hold the money until the clients reach agreement or there is a court order.

Consequently, the firm will not be in breach of rule 3.3 since there is a proper reason for them to continue holding the money.

3. Miss X, a potential client and newly arrived in the UK, has approached a law firm asking if it will hold monies on her behalf. She says that she does not have a UK bank account but is applying to open one. Miss X tells the firm that, although she is not instructing the firm for any legal advice at present, she will do so in the future once a business opportunity she is working on comes to fruition.

<u>SRA view:</u> The SRA would expect the firm to refuse to receive this money. No legal or professional services, which are regulated, are being provided by the firm. There is no evidence that the firm are providing any legal advice or assistance. To accept the money would be a breach of rule 3.3.

How to avoid and identify breaching Rule 3.3

One of the ways we would advise to monitor breaching Rule 3.3, is similar to that of monitoring Rule 2.5 (residual balances). Regular internal reporting on your client balances and ensuring all balances held are for legitimate reasons, related to proper instructions regarding a transaction on which you are acting or in connection with the delivery of regulated services.

This could be done monthly and sent round to individual fee earners.

Checks should also be made on both receiving and paying out all client money, with probing questions asked about the reason for the receipts and the reason and the identity of the person/entity that monies are being paid to. Fee earners should be asked to document that they have reviewed this and note their approval.

If in doubt – check! We are happy to provide assistance with any potentially contentious issues, so please do get in touch.

HUW NICHOLLS
LEGAL SECTOR AUDIT DIRECTOR
HUW.NICHOLLS@ARMSTRONGWATSON.CO.UK

BEING IN BUSINESS IN THE UK IS ABOUT TO GET A WHOLE LOT RISKIER

If being in business in the current economic climate is not risky enough for directors and senior management, the risk of being held accountable for events they may have no knowledge of or participation in is about to increase.

For many years, investigating and prosecuting authorities were vocal in their criticism of being unable to prosecute corporate entities, their directors and senior management for turning a blind eye to financial crime, including tax evasion, by associated individuals and entities. Since the introduction of the Bribery Act 2010, the tables have begun to turn, creating a series of offences for which they can be prosecuted and/or made liable. The latest of these is the Economic Crime and Corporate Transparency Act 2023 which is currently grinding its way to being enacted.

Bribery Act 2010

The Bribery Act brought in a new offence of failure to prevent bribery. A UK company or partnership can be criminally liable if it fails to prevent an associated individual from using a bribe to obtain or retain business or gain a commercial advantage.

If the offence was committed with the knowledge or involvement of senior officers of the business they can also be criminally liable.

A conviction can lead to unlimited fines for both the business and its officers and/or up to ten years imprisonment for the officers.

Whilst to date there have been few prosecutions for failure to prevent bribery, a number have been settled by deferred prosecution agreements, or DPA's, where the organisation voluntarily agrees to be stripped of the benefit it has received from the offence.

Criminal Finances Act 2017

The Criminal Finances Act introduced a new offence of failure to prevent tax evasion. If an associated person facilitates the evasion of UK or foreign tax in the course of business, it can result in criminal liability for a company or partnership and its officers. This includes foreign companies who help to evade UK tax.

An associated person can be a:

- Director;
- Employee;
- Subcontractor;
- Agent; or
- Person who performs services for the company or partnership (dependent upon the nature of the relationship).

The offence can also relate to the actions of an associated business.

For the purposes of the offence the title or status of the individual in relation to the organisation is irrelevant, the key criteria will be what they do within the business.

The numbers of investigations of failure to prevent tax evasion appear to be increasing and they can lead to unlimited fines for both the business and its officers.

Economic Crime and Corporate Transparency Bill

The new bill brings a further 'failure to prevent' offence, this time in relation to fraud. This again relates to fraud committed by an associated person.

The fraud offences which could trigger a failure to prevent offence are currently:

- Fraud by false representation;
- Fraud by failing to disclose information;
- Fraud by abuse of position;
- Obtaining services dishonestly;
- Participation in a fraudulent business;
- False statements by company directors;
- False accounting;
- Fraudulent trading; and
- Cheating the public revenue.

As enacted this offence only applies to businesses to which two of the following criteria apply:

(a) More than 250 employees;

(b) Turnover of more than £36 million; and

(c) Total assets of £18 million.

However, there has been talk of lowering these thresholds to include small and medium sized enterprises. There is still the opportunity for lower thresholds to be incorporated into later iterations of the Act

Other possible penalties

All of the above offences make businesses and their officers or employees culpable for the actions of others, including third parties. Not only can they result in unlimited fines and/or imprisonment and the stripping out of the benefits of the offence, but they can also lead to other penalties such as confiscation orders or serious crime prevention orders, intended to target serious and organised crime.

...continued

Other implications for the businesses and individuals involved

Whilst few of these types of investigations have been seen to date, they are almost certain to increase over the next few years, particularly due to the current push on the prevention, investigation and prosecution of fraud set out in the National Fraud Strategy.

Even if an investigation does not lead to a prosecution of the business or any individuals, or if it is settled by a DPA, such investigations are time consuming for management, involve significant legal and professional fees and can lead to extensive reputational damage for the business and individuals implicated.

Prevention is better than the cure

The key defence in relation to all of these offences is that the business has adequate/ reasonable prevention procedures in place. This will involve directors and senior management not only developing risk-based assessments and developing the required policy and procedures, but demonstrating their own compliance and ensuring that of their staff. The demonstration of a top down commitment to the prevention of these offences is the keystone of any defence.

Each business will need to have robust ethics and avoidance policies and procedures which their staff, senior managers, sub-contractors and agents have agreed to comply with. This agreement should be documented so that it can be presented as evidence of the steps taken by directors. It may be necessary to provide training to all relevant members of staff and other associated persons to ensure they understand their responsibilities.

It will also be necessary to ensure that thorough due diligence is carried out on new employees, subcontractors, agents and other businesses with which they contract or interact. A failure to verify who a business is dealing with could also see it embroiled in an investigation. References should be taken up for all individuals being brought into or associated with the business, and qualifications should be checked with the authorising body. Corporate information should be checked with Companies House and, where possible, references taken and checked. The key consideration will always be to ask whether enough has been done to ensure the business knows who it is dealing with.

This will not be a one time or one off process. It will be necessary to regularly review the risk assessments and systems in place and decide whether they need to be updated to account for changes in the business or industry. It may also be required to provide updated training for existing staff.

Summary

It has never been more important for UK businesses to have robust policies and procedures in place in order to combat the threat of being caught up in the investigation of a rogue director, employee, agent or subcontractor. Failure to do so could lead to an extensive and costly investigation by a prosecuting authority, a significant fine and even a prison sentence. At the very least it will be a significant, and costly, inconvenience and distraction from the key issues for the business.

LIESEL ANNIBLE
FORENSIC DIRECTOR
LIESEL.ANNIBLE@ARMSTRONGWATSON.CO.UK

SHOULD I SET UP AN EMPLOYEE OWNERSHIP TRUST?

If you're looking to pass on ownership of your company you might want to consider setting up an Employee Ownership Trust (EOT).

EOTs were introduced by the Government in 2014 and allow business owners to sell their shares to an employee-owned trust free from Capital Gains Tax (CGT). This form of business ownership, which is similar to the structure of the John Lewis Partnership and growing in popularity, results in the majority of the company's shares being owned by the trust and gives employees a controlling interest.

What are the advantages of an EOT?

- It allows an alternative exit route for situations where there is no obvious third-party purchaser. Many company owners, particularly those approaching retirement or wishing to take on another challenge, want to pass on ownership to their employees.
- The owner can retain some involvement (up to 49%). One advantage from their perspective is that the disposal of shares to an EOT is free of CGT for UK individuals if the transaction is structured correctly.
- From an employee point of view, where a company is controlled by an EOT there is a tax relief which allows it to pay annual bonuses of up to £3,600 per person income tax-free (but still subject to NI).
- Many say there is a mental change when employees are involved in the ownership of a company. There is a shift that helps to drive success. Employees are more heavily involved, and it is shown to reduce absenteeism too.

What are the disadvantages of an EOT?

- Owners will not always receive all the money for the sale immediately. Often they will receive a portion upfront, this amount being funded by existing cash reserves in the company or through utilising existing bank facilities and/or by taking out new bank borrowings – either in the name of the company, or more likely the EOT with a guarantee provided by the company or, in some instances, the former company owner. Any remaining consideration would be paid to the owners on a deferred basis over a number of years with funding being provided by the company. There are clearly risks involved in selling shares to an EOT.
- It's not always easy to determine the value of the business. It is important that the owners and the trustees of the EOT agree on a fair market value for the company, which is affordable for the EOT, and indirectly the company. Servicing too high a price can potentially put too much strain on the working capital of the company. A lack of working capital to reward employees because of the high loan repayments can work as a disincentive.

How is the current economic climate affecting EOTs?

In this period of high inflation what concerns businesses most are:

- High energy prices
- Inflation of goods and services prices
- Falling consumer demand for those goods and services

Rising costs or growth targets not being met, caused by inflation and reduced market demand can impact the cashflow generated by the company from its day-to-day operations, which may fall below the level required to meet the obligations of the EOT to repay the debt to both the lender and business owner.

For EOTs, and by association the company, where loans are taken to pay for the owner's shares plus an interest that may be charged on deferred consideration, the biggest threat can be the increase in interest rates. This has put huge pressure on these companies. A lack of cash flow hinders investment and ultimately can lead to insolvency.

What actions should EOTs take?

- It is critical to prepare a rolling 13-week cash flow forecast for the company. This will identify pinch points and allow management to take appropriate action to address cash shortages.
- Contact a specialist in refinancing and consolidating debt. They will ensure that the company's cost of borrowing is reduced as much as possible by utilising all assets that can be offered as security.
- If all else fails, an insolvency practitioner may be required to advise on procedures needed to ensure the survival of all or part of the business, for the benefit of creditors, employees and other interested parties.

EOTs can be an effective vehicle for owners wanting to pass on business ownership to their employees. Planning is very important, particularly stress testing to ensure that the cost of borrowing to finance the purchase of the owner's shares is covered, even if trading is squeezed and interest rates increase.

Unfortunately, business owners who have sold their business to an EOT are experiencing challenges caused by factors out of their control. Some are now worried about the repayment of their deferred consideration by the EOT, together with the impact that any personal guarantees they may have provided to third-party lenders might have on their personal position. They now need advice on how to protect their personal assets.

For more information about Employee Ownership Trusts (EOTs) or if you are looking at your option for succession planning please get in touch.

ELAINE WILCOX
RESTRUCTURING & INSOLVENCY CONSULTANT
ELAINE.WILCOX@ARMSTRONGWATSON.CO.UK

5 KEY THINGS TO CONSIDER WHEN SELLING YOUR LAW FIRM

Many law firms are considering their future right now, either with succession and retirement in mind or looking for investment and support in unlocking the potential for growth. This may lead towards potential disposals of firms, which can be a long and emotional process.

As leading advisers in law firm sales, we've put together five areas for consideration which, in our experience, will help generate the best result and avoid issues along the way. Here is a brief summary, but to access our full FAQ to selling your law firm please click on the button below:

Full FAQ to selling your law firm

1. When should I start the process?

As soon as possible! Many buyers will also want the current owners to remain in the business in some capacity, even if part-time, for at least a year – leaving it too close to your retirement date will make a disposal more difficult, particularly for a smaller practice.

2. Bring in your advisers at an early stage

By appointing the right advisers, they will know the market inside out and how to get the best results for you. It's best to bring in your advisers before approaching any potential acquirers - but ensure you appoint specialists who are experienced in legal sector transactions, understand how law firms are run and who know potential acquirers to approach.

3. Try not to do too much yourself

It's best not to approach potential acquirers before your advisers are in place as they will know the right people to approach. In addition, direct engagement too early with potential acquirers may make it more difficult for your advisers to engineer the best result for you.

4. How many potential acquirers should be approached?

Your advisers will be able to determine the right number of potential acquirers and can approach them on a no-names basis, and exchange NDAs ahead of providing information.

Be wary of non-specialist corporate finance advisers who may adopt the approach of circulating blind flyers around their networks to as many people as possible, then obtain NDAs and then provide Information Memorandums (IM). In our experience, this can often alert the market that your firm is for sale, which will adversely impact staff, clients and value.

5. Don't waste time and cost preparing expensive information memorandums

Savvy buyers know what they are looking for and value the base information and discussions more highly than expensive documents that are designed to paint the selling firm in its best light.

Non-specialist corporate finance advisers may even want to you pay them for an IM to circulate at an early stage – in our experience, it is wasted time and cost in the legal sector.

Selling your business is one of the biggest decisions you will ever make, and having the right team working alongside you to ensure any merger or acquisition matches your objectives and goals is essential.

Armstrong Watson works in partnership with The Law Society and we have a team of specialist advisers working on legal sector transactions. We are confident to state that we are most likely involved in more law firm mergers than any other accountancy firm in the UK. We know how law firms work and what you need to do in order to obtain the best results.

Please get in touch for an initial confidential conversation about your plans and the best steps to take.

ANDY POOLE
LEGAL SECTOR PARTNER
ANDY.POOLE@ARMSTRONGWATSON.CO.UK

MANAGING FINANCIAL PERFORMANCE: LAW FIRMS PART 3

This is the third part of our published article in Practical Law, the full article can be found at www.practicallaw.com and the first two parts of the article can be found in previous editions of the LAW.

Practical tasks to perform

Daily, weekly and monthly checks

The exact frequency of some checks will depend on the number of fee earners and the types of matters performed and can be adapted to particular circumstances. However, the following is a guide.

Daily

Monies into client and office account. These should be allocated as soon as possible, partially to improve your own cashflow, but also to ensure there are no accidental breaches of the SRA Accounts Rules.

Weekly

Billing. Many firms only bill once a month, which instantly adds 30 days to their cash collection cycle. A much better habit is for all fee earners to bill everything they have completed that week.

Suppliers due for payment. While payment of suppliers in a timely manner is important, weekly monitoring of what is due can help a firm manage its cashflow and ensure it pays the correct people in the correct order.

Update the 13-week rolling cashflow. As above, this key document should be predicting where the firm will be in approximately three months' time and should be "live" and consistently updated.

Bank reconciliations. The SRA mandates a three-way reconciliation (that is, between client account cash at bank, matter listing and financial system) to be performed at least once every five weeks. However, this mandated reconciliation is better done at least weekly; particularly in busy or larger firms where errors might compound if left monthly. A further reconciliation of the office monies should also be performed with similar regularity to ensure cash is what the firm thinks it is.

Monthly

Payroll reporting. Since payroll is likely to be the single largest expense in the firm and comes with a large amount of complexity, many firms monitor it carefully and check actuals to expectations and understand any variances from the usual standard.

Residual balances. A particularly important part of the SRA Accounts Rules is the requirement to return monies that are no longer the firm's. Commonly, those firms that stay on top of these balances regularly find that this chore never gets unmanageable. Conversely, those that only look at their residual balances infrequently often do not know where to start and can take considerable time chasing down former clients; an issue that does not arise when the return of the monies is done in a timely manner.

Old WIP. As noted above, there is some flexibility in recording WIP within the financial standards. But ultimately there will be times where too much WIP is being carried and these write-offs should be monitored and actioned regularly otherwise the performance of the firm can be considerably skewed.

Management accounts. Some form of reporting is expected and monthly is a reasonable frequency. This is particularly true if other information is available daily (perhaps via practice management software or a "dashboard" of the key performance metrics relevant to someone's role or department).

Internal reporting

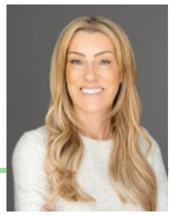
The exact format of the firm's internal reporting will vary depending on the audience and level of detail they require. It is not uncommon, for example, to give fee earners access to lots of detail about their practice area, but very little about the wider firm. Equally, the management of the firm probably need more access than the owners of the firm do, even though both will be looking at firm-wide metrics. There are a variety of software solutions (so called dashboards) that can assist in pulling this information together in a visual form and it will be the function of the FD to set the appropriate metrics that apply to the firm. Everyone, at every level, should have some access to the information pertinent to them as well as the training and understanding of what a "good" result is and how they can change their actions or behaviours to improve on a "bad" one.

Internal auditing

The exact nature of the firm's internal auditing will vary considerably. It might be a fully formed function that acts on behalf of the board or the FD looking at potential problem areas. It might simply be one member of staff, or an external consultant not routinely involved in the finance function who does the occasional spot check. In all cases, and much like the internal reporting, the key point is that someone has some amount of oversight and is checking the detail as much as the overall output.

ANDY POOLE
LEGAL SECTOR PARTNER
ANDY.POOLE@ARMSTRONGWATSON.CO.UK

AN INTERVIEW WITH...



Andy Poole interviews Victoria Ritchie, Head of the Professional Services at HSBC. Andy and Victoria explore funding, with a particular focus on partnership capital loans and invoice discounting.

1. Tell me about HSBC's appetite for the legal sector and the type of firms that you work with.

HSBC provide banking services to most UK Domestic & International Firms, Globally across the banking network of 55 countries; coupled with sector specialist knowledge, we understand the opportunities and challenges the legal sector faces. Due to the counter cyclical nature of full practice legal services and the critical nature of the services provided by the sector, HSBC is supportive of the sector to help firms navigate their strategy and seeks to continues to grow and take our expertise to the market.

2. It is becoming more difficult generally to obtain partner capital funding, what are your views on this?

Growth in partnership numbers and partner contributions in firms in the past few years has resulted in an uptick in need. However, the decrease in growth currently may be due to a reduction or perceived lack of desire for future generations to make Equity Partner, whereby once seen as the traditional career path in the legal sector. This can be contributed by several factors, firstly being the preference for a balanced lifestyle with more flexibility. Secondly, the evolving landscape of the economy and structural changes leads to more competition amongst firms.

Thirdly, the financial reward of the partnership model may be less certain than before due to the current economic landscape. These factors have led to firms potentially moving away from the traditional LLP model and exploring alternative structures to limited companies which changes the financial decision making dynamics for partners.

However it is important to note that the situation is not universal and HSBC has supported over 230 firms though Partner Capital Loans in the UK Legal sector, where we have seen a growing year on year increase in loan completions where firms have been growing their partnership models. We see many firms of a certain size seeking more than one banking partner, which results in providing partners with optionality but leads to increased competition when sharing out services across the banking industry, especially for those firms who provide legal services to Financial Institutions. We are supportive of this approach and continue to offer Partner Capital Facilities for firms with 25+ partners in size, amongst other criteria in which we provide specialist advice. Partner Capital Facilities will be viewed as one of these offerings but HSBC do seek to provide services beyond the provision of Partner Capital Loans.

3. How are firms best going about obtaining funding for general working capital?

Last year HSBC supported the professional services sector with over £1bn of lending and we are keen to continue to support the sector in 2024. There are a number of working capital solutions that can be considered to aid a firms ambitions and/or strategy. Often these extend to working capital solutions through various debt structures depending on the firm, including sustainability solutions, acquisition funding and working capital solutions. These solutions may include Revolving credit facilities, term loans or asset finance products to fund PII or Capital Expenditure. These products have also been used to help firms navigate the Basis Period Reform ("BPR"), where the new BPR regulations will impact over 70% of the firms we surveyed in the latest HSBC Legal Survey. Firms are looking at various levers regarding lending facilities to manage working capital through the BPR transition years, and we're having these types of conversations with many firms. It should also be noted there is also the consideration of third party funders for example Private Equity which we note have taken a real interest in Legal Services in the last 18 months particularly, and while IPO seems like a distant goal for the sector, 3% of firms surveyed believe they may have listed status in the next 5 years.

Additionally the need for working capital often culminates in merging with another firm where culture, integration and cost synergies work. The fundamentals that need to be considered when seeking any working capital needs remain unchanged and any lender would be looking for a firm to have a business plan, strong financial management information to back up the plan, a strong management team, strong people culture and dedicated Finance Leaders to direct the firm. Often early discussions with your trusted advisors accountants, a lender, key members within the partnership is crucial to being able to work with the firm to explore the right solution.

4. There seems to be more acquisition activity in the market at the moment, how can firms fund this?

One of the words I hear when talking to legal firms Managing Partners, COOs and Finance Directors is "growth", and the latest The HSBC Legal Survey suggests that 22% see M&A being one of the key disruptors for the sector this year, while 67% of firms expect there to be more M&A. Given the back drop of economic uncertainly, staff and inflationary cost pressures, regulation including basis period reform impact on firms and technology advancements, notwithstanding succession planning challenges for firms, we should expect much more consolidation in 2024. Whilst many acquisitions in the sector may be deemed cashless, this tends to be where the people involved are continuing to work for a long period in the newly combined firm, where it is a succession solution without many other options to avoid run-off cover, or where the goodwill is personal rather than entity based.

That said funding is often needed to buy practices and also to fund a higher ongoing levels of working capital, which is where banks are often approached for support. Firms take a number of differing approaches to this, with some that seek to take on facilities to support growth in advance of identifying the target as an example.

Firms are also using cash reserves, seeking partner contributions, holding back partner distributions to allow investment in growth, and Private Equity are also very interested in funding growth too.

VICTORIA RITCHIE

HEAD OF PROFESSIONAL SERVICES

HSBC UK