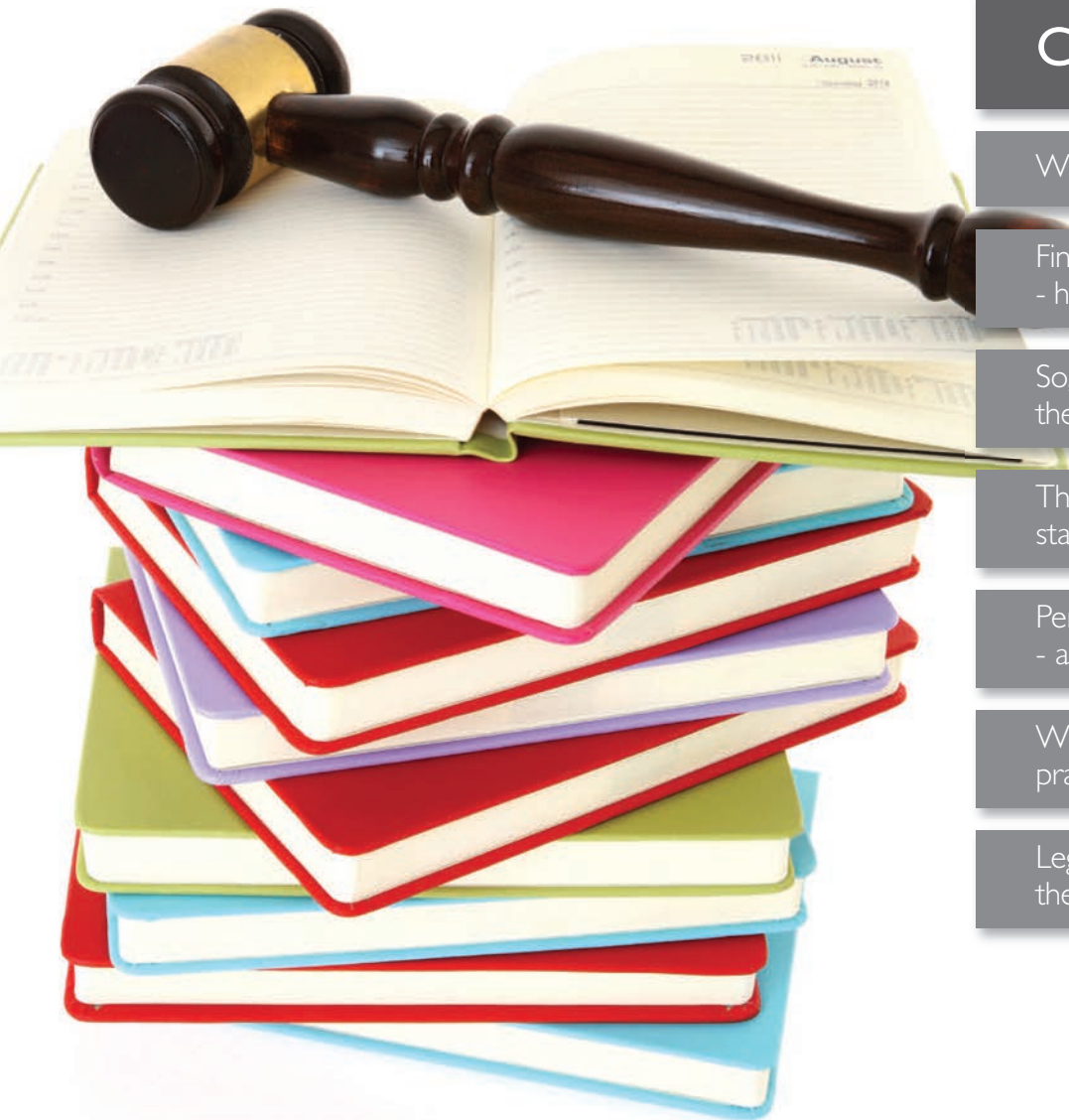


Legal Focus

Guiding you to lifelong prosperity



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HAZLEWOODS

DRIVING LIFELONG PROSPERITY

What is your strategy for growth?

The Bank of England has recently announced that the UK recovery has taken hold, and raised the forecast for economic growth for this year and next. Many experts are predicting that we are now on the steady road to recovery, but like all roads, there are bound to be a few potholes and traffic calmers along the way to slow things down!

So what does the general economic activity mean for your practice?

Generally, clients have commented over the last six months in particular, that they are busier than ever; and this has to be good news.

It would be fair to say that, since 2008, the only strategy that many firms adopted was survival. Getting through the difficult times has been key, and many solicitors will breathe a sigh of relief that they got through it, whilst others have fallen by the wayside.

However with an upturn coming gradually, it is important that you plan for growth.

Why it is important to plan?

Over the last few years, any growth in profits for many practices has mainly come from cost savings. Although this is important, and should be carried out on a regular basis, if a practice is going to survive in the future and grow, it has to increase its level of turnover. Of course, this is a lot harder to do than reducing costs. Without growth, inflation will eat into profits, which will then eat into the ability to make future investment by the practice, and in light of the current climate, investment is key for the future.

So what is a growth strategy?

This will depend upon your plans for the future. Growth can be organic, it can come through acquisition, or a combination of both. What is important is that you have a strategy. Many practices will continue to do the same as they have done before. In the past this was probably fine, as in previous post recession periods the upturn was very similar to the pre recession period and people just got on with it. Profits came back and everyone was happy again.

However, this time it is different. Not only are practices battling with recession, they also need to deal with changes to the market and introduction of competition that was not there before. Therefore, the plans that you have need to, not only take into account coming out of recession, but also the threats that you have from other competitors.

Although many people may think that the worst is behind them now that the economy is recovering and everyone is getting busier; the



bad news is that for many service based businesses, the most dangerous time is in fact now.

The reason for this is that now is when you need cash. It is very true that if you look at previous recoveries, many businesses did not recover with the help from the bank but through their own working capital. After the last recession many practices had cash available, as interest rates remained high throughout, allowing practices to benefit from interest on client monies.

However, this time many practices do not have the same level of cash reserves and interest on client monies is much lower than it used to be. Therefore, using your working capital means relying on other people to assist you with your recovery phase. However, you do not want to be one of those practices where clients use you to help with their own recovery!

It is all about spotting the signs early. For those practices that have commercial clients, you need to be aware of the time it takes for bills to be paid and work in progress to be completed. These types of clients will delay paying bills, as they are using the cash cycle to fund their business, thus putting pressure on you. It is vital through this phase of your growth strategy that cash remains king. Businesses do not generally fail as a result of lack of profits, they fail as a result of lack of cash. Cobbetts were on the face of it, a highly profitable firm, posting profits per partner of over £400,000, but they failed as a result of lack of cash.

Organic growth

Organic growth means continuing to add staff to existing departments, or growing new areas of work with new staff. If you can achieve growth organically, this can be a lot cheaper than through acquisition, albeit potentially a lot slower.

However, although profits will come straightway with the building up of work in progress (providing there is enough work coming through the door), it is cash that needs to be considered. It often takes six to nine months to get a return on any new employee, and sometimes even longer, depending on the level of recruitment. Any organic growth needs to be considered very carefully, and needs to justify that the practice is busy enough to take on new staff. Ensuring staff are as productive as possible and recovering costs well is more important than taking on more and more staff and not improving productivity and recovery.

The second challenge is to make sure that staff are taken on in the right area. It is important to look at the contribution that each department makes to the overall practice. Contribution is often referred to as gross profit (turnover less direct costs associated with each department). Will additional staff improve the contribution that is made by that department to the practice? This is one of the SRA's key financial stability questions (they refer to profitability of departments).

The final point in relation to organic growth is to ensure that any decision you make with regard to taking on staff enhances the unique selling point of the practice. At the end of the day, with the external pressures from the market, you need to make sure that your practice is different, and identifying what your unique selling points are and then working on them will make the difference going forward.

Acquisition

Organic growth is not the answer for some practices. Acquisition is what will achieve growth for them. There are many articles on mergers and acquisitions, and this article is not designed to go into a lot of detail about it, apart from saying that appearances can sometimes be deceiving!

The theory of a merger / acquisition is great, i.e. add on the turnover, reduce some of the costs and there you have a lot more profit, but in reality life is not like that. Often the costs in the short term are a lot higher than anticipated, and it can take a number of years before any return on investment is made.

With any acquisition, the first point that has to be considered is whether it fits in with your strategy for growth and what you want to achieve as a business. If it does then you have got past the first barrier. The second barrier is cash. The level of cash required will depend upon how the acquisition is structured. Do not

underestimate this! Acquisitions, whilst in this current phase of growth in the economy, cannot be undertaken lightly. Planning for cash is the most important aspect of any acquisition.

The future is very exciting for lots of practices as there are plenty of opportunities, but the key is to have a strategy for growth. Without a strategy, you risk being overtaken by the new entrants in the market, and may not be able to capitalise on the upturn in the economy.

With any strategy, do not get carried away with the profitability of it to the detriment of cash flow. Spend the time on preparing the cash

flow forecasts, apply sensitivity analysis and if you are not sure, come and speak to us.

At our legal seminars in December we will be talking about growth in more detail and exploring how a practice should be structured to achieve it.

Financial Stability Indicators - have you been contacted?

Over the last few months a number of our legal clients have been contacted by the SRA, asking them to provide financial information. The information requested has included the following:

- Net profit for the most recent accounting year end;
- Partner drawings for the most recent accounting year end;
- Details of total borrowings;
- Details of the current overdraft facility;
- The highest and lowest bank balances on office account for the last three months;
- Details of any time-to-pay or deferral arrangements with creditors.

Firms have usually been given up to 14 days to provide the information requested.

So, if you are contacted by the SRA, what should you do?

Well, first of all, our advice would be to co-operate with the SRA as much as possible. Remember, just because the SRA have written to you, it does not necessarily mean that they think you are in any difficulty. It could be because your firm deals in PI, legal aid or other sectors that are under particular economic pressure at the moment, or the SRA considers that your firm could have a potential high impact if it were to fail. This reason in particular is why they have contacted a lot of the larger firms already.

Co-operate with the SRA. Tell them what they want to know. The format for the completion of the information has changed since they first started writing to legal firms. Now you have to complete a spread sheet with no room to write comments on it. However, we would also suggest that you provide the SRA with more information than they have asked for if you

think it might help to provide some context. We would always suggest that you send a covering email with the SRA's spread sheet, explaining key points, and the SRA have confirmed to us that they will read it if you do.

In the list of information requested you will see that the SRA ask about borrowings, but do not ask about assets. In our opinion, it is impossible to understand whether borrowings are too high and unmanageable without knowing what assets a firm has. All firms are different, and £2m of borrowings in a firm with £1m of recoverable debtors and £2m of real billable WIP is completely different to a firm with only small amounts of debtors and WIP.

If you are asked for details of drawings, it may be helpful to split them between amounts relating to the previous year and amounts relating to the current year; if it helps for example to show that current year drawings do

not really exceed current year profits.

Remember that most of the people who work at the SRA are not accountants, and may not be able to interpret your information correctly without knowing a little more detail.

Finally, if you think that your practice may be assessed as amber, or even red, under the SRA's new financial stability warning indicators, then chances are the SRA are going to want to see your internal management accounts at some point. Now is a good time to revisit your internal profit and loss account, Balance Sheet, budgets and cashflow forecasts to ensure that they are up to scratch. If you are not sure what to do then contact us, as we have the experience to help.

We will be speaking about the financial stability indicators in more detail at our Legal Seminars in December.



So, why are people incorporating their legal practice?

The first legal practice we helped incorporate was back in 1999, so fourteen years ago now. Back then it was the exception rather than the rule, and when LLPs arrived in 2001 they stole the show. Many of those LLPs then followed up by adding one of more limited companies into their structure somewhere.

In the last decade though approximately 3,200 practices have taken a decision to fully incorporate into a single limited company, and in the last eighteen months this option has really gathered pace.

So why is this?

There are actually many reasons, and over a fairly short period of time they have all lined up together to create, for some, a compelling argument for going down this path.

1. Reductions in the main rate of corporation tax. It was in the Budget on 20 March 2013 that George Osborne announced that mainstream rates of corporation tax were going to gradually reduce to 21%, which was then trumped by a second announcement that this will become 20%. This allows larger practices access to day to day tax saving opportunities as well as those coming directly from the incorporation process itself (more on this below).
2. Opening up of the legal market. As readers will know, from January 2012 it has been possible for non-lawyers to both own and operate legal practices. This very significant change promoted a flurry of private equity backed acquisition transactions, and with it a noticeable increase in practice valuation multipliers. As many readers will know, higher practice valuations means increased tax efficiency on incorporation.
3. A need to retain more working capital. As practices start to see signs of an upturn in activity levels they need additional day to day working capital. Companies allow working capital to remain in the practice after suffering corporation tax only as opposed to the much higher rates of personal tax and national insurance.
4. The likely end to the automatic self employment of all members in all LLPs. The announcement of the HMRC consultation process in the Budget on 4 March 2013 was seen by some as the final prompt they needed to make a decision to fully incorporate. We are not totally convinced by this as a reason, but you do come across practices with large numbers of fixed share partners who are in the category of 'employees yesterday, fixed share self

employed partners today'. These are the individuals who will find the impending changes most challenging so far as trying to avoid a return to employment status, and the 13.8% employer's national insurance contributions that come with it.

5. A thought that a limited company will provide a way of running the practice in a more corporate style. Some might argue that this should be first on the list, and we have deliberately left it until last as we don't fully believe it - a view that is borne out with lots of real life experience advising limited company law firms.

Out of forty four limited company conversions that we have advised legal practices on, nearly all have been largely driven by tax efficiency.

So why do tax savings arise?

This is largely a rehearsal for some, as it is a fairly well trodden path. There are a number of ingredients, and for practices where they all line up well, tax savings can be very significant.

1. Sale of goodwill. This is potentially the biggest component part, particularly since valuation multiples increased in response to the market opening up to third parties in 2012. This can create a tax advantage of c15% of the valuation itself. Clearly it is important not to over-egg the valuation, or to forget things like HMRC not recognising what they call the personal goodwill of the law firm owners.
2. The ability to draw down on what were previously partners' capital accounts and replace them with an equal amount of the company's retained profits. The tax saving can be over 20% of the total partner capital.
3. Taking dividend income within owners' basic rate tax bands - the first £35,000 or so of

cash taken out of the practice might well be totally free of personal income tax.

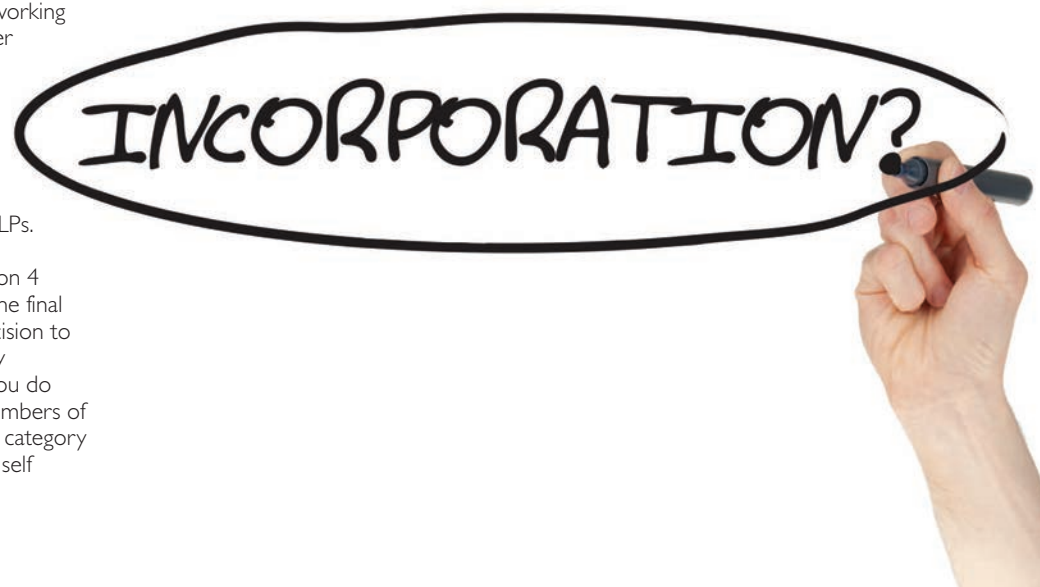
4. The ability to retain profits that are not available for drawing anyway (e.g. because they are needed for capital investment or to increase working capital) after paying corporation tax at 20% as opposed to personal tax/national insurance at up to 47%.

There are a number of other areas where tax savings can be made, but the above should give you the general idea.

We could not write an article on running legal practices via a limited company without saying that there are a number of areas where it is more burdensome than running as a partnership. Examples are:

- a). partners (shareholders) joining and leaving, where you now need share valuations, and deliberate considerations as to whether the seller or buyer of shares are human beings or the company itself. There is a plethora of tax law here, most if it quite cleverly written by the draughtsmen.
- b). how you deal with goodwill values in the future if you adopt goodwill on the way into the company.
- c). how you go about remunerating shareholders, i.e. the mix of salary, dividend, interest on loans to the company and so on.
- d). employment law. Owners will now be employees.

This article is meant to be an informative introduction to what is becoming something of a direction of travel for law firms. It is an area where we have great expertise, so if you want to know more, just ask.



Thinking of incorporating or starting your own legal practice?

As part of a new approach to authorising legal practices the SRA have issued new forms which are now available on the SRA's website, and they are very different to the old ones.

Three forms have been issued:

- Application Form for Applicant Firm (to be used for all new practices, including sole practitioners, partnerships, LLPs, limited companies and ABSs, and also for practices changing their status, for example from partnership to LLP);
- Application Form for Individuals (to be used for individual managers or owners requiring specific approval and the COLP or COFA);
- Application Form for Corporate Manager and/or Corporate Owners.

The forms for individuals and corporate managers/corporate owners are fairly straightforward and easy to complete, and the questions asked are similar to those contained in the old RB2 and RB3 forms.

The form for applicant firms includes a number of new questions asking firms how they plan to manage the risks attached to their business. Applicants are asked to indicate whether they believe there is a low, medium or high likelihood of many different risks occurring in their practice, and then need to state the reason for the risk assessment and explain what systems and processes will be in place to manage those risks. These risks include supply chain risks, the risk of involvement in insolvent businesses, marketing

risks, client service risks and conflict risks.

Applicant firms are required to provide details of any business process outsourcing, sources of funding, services to be offered (including a breakdown of expected turnover by work type) and fee sharing arrangements. They are also asked to submit the following:

- Details of the firm's governance and corporate structure;
- A business plan, including balance sheet projections, forecast drawings and a monthly cash-flow forecast;
- A copy of the Partnership Agreement, Members' Agreement or Shareholders' Agreement;
- Bank account details (office and client account); and

- Details of the firm's Reporting Accountant.

The good news is that the forms are editable PDFs, so they can be completed and saved electronically, and can be submitted to the SRA via email. However, despite this, it is likely that completing the forms is going to take a lot longer from now on and should be factored into the timetable of work.

We have already completed and submitted quite a few forms, and know what the SRA expect to see. The members of our team recently attended an audience with the SRA they spoke to Samantha Barrass, SRA Executive Director, about the application process, and Samantha assured us that the SRA are doing everything they can to improve turnaround times. She has also given us her personal email address, and told us to let her know if we have any problems.

Pensions auto enrolment - a little known quirk

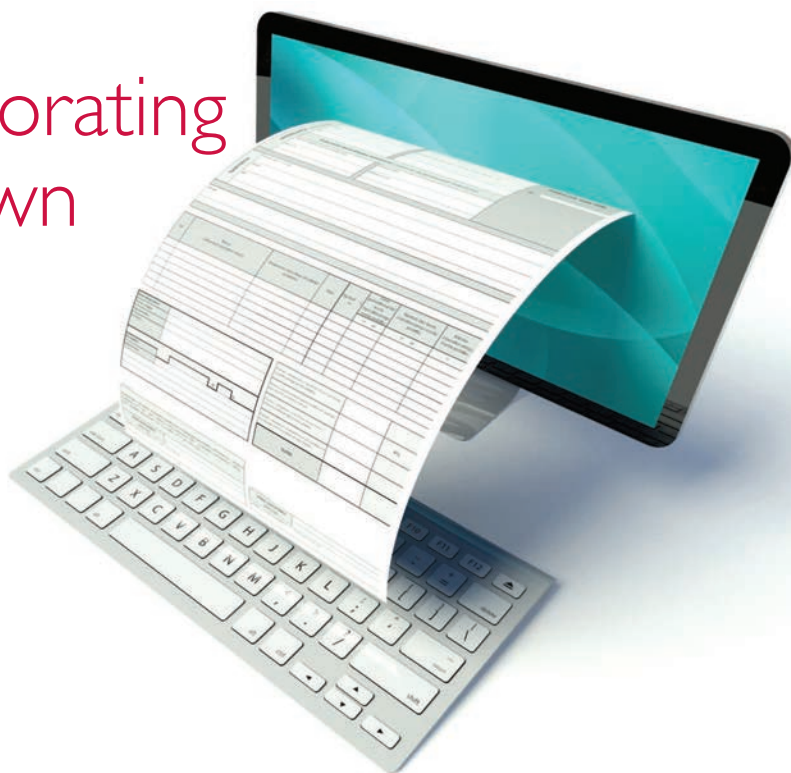
As a follow up to the article in this edition about the incorporation of legal practices, here is a little known fact about pensions auto enrolment. In short, the process of incorporation can result in the staging date for the new pension arrangements changing from whatever your natural date is (generally 1 April 2014 or 1 April 2015, both with an option to extend for up to three months), to 1 May 2017, so either two or three years later.

The reason for this is that when a business changes its legal structure, employees need to be TUPE'd to the new structure, and as a result

a new PAYE scheme reference number is created. Despite the fact that this is clearly an extension of the same employment so far as employees are concerned, it has the effect of treating the situation as a 'new business' for auto enrolment purposes.

We agree that this might sound unlikely, but it is true. We have had it confirmed in writing by the Government's Auto Enrolment Office.

Happy days for some employers maybe?



What to do when you find your practice in financial difficulty



The recession has had a significant impact on legal firms. There have been regular reports of administrators being appointed to law firms and the sale of those firms in "pre-pack" deals. The largest this year so far was the Manchester based firm Cobbetts, but there have also been reports of much smaller firms going through the same process, sometimes where the successor firm purchasing the practice via the pre-pack is formed by some or all of the partners of the firm in financial difficulty.

This particular recession has been particularly challenging for legal firms, not just due to the slow down in general economic activity, which has seen a reduction in both corporate transactions and the personal conveyancing market. In addition to these factors, Government policy is impacting through new legislation, particularly on those dependent on the personal injury and legal aid sectors.

This, combined with a changing regulatory regime, putting the onus on firms to report issues of financial difficulty, have resulted in an increased number of insolvencies, affecting firms both large and small.

Impact of a firm closing on the owners

The presumption of many solicitor practices that trade as an LLP or limited company is that their personal assets are safe, unless of course they have given personal guarantees. However, this is not always the case. For LLPs the claw back provision can be applied by an insolvency practitioner if they felt that the member took money out of the LLP whilst they knew it was in financial difficulty in the two years leading up to the administration.

The increasingly different vehicles used by legal firms to trade (LLPs and Limited Companies) have resulted in the terms of Professional

Indemnity Insurance policies evolving. In the event of a firm closing particular regard must be made to these terms and the extent to which the individual directors/members/partners of the firm may be personally liable for both run off cover and any excess. This personal liability can have a significant impact on the personal solvency position of the individual directors/members/partners of the closed firm.

If a solicitor is declared bankrupt the practising certificate or registration will automatically be suspended by virtue of Section 15 (1) of the Solicitors Act 1974. Application can be made for the suspension to be lifted, although conditions will usually be imposed.

There is no automatic suspension of the practising certificate where a solicitor enters an Individual Voluntary Arrangement (IVA) or a Partnership Voluntary Arrangement (PVA). However, there is a duty to inform the SRA, who may impose conditions on the practising certificate or registration. Entering into an IVA or PVA is a ground for intervention. However, this is unlikely if there is no evidence of any risk to client monies or the interests of the public.

Solicitors Regulatory Authority (SRA) Reporting

As mentioned in the article on financial stability indicators, the SRA have recently contacted lots of practices to obtain financial information, and

we understand that they plan to contact many more.

What you should do

Following the introduction of Outcomes Focused Regulation (OFR) in October 2011 the SRA has tried to target its resources on practices that are considered to impose a high risk to consumers of legal services. Under this policy considerable responsibility is placed upon the practice's Compliance Officer for Finance and Administration (COFA) to report to the SRA on becoming aware of any failure to comply with the SRA Accounts Rules, including any intention to close the practice. However, this does not take away the need for all owners to be aware of the risks and act accordingly. If you have any concerns then contact us.

We work closely with our colleagues in our Business Recovery team, so we can also advise you on restructuring arrangements, combined where necessary with formal insolvency options so as to limit as far as possible the impact of the closure of the practice.

In all such situations, the earlier we are consulted, the more options that are available to find a solution to the issues and prevent any unnecessary personal liabilities crystallising.

Welcome Back

We are pleased to welcome Mike Ingmire back to Hazlewoods and, in particular, as a Senior Tax Manager in our Legal team.

Mike started with us in 1997 as a trainee, then left eleven years later in February 2008. Mike went to work for Crowe Clark Whitehill when he specialised in professional partnerships. We welcome Mike back to our team, and his

knowledge and expertise in this area will certainly enhance the services that we provide to our clients.

Mike's contact details are as follows
t: 01242 237661
e: mike.ingmire@hazlewoods.co.uk



Legal Seminar - Is this the end of the road for partnerships?



We will be holding seminars in Cheltenham and Bristol in December 2013 that look at whether it is the end of the road for partnerships. 2013 will no doubt be known as the year when the spotlight was firmly shone on partnerships. From the announcement in the Budget in March 2013 that the Government intended to review the taxation of partnerships, to the end of transfer pricing for service companies from 25 October 2013, there has been so much happening that you wonder whether this is the end of the road for partnerships!

Cheltenham: Date: Tuesday 10 December 2013
Venue: Hatherley Manor Hotel, Cheltenham, GL2 9QA

Bristol: Date: Wednesday 11 December 2013
Venue: Engineers House, Clifton, Bristol, BS8 3NB

Timings: 4.00pm registration, 4.30pm presentations, finishing with drinks and canapes at 6.00pm

If you are interested in attending either of the above seminars then please contact Emma Halling on 01242 680000 or emma.halling@hazlewoods.co.uk.

Many of you will be aware of the Revenue's consultation into Partnerships and LLPs. The Chancellor has recently confirmed that he will give his Autumn Statement to Parliament on 5 December 2013, and we anticipate that draft guidance following the Consultation will be issued around this time. Our seminar will look at the proposals in detail and explain what they mean for you. We anticipate that many practices will be affected.

From there we will explore different business structures and consider what could be right for your practice. Finally, we will look at the SRA's current hot potato, Financial Stability. We will update you on the latest from the SRA, tell you what you should do if you are contacted by the SRA, and look at how you can use the current emphasis on financial

stability to improve your practice.

If these subjects are of interest to you, please come along and share what we believe will be a worthwhile experience. In addition, it is open to your colleagues and practice managers, so feel free to bring a guest along. Just fill in the enclosed reply slip and we will take care of the rest.

Topics will include:

Consultation on Partnerships and LLPs

Jon Cartwright
Hazlewoods Legal Team Partner

Jon will review the draft guidance issued from the Autumn Statement, what it means for practices, what can be done and what you need to do before April 2014.

What structure is right for you going forward?

Patricia Kinahan
Hazlewoods Legal Team Partner

In light of the Government's Consultation Document and transfer pricing for service companies being stopped, now is a good time to look at practice structures and consider what is right for your practice. Patricia will explore the impact of the recent changes and explain what you can do about them.

Financial Stability

Andy Harris
Hazlewoods Legal Team Director

Andy will look at the SRA's approach to ensuring firms' financial stability, and look at how financial stability can improve your practice's performance.

Speakers



Jon Cartwright

Jon is a Partner in Hazlewoods Legal Team. He is a committee member of the Institute of Chartered Accountants Solicitors' Special Interest Group, a member of the Chartered Institute of Taxation and specialises in partnership taxation.



Patricia Kinahan

Trish is a Partner in Hazlewoods Legal Team. As well as being one of our tax experts, Trish deals with all day to day issues for solicitors, and has been working with many practices on improving their performance.



Andy Harris

Andy is a Director in Hazlewoods Legal Team. Very experienced in all aspects of advising practices, he has a particular expertise in offering advice on management reporting and performance issues.



We are ver happy to discuss matters arising from this newsletter;
as well as any other issues relating to your business or personal financial affairs.

The services we provide include:

- Audit under the SRA Accounts Rules
- Accounting
- Practice strategy planning
- Partnership mergers/acquisitions
- Taxation - compliance and planning
- Practice structure planning, including LLP conversion, limited company incorporation and combinations
- Practice finance and performance reviews
- Improving fee earner and non fee earner efficiency
- Benchmarking against similar practices
- VAT and Stamp Duty
- Partnership changes
- Remuneration planning
- Goodwill valuations
- Expert witness work
- Business plans (including financial forecasts)
- New practice start-ups
- Raising finance
- Advice on practice administration software
- Financial services
- Trusts and estates



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This newsletter has been prepared as a guide to topics of current financial business interests.
We strongly recommend you take professional advice before making decisions on matters discussed here.
No responsibility for any loss to any person acting as a result of the material can be accepted by us.

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