Legal Focus

GUIDING YOU TO LIFELONG PROSPERITY

Autumn 2015

SPOTLIGHT ON FRAUD

Welcome...

to the latest edition of Legal Focus. We hope you like the new format.

In this edition we look at a number of client frauds that we have seen recently, explain the SRA's latest stance on the role of the reporting accountant, and give a reminder of the tax treatment of entertainment expenses. We hope you find it useful.

INSIDE

- → Fraud alert!
- → New UK GAAP – FRS 102
- → Will you be exempt from an audit?
- → Entertaining employees
- → Limited Company Incorporation
- → Capital investment
- → Pensions windfall
- → Say goodbye to abbreviated accounts

HAZLEWOODS

DRIVING LIFELONG PROSPERITY

Fraud alert!

Over the last six months we have heard of seven legal practices losing client money through fraud, with more than £2.4million of office and client money stolen.

Four of the frauds were as a result of social engineering - the act of tricking people into divulging personal or financial information, which can then be used to access their bank accounts or accounting software. The people carrying out these frauds are very clever, professional fraudsters, and they do their homework on practices and their staff.

VISHING

Vishing is the term used to describe scenarios where a fraudster calls a practice (often on a Friday afternoon) claiming to be from their bank, credit card provider or the police and tells them that there is a problem. They then ask them to provide or confirm confidential information in order to solve the problem.

Several of the major banks have put together recordings of calls from fraudsters, based on real-life transcripts, and they are incredibly convincing. At no point do the fraudsters ask anyone to confirm any bank details (they already have them), nor any login details, passwords or secret words. In some cases they also use software to disguise their voices and change the telephone numbers that appear on the caller display to help convince the people at the other end that they are genuinely calling from a bank.

MALWARE

Malware is the term used for software designed to gain unauthorised access to computers and other connected devices, where it then disrupts normal operation, collects sensitive information or spies on the user.

Two of the frauds that we have heard about resulted from fraudsters gaining remote access to the practices' accounting software, and then processing hidden transfers out of client account to accounts overseas. We do not know for certain, but it is believed that access was obtained via some kind of Trojan virus, possibly uploaded onto their systems when someone clicked on an email attachment from an unknown source.

INTERCEPTED EMAILS

The final fraud resulted from an intercepted email, where a fraudster managed to gain access to the client's email account, and then sent an email to the practice instructing funds to be transferred to a different account.

We have recently heard that fraudsters are getting better at accessing lawyers' work email accounts and sending internal emails with fraudulent account details, so don't take anything at face value.

WHY ARE SOLICITORS BEING TARGETED?

Legal practices are prime targets for fraud, as they often hold substantial amounts of client money, and high value transactions tend to be the norm, particularly for practices that deal with conveyancing and probate matters. Also, it is not uncommon for clients to live or be based a long way away from their solicitor, and as a result, more and more correspondence is sent via email.

Transactions are often time critical, meaning that there can be increased pressure on accounts staff to process payments and transfers quickly. Fraudsters know this, and know what to say to make you think that your account will be locked or frozen unless you do as they say.

WHAT HAPPENS IF YOU FALL VICTIM TO A FRAUD LIKE THIS?

The Law Society has recently published a new Practice Note, "Protecting your firm if you fall victim to a scam", which explains the regulatory and legal requirements that apply in this situation. Practices are advised to contact their bank, the police, the SRA and their insurer as soon as possible, and may also need to inform their clients too.

Rule 7.2 of the SRA Accounts Rules requires any missing client money to be replaced promptly, from the partner/member/director's own resources if necessary, regardless of whether a claim is subsequently made on the firm's insurance or the Compensation Fund. If the client account shortage continues, the SRA may deem the practice to have committed serious regulatory breaches.

Whilst there is a shortfall, the SRA is unlikely to permit practices to operate their client account as normal, because any withdrawal will be a breach of the Accounts Rules – by paying some clients their full entitlement, the amount left for other clients reduces. Also, until the missing money is replaced practices should not take money for costs from client account.

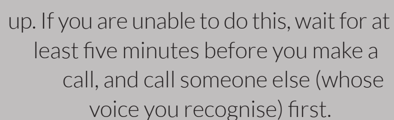
From an insurance point of view, our understanding is that theft of client money will in some cases be covered by a practice's professional indemnity policy, on the grounds that a client will have suffered financial loss. However, the impact on a practice's future insurance premiums could be significant.

Any theft of office money would probably not be covered by the PII policy, but may be covered by the practice's office insurance, if they have fidelity cover in place.

Other potential implications include the impact on the practice's reputation, the amount of time spent investigating and rectifying the fraud, and the impact on staff morale.

WHAT CAN YOU DO TO PROTECT YOURSELF?

First of all, banks will never email or call you to ask you to confirm your login details, and they will never ask you to transfer money to a different account. If you do receive a call like this, hang up straightaway and contact your bank. Make sure that you use a different phone to call your bank (ideally use your mobile phone), as fraudsters are able to keep a telephone line open even after you hang



up. If you are unable to do this, wait for at least five minutes before you make a call, and call someone else (whose voice you recognise) first.

To help protect against malware you should ensure that your anti-virus software is up to date and switched on. Don't be tempted to disable it to speed up your computer systems.

Finally, whenever you receive an email from a client or from someone within the practice with new account details, make sure that you verify that the email did in fact come from them.

Much more information and advice on all of this is available at www.getsafeonline.org Get Safe Online is a public and private sector partnership, supported by the UK Government and leading organisations in banking, retail, internet security and other sectors, such as Barclays Bank, Lloyds Bank, Tesco, Camelot and the Charity Commission. Their website includes tips and advice on protecting both yourself and your practice, including:

- Protecting your computer and other hardware
- Smartphones and tablets
- Online safety and security
- Shopping, banking and payments
- Safeguarding children
- Social networking
- Information security

Also, the SRA has created a dedicated "Scam Alert" section on its website, warning about people who call themselves solicitors but are not.

NEW UK GAAP – FRS 102

FRS 102 is a new accounting standard, which replaces all of the current SSAPs and FRSs. It is a single standard, with 35 sections covering the various different items previously dealt with in separate standards, and is 350 pages long, compared to the 3,000 or so pages of current UK GAAP.

FRS 102 will become the standard for accounting for LLPs and unlisted limited companies in the UK. For medium-sized and large entities it applies to accounting periods commencing on or after 1 January 2015, and therefore the first financial statements to be affected will generally be 31 December 2015 year ends. The comparatives in those accounts will also need to be restated, meaning the opening balance sheet at 1 January 2014 (i.e. at 31 December 2013) will have to be recalculated in accordance with FRS 102.

FRS102 will apply to small LLPs and companies the following year, i.e. for accounting periods commencing on or after 1 January 2016.

Despite the fact that FRS 102 becomes effective in just a few months' time, there is some dispute over how it will impact on legal practices. Based on current interpretation, the main areas where we believe that we may see significant differences between existing UK GAAP and FRS 102 are outlined above.

1. **Revenue recognition.** Currently, UITF 40 permits contingent WIP to be excluded from the financial statements until the contingent event occurs. However, FRS 102 does not include this exemption, and instead requires income to be recognised when it can be reliably measured and it is probable that it will be received in future.

2. **Directors' / members' loans.** There may be a requirement to discount the book values of these loans where they carry no interest, or where interest is below market rate, unless it can be demonstrated that the loans are short term and repayable on demand.

3. **Amortisation of goodwill.** Unless practices can make a reliable estimate of the useful economic life of any goodwill, the default amortisation period will be ten years (this has recently been increased from five years in the draft standard).

Our in-house Technical Team have been looking very closely at this for several months, and have spoken to a number of experts on accounting standards. We will report back as soon as we know more.

Will you be exempt from an audit?

The SRA has recently announced that it will be making major changes to the requirement for practices to have an audit under the SRA Accounts Rules, following a consultation on the role of the Reporting Accountant held at the end of last year.

Proposals included within this consultation included the following:

- A redefinition of the circumstances in which accountant's reports are qualified, so that far fewer reports are qualified in future;
- Changes to the format and content of the accountant's report;
- Removing rule 39 of the Accounts Rules (Test Procedures) in its entirety, and replacing it with a new rule requiring reporting accountants to use their professional judgement to decide whether a practice was compliant; and
- Exempting more practices from the requirement to obtain an accountant's report.

On 15 July 2015 the SRA Board decided to adopt the majority of these proposals.

With effect from 1 November 2015, reporting accountants will be required to use their professional judgement to produce a suitable work programme to decide whether their accountant's report should be qualified. The SRA has produced 20 pages of draft guidance to reporting accountants, detailing the sections of the Accounts Rules that should be focused on, the sort of factors that might lead to qualification of a report, and example tests procedures that might be undertaken in future. Many of these test procedures are similar to the testing currently performed by reporting accountants.

The SRA expects that far fewer accountant's reports will be qualified in future as a result of these changes. Reports should only be qualified where the breaches identified are material and likely to put client money at risk. Material is defined as "likely to arise as a result of an intention to break the rules and/or as a result of a significant weakness in the firm's

systems and controls." Example factors that *would* lead to a qualification include:

- A significant and/or unreplaced shortfall on client account;
- Evidence of the wilful disregard for the safety of client funds;
- Actual or suspected fraud or dishonesty by individuals within the practice;
- A lack of adequate accounting records;
- Incorrect client account reconciliations; and
- Client account used as a banking facility.

Example factors that *might* lead to a qualification include:

- Material breaches not reported to the SRA in accordance with the Authorisation Rules and SRA Handbook (i.e. material breaches not reported to the SRA by the COFA);
- A poor control environment;
- Longstanding residual client balances; and
- Improper use of suspense accounts.

Finally, the SRA has decided to exempt practices from the need to obtain an accountant's report if, during the relevant accounting period, they had an average client account balance of £10,000 or less and a maximum client account balance at any point in the period of £250,000 or less. The average balance and maximum balances are calculated/identified based on the total of all client accounts held, including designated deposit accounts, at each reconciliation point (usually month end, but in theory this could be calculated on a daily basis). The SRA anticipates that some practices will fall into and out of the requirement for an audit from year to year.

The SRA estimates that around 1,000 practices, or 13% of all practices that hold client money, will be exempted as a result of this change. These are in addition to the 120 or so practices that are already exempt because they are wholly legal aid.

The new exemptions will also apply to brand new practices that meet the criteria, not only existing practices. However, all practices will need to obtain and deliver a final report to the SRA should they cease to hold client money, irrespective of whether they meet the criteria and whether the report is qualified or unqualified. This includes final reports for sole practitioners and partnerships converting to LLP or limited company (and vice versa).

If approved by the Legal Services Board, the changes will be included in version 15 of the SRA Handbook, due for release on 1 November 2015. Revised accountant's report forms will be available for use after 1 November 2015 and will apply to all practices with accounting periods ending on or after that date.

ENTERTAINING EMPLOYEES

The tax treatment of entertainment expenses can be a complex area, particularly when looking at the distinction between staff entertaining and business entertaining. Here we take a look at some of the basics.

STAFF ENTERTAINING

Expenditure on staff entertaining can cover a range of items, from clearly defined events such as the Christmas party to those which may be overlooked, such as an employee lunch. Such expenditure will generally fall into one of three categories in terms of the employee's personal tax position:

1) Exempt benefits
2) Trivial benefits
3) Taxable benefits

The most important exemption for staff entertaining is for "annual parties and functions". Under this exemption, annual events, such as the Christmas party or summer barbeque, do not give rise to a taxable benefit for the employees, provided certain conditions are met:

a) The event is open to all employees or all employees at a particular location

b) The cost per head does not exceed £150

In calculating the cost per head, the total cost of the event (venue hire, catering, entertainment, transport etc., plus any VAT on those costs) is divided by the number of attendees, not just employees. If more than one annual event is held during a tax year then, provided the aggregate cost per head of all events is below the limit, they are all exempt from tax. But if the aggregate should exceed £150 per head, then the event that takes the cost over the threshold is taxable in full. For example, if the practice holds three events, two of which cost £70 per head and one costs £20 per head, then the smaller event would be a taxable benefit.

Some modest amounts of staff entertaining may not be taxable on the employees on the basis that they are "trivial benefits". Unlike the exemption for annual events, this is not currently a statutory exemption but Revenue practice, although it is due to be put onto a statutory footing soon. HMRC give guidance on what might be considered a trivial benefit:

- Refreshments, such as tea, coffee and water, provided to staff (if provided to all staff this is covered by a statutory exemption, but if provided to only some staff it should be considered trivial).
- Small gifts in recognition of a particular event (such as flowers for a wedding or birthday).
- Seasonal gifts, such as a bottle of wine or box of chocolates at Christmas

There is no monetary limit set out in the law, and it is the cost per employee not the total cost to the employer that is considered. However, it is expected that the statutory exemption, when introduced, will be £50 per person, and this could be used as a guide. HMRC will look to tax items viewed as a reward as opposed to those related to staff welfare.

Any staff entertaining that does not fall under a statutory exemption and which would not constitute a trivial benefit is taxable on the employees as income. This includes working lunches, staff socials and events not classed as 'annual'.

Mainstream law prescribes that the benefits must be reported on a form P11D for the employees concerned, and each employee will pay tax on their share. Often, this is not a desirable outcome, either because of the practicalities of apportioning the costs between employees and the subsequent form filling, or because it would undermine the goodwill generated by providing the entertaining if the employees are then lumbered with a tax bill.

Thankfully there is an alternative, known as a PAYE Settlement Agreement (PSA). This is where the practice agrees with HMRC to pay the tax and National Insurance on behalf of the staff (calculated on a grossed up basis). A PSA can be put in place to cover benefits which are minor, irregular or impractical to apportion, and we have seen a wide range of items agreed by the Revenue.

The cost of staff entertainment will generally be an allowable (i.e. tax deductible) expense for the practice, irrespective of the personal tax treatment for the staff involved, on the basis that it is part of the cost incurred in employing the staff.

BUSINESS ENTERTAINING

Many readers will be aware that, unlike staff entertaining, tax law prohibits tax relief being claimed for the cost of business entertaining in calculating the taxable profits of the practice. If the attendees at a staff party or function include clients, suppliers or anyone else who is not a member of staff or their partner then the cost related to those attendees should be adjusted in the tax computation.

Where an employee is involved in business entertaining, that should not constitute a taxable benefit, provided the event has a clear business purpose and the employee's attendance forms part of their role. This will be the case even though the employee may enjoy some of the entertainment laid on by the practice, as that would be seen to be incidental to the primary business objective.

On the other hand, if an event lacks a business objective, or perhaps the employee's attendance is an incentive or reward, then HMRC are likely to view it as a taxable benefit.

LIMITED COMPANY INCORPORATION

The question of whether to incorporate a legal practice is rarely off the agenda, but following a number of changes to the tax system aimed at tax-motivated incorporations it may be slipping from favour as practices start to question whether it is now worthwhile.

From December 2014, goodwill acquired by a company related to the seller ceased to qualify for Entrepreneurs' Relief, which took away much of the benefit of incorporation for many practices. At the same time, corporation tax relief on the amortisation of goodwill was withdrawn where a company acquires goodwill from any related party, although that change affects only relatively new practices (only those which commenced after 1 April 2002 previously qualified for corporation tax relief on the amortisation anyway).

It was then announced in the 8 July Budget that, from 6 April 2016, the tax regime for dividends would be changed. Draft legislation has not yet been released, but we know that the dividend tax credit is being scrapped, a 'Dividend Allowance' of £5,000 per annum will be introduced, and dividends will then be taxed at 7.5%, 32.5% and 38.1% for basic rate, higher rate and additional rate taxpayers respectively. This is an effective 7.5% increase in the tax payable on dividend income at all three levels, and is seen by some as the start of an attack on those who draw income from their private companies primarily by way of dividends.

There is a ray of light in the Chancellor's announcement that the corporation tax rate would be reduced from the current rate of 20% to 19% from 1 April 2017 and then to 18% from 1 April 2020.

Taking the impact of the loss of Entrepreneurs' Relief on goodwill and the increased tax on dividends together, one could be forgiven for thinking incorporation is dead in the water. But is that really the case? The quick answer is no. Incorporation has never been a "one size fits all" solution, and there will still be many practices that can benefit, particularly if they do not or cannot extract all of the profits made each year, for example because of a need to repay debt, invest, or build work in progress levels.

Capital investment

With confidence continuing to return to the economy we are beginning to see more practices making substantial investment in their IT systems and other areas of infrastructure. For some practices the capital allowances Annual Investment Allowance (AIA) allows a 100% write off of this expenditure for tax purposes when incurred, currently up to a maximum of £500,000 in a 12 month period.

The AIA was all set to reduce to £25,000 with effect from 1 January 2016, but it was announced in the Summer Budget that it would instead reduce to a permanent level of £200,000 from that date. For those planning their capital expenditure over the longer term, having a permanent AIA will be make things easier, especially since it has been set at six different levels over the past eight years!

Although the AIA effective from 1 January 2016 will be higher than previously announced, care must still be taken where practices are planning expenditure on equipment in the coming months. Transitional rules apply where there is a reduction in the AIA, and for accounting periods spanning the change the AIA available will most likely be lower than £200,000 for expenditure incurred after 31 December 2015.

PENSIONS WINDFALL

Amid news of tax rises and spending cuts delivered in the 8 July Budget was a potential windfall for anyone looking to top up their pension fund.

Since 6 April 2011, tax relievable pension savings have been subject to an annual contribution limit set at £50,000 initially, and then reduced to £40,000 from 6 April 2014. However, in a fit of short term generosity, George Osborne announced that savers could potentially add £80,000 to their pension funds in the current tax year, with the full amount benefiting from tax relief at their marginal rates of tax.

This means that those who made their contributions early in the tax year (perhaps fearing the tax relief may be withdrawn, not increased!) and thought they had used up their £40,000 allowance may now get another bite at the cherry.

This announcement coincided with the news that from 6 April 2016 the annual limit for pension savings will be reduced on a sliding scale, from £40,000 to £10,000 for those with income of more than £150,000. The annual allowance will be reduced by £1 for every £2 of income in excess of £150,000, so those earning over £210,000 a year will have an allowance of just £10,000. The ability to make greater contributions in the current tax year will be welcome news for those whose tax relief will soon be restricted.

As ever, the application of these new rules is not completely straightforward (so much for pensions simplification!). The additional £40,000 allowance applies to the period 9 July 2015 to 5 April 2016 and can be affected by the level of contributions made prior to that. Advice should therefore be sought before making further contributions to take advantage of the additional tax relief.

Say goodbye to abbreviated accounts

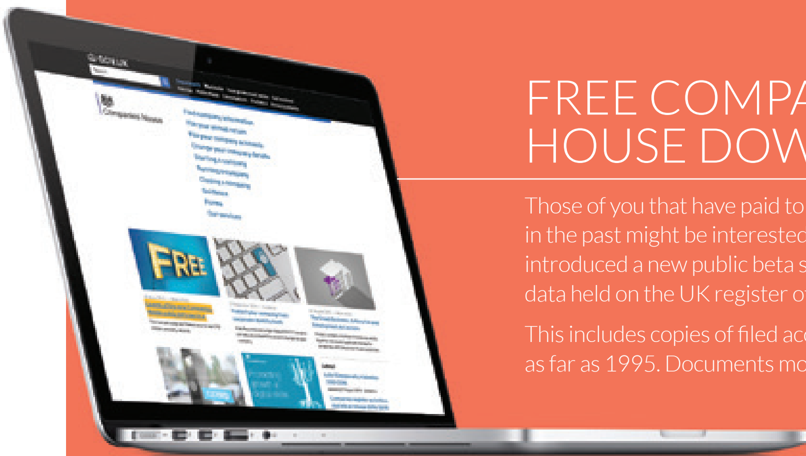
Small companies and LLPs currently have three options when it comes to filing their statutory accounts; file full accounts, remove the directors'/members' report and/or the profit and loss account from the full accounts and file the rest (abridged accounts), or file abbreviated accounts.

The abbreviated accounts option is by far the most popular, and allows a small company or LLP to prepare full accounts for its members, but then file abbreviated accounts with Companies House. These contain no directors'/members' report or profit and loss account, the balance sheet is less detailed, and only a small number of notes are required (mainly the accounting policies and fixed assets notes).

Earlier this year the Government approved new regulations removing the abbreviated accounts option for small and medium-sized entities. Instead, they will need to file the version of the accounts as prepared for their members, although small entities will still be able to remove the profit and loss account and/or the directors'/members' report.

The regulations also permit the accounts for the members to include an abridged profit and loss account or balance sheet, provided a statement is filed with Companies House confirming that the members consent to this.

The change will come into effect for financial years beginning on or after 1 January 2016, although early adoption is permitted.



FREE COMPANIES HOUSE DOWNLOADS

Those of you that have paid to download information from Companies House in the past might be interested to know that Companies House have recently introduced a new public beta search service on its website, meaning that all public data held on the UK register of companies is now accessible free of charge.

This includes copies of filed accounts, annual returns and other forms dating back as far as 1995. Documents more than 20 years old are available for a fee of £3.

THE SERVICES WE PROVIDE

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

- Accounting
- Practice strategy planning
- Partnership mergers/acquisitions
- Taxation - compliance and planning
- Audit under the SRA Accounts Rules
- 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
- Partnership changes
- Remuneration planning
- Goodwill valuations
- Expert witness work
- New practice start-ups
- Business plans (including financial forecasts)
- Raising finance
- Financial services
- Advice on practice administration software
- Trusts and estates
- VAT and Stamp Duty Land Tax

Windsor House, Bayshill Road, Cheltenham, GL50 3AT
Tel. 01242 237661 Fax. 01242 584263

www.hazlewoods.co.uk / @HazlewoodsLegal

HAZLEWOODS
DRIVING LIFELONG PROSPERITY

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. Hazlewoods LLP is a Limited Liability Partnership registered in England and Wales with number OC311817. Registered office: Staverton Court, Staverton, Cheltenham, Glos, GL51 0UX. A list of LLP partners is available for inspection at each office. Hazlewoods LLP is registered to carry on audit work in the UK and Ireland and regulated for a range of investment business activities by the institute of Chartered Accountants in England & Wales.

HLB Member of International