Legal Focus

DRIVING LIFELONG PROSPERITY July 2023

SPOTLIGHT ON COMPLIANCE

Welcome...

Welcome to the July 2023 edition of the Legal Focus. In this edition we dive into the world of SRA Accounts Rules compliance, consider the key accounting updates on the horizon and explore the key tax issues you must be aware of.

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DRIVING LIFELONG PROSPERITY

Update on the world of SRA Accounts Rules compliance

A (RELATIVE) FLURRY OF RECENT ACTIVITY

In our last Legal Focus, we noted that the SRA were poised to issue further guidance on their often misinterpreted rule concerning the provision of prohibited banking facilities.

With little in the way of fanfare, and shortly after publication of our last edition, the guidance did indeed appear, along with an updated practice note from the Law Society concerning residual balances.

On top of all of this activity, the SRA's consultation on changes to the Accounts Rules (and wider regulation) closed for public response in early March and so, while we wait for the outcome of that, it is quite easy to lose track of what is going on in the world of SRA Accounts Rules compliance.

For quite a long time, there was very little update from the SRA on Accounts Rules guidance and, prior to the recent activity, the last time anything substantial was issued was back in late 2020 when the SRA released a detailed note on when firms should and should not withdraw money from the client account to pay for disbursements.

It is interesting to see therefore that the Accounts Rules have come once again into sharper focus with the SRA.

Most firms with a March or April year end (and that is the vast majority in our experience) will either be planning for, be in the midst of, or be recovering from this year's Accounts Rules audit. For those yet to begin the process, the following round up will be a useful checklist of the key issues that your Reporting Accountant will be focusing their efforts on. For those finishing up or reflecting on this year's visit, this will provide a debrief and reminder of some of those issues that probably did crop up in some way and will help focus the mind on areas of improvement for next year.

NEW GUIDANCE ON PROVISION OF PROHIBITED BANKING FACILITIES

Rule 3.3 of the SRA Accounts Rules (as they stand at the time of writing this), states that firms must not allow the client account to be used to provide banking facilities to clients.

In a nutshell, this means that firms should only allow money to pass through or be held in the client account to the extent that the money relates directly to an ongoing legal service that the firm is providing to the client.

This is a fairly straightforward concept, and most firms are well aware of the risks of receiving money from clients and paying that money to unrelated (and unchecked) third parties without any apparent reason. However, the requirement of the rule does not end there, and we tend to see firms unintentionally breaching the rule in a number of ways, such as:

- Holding on to rent deposits for clients following completion of a lease arrangement
- Acting for property developers and funds are held back for long periods of time to settle future liabilities to various third parties
- Acting for trustees on a relatively straightforward administrative basis, but holding large sums of money for indefinite periods of time or paying money on behalf of the trustees from the client account when this should be dealt with by the trustees themselves
- Receiving money for clients who are unable to hold the money for themselves – for example when holding compensation payments on behalf of clients who do not have a bank account
- Holding money in-between cases for recurring clients in anticipation of future work

Back in 2014, the SRA published a warning notice on the subject, but that mainly considered more extreme (and blatant) examples of non-compliance, and therefore, several years ago, the SRA released further guidance, including a dozen case studies that set out some practical, real life examples of where firms had been misinterpreting the rules.

Those case studies were fairly detailed and provided a useful reference for many of us, but there were clearly some gaps. It is also fair to say there were some areas that revealed a lot of firms that had been unintentionally in breach of the rules for a long time (holding commercial rent deposits being the main point).

Since then, a lot of firms have struggled to bring themselves into line with the requirements of the rules, while still feeling they are acting in the best interests of their clients.

In March 2023, the SRA released updated guidance with the aim of clarifying some of the uncertainty, while also filling the gaps from the original guidance.

The first part of the guidance offered little new, being a simple re-emphasis of the need for firms to avoid providing banking facilities, but the second part of the guidance is much more helpful, expanding the original dozen case studies to 16, while also adding more weight to some of the original examples.

Here are the highlights:

- Commercial rent deposits – holding on to deposits indefinitely where a matter has ended is still a breach of the rules. However, there is recognition from the SRA that some firms are holding on to deposits that predate the guidance and warning notices and, in these cases, the SRA does not expect firms to renegotiate the terms of the leases. They do however expect firms to at least look for opportunities to enter into alternative arrangements, such as opening a joint account with the landlord.

  For Reporting Accountants, this is a particularly welcome clarification, as this has been the topic of countless discussions over recent years.

  It is an acknowledgement of the difficulties facing some firms, if not an outright relaxation of the requirements, and firms need to be absolutely clear that entering into new arrangements of this type with clients is still prohibited. From the point of view of the Reporting Accountant, this would most likely constitute a reportable breach.

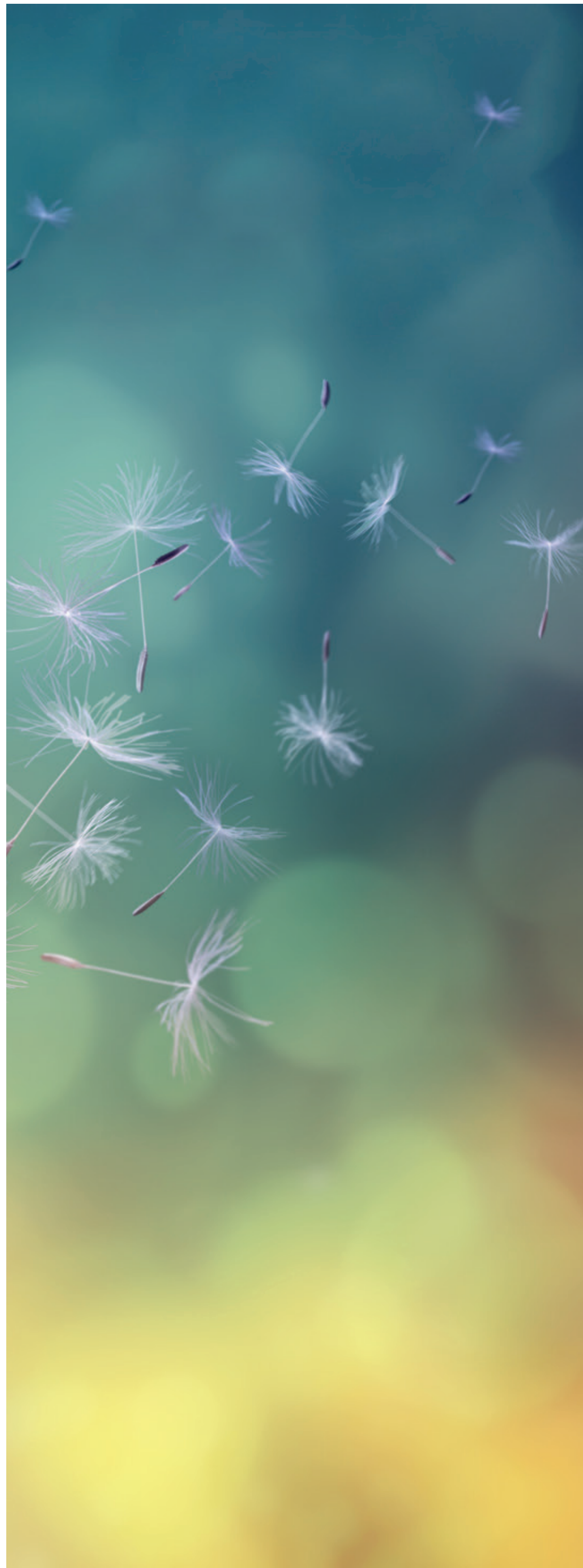
- Lasting powers of attorney (LPA) – acting under an LPA and holding the client's money in the firm's client account (presumably rather than operating a client's own bank account) is fine and in accordance with the rules, though firms should consider whether operating a client's own account or designated deposit account would be in the best interests of the client.

- Lenders and mortgage offers – the example used by the SRA is where a firm acts for the lender and the borrower (common practice in conveyancing matters) and a condition of the lender is that certain debts, such as credit cards, of the buyer are paid prior to completion.

  In this case, the payment to third parties would be allowable, providing the firm acts strictly in accordance with the conditions of the mortgage.

  This is also a helpful clarification given that acting in this way on most other types of matter would be a clear breach of the rules.

- Legal only advice retainers – put simply, where a firm's engagement with a client is purely to give advice to a client, there is little justification for the firm to be asked to handle client money. The SRA example is based on a firm providing specialist SDLT advice and then being asked to deal with the physical payment of the tax.



As Reporting Accountants, it is easy for us to see that there is no justification for the firm to actually receive and pay the tax on this type of matter. In our world, we are always advising clients on tax related matters, as well as commercial arrangements, share sales, property disposals etc. and we never (or at least very rarely) handle any cash transactions arising from that advice. Just because it is normal for law firms to operate a client account for certain types of work, it should not be the default that they will do the same for others.

- Divorce matters – another common area of confusion for law firm finance teams arises on divorce cases and, specifically, what to do with funds when things grind to a halt.

  The SRA makes it clear that, where there is client money held but it can only be distributed with joint instructions, then holding onto that money – even for a long period of time – is not a breach of the rules while the matter is still technically ongoing.

  Furthermore, if some of those retained funds need to be paid out to a third party, in this case settling a backlog of school fees for a child, then there's no problem, even when that could be considered ancillary to the legal matter.

- Conveyancing matters – the final point we want to highlight is the common issue where firms end up holding on to money at the end of a conveyancing matter, subject to a developer dealing with a snagging list or the local authority adopting a road.

  Readers will be happy to note that these scenarios will not be viewed as a breach of the rules, hopefully bringing to an end a lot of debate between COFAs and Reporting Accountants.

It is useful for firms to be fully up to date with all of these cases studies, especially for those firms currently undergoing the annual audit. Some, less experienced, Reporting Accountants may raise issues that were previously viewed as a breach but may now be viewed differently in light of the updated guidance.

The updated list of case studies can be found at: www.sra.org.uk/sra/news/press/banking-facilities-ban-case-studies

RESIDUAL BALANCES – THE LAW SOCIETY HAS UPDATED ITS PRACTICE NOTE

The concept of having to deal with residual balances is not new – the requirement to deal with them has been around for 15 years now – but that does not mean the problem has gone away.

In our experience, and along with the provision of prohibited banking facilities, this is the leading source of qualified Accountant's Reports.

The updated Law Society practice note, issued earlier this year, acts as a useful reminder of the steps firms should be taking when trying to locate their clients.

Bearing in mind the SRA requirement that firms take reasonable steps to locate their client before donating the balance to charity (or making an application to the SRA for permission to do so), firms might view this note as a handy checklist of steps needed.

The practice note can be found at www.lawsociety.org.uk/topics/client-care/residual-client-balances

CLIENTS' OWN ACCOUNTS – WHERE ARE WE NOW?

As reported in our last Legal Focus, a recent SRA consultation looked at easing the requirement on firms to reconcile clients' own accounts every month.

Since the consultation closed on 8 March, we have not heard any more on the subject, though we understand that the SRA are in the process of carefully considering the responses they received.

While we wait for the SRA decision, here is a reminder of the things you should be doing to ensure you stay compliant – pending any update to the rules:

- Make sure all staff members understand what a client's own account is, and make sure they tell you if they are operating one, or are just signatories on one, even if they do not initiate any transactions. It is important that you can identify them all and keep a central register of them, making sure that the register is available to your Reporting Accountant.
- Where possible, you should reconcile these accounts every month. Eventually, this monthly requirement will more than likely move to a 16-week requirement, but be aware that if you can reconcile these accounts, then you should. Only where you have a valid reason for not reconciling – for example, where the account does not provide regular statements, or where your firm is not the only party initiating transactions – are you able to justify not doing so.
- Where you cannot reconcile the accounts, you need to keep a record of transactions originating from within your firm and make that available to the Reporting Accountant too. We have seen well-managed firms carry out an internal review of these records by somebody independent of the signatory.

THERE ARE NO LONGER EXCEPTIONS FOR COVID-19

Most of you will remember that, back in the midst of the COVID-19 lockdown a few years ago, the SRA released some temporary guidance for firms struggling to remain compliant due to offices being closed or members of staff being forced to isolate.

There were a few allowances relating directly to the Accounts Rules:

- Obtaining an Accountant's Report more than six months after the reporting date was not considered a serious breach of the rules, as long as the reason for the delay was COVID-19-related
- Late preparation of client account reconciliations was not considered a serious breach, if as a direct result of COVID-19
- Being unable to bank client money 'promptly' due to COVID-19 was allowable, as long as the money was kept safely in the meantime

We are aware of some firms that believe these relaxations still apply, but it is important to note that the SRA expects firms to be fully compliant.

So, it is back to business as usual.

REPORTING DEADLINE EXTENSIONS ARE A THING OF THE PAST

Another point that is often misunderstood by firms is the possibility, or not, of extending the deadline for obtaining an Accountant's Report.

Rule 12 of the Accounts Rules requires firms to have a report prepared by their Reporting Accountant within six months of their reporting year end. Up until the regulatory amendments that took effect from November 2019 (including the updated and shortened 2019 Accounts Rules), it was possible to obtain an extension to this by simply emailing the SRA, explaining why an extension was needed and the period of additional time required. In our experience, the SRA would usually grant an extension of up to three months with little resistance.

We understand that this is no longer possible, and the SRA has made it clear that there is no mechanism whereby a firm can apply for any sort of dispensation.

Put simply, if a firm requires an Accountant's Report, the audit must be completed and the report must be prepared within six months of the firm's year end, even if the report is unqualified and does not need to be submitted to the SRA. Any failure to meet this deadline is a breach of Rule 12.1 and will usually be classed as reportable.

IF IN DOUBT, GET IN TOUCH

Our dedicated Legal Team consists of 45 accountants and tax specialists who deal with law firms all day, every day. If you have any questions at all about past, current or future regulation, please just get in touch – we are always more than happy to help.

Accounting updates on the horizon…

COMPANIES HOUSE

A number of Companies House reforms are currently being legislated through the Economic Crime and Corporate Transparency Bill, which is passing through Parliament. There are several elements to this that will impact on firms in the short to medium term (though the timetable for implementation has not yet been announced):

1. Filing requirements for accounts
   All company accounts will in future need to be filed digitally rather than in paper form. In addition, Companies House will require all entities of all sizes to file a profit and loss account, and the option to file abridged or filleted accounts will be removed.

2. ID verification
   To help counteract identity fraud, ID verification will be needed for new and existing company directors and LLP members. For new companies and LLPs, all directors and members, and people with significant control (PSCs), will need to complete identity verification before or as part of the company/LLP incorporation process. For existing entities, all directors, members and PSCs will need to verify their identity within a set period.

3. New registrar powers
   To help improve the integrity of information lodged at Companies House, the registrar will have the power to query, reject and remove information provided to the register, including existing information. The registrar will have the power to punish non-compliance by imposing sanctions on the entity. The registrar will also be given the power to share personal data and pass relevant information to certain public, regulatory and supervisory bodies, including law enforcement.

4. Corporate directors
   There are proposals that all entities registered at Companies House must have at least one fully verified natural person directly associated with them on the register. Corporate directors will be restricted to only those entities that are registered in the UK.

IFRS 16 LEASES

The Financial Reporting Council (FRC) has proposed changing the lease accounting requirements in FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland. This applies generally to all law firms with turnover of over £650,000 per annum. The proposed changes are intended to align FRS 102 to International Financial Reporting Standards.

This new standard will require all leases to be recorded on the balance sheet as liabilities, measured at the present value of the future lease payments, with a corresponding asset on the balance sheet. For expenses such as rent, this will result in the operating expenditure incurred from the operating lease no longer being shown as such in the profit and loss account, and instead it will be recognised as depreciation and interest. On initial recognition, the balance sheet will have a matching increased level of assets and liabilities, but once the lease progresses through its lease term this balance will alter, as a result of the depreciation of the asset occurring on a straight-line basis across the life of the lease, whilst the interest cost will be incurred at a percentage of the remaining liability that will change over time. This will result in a net liability position for the first part of the lease and a net asset position for the second part.

Given the above impacts EBITDA and debt levels, it may impact on exit values and therefore needs due consideration going forward.

FRS 102 1A (GENERALLY FIRMS WITH TURNOVER OF UNDER £10.2M)

Finally, for law firms incorporating in Great Britain, much of the accounting standards have been set by EU precedent. Now we are out of the EU, the FRC can amend them. All incorporated entities will have to make specific disclosures that the firm is a going concern, and also disclose any material uncertainties. One fairly significant change for limited companies is that dividends declared and paid or payable during the period will have to be disclosed in the accounts.

Operating as a limited company – a reminder of the key tax issues to be aware of

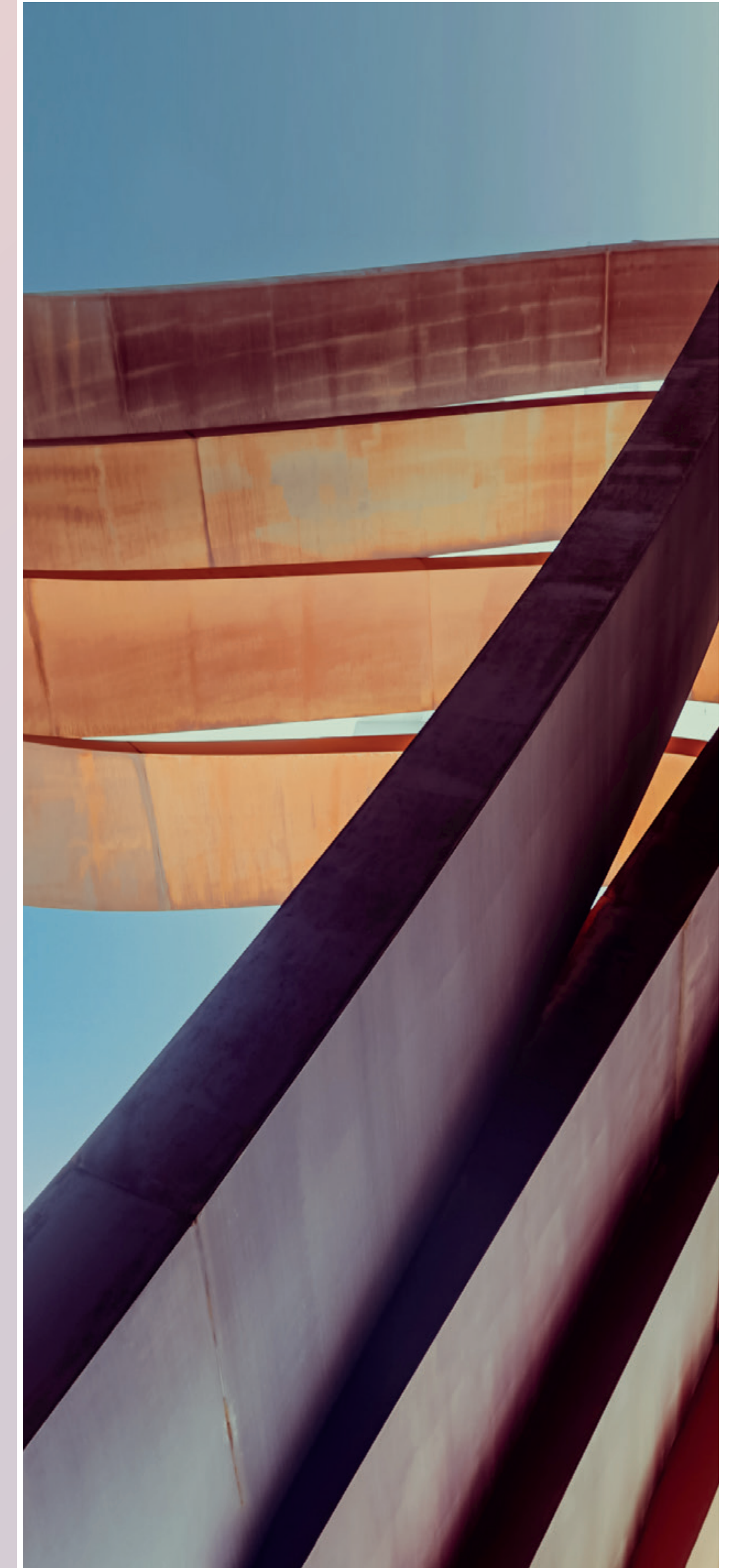
Whilst the partnership has been the common operating vehicle for legal practices, historically unincorporated partnerships and in more recent years LLPs, many firms now trade through limited companies.

A large number of limited company law firms will have transitioned from a partnership (or sole practitioner) at some point in the past, and whilst the 'day job' may have remained the same, the tax issues affecting the two types of entity are completely different.

Here we highlight a few of the tax aspects of limited companies that firms should be aware of.

- **Employment related securities rules**
  In general terms, these rules require transactions in the company's shares that involve employees or directors of the company to take place at market value, otherwise income tax and national insurance liabilities can arise for the seller or acquirer of the shares (and there could be a National Insurance liability for the company as well). Changes in profit sharing arrangements, as well as retirements and new partner appointments, frequently trigger these rules. Care needs to be taken to ensure unwanted tax charges are avoided, and planning early for shareholder changes is advisable.
- **Company purchase of own shares**
  Companies are able to acquire their own shares (for example, where a shareholder retires and sells their shares to the company), provided the acquisition satisfies the requirements of the Companies Act. The vendor will typically pay income tax on the payment received from the company, but where certain conditions are met the payment may be taxed as capital and subject to the more favourable capital gains tax regime. If the desired result is for the payment to be taxed as capital, it is advisable to obtain an advance tax clearance from HMRC.
- **Loans to employees and/or shareholders**
  Where an employee or director receives a loan that exceeds £10,000 and on which little or no interest is paid, a benefit in kind will arise that is taxable as employment income. Where a shareholder receives a loan from the company, there will generally be a corporation tax charge levied on the company that is repayable when the loan is cleared. The corporation tax charge is due irrespective of the amount of the loan or the payment of interest.
- **Personal expenses**
  Where the company pays personal expenses on behalf of an employee or director, or reimburses personal expenditure, a benefit in kind will generally arise. The benefit in kind may be avoided if the payment is treated as a loan, and if the individual in question is also a shareholder the loan might be cleared by declaring a dividend. In either case, the amount of expenses paid will ultimately be taxable on the individual, either as employment income or as dividend income.
- **Increased corporation tax rates**
  Prior to 1 April 2023 the corporation tax rate was 19% regardless of the level of the company's profits. From 1 April 2023, the rate increased to 25% for companies with profits exceeding £250,000. For companies with profits of no more than £50,000, the rate remains at 19%, and where profits fall between £50,000 and £250,000 an effective rate of 26.5% applies.
- **Enhanced capital allowances**
  Companies are able to claim an enhanced amount of tax relief on qualifying capital expenditure incurred between 1 April 2021 and 31 March 2023, prior to the increase in the corporation tax rate described above. Therefore, if you have incurred expenditure in this period, ensure the enhanced relief is claimed.
- **Timing of corporation tax payments**
  The company's corporation tax liability is due nine months and one day after the end of the accounting period where the taxable profit does not exceed £1.5m. For companies with taxable profits exceeding £1.5m, the liability is payable in quarterly instalments, with two payments being due within the financial year and two payments due after the end of the year. Where profits exceed £20m, all four instalments are due within the year. Growing practices therefore need to monitor their annual profits and plan their tax cashflow accordingly.
- **Associated companies**
  For corporation tax purposes, companies are associated if one company controls the other or both are under the control of the same person or group of persons. This is important for two reasons: (1) the profit limits for determining the rate of corporation tax are divided by the number of associated companies; and (2) the profit limits for determining whether quarterly instalments are required are also divided by the number of associated companies. Where practice owners have other shareholdings, it is important to determine whether any other companies are associated with the practice.

We can advise on the above tax implications for your practice, and ensure you do not fall foul of any of the rules specific to limited companies.



Thinking of changing your year end? Some important points to consider

In a previous edition of Legal Focus, we highlighted the need for sole practitioners and partnerships to consider a change of year end to 31 March where their annual accounts are not currently prepared to a date falling between 31 March and 5 April.

As a reminder, new rules were introduced with effect from 6 April 2023 that govern the way self-employed business profits are taxed, and require profits to be apportioned between tax years where the accounting period end is not the same as the tax year (i.e. 31 March or 5 April). So, a firm preparing its accounts to 30 April 2024 will apportion 340 days of profit to the 2023/24 tax year (1 May 2023 to 5 April 2024) and 25 days to the 2024/25 tax year (6 April 2024 to 30 April 2024). This requirement to apportion profits, which will add complexity to the calculation of tax liabilities and tax reserves, can be avoided by changing the accounting date to 31 March.

While the focus is naturally on the accounting and tax aspects of the changes, there are a number of non-tax factors to consider, and these might come with their own administrative challenges. Here are some of the issues that firms will need to think about:

- **Holiday year end –** Is this currently aligned to the accounting date and will it be changed?
- **Staff appraisals, pay reviews and bonus schemes –** Pay reviews and bonus schemes are often linked to the financial year, with appraisal timings structured accordingly.
- **Professional indemnity insurance –** Will the renewal date need to be changed, or will arrangements be impacted by a change of accounting date?
- **Solicitors Accounts Rules reporting period –** This could be changed so that it is in line with the new accounting date. However, it is also possible for the current reporting period, and therefore the reporting deadline, to be retained.
- **Linearity of profit and cash generated throughout the year –** Where fee income is not generated evenly throughout the year, a change of accounting date could change the pattern and timing of peaks and troughs, especially where there is normally a year end 'push' to get WIP billed and debts collected.
- **Overdraft facility –** This may also need to be reconsidered if there is a significant change to the firm's cashflow cycle. This is where robust and reliable cashflow forecasting is critical.
- **Workload of internal accounts team –** Changing the accounting date may change the team's pattern of work throughout the year.
- **Updating IT systems –** A number of systems, not just the accounting system, may need to be updated. Some accounting systems are able to handle extended or altered year ends easier than others, so engaging with software providers at an early stage is recommended.
- **VAT returns –** If the VAT quarters are currently aligned with the accounting date or staggered for cashflow purposes, the advantages and disadvantages of changing the timing will need to be considered.
- **Partnership agreement –** For Partnerships and LLPs, the partnership agreement may need to be revisited where it refers to a specific year end.
- **Notifying stakeholders –** Staff, banks, insurance providers, Companies House, HMRC and the SRA will need to be notified.

Whilst some of these points may be relatively minor, there are a number of factors to consider which may not be immediately apparent when considering a change of accounting date. If you would like to discuss any of the practical implications, please get in touch.

An audience with... Luke Dickinson

People are the essence of our Legal Team and, in this article, we get to know more about Luke Dickinson, SRA Accounts Rules Specialist.

WHAT DO YOU ENJOY MOST ABOUT YOUR ROLE?

I enjoy speaking to clients all over the country. I especially like visiting them and meeting with them in person.

WHAT WOULD PEOPLE NEVER GUESS YOU DO IN YOUR ROLE?

Whenever we have a new intake of trainees in our department, I will spend a couple of days training them and helping them with their first few days of working for Hazlewoods.

WHO HAS INSPIRED YOU WHEN IT COMES TO YOUR APPROACH TO WORK?

Andy Harris and Ian Johnson, who are Partners in our Legal Team, have both inspired me when doing presentations, either with clients or internally. Presenting and training are particular areas of interest for me, so watching these two amazing speakers has inspired me to do more training/presenting in front of clients and colleagues.

WHAT IS THE BEST CAREER LESSON YOU HAVE LEARNED SO FAR?

Always make time to speak to people, whether they are a client or colleague, getting to know people on a personal level always makes work life easier.

WHAT SHOULD CLIENTS BE CURRENTLY THINKING?

Technology, whether it is new automation software or new accounting software, firms should demand better products and should be prepared to take on new innovations.

HOW DO YOU SEE THE LEGAL TEAM CHANGING IN THE NEXT 10 YEARS?

I believe we will be providing a wider range of offerings, which will be in line with emerging technologies and related advice on them.

CAN YOU SHARE ANY INSIGHTS REGARDING THE CURRENT LEGAL SECTOR?

Currently, the landscape for Legal software is not as bright as we hoped, however we believe several firms are looking to change this and hopefully offer the sector something more.

WHAT IS THE BEST ADVICE YOU CAN GIVE TO SOMEONE JUST STARTING OUT IN THEIR CAREER?

Make loads of friends, work should not be just where you go every day. You will on average spend 40-50 years of your life working, so why not make it more enjoyable and make some friends along the way.

WHAT DO YOU LIKE DOING IN YOUR SPARE TIME?

I like to do track days and go karting. My friends and I often go for fuel filled weekends racing each other in anything with an engine.

HAVE YOU READ THE PREVIOUS EDITIONS OF OUR LEGAL FOCUS?

www.hazlewoods.co.uk/sectors/legal-accountants/legal-focus

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DRIVING LIFELONG PROSPERITY

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