PKF FRANCISCLARK

Chartered accountants & business advisers

Legal

Summer 2018

supporting you and your business

Welcome to our Summer newsletter focusing on topical issues affecting the legal sector

In this edition we cover a range of subjects including the continuing debate around trading structures in law firms and revisiting the question around whether a Limited Company or an LLP might be the most appropriate vehicle for a law firm to operate within.

We also consider the factors associated with planning for the retirement of an owner from a law firm business, provide an update on the Reporting Accountants' regime as well as exploring some of the signs of financial instability which appear to be creeping back into elements of the legal sector.

Within our own firm we are also pleased to welcome some new key members to the legal team across our firm reflecting the growth and investment we are making in our presence in the legal sector nationally.

We hope you find the newsletter helpful and informative. If you have any queries or want further details on any aspect then please get in touch with us.

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Checking out
a practical guide to partner exits

There are a number of reasons why 'partner' exit arrangements is a common agenda item for law firms these days. Firstly, we have the natural demographics of an ageing population amongst law firm owners; we also have the challenges of a competitive market place which means it is commonplace for law firm owners to be mobile during their careers.

Exiting a partnership (LLP or unincorporated partnership)

In most cases the practical issues regarding the repayment of balances to retiring partners will be outlined in the Partnership or Members' Agreement.

Many firms operate a financial structure whereby each partner holds a Current Account (undrawn allocated profits to date), Capital Account (long term contribution to funding the business) and a Tax Reserve.

Taking each of these in turn it is worth considering the common repayment arrangements on these amounts and practical issues arising:

a) Current Account

In most law firms, profit allocation in the year of retirement will be based on a full year of financial results; pro-rated where a partner retires part way though the financial year.

Most commonly, any balance on a current account will be paid out relatively swiftly to a retiring partner; typically within six months of either retirement or the accounts being approved.

Typically a period of three months after the accounts are approved is available for any partner to identify and require correction of a significant error that has been identified.

b) Capital Account

This is usually the largest balance to be repaid to partners on retirement and in most cases the repayment is prescribed in the Members' Agreement. The most common approach is for the balance on the capital account to be repaid within two years of retirement. Perhaps the most frequent arrangement we will see here is, say, four equal instalments; half yearly in arrears from the date of retirement.

The range of experience between firms in pretty limited; we rarely see capital accounts repaid within 12 months of retirement or in excess of 24 months.

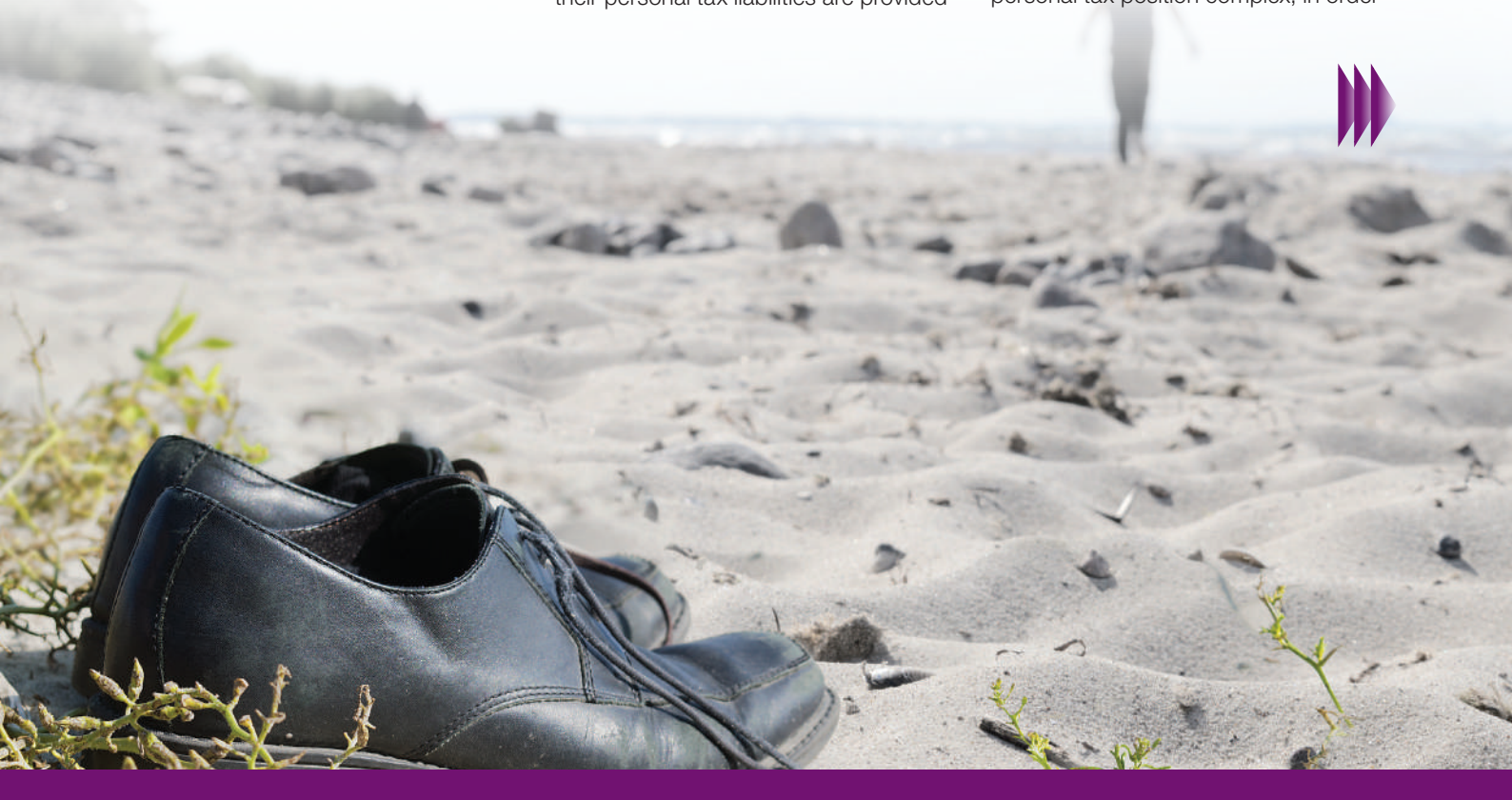
c) Tax Reserve

There is a good degree of variation in the policy which law firms adopt in making tax reserves for Members. This means that for a retiring Member it is crucial they understand the extent to which their personal tax liabilities are provided for, and in short, how much more money they may need to use from their Current Account above to top up the payments needed for tax in the year or so following their retirement from the LLP.

Increasingly, in many law firms we are seeing that Members Agreements will provide that the personal tax reserve is repayable to Members once the final or retirement Accounts are agreed. In practical terms the retired Member is responsible for organising all future payments to HMRC in respect of their past earnings in the partnership.

The alternative, and perhaps still dominant policy we see in firms, is that the taxation reserve is retained by the partnership and made available to Members to meet their tax liabilities as they fall due for payment post retirement. The key point here is that the maximum the law firm will ever pay out is the amount held in a partner's personal Tax Reserve. Ultimately, if this is not enough then the retired partner will still need to fund the gap.

Post retirement income and exit arrangements can make a partner's personal tax position complex; in order



to provide peace of mind in terms of cash flow, planning it is important for retiring partners and they need to consider this issue at an early point in their retirement plans.

Pitfalls for retiring partners to consider

The following are broadly centred around ensuring that, as a retiring partner you have been allocated the correct profits up to the date of retirement and that you also consider a range of practical personal issues:

- Valuation of accrued income and work in progress - whilst the valuations included in the accounts may be adequate and correct for accounting and tax purposes, there is potential for partners to consider whether they represent a fair value or whether they are understated. Whilst ability to influence the approach here by an individual Member may be constrained by the Members Agreement, there is often merit in reviewing the valuation approach - if the value is commercially understated by a significant amount then, in effect, the retiring partner will be giving up profit already earned and instead will be giving it to future partners in the firm.
- Reserves for subjective areas e.g. bad debts, claims provisions and dilapidations - the point here is similar to above except here, in effect, we are looking for instances where liabilities in the balance sheet are being overstated compared to the commercial position. For a retiring partner, if these liabilities are overstated when they leave the business then, in effect, their profits (and current account) will have been charged (understated) and this will never be recovered by the retiring partner unless specifically provided for in any retirement agreement with the partnership.
- Investments in subsidiary businesses - with more complex law firm group structures emerging in the post Legal Service Act landscape, there is more scope for retiring partners losing out on real value captured in subsidiary companies to the main partnership. Key issues for retiring partners to consider here is how they are compensated for any value in the retained reserves (profits) of subsidiary businesses, to what extent any goodwill valuation in such business should be recognised for them and, of course, considering their personal taxation position and planning for any tax costs arising.

Some more practical points to consider

- Tax planning for retirement date - a partner's personal tax position on retirement is often more complicated as a result of factors such as personal overlap profits, their future income from new activities after retirement and often exit deals agreed in the year of retirement. It is always important that partners who are retiring consider the formal date of their retirement in this context as this can in some circumstances have a significant impact on the rate of tax they pay and the timing of when tax liabilities arise from a cash flow viewpoint.
- Deed of retirement - an important document for obvious reasons to our legal readers! However, surprisingly something which in our experience is often not put in place. Key aspects that may well need to be covered in this document for the retiring member includes:
  - o any agreed exceptions to restrictive covenant clauses in the Members Agreement
  - o confirming the partnerships obligation to continue to maintain PII cover
  - o confirming the retiring partners rights to access information from the partnership
  - o any specific adjustments to assets or liabilities in the accounts taken into account in closing current or capital accounts
  - o confirming any rights to annuities or consultancy arrangements
- Retirement through death or critical illness - an event in law firms that happens more frequently than you might first think. Key points to consider here will include ensuring that any interest in an insurance payout is not taxable in the partnership as well as having clear policies on who owns the proceeds from any insurance policies to avoid disputes with the deceased members estate.

Pitfalls for the law firm to be alert to

In respect of the financial aspects mentioned above for a retiring member the reverse could be said for the law firm (and continuing partners). Spending time making sure the balance sheet is correctly valued is key here i.e. ensuring assets are not over valued and that liabilities are not under stated or completely excluded from the balance sheet will be a valuable process.

We still commonly see situations where liabilities are not properly recognised; this then becomes a cost for the future partners and the retiring partners escape their obligations.

Some other specific angles to consider during the retirement process include:

- Undertakings in respect of partner capital loans - ensuring the law firm does not breach these undertakings when repaying capital and other balances to retiring partners. Registers of undertakings and due process over repaying capital should mitigate the risks here.
- Overpaying tax reserves - where a partnership is continuing to retain the tax reserve and becomes accustom to making tax payments on behalf of the retired partner; we often see cases where the law firm inadvertently overpays the reserve and then needs to recover the cash from the retired partner. Simple payment controls should avoid this.

Exiting a law firm company

In the majority of cases owners from law firms will be retiring from a partnership or LLP. However, increasingly these days a Limited Company will be the core trading vehicle for the law firm business and there are some specific considerations.

A large amount of the comments above in respect of partnership retirements remain relevant for Limited Companies. However, the starting point here in terms of the rule book for retirement is likely to be the shareholders agreement.

The key issues such an agreement should cover would include:

- Repayment of any directors loan account balances
- Mechanism and valuation approach to the sale of shares

In general 'retiring' as a shareholder in a law firm can be a more complicated process than in a partnership. Taking advice at an early point on the specific issues is an important step for both parties to plan for.

Overall there is a good deal for retiring owners of law firms businesses to consider in the run up to 'checking out' There are also practical and risk areas for the law firm to consider during this process. Early planning by both parties before striking the 'exit deal' will often be key to ensuring all parties have a 'pleasant exit'.

If you would like to discuss retirement planning in your law firm business we would be pleased to discuss the issues with you in further detail.

Incorporation and law firms
the latest position

The core trading structure of a law firm remains a topical issue in the legal sector with most of those discussions circling around a combination of governance, investment and tax planning aspects.

Continued development of law firm businesses following the Legal Services Act and continued 'de-regulation' of the sector mean that the trading arrangements for many law firm businesses continue to be under review.

In this article we consider some of the key factors surrounding a law firm's decision as to when a company, as the core trading vehicle, may be a logical structure to operate.

When does a company structure work well for a law firm?

a) Retaining profits

Where a law firm earns profits and retains them in the business as a company the amount of Corporation Tax paid at this point is much lower than personal tax which is suffered instead in a partnership - broadly 19% Corporation Tax compared with up to say a marginal rate of at most 47% including National Insurance in an LLP.

This means a company operating in this way has considerably more cash to fund investment in the business itself e.g. funding IT development, funding lock up for absolute growth, and funding business acquisitions.

A common point that is often forgotten by many law firms is that further tax of some kind is ultimately payable when those profits are extracted by the shareholders from the company either in the form of salary, dividends or capital gain. So owners have to remember they are deferring tax not necessarily saving it!

b) Capital value on exit

Companies as a structure were originally designed with the concept of capital appreciation on investment. If the owners of a law firm are looking for a medium or long term exit by way of a capital sale then a company structure generally provides the best taxation and investment environment for this to take place.

c) Easing cash flow challenges (income tax holiday)

Incorporation from a partnership to a limited company will often provide a finite short term cash benefit to a law firm. This arises through the process of converting existing capital accounts in the partnership into retained reserves in the company.

In effect, the process means that there is a cash saving in the business over time arising from the difference in corporate tax rates and marginal Income Tax rates on the capital in the business. For example, the maximum cash flow benefit to a firm with say, £1 million of capital accounts during the first few years could be at most £280,000 (circa £1 million x 47% - 19%).

The extent of this cash benefit is limited (by reference to the absolute capital level in the business) however, for firms under severe cash flow difficulties, this short term cash flow benefit can be essential to survival.

d) External investment

A limited company is often more attractive to external investors. It is a more familiar structure for them, in broad terms is more regulated and controlled and of course as outlined above the original purpose of the limited company structure was to provide an environment in which external third party capital could be accessed by a business. There are also a number of tax regimes and benefits around companies which makes them an attractive structure for pure external investors and joint venture parties.

Overall; for those firms seeking joint ventures or equity investment, a company model can often be a more attractive vehicle.

When does a company structure present problems for a law firm?

1) Profits primarily extracted

Point a) above explains the tax deferral benefits of leaving profits behind in a law firm.

In most law firm businesses, however, most of the profits earned are extracted fairly quickly and not left in the business long term. Whilst perhaps inherently this is a problem with the partnership model the reality is that most partners in firms live on the profits they earn and want to withdraw them.

In a company scenario once those profits are withdrawn; the combined cost of the Corporation Tax and the Personal Tax on extraction usually means there is no tax benefit to the company structure and, in certain cases, it can actually be more expensive from a tax viewpoint than an LLP.

2) Employment related securities (ERS)

In a partnership, becoming a partner and moving from being an employee to self-employed for tax purposes is relatively straightforward and there are no hidden tax costs. In effect, an employer can give their employee the right to change their status and benefit from future profits in their business.

In a company, ownership can only be achieved by the employee receiving shares. If the employee does not pay the market value of these shares at that time, then under ERS rules they will usually be subject to income tax on the value of shares they have received (or at least on the extent to which the amount they have paid for them is less than market value).

Therefore, employees end up with a choice of either having to incur a tax liability on share values or pay market value for the shares themselves (implicitly involving some value for goodwill).

Whilst there are legitimate mechanisms to argue or repress the market value of such shares, or indeed put employee share options schemes in place, the main point is that the process is considerably more complicated than simply becoming a self-employed Member of an LLP. In a landscape of firms who continue to struggle to secure investment in firms by the next generation of law firm owners, this in itself is not an insignificant point.

3) Inflexibility on profit sharing

Within a company the allocation of profits being earned through dividend payment is usually the most tax efficient approach; the common structure of a minimal PAYE salary for partners and large dividend payments. The problem with implementing this approach is that without a range of different share classes there is relatively limited scope for variable profit sharing between owners.

Whilst multiple share classes are effective in a smaller law firm, this starts to become a difficult process to manage in larger firms. There is also always the impending risk that HMRC will take a stronger stance on such arrangements which to date has not been evident.

One has to keep in mind the planning approach of swapping self-employed income for dividends may work for the original partners who incorporate a partnership into a company but for future employees of the company who become shareholders the position is more complicated. HMRC challenging an employee who suddenly reduces their salary to swap it for dividends once they become a shareholder is a much higher risk in our experience.

4) Personal borrowing

A further challenge of receiving a large amount of income in the form of dividends is the ability to secure personal borrowing. Dividend income is often ignored by lenders for the purposes of personal mortgage borrowing, for example. Whilst the problem is not insurmountable there is usually less choice of lenders available and the cost of borrowing can be higher. Typically, this is less of a problem for owners who are older/later in their career with less personal debt but often challenging for future owners.

5) Partner capital loans

For partners joining a partnership there is usually a relatively easy process of securing a personal partner capital loan from a bank to fund their capital account in the partnership. For an incoming owner purchasing shares in a law firm company the ability to secure lending is more difficult; banks are unable to directly lend to finance the purchase of equity in companies.

Whilst funding can usually be secured in one form or another, this places another hurdle in the path of incoming future owners at a time when it is proving more challenging than ever to find individuals prepared to invest the time and energy into running a law firm business.

Common experience of company structures in law firms

The comments below summarise our typical experience of structures implemented in the legal sector today:

- Small firms (three or less owners/less than £1.5 million turnover)

Commonly, these will be Limited Companies; predominately because there will be some retirement planning angle to the owners retaining profits in the business. Succession in these businesses is less likely to come in the form of an employee taking on the shares and may, instead, either be a sale to third party, orderly winding up or some form of licensing of the name to a successor business.

- Medium firms (up to 20 partners/less than £15 million turnover)

Most frequently these will be partnership models with no other trading entities. They will be firms who generally draw most of their profits within 12 months of earning it; they will generally finance the balance sheet with a mixture of debt and partner capital and most of their future owners will generally be expected to come from their employee group.

Limited Companies are sometimes seen at this size but, in our experience, they can frequently be businesses that incorporated for some short term tax benefits and perhaps didn't fully appreciate the longer term problems that arise on succession, or perhaps needed to incorporate for survival from a cash flow perspective to take advantage of the income tax holiday outlined earlier.

These are perhaps sweeping statements because there are clearly company law firms operating within this structure for specific strategic reasons e.g. securing joint venture external capital, having a view to medium term capital sale, seeking a corporate governance model which they believe is only available in a company structure.

- Larger firms (over 20 partners and over £15 million turnover)

At this level the LLP remains the dominant core trading model in our experience. However, law firm businesses at this level have a lot of different activities and we would commonly expect, at this level and upwards, that the LLP may be used in conjunction with other Limited Company entities, either as a subsidiary, separate entity to the law firm or sometimes as a corporate member of the LLP.

Synopsis

The choice of trading structure in law firms remains a relevant and frequently discussed topic. There are clearly situations where a company can provide a very effective environment for a law firm to operate in. Equally, companies in isolation as a law firm model can often bring with them a degree of inflexibility and succession challenges that may be unwelcome.

In recent years we have seen many law firms incorporate as Limited Companies having been 'sold' some short term tax benefits to the partners at the time. These benefits soon evaporate and then leave the law firm (and future incoming partners) with longer term challenges that can arise for a firm operating in this structure. Incorporation decisions for most law firms should be considered as a long term commercial strategy - not a short term tax planning measure.

At PKF Francis Clark we continue to see a wide range of law firm structures being established; many of these are becoming more innovative for genuine commercial reasons and adapting to the modern legal sector. In volume terms, however, it is fair to say that most commonly in very small firms this trading structure is more likely to be a Limited Company. In law firms of more than a few partners, in contrast, the LLP dominates the landscape still and more frequently these days we see a core LLP with either a company subsidiary or separate company for a mixture of commercial and tax planning reasons.

Our legal sector team at PKF Francis Clark works everyday with law firms on structuring issues and would welcome the opportunity to discuss your particular business with you in more detail.

Bank reconciliations
a COFA's review checklist

We often see bank reconciliations where the COFA has diligently signed and dated the bottom of the reconciliation to evidence they have reviewed the reconciliation. When completing this sign off our experience tells us that it would be useful if the COFA considered the following points:

- If the SRA asked what I have done to review this reconciliation what would I say?
- If the SRA asked me to explain the reconciliation to them would I be able to?
- Have I done enough to discharge my obligations as a Manager and COFA in the firm?

The following may be a useful 'work programme' and checklist to help COFA's in their efforts to review bank reconciliations and to ensure they are more comfortable in answering the above questions.

1. Is the reconciliation a complete three way reconciliation?

Is there part of the reconciliation which compares the total of client ledger balances from a report generated by the practice management system (1) with the bank reconciliation balance i.e. the bank statement less outstanding items and lodgements (2) which is finally compared with the trial balance figure for the client account (3).

Many reconciliations only compare items (1) and (2); without (3) as well, this does not comply with the SRA recommended format for a full reconciliation.

2. Review of outstanding payments for cheques older than three months

Outstanding cheques over three months can be an indication of a number of problem areas including fraud, teeming and lading of client funds and also instances where client money is incorrectly being held on the office account.

Reviewing old outstanding payments to investigate the reason why the amount has not cleared is an important task for someone reviewing a reconciliation. Often the outcome will identify a breach of the SAR which can be corrected or prompt a fee earner to follow up the issue to prevent a breach arising in the future.

3. Review outstanding receipts which have not cleared promptly

Receipts that are genuinely banked clear quickly. Instances where this is not happening suggest some underlying issue that may require investigating.

For example it may be that delays are happening between monies being received and actually banked; it could in some instances represent misappropriation of other client funds on other matters which are being covered temporarily by amounts anticipated from other clients. It could also be evidence of fee earners taking risks with other client's money by covering transactions before amounts from the client concerned have actually been received.

4. Review outstanding bank transfers in and out which have not cleared promptly

Bank transfers genuinely completed rarely take more than a day to complete (save around weekends). Bank transfers that take notably longer than this can be indicative of transactions which have not actually taken place or ones where the transaction date differs to the date recorded in the client ledgers.

Again, investigating such instances is important because it can indicate a range of problems from; poor matter management, underlying breaches of the SAR or more significantly fraud and misappropriation of client funds.

5. Agreement of bank statement balance to the bank reconciliation

Simple checks of integrity to ensure the bank statement balance(s) being used in the reconciliation process is the actual balance per the bank statement and that they have been extracted at the same dates.

6. Cast of bank reconciliation

A physical check to ensure the reconciliation has not been manipulated in any way in transition as output from the Practice Management system to the final form reconciliation.

So a check to ensure that the bank statement balance less outstanding payments listed plus outstanding lodgements agrees with the reconciled bank balance shown on the bank reconciliation statement.

7. Agreement of client control account balance to matter listing report

Physical checks that the amounts recorded on the reconciliation does actually agree to the 'hard copy' or 'electronic copy' that is retained of the client matter listing.

It may also be appropriate from time to time to undertake a casting check of such matter listing reports to ensure there is not intermediate adjustments being made from the electronic output of the practice.

8. Agreement of client control account to trial balance

Physical checks that the amounts recorded on the reconciliation summary do actually agree to the 'hard copy' or 'electronic copy' that is retained of the trial balance.

Ensure that the matter balance and the trial balance reports have been extracted from the Practice Management System at the same date as the reconciliation statement is being prepared.

9. Review the client matter listing

A specific review of the matter listing for unusual items such as:

- overdrawn client ledgers (debit balances on client ledgers)
- client money on office ledgers (credit balances on office ledgers)
- suspense matters/general ledgers listed
- matters in the name of the firm
- matters in the name of partners

The above are some items in the matter listing which should alert the reviewer to potential areas of risk from a SAR breach viewpoint and potential misappropriation of client funds.

10. Review the reconciliation statement for unusual items

By definition it is difficult to be precise here but examples of what might be defined as unusual could include the following:

- adjusting items needed to make the reconciliation report balance
- very large outstanding payments that do not clear very shortly after the balance sheet dates

These types of instances require further enquiries by the COFA and can point to more significant problems in the reconciliation.

11. Review the office account reconciliation

The office reconciliation warrants a review by the COFA in its own right. In the context of client funds it is important to look at the office account reconciliation for a number of reasons.

A good example to illustrate this point is outstanding payments on office account; these can indicate instances where money has been transferred from client to office to cover expenses that the firm has not actually incurred on a clients' behalf.

In practical terms our experience over many years has been that we actually identify more frauds with client funds by careful review of the office reconciliation in the first place than through the client account.

A COFA should in our view insist on having the office reconciliation to review at the same time as reviewing the client funds reconciliation.

12. Monitor previous reconciliations

A more difficult procedure but in effect what you may be looking for here is trends across different months; for example outstanding payments or groups of outstanding payments which are recurrent in different reconciliations - not necessarily month by month but maybe with a month or so gap.

You may also be looking for recurring unadjusted differences or similarities in types of differences that can point to control deficiencies in managing client funds.

An experienced reviewer will start to be able to identify what looks 'normal' and 'abnormal' by undertaking these types of procedures on a regular basis.

COFA's live busy lives and it is all too easy for the review of the client funds reconciliation to be undertaken on a light touch basis. It is, however, a fundamental control in protecting client funds and discharging both the COFA's and all the Managers responsibility for the custody of client funds.

The above 'work programme' whilst unlikely to be comprehensive is a good starting point for COFA's in this process.

At PKF Francis Clark we have worked with a large number of law firms in developing their control systems around client fund reconciliations. If you would like an independent review of your own processes and approach in this area we would be pleased to provide our support and advice.

Accountants reports
past and future

In this article we reflect back on our own experience in Accountants Reports in 2017 and also provide some information from the SRA about the impact they have seen since the changes in regime that commenced back in 2014.

There have been three main phases in terms of changes in the reporting regime over recent years which can be summarised as follows:

Phase 1 (Oct 2014) - exemptions for certain LAA firms, unqualified reports not submitted

Phase 2 (Nov 2015) - new report, outcomes based, extended exemptions for report being required

Phase 3 (expected - 2018/2019) - new rules to come into effect

Before Phase 1 commenced around 10,000 reports were prepared each year; with the advent of exemptions for LAA and small balance firms this has now reduced to around 7,500. So in absolute terms the impact of phases 1 and 2 was significant in this respect.

To date however the most significant impact has been phase 2 and the move to RAs being required to exercise 'professional judgement' in their conclusions and reporting. From the RA's perspective this has changed the way we approach a good deal of our work and our general audit approach; from the SRA's perspective this change has reduced the volume of qualified reports submitted.

In broad terms before Phase 2; as a firm our statistics show that we typically qualified between 35% and 40% of the reports we completed for law firms. Since the implementation of Phase 2 combined with guidance issued by both the SRA and ICAEW this has reduced to between 10% and 15%. With further public guidance by the SRA on certain areas we expect this percentage may reduce further in the future.

Looking back to 2017 the most common reasons we experienced for the qualification of reports included:

- Provision of banking services.
- Residual balances not being returned to clients on completion of matters.
- Residual balances being transferred to office without notification of costs of disbursements to clients.
- Deficiencies in the reconciliation of client funds.
- Lack of underlying client accounting records.

The SRA have provided some initial analysis of their qualification experience and this is outlined in the table opposite:

Date reports received	Total number of qualified reports received	Reports referred	Reports referred as a percentage
June 2015 to November 2015	2,797	70	2.5%
June 2016 to November 2016	1,104	94	8.5%
January 2017 to July 2017	527	65	12.3%

Interestingly what the above trends are showing is that qualification rates have dropped from approximately 37% in 2015(*) to 15% by 2016(*) which the first full reporting dataset since phase 2 took effect. It seems likely this result could decline still further once the full 2017 year is analysed.

At the same time we can see that in 2016 the number of reports referred to further review actually increased slightly compared with 2015. The SRA sees this as evidence that the quality of reports being submitted is improving because volumes have declined (cutting administration costs for the SRA) whilst investigation rates have been maintained.

The SRA data suggests that investigation rates remain solid in respect of qualified reports and they have explained that where they receive a report action is taken as follows: either;

a) The report is reviewed and the SRA are satisfied no further action is needed, or;

b) The report is reviewed and followed up by desktop investigation (usually a call to the firm or RA), or;

c) The report is reviewed and a follow up investigation visit with the law firm is undertaken.

(assumes a total population of 7,500)*

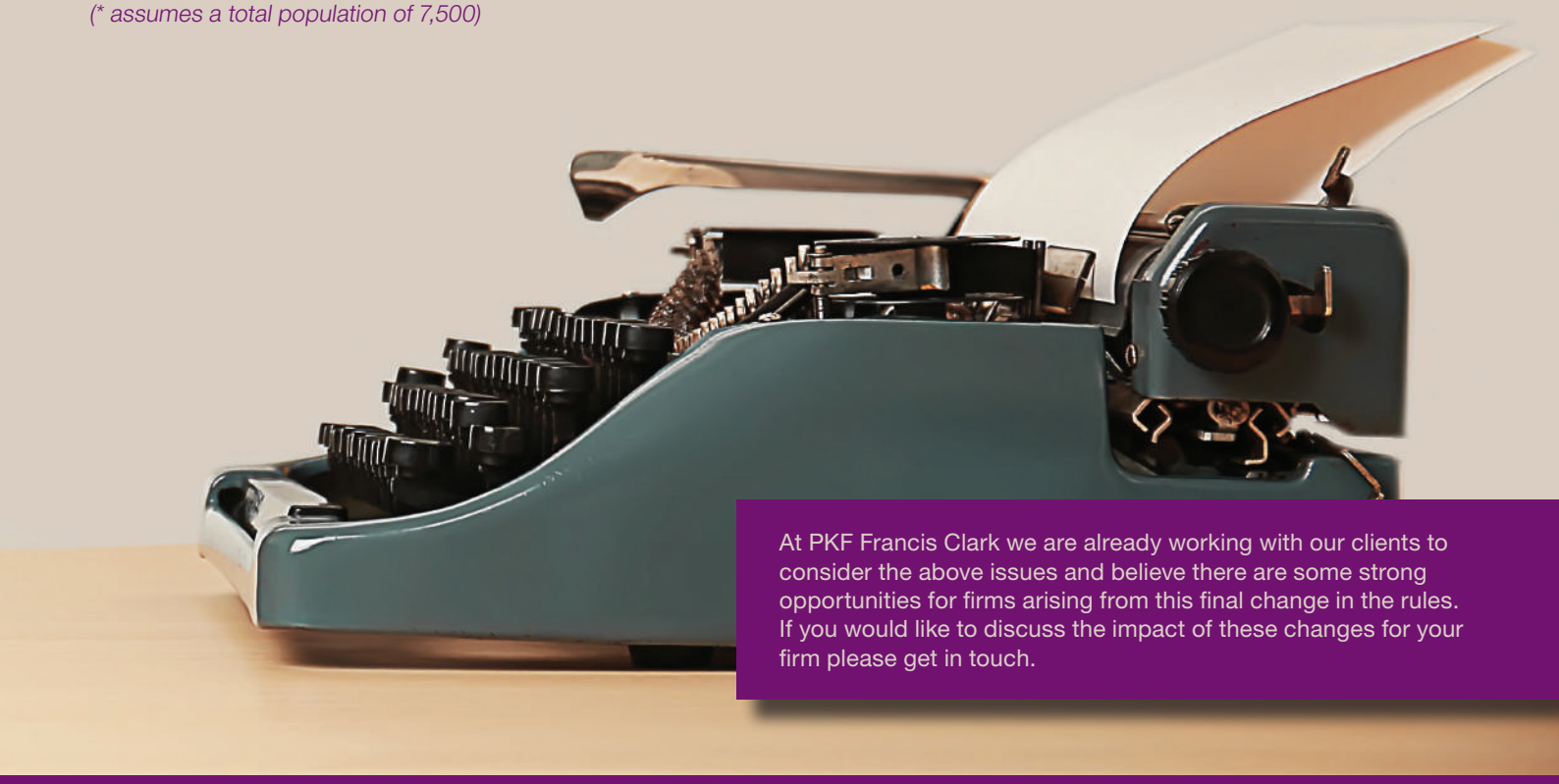
Looking forward; the final - Phase 3, which will see the implementation of the proposed new rules, is now anticipated either later during 2018 or early 2019. Whilst this is a very significant change in terms of the degree of detail within the rules it is not envisaged it will have a significant immediate impact for the majority of law firms.

There will, however, be a number of searching questions for law firms to consider when Phase 3 comes into force:

1) Are there any opportunities to deviate from the existing SAR which could be commercially beneficial for a law firm and/or better safeguard client funds?

2) Practically, how will law firms train incoming finance team members and fee earners when there is a risk that incoming individuals operated under different regimes in other firms?

3) At what point in the future will it no longer be acceptable to the SRA for a law firm to simply say “we follow the old SAR because the SRA deemed them appropriate”?



At PKF Francis Clark we are already working with our clients to consider the above issues and believe there are some strong opportunities for firms arising from this final change in the rules. If you would like to discuss the impact of these changes for your firm please get in touch.

Financial instability

A phrase that many of us will remember as the buzzwords from the SRA in 2007 to 2009; the time at which the last recession started to bite in many law firms.

Whilst it is true to say that the financial performance of the legal sector today remains significantly buoyant compared with that period, we have seen some early signs of instability creeping back into the sector, with some more potential challenges on the horizon.

In this article we briefly consider some of the sources of this instability and direct firms to some early actions they might consider taking to reduce the scope for problems developing.

1. Increased partner retirement rates

Challenge: demographics and to some extent less appetite from individuals to join law firms as equity partners is slowly producing a net outflow of cash. The momentum for this is growing because many partners delayed their retirements after the 2008 recession so there has been more 'bunching' of retirements in many firms.

Possible actions:

- **Earlier planning of partner retirement and appointments**
- **Capital funding model to give advance notice to partners of increased capital requirements**
- **Communication with external funders of overall business funding model**
- **Maintaining reliable management information to provide confidence to funding providers and partners of underlying profitability and sustainability.**

2. Higher volumes of CFA based work

Challenge: a wider range of work now operates with some degree of conditional fee compared with 2008. This is a trend which is likely to gain further momentum. This has a negative impact on cash flow in the business, even if sometimes it can be positive from a profit margin viewpoint.

Possible actions:

- **Controlling the mix of CFA work types with other cash generative work types in the firm**
- **Strong financial information to assess success rates and profitability of CFA matters**
- **Consideration of trading structure to finance lock up**
- **Early review of long term mix of balance sheet debt and equity**

3. Lower profit margins

Challenge: regulatory changes and increased competition in the sector have all contributed to declining margins in a range of mainstream work areas for law firms. Over time this has been reducing both gross and net profit levels in firms.

Possible actions:

- **Drawings need to be linked to profitability on a regular basis**
- **Work allocation - ensure appropriately skilled (and cost) staff undertake appropriate elements of work on individual client matters; move away from partner/fee earner 'ownership' of a matter**
- **Productivity focus chargeable hours and recovery rate focus at a fee earner level**
- **Process review consider the various types of work and consider where value and costs are added**

4. Investment in law firm businesses

Challenge: the need for law firms to invest to meet the changing market place and increased competition. The big cash investment areas are generally in IT and marketing in most firms. The cost of these investments can increase debt on the balance sheet and repress reported profits even though the cash demand from partners at a drawing level continues.

Possible actions:

- **Ensure there is appropriate future reward for partners giving up profits today for investment in the future**
- **Make sure appropriate debt is matched with appropriate spend - e.g. don't use an overdraft for fixed assets; use a medium term loan with amortisation periods in line with depreciation write down levels in the financial accounts**
- **Where significant profit retention is required to support investment consider whether a limited company within the trading structure might be part of the solution**

5. Better informed lenders

Challenge: lenders continue to have an appetite for the legal sector but in our experience it is more volatile than ten years ago. They are quicker to make decisions and form policy views and they understand the information they need from law firms much better. For law firms this presents a more volatile position but one which can be managed.

Possible actions:

- **Reliable, relevant and regular management information for third party lenders (monthly)**
- **Full financial forecasts; monitored against actual on a monthly basis**
- **A clear plan on business debt versus partner equity levels**
- **Sensitivity analysis of business plans and projections**
- **Demonstration of partner/owner commitment to the business**

There is no doubt that the legal sector financial performance remains buoyant compared with 2007 and subsequent years. However, the sector is facing some different challenges in 2018 and in our experience we have seen the cracks start to show in some areas of the sector. Early action by firms to address those challenges will place them in a stronger position for the future.

Our legal sector team at PKF Francis Clark works closely with a range of law firms to help them with areas such as financial management, profit improvement and strategic planning. If you would like to discuss the future of your firm with us please get in touch.

PKF Francis Clark legal sector team grows

We are delighted to see the continuing growth of specialists in our legal sector team at PKF Francis Clark with the promotion of three key members to new positions.

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Jason Mitchell, a long standing and well known adviser to our law firm clients became a partner in our firm in 2017. Jason continues to develop his reputation in the legal sector within our firm and nationally through his work with our clients and contribution to national publications including the ILFM and ICAEW newsletters.

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James Barrett has been appointed as Partner and **Sonia Fisher** has been promoted to Director at PKF Francis Clark; they both work day-to-day with our legal sector clients in a range of areas including taxation, compliance and consultancy support.

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If you would like to be added to, or deleted from our mailing list, please contact Peter Finnie, peter.finnie@pkf-francisclark.co.uk or sign up online at:

www.pkf-francisclark.co.uk

PKF FRANCISCLARK

Chartered accountants & business advisers