

BACK TO BASICS IN THESE CHALLENGING TIMES

The whole legal sector is experiencing the difficulties that arise out of an economic climate where demand for core services is reduced, clients are reluctant to incur and pay fees and want to pay less for advice generally. We therefore thought it worthwhile to revisit a topic covered in a previous edition of LegalPlus News – management of working capital.

With new engagements in short supply, we should focus on releasing the assets that already sit in the balance sheet - work in progress and debtors, together with adopting good working practices generally.

Let's start with an equation:-

- High productive time + low Work In Progress (WIP) + quick collection = low lock-up

All those involved in a professional practice will recognise this as an indicator of a well run practice.

Certainly high productive time is a challenge but given the reductions in head count at many firms this should return to previous levels.

Lock-up commences upon the first charging of time (assuming time recording) to a client's case ledger all the way through to collection of the fee levied.

An effective well-run practice would maintain relatively low levels of lock-up by:-

- interim billing;
- timely billing at the conclusion of a matter; and
- effective and quick collection of fees/costs.

Other practices experiencing drop in profits, drawings and cash availability are typically:-

- not charging time to the ledger;
- writing off a large percentage of WIP upon billing; and
- writing off bad debts.

One would hope that the Finance Partner (or Director) would spot these practices and cease these inefficient working methods, which can be prevalent, as mentioned, in low profit Practices.

In present times, a Partner's low chargeability can be accepted in the short-term providing that the time is being put to good use, i.e. business development and generating additional revenue streams of profitable work.



It should be noted that to provide general benchmark figures for the level of lock-up would be irresponsible given the wide-ranging areas of law that the readers will be practicing. For example, Clinical Negligence will have a considerably different benchmark for the constituents of lock-up than work on a conveyance or a MBO.

WHAT SHOULD BE MEASURED

Each individual fee earner, partner and department should have a target of lock-up days. The equation would be:-

$$\frac{\text{Work In Progress} + \text{Debtors}}{\text{Annual Fees}} \times 365 \text{ days} = \text{lock-up days}$$

As indicated this will vary from each area of law that firms offer and individual fee earners practice.

The reason for suggesting a "Days" measure rather than an absolute figure is that the quantum of lock-up can be misleading and lead to incorrect assumptions, for example:-

	Total Lock-up	Total Annual Fees
Partner A	£100,000	£200,000
Partner B	£300,000	£900,000

Partner A despite only having lock-up of a third of Partner B has lock-up days of 182 days compared to Partner B's lock-up days of 122 days.

This is not to suggest that quantum of lock-up is ignored but the focus of concern would appear to be with Partner A whilst perhaps having a consideration to the ageing profile of WIP and Debtors of both partners as part of ongoing Finance Department controls.

STRONG CONTROLS (OR NOT?!)

Again, this indicates further the requirement for a solid internal control function and a Finance Partner with the authority to question each and every partner as to his or her portfolio's performance.

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Residual Client Account Balances – An update two years on

It's now over a year since The Solicitors' Accounts (Residual Client Account Balances) Amendment Rules 2008 were implemented with effect from 14 July 2008.

If you have not had a visit from The Solicitors Regulation Authority monitoring unit recently, be warned. From our understanding of recent monitoring visits it would appear how firms are dealing with old balances and ensuring they have systems in place to ensure compliance with the new accounts rules is a hot topic.

Many firms have not yet fully adopted the rules, so to assist our legal clients and contacts the LegalPlus team have provided a summary of the Rule amendments and practical advice to assist you in dealing with the changes.

RETURNING SURPLUS CLIENT MONEY

Rule 15(3) has imposed a specific obligation to return client money promptly as soon as there is no longer any proper reason to retain the funds. "Promptly" is not defined but should be given its natural meaning in the particular circumstances - see new note (x) to rule 15. Rule 15(3) does not apply to the return of surplus funds whilst a matter is ongoing - see new note (xi).

Our advice would be to ensure that all fee earners are fully aware of the rule change as they will be best placed to ensure client monies are returned promptly.

REPORTING TO CLIENTS

Rule 15(4) requires a solicitor to inform a client promptly of the amount of any funds retained at the end of a matter, and the reason

for that retention. This rule introduced an obligation to report in writing to the client on at least an annual basis if funds continue to be retained, with an explanation for the ongoing retention.

Our advice would again be for the fee earner responsible for the client to inform the client of any client monies retained, and the reason for that retention.

The obligation to write to all clients on at least an annual basis where clients' monies continue to be held may be better dealt with on a global basis perhaps by the legal cashiers.

LEFT OVER BALANCES

Under an amended Rule 22, solicitors have the option to withdraw from client account left over balances of £50 or less without prior SRA authorisation, subject to paying the balances to a charity and complying with the other safeguards set out in a new rule 22(2A). Prior SRA authorisation continues to be required for amounts exceeding £50, or for amounts not to be paid to a charity because, for example, they represent costs - see notes (viii) and (viiiia) to rule 22.

Many firms have a number of small old balances on their ledgers, some going back to pre-computerisation. The old rules never worked particularly well, especially when firms had a large number of very small balances which were not cost effective to trace.

The new rules give firms an option to withdraw from client account left over balances of £50 or less without SRA

authorisation. However, Rule 22(2A) must be followed i.e. the solicitor must make reasonable attempts to establish the identity of the client and to have returned client money unless the reasonable costs of doing so are excessive, to pay the funds to a charity and to keep proper records of any monies paid out. We have a checklist for firms to follow, if you would like a copy please contact your local LegalPlus representative.

PROCEDURES AND SYSTEMS

Paragraph 2.1 of the Guidelines for Accounting Procedures and Systems in Appendix 3 of SAR states that policies and systems should be established to ensure that the firm complies fully with the Rules. Solicitors wishing to deal with left over balances of £50 or less, without prior SRA authorisation, need to set up appropriate internal procedures and systems to ensure compliance with the new provisions of rule 22.

New paragraphs 4.6 and 4.7 of the Guidelines state that policies and systems should be established for the timely closure of files and prompt accounting for surplus balances, and for reporting to clients when funds are retained.

Firms need to review policies and systems to ensure all staff and partners are aware of the changes to the rules which became effective from 14 July 2008 and the actions they should be taking.

For the full SRA article and rule amendments please refer to www.sra.org.uk/accounts-rules

Increase in tax rates – what options are available?

It has been well publicised that the rate of tax on an individual's income in excess of £150,000 will be at 50%. A lesser known fact is that one year later the rate of national insurance will increase to 10% giving a marginal rate of tax at that level of 52%. In addition when an individual has income of between £100,000 and £112,950 there is actually an effective tax rate of 60% (or 62%) next year.

We are aware there are a number of options that maybe available to mitigate or at least defer the impact of the tax changes. We have spent a considerable amount of time looking at the various alternatives for our clients.

This article aims to give you an indication of the main planning areas that should be considered when considering the options for the future:

1. CHANGE OF YEAR END

For partnerships and limited liability partnerships with a 31 March or 5 April year end there is no need to read any further. For those partnerships with other accounting reference dates there could be some merit in changing the year end the partnership prepares its accounts to. The reason for this is that a change of year end could give rise to some overlap relief (the element of double taxation when the partnership first started) and could also more closely align the tax payments to the earning of profits.

In many examples that we have seen, where profits are rising year on year, it is still probably beneficial to maintain the current accounting reference date but it is worthwhile keeping under review nonetheless. If we expect tax rates to drop at some point then it might be worth looking at this during the period when the rates drop.

2. INCORPORATION OF THE PARTNERSHIP

This is a very dramatic move and will inevitably involve a considerable amount of upheaval. For some partnerships the time could be right to transfer the entire business into a new limited company.

The transfer would trigger a capital gains tax charge on the disposal of the goodwill of the existing practice to the company which could then give rise to a large balance that may be drawn out without incurring a further tax charge in the future.

There are a number of issues to consider with incorporation including the fact that the business would need to value goodwill in perpetuity and thus the transmission of

shares between incoming and outgoing members will become more expensive in the future. The flexibility of existing partnership arrangements would be lost.

3. INTRODUCTION OF A CORPORATE PARTNER

Some partnerships have considered introducing a separate corporate partner as a "dummy" member of the partnership. In outline this would involve a proportion of the profits in the partnership being allocated to that corporate partner and tax being paid in the company by the corporate partner of between 21% and 28%. Our understanding is that since this is a transfer of an assets between connected parties, the usual partnership exemptions for capital gains tax will not apply and thus the value of the goodwill the corporate partner takes on would be a deemed disposal by each of the partners of the Practice. This disposal would be without receipt of any funds and thus could be relatively costly to the individual partners. This corporate partner must look and feel like a genuine partner in practice and so arrangements where profits are retained in the partnership in perpetuity could be construed by HM Revenue & Customs as indicating some form of artificiality. If firms were considering this as a possibility we would recommend extreme caution.

4. SERVICE COMPANY

Those of us old enough to remember profit related pay will know that many professional practices incorporated a company to employ their staff in order to take advantage of the tax breaks available under these profit related pay. These provisions were phased out over a decade ago but the principles of moving staff into a separate service company still hold true.

The idea here would be that the staff (and probably also overhead costs) would be transferred down to a separate service company which operates the administration and support of the Practice. The service company should then charge the Practice a fee plus a mark up for profit that the company needs to make. It is that mark up that effectively creates a tax deduction in the partnership and taxable profit in the



company. The company will pay tax of between 21% and 28% and the partnership (based on the above) at up to 52%. Accordingly there is a tax saving on the difference although this is in effect only a tax deferral. If at some point in the future the company is closed then any surplus profits would be able to be distributed by way of capital distribution thus obtaining a tax saving.

There are some significant opportunities for tax deferral by using companies in partnerships structures. In certain circumstances there could be some significant savings as well. It is important that you seek tax advice that is specific to your circumstances before progressing with any planning such as this and therefore we invite you to contact your normal Menzies relationship Partner.

These articles have been prepared as a guide to topics of current financial and business interest. We strongly recommend that you take professional advice before making decisions on matters discussed here. No responsibility for any loss to any person acting or refraining from acting as a result of this publication can be accepted by us.

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Just when pension funding was supposed to get easy...

In 2006 radical changes were made to Pensions legislation making it easier to understand for all. The Finance Act 2009 has effectively thrown out this simplification and added in a great deal of complexity.

However, what it has thrown open are a number of planning opportunities particularly for those earning near to or in excess of £100,000. At the other end of the scale it has created a significant amount of complexity for anybody whose total income in any of the last three years exceeded £150,000. The latter affecting the level of higher rate tax relief that is available on pension contributions moving forward.

The whole area is extremely complex and complicated.

We would urge anybody looking to make a substantial pension contribution to seek professional advice in respect of their financial planning to ensure that the most tax efficient solutions are achieved.

If you would like to know more about Wealth Management please call us on 01784 497100 or email us at advice@menzieswm.co.uk
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How do you compare?

Did you know that the LegalPlus Benchmark includes over 150 firms of solicitors each year? The data for the 2009 year ends has just been collated and as you may have anticipated, the average results have slipped from the levels of 2008.

The headline figures include:	2009	2008
Net profit per equity partner	£89,388	£118,159
Net profit percentage	22%	25%
Average capital invested per partner	£122,972	£162,282

Each of the LegalPlus member firms has access to the benchmark which includes a whole range of relevant statistics. We are able to compare your detailed results to the benchmark in order to help to improve your business. If you would like us to benchmark your firm, please contact your local LegalPlus representative.

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It is worth a reminder that poor lock-up leads ultimately to slower cash collection and therefore, at best, lower drawings and worst, demands for further capital injections. Many firms are experiencing this already, so urgent attention is required.

Poor lock-up especially when combined with ineffective partner or firm-wide working practices will have a drastic effect on your practice.

WHAT TO DO

The following pointers may well already be in place in your practice (but even if they are, are they enforced?):-

- A strong Finance Partner ensuring that good procedures are actually followed. The threat of reduced drawings for a month or two often has an effect!
- Lock-up day targets.
- Ageing profile of WIP and debtors, 90 days+ column to be no more than (say) 20%, or other appropriate benchmark percentage.

- Billing targets – not just annual, but monthly. The “annual biller” is the partner who does (say) 80% of his billings in the last 20% of the year. This does not assist cash flow in the middle part of your financial year.
- WIP write-off targets – control of recoverability.
- Collection targets of bills raised; use a credit control function if fee earners appear uncomfortable with this role – it often pays for itself!
- Assessment of support staff vs. fee earner ratios. Very crucial when fees are reducing.
- External comment and review. A presentation by your Accountants reminding everyone concerned of the Key Performance Indicators has been useful for many clients.

Should you require any assistance with your lock-up, or financial control, contact your relationship Partner or LegalPlus representative.



If you have any queries or would like to discuss any of the issues raised in this newsletter, please contact your Menzies partner or one of the LegalPlus representatives listed below.

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