Winter 2018

Kingston Smith

Your potential, our expertise

Professional Firms Insight

In this issue:

Welcome to the winter 2018 edition of Professional Firms Insight.

Looking back over 2018, Brexit has remained at the forefront of the political agenda and its decision making process continues to drive uncertainty in the UK economy. As we go to print, Theresa May has taken the decision to delay putting her Brexit deal to a vote by Parliament, fearing a devastating defeat and is now returning to Brussels to attempt to renegotiate the deal, at the same time as contesting a vote of no confidence! Although it may take months, or even years to understand the true implications of Brexit, economic forecasters are predicting a period of low growth in the UK economy. Profits across the sector have been largely flat and growth in business volumes has slowed down. This has contributed to a decline in optimism regarding the general business situation. While day-to-day business operations have seemingly remained the same as before, firms are preparing for leaner times ahead.

Although business expansion has taken an expected hit, professional firms continue to invest in people and their workforce, with numbers employed growing at a steady pace. Employee engagement has become an important factor in improving revenues, productivity, retention and profitability. Our suggestions on how to achieve good levels of employee engagement will be discussed in this edition. Trends within the legal sector in particular are looked at, analysing how law firms have fared throughout the year.

As benefactors at this year's London Festival of Architecture, our Head of Architects, Jamie Sherman shares the team's experience at the various events held across the capital. From open studios to inspirational lectures, the team gained valuable insights. Following on from our summer 2018 edition, we provide an update on changes to the SRA Accounts Rules and suggest how our law firm clients and contacts can prepare for any changes to the existing rules.

Finally, alternatives to pensions for professionals and their clients are weighed up by David Hume, one of our Kingston Smith Financial Advisers. Individual savings accounts (ISAs), Venture Capital Trusts (VCTs), Enterprise Investment Schemes (EIS) and Seed Enterprise Investment Schemes (SEIS) are explored as some of the options clients can invest in.

I hope you enjoy reading this edition of Professional Firms Insight. Our team are always on hand to help and welcome any feedback or questions you may have.

Wishing all our professional firms clients and contacts a Merry Christmas and a happy and prosperous New Year!

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Employee engagement

As Richard Branson once said, “take care of your employees, and they’ll take care of your business. It is as simple as that. Healthy, engaged employees are your top competitive advantage.” This is extremely pertinent amongst professional services firms; having engaged employees that are all working towards common goals will improve revenues, productivity, retention and ultimately profitability, not to mention making the office environment more enjoyable for all!

An engaged workforce is usually based on trust, integrity, two way commitment and communication between the firm and employees. In turn, this will generally result in loyalty and better advocacy from your employees as more champions of the firm are created.

It is clear that employee engagement matters.

So, the key question becomes how do you achieve good levels of employee engagement and ultimately that competitive advantage?

Firstly, you need to assess the current situation. The easiest way to understand your current engagement levels and ways to improve this is through a structured employee engagement survey. A survey will only be effective if conducted anonymously and results can be aggregated to enable you to identify the critical areas where there is room for improvement, meaning you can focus your attention on the few key areas that will provide enhanced levels of engagement from employees.

The message to employees is key; the survey is being conducted as a drive to improve engagement levels and the firm must act on the outcomes. Examples of areas identified by the sample could be agile working practices, a need to modify your appraisal process or simply providing more social functions for employees. Communication with employees on this matter is an on-going process; firms must ensure that the results and key outcomes are communicated regularly. Publishing the results to the whole firm is critical to ensure the process can be repeated and benchmarked moving forward.

Indeed, the key point here for professional practices is that this should be considered as one of your key performance indicators (KPIs) and you can actively illustrate the improvements in engagement levels year on year.

The cost of obtaining key insights from employees is relatively low, especially when compared with the benefits. Indeed, the total cost to a firm may well be less than the

recruitment fee for one new employee, so the improvement to retention rates alone could cover the cost of the survey.

A common hot topic for many professional firms is succession and identifying appropriate strategies to take the business forward. Employee engagement is critical to any succession. If it is the case that the current employees will take the business forward as the future owners, be it as partners/shareholders or even as a collective through an employee ownership trust (which is becoming increasingly popular as a succession mechanism among professional firms), keeping the best talent engaged is crucial. If succession is to be achieved through a trade sale, having a fully engaged workforce will only enhance the enterprise value achieved on an exit. Being able to illustrate the annual survey results and improvements over time will most definitely help any sale process.

With the new age of millennial employees generally demanding more, whilst seemingly not being afraid to jump ship, improving engagement levels and subsequently retention rates will definitely be a sound investment and one that should lead to improved profitability for professional firms.

Insights into law firm performance

2017/18 has been a mixed year for legal practices. Whilst some practices have been very successful, the economic climate remains uncertain for most and we are seeing larger numbers experiencing financial difficulties. With Brexit on the horizon, the continuing uncertain environment remains challenging for the UK legal sector, with many of the larger firms having Brexit committees in place to deal with the forthcoming changes.

Key trends we have witnessed in the last 12 months and reported in NatWest's 2018 legal benchmarking survey can be summarised as follows:

- Fee income per equity partner has decreased from £884,000 in 2016/17 to £679,000 in 2017/18;
- Fee income per fee earner has fallen from £136,000 in 2016/17 to £132,000 in 2017/18.

A factor behind the decline in fee income per fee earner is due to increasing staff numbers, following investment by a large number of firms. The decline is also surprising given that fee income being generated by firms is continuing to rise and therefore suggests that firms are too quick to recruit to cope with this increase in work, rather than thinking about how the productivity of existing staff could be improved. With increasing use of new technology, the legal sector should perhaps be considering a reduction in headcount in the future.

Profits have also suffered in the year, with profit per equity partner reducing for a large number of firms. This highlights the need to concentrate on efficiencies and possibly the use of technology. NatWest's 2018 legal benchmarking survey reports the median profit per equity partner in London & South East at £143,000. Unsurprisingly, there is a large regional variance in the best performing firms with the upper quartile figure for profits

per equity partner in London & South East reported at £338,000, almost twice the figure for that in Wales and the Midlands of £151,000.

Firms continue with the struggle to reduce lock-up. In their 2018 legal benchmarking survey, NatWest report a median lock-up of 101 days, a reduction on last year's number by four days. Although this does show an improvement, the survey reports that law firms fail to manage lock-up effectively and continue to take too long to collect cash from the time that the work is delivered. By failing to improve lock-up procedures, many firms experience an adverse impact on financing and cash resource, in some cases resulting in borrowing facilities being extended.

Conversations with our own clients and contacts confirm that almost all view new technology as both the key challenge and opportunity facing the legal sector over the coming years. Firms that have invested in technology are benefiting from efficiencies, while others who are slow to embrace innovation or not leveraging technology effectively struggle to gain competitive advantage.

It is still worth noting that the need to retain key talent continues to cause concern in the sector and remains a challenge for many firms. Salaries are continuing to increase, however employee wellbeing should not be ignored and firms need to think beyond financial reward, offering the flexibility lawyers are looking for from their roles (please see our article on "Employee engagement" in this edition of PFI).

Despite the seemingly difficult environment, it would appear most lawyers are positive about the future outlook for the sector.

The London Festival of Architecture

by Jamie Sherman

So it turns out architects have more fun than I realised! When Kingston Smith agreed to be a part of the London Festival of Architecture (LFA) for the first time, most of our architects' team thought we would be attending events to gain some useful insight into the current landscape of London architecture - and meet some new, friendly faces in the process. While the festival did achieve this (and hi to all of you that I met during the festival), we also found that we were having lots of fun attending the diverse range

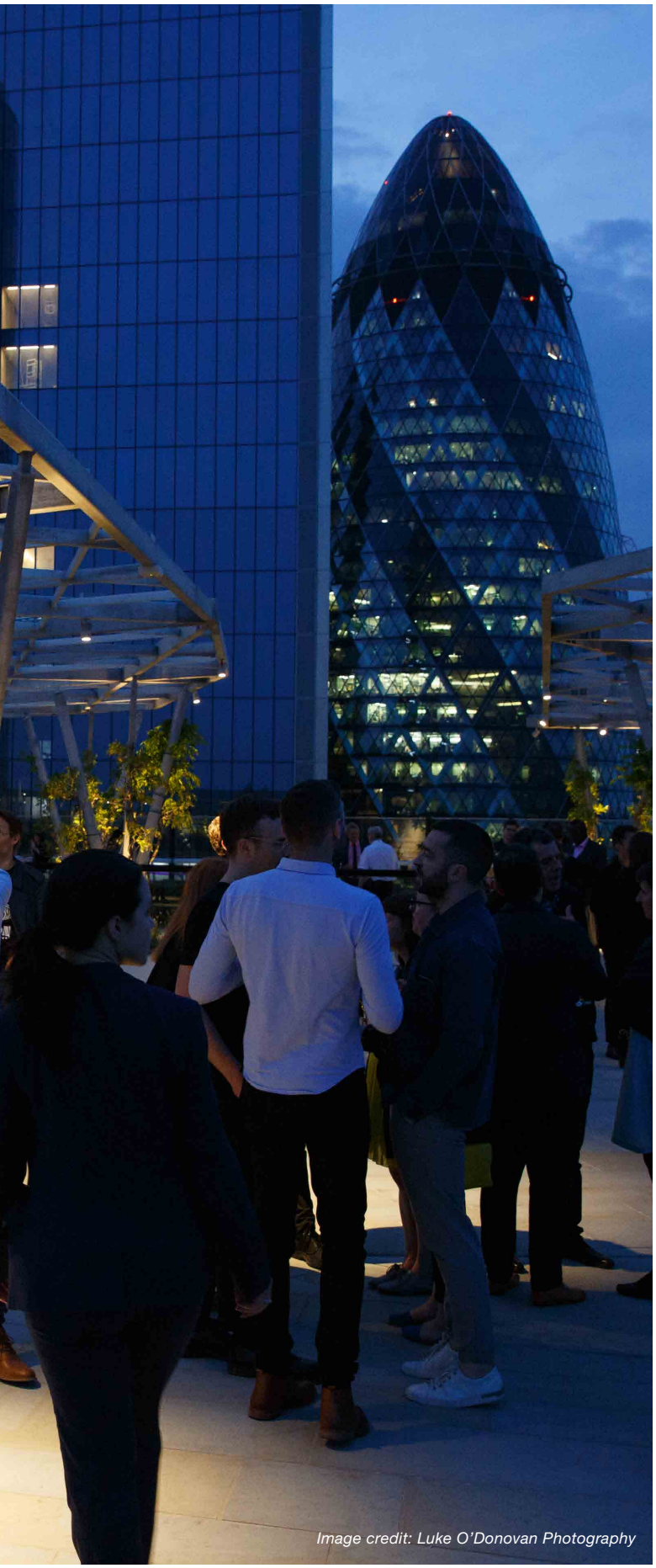


Image credit: Luke O'Donovan Photography

of events. From open studios showcasing some fantastic projects to lectures about architects' inspiration for certain designs (including architectural greats Sou Fujimoto and Mary Duggan), the festival certainly did not disappoint.

I think it is fair to say that creative architecture remains at the heart of the capital.

It all started for us with a whistle-stop visit to the open studio of David Morley Architects. By introducing us to some of their projects, including the Sports Hub in Warwick and the Nursery Pavilion at Lords, David Morley provided a fascinating insight into the challenges they faced with the designs. David's passion was clear to see and it was great to hear first-hand how such high-class facilities were designed. Thanks to the team at David Morley Architects for a cracking start!

> ***"We loved the opportunity to host so many clients, consultants and members of the public to show them what we are up to and how we have addressed the theme of this year's London Festival of Architecture – 'identity'. In my view, it has to begin with people and that's something all our projects address. It is also about context, both historical and physical and this is so important to London, where the character of an amalgamation of distinct villages is increasingly under threat. In our exhibition, we have shown how projects emerge from an initial sketch to a completed project to make a human impact, each with an identity generated by the people they serve, their historical, physical and cultural context."***
>
> *– David Morley*

Next stop: the LFA opening party at the newly opened Fen Court building. Well, what a view! The rooftop garden offers stunning views over London and I have to say the design is quite spectacular! Hats off to Eric Parry Architects for the brilliant, unique design and a truly inspiring open rooftop garden space in the heart of the City. Make sure you pay it a visit to see the fantastic views of London.

Perhaps the most impactful story I heard at the LFA was that of Mary Duggan. Mary is a hugely successful architect and she shared details with us of some of the marvellous projects that she has been involved in over the years, both while part of Duggan Morris Architects and more recently with her own practice, Mary Duggan Architects. While the stories behind the design were insightful and interesting, it was Mary's journey through architecture that really inspired the audience (well certainly me).

Mary described how the partnership she had helped build over the years had become a sizeable business and, while most would relish such growth, Mary had missed the day-to-day work as a project architect. She told us how she

The London Festival of Architecture

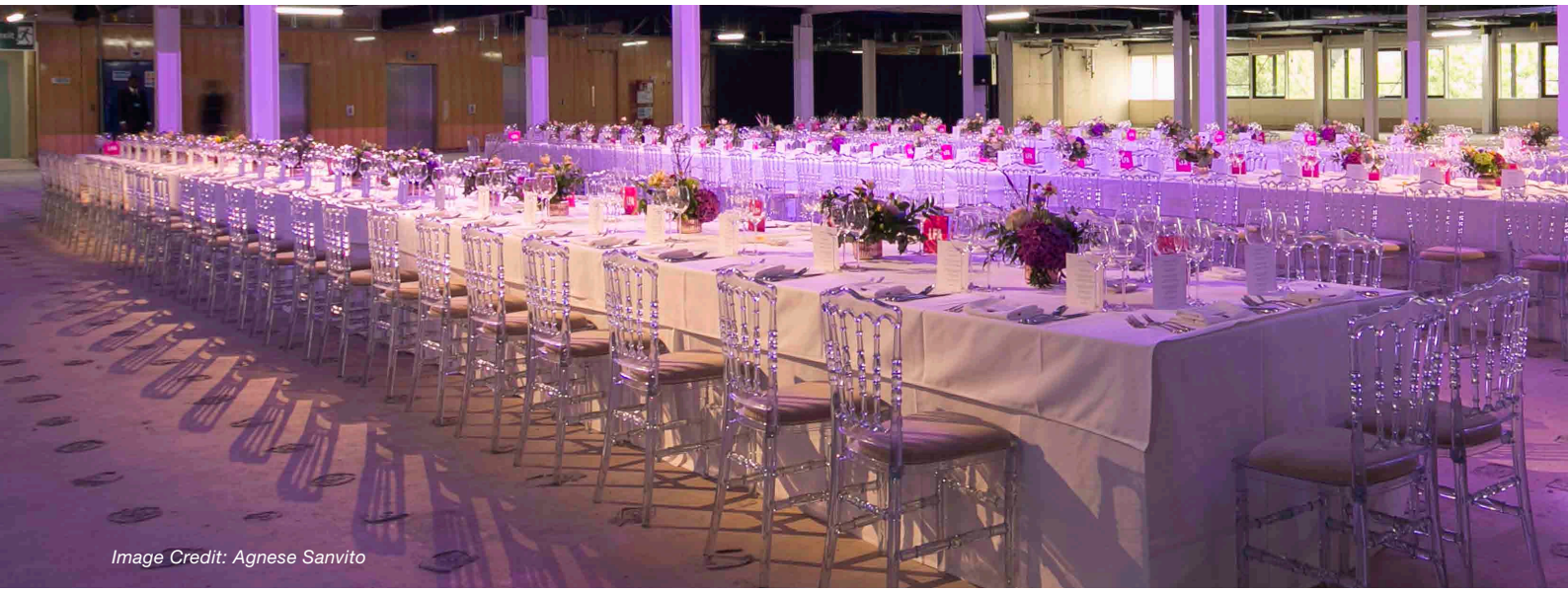


Image Credit: Agnese Sanvito

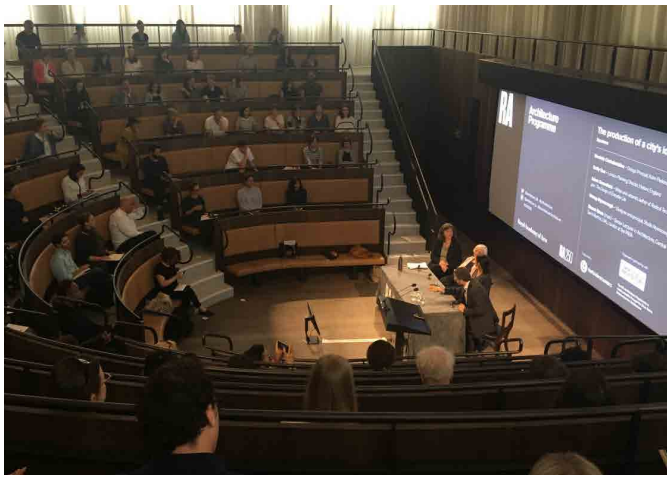


Image credit: LFA

had longed to return to her passion of design and project architecture, and how this longing led her to found her own, new practice, to free her up to focus on project work. This is a story that no doubt reverberates throughout the industry. Getting bogged down in practice management issues, be it HR or finance for example, can drain valuable time and stifle creativity. Such talent should never be curtailed in such a creative industry (or any industry for that matter). This is a prime example of how business owners may be better served "doing the knitting" and leaving the running of the business to others.

The final curtain was drawn on the LFA with the Patrons Dinner. I have to say it was a first for me to enjoy a black-tie dinner with 150 people delivered on a live construction site! A remarkable achievement from the team, particularly considering the lack of fixed electrics and air conditioning (in the midst of a UK heatwave). While the views were not quite as breathtaking as those at the opening party, it was clear to see that the building design was intended to be inclusive for all, with a large atrium spanning several floors. I hear that Mimecast have taken over one third of the space already, promising to be an exciting building with a mix of office accommodation and retail space in the heart of Broadgate. All in all, the LFA was creative, inspiring, eye-opening – and more fun that I'd expected!

Image Credit: Agnese Sanvito

Fast-forward a couple of months and the 2019 theme has been launched. "Boundaries" is an excellent theme with many facets and judging from the conversations I had at the launch event, will lead to a diverse range of events and exhibitions. It is certainly a topical issue for 2019 with Brexit around the corner and the boundaries this may create.

I'd be interested to hear your views, so do get in touch with any comments - or just to say hello back. Here's to next year's event and the LFA once again breaking "boundaries" to achieve an even better festival!

Update on changes to the SRA Accounts Rules

In our summer 2018 edition we summarised the proposed changes to the SRA Accounts Rules as part of Phase 3 of the SRA's Outcomes-Focused Regulations project. On 14 June 2018 the Solicitors Regulation Authority announced that the SRA Accounts Rules [2018] have been approved by the SRA Board and will, subject to the approval of the Legal Services Board, be introduced in April 2019.

Whilst April 2019 may seem a long way off, law firms really need to start planning now for the introduction of the new rules, particularly as there are still some aspects of the Rules that could have an impact on many firms. Assuming that the draft Rules are approved without any further changes, there are two areas which may require law firms to amend their systems in order to continue to be compliant.

Under the 2011 Rules, Rule 20.1 (c) states that client money may be withdrawn from a client account if it is properly required for payment of a disbursement on behalf of the client. There is no equivalent to this in the 2018 Rules, with rule 4.3 of the 2018 Rules stating that where client money held is to be used to pay for your costs (there is no distinction between profit costs and disbursements), then you must issue a bill of costs to the client before you transfer any client money from a client account to make a payment. The apparent impact of this is that in the future, a firm will not be able to transfer funds held on client account to cover disbursements paid out of office monies prior to giving or sending a bill to the client.

The 2018 Rules are also silent on the treatment of residual balances which cannot be returned to clients upon the completion of a matter. In the 2011 Rules, Rules 20.1 (j) and 20.2 cover the treatment of paying residual balances to charity. Rule 5.1 (c) of the draft 2018 Rules only makes reference to withdrawing money "on the SRA's prior written authorisation or in prescribed circumstances". It is expected that the SRA will publish guidance covering the payment of residual balances to charities and that this will form the 'prescribed circumstances' referred to in the draft Rules. However, we do not know exactly what that guidance will say, or if it will be more onerous than the current provisions. Our advice to law firms would be, given the uncertainty that exists, to deal with any residual client ledger balances under £500 in value under the existing rules.

Alternatives to pensions for professionals and their clients

by David Hume

There are many reasons why our professional connections, and their clients, are looking for alternatives to pensions to build a fund for their retirements, but should you give these alternatives serious consideration? With cuts to pension tax relief for higher earners hitting investors in the pocket, it may be that they are looking at ways to complement their current pension arrangements rather than replace them. One thing I can guarantee you is that the favourable tax treatment of pensions will continue to be considered a target for the UK government as a way of raising funds and it is likely that future legislation will be introduced to further alter the current pension regime.

To recap, since 2012, wealthier pension savers have seen their lifetime allowance reduced from £1.8 million to the current £1.03 million figure.

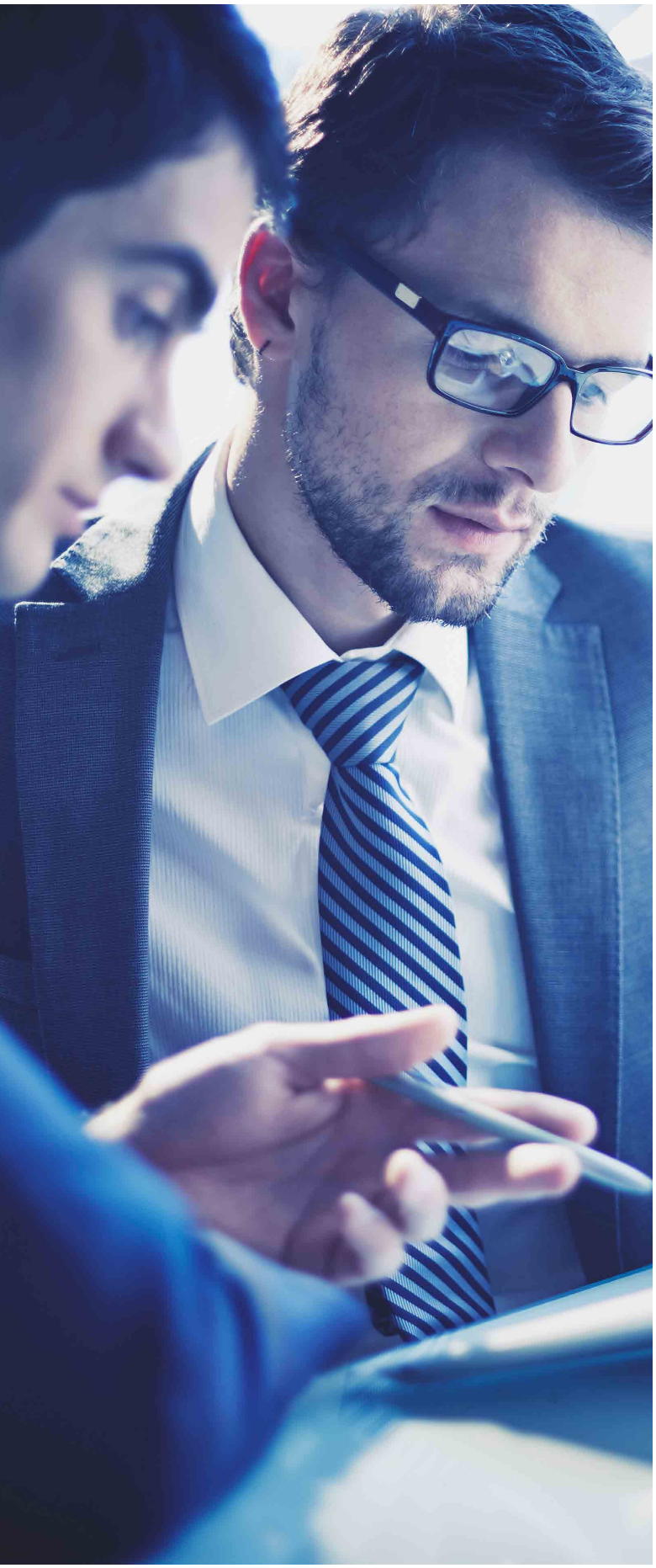
The introduction of the Tapered Annual Allowance (TPA) in April 2016 also negatively impacted higher income earners. Many of our professional connections are considered higher hitters, who have a 'threshold income' in excess of £110,000 in any tax year and will have their adjusted income tested to see if this is in excess of £150,000 in that tax year. If both tests are met, then the standard £40,000 Annual Allowance (AA) is reduced by £1 for every £2 of adjusted income over £150,000 in a tax year. This restricts the level of tax-efficient pension funding which high earners and their employers can make into pension schemes.

The maximum AA reduction is £30,000, so those individuals who have an adjusted income of £210,000 or more, will have an AA of £10,000 from 2016/17 onwards. Hence, if you are impacted by this reduction you may wish to consider alternatives for investing this annual budget of up to £30,000 elsewhere.

It is possible to carry forward unused allowances from the previous three tax years if you had been a member of a registered pension scheme. The carry forward of unused AA from previous tax years still provides higher earners the opportunity to maximise tax-relieved contributions into pensions if they have not maximised these allowances in the past.

According to the Office for National Statistics (ONS), an estimated 364,000 people have been affected by the TPA on pensions. It is important that you review your pension contribution limits, as those who breach their AA may face a tax charge that could be thousands of pounds. The tax charge will be calculated based on taxable income and the amount put into a pension that is in excess of your AA. I recommend that you seek professional advice so that you can be certain of how this impacts you personally and our team at Kingston Smith welcomes the opportunity to hold these conversations with you.

So which investment is the best alternative to pensions that you and your clients should consider? The options are numerous and include shares, investment bonds, Enterprise Investment Schemes (EIS), Seed Enterprise Investment Schemes (SEIS) and Venture Capital Trusts (VCT) to name a few.



However, for many the starting point for diversifying your retirement provision should be an ISA.

Individual savings account (ISAs)

Many professionals who have 'maxed out' their pension allowance have started to consider ISAs as an alternative means of boosting their retirement income. These tax-free savings accounts are an attractive alternative to pensions, whether you are a high earner or basic rate taxpayer. Although you don't benefit from any tax relief on contributions into your ISA, any capital growth and income generated is tax free. This ability to build an additional, complementary, flexible tax free lump sum and income to draw upon in your retirement is a compelling one.

With the unprecedented nominal interest rates available and the anticipated extended period of low inflation and interest rates within the UK, you can see why cash ISAs have fallen in popularity over recent years.

However, the £20,000 annual ISA limit and government cuts to pension's tax relief for high earners, has rekindled interest for the humble ISA once more. If you had been saving the maximum allowance within an ISA since their introduction, you would now have a substantial lump sum available as you would have contributed £206,560 in total since their introduction in April 1999.

Depending on your risk appetite and time horizon, there are many different investment options available rather than investing in cash deposits within your ISA.

If inheritance tax planning is important to you then you may wish to consider transferring existing ISAs and/or invest future annual contributions into Alternative Investment Market (AIM) portfolio ISAs. AIM portfolio ISAs can potentially save 40% inheritance tax (IHT) on monies held due to the application of the Business Relief (BR) rules after a two year holding period. Importantly it is still possible to access the monies held within the ISAs if required in the future. AIM investments should be considered higher risk and are not suitable for all so it is important to take specialist investment advice.

Legislation means you are now able to transfer your ISAs to your spouse on death. Your surviving spouse will receive an 'Additional Permitted Subscription' (APS) allowance that is equal to the value of the ISA, however on the second death these would fall back within the chargeable estate value.

ISAs may not be the solution for everyone, but they should be considered as one of the first alternative solutions available. For our professional connections who are looking for an alternative tax-efficient investment

opportunity outside of pensions, many could consider a (VCT) or (EIS). These were both introduced by the government to encourage investment into newer, smaller UK companies by offering investors a range of tax incentives, including income tax relief. However, they are sophisticated and considered higher risk than many more mainstream investments.

What are VCTs?*

VCTs are listed companies that invest in the shares of other companies. The VCT manager will research and select companies in which to invest. The headline tax advantage for investors is 30% income tax relief on the amount they invest, up to a maximum of £200,000 each tax year. Tax relief is given as a credit against the investor's total income tax liability.

Furthermore, any dividends paid by the VCT on the shares will be tax-free, which may be attractive to supplement pension income in retirement. When the client then chooses to sell the VCT, any gains they make will be free from capital gains tax.

Investors must hold the VCT for a minimum of five years to maintain the income tax relief.

What is an EIS?*

Although similarly designed to encourage investment in small, unquoted companies, typically an EIS is considered to be higher risk than a VCT because it focuses investment in fewer companies. The normal maximum investment level is up to £1million per annum, but this can be increased to £2million if the excess above the £1million is invested into knowledge-intensive companies.

Similar to a VCT, an EIS also offers the investor 30% tax relief through a reduction in their income tax liability, but it also offers capital gains tax advantages by allowing an investor to defer a capital gains tax liability. This can be particularly attractive for capital gains being deferred at 28% from a property sale, where these may be based on the potentially lower capital gains tax rate of 20%, applicable at that time of crystallisation for an investment.

Importantly, any future capital gain generated via the EIS investment itself will be tax-free and after holding the EIS for a two year term, it will also qualify for Business Relief for inheritance tax purposes.

On top of the above investment limits, it is also possible to invest an additional £100,000 into a Seed EIS (SEIS) which attracts an even greater level of income tax relief

of 50%, but the investment is less diverse and would be considered even higher risk than an EIS.

Investors must hold the EIS for a minimum of three years to maintain the income tax relief.

It is important to note that investing in smaller, newer companies carries a higher level of investment risk and is not suitable for everyone. It is therefore important to seek out professional advice from the Kingston Smith team before committing your money, as this is a specialist area of advice.

For any queries, please contact our Kingston Smith Financial Advisers team and speak to one of our financial planners +44 (0)20 7566 4000.

Information is based on our current understanding of taxation legislation and regulations. Any level and bases of, and reliefs from taxation, are subject to change.

Tax treatment is based on individual circumstances and may be subject to change in the future.

The value of investment and income from them may go down. You may not get back the original amount invested.

***Some funds will carry greater risks in return for higher potential rewards. Investment in emerging market funds can involve greater risk than is customarily associated with funds that invest in developed, more established markets. Above average price movements can be expected.**

Kingston Smith

Kingston Smith has been helping clients build their businesses for more than 90 years.

As chartered accountants and business advisers, we work with clients to understand their potential and ambitions, and provide all the information and support they need to achieve them.

Most of our commercial client businesses are managed by the people who own them. We have over 60 partners and more than 500 professional staff focused in and around the London/South East region, where our commitment to the more entrepreneurial types of business has created long-lasting successes. Our sector focus provides us with the insight our clients need to deliver strategic and practical advice.

Our founder membership of international accountancy association, Morison KSi, offers our clients the strength and experience of offices in 88 countries to support their international reach. That combination of geographic knowledge, commercial expertise and client empathy has given us a great track record in helping clients grow their business.

More information about Kingston Smith LLP and our services can be found at **www.ks.co.uk**

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