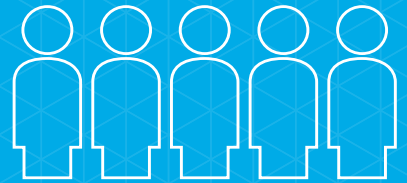


Employment agency sector Using payments to build competitive advantage

April 2017



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Using payments to build competitive advantage



Modulr Finance, April 2017

The UK temporary and contract worker market is currently the strongest it has ever been, with around 20% of the workforce met by flexible resources¹. However, the market is also getting tougher for employment agencies and intermediaries. While demand is at record levels, talent is in short supply and competition is intense.

At the same time, legislative changes and a tightening of HMRC focus on employment status compliance are increasing the volume of PAYE, National Insurance payments and reporting. All of this is placing pressure on margins, and heightening the need for agencies to differentiate the services they offer to employers and contractors.

Innovative, focussed, businesses can turn these market and regulatory challenges to their advantage. Those that don't risk declining revenues and squeezed margins. Optimisation of payment processing and reporting should be a priority for employment businesses that want to minimise the burden of compliance, compete on client service and excel at candidate care.

The payments industry is also undergoing a revolution driven by a vibrant Fintech sector and changes in regulation. A new breed of payment providers is now delivering flexible, API-based payment processing tools and services that can help employment businesses achieve payment optimisation.

This paper explores these challenges and potential solutions in more detail, outlining how you can potentially use payments services to compete as well as comply.



The payments industry is undergoing a revolution

1. Source: FCSA

An increasingly competitive landscape

The regulatory burden increases

Changes to IR35 regulation, the tax treatment of expenses, and rules affecting salary sacrifice, will all have a major impact on agencies, intermediaries, contractors and employers. It is likely that these will squeeze revenues and margins, and increase the volume of PAYE & NIC payments that agencies need to make.

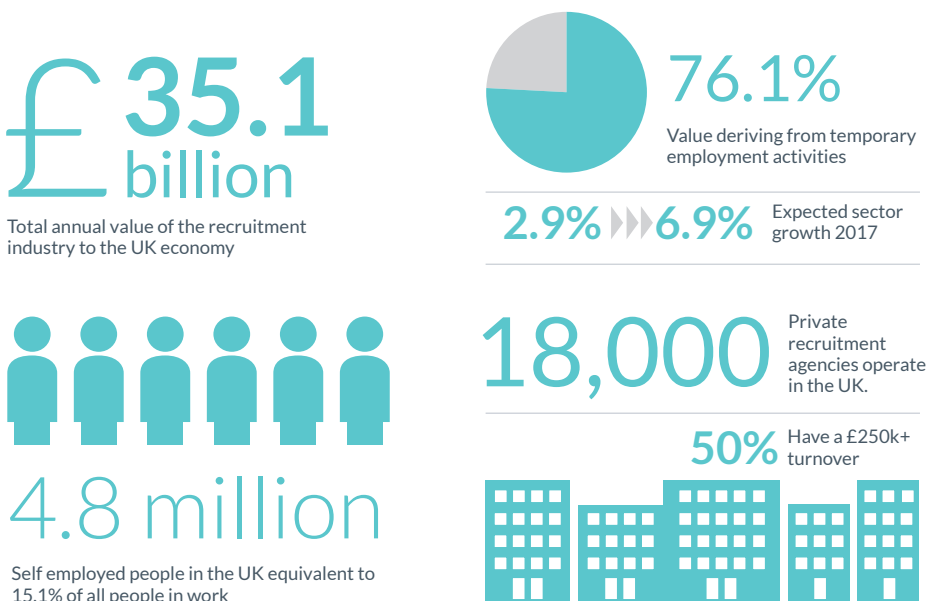
Additionally, changes to the flat rate VAT scheme, the application of the Apprenticeship Levy and new gender pay gap reporting requirements will impact on payroll processing, contracts, due diligence and audit processes for employment businesses.

It is unlikely that change will stop here. The Taylor review of employment practices in the Modern Economy (launched by the UK Government in October 2016) along with ongoing focus from HMRC on the targeting of non-compliant self-employment, may well trigger additional legislative changes. It will certainly increase the focus that companies need to place on employment status compliance.

Skills shortages fuel competition

The UK recruitment industry is worth £35.1bn to the UK economy, and more than three quarters of this value is delivered by temporary employment activities². Successful agencies are achieving spectacular growth; some of these agencies are listed in the 2017 Recruiter Magazine/Clearwater International Fast 50 and are registering average compound annual growth rates of 43%. However, the market is becoming ever more competitive with an estimated 18,000³ agencies operating in the UK. This market challenge adds to those of changing legislation and more onerous tax compliance.

Temporary and contract employment in the UK



By getting it right, payments can be turned into a source of competitive advantage for businesses.

2 Recruitment & Employment Confederation: 2015-16 Recruitment Industry Trends

3 World Employment Confederation (previously Ciett)

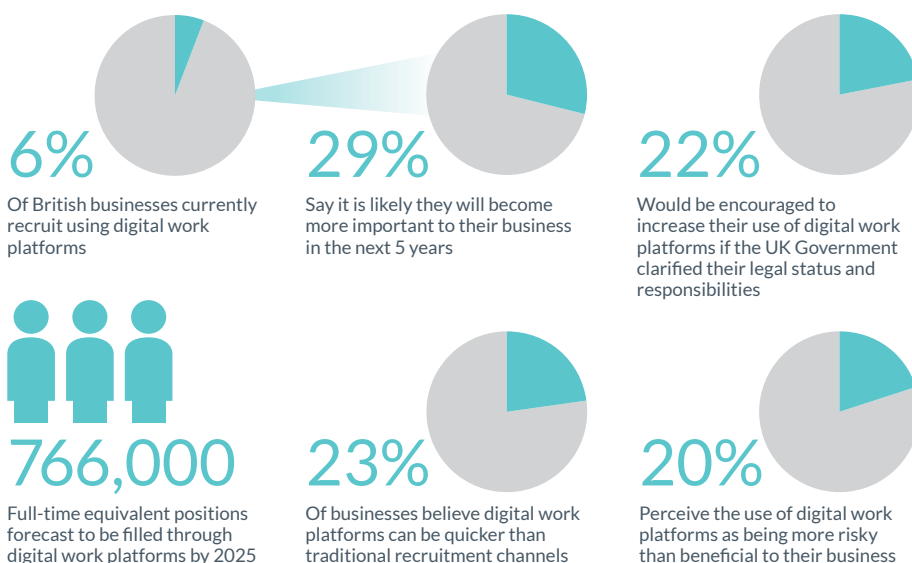
The health sector brings these issues into sharp focus. While niche companies servicing this market have been among the strongest performers, the challenges are still significant. There is a chronic shortage of key skills alongside a known funding crisis in the NHS. This has led to the introduction of price caps, and a target for reducing agency staff expenditure by £1bn in 2016/17. This means that even agencies with NHS Framework Agreements need to work hard to ensure they can attract and place the best candidates, and defend operating margins. There are similar pressures in other sectors where demand for skills outstrips supply, notably in education, construction and IT.

High performing growth agencies share some common characteristics. They are often relatively young companies focussed on serving niches where demand is high and skills are in short supply. These agencies are also challenging traditional agencies and umbrellas by using more efficient models, having lower costs and offering attractive benefits to contractors, such as immediate payment. A recent post on the REC blog by Susannah Lawson of CJUK⁴ highlights the critical importance of candidate care when an agency is trying to grow in a sector with severe skill shortages. The post highlights the importance of building and maintaining a strong community of candidates, proactively communicating with them, and providing important benefits such as access to training.

A further challenge comes from Digital Work Platforms such as Freelancer.com. According to research by REC, these are currently used by a small minority – approximately 6% of employers. This is changing, with 29% expecting that these platforms will become more important in the next five years. While Digital Work Platforms are still perceived as risky by some employers, they are also seen by some as being a quicker way to recruit when compared to traditional channels. Once the outstanding questions about the legal status and responsibilities of digital work platforms are clarified by the UK government, they are likely to become more attractive.

Leading agencies highlight the critical importance of candidate care when an agency is trying to grow in a sector with severe skills shortages.

Attitudes to digital work platforms amongst UK businesses



Source: REC Gig Economy – The Uberisation of work

4 <https://www.rec.uk.com/news-and-policy/corporate-blog/is-your-candidate-care-strategy-an-obstacle-to-growth>

Payments present a major opportunity

The challenge of staying competitive and how better payments can help

Payment processing is the lifeblood of a temporary or contract worker agency or umbrella business. If you think about it, it is a major part of what your company does: invoicing and receiving payments from employers, paying VAT, PAYE and NI and, of course, paying the contractor or worker. The way you handle payments fundamentally drives the quality of the service you provide to your clients. It also impacts your ability to optimise your cash flow and maximise your margins.

We have all been used to relying on our bank or Bacs bureau to handle our payments. The system works but has disadvantages in terms of cost, admin overhead and payment delay. Faster Payments helps, but access to it is tightly controlled by banks. Restrictions like cut-off times for same day payments are common when making Faster Payments through a bank, and each has its own fee structure.

However, the payments industry is in the middle of a revolution. This is seeing faster, simpler and cheaper payment services made available to businesses. It is becoming much easier for companies to integrate their software and systems with those used by their banks and payment processors through the use of simple APIs. This allows more processes to be automated, makes reconciliation much easier and provides richer data for reporting.



Payment processing is the lifeblood of a temporary or contract worker agency or umbrella business.



What is an API, and why does it matter?

An Application Programming Interface or API is a defined set of commands and tools that make it easy for separate computer systems to be programmed to talk to each other.

An API allows a developer to create software that can work and exchange data with other systems without having to write all the code from scratch. Payment providers, such as Modulr, use APIs to allow customers to trigger payments from accounting, payroll, HR or other software. They also allow these systems to query bank balance information and import statement data, considerably reducing the manual overhead.

These changes have come about due to a combination of developments in technology, changes to regulation, notably the European Union's Payment Services Directive 2 (PSD2) and the UK Government's Open Banking Initiative, along with the emergence of a well-funded fintech sector that is grasping the opportunity to offer innovative new payment solutions. Core to much of this is the concept of open APIs that make it much easier for payments to be initiated and data to be exchanged.

Instant Payment Accounts are another innovation that allow businesses to be much more flexible in the way they make and receive payments, and make reconciliation much more straightforward.

Instant Payment Accounts allow you to have what is effectively a separate bank account for each client and/or contractor. So, all of the receipts and payments associated with that client can be managed through an account with a unique number along with individual reporting and statements. This means that if a client misses or uses an incorrect reference for a payment, it is still possible to identify the payer without going through a complex reconciliation process. Furthermore, funds held on behalf of contractors can be clearly identified as belonging to each individual. Unlike traditional bank accounts, payment accounts can be set up or closed almost instantaneously.



What is an Instant Payment Account?

An Instant Payment Account is like a standard bank account in that it has a dedicated account number, holds a balance and statements can be produced for it.

However, unlike a standard bank account, there is no need to go through the time consuming due diligence or 'Know Your Customer' process required each time a new standard account is created. Additionally, there is no limitation on the number of payment accounts that can be opened. Customers need to be validated once when the facility is set up, but when that has been done, the customer can create and close accounts as required. There is no need to worry about the security of funds held. Instant Payment Accounts are managed by authorised companies, such as Modulr, backed by partner or 'sponsor' banks who are custodians of the funds.

New players, such as Modulr, are now able to offer simple payment solutions that are responsive to the specific needs of businesses, including employment agencies and umbrella companies. These solutions can improve businesses' flexibility and efficiency, and can meaningfully help employment businesses to respond to the key challenges that have arisen from the changes to employment and tax legislation. Most importantly, the solutions provide differentiating service levels in sectors where competition is intense.

Turning opportunity into advantage

Using new regulation as a catalyst for change

The changes to IR35, effective from April 2017, impact all agencies who place workers or contractors into the public sector. The new rules, designed to tighten up the interpretation of employee status, shift the responsibility for deciding whether IR35 applies from the contractor to the employer. Going forward, where it does apply, responsibility for paying tax moves from the contractor to the agency. This places several new responsibilities, administration overheads and liabilities on agencies. In particular:

- Agencies will become responsible for paying more of the contractors on their books through PAYE, and will need to make the tax and National Insurance contribution payments for those contractors.
- Agencies will need to invoice for, collect and process VAT reporting and payments on behalf of those contractors who they are paying through PAYE.

Simple payment solutions that are responsive to the specific needs of businesses

- The legislation places the responsibility for determining the contractor’s IR35 status on the entity that pays the contractor. Very often this will be the agency. In many cases, agencies will have insufficient information about working practices to make a correct judgement and will need ask the client to give an opinion on IR35 status. The client is statutorily obliged to provide an answer within 31 days.
- If an agency concludes that IR35 does not apply but HMRC subsequently judges that that it should, the agency is ultimately liable for the underpaid tax.

All of this will significantly increase the volume of payment processing and administration/compliance overhead costs for many agencies. To make matters worse, the IR35 changes are not the only ones that have come into effect over the course of 2016 and 2017 (see below). Introduction of the Apprenticeship Levy will also raise the administration and processing overhead for those to whom it applies, and the responsibility for agencies to undertake due diligence on contractors, Personal Service Companies (PSCs) and Managed Service Companies (MSCs) is increasing.

In addition to upward pressures on their cost base, agencies face downward pressure on fees. As in-demand contractors see more of their work moving onto a PAYE basis and lose tax deductions against expenses, they are expected to push for higher rates. Meanwhile key hirers, notably in areas such as health and education, are cutting expenditure and will resist those rate rises. This will undoubtedly place further pressure on agency fees and margins.

Even though this seems negative, we believe it to be a major opportunity. For forward thinking agencies, the changes should be a catalyst to review and improve processes. Where this is done effectively, it will drive greater process efficiencies, improve reporting and reconciliation, and reduce the risks of non-compliance.



For forward thinking agencies, the changes should be a catalyst to review and improve processes

Legislative and tax compliance changes impacting contract and temporary worker payment

2016 and 2017 have seen several legislative and tax compliance changes that impact agencies, umbrella companies and personal service companies (PSCs). To varying degrees, these impact payroll processing, contracts, due diligence and audit processes. This is a summary of the main changes:

IR35

As of April 2017, the IR35 status of contractors working in the public sector will be determined by the client and not the contractor. Where contractors are placed through agencies and deemed to fall within IR35, the agency will be responsible for paying the contractor through PAYE and must process tax, NI & VAT payments.

VAT Flat Rate

From April 2017, a new VAT flat rate of 16.5% will apply to limited cost companies including PSCs, or mini umbrellas supplying labour only. This is in response to significant growth in the number of such companies registering for flat rate VAT.

Tax Treatment of Expenses

As of April 2016, tax relief for contractors was limited where an end user supervises, directs and controls the contractor.

Apprenticeship Levy

The levy applies from April 2017 to all payrolls above £3M per annum, including recruitment businesses whom it will disproportionately affect due to the size of payrolls they run. Also, these businesses won’t benefit from levy funding. Companies will need to calculate and inform HMRC of the amount they owe and pay it through PAYE.



HMRC Employment Status and Intermediaries Team

In October 2016, HMRC established a team that proactively investigates companies that declare the use of significant numbers of self-employed workers. The team will also act on intelligence and complaints about alleged abuses of the rules around self-employment. There is speculation that this team will also be used to enforce new IR35 legislation applying to the public sector

Liabilities under MSC Legislation

In April 2016, a tax tribunal passed a ruling under Managed Service Company (MSC) legislation of 2007 that could entail the transfer of tax liability to recruitment agencies. In summary, where an MSC has set up and run PSCs on behalf of contractors, and those contractors have tax liabilities that they are unable to pay, the MSC and/or any agency that recommended the MSC could be liable.

Revised Equality Act 2010 (gender Pay Gap Information) Regulations 2017

Employment businesses must report on the pay of temporary workers who are engaged in contracts to perform work personally, and who they payroll directly. If there is an umbrella or other intermediary in the supply chain, they will be the relevant employer for reporting purposes. This applies to private/voluntary sector employers with 250 or more employees.

Modernizing your approach to payment processing is a good place to start. The use of traditional Bacs services, manual CSV files and reconciliation can be time consuming and expensive. Payroll processing is not only an overhead; it is also prone to errors, particularly when it relies on manually compiled batch files. PwC has estimated that the average FTSE100 company loses a massive £10-£30 million every year due to payroll mistakes. While the payrolls of most agencies will be significantly smaller than this, the losses can still be significant.

Businesses can't escape the need to increase the volume of payments they process, but the cost, errors and the administration overhead can potentially all be reduced. Alongside this, improvements can be made to reporting and compliance processes.

More flexible and automated payment processing services are now on offer. These can be integrated into existing administration systems through a simple API. This removes much of the administration and reconciliation requirements, and reduces the risk of manual error. An additional benefit of using upgraded payment processing is access to more immediate reporting, and better information for compliance.

To put this into context, Modulr has already helped ICS, a leading business outsourcing specialist, to overhaul its payroll processes, achieving a 65% reduction in payroll processing costs by simplifying and automating its existing payment processes.

Turning payments into a competitive advantage

Improved payment processing can also help agencies and umbrella companies offer the excellent level of service that is essential to winning and retaining clients, and to building a strong book of contractors.

One way to do this is by offering a better payment service to customers. It is fairly standard for workers to receive their earnings about a week or so in arrears. However, this isn't ideal for people who work infrequently, or for those working a shift pattern.

By using a payments service like Modulr, it's now possible to access Faster Payments easily and affordably. Contractors can be paid as quickly as 30 minutes after finishing work on any day of the week. Being able to provide contractors with transparent and accurate account statements, while



The use of traditional Bacs services, manual CSV files and reconciliation can be time consuming and expensive

simultaneously reducing payroll errors, is not just a saving for businesses – it also makes life easier for contractors. This reduces the likelihood of queries and disputes, and raises their level of trust in their agency. This is all a key part of candidate care.

At the same time, the ability to link payments processing directly to incumbent management systems enables businesses to offer a much more efficient service to hiring clients. Again, this reduces reconciliation issues and disputes, and helps to ensure that the business remains a preferred industry supplier.

Better payments, better business

Use faster, flexible payments to revolutionise your business

The way payments are managed determines how well employers and contractors are served. It also impacts businesses' cost base and their ability to comply. By getting it right, payments processing can become a competitive advantage. Employment agencies and umbrella companies can take advantage of changes in payment technology and regulation to improve the services offered to their employers and contractors/PSCs.

The benefits innovative API enabled payments services bring include:

- Flexible and cost effective access to instant payments. This can allow individual workers to be paid as quickly as within half an hour of completing a shift
- Reduction in the administrative overhead of processing Bacs files
- Reduction in payroll processing errors and costs. A critical consideration as the volume of PAYE payments increases
- Reductions in reconciliation overhead
- Reduced cost and complexity of integration with payroll and other critical business systems

As employment businesses respond and adapt to current legislative changes and prepare for further potential compliance challenges it makes sense to review payment processing arrangements and options and see whether it is possible to benefit from these innovations.

Contact Modulr at hello@modulrfinance.com to find out how we can help your business turn payments into a competitive advantage.

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