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Brought to account

US and UK firms are poles apart when it comes to their cash-based and accrual accounting systems. Tony Williams reports

WHEN comparing the financial performance of US and UK law firms it is important to appreciate that one is not necessarily comparing like with like. This is particularly important when contemplating that most rare of occurrences – the transatlantic merger.

Generally, US firms account on a cash basis, and UK firms on an accrual system. This means that a US firm only treats the value of work billed and paid for as income. In the UK,firms treat the value of work billed and the value of work done but unbilled as income. The UK firm may adjust the value of work billed to make specific and general provisions for bad debts. In addition, the value of unbilled work in progress may be discounted to its 'cost' price,which is often between 50 per cent and 66 per cent of its headline value.

Although this accounting treatment is primarily tax driven – the UK Inland Revenue determines profits on an accruals basis – it does have important implications on how firms are run,the financial disciplines applied and the capital and distribution policies.

In the period up to the financial year end, US partners will be very focused on getting bills paid, especially if their firm has a merit-based remuneration system. Any items unpaid at year end will only be brought into account in the next financial year. When the accounts are finalised, a US firm will be able to distribute the balance of the firm's profits reasonably quickly as the profit has not only been earned but also received by the firm.

For a UK firm,the year-end focus is on billing rather than collecting payment. The last week of the financial year is often in the highest billing month of the financial year. But this flurry has its downsides. Bills may be entered on the books even though they have not been sent to the client, and bills issued may not have been discussed or agreed with the client in advance. In the month or two after the year end, those bills may be reissued or revised, usually downwards. This approach has important implications for a UK firm. Unfortunately, many partners assume that their role is over when they have done the work. If pushed, they will appreciate the need to bill the client, although will often fail to do so on a timely basis. Very few partners will consider it to be an integral part of their role to ensure that the bill is subsequently paid. They may even obstruct the credit controllers trying to effect recovery. In the current downturn, partners are even more sensitive about upsetting important clients by pressing them for prompt payment. This approach can result in the amount of capital tied up in outstanding bills being very substantial – 20 per cent of annual turnover is not unusual. Even worse, if a client is restructured and the original contact leaves, it may also result in the bill being written down in order to secure payment.

Because a UK firm's accounts are calculated on an accruals basis and tax is paid on that profit, the cash has not been received when the profit is calculated. This results in a UK firm's profits being distributed later than a US firm's. It is not unusual for the balance of a UK firm's profit to be distributed 12 months after the financial year end.

It is also important to realise that the financial performance of UK and US firms reflects different time periods. This is particularly pointed when the legal market is moving rapidly, whether up or down. US firms generally operate to a 31 December year end. In general these accounts relate to work done up to early November. In a UK firm, the usual year end is the end of March or April. These accounts include work done but unbilled right up to year end. If legal activity is increasing, a UK firm should show a better performance, as in reality its accounts cover a period six months later than a US firm. Conversely, if legal activity is reducing, a US firm will apparently be performing better.

The accruals system, being based on current activity levels, should enable a firm to take more timely remedial action in a sustained downturn, but this does not, in practice, appear to be the case. US firms watch utilisation (chargeable hours) very carefully and adjust headcount and other overheads more readily than UK firms. In part, this is assisted by more flexible employment laws in the US, which greatly reduce the payback period of any staff rationalisation.

The cash versus accruals debate does not just have implications for the income side. A UK firm is far more likely to accrue for future liabilities. Such provisions may include dilapidations on leasehold premises, pension provisions and bad debts. In the absence of uniform accounting standards for partnerships, it is quite possible that these are to a greater or lesser extent used to smooth law firm profits over a number of years. Using this approach, provisions are made in good years and released in bad ones, but this approach and the fact that UK firms' profits are generally distributed quite late can divorce the partners from the reality of the market. Because partners may be drawing record profits that relate to a prior year, they may not recognise that urgent remedial action is required until very late in the downturn. A cash accounting system does keep the partners very focused on cashflow and probably has the effect of reducing the capital needs of the partnership. But ultimately, this is determined not just by the speed of cash collection, but also by the speed of cash distribution to partners.

In a merger, two important issues arise: the year-end date and the accounting method. A move to an April year end and accruals may produce a windfall for the US firm as it will be able to add four months profits and a further few months due to the change from cash to accrual accounting. Whether this so-called bonanza can be distributed will depend on the cashflow of the firm. Given the differing tax treatments, the relative sizes of the merging operations will be important, as a relatively small operation may not justify a wholesale review of the firm's accounting principles. As law firms become more complex with a range of limited partnerships and other vehicles operating in different countries, the tax treatment of a firm's profits (both as to the period for which they are calculated and the basis of calculation) will become increasingly significant. Of even greater significance will be the effect of accounting policies on partner behaviour and the firm's cashflow.

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