The End of Cash?

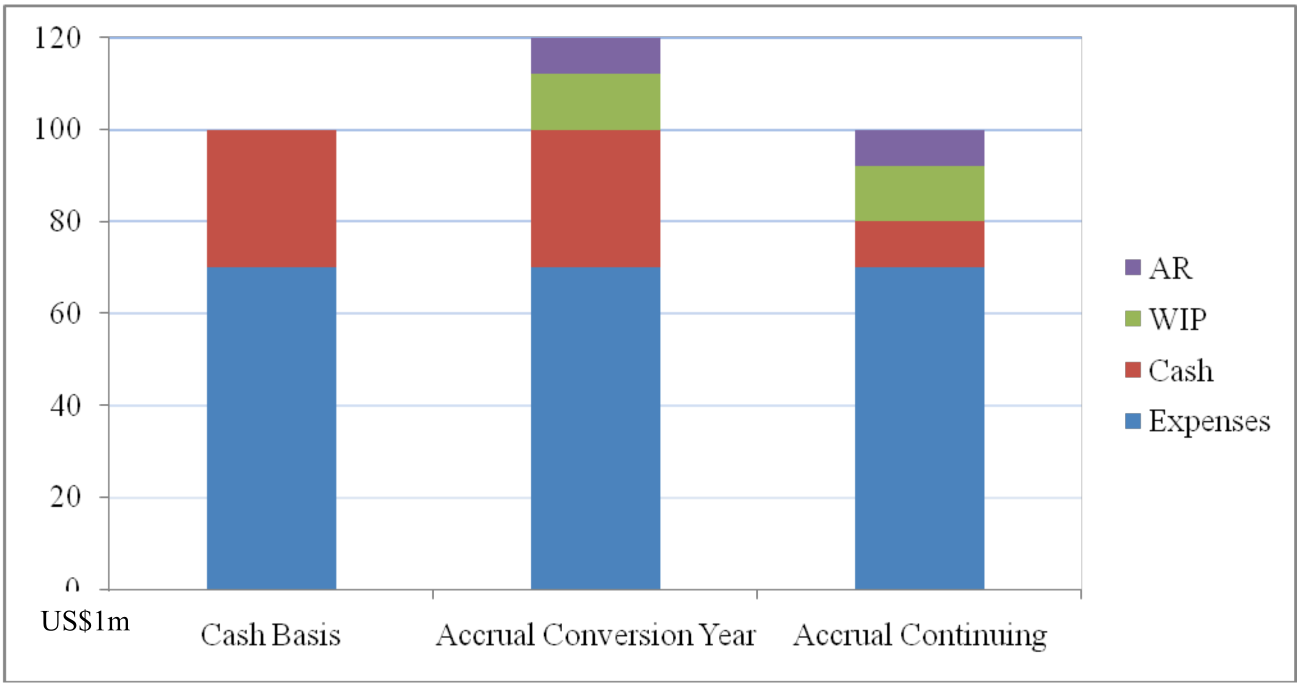
Congress is currently considering proposals to require certain professional service firms, including law firms, with revenues in excess of $10 million, to move from the cash basis of accounting to the accrual method. This may sound like a dry and irrelevant subject for most lawyers, but it will have fundamental implications as to how law firms fund themselves and calculate and distribute their taxable profits, and it could require their partners to pay significantly higher tax bills over a number of years. Two proposals now exist: One, by Chairman Dave Camp of the House Committee on Ways and Means, has a proposed effective date of the tax year commencing in 2014. The other, by Senate Finance Chairman Max Baucus would take effect in the tax year commencing in 2015. Whether the legislation will be passed and if it is, what the effective date will be is still uncertain. But if the change is implemented, law firms will be faced with major financial and managerial challenges both in the transition period and thereafter.

Cash accounting is relatively simple. Cash received (i.e., bills paid by clients) in the tax year is the firm's revenue, and expenses actually paid in the tax year are its expenses. The difference between the two is the firm's taxable profit, on which tax is paid. (In fact, the tax is paid by the partners on the share of the profits allocated to them.)

Accrual accounting is more complex. Revenue is recognized when work has been performed and the firm can determine the amount due with reasonable accuracy. Accordingly, revenue generally will include work done but unbilled where the income is foreseeable (for instance, the client has agreed to certain hourly rates), accounts receivable where the work has been done and billed but the bill has not been paid, and accounts paid where the work has been done, billed and paid for. This revenue figure is adjusted for amounts that are unlikely to be collected.

Expenses are deductible in the period the products or services are used, whether or not they were actually paid in that year. For a firm with a December 31 year-end, rent paid in December which relates to December, January and February would only be deductible that year in relation to the portion attributable to December, with the January and February rental expense being a deduction in the following year. Similarly, an electricity bill relating to December which was not paid until January would still be deductible in the year to which it related rather than the year in which it is paid.

For law firms used to cash accounting, the effect of the change is to accelerate the recognition of the revenue into the period in which the work is done rather than the period in which it is paid for. For example, if a firm has cash-basis revenues of $100 million and expenses of $70 million and at year-end has work in progress of $12 million and accounts receivable of $8 million, its taxable revenue would be as follows:



In the year of conversion to the accrual method of accounting the firm's revenue will include the aggregate value of all work in progress and accounts receivable, minus allowances for writedowns and bad debts. If there are no major adjustments to the expenses, the gross revenue will increase to $120 million, producing a taxable profit of $50 million, compared to

$30 million under the cash method. This $20 million of extra "profit" is not represented by any extra cash in the firm and will be taxable at the partners' highest marginal rate.
In subsequent years, effectively, only the increase or decrease in work in progress and accounts receivable over the prior year is treated as revenue. However, in those subsequent years, even if the firm records $100 million in revenue and $30 million in profit, it will be in a significantly different cash position, since its work in progress and accounts receivable will not yet have been received in cash at year-end. (For some firms, the level of work in progress and accounts receivable may be significantly higher than in this example, so the impact would be even more substantial.)

The current proposals would not amend other existing tax laws and would therefore permit the initial accrual conversion adjustment to be amortized evenly over four years. So in this example, taxable profits would not increase from $30 million to $50 million in year one but from $30 million to $35 million in each of years one, two, three and four.

If adopted, the accrual method of accounting will require firms to adopt a range of tax and accounting rules regarding income and expenditures that will be recognized in any one financial year. For revenues, these may include special rules for contingency fees so that they are recognized only when the contingency has occurred or is sufficiently likely to occur. Fixed fees could be prorated: For a matter where a fixed fee of $50,000 has been agreed upon, it may be apportioned so that if half the work has been done at year-end, $25,000 of revenue will be recognized, irrespective of the value of the time actually recorded. Firms will also want to adjust the value of work in progress and accounts receivable to allow for further client discounts or for bad debts. Regarding expenses, firms may need to alter the treatment of the benefit of any rent-free period or landlord's contribution to an office fit-out. Accruals may also be necessary for unused holiday pay, bonuses and other liabilities that accrue in one period but are paid later.

The immediate consequence for a law firm is that its profit is no longer related to the cash it has earned and collected by year-end. Since its "profit" includes income yet to be received, the firm will not be in a position to pay out of its own cash all of the balance of the profit shares due to partners in the early part of the following year. Firms will be faced with three options (either alone or in combination). First, increase the level of bank debt to fund the distributions according to their usual schedule; second, increase the level of partner capital (possibly including capitalizing the additional profit arising from the conversion, minus the tax payable by partners) to fund the distributions according to their usual schedule; or third, change the schedule of distributions of partner profit shares to allow for the work in progress and accounts receivable to have been converted into cash by the time the distributions in full are made to partners. This cash-flow issue is the key reason why firms that use accrual accounting, including the U.K. firms, tend to distribute their profit shares over a materially longer period (often up to at least one year after the year-end) than firms operating on a cash basis do.

If accrual accounting is applied to law firms for tax purposes, they will need to amend their partnership agreements so that their accounts are also prepared on an accrual basis. Such a conversion may have some important consequences. For example, a partner considering retirement may want to stay on during the transition period to enjoy the benefit of the value of work in progress and accounts receivable being brought into account. In the previous example, the impact, even if phased over four years, will be a $5 million increase in profits for each of these years, equal to a 16.66 percent increase in the profits in each year. Complications may also arise if partners join the partnership during the conversion period. In the absence of special arrangements, they may achieve a windfall of an increase in profits that is attributable solely to the change in accounting treatment rather than the underlying performance of the business.

But some changes within law firms may be more subtle. Partners may focus more on year-end billings than on collections, and partners may be less tempted to offer clients extra discounts to make payments before the year-end, both of which will exacerbate the firm's cash problems. Client engagement letters will need to be reviewed to make clear the circumstances in which the fee is payable (i.e., only on completion, by staged payments or subject to a contingency). Firms, based on their experience, will need to adjust the value of work in progress and accounts receivable based on their likely recoverability.

The only possible consolation in the conversion is that most non-U.S. firms use a type of accrual accounting, so the change may facilitate full economic mergers between U.S. and foreign firms.

While it is understandable that any government grappling with record levels of debt will look at any potential source of income, even that arising from a one-off conversion of this sort, there is really no such thing as free money. For large law firms the amounts involved in the conversion process are huge, given that a growing number of firms now report billings in excess of $1 billion. It is unlikely that most firms' bankers will be willing to lend the amount of this extra "income" in addition to existing credit lines. Any additional borrowing will expose firms to greater risks, and we have already seen collapses of major U.S. firms in recent years caused by excessive levels of debt. If this extra "profit" is paid out to partners (and whether it is or is not, the Internal Revenue Service will want about 40 percent of it), the impact is likely to be material.

This is not to suggest that either cash or accrual accounting is right or wrong. They are just fundamentally different ways of accounting, and the conversion from one to another has consequences. Potentially, law firms will need to increase their level of debt or partner capital to adjust to this change, and this will inevitably divert cash from other potential investments such as lateral hires, new offices, IT and new working methods. In a period when U.S. law firms are encountering a sluggish recovery at home and fierce competition abroad, the potential change will be unwelcome, at best. Cash may be king, and when it comes to cash accounting, many firms will be wishing "long live the king."

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