CASH VERSUS ACCRUAL FINANCIAL REPORTING

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I've never encountered a law firm which did not operate on a cash basis. That means that your revenues are not earned from a tax perspective until they arrive in the door. It doesn't matter if you sent an invoice one day or one year ago. You have no taxable income to declare until you receive payment. And your expenses are not deductible for tax purposes until you actually pay them. So no matter how many past due bills you have from vendors, until you pay them, you have no deductions.

The advantages of a cash business are many. First, most law firms wind up financing a good deal of client's business by way of carrying receivables which are too large and too old. This often creates a cash flow problem for midsize and small firms. But just imagine having to pay income tax on those outstanding invoices before the cash actually arrived. That's what commercial businesses, most of which operate on an accrual basis, have to do.

Another strong advantage of cash-basis accounting is the ability to bring the books to "zero sum" at year end merely by paying more or less of the outstanding payables, and often distributing bonuses to partners. This is a common methodology to ensure there is no taxable income for professional corporations, and no K-1 income without matching cash to pay taxes within partnerships.

Cash basis accounting does have some disadvantages. Because law firms operate on a cash basis, the accounts receivable and accounts payable do not show on the balance sheet. Therefore, they do not require any type of "audit" in order to produce a financial statement. Unfortunately, in many firms errors abound on these reports, and there is little incentive to spend the non-billable and administrative time to clean them up. Likewise, in a cash-basis business there is no inventory appearing on the balance sheet. And therefore errors on work-in-process reports are often overlooked for the same reasons. These reports tend to give partners a false sense of potential income when they are inflated due to accumulation of errors. Accrual-basis companies must "prove out" or audit their balance sheet items, which ensures accuracy over the long term.

Perhaps the most serious disadvantage of cash basis financial reporting is a misalignment between income and the expenses incurred to produce that income. Simply put, your monthly cash basis financial statement does not give you an accurate picture of your actual profitability. Let me explain.

Consider a month in which the firm is particularly busy. Billable hours are much higher than usual. Typically, expenses will also be higher to support the additional productivity. So expenses will be high. But income will not reflect the increase in the same month. It may not be reflected for several months, until it is billed, and ultimately collected. This creates the illusion of low income, or even a loss, on the profit and loss statement for the month in which productivity is higher. Months later, when the cash receipts arrive, the firm will show a larger profit than it actually has, because receipts will be up but the expenses showing on the profit and loss will be for the current period, not the period in which those increased receipts were created.

Typically at year end, most firms push hard to collect as much of their receivables as possible so that bonuses can be distributed to partners. Profits become distorted as cash receipts collected from prior accounting periods far outstrip expenses during the current period. It is not uncommon for partners to be lulled into a false sense of security, because they equate bank account cash balance increases with increased profitability, when in fact they have only to do with collection efforts.

The problem with the mismatch of income and expense is that it does not let a firm know each month how they are really performing financially. In fact, usually a firm will not realize it is not doing well until it is too late to do much about it, that is, when the cash flow stops or slows to a crawl, and vendor bills and/or payroll cannot be paid.

Consider a scenario where a firm’s lawyers have significantly slowed in productivity. Perhaps certain practice areas are flat or declining. Maybe there’s an attorney out on disability or maternity leave. If the attorneys or firm administrator have been working hard to collect the past due receivables, and maybe even hold back on paying some outstanding bills, the profit and loss will reflect a healthy profit despite the decline in productivity. Continued activities along the same vein will effectively “mask” the firm’s actual monthly losses until months later, when the decreased inventory results in decreased billings, decreased receivables, and eventually a tight cash situation. And of course eventually the vendor bills will have to be paid. At that point in time, consider all the attorneys are back in the office, and working hard. They will be bewildered by the loss on the income statement when they are all working at peak productivity. Often they will conclude that there is “something wrong” with the numbers on the financial reports, because they just “don’t make sense”. And that’s true with cash-basis reporting.

By the time the profit and loss actually starts to show a loss, it will take the typical firm months to rebuild the inventory, bill it, and begin to collect to turn the financial situation around. Firms which do not closely monitor all the key statistical factors, including amounts billed, hours worked, and so forth, can be easily misled by cash-basis financial reports, and therefore fail to take action when the timing is most critical.

There are two choices. First, your firm can produce modified financial reports which includes increases/decreases to receivables and work-in-process and payables, such that you’re looking at your income statement on an accrual basis. Although this method is for internal use only, and not for tax reporting, it will match revenues against expenses for the same period and give a realistic view of how the firm is doing each month. It will not necessarily match the firm’s cash position. But like any accrual business, you will come to realize that profits will only match cash if you properly manage your receivables and work-in-process. If you do not have a good controller, however, the chances are you will not be successful producing a modified income statement unless your accountant assists regularly, and that can get pricey.

A second choice is to produce a monthly snapshot of what I call *Key Statistics*. It should show your current month and year-to-date and prior year's current month and year-to-date for all numbers which are key to monitoring the firm's financial health. In no time you will develop a comfort level with this report, and in a matter of minutes will be able to assess how the firm is performing. You'll have the best of both worlds — cash-basis accounting and regular review of accrual–type information. And you'll be able to recognize problems and make course corrections long before your cash flow becomes problematic.

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