



THE END OF THE YEAR HUSTLE

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Most law firms around the country are preparing for end of year. Most close their fiscal year on December 31. Accordingly, there's much to be done at end of year.

Most firms are pushing to collect outstanding receivables, especially receivables that are overdue. However, some lucky firms will occasionally need to do the opposite; going so far as to ask some clients to refrain from paying until the new year starts.

Most firms are pushing to put in as many hours as possible before year end. And most firms are pushing to get bills out the door as early in December as possible, in hopes that the money will come in before year end.

Because law firms operate on a cash basis, most will work to bring the firm to zero profit at year end. In this way, there is no tax payment. Accomplishing this usually entails paying all operating expenses, and sometimes paying in advance for expenses which are normally incurred early the following year.

Let's not overlook the glorious compensation bonuses which are often generously dispensed at this time of year. Countless hours are devoted at firms in determining just how much money can be allocated to bonuses. Once that decision is made, thoughtful firms will carefully examine objective metrics, and subjective contributions to the well-being of the firm in order to properly reward the behaviors desired. These decisions are made much easier and faster when cash is plentiful.

The problem with cash-basis accounting is that there is often a disparity between profit and cash in the bank. So a firm may have a very profitable year but for a number of valid reasons may not necessarily have cash to reflect the profit. That creates an uncomfortable situation for attorneys; one which I have come to recognize over the years as much more troubling than in other industries: the need to acknowledge taxable income.

There are many reasons why profit and cash may misalign. The clearest reason is simple timing. A typical scenario involves a substantial matter. Labor

costs, including attorney time and staff time and overtime, mount up and must be paid immediately. Taxes on the payroll will also need to be paid in short order. The firm may have to advance substantial costs on behalf of the client. In many instances — too frequently in law firms — there is a delay in billing, and significant additional delay in collecting. Too often costs are expended in one fiscal year, and receivables covering those costs are collected in a different fiscal year. In other words, the more money a firm collects in a year from a prior year's efforts, the greater the disparity between profit and cash.

In other industries, which operate on an accrual basis, the earnings are realized at time of sale, not time of collection. Expenses and the income (or inventory) that results are occurring in the same fiscal period.

Client expenses are balance sheet items, unless they are declared uncollectible. Balance sheet items don't affect the profit and loss equation. So again, the firm reduces cash without reducing profit if cash advances rise.

And, of course, there are legitimate capital expenditures in the infrastructure of the firm if the firm is to remain healthy. Whether that money is spent on building improvements or computer upgrades doesn't change the fact that cash is spent without impacting (reducing) profit. This is often extremely difficult to understand.

While a disparity may be small at first, firms exacerbate it by using methods which provide short-term relief in avoiding a taxable year-end profit but tend to amplify the problem in the following year. Typically, firms employ the same strategies repeatedly, year after year, and so the disparity continues to grow until eventually it collapses like a house of cards. When this happens, there are usually a few shareholders who face a big tax bite and cannot fathom how it happened. The firm can bring in a cadre of CPAs to examine, verify, and explain. But I guarantee no explanation will be found acceptable.

Here are a few guideposts and warning signs to keep in mind, so you can avoid getting your firm into this situation.

Watch how you are using your line of credit. Your line should never be used to compensate owners. Owners are paid from profit. If there is no profit, there should be no compensation for an owner. If cash is short, the firm needs to be better managed on the financial side.

It's one thing to dip into the line to pay overhead. In fact, for contingent fee firms, most overhead, especially the first few months of the year, is financed from



the line. When a significant fee comes in, the line is repaid and owners get paid. Frequently bonuses are distributed as well. But many firms go overboard and don't leave sufficient cash behind to keep paying operating expenses. The firm should have a cushion of three months of operating expense, excluding partner compensation. If this doesn't happen, the firm quickly finds, in a few short years, that the line has grown to an amount which probably can never be repaid.

Withdrawing equity is another strong warning sign. Firms that turn to refinancing of property and/or loans to make up for cash shortages are usually sliding down a very slippery slope. By the same token, when owners take profits that don't exist as compensation which is then "loaned" to the firm so as to not impact cash on hand, it embraces a strategy which will surely fail. The proper solution is an equity contribution from owners, not a loan.

As the firm approaches mid-year it should undertake a detailed examination of profits and cash and do some projections for year-end. Capital expenditures can be handled in tax-neutral methods such as seller-financing. Improve receivable management, including accelerating the point at which receivables become declared uncollectible, so the firm can expense any advanced costs in the current fiscal year.

The firm should look at improving both billing and collection realization and the speed at which the billed hour turns into collected fees.

I have lots of other ideas, but space precludes me from going into additional detail. If your firm struggles with these year-end issues, whether for the first time or for countless years, I invite you to reach out if you are a PBA member. Together we can brainstorm some strategies which will help you turn things around.

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