From Cash to Accrual

Larger Law Firms May Face Major Changes

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May12, 2014

Moderator

John Fitzgerald, CPA, Audit Partner – BERDON LLP | Accountants and Advisors

With more than 20 years of experience, John is an audit partner and one of the firm's key advisors to law practices. Consulting with practice leaders, he evaluates the financial and economic impact of partnership agreements and reviews candidates for mergers and lateral partner additions. Leveraging his insights on law firm operations, he analyzes the internal control environment to isolate weaknesses and reduce risk. To help firms secure long-term financial strength, he structures and arranges financings and refinancings.

Webinar Overview

John Fitzgerald, CPA
Berdon LLP

- Congressional proposals mandating how law firms report their taxable income
- Firms with revenues of $10,000,000+ to use the accrual method of accounting
- Cash vs. accrual accounting
- Q&A with expert panelists

Panelists

Jude Coard, CPA, Tax Partner – BERDON LLP | Accountants and Advisors

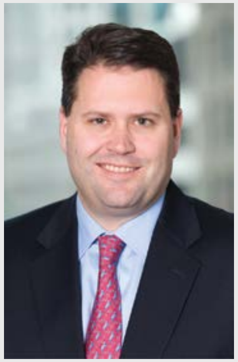
Jude is a tax partner advising professional service firms on reducing tax exposure and gaining tax advantages in all aspects of their operations. Working closely with management, he identifies and structures tax-efficient business entities and consults on the tax aspects of mergers, acquisitions, and reorganizations. For the attorney, he specializes in developing tax deferral and reduction strategies that integrate business and personal financial needs.

Warren E. Friss, Partner – Ingram Yuzek Gainen Carroll & Bertolotti, LLP

Warren provides clients with a uniquely business-minded approach to the provision of legal services, leveraging more than 25 years of experience in private practice, as General Counsel to a public company, and as a senior business executive. As the leader of Ingram's corporate practice, Warren represents public and privately-held companies, not-for-profits, entrepreneurs, investors and senior executives in a broad spectrum of matters including contract negotiations, mergers and acquisitions, joint ventures and strategic alliances, and employment law and debt financing. Warren is a frequent author, speaker, and media commentator on corporate law issues.

Christian J. Covello, Senior Vice President – HSBC Bank USA, N. A.

Chris's banking career spans more than 20 years. In his current role, he manages the HSBC Legal Team, a dedicated group of Relationship Managers who are focused on providing strategic solutions and insight on domestic and international financial services to law firms, their partners, and employees. Prior to his present role, he was Senior Vice President & Market Executive of Bank of America's Professional Services Group and a Vice President at JP Morgan Chase. Chris frequently participates in legal industry conferences and seminars and has also authored several articles on financial topics for law firms.



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What is the current status of these Congressional proposals?

What is the current status of these Congressional proposals?

Jude Coard, CPA
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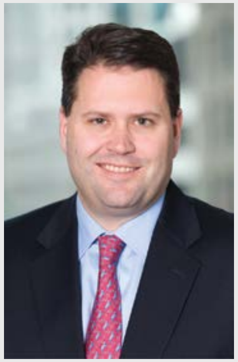
- Two discussion drafts in Senate and House:
  - The Baucus proposal (Section 51 of draft Senate bill)
  - The Camp proposal (Section 3301 of the House Ways & Means Committee "Tax Reform Act of 2014")
- Strong opposition by both the AICPA and the ABA
  - Increases complexity in tax law and compliance costs
  - Inflicts financial burdens on many law firms by requiring them to pay taxes on income not yet received
  - Leads to economic distortions adversely affecting firms currently using the cash method of accounting



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What are the

tax consequences

if these proposals are passed?

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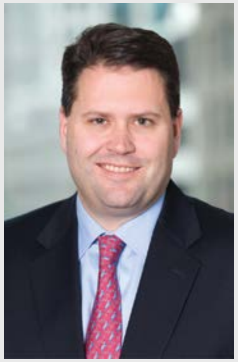
- Acceleration of taxable income
  - Account receivables (A/R) and work in process (WIP) will become reportable for U.S. federal tax purposes.
- Section 481(a) adjustment to spread income over a four-year period
- 45-50% average income tax for NY partners
  - $125,000 acceleration of income = $60,000 tax payment due before cash collected



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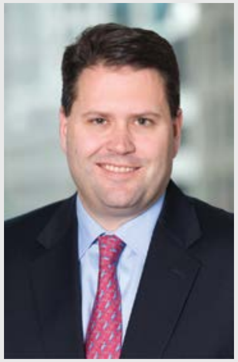
How would firms finance additional tax liability created from this conversion?

How would firms finance additional tax liability created from this conversion?

Chris Covello
HSBC

- Several potential options – which one a firm chooses will be a function of its cultural philosophy and financial profile
  - Funded by individual partner from his/her personal resources
  - Funded by the individual partner with assistance from the firm either via:
    - Working with the firm's relationship bank(s) to establish a partner loan program (offers better terms than what an individual partner may be able to obtain on their own)
    - Financed directly by the firm via additional distributions— likely resulting in assumption of debt by the firm



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Would the firm's partnership agreement need to be amended?

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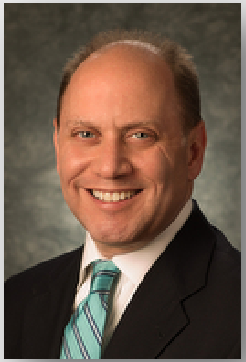

Warren Friss, Esq.
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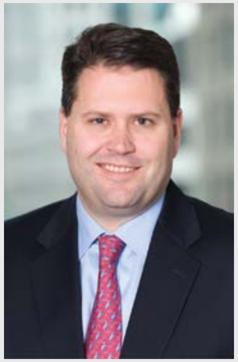
- The changes will impact many provisions of the partnership agreement, including:
  - Income recognition
  - Distributions
  - Tax payments
  - Partners joining the firm
  - Partners leaving the firm
- Changes will need to address both transition period and beyond.
- Making (and agreeing on) these changes will take significant time.



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What would be the impact on existing partners?

What would be the impact on existing partners?

Warren Friss, Esq.
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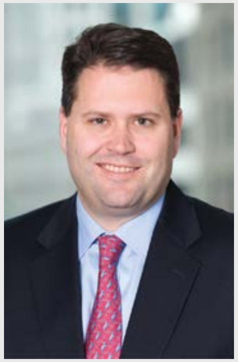
- Timing of income recognition
- Tax payments
- Distributions
- Will force law firms to become better “collectors”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How would this affect new partners?

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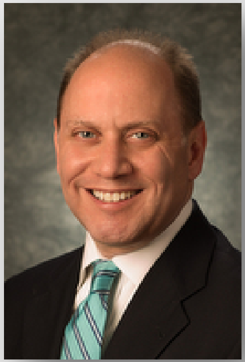

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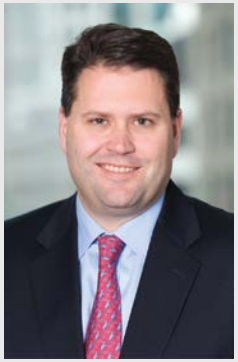
- Will better align the income with the timing of a partner joining the firm
- Significant cash flow issues for new partners
- Transition period issues



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What are considerations for exiting partners?

What are considerations for exiting partners?

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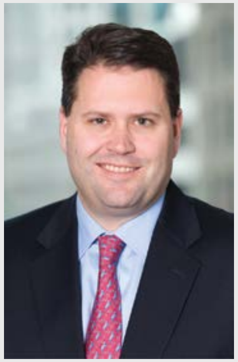
- Will better align income with the timing of the exit
- Will increase the amount of income deferred and paid after the exit
- Issues regarding bad debt
- Transition period issues



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What would be

the affect on the firms'

financial statements?

What would be the affect on the firm's financial statements?

Jude Coard, CPA
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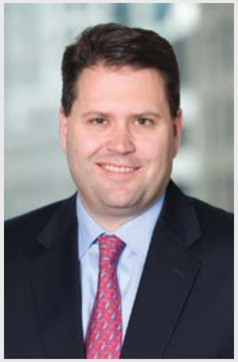
- Dependent upon firm's corporate structure
- If the firm operates as a corporation, corporate taxes can be accelerated and liabilities can be added to the balance sheet.
- Zeroing out salaries
- For firms operating as partnerships, liabilities will be on the partner level.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How will a firm's collections be impacted?

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Jude Coard, CPA
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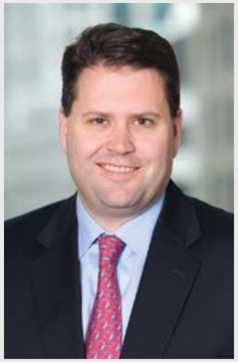
- Collection process will become more critical and need to be modified
  - Throughout the year and not only at year-end
- Treasury will likely establish regulations as to when WIP to be included in reportable income



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What are the implications for the firm's banking relationship?

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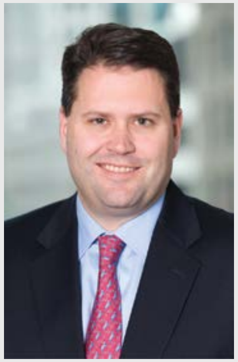
- Communication is key.
- Purpose not ideal from a lender's perspective
- Change in accounting method will most likely require a complete redesign of loan covenants (definitions and levels)



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How would loan covenants be impacted?

Potential impact on loan covenants?

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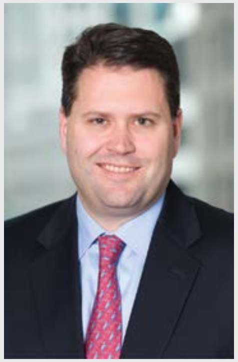
- Covenant impact would be material. Typical covenants (on a modified cash accounting basis) include:
  - Limitation on distributions to less than or equal to net income
  - Minimum cash flow coverage: net income before distributions less unfunded capital expenditures divided by principal payments plus interest plus distributions
  - Minimum annual cash flow – at least 85% of prior year's cash flow

Potential impact on loan covenants?

Chris Covello
HSBC

- Annual 30 day clean-up for working capital line of credit facilities
- Minimum partners’ capital
- Maximum leverage: total unsubordinated liabilities divided by partners' capital
- Asset coverage test/borrowing base: 75% of billed accounts <120 days past plus 50% of unbilled A/R <120 days. Excludes contingencies.
- Minimum partner maintenance



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What should firms do now to prepare?

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Ingram Yuzek

Jude Coard, CPA
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- Begin reviewing partnership agreements to get an overview of changes that will be required.
- Review and improve collection policies.
- Start talking to partners about possible changes so they are aware of looming cash flow issues.
- Consider and prepare for new financing arrangements.

Questions?

This communication is for general information purposes only. It is not intended as professional advice in connection with any specific circumstances. Any actions based on the content of this communication should only be undertaken after consulting your professional advisor.

THANK YOU

John Fitzgerald, CPA

BERDON LLP | Accountants and Advisors

T 212.331.7411 | jfitzgerald@berdonllp.com

Jude Coard, CPA

BERDON LLP | Accountants and Advisors

T 516.806.3431 | jcoard@berdonllp.com

Warren E. Friss, Partner

Ingram Yuzek Gainen Carroll & Bertolotti, LLP

T 212.907.9660 | wfriss@ingramllp.com

Christian J. Covello, Senior Vice President

HSBC Bank USA, N. A.

T 212.525.4910 | christian.j.covello@us.hsbc.com