

# *Kowalski & Associates*

*The latest from our blog: [www.kowalskiandassociatesblog.com](http://www.kowalskiandassociatesblog.com)*

## **The Dummy's Guide to Forensic Analysis of Law Firm Financial Accounting and Reporting While Leaving the PPP in the Commode**

**Jerome Kowalski  
Kowalski & Associates  
May, 2011**



*Law firm financial statements: What you need to know and why you need to know it.*

My friend and distinguished colleague, [Ed Reeser](#), who previously served with distinction as a managing partner at

major international law firms, along with [James Hunt](#), a retired PriceWaterhouseCoopers partner who

headed PWC's forensics accounting group, recently published a series of articles entitled *Super Fuel for the Law Firm PPEP Drag Race- Modified Cash Basis Accounting in [The Los Angeles Daily Journal](#)* (subscription required) addressing law firm financial reporting and some of the excessive – perhaps, better, unwarranted – exuberance sometimes contained in law firm financial reporting.

Ed and Jim assert that in analyzing financial statements of law firms which have failed, one almost always finds gimmickry and manipulation in the financial reporting of these now defunct firms. The essence of their work is that a law firm may be in a death spiral and creative accounting gimmickry serve to avoid detection of systemic failures, while management seeks to resolve the issue, without adequately disclosing the severity of the firm's problem. In short, in the absence of an audited financial statement, certified by a reputable accounting firm attesting that the report was audited in accordance with Generally Accepted Auditing Standards and certified that the firm's books and records are maintained in accordance with Generally Accepted Accounting Principles, some firms too often game their own financial reports to deflect attention from material adverse events.



In this season of the issuance of AmLaw reports and law firms' issuance of their own financial reports, the observations and warnings by Ed and Jim are timely. And, this season is also one in which some law firms are having advanced stage discussions about combining with another law firm, or acquiring a practice group, making some of these observations of further current interest.

We've previously discussed the absolutely critical need for due diligence in the world of lateral acquisitions accessible [at this link](#).

### ***Accounting Basics***

Ed and Jim first begin with the basic premise that all law firms keep at least two sets of books (no, we're not talking about double entry accounting): Most often, the first is a report using the "cash basis" method of accounting and the second is the "modified cash basis."

The essence of cash based accounting is that income is reported when actually received and expenses are posted as either operating or capital costs. Operating costs are day to day expenses and reported as and when disbursed. Capital costs are expenses incurred for items that have longer term useful lives. Buying a pen or a pad is an operating cost. Buying a computer is a capital cost, because the computer has a longer term useful life and the cost of the computer is spread over the presumed useful life of the computer.

Cash based accounting is required by the IRS for all partnerships. But from an accounting point of view, the gold standard is accrual accounting, the darling of the AICPA and financial analysts. Accounting on an accrual basis should require audited

and certified financials – all done under the watchful eyes of independent auditors. They are pricey propositions which law firms generally prefer to avoid. The essence of accrual accounting is that assets and expenses are recorded when they accrue, determined in accordance with AICPA standards. But there is little doubt that a financial statement prepared on an accrual basis presents a more accurate snapshot of the reporting entity's financial status as of the date of the report.



Enter a hybrid, the middle ground – neither fish nor fowl – “Modified Cash Basis Accounting.” The modified cash basis accounting falls short of the rigors required of certified accrual statements, but provides a more accurate snapshot than the cash based system. But, it comes with a very big catch, namely it invites, to put it kindly, the exercise and abuse of both judgment and discretion, which too often allows a law firm to Photo Shop its financial statements to present an altered snapshot.



### *Altering Reporting of Actual Financial Performance*

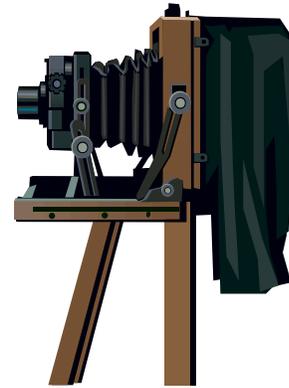
For example, as Ed and Jim point out, cash based accounting means you include as income a contingent fee as income if and when collected and not a moment earlier. But under the modified cash system, some law firm managers may be tempted to juice up their reported income by recording as income a percentage of fees yet to be earned on contingent fee cases where there is a “high confidence” of success.

Other Photo Shop opportunities available when using modified cash basis accounting:

- **The Thirteen Month Year.** Some firms “hold their books” open and record receipts received after the last day of the year as if received on the last date of the year.
- **November and December Billing Mania.** Bill every potential item in the last two months of the year. Bill often and bill early.
- **The Eleven Month Year.** Some firms stop paying vendors during the last month of the year.
- **December Discounts.** Clients are offered discounts to remit payments before year end.
- **WIP Prestidigitation.** Recording work in progress or some portion of WIP as income.

- **Aggressive Amortization of Capital Assets.** Accomplished by extending the anticipated useful life of capital assets.
- **Reducing or eliminating cost reserves.**
- **Defer start dates of laterals until after the first of the year, eliminating the “ramp up expense.”**
- **Capitalize Partner Recruiting Expenses.**
- **Extend useful lives on capital acquisitions.**
- **Defer 401 (K) contributions.**

Most of the foregoing probably might not appear very unusual and you probably have seen all or most of this at your own firms. But, let's recall something most of us too easily forget: A financial statement is not an analysis of any law firm's financial performance over an extended period. It is a snapshot of a firm's assets and liabilities on a given day, the date as of which the snapshot was taken, and that date is the last day of the firm's fiscal year. A financial statement is not a video or a documentary covering any extended period. But, in understanding this snapshot, you must know how the frame was staged.



### *Profits Per Partner and Profits Per Equity Partner*

In doing so, the reader must always bear in mind that much of what appears in many firms' financial report is geared towards a single purpose: The ability to report on the highest possible Profits Per Partner imaginable. Thus, where the financial statement is gussied up through creative artifices, the PPP report simply doesn't bear sufficient relationship, if any, to reality. The simplest example is using the modified cash basis accounting method to recognize future contingent fee income. It sometimes can really look great, even eye popping. But you can't deposit "high confidence" of success in a contingent fee case in a bank, nor can you send it along to your landlord or mortgage lender.

The problem in large measure is that the profession as a whole has attorned to the holy grail of PPP and the need to wave that number from the rooftops, a practice [we previously suggested should just come to an end.](#) In truth, reports of average profits per partner or average profits per equity partner are meaningless. Reported PPP and

PPEP are regularly manipulated in a variety of fashions, chief among them is simply changing the status of lawyers within the firm. Thus, an equity partner might be demoted to a non-equity role; a non equity partner will be shifted to a “counsel” role, often with little change in the compensation of the affected partner. What does change is the PPP and PPEP number. It has often been suggested that, inflated PPP numbers are necessarily reported for recruiting purposes and because all of the other kids on the block also do so. In reality, nobody jumps ship because the firm across the street has eye popping PPP numbers and no firm with eye popping PPP numbers will compensate a lateral partner materially more than the market dictates. Partner compensation is based on the lawyer’s production, productivity and practice specialty and not a firm’s reported PPP.

*The simple truth is that the best single metric in the AmLaw reports for determining a law firm’s true profitability if you are going to rely on any of the information reported by AmLaw is actual revenues per lawyer, a fact too often glossed over.*

We must therefore confront the world as it exists and not as we would prefer it to be. In the thirty years during which PPP and PPEP were hyped and simultaneously criticized nobody has been able to convince the community to abandon this charade.

### ***Determining Actual Law Firm Performance: The Essence of Required Due Diligence***

Thus, as Ed and Jim suggest, when presented with a financial statement of a law firm of which you are a member, which you are considering joining or you are considering acquiring and the financial statement of that law firm is prepared on a modified cash basis, you should first require the firm’s accountants to provide a reconciliation of the modified cash basis financial statement with its cash basis statement, upon which partner K-1’s are prepared.

Don’t stop there: do the same for the preceding two years. Then, lay them out side by side and look for, among other things, trending or sudden aberrations.



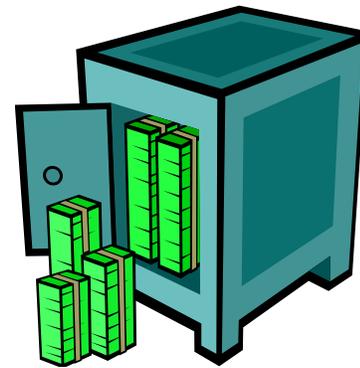
If you are considering joining a law firm as a lateral, discuss openly the firm’s policies with regard to the items identified in the bullet points above.

But, certainly don’t stop there. You must also look at monthly income and expense statements (on a *cash* basis) for a three year period and aged WIP and A/R statements over the same period. If the firm has credit facility, obtain a copy of all of the firm’s loan agreements and copies of the reports the firm sends the banks as required by the lending documents. Be sure to obtain any requests the firm has made for waivers

for any covenants and copies of any waivers granted. Also pay particular attention to all of a firm's real estate leases and significant capital equipment leases. Yes, of course this is a boatload of materials but always recall that when law firms slip beneath the waves, the biggest class of largely unsecured creditors is always the landlords and equipment lessors. And in virtually every law firm failure over the past thirty years, it was these creditors who kept waterboarding partners at firms in dissolution until they agreed to write checks out of their own pockets to repay the creditors, [as I've previously discussed](#).



You will also want to have a list of the firm's 100 largest clients and the billing and payment history of these clients. You also will want to see how the firm's business is divided among its various practice groups. By now, you should be well aware of the alarms that should be sounding if any one client is responsible for more than 5% of a firm's revenues. Similarly, practice concentrations should similarly be scrutinized. Recall those firms that were virtually minting money handling structured finance; or, a couple of years before that, handling dot.coms.



An additional item you you will want to see is the compensation of partners, both equity and non-equity (assuming, of course that the firm does not keep partner compensation in a black box, which some do as a matter of policy). By this time, assuming you are a lateral candidate, you will have an understanding of the compensation you will be receiving. You must understand how draws and distributions are paid. In this regard, you should also compare how these payment schedules have been met during the course of the three preceding years. It is obviously of some consequence if the firm is stretching final distributions later and later in to the following year. You should determine the sources of these payments, that is, whether they are paid out of current income or are the proceeds of bank lending.

Most significantly, you should have a complete understanding of the firm's policies with regard to partner compensation, as it is fixed from year to year. [You should gain a full understanding as to how each category of partner, finder, minder or grinder is compensated.](#)

Let's be sure to add to the pile the firm's partnership agreement, any pension plans to which the firm

is obligated to contribute and a schedule of payment obligations that the law firm has to retired or withdrawn partners.

Yes, all of that is a boatload of stuff. If you are already partner at the firm, you should have a file containing all of these materials. If you are considering joining the firm as a lateral, you need to have all of the materials reviewed carefully, particularly, if as is so often the case, the firm's financial reports are prepared utilizing modified cash basis accounting. These reports are not inherently evil or intrinsically deceptive. But they can be.



Former New York City Mayor Ed Koch famously greeted constituents with “how am I doing?” Too few managing partners greet partners with this inquiry. Messrs. Reeser and Hunt submit that instead, management circulates financial reports that are, in their words, “manipulated” and “a good tool put to a bad purpose” in order to deflect attention from systemic problems. The result, report these authors, is that the partnership too often does not know how the firm is actually doing until the day arrives when a dribble of partners begin leaving the firm and this dribble escalates in to a torrent, ultimately with the firm having no choice but to dissolve.

Ed and Jim’s advice: partners should know how their firm is doing and shouldn’t be lulled in to a comfort zone because of a rosy looking financial statement. Most law firm leaders welcome transparency and find that the firm moves forward best when partners are both fully informed and productively engaged.

The probabilities are that you’re doing just fine, thank you. But in this world of AmLaw 200 and NLJ 250, we all need to keep in mind that in the last 25 years, over 40 major law firms failed (three thus far this year) and the implosions of those failed firms all followed identical patterns with the dissolution votes taking place with head-spinning swiftness and affected partners then rubbing their eyes wondering “how did that happen?”.

© Jerome Kowalski May 2011. All Rights Reserved.

**Jerry Kowalski is the founder and principal of Kowalski & Associates ([www.kowalskiassociates.com](http://www.kowalskiassociates.com)), a firm providing a broad range of consulting services to law firms, including strategic growth strategies, enhancing law firm profitability and marketing services.**

**Jerry can be reached at [jkowalski@kowalskiassociates.com](mailto:jkowalski@kowalskiassociates.com)**