The Basic Principals of General Accounting

Presented by
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FM 11: The Basic Principles of General Accounting

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General Accounting Functions

• Accounts Payable
• Accounts Receivable
• Client Intake, Conflict Checks, Billing
• General Ledger
• Cash vs. Accrual Accounting Method
• Fixed Asset Management
• Financial Reports: Balance Sheet, Income Statement
General Accounting Functions – Personnel

- Accounts Payable Clerk
- Accounts Receivable Clerk/Specialist
- Client Intake/Conflict Analyst
- Billing Specialist
- General Ledger Accountant
- Collection Specialist/Client Service Specialist
- Accounting Manager
- Controller/Director of Finance
- C.F.O.

ACCOUNTS PAYABLE

- Vendor payables
  - Approval process
  - GL Coding
  - Client/matter Coding

- Disbursement checks – client expenses
  - Filing fees, Witness checks, etc.
ACCOUNTS RECEIVABLE

• Proper cash application of payments
  – Accurate client statements
  – Reduce collection issues
  – Accurate timekeeper cash receipts/productivity
  – Accurate Fee Revenue on Income Statement
    • Checks
    • ACH, Wire
    • Credit Card Processing

Intake, Conflict Checks, Billing

• Client Intake
  – Conflict check
  – Intake information
  – Engagement letter
  – Retainer Payment

• Billing
  • Time entry habits
  • Timely billing
  • Improved receipts
CASH VS. ACCRUAL BOOKKEEPING

- **Cash Method:**
  - Record revenue when cash receipts received
  - Record expenses when paid
  - Used by sole proprietors
- **Modified Cash**
  - Includes Fixed & Long Term Assets and Liabilities included
- **Accrual**
  - Recognizes economic events, regardless of when cash transaction occurred
  - Record revenue in period billed or service took place
  - Record expenses in period when invoices or disbursements were incurred
  - Accounts payable and receivable included on balance sheet

Tax Reform Legislation – Mandatory Accrual Accounting for Law Firms

- Impose financial burdens and potential hardships to many law firms, accounting firms, medical firms, etc.
- Would require businesses with annual gross receipts over $10M to use the accrual method of accounting.
- Require entity to pay tax on income they have not yet received or may never receive.
- ABA involvement and letters to Senate
• Statement of financial position of organization at a particular moment in time
• Illustrates organization’s net worth
• States what an organization owns (Assets)
• States what an organization owes (Liabilities)
• Derived from General Ledger

Accounting equation:
Assets = Liabilities + Partner’s Capital/Owner’s Equity

Assets:
• Cash/Bank Accounts/Investments
• Accounts Receivable for Disbursements: billed, unbilled, delayed cost recovery
• Unapplied Cash
• Fixed Assets, Accumulated depreciation
• Other Assets
• Equity Members Draw

Liabilities
• Current (Short Term) and Long Term
• Notes payable

Partner’s Capital/Owners Equity

* Modified Cash Basis Accounting doesn't show accounts receivable or accounts payable)
GENERAL LEDGER – INCOME STATEMENT

• (Profit & Loss Statement)
  Revenues:
  • Fee income, bad debt income, interest income
  Expenses:
  • Salaries, fringes, technology, business development, office operations, occupancy
  • Categorized by department
    – Detailed
    – Summary
  Revenue less Expenses = Net Income, Profit/(Loss)

GENERAL LEDGER – INCOME STATEMENT

• Compare Actual vs Budget
  • Monitor variances
• Current Year vs Prior Year
  • Monitor performance
    – Fee Income
    – Net Income
FIXED ASSET MANAGEMENT

• Determine dollar threshold of items that should be capitalized
• Refer to IRS guidelines
• Types of Depreciation
  • MACRS
    – Straight Line
    – Declining Method

FIXED ASSET MANAGEMENT

• IRS Code Section 179
  – 2018 Limit $1,000,000
  – 2018 Spending Cap $2,500,000
  – Applies to new and used equipment, off the shelf software
  – Must be:
    • Financed or purchased
      – AND
    • Put into service 1/1/18 – 12/31/18
## 2018 Section 179 Example

### 2018 Section 179 Example Calculation

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment Purchases</td>
<td>$1,150,000</td>
</tr>
<tr>
<td>First Year Write Off</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>100% Bonus First Year Depreciation</td>
<td>$150,000</td>
</tr>
<tr>
<td>(repealed by US09-10 Tax Cuts and Jobs Act)</td>
<td></td>
</tr>
<tr>
<td>Normal First Year Depreciation</td>
<td>$0</td>
</tr>
<tr>
<td>Total First Year Deduction</td>
<td>$1,150,000</td>
</tr>
<tr>
<td>Cash Savings</td>
<td>$402,500</td>
</tr>
<tr>
<td>Equipment cost after Tax (assuming a 30% tax bracket)</td>
<td>$747,500</td>
</tr>
</tbody>
</table>
Your opinion matters!

Please take a moment now to complete the evaluation.

Thank You!
Make your working capital work for you

Strategies for optimizing your accounts payable

Part of the Deloitte working capital series
The Deloitte working capital series

Strategies for optimizing your accounts receivable
Strategies for optimizing your accounts payable
Cash management
Strategies for optimizing your inventory
In today’s business climate, organizations in every sector are under pressure to do more with less. That means businesses cannot afford to squander opportunities to free up their working capital. By giving you greater availability to the cash trapped on your balance sheet, a formal working capital strategy can deliver the added liquidity you need to fund growth, streamline processes, reduce costs, enhance service levels and seize new investment opportunities as they arise.

While there are numerous ways to free up working capital, this series focuses on four core strategies: accounts receivable, accounts payable, cash management and inventory. This second installment looks at accounts payable.
Taking a strategic approach to accounts payable management
Because accounts payable is a back-office function, it doesn’t always take centre stage as businesses look to grow or build competitive advantage. In fact, often accounts payable takes a back-seat to management’s competing priorities.

When it comes to working capital optimization, however, increasing payables should be a core strategy. To be sure, many businesses work this strategy by extending payables as long as possible to maximize free cash flow. Unfortunately, this approach is not always the right one. In some cases, delaying payment can erode supplier goodwill, resulting in slower delivery times, less willingness to fix defects, slower responses to queries and more onerous payment terms. On the flip side, paying early can sometimes yield substantial benefits in situations where suppliers offer discounts or rebates for early payment.

To effectively identify these opportunities and determine the right course of action when facing potentially conflicting outcomes, businesses must take a more strategic approach to accounts payable. The Accounts Payable team, along with the Purchasing and/or Procurement departments, must collaborate with senior management to inject a working capital culture throughout the company. This is about more than ensuring invoices are received and processed in a timely fashion. It’s about adopting a management focus that emphasizes the importance of optimizing payables and freeing up working capital to fuel growth.
Adopting best practices

While organizational change is rarely easy, fostering a working capital culture can yield sizeable benefits. For instance, refining your accounts payable processes can help enhance the accuracy of your cash flow forecasts, ultimately positioning you to improve liquidity, mitigate potential funding gaps and realize higher profits. Using the insights gained from improved processes, you can also strengthen your own negotiating power, potentially partnering with major suppliers to share risk, extend payment terms, increase warranty periods or even hold some inventory on consignment.

Common risks

A failure to adopt effective accounts payable processes can hamper a company's ability to process invoices on a timely basis, take advantage of available discounts and set either longer or shorter payment terms with suppliers, depending on which are most favourable. These consequences can arise when businesses:

- Rely too heavily on error-prone manual processes to approve requisitions, scan supplier invoices and issue payments
- Fail to issue purchase orders for each new order
- Do not confirm if order deliveries match contractual terms or cannot easily access vendor contracts
- Lose access to early payment discounts by over-extending payment cycles or simply accept discounts without calculating the cost of capital outlay
- Neglect to take advantage of maximum savings through volume rebates or trade spend initiatives
- Incorrectly load supplier and/or contract information into master data files
- Lack processes and systems to prevent late payments, under- or over-payments, duplicate payments or missed payments
While each business must adopt a customized approach to realize these goals, there are best practices that can guide the way. Some strategies include:

- **Centralizing accounts payable processing and reporting** across the enterprise through a shared service environment to ensure all staff members adhere to common practices and standards and measure their performance against established business metrics. This has the added advantage of enabling you to accomplish more tasks in a faster timeframe and with fewer resources, ultimately reducing enterprise costs.

- **Moving towards a paperless processing environment.** Although EDI (electronic data interchange) is not for everyone, businesses that automate their accounts payable systems by enabling electronic communication with vendors gain significant functionality advantages and savings through available discounts or rebates. With an eProcurement system, for instance, you can communicate electronically with vendors and customers to automatically generate purchase orders (POs) for each new order, electronically validate and accept invoices, approve requisitions, track goods received and pay invoices on a timely basis. Depending on the level of automation you select, you may even be able to scan invoices automatically, track delivery receipts and resolve disputes electronically rather than through manual follow up.

- **Adopting more robust governance practices,** which can reduce the risk of manual error and strengthen internal controls around accounts payable processing, and contract review.

- **Setting up supplier portals** so that suppliers can electronically track the status of orders, delivery schedules, potential product shortages and payments received. In addition to reducing time spent on these processes, these systems also cut down on manual errors, improving order accuracy.

- **Creating management workflows** to enhance the efficiency of your accounts payable processes. Management workflows can help you identify and resolve system bottlenecks and streamline process handoffs to improve liquidity management in the most effective manner possible.

- **Strengthening purchasing approval processes** by defining the level of management authority required to make various-sized purchases.
Strategies for increasing payables
There are six main activities within the accounts payable function that, if optimized, can help you free up cash and strengthen your working capital:

1. **Vendor selection process**
   One of the first steps towards implementing a robust accounts payable system involves setting up preferred supplier lists to prevent maverick buying and position your organization to negotiate the most favourable buying terms. As part of the vendor selection process, there are several steps you can take to negotiate terms designed to optimize your working capital:
   - Establish priorities for the vendor negotiation process and ensure key personnel and decision makers are involved (e.g. Chief Financial Officer and Chief Procurement Officer)
   - Develop supplier performance scorecards for strategic vendors and leverage these scorecards during negotiation as a way to induce suppliers to improve product or service quality, customer service standards, and/or price
   - If you are coming from a position of strength, negotiate longer payment terms
   - Regularly seek opportunities to negotiate better pricing as well. Strategies might include asking vendors to match lower prices offered to your competitors or negotiating for volume discounts

2. **Supplier master data set-up process**
   Once you have negotiated terms with vendors, it is essential to properly capture and maintain this data. Inaccurate entry of this data can result in more than payment errors. It can also lead to account delinquencies which prevent you from taking advantage of available discounts and may even lead to disruptions in supply. To avoid these outcomes:
   - Ensure all service level agreements (SLAs) are accurately reflected in your purchasing and payables systems. Among other things, supplier master data should indicate product/service details, quality standards, delivery timelines, supplier responsibilities, and any regulatory compliance mandates that apply
   - Regularly update payment terms and the availability of volume discounts, trade credits or other ongoing or periodic rebates. If supplier contractual terms change or are renegotiated, the supplier master data must also be changed to keep pace
   - Properly store your supplier contracts. Document management systems can help streamline this process and simplify information searches
3. Contractual review process

To prevent inaccurate — or even fraudulent — vendor billing practices which may result in overpayment or duplicate payment, it is essential to regularly review vendor contracts:

- Assign responsibility for data to a central master data team that can check for completeness, accuracy and compliance with standard terms. This team should also periodically review vendor performance to ensure vendors continue to meet their contractual terms.

- Include supplier contract clauses that pass accountability for fines and penalties to vendors where they are found to be underperforming in some respect.

- Complete periodic and timely vendor contract reviews, in addition to reviewing such contracts against industry standard terms.

- Ask your legal team to check vendor authorization limits, assess the appropriateness of contractual terms and confirm compliance with regulations.

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Tracking key metrics

From a contractual review standpoint, many organizations use supplier scorecards to monitor supplier performance on a range of metrics, such as on-time delivery, defect rates and quality of service. In addition to alerting you to potentially floundering supplier performance, this type of scorecard system can also yield financial benefits by triggering discounts if suppliers fail to meet established SLAs.

Of course, supplier metrics are not the only ones organizations should track in an attempt to free up working capital. From an accounts payable perspective, it is also important to track days payable outstanding (DPO) to determine how well you are managing your cash flow. Beyond understanding the actions that drive DPO, finance departments should track any variance in this metric and follow up to ensure variances align with the company’s cash management goals.
4. Procurement process

Some businesses work with hundreds, and even thousands, of suppliers. Even if your environment is more streamlined, it can be challenging to keep track of all the invoices you receive and reconcile each invoice to its associated PO. Failure to accurately manage payables, however, makes it harder to forecast and manage cash flows and anticipate short-term liquidity needs, putting many businesses on an unnecessary cash flow tightrope.

Lax procurement standards can also place the business at risk of over-spending or trading with unapproved suppliers. To prevent maverick buying or purchase control over-rides, you must track internal buyer practices to ensure buyers work with pre-approved vendors and stay within authorized spending limits. Here are some strategies to consider:

- Issue POs for each new order so you can validate any orders received, lock in payment terms in advance and track invoices against existing POs to ensure suppliers bill in accordance with agreed-upon terms
- Maximize your savings potential by exploring the viability of any available early payment discounts, volume rebates or trade spend initiatives, but keep in mind that you don’t need to accept all early payment discounts. If you don’t have the cash on hand or the capital outlay exceeds the benefit of the discount offered, it may make sense to pay later
- Track payables outstanding by vendor and by payment terms
- Set clear accounts payable metrics (such as frequency of invoices that match POs, percentage of invoices paid to terms and percentage of negotiated discounts captured) and adhere to them across the organization
- When purchasing a new or riskier product, negotiate longer payment terms to increase working capital or ask to add the product to consignment stock rather than inventory as a way to maximize liquidity and reduce risk

The role of accounts payable in trade spend initiatives

Recently, businesses in many industries have begun to introduce trade spend initiatives as a way to strengthen partnerships between suppliers and retailers. Under these agreements, suppliers grant price concessions, rebates or marketing/advertising dollars in exchange for preferential product placing at the retail level.

In entering these partnerships, it is essential not to leave accounts payable behind. To get the full benefits of a supplier relations initiative, businesses must accurately track contract terms, communicate information about any special arrangements to staff and maintain management focus on working capital. The risk is that dollars negotiated by your purchasing team are lost through an inability to track the terms.
5. Invoicing process
Properly managing the invoicing process is yet another way to improve liquidity. Here are some strategies to consider to improve processing:

• Set up a centralized processing office to ensure a standardized and consistent approach

• Refuse to pay inaccurate invoices (e.g. errors in quantities, amounts, address, etc.). These should be sent back to the supplier

• Process invoices on a timely basis and include a date stamp. Be sure to complete this process in line with defined internal service level agreements (e.g. process invoices within two days of receipt)

• Avoid paying invoices early; without risking key supplier relationships, you should pay invoices only when they are due

• Conduct a management review of the AP aging listing to determine appropriate follow-up actions

• Develop appropriate channels and processes for exception reporting and handling

• Implement an EDI system that allows vendors to submit invoices electronically while enabling you to track invoices against their associated POs, validate and approve payments and maintain accurate payment records

Process invoices on a timely basis and include a date stamp. Be sure to complete this process in line with defined internal service level agreements (e.g. process invoices within two days of receipt)
6. Accounting and reporting process

Before you can actively manage payables, you need assurance that your accounting reports are up-to-date and that your financial records fairly reflect current accounts payable balances. Without this data, many businesses lack visibility into how much, how often and when they pay their suppliers. This can hamper you from choosing the most advantageous payment terms or selecting appropriate timing in which to pay vendors. To bolster your accounting and reporting process, you need to:

- Validate supplier invoices against contract terms and their associated POs to ensure billing accuracy
- Improve real-time reporting capabilities by automating reconciliations and ensuring they remain current
- Follow up on and resolve unreconciled items on a timely basis
- Have the same individuals prepare and review all reconciliations to reduce the likelihood of overpayment or duplicate payments
- Post journal entries before reporting period cut-off dates
- Apply payments to each invoice on the date they’re made to maintain system accuracy
- Properly track all payments made, not just vendor payments
- Select a method of payment (i.e. cheque, EFT, credit card) that minimizes bank charges
Getting cash fit

By improving accounts payable governance, setting up clear management processes and consistently tracking key metrics, businesses can streamline their processes and inject a working capital culture into the enterprise. Approached effectively, this can strengthen corporate cost management, reduce process complexity, minimize the risks associated with routine transaction processing and enhance vendor contract compliance.

Businesses that invest in EDI technology or improve existing electronic processes can further benefit by empowering fewer resources to manage the accounts payable process while simultaneously increasing processing accuracy, accelerating invoice processing and optimizing payment timing to take advantage of available discounts.

With proper executive-level support, these steps can help you do more than simply maintain operating margins. They also support greater liquidity, which can lead to stronger bottom line performance.
Mandatory Accrual Accounting for Law Firms

Overview

Congress is still considering proposed tax reform legislation that would impose substantial new financial burdens and potential hardships on many law firms and other types of personal service businesses throughout the country by fundamentally changing the manner in which they must pay their taxes. Section 3301 of H.R. 1, the "Tax Reform Act of 2014" introduced by then House Ways & Means Committee Chairman Dave Camp (R-MI) during the 113th Congress, and Section 51 of a similar Senate draft bill prepared by then Senate Finance Committee Chairman Max Baucus (D-MT), would require all such businesses with annual gross receipts over $10 million to use the accrual method of accounting rather than the traditional cash receipts and disbursements method. Both proposals remain under active consideration in the 115th Congress by the two Committees, and if they are enacted, many law firms, accounting firms, medical firms, and other personal service providers would be forced to pay taxes on "phantom" income long before it is actually received.

Current law allows individuals and most partnerships, S corporations, and other pass-through entities—as well as other types of businesses with annual gross receipts of $5 million or less—to use the simple cash method of accounting for tax purposes, in which income is not recognized until cash or other payment is actually received. In addition, all law firms, accounting firms, and various other types of personal service businesses are allowed to use cash accounting regardless of their annual revenue unless they have inventory. Most other businesses are required to use the more complex accrual method of accounting, in which income is recognized when the right to receive it arises, not when the income is actually received.

Mandatory accrual accounting proposals like Section 3301 of the House bill and Section 51 of the Senate bill would dramatically change current law by raising the gross receipts cap to $10 million while eliminating the existing exemption for law firms, other personal service businesses, and other pass-through entities. If enacted, these far-reaching proposals would create unnecessary new complexity in the tax law; increase compliance costs; and cause substantial hardship to many law firms and other personal service businesses by requiring them to pay tax on income they have not yet received and may never receive.

Jump to Any of the Following Sections

- Overview
- Status
- Key Points
- ABA Policy

ABA Resources

- ABA Fact Sheet (Updated September)
- List of Bars Opposing Mandatory Accrual Accounting Legislation (Updated September 2017)
- ABA Letter to Senate Finance Committee (April 21, 2017)
- ABA Letter to House Ways and Means Committee (April 21, 2017)
- ABA News Release Regarding Letters to Congress (April 24, 2017)
- Sample Law Firm Letter to House (September 2017)
- Sample Law Firm Letter to Senate (September 2017)
- Sample Bar Letter to House (December 2017)
- Sample Bar Letter to Senate (April 2017)
- List of States with Senators or Representatives on Senate Finance Committee or House Ways and Means Committee (April 2017)
- List of Members of Congress signing to Senate or House Dear Colleague letter in support of cash accounting (April 2017)
- ABA Letter to Senate Finance Committee regarding hearing on "Navigating Bush Tax Reform" (April 26, 2016)
- ABA Letter to House Subcommittee of Policy (April 13, 2016)
- ABA Letter to Senate Finance Committee (April 13, 2016)
- PowerPoint Slides and Materials from ABA Webinar, "Mandatory Accrual Accounting for Law Firms: Tax Reform or Impending Storm?" (December 14, 2015)
- ABA Legislative Action Alert (April 7, 2016)
- ABA Letter to Senate Finance Committee (April 6, 2015)
- ABA Letter to House Ways and Means Committee (April 6, 2015)
- ABA News Release Regarding Letters to Congress (April 7, 2015)
- ABA News Release; Letter from 233 Representatives to House Leadership (September 12, 2014)
- ABA Statement to House Small Business Subcommittee (July 10, 2014)
In the spring of 2013, then Chairman Camp released his original draft tax reform bill known as the “Tax Reform Act of 2013,” which included many provisions such as the accrual accounting requirements contained in Section 212 of the legislation. The ABA Board of Governors subsequently adopted a Resolution in November 2013 opposing Section 212 of the original Camp draft bill and any other similar measures that would require law firms and other personal service businesses to switch from the cash method of accounting to the accrual method. Draft tax reform legislation was also prepared by then Senate Finance Committee Chairman Baucus in 2013, including similar mandatory accrual accounting language contained in Section 51 of that measure.

On January 13, 2014, the ABA sent a letter to the House Ways & Means Committee and a separate letter to the Senate Finance Committee opposing the accrual accounting provisions in the respective draft bills and urging the Committees to remove these provisions from the legislation. The ABA also sent a Legislative Action Alert to state and local bar leaders on January 31, 2014 urging them to adopt their own resolutions opposing the legislation and to send letters to their Members of Congress. Numerous state and local bars subsequently adopted resolutions or sent letters to their congressional delegations opposing the legislation. The ABA also sent letters to hundreds of law firm managing partners requesting their firms’ assistance in defeating the harmful legislation.

In addition to the concerns raised by the ABA, state and local bars, and various other associations and entities, many Members of Congress from both parties have voiced objections to the legislation. On November 25, 2013, 71 Representatives sent a letter to leaders of the House Ways and Means Committee expressing concerns over the accrual accounting provisions in the original draft House bill. Subsequently, 46 Senators sent a letter to the Senate Finance Committee leadership on August 6, 2014 supporting cash accounting and opposing mandatory accrual accounting legislation, and 233 Representatives (a majority) sent a similar letter to the House leadership on September 11, 2014. In addition, the House Small Business Subcommittee on Economic Growth, Tax and Capital Access held a hearing on July 10, 2014 on the benefits of cash accounting for small business, and the ABA submitted a written statement in support of preserving cash accounting for law firms and other personal service businesses.

At the end of the 113th Congress in late 2014, Chairman Camp introduced a revised version of his comprehensive tax reform legislation as H.R. 1, and the mandatory accrual accounting provisions in Section 3301 of that legislation were almost identical to those contained in Section 212 of the original Camp bill. However, while H.R. 1 and the draft Senate bill generated extensive discussion, neither bill advanced during the 113th Congress.

Additional Resources

- Coalition to Preserve Cash Accounting Letter to Senate Finance Committee (August 1, 2017)
- Coalition to Preserve Cash Accounting Letter to House Ways and Means Committee (April 20, 2017)
- Cash to Accrual Accounting Stakeholders Coalition Letter to Senate Finance Committee (April 15, 2015)
- Treasury Department’s FY 2016 Green Book (February 2015)
- Letter from 233 Representatives to House Leadership (September 11, 2014)
- Letter from 46 Senators to Senate Finance Committee (August 6, 2014)
- Letter from 71 Representatives to House Ways & Means Committee (November 2013)
- PwC White Paper on Challenges the Legislation Will Create for Law Firms (2014)
- PwC White Paper on the Legislation’s Harmful Effects on Law Firms (December 2013)
- Text of Section 3301 of H.R. 1, “Tax Reform Act of 2014” (December 2014)
- Section-by-Section Summary of House (February 2014)
- Text of Section 51 of Draft Senate Tax Reform Legislation (November 2013)
- Joint Committee on Taxation Technical Explanation of Senate bill (November 2013)

Articles

- “ABA President Reiterates Opposition to Mandatory Accrual Accounting Proposals;” (ABA Washington Letter, May 2017)
- “ABA Urges Congress to Preserve Cash Accounting Method” (Law360, April 24, 2017)
- “ABA President Brown Reiterates Opposition to Accrual Accounting” (ABA Washington Letter, April 2016)
- “Cash Accounting Vital for Law Firm Stability,” ABA Says” (Law 360, April 7, 2015)

https://www.americanbar.org/advocacy/governmental_legislative_work/priorities_policy/independence_of_the_legal_profession/mandatory-accrual-acc...
During the 114th Congress, the new chairmen of the House Ways & Means Committee and the Senate Finance Committee—Representative Kevin Brady (R-TX) and Senator Orrin Hatch (R-UT)—both announced plans to pursue comprehensive tax reform, and members and staff from both committees reiterated that the previous mandatory accrual accounting proposals remained viable options to help pay for tax rate reductions. After the Senate Finance Committee created a series of tax reform working groups and requested written comments from interested stakeholders, the ABA sent new letters to that committee and to the House Ways & Means Committee in April 2015 urging them to preserve cash accounting for law firms and other personal service businesses and to oppose any proposals requiring these businesses to switch to the accrual method. The ABA also sent an updated Legislative Action Alert to state and local bars in April 2015 urging them to send new letters to their Members of Congress.

After receiving input from many stakeholders, the Senate Finance Committee’s Business Income Tax Working Group issued its Report to the full Committee in July 2015 discussing various tax proposals and options. Although the Report did not expressly endorse the previous mandatory accrual accounting proposals, it stated that “it would be difficult to achieve significant rate reduction in a revenue-neutral tax reform process without curtailing many of the most popular tax expenditures utilized by pass-through businesses, such as...cash accounting,” and the Report also listed the Baucus and Camp accrual accounting proposals as viable “Options” for the Committee to consider (See Report at page 27 and the Appendix at pages A-5 to A-8).

In February 2016, Speaker Ryan created a new House Tax Reform Task Force chaired by House Ways & Means Committee Chairman Brady to develop a new tax reform plan based on several key principles including tax simplification, closing loopholes, lowering rates, and encouraging the growth of small businesses. The House tax reform plan, known informally as the "Blueprint," was released in June 2016 and included several major proposals such as lower corporate and individual tax rates, a new 25% tax rate for small pass-through businesses, and full expensing. To pay for these tax reductions, committee members and staff continue to examine other possible changes to the tax code, including the previous mandatory accrual accounting proposals.

To address this continuing threat, the ABA sent a new letter to the House Ways and Means Subcommittee on Tax Policy on April 13, 2016 in connection with its hearing on "Fundamental Tax Reform Proposals." The ABA also sent similar letters to the full House Ways and Means Committee and the Senate Finance Committee in April 2017.

Although the Trump Administration has not taken a formal position on the mandatory accrual accounting proposals, there is still a significant risk that the proposals could be included in the new

Links

- House Ways and Means Committee
- Senate Finance Committee

Contact

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comprehensive tax reform legislation that is now being developed in the 115th Congress as one means for paying for lower tax rates. Therefore, the proposals remain an active and serious threat to law firms, accounting firms, and many other types of small businesses.

Key Points

Congress should reject the proposed mandatory accrual accounting legislation because:

- **Instead of simplifying the tax law as its sponsors claim, the proposals would create unnecessary new complexity in the tax law and increase compliance costs.** Law firms and other personal service businesses favor the cash method of accounting—where income is not recognized until payment is actually received—because it is simple and generally reflects the way they operate their businesses, i.e., on a cash basis. Requiring them to switch to the more complex accrual method of accounting—where income is recognized when the right to receive it arises—would substantially raise their compliance costs by forcing them to keep more detailed work and billing records and hire additional accounting and support staff.

- **The proposals would impose substantial new financial burdens on many law firms and other personal service businesses.** By forcing them to pay taxes on phantom income long before it is actually received—and to use their scarce capital or borrow money to do so—would impose a serious financial burden and hardship on many of these firms. The legal profession would suffer even greater financial hardships than other professions because many lawyers are not paid by their clients until long after the work is performed.

- **The proposals would adversely affect clients, interfere with the lawyer-client relationship, and reduce the availability of legal services.** If law firms are forced to pay taxes on accrued income they have not yet received, the resulting financial pressures would require many firms charging on a traditional hourly fee basis to collect their fees in advance or immediately after the legal services are provided to the clients (or at least much sooner than they currently do). Also, many firms would be unable to represent as many accident victims, start-up companies, or other clients on an alternative or flexible fee basis as they now do and would have to reduce the amount of pro bono legal services they currently provide to their poorest clients.

- **The proposals would constitute a major, unjustified tax increase on small businesses, discourage economic growth, and kill jobs.** The Joint Committee on Taxation estimated that the House proposal would generate $23.6 billion in new taxes over ten years by forcing many thousands of small businesses to pay taxes on phantom income up to a year or more before it is actually received—if it is ever received. Both proposals would also discourage individual professional service providers from joining with other providers to create or expand a firm because it could trigger the costly accrual accounting requirement. The proposals could also pressure many firms to shed existing employees to avoid the accrual accounting requirement or to help pay the firms’ accelerated tax liabilities. Sound tax policy should encourage—not discourage—the growth of small businesses and job creation, especially in today’s fragile economy.

ABA Policy

Although the ABA supports simplification of the tax laws, the Association opposes any proposed legislation, regulations, or other governmental measures that would require law firms and other personal service businesses that now compute taxable income on
the cash receipts and disbursements method of accounting to convert to the accrual method of accounting.

**Updated September 2017**
April 21, 2017

The Honorable Orrin G. Hatch The Honorable Ron Wyden
Chairman Ranking Member
Committee on Finance Committee on Finance
United States Senate United States Senate
Washington, D.C. 20510 Washington, D.C. 20510

Re: Preserving Cash Accounting for Law Firms and Other Personal Service Businesses and Concerns Over Burdensome Mandatory Accrual Accounting Proposals

Dear Chairman Hatch and Ranking Member Wyden:

On behalf of the American Bar Association (“ABA”), which has over 400,000 members, I am writing to express our views regarding an important aspect of the tax reform legislation that your Committee and its tax reform working groups continue to develop. In particular, we strongly oppose those proposals—such as Section 51 of the Committee’s staff discussion draft bill to reform cost recovery and tax accounting rules prepared during the 113th Congress and other similar proposals still under consideration—that would require personal service businesses with annual gross receipts over $10 million to switch from the traditional cash receipts and disbursements method of accounting to the more complex and costly accrual method. These mandatory accrual accounting proposals are also strongly opposed by the Utah State Bar, Oregon State Bar, and over 30 other state, local, and specialty bars throughout the country.

Although we commend you and your colleagues for your efforts to craft legislation aimed at simplifying the tax laws—an objective that the ABA and its Section of Taxation have long supported—we are concerned that mandatory accrual accounting proposals like Section 51 would have the opposite effect and cause other negative unintended consequences. These far-reaching proposals would create unnecessary new complexity in the tax law and increase compliance costs by disallowing the use of the simple cash method for many law firms and other personal service businesses. In addition, by requiring these businesses to pay their taxes on accrued income up front instead of when the income is actually received, the proposals would cause substantial hardship to many lawyers, law firms, and other personal service businesses and would be a job killer. Therefore, we urge you and your colleagues not to include these or any other similar mandatory accrual accounting proposals in the new tax reform legislation that is now being developed.

Under current law, businesses are permitted to use the simple, straightforward cash method of accounting—in which income is not recognized until cash or other payment is actually received—if they are individuals or pass-through entities (e.g., partnerships or Subchapter S corporations) or their average annual gross receipts for a three year period are $5 million or less. In addition, all personal service businesses—including those engaged in the fields of law, accounting, engineering, architecture, health, actuarial science, performing arts, or consulting—are exempt from the revenue...
cap and can use the cash method of accounting regardless of their annual revenues, unless they have inventory. Most other businesses are required to use the accrual method, in which income is recognized when the right to receive the income arises, not when the income is actually received.

Mandatory accrual accounting proposals like Section 51 would dramatically change current law by raising the gross receipts cap to $10 million while eliminating the existing exemption for law firms and other personal service businesses, other sole proprietorships and pass-through entities, and farmers. Although these proposals would allow certain small business taxpayers with annual gross receipts in the $5 million to $10 million range to switch to—and thereby enjoy the benefits of—cash accounting (a concept that the ABA does not oppose), the proposals would significantly complicate tax compliance for a far greater number of small business taxpayers, including many solo practitioner lawyers, law firms, and other personal service businesses, by forcing them to use the accrual method.

Sole proprietors, partnerships, S corporations, personal service corporations, and other pass-through entities favor the cash method because it is simple and generally correlates with the manner in which these business owners operate their businesses—i.e., on a cash basis. Simplicity is important from a compliance perspective because it enables taxpayers to better understand the tax consequences of transactions in which they engage or plan to engage. In this regard, simplicity helps to mitigate compliance costs, which already are significant, and to improve compliance with the tax code.

If law firms and other personal service businesses are required to use the more complex accrual method of accounting, they would be forced to calculate and then pay taxes up front on multiple types of accrued income, including work in progress, other unbilled work, and accounts receivable (where the work has been performed and billed but payment has not yet been received). To meet these requirements, law firms and other affected businesses would need to keep much more detailed work and billing records and hire additional accounting and support staff. This would substantially raise compliance costs for many law firms and other personal service businesses while greatly increasing the risk of noncompliance with the tax code.

In addition to creating unnecessary complexity and compliance costs, these mandatory accrual accounting proposals would lead to economic distortions that would adversely affect all law firms and other personal service businesses that currently use cash accounting and their clients in several ways.

First, the proposals would impose substantial new financial burdens on many thousands of personal service businesses throughout the country—including many law firms—by forcing them to pay taxes up front on accrued income they have not yet received and may never receive. Requiring these businesses to pay taxes on this “phantom” income—and to borrow money or use their scarce capital to do so—would impose a serious financial burden and hardship on many of these firms. The legal profession would suffer even greater financial hardship than other professions because many lawyers are not paid by the clients until long after the work is performed.

Second, mandatory accrual accounting would adversely affect clients, interfere with the lawyer-client relationship, and reduce the availability of legal services. If law firms are required to pay taxes up front on accrued income they have not yet received, the resulting financial pressures could force
many firms charging on a traditional hourly fee basis to collect their fees in advance or immediately after the legal services are provided to the client. As a result, many clients could find it more difficult to afford legal counsel. In addition, many law firms would no longer be able to represent as many accident victims, start-up companies, or other clients on an alternative or flexible fee basis as they now do, and many firms would also have to reduce the amount of pro bono legal services they currently provide to their poorest clients.

Third, the proposals would constitute a major, unjustified tax increase on small businesses, discourage economic growth, and kill jobs. The Joint Committee on Taxation estimated that the similar House proposal introduced in the 113th Congress, which closely parallels Section 51 of the Senate draft bill, would generate $23.6 billion in new taxes over ten years by forcing many thousands of small businesses to pay taxes on income up to a year or more before it is actually received—if it is ever received. Because this acceleration of a firm’s tax liability would be permanent and continue year after year, it would constitute a major permanent tax increase for the firm, when compared to the taxes the firm currently pays under the cash method, until the firm eventually dissolves, merges with another firm, or otherwise ceases to exist.

The proposals would also discourage professional service providers from joining with other providers to create or expand a firm, even if it made economic sense and would benefit their clients, because it could trigger the costly accrual accounting requirement. For example, solo practitioner lawyers would be discouraged from entering into law firm partnerships—and existing law firms would be discouraged from growing or expanding—because once a firm exceeds $10 million in annual gross receipts, it would be required to switch from cash to accrual accounting, thereby accelerating its tax payments. The proposals could also pressure many affected firms to shed existing employees to avoid triggering the accrual accounting requirement or to help pay the firms’ accelerated tax liabilities. Sound tax policy should encourage, not discourage, the growth of small businesses and job creation, especially in today’s difficult economic environment.

For all of these reasons, as discussions on tax reform continue, we urge you and the Committee to preserve the ability of law firms and other personal service businesses to use the simple cash method of accounting and not to support any proposals that would require these businesses to switch to the more burdensome accrual method.

Thank you for considering the ABA’s views on this important issue. If you have any questions regarding our position, please contact ABA Governmental Affairs Director Thomas Susman at (202) 662-1765 or Associate Governmental Affairs Director Larson Frisby at (202) 662-1098.

Sincerely,

[Signature]

Linda Klein
President, American Bar Association

cc: Members of the Senate Finance Committee
**Accounts Payable**: Money owed to vendors for products and services.

**Accounts Receivable**: Money owed to a company by its clients/customers.

**General Ledger**: A complete record of financial transactions over the life of a company. The ledger holds account information that is needed to prepare financial statements.

**Cash Accounting**: Method where receipts are recorded during the period they are received and expenses are recorded in the period in which they are actually paid.

**Modified Cash Accounting**: Allows the company to decide what items to modify from the pure cash bases. Examples: Fixed Assets and Long Term Debt.

**Accrual Accounting**: Method that records revenues and expenses when they are incurred regardless of when cash is exchanged.

**Asset**: Is a resource with economic value that a company owns or controls with the expectation that is will provide future benefit. Recorded on company balance sheet.

**Liability**: Future sacrifices of economic benefits that the entity is obliged to make to other entities as a result of a past transaction or other past events. Recorded on company balance sheet.

**Partner’s Capital/Owners Equity**: Represents partner’s ownership interest in the business. Total contributions of all partners plus retained earnings are reflected on a partner’s balance sheet as Equity.

**Revenue**: Money received for goods sold or services provided.

**Expense**: Money spent or cost incurred by a company in efforts to generate revenue, representing the cost of doing business.

**Accounting Equation**: Assets = Liabilities and Shareholder Equity

**Advanced Client Costs**: Costs incurred by a law firm that relate to a specific client’s case. Examples: expert witnesses, deposition costs, filing fees, etc. Remain on the balance sheet and considered as loans to clients.

**Straight Line Depreciation**: Assumes asset will lose an equal amount of value each year.
Declining Method Depreciation: Accelerated system to record depreciation over a period of multiplying an asset’s beginning book value by a depreciation rate.

MACRS Depreciation: “Modified Accelerated Cost Recovery System” is the current tax depreciation system of the U.S. The capitalized cost basis of tangible property is recovered over a specified life by annual deductions for depreciation.

Section 179 Depreciation: US IRS code section 179 allows a taxpayer to elect to deduct the cost of certain types of property on their income taxes as an expense, rather than requiring the cost of the property to be capitalized and depreciated.