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wellness matters for law firms

# LAW FIRM MANAGEMENT

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990 Stewart Avenue  
Garden City, New York 11530

☎ 516.288.7400

☎ 516.288.7410

✉ [info@garibaldicpas.com](mailto:info@garibaldicpas.com)



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GROUP

Certified Public Accountants  
Financial and Management Consultants

[www.garibaldicpas.com](http://www.garibaldicpas.com)

## IRS focuses on attorney audits

The IRS recently released an updated Attorneys Audit Technique Guide to help its examiners effectively audit attorneys. While no one enjoys being the subject of an audit, the guide provides some valuable insights into the areas auditors are likely to focus on, which, in turn, can help law firms avoid costly missteps.

### AREAS OF INTEREST

The revised guide identifies several issues that merit examiner attention, including the following:

**Segregated client trust accounts.** The guide instructs examiners that attorneys should be able to provide an accounting of any amounts in segregated trust accounts. They should keep detailed schedules with the client's name, the type of asset held in trust and its value. The balance sheet should reflect a liability equal in value to the total amount of the schedules and trust account balances.

The guide also notes that attorneys may deposit fees into a personal or business account or bypass bank accounts entirely. Because many attorneys compute their gross income based only on

withdrawals from the client trust account, auditors will examine deposits into all bank accounts, personal living expenses and other cash expenditures for signs of unreported income.

**Deferred income.** The guide suggests examiners stay on the alert for attempts by attorneys to defer income. After a case has been settled, for example, an attorney may leave the related fees in the trust account until the next tax year.

But the attorney's fee is both determinable and available once the settlement is received — and therefore should be included in income for that tax year. Auditors are advised to analyze the sources of funds remaining in the trust account at year-end, particularly if the account has a large ending balance.

**Advanced client costs.** Attorneys, especially those who work on a contingency basis, may advance costs and expenses for clients. If they use the cash basis method of accounting, they might deduct these expenses when paid and include the recovered costs in income on receipt. This can distort income, as it can take years to resolve the related cases.



The guide points out that courts have found that costs paid on behalf of a client should be treated as loans for tax purposes — and not deducted as business expenses. You're generally allowed a current deduction only for those client-reimbursed costs that are allocated to normal operating expenses that would reasonably be incurred even if not charged to a specific client. The subsequent reimbursement should be treated as income in the year of reimbursement.

**Employee misclassification.** Attorneys may improperly treat their receptionists,

## PREPARATION CAN GO A LONG WAY

Providing the IRS with the necessary documentation upfront can both expedite the audit process and demonstrate a commitment to transparency. The new Attorneys Audit Technique Guide (see main article) has a nonexclusive list of documents that the auditors will need, including:

- All books and records (for example, appointment books, cash receipts and disbursements journals),
- Bank statements, canceled checks and deposit slips for all personal, business and trust accounts, including reconciliation statements for the last month of the calendar year for all business and trust accounts,
- Investment records, account statements and other investment information,
- Work papers associated with the tax return,
- Client listing,
- Forms 1040 (U.S. Individual Income Tax Return),
- Forms 8300 (Report of Cash Payments Over \$10,000 Received in a Trade or Business),
- Quarterly tax returns,
- Forms W-2 (Wage and Tax Statement), W-4 (Employee's Withholding Certificate) and 1099 (Miscellaneous Income) received and issued,
- Invoices for acquisitions and dispositions of capital assets and verification of basis for depreciation purposes, and
- Records substantiating travel and entertainment expenses.

The auditors will inform you in advance of the periods for which they require each type of document.

secretaries, paralegals or law clerks as independent contractors for tax purposes. Although the guide directs examiners to refer this issue to the Employment Tax Specialist Group, it devotes several pages to providing background to help examiners identify it.

An employer-employee relationship exists when the business for which services are performed has the right to direct and control the worker. The "control" refers to both the work to be done and how it must be done. The employer doesn't need to *actually* direct or control how the services are performed if it has the right to do so. According to the guide, paralegals and clerks under an attorney's

close supervision and control generally should be classified as employees. And close scrutiny will be given in cases where the same party receives both W-2 and 1099 forms.

### GET AHEAD OF THE GAME

You may not be able to avoid an IRS audit, but you can take steps to reduce the risk of negative outcomes. As the guide notes, "A good accounting system for attorneys will include strong internal controls to monitor both fees billed and costs and expenses advanced for clients." We can help you establish the strong and effective controls you need. •

# What's it worth?

## UNDERSTANDING VALUATIONS IN LAW FIRM ACQUISITIONS

Merger and acquisition activity remains steady in the legal industry. If your firm is targeting another, you have many questions to ask and avenues to pursue as part of due diligence. Among the most important is the value of the other firm, taking into account such factors as its assets, liabilities and ability to generate revenues into the future.

### LAW FIRMS VERSUS OTHER BUSINESSES

Attorneys often work with valuation professionals to obtain appraisals of businesses for clients, whether for divorce proceedings, shareholder lawsuits, buy-sell agreements or other purposes. But valuing law firms can prove trickier than valuing typical businesses. A widget factory, for example, typically can be expected to continue to generate a certain level of revenue after it's sold. That's not necessarily the case with law firms.

Clients (and referral sources) tend to be more loyal to their specific attorneys than to the actual firms. In addition, the merger with or acquisition of another law firm could lead to conflicts of interest that limit — or even lead to the loss of — revenues. For these reasons, it's imperative that you choose an appraiser who has extensive experience valuing law firms.

### VALUATION METHODS

The legal industry doesn't have a long history of valuing individual firms, meaning valuers can't just turn to a comprehensive database to "plug and play" the numbers and reach a reasonable, supportable estimate. Instead, they generally apply one or more of the following four valuation methods:

**1. Asset-based.** This approach has the benefit of being straightforward — the appraiser deducts a firm's liabilities from its assets to arrive at a net



value. But it ignores earnings and cash flow, two critical indicators of a law firm's financial health.

**2. Comparable transactions.** The appraiser looks to sales of similar firms in terms of geography, practice areas, size and financial performance to estimate value. It's usually difficult to access the necessary data, though, and even harder to uncover behind-the-scenes circumstances that can affect sales prices. Comparable transactions can, however, be helpful to back up or contradict values produced by other valuation methods.

**3. Rule of thumb.** The rule-of-thumb method applies a multiplier (generally, 0.5 to 3.0) to average gross fee revenues or net income over the past five years or so. The multiplier figure reflects the likelihood of revenues remaining steady or increasing going forward, as determined based on factors such as the number of clients, transferability of client relationships, amount of repeat business and reliance on large clients. The approach is a bit simplistic, though. For example, if the appraisal focuses solely on revenues, it doesn't reflect how well the firm is managed, which will affect profits.



**4. Discounted cash flow.** Appraisal experts frequently favor this method, which is based on the targeted firm's future financial performance. It uses historical financial data to predict future cash flows and applies a growth rate (or expected rate of return) to them, discounting the result to net present value.

### FIRM-SPECIFIC ADJUSTMENTS

Law firms, of course, have individual characteristics that won't easily fit into a valuation formula. For example, a firm's brand identity, growth potential, fee structures, client satisfaction and

nonattorney staff all have the power to boost or undermine its value.

A qualified appraiser will make adjustments for such factors. The appraiser also will adjust for unusual or nonrecurring items such as professional fees, non-arm's length transactions and capital projects.

### CHOOSE WISELY

An attorney wouldn't hire just any appraiser to conduct a client's business valuation. You should exercise equal care when hiring for your firm's own purposes. •

## Communication is key to timely client payment

How regularly do you communicate with clients? Failure to do so might cause a client to become disgruntled and slow down — or stop — payments. Being in touch with your clients regularly will help you gauge a client's level of satisfaction with your firm's work. And satisfied clients generally pay their bills.

### BE CLEAR

The first stage of communication comes when you ask a new client to sign a fee agreement. Make sure it clearly explains all your fees and how they're calculated and states when payment is due. Be sure you get a retainer fee up front and work with the client as needed. Be clear about the consequences of nonpayment, including your right to withdraw before any work begins.

To make it more convenient for your clients to pay, accept credit card payments or set up an online payment system. And remember, clients are more likely to quickly pay bills for smaller amounts sent more frequently than they are if they receive one big bill for the same work.

### BE FIRM

The second stage of communication comes when accounts become delinquent. Train your staff to respond to past-due bills quickly, because the likelihood of collecting on them decreases as time goes by. If the client is reluctant or unable to pay the full outstanding amount, work out a payment arrangement.

And if it comes down to making collection calls, be diplomatic. You don't want to strain an otherwise pleasant client relationship.

### BE CONSISTENT

Resist reducing your original fees, particularly if the client has signed an agreement to pay the full amount. Doing so could set a precedent for future dealings, and that's something you want to avoid. Then again, you may not have a better option.

An engagement letter and detailed documentation of work performed should defuse any arguments over fee amounts. Disputes over quality are harder to resolve. If the client has a good



point, offer to make appropriate amends or reduce the fee. Agreeing to a discount — rather than withdrawing representation — might be a better option for eliminating the issue. This can prevent your firm from paying for collection efforts and help it avoid other legal ramifications.

Also, keep in mind that the American Bar Association's Code of Professional Conduct states that lawyers are allowed to withdraw only if "the client fails substantially to fulfill an obligation to the lawyer regarding the lawyer's services and has been given reasonable warning that the lawyer will withdraw unless the obligation is fulfilled."

Some state bars require that you provide pro bono work to the client to fulfill your ethical obligations.

### BE PERSISTENT

The final form of communication comes via your written collection policy. It should specify how to track and deal with delinquent and unpaid accounts. The policy should spell out credit terms, fee agreements, and collection guidelines and procedures — including when to use a collection agency.

If your budget permits, consider hiring a collection staff person to help develop a firmwide policy to manage collection efforts. Otherwise, designate someone from your staff to perform these duties.

### THE PAYOFF

While you'll likely never receive payment on 100% of your bills, you can get close to that realization rate. By carefully selecting your clients and cases, and then communicating clearly and consistently, you should see some mitigation in your delinquent accounts. •

## Why attorneys' financial wellness matters for law firms

In the midst of the continuing economic uncertainty, even affluent attorneys free of student debt have voiced concerns about their financial stability and retirement readiness. Law firms that heed and respond to their worries can gain valuable competitive advantages.

### FINANCIAL STRESS IS WIDESPREAD

A 2021 American Bar Association (ABA) survey of 1,300 of its members under age 36 found that 90% of respondents borrowed to fund their education. About two-thirds of all respondents

reported high or overwhelming stress over finances in general. More than half — including those who didn't borrow or reported no student debt at graduation — said they sometimes or always worry about meeting monthly living expenses, inability to do the activities they'd like to do or living paycheck to paycheck.

A majority of those with debt over \$100,000 agreed that their loan obligation has caused them to feel depressed or hopeless. That's not surprising. Mountains of debt — whether from student loans, mortgages or otherwise — can make it seem impossible to save for other goals, like retirement and children's education.

For some of the respondents to the ABA survey, answering these questions might have been among the first times they've been so forthright about their financial wellness-related fears. Attorneys often are reluctant to discuss such thoughts because they're embarrassed or feel like failures. Keeping these thoughts to themselves can not only damage their emotional — and even physical — health but also prevent them from seeking assistance.

Financial concerns can have an impact on their performance on the job, too. Stress is well known to affect everything from sleep to decision making. Working in the legal industry tends to be stressful as it is, without the compounded stress from financial problems.

*Law firms can offer counseling that helps attorneys make the most of their retirement plans and provide workshops on topics such as budgeting, investing and managing debt.*

Moreover, it's not just millennials who struggle with student debt or other financial issues. A survey sponsored by AARP found that 31% of baby boomers and 38% of Generation Xers said



student loan debts stopped them from saving for retirement. And attorneys tend to retire later in life than their contemporaries in other fields, which sometimes means that they don't start thinking about retirement planning as early as they should.

### LAW FIRMS CAN HELP

Less than one-third of respondents in the ABA survey have obtained financial advice from a professional. This gap suggests an opportunity for law firms to provide financial wellness employee benefits. Such benefits can help recruit and retain attorneys, while also reducing the risk of financial-related distractions leading to mistakes on the job.

A range of options is available. At the most basic level, a firm can offer counseling that helps attorneys make the most of its retirement plans. Firms also can provide expert-led workshops on topics that include budgeting, investing and managing debt or bring in third-party financial planning services. •





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990 Stewart Avenue | Garden City, New York 11530

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