
Why Integrated Accounting Is Essential to Practice Management Software for Law Firms

The Perils & Pitfalls of Law Firm Accounting

White Paper by CosmoLex Cloud, LLC

A law firm may be a small business but that doesn't mean that it can use the same tools as other service organizations of the same size. Any business owner has to follow the law, but attorneys are regulated by additional layers of rules that come both from the government and from their local ethics rules. One of the most difficult areas for small law practices is financial management. Legal accounting requirements are unlike any other business, and the penalties for errors are significantly more severe than in other businesses. It's no surprise that, in a recent survey, accounting frustration was the #1 concern at small law firms. The purpose of this paper is to explain unique nature of legal accounting and solution to six important legal accounting related challenges.

The Three Foundations of Legal Accounting

Legal accounting is significantly more complicated than standard small business accounting. In addition to dealing with the basics such as profit and loss, cash flow, and account reconciliation, a law practice must also deal with three unique areas: client funds accounting, matter cost accounting and back office accounting.

- **Client Funds Accounting** - Most law firms use retainers to secure cash flow from clients. However retainer funds do not belong to the law firm until they are earned. In addition attorneys often handle funds such as personal injury settlements that belong to the client rather than the practice. Client funds accounting must ensure that client funds are not comingled with other clients' monies or operating funds and not used to pay for the law firm's expenses. On your balance sheets, client funds must be clearly distinguished from the law firm's assets and revenue. Improper client funds accounting is the leading cause of disbarments across the country.
- **Matter Cost Accounting** - Law practice by nature incurs matter costs that is subsequently billed to clients. While the process is simple, tax accounting for matter cost is not that simple. First, such costs must be tracked correctly as not all matter costs are the same. Advanced client costs would show up as an asset on the firm's Balance Sheet, while reimbursable client costs would be recorded on the Profit & Loss Statement. Second, law firms needs to make sure each cost gets allocated to the appropriate matter contemporaneously or it will not get billed and that is a net loss to the firm. And lastly, when those bills get paid, the cost portion of the revenue needs to be tracked separately from fee payments.
- **Back Office Accounting** - Don't get so focused on the client billing side of things that you forget about your own expenses. You have ongoing costs that include the office lease, payroll, electricity, phone, internet, and more. Tracking these operating fees helps you get a handle on how much you spend on overhead, and may show that you need to adjust your billing accordingly. Your back office accounting gets more complicated as reimbursement for indirect matter costs (overhead) requires a different accounting treatment than reimbursement for direct matter costs.

You probably didn't learn about the challenges of legal accounting in law school. Although these facets of accounting are unique to law firms, if you implement a properly designed system then you can overcome these difficulties with ease.

How Legal Accounting Interacts with Law Office Billing System?

A law practice must have two systems for efficient operation:

- Practice management software for activities such as case management, billing, calendaring and task management.
- Accounting software that supports legal accounting and generates financial reports.

Let's examine how these two areas of a law practice interact with each other on a day-to-day basis. Here are just a few examples of the need for integration:

- Retainer management requires precise accounting as funds are received in trust accounts or, if your jurisdiction allows it, in operating accounts. Both your billing system and your accounting system must have this data for the purpose of billing and accounting.
- When invoices are paid from retainers, this must be reflected in both the billing system as a decrease in a matter's unpaid balance and updated remaining balances, and in the accounting system as it impacts your bank balance and your liability account balance.
- Client costs paid by the firm must be entered not only in your accounting system but also in your billing system as a matter expense card so the cost can be billed to the client.
- Invoice payments received must be captured in both your billing system and your accounting system. From an accounting perspective, the cost portion of the revenue is not income and must be recorded separately. The accounting system must know what portion of a payment covers costs and what portion is income.

We can see that law firm operation has unique accounting needs and the billing and accounting system must constantly interact. However, if these are two separate systems, making these two work in tandem is not easy. Have you ever gone on a road trip with someone who navigates while you drive? And the navigator has never driven a car but is a lifelong pedestrian so tends to look for different landmarks than you do and doesn't give you directions soon enough? Plus he speaks a different language than you so he has to keep looking in a dictionary to find the right words to use?

OK, probably not, but that's what it's like when you try to use separate practice management and accounting programs in your law firm. They use different inputs and file formats and don't ever directly communicate. You might try synchronization or export/import of data, but those are highly error prone and if you miss one synchronization then everything is out of balance. A more common outcome is to enter information manually into each program, but that double entry leads to inevitable keying errors and hours spent hunting down discrepancies.

It's not surprising, then, that 90% of respondents in our recent survey list synchronization between practice management software and accounting as their main operating concern.

What Happens When Practice Management & Accounting Systems Are Separate?

Here are just a few challenges your law practice will face if your practice management system is separate from your accounting system:

- **Adaptation** - It's a nightmare to try to convert a general business accounting solution into a specialized legal solution. Trying to fit the square peg of general accounting software into the round hole of legal accounting requirements is doomed to frustrate you. Since specialized accounting is needed at each step -- client funds handling, case cost accounting, proper allocation of invoice payments -- even a well-trained bookkeeper can make mistakes.
- **Data Entry Errors** - Entering the same information separately into both practice management and accounting software gives you twice the chance of making a keying error. It's slow, since every piece of information has to be entered twice, and if someone edits a transaction in one place it's easy to forget to edit it in the other. When inevitable mistakes are made, they are very difficult to locate without tedious comparison of many transactions.
- **Matter Costs Recovery** - Without an easy way to tie actual disbursements from the accounting system to the billing system, you can't tell whether a matter expense has been billed or not. Expenses get misplaced, never billed and that is lost revenue. Desktop-based systems give attorneys no way to enter expenses in the field meaning charges put on a credit card might not get entered until the statement arrives weeks later. In case of an audit or a client inquiry, practice staff must look in several places to find answers. In contingency cases, attorneys must provide a detailed statement of charges before distributing the settlement and that is hard to provide with expenses scattered all over your system.
- **Inflated Revenue** - Without the ability to mark reimbursable expenses separately from billable legal fees, you end up exaggerating your revenue. Expense reimbursement should not show as revenue, but how is your bookkeeper supposed to know that a \$2172 payment from a client includes \$1700 in fees (revenue) and \$472 in reimbursed expenses (non-revenue)? If the payment is not entered correctly, it all shows up as revenue on your Profit and Loss Statement, which is incorrect.
- **Practice Area Income Tracking** - If you offer services in multiple areas of law, you may have a different billing model for each specialty. For example, let's say you offer Elder Law and Estate Planning. Elder Law is billed as a monthly contract amount for a set number of hours, plus hourly billing at reduced rate. Estate Planning bills hourly for tasks such as wills or trust setup but earns a percentage of the estate when probating a will. To make strategic decisions about the future of the firm, you need to understand how profitable each area is. The practice management system understands the different practice areas but the accounting system doesn't without special coding of each transaction.
- **Financial Overview** - When information is spread across multiple systems, you never get a high-level view of your practice's total financial situation. You can look at pieces here and there but never the entire picture. Clients and auditors get frustrated when they ask for information and it takes your office forever to gather the data because it's not all in one place.

What Happens When Practice Management & Accounting Systems Are Integrated?

When you use an integrated, legal-specific software solution all of the problems above disappear.

- **Turnkey System** - You have a full legal accounting and practice management system right out of the box with no need for legal specific accounting customizations.
- **Synchronization** - An integrated system pulls data from the same source of information, with no clumsy synchronization, import/export or double entry needed. Your accounting and billing systems are always up-to-date, always in sync. This means fewer mistakes and less time fixing errors.
- **Matter-Centric Organization** - All information is tied to specific matters. Expenses don't fall between the cracks, never to be billed. You can see at a glance all fees and expenses associated with a matter, as well as the unbilled and unpaid balances. Client questions about billing are answered easily with all information on one screen.
- **Correct Revenue** - Reimbursable expenses are automatically separated from billable fees. As payments come in, your payments are automatically divided between fee income and expense reimbursement categories. Your Profit and Loss Statement shows only your actual revenue.
- **Segregated Practice Areas** - Each practice area can have its own income account. You can see at a glance the profitability of each area and the practice as a whole.
- **Unified Reporting** - Everything is on one screen, whether it's a financial overview of your entire firm or the billing and collection status of an individual matter. Reports such as Profit & Loss, Matter Costs and Balance Sheet make it easy to see important financial details of your firm's operation.

An integrated practice management and legal specific accounting system can be a game changer for law office profitability, compliance and peace of mind. If you put this system in the cloud, then you add the power of mobility, flexibility and freedom from IT hassles.

About Us

CosmoLex (www.cosmolex.com) is a cloud-based law practice management system specifically designed for solo and small law firms. CosmoLex's sole mission is to simplify law firm operation. CosmoLex integrates practice management and accounting functions, allowing lawyers to focus on the practice of law. CosmoLex's CEO, Dr. Rick Kabra, has years of experience in the legal software industry, catering to the specialized technology needs of small to mid-sized law firms.