

LAW FIRM ACCOUNTING DEMYSTIFIED



*A Guide to Handling Everyday Legal, Trust,
& Business Transactions*

Written By:

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President, PWR Resources

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FOREWORD

When I walk into a law firm office and ask how they track their accounting information, I will often get a glazed look or be told to talk to the bookkeeper or accountant. While there are some exceptions, most lawyers don't understand accounting; after all, they went to law school and not business school, and most law schools don't teach business or accounting. Accounting has become a scary word for lawyers, but it doesn't have to be.

In order to be able to provide the information to file your taxes, borrow money, or understand how your business is doing, you need accounting. Law firms have extra requirements for properly tracking client money (IOLTA) and may have additional government requirements. While a law firm may have an accountant and/or bookkeeper to do the work, it is important for the owner to understand the basics since they must make wise decisions.

After writing *QuickBooks for Law Firms*, I have often been asked basic legal accounting questions since that book is focused on implementation within a single program. With this book, you go back a step and get an understanding of the fundamentals before you choose a software solution.

Rick and Pam have many years of experience working with law firms and implementing systems to help with the accounting. With this book, they have simplified the concepts of law firm accounting and identified the challenges for law firms. No matter who in the firm does the accounting, this book will help those at the top better understand what is happening. More information and understanding can only lead to better decisions.

Knowledge is power and understanding accounting gives you the power to move the firm forward.

Caren Schwartz

Time & Cents Consultants

*35*45 Consulting Team Member*

November 2017

PREFACE

Mention the word “accounting” in front of lawyers, then take a step back and appreciate the look of terror that comes across their faces. You can trust me or try it for yourself, but just mentioning the word almost always strikes fear in attorneys’ hearts everywhere. The

Legal accounting is extremely important.

reason why is simple. Attorneys are not accountants, but when it comes to running a law firm, especially a small law firm, legal accounting is extremely important. The problem is that as important as accounting is to a law firm, it can be equally as challenging.

First, it’s crucial to understand why accounting is of such importance to law firms. First and foremost — COMPLIANCE! In the legal world, compliance is key, and a law firm’s accounting is no different. Failure to remain compliant could result in stiff penalties for law firms, even disbarment.

Second, is a firm’s income. If your firm’s accounting isn’t up to snuff, you could fall victim to leakage. This means money that should end up in your pockets could very well remain in the pockets of your client or other service providers based on poor accounting practices.

Third, is the continued success of a law firm. If a firm effectively manages their accounting, they develop extremely valuable business intelligence surrounding some of their more successful practice areas and allocate the appropriate resources to ensure the greatest levels of success for the firm.

When we sat down to begin writing this book, we decided that we wanted to create the go-to resource for small firms looking to increase their ability to successfully manage the business of running a law firm. All too often smaller firms think because they don’t have all of the same assets and staff that larger firms do, they have no choice but to fall behind and take risks in how they manage their accounting. Not only is this not true, but it’s also dangerous!

In this book, we hope to demystify legal accounting, and make it both easy to understand and manage. Just because you’re not an accountant or don’t have a high-priced accountant on staff, doesn’t mean that you can’t run a successful law firm.





ACKNOWLEDGMENTS

The saying goes, “It takes a village ...” and this book is no different. When we set out to create this resource we were well aware that we are not in the business of writing books, despite knowing that we had valuable information we felt needed to be shared with the legal community. We are grateful and honored to have had the help of so many in creating a legal accounting resource that really stands alone.

The effort of the CosmoLex staff cannot go unnoticed. They have all worked tirelessly to create the reports and charts you see throughout this book. Their efforts didn’t stop there, though, as they were integral in reviewing our content, working alongside graphic designers, and helping publishing professionals and editors capture the most vital information.

It was also extremely important to have the input of multiple attorneys and consultants throughout the process. We work for attorneys, but can’t claim to have all of the insight that they do when it comes to their profession. Without their feedback this book would not be what it is.

Caren Schwartz, President of Time & Cents Consultants LLC provided us with countless suggestions and corrections to ensure that we produce the best and most accurate information to anyone who sits down to read this book.

Last, but certainly not least, we owe a great deal of appreciation and thanks to our law firm customers! For years, both Pam and Rick have been working with small law firms. Working with all of these firms has provided a never ending opportunity to see more, learn more, and work alongside some intelligent and wonderful people. We cannot stress how much we have learned from our customers, and thank them so much for it.



OVERVIEW

**“A lawyer’s time and advice are his stock in trade.”
Abraham Lincoln**

Law firms are in the business of practicing law. There are income and expenses, assets and liabilities, and equity in the financial statements of all law firms, just as with any other business. It is true that most attorneys prefer to practice law rather than manage a business, but it is still a business. Accounting is the backbone of understanding the financial activities and health of a business. And the accounting requirements used to understand the financials of a law firm are unique — time billing, advanced client costs, retainers, and trust activities. Attorneys must be diligent when they track time, enter expenses, and most importantly — when they manage funds on behalf of their clients.

There are three essential components of a successful law firm accounting system — legal accounting, trust accounting, and business accounting.

Common Terms

Revenue/income: Monies received for doing work. In a law firm, revenue is generated from working on client matters. Law firms typically report on a “cash” basis, i.e. the revenue is recognized when it’s received.

Expenses: Money spent or costs incurred in efforts to generate revenue. A law firm recognizes two types of expenses:

- Generated on behalf of a client, e.g. filing fees, medical records. *Note: these expenses are booked on the balance sheet as Advanced Client Costs or on the Profit and Loss as Reimbursable Client Costs, see Chapter on “Matter Expenses.”*
- Generated in the normal course of business, e.g. rent, payroll.

Assets: Something owned by the firm that can provide future economic benefit, e.g. cash, advanced client costs, buildings.

Liabilities: Obligation of the firm, either money that must be paid or services that must be performed, e.g. loans, retainers, trust activities.

Equity: The owner(s) value in the assets of the firm. This can be from contributions and/or a function of net profits.

Cash basis accounting: Revenue is recognized when received; expenses when paid, i.e. the financial statements are not impacted until an invoice is paid (revenue) or a check is disbursed (expenses). Only the Profit & Loss (income statement) is impacted, not the balance sheet. Law firms are generally on cash basis accounting.

Modified cash accounting: Revenue and expenses are treated on the cash basis with accruals for long-term balance sheet elements, such as Advanced Client Costs. Firms use a modified cash method to develop what it feels is a more accurate picture of its finances.

Accrual basis accounting: Revenue is recognized on the income statement when the transaction occurs, i.e. the invoice is created, the bill is created. The balance sheet is also impacted by an increase to accounts receivable/accounts payable.

Legal Accounting Components

Time & Expenses

The time and advice relevant to matters is the foundation of the law practice business model. While there are many practice areas that bill according to a fixed fee or on contingency, most attorneys still track and bill for time spent on a matter. Even fixed fee and contingency

work may require time to be tracked, but not directly billed. With the advent of technology, tracking time has become easier — no more lost slips of paper — reducing lost revenue. Some applications have built-in timers linked to the matter.



With the advent of technology, tracking time has become easier

The screenshot shows a web-based form for adding a timecard. The form is titled "Add Timecard" and has a close button (X) in the top right corner. It is divided into several sections:

- Client Matter:** A dropdown menu showing "Collins, Jim-Family Law".
- Enter Info:**
 - TimeKeeper *:** A dropdown menu showing "John Smith".
 - Date:** A date picker showing "10/12/2016".
 - Task *:** A dropdown menu showing "Case Information Statement".
 - Description:** A text area containing "Prepare Case Information Statement". A "966 characters left" indicator is visible at the bottom right of the text area.
- Time & Amount:**
 - Time Spent:** A dropdown menu showing "1.20".
 - Time Billed *:** A text input field showing "01:12".
 - Rate Level:** A dropdown menu showing "Default".
 - Rate/Price *:** A text input field showing "200.00".
 - Rate Type:** A dropdown menu showing "Hourly".
 - Value:** A text input field showing "240.00" in green.

At the bottom of the form, there are three buttons: "Cancel", "Save and New", and "Save".

Figure 1-1: Matter linked timecard (Source - CosmoLex)

This linked timecard automatically tracks the time with the matter for billing purposes.

Expenses advanced on behalf of the client require due diligence to ensure they are correctly appropriated to and reimbursed by the client. This is a significant area of revenue “leakage” in

many firms. That FedEx mailing or fee for medical records can often be missed. To ensure that the expense is correctly posted, expenses should be linked to the matter. A system that provides the option to link a bill or check payment to the matter for invoicing when the bill or check is entered is most effective.

Figure 1-2a: Matter linked soft cost (Source - CosmoLex)

Figure 1-2b: Matter linked hard cost (Source - CosmoLex)

Retainers

Many businesses require a customer deposit before work is commenced, so what's the big deal for law firms? Retainer management is more significant than deposits. Retainers remain the property of the client until earned. In other words, while a customer can give the contractor a deposit to order garage doors, that money no longer belongs to the customer and, in most cases, it is non-refundable and is booked as income. In a law firm, the retainer remains a client advance and is a liability of the firm until

it has been earned by the attorney for work performed. This is significant. Whether an **operating or trust retainer**, client advances must be segregated and easily identifiable in the accounting software. Most states do not even allow attorneys to hold client advances in an operating or business account, i.e. operating retainer. Please check with your jurisdiction.

Please see chapter **“retainer management”** for an explanation of the difference between operating and trust retainers.

ID#	Client	Matter	File#	Matter Owner	Unpaid Balance	Unbilled Balance	Client Funds-Operating	Client Funds-Trust
2	Brooks, Pablo	Corporate		Atticus Finch	2,067.80	0.00	0.00	9,055.53
8	Browns, Pedro	Corporate		Perry Mason	0.00	0.00	0.00	6,110.00
6	Coleman, Gloria	Contract		Atticus Finch	1,007.50	0.00	0.00	1,929.00
1	Collins, Jim	Family Law		John Smith	3,494.17	0.00	0.00	7,569.00
5	Jones, Kay	Contract		Atticus Finch	3,276.00	0.00	2,500.00	0.00
7	Walker, Lillian	Estate Planning		John Smith	1,335.35	0.00	0.00	0.00
3	Wolf, Michael	Consultation		John Smith	0.00	0.00	1,020.00	0.00
4	Wolf, Michael	Estate Planning		John Smith	0.00	0.00	0.00	3,083.00

Figure 1-3: Operating advances & trust funds individually listed for each matter (Source - CosmoLex)

Trust Activities

The words “IOLTA audit” will strike fear in even the most careful attorney. Trust transactions require attention to detail, compliance, and thorough reconciliation. There must be no evidence of commingling of client funds, or commingling of client and firm funds. Trust transactions must be separate and distinct.

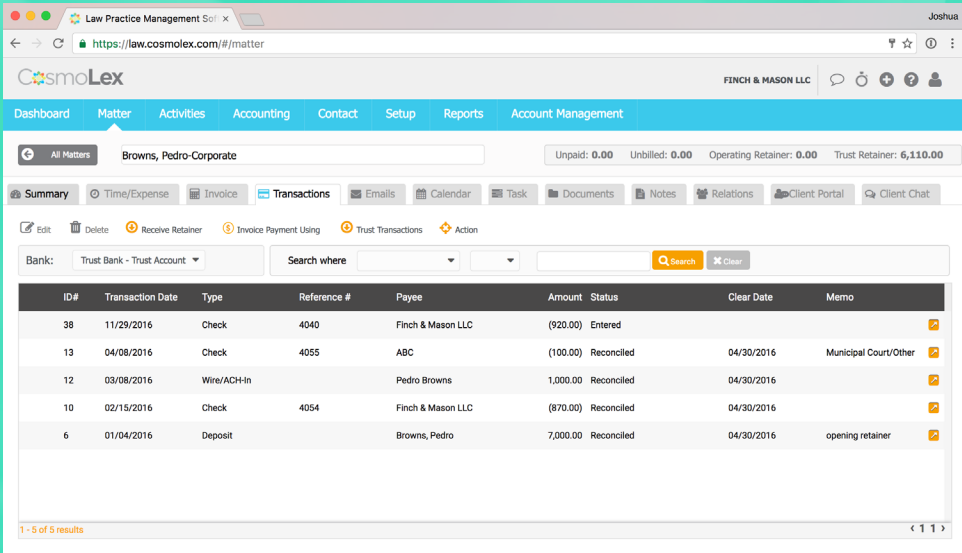


Figure 1-4: Client ledger for trust transactions (Source - CosmoLex)

Business Accounting

All businesses track revenue/income, expenses, liabilities, assets, and equity. Law firms are in the business of practicing law. In addition to the legal accounting, the law firm has to manage the “back office,” or general accounting that is required of all businesses. What is the relationship between these categories? How do they affect the business of a law firm?

The interdependence of revenue and expenses, assets, and liabilities, cannot be understated in terms of managing a law firm. When revenue exceeds expenses, the firm realizes a profit. When expenses exceed revenue, there is a loss. Cash flow, often overlooked, is a significant variable in the financial health of a law firm. Advanced Client Costs — expenses advanced on behalf of a client — are not calculated on the profit and loss (income statement) but are an asset (monies owed to the firm) on the balance sheet. A firm could have significant funds in trust retainers, a liability of the firm, but until the work is performed, billed, and paid, the cash is not available to the firm.

Reports

Financial management of any business requires generating relevant reports. Common business reports include a Profit & Loss (a.k.a. Income Statement), Balance Sheet, Cash Flow Analysis, Accounts Receivable, and General

Ledger. Law firms also need Work in Progress (pre-bill), Trust three-way reconciliation, Billing (by timekeeper and matter owner), Collection (by timekeeper and matter owner), and Compensation Reports (by timekeeper and matter owner).

System

Before technology provided the ease of electronic timekeeping and facilitated more accurate record-keeping, attorneys tracked time on paper — legal pads, index cards, slips of paper, the front of the file folder — and, more typically than not, under-billed most of their clients. Expense receipts were typically thrown into an envelope within the “Redweld” of the matter file. Sometimes these receipts slipped into other sections or didn’t get into the Redweld at all. Trust activity was tracked using a ledger book or cards. Remember those green, hardbound, 11 x 14-inch ledgers with the green or pink columns for double entry? Typically, each client was designated a page or two. Or, firms used card stock ledger cards that

were stapled together to maintain all the transactions with the file. Transactions were noted in pencil, and the potential for errors was great.

With the digital age came less cumbersome record-keeping, but diligence is still required. With more sophisticated computer software, time tracking is easily transferred to client time cards, expenses can be linked to matters, and trust accounting is more systematic. The “system” is established by the application, with a prescribed process to facilitate the various functions. In the next chapter, we’ll review what an accounting system is.



02

WHAT IS AN ACCOUNTING SYSTEM?

An accounting system provides all of the components to track, monitor, and report on the financial status of a law firm. It isn't impossible for a law firm to build an accounting system based on paper, pencils, and spreadsheets. In fact, it's impressive if they can build that accounting system and remain compliant and successful. Most successful small businesses inside and out of the legal industry depend on a computerized system to manage the financials of their business. Law firms may have some very specific needs when it comes to accounting, but they also need many of the same components that other small businesses do.

Chart of Accounts

These are the General Ledger accounts to which all transactions are posted. For law firms, there are certain “accounts” that set it apart from more generic business chart of accounts. The list below contains accounts that are specific to law firm accounting. Note that a particular firm may not need all of these accounts.

- Client Trust Funds (Liability)
- Client General Retainer – Trust (Liability)
- Client General Retainer – Operating (Liability)
- Advanced Client Costs (Asset)
- Reimbursed Client Expenses (Direct) (Income)
- Inhouse Reimbursed Expenses (Indirect) (Income)
- Fee Income (Income)
- Discount (Income)
- Reimbursable Client Costs (Expense)
- Non-Reimbursable Client Costs (Expense)
- Unrecovered Client Expenses (Expense)

Accounts fall into five categories (with subcategories that act the same as the parent), and in two different types of GL accounts:

Balance Sheet	Income Statement <i>(Profit & Loss)</i>
Assets <i>(what business owns)</i>	Income <i>(Revenues from activities)</i>
Liabilities <i>(what business owes to others)</i>	Expense <i>(costs from activities & losses)</i>
Equity <i>(the difference between assets & liabilities)</i>	

More on the effect of different accounts on activities, and reporting is described in **reports sections**.



Double-entry Bookkeeping

All financial activities are posted by crediting one account and debiting another. This is not synonymous with increasing and decreasing the account. A few simple examples, in the accounting world:

- **Operating (Firm) funds:** Revenue received will post to both the bank account (debiting cash) and income account (crediting income) as increases in those accounts.
- **Trust:** Revenue received will post to both the bank account (debiting cash) and to the trust liability account (crediting trust liability) as increases in those accounts.
- Paying an expense will decrease (credit) the bank account and increase (debit) the expense account.

The benefit of financial software is that all of this activity goes on behind the scenes. Therefore, if you have legal-specific accounting software, you don't have to worry about it. In situations where law firms are using generic or manual accounting systems, data may be required to be entered more than once. Financial software can link numerous accounts so that data only needs to be entered one time, reducing errors that come along with duplicate data entry. For law firms, this is a major win, because when data in one account doesn't match another, it can lead to mistakes, and in the case of smaller firms, many times they don't have the resources to fix these mistakes. By reducing the time spent on data entry these firms can spend more time with their clients and know that their books are clean and audit-ready.



General Ledger

The foundation of double-entry bookkeeping is the General Ledger (GL). The compilation of all the transactions and activities that occur in accounting is in the GL. Each account from the Chart of Accounts (COA) is listed with all activities within the time period requested. This essential component of good financial software allows the user to track and easily find transactions. The interrelationship between the firm's COA and the GL is straightforward. Every single transaction done in the system is posted twice in the GL, with a debit to a COA account and corresponding credit to another COA account using journal entries.

Journal Entry

While the General Ledger is the foundation, built with the chart of accounts, journal entries are how the financial data is entered. Every entry, without exception, is promulgated using debits and credits. In order to perform this correctly, one must understand how debits and credits affect each type of account. This can be very confusing because, in some cases, our colloquial descriptions are different from accounting definitions.

To increase an asset one posts a debit to the account. This seems counter-intuitive. When depositing money in the bank, the system debits cash and credits either income or accounts receivable. For this explanation, we're assuming cash basis reporting. Looking at the work behind the scenes, and consider the actions. You've billed your client for time. The client pays the invoice. In the system, you increase revenue with a credit to "income" on the income statement, but you also need to post the cash to the bank. The corresponding entry is a debit to cash. An accrual system simply adds one additional step. When the invoice is created, the income is immediately recognized by crediting income and debiting accounts receivable (the debit side of the entry). When the invoice is paid, accounts receivable is credited, and cash is debited.

In sum, the following accounts are increased with a debit: Bank (cash), Assets, Expenses, and Cost of Goods Sold. Consequently, these accounts are decreased by a credit.

The following accounts are increased with a credit: Equity, Liability, and Income. Consequently, these accounts are decreased by a debit.

Imagine having to enter every transaction for your law firm using journal entries, posting debits and credits. For those of you old enough to remember paper ledger books, there were two essential columns (plus columns for the account name / number, description, and additional information). The advent of electronic accounting software allowed non-accounting users to handle their bookkeeping because it makes the journal entry for transactions, such as writing a check or receiving a payment on an invoice, behind the scenes.

Sometimes a manual journal entry is needed to input financial data. For example, payroll liabilities are an expense as well as a liability. The expense must be entered properly to be included on the income statement, but also entered in the liability account until paid. In many systems, a manual journal entry is required. We encourage a full understanding of journal entry functionality before taking on this type of transaction.

Account Type	Debit	Credit
Asset	Increase	Decrease
Liability	Decrease	Increase
Equity	Decrease	Increase
Income	Decrease	Increase
Expense	Increase	Decrease



The advent of electronic accounting software allowed non-accounting users to handle their bookkeeping because it makes the journal entry for transactions behind the scenes.

Journal Entry Info

Entry# * ? Adjusting Journal Entry

Date * ▼

+ Add 🗑️ Delete Difference: **0.00**

Account	Debit	Credit	Name	Memo
1700:Advanced Client	11,562.00			
1620:Furniture and Eq	77,963.00			
2600:Notes Payable (L		72,572.00		
3100:Opening Bal Equi		16,953.00		
Total	89,525.00	89,525.00		

Figure 2-1: Journal entries showing debits & credits (Source - CosmoLex)

Challenges of Legal Accounting

For so many solo and small law firms, legal accounting is a major challenge. Lawyers certainly aren't accountants and accountants rarely have the particular expertise needed to successfully navigate the legal accounting landscape. Unfortunately, this creates the perfect storm for legal accounting errors to occur at many solo and small and law firms. In a nutshell, the following are five major challenges law firms encounter when it comes to legal accounting:

#1: Client Trust Fund Accounting

Using retainers to secure payment from clients is common practice for law firms. This means that funds may be in the firm's possession, but they do not belong to the firm until they have been earned.

Complications for law firms arise, as they need to track client ledgers individually while still keeping all trust funds pooled in one bank trust/IOLTA account. Law firms need to ensure that one client's funds are not used on behalf of another client or used with the funds of the firm. Law firms generally don't receive a save the date months in advance when they will be subject to an audit. For law firms looking to survive those accounting audits, it is imperative that they have various reports at the ready at all times.

Providing an auditor with a series of three to four highly specialized reports will quickly show them that a firm's trust accounts are in order. These reports can include bank reconciliation reports, bank ledgers, receipt journals, disbursement books, and client ledgers.

#2: Proper Accounting of Matter Costs

When practicing law, often costs are incurred from the outset of the matter. Depending upon the nature of the matter, these costs are either billed to the client or collected at settlement (if there is a settlement). It is required that all costs are accounted for properly. This sounds simple enough until you understand that not all costs can be treated the same.

#3: Differentiating Income & Revenue

When an invoice is paid, a portion of the revenue must first be allocated to incurred costs. This portion must be recorded separately and not considered income. Firms who have difficulty in separating revenue that covers incurred costs from their actual income will have inaccurate books, battle compliance issues, and experience difficulty recognizing which cases have become more valuable to the firm.

#4: Duplicated Data Entry & Resulting Errors

It is crucial that a law firm's billing and accounting systems use matching sets of data. The problem is that more often than not law firms use two separate systems for their accounting and billing. This means that all financial data must be entered twice and must be done correctly across both systems. Failure to accurately keep these two systems in sync may create bookkeeping issues, resulting in billing complications, missed revenue, or ethics violations.

#5: Understanding Where The Money Came From

Nobody has ever said being a lawyer is easy, it becomes that much more difficult when a lawyer decides to manage a firm. There's much more to think about than just a caseload. The lawyer needs to make a transition from attorney, to attorney/businessman or woman.

The following chapters cover all of these challenges in more detail while systematically explaining many other legal accounting topics.

Chapter Tips :

1. Have a legal-specific Chart of Accounts
2. An understanding of the segregation of matter-related transactions and business related transactions is essential
3. Only use manual journal entries if you understand the relationship between debits and credits and account types

03

RETAINER MANAGEMENT

Managing retainers should be a straightforward process, but it is one that frequently causes compliance problems for law firms. Retainers are client monies held “on account” to be used toward legal services and expenses. They may only be applied to matter expenses when incurred and legal services when earned. There are rules that govern how retainers are held (trust or operating accounts) and disbursed.

Operating vs. Trust Retainers

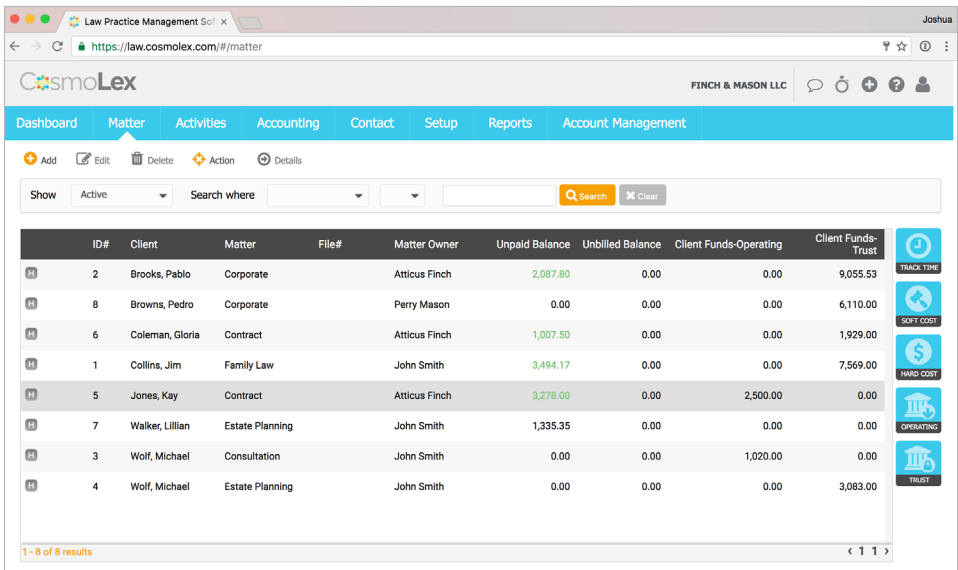
An operating retainer (only allowed in few jurisdictions; please check your local rules) is held in the firm’s operating account. Other than the account in which it is held, the rules governing use of the retainer are the same. This creates very complex accounting in order to segregate funds not only from other client funds but also from firm funds. Trust retainers are monies held in a dedicated bank account exclusively for holding client funds and properly titled at the bank as “Attorney Trust Account” or “IOLTA Account.”



Segregation of Retainers

Each client's funds must be identified and segregated from other client funds and must be used exclusively for that client. This can cause confusion and bookkeeping errors (and nightmares) since the funds are deposited to a single trust bank account.

In light of this, the accounting system must be capable of maintaining pristine client ledgers that clearly identify transaction and balances for each client.



ID#	Client	Matter	File#	Matter Owner	Unpaid Balance	Unbilled Balance	Client Funds-Operating	Client Funds-Trust
2	Brooks, Pablo	Corporate		Atticus Finch	2,087.80	0.00	0.00	9,055.53
8	Browns, Pedro	Corporate		Perry Mason	0.00	0.00	0.00	6,110.00
6	Coleman, Gloria	Contract		Atticus Finch	1,007.50	0.00	0.00	1,929.00
1	Collins, Jim	Family Law		John Smith	3,494.17	0.00	0.00	7,569.00
5	Jones, Kay	Contract		Atticus Finch	3,278.00	0.00	2,500.00	0.00
7	Walker, Lillian	Estate Planning		John Smith	1,335.35	0.00	0.00	0.00
3	Wolf, Michael	Consultation		John Smith	0.00	0.00	1,020.00	0.00
4	Wolf, Michael	Estate Planning		John Smith	0.00	0.00	0.00	3,083.00

Figure 3-1: Client ledger balances for all matters (Source - CosmoLex)



“Evergreen” Retainers

Many ongoing matters require the replenishment of retainer balances as legal services and expenses are paid. This is commonly known as “evergreen.” Attempting to track this manually rarely

produces successful results in most firms. The billing system should have a feature that provides automatic notifications and is able to bill the client when the retainer dips below a specified minimum.



Many ongoing matters require the replenishment of retainer balances as legal services and expenses are paid.

The screenshot shows the 'Edit Matter - ID # 8' interface in CosmoLex. Under 'Advanced Settings', the 'Accounting' tab is active. The 'Apply Rate' is set to 'Timekeeper' and 'Rate Level' is 'Default'. 'Overhead Charges' are set to '0.00 % of Time and Expense Card'. The 'Minimum Retainer Balance Required' checkbox is checked, with a value of '7,000.00' entered in the adjacent field. Other options include 'Localized Billing Rate' (unchecked) and 'Customize invoice formats just for this matter' (checked).

Figure 3-2: Matter setting for a minimum retainer balance (Source - CosmoLex)

INVOICE

Date: 10/31/2016
 Invoice #: 1010
 Matter: Corporate
 File #:

Bill To:
 Pedro Browns

Due Date: 11/30/2016

Payments received after 11/29/2016 are not reflected in this statement.

Professional Services

Date	Details	Hours	Rate	Amount
10/17/2016	PM Property Settlement Agreement Prepare Property Settlement Agreement	2.30	\$400.00	\$920.00
For professional services rendered			2.30	\$920.00
Invoice Amount				\$920.00
Additional Required Retainer Amount				\$890.00
Payment Received				\$920.00
Invoice Balance				\$890.00
Retainer Balance (as of 11/29/2016)				\$6,110.00

Figure 3-3: Client invoice showing retainer replenishment and remaining retainer (Source - CosmoLex)



TRUST ACCOUNTING

Trust accounting is something most attorneys are familiar with as a requirement of practicing law. Many attorneys are also aware of how essential it is to properly manage their trust accounts to remain compliant with the strict trust accounting requirements in their respective state. It is crucial that attorneys understand what makes trust accounting different from general business accounting, the strict guidelines attached to trust accounting, and the reports that are necessary to successfully manage a firm's trusts.

Key Trust Accounting Concepts

Virtually every law firm must observe the rules governing trust accounting. The Rules of Professional Conduct for each state bar are typically based on the American Bar Association model rules, and regulations for trust fund management will be found under Rule 1.15 (Safekeeping Property). Each state may have other rules that add to or supersede bar association guidelines.

Client trust account management can be dull, so it's tempting to assign the clerical work to somebody else in the office. While it's easy to entertain that thought, it's important to remember that office staff doesn't get disciplined, lawyers do! A large number of disciplinary actions and disbarments arise out of the mishandling of client trust funds.

In this section, we will cover key concepts of trust accounting and what makes it so unique.

Know Which Funds Belong in Client Trust Accounts

In general, the only funds that can be deposited to a trust account are client funds such as:

- Real estate transaction funds
- Personal injury settlements
- Other settlements or judgments
- Collections
- Retainers and advances for fees until actually earned

Funds held in a fiduciary capacity should be deposited to a separate properly entitled account.

The following types of funds cannot be kept in a trust account.

- Personal funds
- Earned income
- Payroll
- When attorney is not Fiduciary Trustee

All Client Funds Must Be Kept Separately

“Client A’s” money has nothing to do with “Client B’s” money. Even though all client funds are kept in the same bank trust account at an approved institution, each client’s funds are completely separate entities. At any given time, you should know each client’s balance held in your trust account and generate a required client transaction report, which shows all activity for that client and the remaining balance.

Client Ledger Must Never Have a Negative Balance

Each client has only his or her own funds available to cover their matters, regardless of how much money is in your pooled client trust bank account. If there is an instance where you unintentionally spend more than a client has on deposit, the over-drafted amount will have to be paid back from the firm’s funds and is likely to result in a disciplinary action upon audit.

All Funds In and Out Must Balance

The goal in client trust accounting is to make sure that every dollar you receive on behalf of a client is ultimately paid out. What “comes in” for each client must equal what “goes out” for that client — no more, no less.

Trust account is a Liability Account (on Balance Sheet)

Trust funds belong to the client and not to the attorney — not ever. Yes, some of the funds will eventually benefit the attorney in the way of fees earned, either by being directly billed and paid (retainer monies), reimbursed costs, or through fees earned at settlement. But until earned, the funds belong to the client. Any unearned funds must be returned to the client. Therefore, trust funds are a liability of the firm and are included on the balance sheet as such.

Trust Account Management Guidelines

Trust accounting itself is not difficult and most compliance challenges arise from the firm's inability to understand unique bookkeeping requirements and deploying proper systems and processes to maintain strict compliance. Challenges associated with business bank accounts that are not normally associated with trust bank accounts may include:

- Trust funds are not part of Income Statement (aka Profit and Loss)
- Trust balances do not need any depreciation or amortization
- Trust balances do not accumulate interest — for most IOLTA accounts, interest is deposited and withdrawn on the same date and credited to designated state agencies by the bank
- Trust funds do not affect firm's tax liabilities
- A properly configured trust bank account should not incur any management fees or bank fees

These attributes make handling trust funds simpler than business funds. However, as we saw in an earlier section, trust accounting guidelines have some unique characteristics and require specialized solutions. This section provides guidelines on how to administer trust funds correctly.



Avoid Manual Record Keeping

Review your firm's trust bookkeeping procedures and identify which ones are being managed manually. Often, law firms are entering each client's transactions separately and issuing hand-written trust checks. Manual bookkeeping takes an enormous amount of time, mistakes are hard to detect, hand-written checks are more subject to fraud and can easily be misread, and reports are next to impossible to prepare.

A good trust accounting program can easily replace ALL of your manual books and provide you with total control of your trust accounting. Transaction entries, trust check printing, bank reconciliations, report generating, error detection and corrections become simple, and you will be able to maintain an audit trail for any changes made in your trust books. Your accountant can easily review your trust data and make the appropriate corrections rather than shuffling through stacks of papers.

Verify Funds Before Disbursement

Don't make any disbursements until the deposited funds have cleared. Knowing your local jurisdiction rules on how long to wait before considering funds cleared is an important safeguard. Be diligent, but don't let a client rush you. After you have written the trust check(s), take a moment to add them up and compare them against the client's balance in the trust account. Make sure there are funds available to cover the checks.

Manual bookkeeping takes an enormous amount of time, mistakes are hard to detect, hand-written checks are more subject to fraud and can easily be misread, and reports are next to impossible to prepare.

Match your Books with Bank Statements (Reconciliation)

You must keep a record showing that you “reconciled” or “balanced” each trust bank account every month. The balance in the bank must agree with the total of the client balances listed on your books. Firms that do not reconcile monthly are waiting for disaster to strike, as most trust account mistakes are identified at the time of reconciliation. Monthly bank reconciliation is one of the most critical aspects of trust bookkeeping.

Lawyers looking to enhance the integrity of their reconciliation process can do so by taking the following steps:

- Many attorneys attempt to perform reconciliations by downloading an electronic bank statement. This simply isn't advisable, as all entries should be manually checked against the bank statement.
- Reconciling a firm's accounts is serious business. If the reconciliation is being performed by a third party, it is imperative that it all work is checked over by a senior member of the firm.
- A senior member of the firm should open and review the bank statement to help protect against fraud.

Once bank reconciliation is successfully completed, the following tasks should be performed:

- Review uncleared disbursements which are 30-days or older. Why are these funds not cleared? Until funds are cleared, you are still maintaining fiduciary responsibility. Follow up with

payees to see why funds were not cashed. Perhaps the check was lost in the mail, in which case you need to void and reissue the disbursement. If you cannot locate payees or clients, follow your state's rules to handle unclaimed trust funds, which often requires sending it to your state's designated agency.

- Check to ensure there are no deposit transactions in uncleared status.
- Eyeball client balances. Do they make sense? If a matter is no longer active, consider returning ledger balances to the client. Otherwise, you are still maintaining fiduciary responsibility. Most states have rules on how long the firm can hold the client funds after the case is settled. Failure to return funds in a timely manner can subject the attorney to disciplinary action.
- Close your trust accounting books for each reconciliation period to prevent accidental edits. This is a critical step and should be offered by your bookkeeping system.



Keep Paper or Electronic Images in Addition to Bank Statements

Have a good audit (paper) trail. In addition to the bank account statement and any canceled checks, keep a monthly folder with the following: copies/stubs of all checks deposited to or written on the account; copies of all deposit slips (copies made by you — don't rely on the bank); as well as a copy of your receipts and disbursements journal (or reports from your trust software) showing the account transactions for that month.

Each deposit and disbursement instrument (i.e. canceled checks, deposit slips) should describe the client and the matter to which it relates. This is a critical requirement and will help you identify the source of each and every transaction.

Archive Closed Client Accounts

When a client matter has been completed, the balance on the client's ledger is zero, and all transactions have been reconciled with the bank statement, you should "close" or archive that client ledger. Otherwise, over a period of time, you will be dealing with hundreds or even thousands of "open" client ledgers in your manual books or software program.

Maintain Strict Access Controls

Bookkeeping data, access to trust records, bank statements, bank logins, unprinted checks, etc., must all be under strict controls. Your trust bookkeeping software should allow you to limit viewing or editing capabilities by users, thus providing you with an effective mechanism to regulate staff access.

Maintain an Audit Trail

Maintain an audit trail for any changes made in your trust books. Your trust bookkeeping software should be able to keep track of your staff activities — which ledgers are being worked on, what activities are performed, etc. This would be immensely helpful in the event you run into serious trust bookkeeping issues and need to locate which staff member made those entries/changes.

Know Your State's Trust Account Requirements

Each state has its own set of rules and regulations related to client trust accounts, which are periodically updated. General descriptions provided in this book may or may not be applicable in your state. Always refer to the rules as maintained in your state by bookmarking the website and consulting it as your first source of information.

Key Trust Account Management Reports

To ensure law firms are managing client funds as per requirements, each jurisdiction specifies certain sets of reports, which are required to be maintained to show proper administration of trust accounts. Note, these reports are produced from a law firm's bookkeeping system and cannot be provided by the bank. This section

provides examples of these required reports as well as its purpose.

Apart from these reports, physical copies or electronic/scanned images of the actual instruments (deposit slips, canceled checks, paper statements) are also required to be maintained.

Bank Ledger

The bank ledger is a summary of all activity for the trust bank. It includes all receipts, disbursements, voided entries. Each listing must show Date, Payee/Payer, Amounts, Purpose, running balance and most importantly identify its client-matter.

Key information found in the Bank Ledger:

- Running balance will identify if law firm is overdrafting
- If disbursements are being issued prior to deposits
- Purpose of each transaction

Finch & Mason LLC BANK ACTIVITY REPORT 01/01/2016 - 12/31/2016					
BANK:		Trust Bank			
ACCOUNT:		Trust Account			
ACCOUNT #:					
DATE	TRANS TYPE REF # SUB-A/C #	PAYOR/PAYEE CLIENT-MATTER MEMO	INCREASE (DECREASE)	BALANCE	
	Beginning Balance				\$0.00
01/04/2016	Deposit	Browns, Pedro Browns, Pedro-Corporate opening retainer	7,000.00	7,000.00	
01/21/2016	Deposit	Brooks, Pablo Brooks, Pablo-Corporate	1,000.00	8,000.00	
09/21/2016	Adjustment In	Brooks, Pablo Brooks, Pablo-Corporate Trust	8,055.53	28,666.53	
11/29/2016	Check 4040	Finch & Mason LLC Browns, Pedro-Corporate	(920.00)	27,746.53	
	Ending Balance				\$27,746.53
SUMMARY:					
				BEGINNING BALANCE:	\$0.00
				TOTAL CREDITS (INCREASES):	\$30,624.53
				TOTAL DEBITS (DECREASES):	(\$2,878.00)
				ENDING BALANCE:	\$27,746.53

Figure 4-1: Bank activity report (Source - CosmoLex)

Receipts Journal

A cash receipts journal shows the cash received from each client. This report is basically the deposit portion of your bank ledger.

Key information found in the Cash Receipts Ledger:

- Identification of each source of deposits.

Finch & Mason LLC				
CASH RECEIPTS JOURNAL				
01/01/2016 - 12/31/2016				
BANK:	Trust Bank - Trust Account			
ACCOUNT:	Trust Account			
ACCOUNT #:				
DATE	TRANS TYPE REF # SUB ACCT #	PAYOR CLIENT MATTER	AMOUNT	DEPOSIT SLIP TOTAL
01/04/2016	Deposit	Browns, Pedro Pedro Browns Corporate	7,000.00	
				7,000.00
01/21/2016	Deposit	Brooks, Pablo Pablo Brooks Corporate	1,000.00	
				1,000.00
03/08/2016	Wire/ACH-In	Pedro Browns Pedro Browns Corporate	1,000.00	
				1,000.00
08/01/2016	Deposit	Collins, Jim Jim Collins Family Law	7,569.00	
				7,569.00
08/02/2016	Deposit 4073	Wolf, Michael Michael Wolf Estate Planning	3,500.00	
				3,500.00
08/05/2016	Deposit	Coleman, Gloria Gloria Coleman Contract	2,500.00	
				2,500.00
09/21/2016	Adjustment In	Brooks, Pablo Pablo Brooks Corporate	8,055.53	
				8,055.53
Total Received:			30,624.53	

Figure 4-2: Cash receipts journal report (Source - CosmoLex)

Disbursements Ledger

A cash disbursement journal shows the disbursements made on behalf of each client. This report is basically the withdrawal portion of your bank ledger.

Key information found in the Cash Disbursements Ledger:

- Identification of each payee. Special interest for auditors are payments being issued back to the law firm.
- Are disbursements happening sequentially by both date and check numbers, e.g. why was check number 4074 printed after check number 4075? Was check number 4074 post-dated? Was it a simple collation error?

Finch & Mason LLC				
CASH DISBURSEMENTS JOURNAL				
01/01/2016 - 12/31/2016				
BANK:		Trust Bank - Trust Account		
ACCOUNT:		Trust Account		
ACCOUNT #:				
DATE	REF # SUB ACCT #	Trans Type	PAYEE CLIENT MATTER	AMOUNT
02/15/2016	4054	Check	Finch & Mason LLC Pedro Browns Corporate	(870.00)
04/08/2016	4055	Check	ABC Pedro Browns Corporate	(100.00)
08/11/2016		Wire/ACH-Out	Court Michael Wolf Estate Planning	(125.00)
08/17/2016	4073	Check	Court Gloria Coleman Contract	(45.00)
08/19/2016	4075	Check	Merrill Lynch Michael Wolf Estate Planning	(265.00)
08/19/2016		Wire/ACH-Out	Court Reporters Gloria Coleman Contract	(526.00)
08/31/2016	4074	Check	Parking Authority Michael Wolf Estate Planning	(27.00)
11/29/2016	4741	Check	Finch & Mason LLC Pedro Browns Corporate	(920.00)
TOTAL DISBURSED:				(2,878.00)

Figure 4-3: Cash disbursement journal report (Source - CosmoLex)

Client Ledger Balances

The Client Ledger Balance Report is a critical report and is an essential part of trust bookkeeping. It provides balances for each of the clients in your books. Each client balance can be broken down into what has cleared the bank and what remains uncleared. Until funds are cleared from the bank, you are still in possession and maintain fiduciary responsibility. For example, you wrote a check of \$100 seven months ago and perhaps the check was lost in the mail. Your books may show the client balance to be \$0, as you have issued the check and closed the file. But as the funds never cleared the bank, you still need to account for these balances.

Key information learned the Client Ledger Balances:

- Any negative balance for any client. Remember, there is no such thing called “negative balance” in trust accounting.
- The amount of “uncleared” balances. Why are the funds uncleared? Are monthly reconciliations being performed?
- Inactive client matters with balances. Why are funds not disbursed?

Finch & Mason LLC					
TRUST CLIENT BALANCE REPORT					
Balances as of 08/31/2016					
CLIENT:	Brooks, Pablo				
DATE OPENED	MATTER NAME	MATTER FILE #	ATTORNEY	TRUST BALANCE	
09/07/2016	Corporate		Atticus Finch	1,000.00	
				TOTAL :	1,000.00
CLIENT:	Browns, Pedro				
DATE OPENED	MATTER NAME	MATTER FILE #	ATTORNEY	TRUST BALANCE	
11/23/2016	Corporate		Perry Mason	7,030.00	
				TOTAL :	7,030.00
CLIENT:	Coleman, Gloria				
DATE OPENED	MATTER NAME	MATTER FILE #	ATTORNEY	TRUST BALANCE	
08/23/2016	Contract		Atticus Finch	1,929.00	
				TOTAL :	1,929.00
CLIENT:	Collins, Jim				
DATE OPENED	MATTER NAME	MATTER FILE #	ATTORNEY	TRUST BALANCE	
08/12/2016	Family Law		John Smith	7,569.00	
				TOTAL :	7,569.00
CLIENT:	Wolf, Michael				
DATE OPENED	MATTER NAME	MATTER FILE #	ATTORNEY	TRUST BALANCE	
10/12/2016	Estate Planning		John Smith	3,083.00	
				TOTAL :	3,083.00

Figure 4-4: Ledger card balance report (Source - CosmoLex)



The Client Ledger Balance Report is a critical report and is an essential part of trust bookkeeping.

Individual Client Trust Ledger

The Individual Client Ledger Report is another crucial report and is an essential part of trust bookkeeping. It is basically a mini-bank account, one for each client-matter. It provides a chronological listing of transactions and running balances for each of the clients in your books. No running balance should ever show a negative balance, as that would indicate disbursements are being made prior to receipts.

Key information learned from the Client Trust Ledger:

- Any transaction that causes a negative balance.
- Are transactions being periodically reconciled?
- Are disbursements happening in sequential numbers? i.e. is check number 1007 being printed before 922?

Finch & Mason LLC LEDGER CARD DETAIL 01/01/2016 - 12/31/2016					
CLIENT NAME: Pedro Browns		BANK: Trust Bank			
CLIENT ID:		ACCOUNT: Trust Account			
MATTER: Corporate		ACCOUNT #:			
MATTER FILE #:		SUB-A/C #:			
MATTER OWNER: Perry Mason		BEGINNING BAL:		0.00	
DATE	TRANS TYPE REF #	PAYOR/PAYEE Memo1	INCREASE (DECREASE)	BALANCE	STATUS
01/04/2016	Deposit	Browns, Pedro opening retainer	7,000.00	7,000.00	Reconciled
02/15/2016	Check 4054	Finch & Mason LLC	(870.00)	6,130.00	Reconciled
03/08/2016	Wire/ACH-In	Pedro Browns	1,000.00	7,130.00	Reconciled
04/08/2016	Check 4055	ABC Municipal Court/Other	(100.00)	7,030.00	Reconciled
11/29/2016	Check 4741	Finch & Mason LLC	(920.00)	6,110.00	Entered
SUMMARY:					
TOTAL CREDITS (INCREASES):				8,000.00	
TOTAL DEBITS (DECREASES):				(1,890.00)	
ENDING BALANCE:				6,110.00	

Figure 4-5: Ledger card details report (Source - CosmoLex)



Bank Reconciliations

One of the most critical aspects of proper bookkeeping is performing bank reconciliations. It's an activity that is normally performed once a month where all bank statement transactions are tallied with the book transaction. Bank reconciliations compare two balances: the book balance and the adjusted bank balance. The book balance is the balance your records show for an account — basically, this is your check register. The adjusted bank balance reflects the balance shown by the bank, adjusted for checks and deposits that haven't cleared. Performing bank reconciliation, especially for trust accounts, is a mandatory requirement for most jurisdictions.

The key purpose of bank reconciliation is to ensure your books are in sync with bank activities. It helps you in locating any bookkeeping mistakes made on your side, as well as locating any mistakes the bank may have made in your account. The bank may have credited or debited a wrong amount or posted a check or deposit to your account that does not belong to you. These errors are often detected only at the time of the bank reconciliation. It is imperative to perform bank reconciliation in a timely manner as the bank is only obligated to fix mistakes if they are reported within a certain time-frame.



The key purpose of bank reconciliation is to ensure your books are in sync with bank activities.

Bank Reconciliation Tips:

Close books as of the date reconciliation is complete. You must prevent any accidental edits in the closed periods. Many software programs provide this feature where once the trust books are reconciled, no edits in prior periods are allowed, ensuring reliability of your reconciled reports.

- If your program does not allow printing of prior reports, ensure to save a PDF copy of the reconciled statement.
- Keep each reconciled report separately. Ideally, just as you have a monthly bank statement, you should have a corresponding monthly reconciliation statement.

Key information learned from the Bank Reconciliation Report:

- List of “Uncleared Deposits.” Why are these deposits in your books not showing at the bank?
- List of “Uncleared Checks.” If sufficient time has passed, why do these checks remain uncleared?

Finch & Mason LLC
BANK RECONCILIATION
8/01/2016 - 8/31/2016
Reconciled

Bank Name: Trust Bank
Bank Account Name: Trust Account
Bank Account #:

Beginning Statement Balance:	08/01/2016	8,030.00
Plus Cleared Deposits (Increases):		13,569.00
Less Cleared Payments (Decreases):		(961.00)
Difference:		0.00
Ending Statement Balance:	08/31/2016	20,638.00
Plus Uncleared Deposits (Increases):		0.00
Less Uncleared Payments (Decreases):		(27.00)
Difference:		0.00
Ending Checkbook Balance:	08/31/2016	20,611.00

DATE	TRANS TYPE	REF #	PAYOR/PAYEE	AMOUNT
Cleared Deposits (Increases):				
08/01/2016	Deposit		Collins, Jim	7,569.00
08/02/2016	Deposit	4073	Wolf, Michael	3,500.00
08/05/2016	Deposit		Coleman, Gloria	2,500.00
Total Cleared Deposits (Increases):				13,569.00
Cleared Payments (Decreases):				
08/11/2016	Wire/ACH-Out		Court	(125.00)
08/17/2016	Check	4073	Court	(45.00)
08/19/2016	Check	4075	Merrill Lynch	(265.00)
08/19/2016	Wire/ACH-Out		Court Reporters	(526.00)
Total Cleared Payments (Decreases):				(961.00)
Uncleared Payments (Decreases):				
08/31/2016	Check	4074	Parking Authority	(27.00)
Total Uncleared Payments (Decreases):				(27.00)

Figure 4-6: Bank reconciliation report (Source - CosmoLex)

Three-Way Reconciliation

Three-way reconciliation is a process of safeguarding trust account bookkeeping and is unique to law firms. When you have a trust account or IOLTA account, then you must have separate client ledgers for each matter, plus a ledger for bank charges. The sum of these individual ledgers must be the same as the book balance and the adjusted bank balance.

Three-way reconciliation reports ensure that a trust administrator is correctly accounting for all monies entrusted, and that a client's funds aren't being used to pay bank fees, firm expenses, or another client's charges. These reports are, if nothing else, a function of good accounting practices. However, they serve another purpose — compliance with state trust regulations. Most states require three-way reconciliation reports at specified intervals, such as 30 or 60 days, or on demand at the time of an audit.

Finch & Mason LLC		
THREE-WAY RECONCILIATION		
08/01/2016 - 08/31/2016		
Reconciled		
Bank Name:	Trust Bank	
Bank Account Name:	Trust Account	
Bank Account #:		
I. Book Balance		
Beginning Balance:	08/01/2016	8,030.00
Plus Cleared Deposits (Increases):		13,569.00
Less Cleared Payments (Decreases):		(961.00)
Balance at End of Month:	08/31/2016	20,611.00
II. Bank Balance		
Ending Statement Balance:	08/31/2016	20,638.00
Plus Deposits in Transit (Increases):		0.00
Less Outstanding Payments (Decreases):		(27.00)
Reconciled Bank Balance:		20,611.00
III. Client Ledger Balance		
	See attached report	

Finch & Mason LLC					
CLIENT LEDGER BALANCE REPORT					
Balances as of 08/31/2016					
BANK:	Trust Bank				
ACCOUNT:	Trust Account				
ACCOUNT #:					
CLIENT ID MATTER # SUB-A/C #	CLIENT MATTER ATTORNEY	CLEARED BALANCE	UNCLEARED BALANCE	BALANCE	CURRENT STATUS
	Brooks, Pablo Corporate Atticus Finch	1,000.00	0.00	1,000.00	Open
	Browns, Pedro Corporate Perry Mason	7,030.00	0.00	7,030.00	Open
	Coleman, Gloria Contract Atticus Finch	1,929.00	0.00	1,929.00	Open
	Collins, Jim Family Law John Smith	7,569.00	0.00	7,569.00	Open
	Wolf, Michael Estate Planning John Smith	3,110.00	(27.00)	3,083.00	Open
SUMMARY:					
LEDGER CARD BALANCES				20,611.00	

Figure 4-7: Three-way reconciliation report (Source - CosmoLex)

Trust Account System Checklist

Despite the uniqueness of trust accounting and the danger of non-compliance, too many law firms depend on clumsy manual methods, generic spreadsheets, or general use accounting software. Use of such methods for trust accounting is inefficient, time consuming, and error prone. Most trust violations are not deliberate fraud, but rather simple bookkeeping mistakes that could be avoided with the right software. The following checklist can be used as a guide in evaluating or selecting a solution for your trust account bookkeeping:

- Each trust transaction must be associated with client-matter details including source/payee, amount, date, matter and its purpose (memo field).
- A trust transaction entry must not be allowed without its associated client matter specified.
- All funds are identified and maintained by individual client matters in the books even though they all may be in a single bank trust account.
- Automatically prevent key trust management errors such as overdrafts, duplicate check numbers, or editing of closed transactions.
- Transactions can be voided (i.e. human error, lost checks, etc.) but should remain in the ledger for an accurate audit trail.
- Monthly reconciliation statements are archived and kept separate from one another so you can view/print prior reconciliations during an audit.
- Cleared and outstanding transactions are sequentially numbered.
- After monthly reconciliation, it's easy to produce a three-way reconciliation statement that links bank balance, book balance, and individual ledger balances.
- Trust account control reports show receipts, disbursements, and running balance for each month.
- Ledger balance reports show cleared and uncleared portions of each client trust fund.
- Disbursements checks can be printed for easy mailing by the firm.

Fully reconciled ledgers with zero balance can be closed out to prevent accidental data entry.

05 MATTER BILLING TYPES

Different practice areas may be billed under different models, i.e. hourly, fixed fee, value billing, and contingency (including any percentage-based billing). In most cases, time tracking is a key component to the generation of fees. For example, while fees for an estate administration are generally billed as a percentage of the estate, attorneys must track the time spent in case issues arise regarding the fee charged.

Hourly Billing

A common practice, hourly billing requires time tracking by the attorney at specified rates. The typical fraction of an hour is 1/10th (.1 or 6 minutes) with a minimum for any particular task. For example, a firm might establish that emails have a minimum time of 3/10 (.3) hour.

Rates can vary by practice area, by the person doing the work, and type of work being done. Partners, senior associates, associates, paralegals, and even clerical staff can all bill for time. It's vital to have a system that can easily manage these various rate scenarios. For example, the partner rate is \$425 per hour for transactional work but provides a preferential rate of \$350 for a particular client. Or, for the same person, travel rate could be \$200 per hour.

Having a system that enters correct rates when logging time prevents confusion and errors at the time the invoice is created.

It should also be noted that many firms bill for "tasks" associated with a matter in conjunction with hourly or fixed fee (see below) billing. For example, in estate planning, the attorney has set task rates for wills, power of attorney, and living will. These "tasks" can be part of an hourly matter or fixed fee matter.

Level	Rate
Default	Level 1 (250)
Level 1	250.00
Level 2	100.00
Level 3	0.00
Level 4	150.00
Level 5	0.00
Level 6	0.00
Level 7	0.00
Level 8	0.00

Figure 5-1: Timekeeper's multiple rate chart with default rates (Source - CosmoLex)

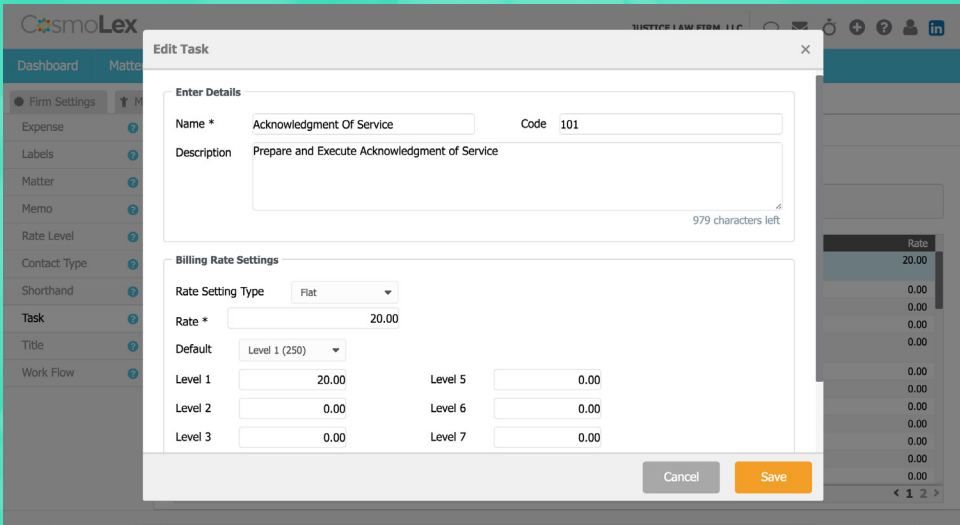


Figure 5-2: Example of a task rate chart (Source - CosmoLex)

Hourly Billing Workflow

When it comes to billing & accounting, a normal hourly billing matter encompasses the following workflow:

- Set up the matter as an hourly fee — input matter or attorney-specific rates if rates are different from global defaults.
- Initial fee retainer, if any, is deposited into the trust or operating account.
- All work is tracked with an associated time entry. Work that is not to be billed can be entered as no-charge or non-billable depending on whether it should be shown to the client. Wherever possible, associate time entry with its activity i.e. with an event, task, document, or an email.
- All direct* costs are posted to matter as a hard-cost expense for future billing.
- All indirect* costs are posted to matter as a soft-cost expense for future billing.
- Periodic bills, e.g. monthly, task completion, are generated and first paid with trust funds, if any.
- All payments, from trust or new funds from clients, are segregated into payments for cost and fee.
- When retainer balances fall low, a new retainer replenishment demand is made.

*See chapter on “**Matter Expenses**” for an explanation of direct and indirect costs.

Add Timecard ⊕ ✕

Client Matter

Enter Info

TimeKeeper * Date

Task *

Description
966 characters left

Time & Amount

Time Spent Time Billed * : : ▶ ■

Rate Level Rate/Price * Rate Type **Value: 240.00**

Figure 5-3: Example of an hourly fee timecard (Source - CosmoLex)

Expense - Hard Cost ⊕ ✕

Hard Cost is billing for direct cost such as filing fees, expert fee, etc. This screen is used for both bank transaction entry and and posting expense to the matter. Do not use "Hard Cost" for expense entries If you are not doing business accounting within CosmoLex and instead use "Soft Cost" option.

Client Matter

Date * Amount *

Type * Check# To be Printed

Pay To * ▼ More Info

Bank

Memo

Memo2

Account *

Post as matter expense

Remember Payee

Figure 5-4: An example of a hard cost transaction which is being posted to matter (Source - CosmoLex)

Fixed Fee

There are many practice areas where setting a fixed fee is appropriate. These are usually task-oriented matters where the amount of time the task requires is generally “fixed” so the attorney can gauge a profitable fee based on the work. An example, as above, is the drafting of simple

wills and estate planning paperwork. In this instance, tracking non-billable time helps the attorney monitor the activities required to generate the fee and make necessary adjustments to the fee schedule for future matters.

Add Timecard ×

This card is UnBillable because the billing method is set as Fixed Fee

Client Matter

Enter Info

TimeKeeper * Date

Task *

Description
970 characters left

Time & Amount

Time Spent Time Billed *

Rate Level Rate/Price * Rate Type **Value: 280.00**

Figure 5-5: An example of fixed fee matter's unbillable timecard (Source - CosmoLex)

Fixed Fee Workflow

When it comes to billing & accounting, a normal fixed fee billing matter encompass following workflow:

- Set up the matter as fixed fee.
- Initial fee retainer, if any, is deposited into trust or operating account.
- All work is tracked with an associated time entry but marked as “non-billable.” This is to track productivity.
- All direct costs are posted to matter as a hard-cost expense for future billing unless included as part of the fixed fee.
- All indirect costs are posted to matter as a soft-cost expense for future billing unless included as part of the fixed fee.
- Periodic bills, e.g. monthly or task completion, are generated that include fixed fee amount and all costs. These bills are first paid with trust funds, if any.
- All payments, from trust or new funds from clients, are segregated into payments for cost and fee.

Contingency

When a matter is taken “on contingency,” the fee is based upon a percentage of the total, e.g. settlement, judgment, estate administration. Tracking non-billable time may be significant in this type of billing in order to successfully defend the amount charged. Calculation of fees are customarily completed before any

costs advanced on behalf of the client (for explanation, see section **Posting of Direct Cost**). Additionally, any **3rd party lien claims** are satisfied first — prior to final distribution to the client. A final 33.33% of settlement statement summary may look like this:

Total gross settlement amount	\$75,000.00
Law firm compensation (33.33% of gross settlement)	\$25,000.00
Subtotal	\$50,000.00
Attorney costs (See attached breakdown of direct and indirect cost)	-\$2500.00
Subtotal	\$47,500.00
Payment of outstanding 3rd party bills (see attached breakdown)	-\$4,800.00
Net payment to client	\$42,700.00

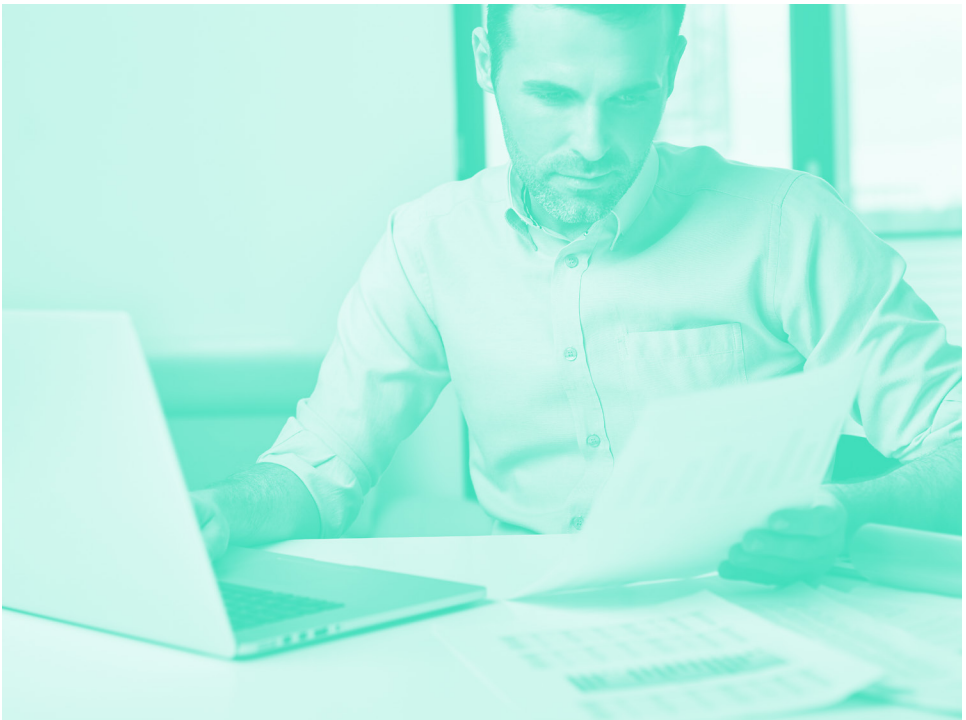
An example of contingency fee settlement statement summary

As cost tracking plays an important part of contingency matters, it is also important to have a system that easily tracks and associates advanced client costs to matters.

Contingency Workflow

When it comes to billing and accounting, a normal contingent billing matter may use the following workflow:

- Set up the matter as contingency fee.
- All work is tracked with an associated time entry but marked as “non-billable.” This is to track productivity.
- All direct costs are posted to matter as a hard-cost expense for future reimbursements upon settlement.
- All indirect costs are posted to matter as a soft-cost expense for future reimbursements upon settlement.
- All third party lien claims are tracked and tallied.
- Upon settlement, deposit funds in trust account.
- Generate your settlement statement with supporting details that itemizes costs and contingent fee for approval for payment.
- Upon approval, and after the required period of time for the settlement check to clear, pay the invoice and move funds from trust to business account.
- Prepare an itemized list of third party lien claims and upon approval, disburse from trust account.
- All remaining funds in trust accounts are settlement funds for the client and disbursed directly from the trust account.





MATTER EXPENSES

One of the most notorious areas for revenue “leakage” are unbilled expenses incurred by the firm on behalf of the client. To ensure the expense is billed it must be linked/ applied to the matter. There are two types of expenses— direct or hard costs and indirect or soft costs.

Direct Cost vs. Indirect Cost

A “Direct Cost” (aka Hard Cost) can be identified as any disbursement a firm pays directly to a vendor on behalf of their client. These expenses can include filing fees, costs paid to expert witnesses, the cost of court reporters, and various other direct expenses paid to vendors for a firm’s clients. At the time of disbursement, these costs should be linked to the matter for future billing and reimbursement. The Direct/Hard cost is a new expense being incurred and should be posted to the appropriate chart of accounts.

An “Indirect Cost” (Soft Cost) is identified as an “in-house” expense associated with a client matter. These costs can include postage, phone service costs, facsimiles, and even photocopies. Essentially, these indirect costs are associated with the general business activity of a law firm wherein a specific amount or percentage can be charged to a client, but isn’t paid directly on behalf of the client. These should be linked to the matter for future billing and reimbursements.

Expense Accounting

In the area of expense accounting, an expense such as photocopies has already been applied to a law firm’s profit and loss as an office expense. While it is legitimate to bill the client for part of this cost, it cannot be booked as a new expense on the profit and loss statement, as it has already been expensed during the course of general business.

On the other hand, a direct cost is a new expense and will have an effect on either the firm’s profit and loss or its balance sheet. Direct costs, like filing fees, can be posted as either “Advanced Client Cost (Asset)” or “Reimbursable Client Costs (Expense),” a decision that only you and your accountant can make. The decision is usually based on the practice area, firm priorities, and the volume and timing of expenses and collections. The IRS has rules regarding the handling of direct costs.

Posting of Direct Cost

The accounting for each type of expense requires attention to detail and consistency in application. After consulting with an accountant, direct/hard costs may either be carried as advanced client costs (ACC, an asset item) or as reimbursable client costs (RCC, an expense item), or a hybrid of both, i.e. a firm's transactional matters book expenses to RCC and its contingent matters book expenses to ACC. It is a decision you must make very carefully with your accountant as the posting of an expense as ACC will impact your balance sheet while posting it as RCC will impact your profit and loss (P&L). In the latter, there must also be a corresponding income account to which reimbursements are applied.

ACC is commonly used for contingency matters and, while there is impact on the firm's cash flow, there is no impact to the P&L, except if the expense is not recovered. The RCC is carried on the P&L as an expense. This is very common for expenses that are invoiced contemporaneously. The effect on the P&L flows over time, with reimbursements posting to a designated income account, segregated from fee income. Indirect/soft costs are already expensed on the P&L since they are part of the firm's expenses, with reimbursement posting to a designated income account, segregated from fee income and, ideally, from the direct/hard cost income account.

Matter Costs	Cost Posted to Expense
Filing Fees: \$57	Reimbursable Client Costs (Expense)
Transcription Fees: \$1,125	Reimbursable Client Costs (Expense)
Internal Photocopying: \$23	None (Indirect Cost)
Auto Mileage: \$65	Non-Reimbursable Client Cost (Expense)

Example: Hourly matter where direct cost is being posted as reimbursable client costs

Matter Costs	Cost Posted to Expense
Filing Fees: \$57	Advanced Client Costs (Asset)
Transcription Fees: \$1,125	Advanced Client Costs (Asset)
Internal Photocopying: \$23	None (Indirect Cost)
Auto Mileage: \$65	Non-Reimbursable Client Cost (Expense)

Example: Contingency matter where direct cost is being posted as advanced client costs

Why is this Accounting Configuration Important?

Disbursements on behalf of clients affect the cash position of the firm. As an asset, the firm may be able to get a secured bank line of credit to reduce the impact on cash flow. Carried as an expense, disbursements on behalf of clients impact the profit and loss and, as a result, the tax liability of the firm. Get guidance from your accountant/tax professional in order to select what is appropriate for your firm and to comply with IRS regulations.

The Cost of Not Tracking Direct and Indirect Costs Separately

Whether a firm is posting direct costs as “Reimbursable Client Costs” impacting the Profit and Loss of the firm or as “Advanced Client Costs” impacting the assets on the firm’s balance sheet, doing this inaccurately can have severe implications for the firm’s financial statements. The ideal way to handle the differentiation of costs is to utilize a software system that pre-defines and globally sets to which accounts the costs are posted. This will ensure that all expenses are posted to the appropriate account.

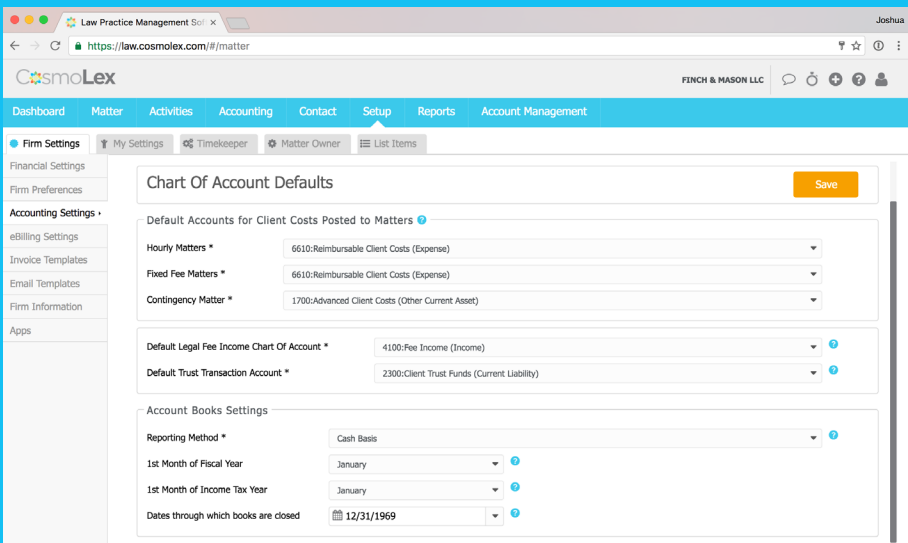


Figure 6-1: Firm level settings for client cost accounts based on matter type (Source - CosmoLex)

It is the consistency of tracking expenses and the associated reimbursements that is crucial to the firm’s financial statements and position. When using RCC, inaccurately tracking direct costs and posting associated reimbursements can increase or reduce the net income of a firm in a given tax year, impacting the firm’s tax liability. When using ACC, inaccurate-

ly tracking direct costs and associated payments will impact cash flow and potentially have tax implications. A common bookkeeping error posts client costs to ACC and the reimbursement to income. Both the asset on the Balance Sheet and the income on the Profit and Loss are inflated.

Third-Party Accounts Payable

When it comes to personal injury contingent cases, there is another type of expense attorneys may have to deal with, called “lien claims.” These are liens and third party claims for reimbursement (e.g. unpaid medical providers). There are many legal and ethical requirements for attorneys on how to deal with lien claims, which are beyond the scope of this book. However, from an accounting

perspective, post settlement, these disbursements are made directly from trust accounts and thus do not impact the firm’s profit and loss or balance sheets. However, as a practice, law firms are advised to keep track of all such lien claims and keep the client informed about these accumulated obligations, which are to be satisfied prior to any funds being disbursed to the client.

Chapter Tips:

1. Take some time to price your indirect costs, e.g. photocopies — calculate the monthly cost of the lease, maintenance costs, paper, staff time per copy, and determine a price per page or a minimum fee plus price per copy for this service.
2. Review your P&L with your accountant. Are there long-term client costs in Reimbursable Client Costs that might be better booked as Advanced Client Costs? How will that impact your tax liability?



07

BILLING & PAYMENTS

Billing clients and receiving payments is an essential component of running a law firm. There are a number of different billing and payment methods that can be used. No matter what method a firm chooses to utilize, it's necessary to understand both the advantages and potential issues that could be associated.



Billing Methods

Whether hourly, flat fee, value, or contingency, firms bill clients using an invoice. Certain practice areas or clients require detailed statements of work (logged hours, tasks) and disbursements,

and some may require court approval prior to releasing funds to satisfy the invoices. A strong legal accounting software has statements and reports that readily meet this requirement.



Whether hourly, flat fee, value, or contingency, firms bill clients using an invoice.

INVOICE

Date: 10/31/2016
Invoice #: 1011
Matter: Corporate
File #:

Bill To:
Pablo Brooks

Due Date: 11/30/2016

Payments received after 11/29/2016 are not reflected in this statement.

Professional Services

Date	Details	Hours	Rate	Amount
10/04/2016	AF Case Information Statement Prepare Case Information Statement	1.30	\$400.00	\$520.00
10/05/2016	AF Modification of Agreement Modification of Agreement	1.40	\$400.00	\$560.00
10/19/2016	AF UCC Filing Prepare and File UCC Forms	2.20	\$400.00	\$880.00
			For professional services rendered	4.90
				\$1,960.00

Additional Charges

Date	Details	Quantity	Rate	Amount
10/04/2016	AF Federal Express	1	\$45.00	\$45.00
10/04/2016	AF Federal Express	1	\$45.00	\$45.00
10/08/2016	AF Print/Reproduction Printing and Reproduction of Documents	108	\$0.35	\$37.80
			Total additional charges	\$127.80
			Invoice Amount	\$2,087.80
			Balance Due	\$2,087.80
			Retainer Balance (as of 11/29/2016)	\$9,055.53

Figure 7-1: Hourly invoice which shows time and expense charges (Source - CosmoLex)

In other practice areas, such as insurance defense work, electronic billing (LEDES 98B/UTBMS) is mandated by the client. This billing method codes tasks and fees in a uniform format for electronic submission that facilitates client review

and expedites payment. Frequently the client batch processes LEDES 98B bills for multiple matters. (Note: LEDES 98 is one format. There are others that may be required by certain firms, but the concepts are the same.)

Client Payment Options

Once you've done the work, advanced costs, and created the invoice, there are many mechanisms by which you can receive payment. These include cash, check, ACH, credit card, and trust funds.

Payment by Check/Cash/ ACH

Most accounting systems easily handle receiving payment by cash or check. As with any business, the payment is applied against the invoice and deposited to the bank. The payment can come from the client or a third party.



Payment from Trust Funds

Payment using trust funds is not a functionality easily handled by generic accounting software. As we learned in the chapter on **Trust Accounting**, there must be defined safeguards to avoid the pitfalls of overdrawing a client's trust account, using one client's funds for another client, etc. Generic accounting

software does not have these safeguards in place. The user must manually check to see if there are enough funds available prior to paying the invoice. A legal-specific accounting software will prohibit overdrafts and not allow withdrawals over the available client balance.

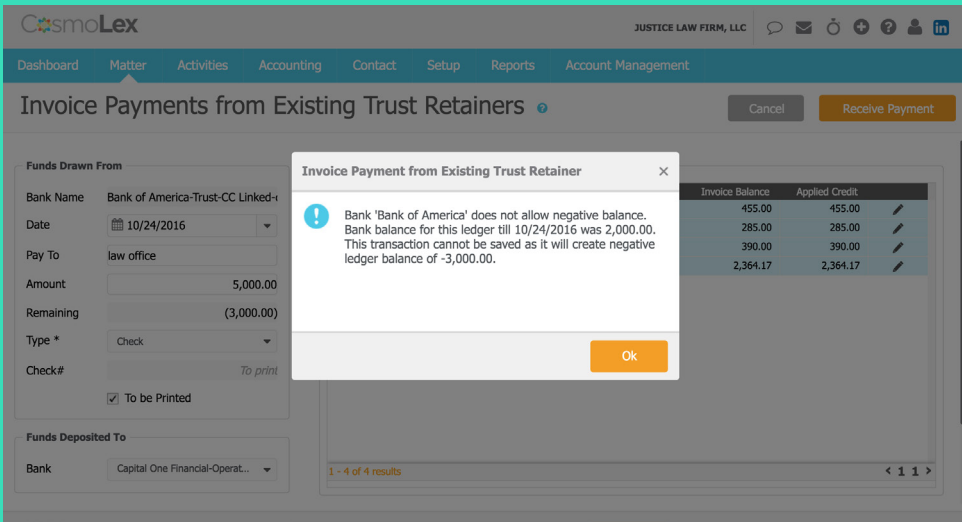


Figure 7-2: An error message screen when payment is higher than trust balance

When there are enough funds, the firm will move the funds from the trust account to the operating account, where all legal fees are deposited. Typically, the bookkeeper or person handling these transactions tracks the amount of payments, and either cuts individual checks or batches them and cuts a single check to the operating account. While individual checks can be time-consuming, they provide many key advantages:

- Each withdrawal instrument is tied to its matter and will reflect properly on client ledgers.
- An error on one payment does not corrupt the entire batch.

If you batch payments into a single check, as long as the transactions accurately appear on the client ledger cards and the batch matches the total, the system will be compliant. However, this can be a multi-step process, and errors may occur. It is imperative to have the batch verified before processing.

Apply Operating Retainers

The same pitfalls are prevalent in applying operating retainers to matter invoices. Remember, there can be no commingling of client and firm funds. If the system does not provide an alert that funds are not available specific to the client matter, other client funds or firm funds may be used to pay the invoice.

As Operating Retainers are already within the firm's business accounts, no funds are transferred between accounts. Upon payment of an invoice using existing operating retainers, the invoice balance is updated as well as the client retainer balance record. The bank balance does not change.



Fee waivers — waivers in general — occur when the attorney is willing to “write-off” the entire balance due on the client’s invoice (use discount when for a partial amount). Since no revenue is posted to the income account, the waiver merely removes the invoice and its amount, but does not void it. No amount appears as a discount. Financial software should provide the data on these waivers since the amounts do not appear on the financial statements. When the waiver is for hard costs, i.e. the hard cost will not be recovered; the amount can be moved from the client cost account to a bad debt expense account through a journal entry.

Discounts & Fee Waivers

Firms may offer discounts. Discounts should only apply to fee income and not expenses. Discounts are courtesies extended by the attorney to the client. In order to track discounts on the P&L when accounting is done on a cash basis, the system should post the revenue in full with the discount as a negative income item. This accurately records actual cash received.

Finch & Mason LLC	
Profit and Loss	
01/01/2016 - 08/31/2016	
	Total
Income	
4100:Fee Income	879,396.31
4125:Discounts	(518.00)
4200:Reimbursed Client Costs (Direct)	8998.00
Total Income	880,176.31
Cost of Goods Sold	
.....	89.00
Total Cost of Goods Sold	89.00
Gross Profit	880,176.31
Expenses	
6050:Automobile Expense	82,000.00
6200:Dues and Subscriptions	832.00
6300:Insurance	\$1,218.00
6350:Legal Library	8126.00
6400:Salary & Benefits-Other Payroll	837,103.00
6601:Professional Fees-Accounting	81,899.00
6610:Reimbursable Client Costs	\$1,076.00
Total Expenses	864,332.00
Net Operating Income	835,784.31
Other Income	
.....	89.00
Total Other Income	89,176.31
Other Expenses	
.....	89.00
Total Other Expenses	89.00
Net Income	835,784.31

Figure 7-3: Profit & Loss statement with discount(s) as separate line item (Source - CosmoLex)

Online Payments via Credit Cards

In this electronic world, many clients prefer to use electronic/online payments for all of their expenses. Nowadays, most law firms accept credit card payments. In most cases the merchant services fees are expensed to the firm. Refer to your merchant services agreement and your state's regulations before passing along merchant services fees to your clients. No fees can be charged to the trust bank account. Fees for credit card transactions for trust retainer payments must be posted to the operating account.

CosmoLex JUSTICE LAW FIRM, LLC

Dashboard Matter Act

Invoice Payment

Funds Received From

Client Brookes, Pablo
Date * 10/25/2016
Amount

Credit Card Funds Deposited To

Bank Capital One Financial

Summary

Payment Received
Applied Amount

Charge Credit Card

Applied Credit
0 234.00

This is a secure 256-bit SSL Encrypted payment. You're safe.

Amount to be charged: **\$234.00**

Credit card info

Card number: 4111111111111111 **VISA** Expires: 10 / 2019
Security code: 111

▼ Billing Info

Name: Pablo Brookes

Address 1 10 Main Street Address 2
City Providence State/Province RI
Zip/Postal Code 02902 Country United States Of America

Cancel Charge

< 1 1 >

Figure 7-4: A credit card payment showing fee posting (Source - CosmoLex)

Challenges of Accepting Credit Card Payments



On the surface, law firms accepting credit cards seems like an open and shut case. Law firms who accept credit cards see a significant improvement in their cash flow. Clients enjoy the ease with which they can submit payments. With rewards available through different credit card companies, many clients prefer to use credit cards.

With multiple benefits, you may find yourself scratching your head trying to figure out why more law firms aren't accepting credit card payments already. The truth is that while there are many benefits associated with credit card acceptance for law firms, there are also real concerns, ones that could result in bookkeeping and compliance consequences in your firm.

Areas of Concern around Credit Card Acceptance for Law Firms

When considering the acceptance of credit cards for your law firm, there are three major areas of concern. First is the cost, which varies by the merchant services provider you choose and is a business choice not covered by this book. The second area of major concern is external, and it pertains to how credit card merchant service providers operate. The final area is internal and has more to do with how your firm is set up to receive funds via credit card.



The truth is that while there are many benefits associated with credit card acceptance for law firms, there are also real concerns.

Credit Card Acceptance Issues Associated with Credit Card Merchants

A major issue behind accepting credit cards as a law firm is that law firms face a unique set of requirements associated with legal accounting. Many credit card merchant services providers are set up to cater to restaurants and retail businesses. While that is great for restaurants and retail businesses, law firms need to work with credit card merchant services providers who offer services that are distinctly for the legal industry.

Law firms rely on collecting initial retainers prior to commencing work, and these retainers are normally deposited into an IOLTA/trust account. A legal-specific merchant services provider understands specific legal accounting requirements associated with IOLTA trust fund accounting compliance.

The proper setup of a compliant credit card acceptance service allows for law firms:

- **to create separate merchant accounts for trust accounts and business or operating account** – If a law firm allows for commingling of activities in trust and operating accounts, they run the risk of disbarment for noncompliance. There must be unique merchant accounts for the operating and trust bank accounts.
- **to correctly post fees predeposit** – There should be no deposit fees associated with IOLTA trust account. This ensures that when trust credit card payments post to an IOLTA account the amount received will always match the client payment as well as the sum of payments when credit cards are batched.

- **month-end fee collection** – For improved accounting management a legal credit card merchant service provider collects all fees at month end, as a separate transaction. This is in contrast to those that deduct the fee from each credit card batch. Fees must only be deducted from the business account, not the IOLTA account. This improves the efficiency of the system, and provides accurate posting of payments against invoices as well as expense tracking.
- **to isolate chargebacks to operating accounts** – Chargebacks are a demand from providers for funds to make good on fraudulent or disputed transactions. These funds must be withdrawn from operating funds and not trust funds.

These concerns are very real, and shouldn't be ignored by any law firm. The best way to meet them head on is by finding a merchant services provider that is suited to the legal industry. Merchant services providers, like **LawPay**, provide an out-of-the-box solution that is ready for any law firm to use.

Internal Concerns Associated with Law Firms Accepting Credit Cards

While the concerns previously mentioned all have to do with a merchant services provider’s ability to meet the unique requirements of a law firm, there are also concerns associated with how your firm handles its bookkeeping. With many firms using two separate systems for billing and accounting, multiple challenges can arise. Let’s identify what they are:

How will your accounting system understand which invoices are actually being paid?

When your firm charges a client, it is done through your billing system. Alternatively, your client may pay the invoice online. Either way, the payment will post to your accounting system. Unfortunately, unless these systems are integrated with each other or manually reconciled constantly, there is no way for your accounting system to identify to which invoice the payment should be attached.

Not being able to identify which client matter and invoice has been paid could lead to commingling of funds and accounting compliance issues for your firm.

How will your firm manage credit card “batching”?

Credit card batching allows payments from multiple clients to be posted to your accounting system as one deposit,

just as when you use a single deposit slip to post check payments from multiple clients. In the latter case, the process should have applied the payment to the invoice prior to creating the deposit ticket. The challenge with credit card batched payment is the payment posts without being applied to the client invoice requiring daily manual reconciliation. Without reconciliation, your accounting system will not know what to do with batch deposits that come into your bank.

Example: Your billing system sent invoices to clients on the third of the November. You received the following invoice payments by credit card on two separate dates. Note that the single payment does not need to be batched. However, it is important to batch the multiple payments in order to accurately match what’s deposited to your bank account to avoid significant frustration when reconciling your bank account.

Date Payment Processed by Credit Card	Date Funds Received At Bank	Client	Amount	Batch	Bank Deposit
11/7/16		Client A	\$1,200	No	
	11/8/19				\$1,200
11/8/16		Client B	\$2,750	Yes	
11/8/16		Client C	\$4,250	Yes	
11/8/16		Client D	\$1,500	Yes	
	11/9/16				\$8,500

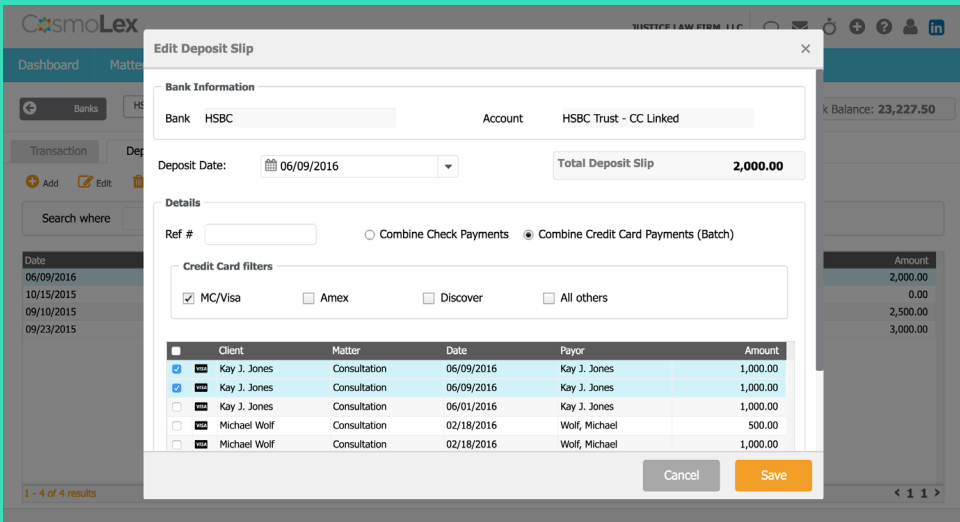


Figure 7-5: Invoice payments by credit cards and how funds are to be batched (Source - CosmoLex)

How will voids and chargebacks be handled?

Nobody is perfect, and your firm will make mistakes. Sometimes your firm will need to refund money that was charged to a client's credit card. The issue with void refunds is that they take place inside your billing system, while the funds need to be withdrawn from your accounting system. How will your firm reconcile these two separate systems?

These challenges exist, but can be addressed. For law firms looking to mitigate the challenges associated with credit card processing, it is imperative that they utilize a legal-specific system that integrates their billing and accounting systems. In doing this law firms will:

- Identify and properly post which invoices are being paid. As a result of the billing and accounting systems being able to easily communicate with each other, accounting systems

will automate the process of tying a particular credit card payment to an invoice.

- Voids and refunds posted in the billing system will be reflected in the accounting system.
- Automate the reconciliation process. Credit card payment batching requires firms to reconcile their accounts on a daily basis to understand which client invoice payments are part of the daily deposit from credit card merchant services provider. A legal-specific solution will automate the reconciliation process, allowing the law firm to easily identify which invoices are being paid. This same automation of the reconciliation process will ensure that voids and chargebacks appear in both the law firm's billing and accounting systems.

Fee Disputes

Let's face it. There isn't an attorney out there who looks forward to a fee dispute with one of their clients. Despite the lack of interest in fee disputes, they are an unfortunate reality in the legal industry. It's important to understand where and how these disputes can form, and the technology available to attorneys that can help them avoid such disputes.

- **Client Fees** — Disputes associated with client fees are commonplace in the legal world. One way attorneys can avoid fee disputes is to meet their clients' expectations when it comes to billing. It's necessary to employ a legal technology solution that allows firms to create clear and concise invoices that are easy for clients to understand what they are being billed for. In addition to this, an effective system will bill clients on a regular basis and provide timely payment reminders.
- **Breakdown in Communication** — Communication is key in everything. When firms don't have a constant open line of communication with clients, problems surface and the firm's reputation and trustworthiness are affected. Disputes surrounding poor communication can be avoided by establishing a primary method of communicating with each client, consistent with the comfort level of the client. Documenting all communication will ensure that there is a paper trail should any issues arise.
- **Missed Deadlines** — A sure-fire way for any attorney to find themselves in their clients' doghouse is to miss deadlines. It's critical that attorneys are able to deliver on what they promise when they promised it would be done. An effective way to stay on top of a number of different deadlines with many different clients is to utilize shared calendars. Firms who do this are able to stay aware of critical dates across the entire organization. Legal calendar solutions are available in the cloud across a number of different devices, so there is no reason to ever miss a deadline again.
- **Time Tracking** — It's crucial that all activity related to a particular matter is efficiently tracked and time recorded. Legal technology that can keep a detailed record of time, notes associated with time entries, and expenses generated on the client's matter will go a long way in avoiding disputes with clients over what time was spent on activities and what costs were incurred.
- **Mismanagement of Finances** — A firm's finances are heavily scrutinized. In order to avoid disputes with clients firms must account for all client funds and report on them to the client, show all expenses on invoices, properly batch and reconcile all payments including credit card payments, and make sure that all trust records are kept clean and audit ready. An attorney trying to handle this manually or without legal-specific accounting technology is facing complexity and unnecessary risk. Firms looking to avoid problems with their clients regarding finances need to depend on technology that allows them to automate these processes.



Despite the lack of interest in fee disputes they are an unfortunate reality in the legal industry.



INCOME TRACKING

Once a firm receives payment from a client, there is still a lot to do when it comes to tracking income. Attorneys need to be very precise in how they track their income. It isn't as simple as the money that comes into the firm can be realized as income. This chapter analyzes how costs are allocated, how income can be realized, and the categorization of income to help the firm make the best decisions.

Hierarchy of Payments

The nature of legal accounting requires that liabilities and out of pocket disbursements on behalf of clients be reimbursed prior to earning fees. Therefore, when an invoice is paid, the following hierarchy is used:

- Liabilities, including sales tax payables
- ACC
- RCC – hard costs
- RCC – soft costs
- Finance charges and late fees
- Fee Income

For obvious reasons, it makes little sense to post income prior to being reimbursed for out of pocket disbursements. The attorney is subject to an ethical obligation to pay and be reimbursed for costs before taking any income.

When a client pays the invoice in full, the issue is resolved. However, partial payment requires the attorney be astute to assure the hierarchy is followed. To do so in generic accounting software, the invoice must be split by the parts being paid.

Manual Allocation of Payments

Generic accounting systems may not have the capacity to implement a hierarchical payment system. When a partial payment is received, it may allocate the payment by percentage of the billed amount across account types. For example, on a client invoice of \$2,494, composed of \$394 for cost and \$2100 for fee. The client makes a partial payment of \$1000, which is 40% of the invoice

amount. A generic accounting software might allocate \$157.98 towards costs (40% of total invoice costs of \$394) and \$842.02 towards fee (40% of total invoice fee of \$2100).

Take a look at this exact same scenario with a popular general accounting system – QuickBooks Online:

Exhibit 1 Invoice 2026

BILL TO		DATE	PLEASE PAY	DUE DATE
Ms. E. Folmsbee 1234 Main Street Anywhere, IN		07/01/2016	\$2,494.00	07/31/2016

DATE	DESCRIPTION	HOURS	RATE	AMOUNT
	06/06/2016			
06/06/2016	Medical Records		354.00	354.00
	06/16/2016			
06/16/2016	Draft Summons and Compliant	6	350.00	2,100.00
	06/24/2016			
06/24/2016	Filing Fees		40.00	40.00
TOTAL DUE				\$2,494.00

THANK YOU.

Figure 8-1: A new invoice (Source - QuickBooks™ Online)

Exhibit 2 Invoice 2026

BILL TO		DATE	PLEASE PAY	DUE DATE
Ms. E. Folmsbee 1234 Main Street Anywhere, IN		07/01/2016	\$1,494.00	07/31/2016

DATE	DESCRIPTION	HOURS	RATE	AMOUNT
	06/06/2016			
06/06/2016	Medical Records		354.00	354.00
	06/16/2016			
06/16/2016	Draft Summons and Compliant	6	350.00	2,100.00
	06/24/2016			
06/24/2016	Filing Fees		40.00	40.00
PAYMENT				1,000.00
TOTAL DUE				\$1,494.00

THANK YOU.

Figure 8-2: Invoice after partial payment (Source - QuickBooks™ Online)

Exhibit 3

Advanced Client Costs - billed to client Jun-16							
	Date	Transaction Type	Num	Name	Memo/Description	Account	Amount
Advanced Client Costs	06/06/2016	Check	NA	Anytown Hospital	Medical Records	Advanced Client Costs	354.00
	06/24/2016	Check	NA	Anytown Courthouse	Filing Fees	Advanced Client Costs	40.00
Total for Advanced Client Costs							<u>\$ 394.00</u>

\$1000 Payment Received August 10.								
Advanced Client Costs - system applied payment from client Aug-16								
	Date	Transaction Type	Num	Name	Memo/Description	Account	Amount	Balance
Advanced Client Costs	08/10/2016	Invoice	2026	Elaine Folsbee	Medical Records	Advanced Client Costs	141.94	\$ 212.06
	08/10/2016	Invoice	2026	Elaine Folsbee	Filing Fees	Advanced Client Costs	16.04	\$ 23.96
Total for Advanced Client Costs							<u>\$ 157.98</u>	<u>\$ 236.02</u>

Consulting Income - system applied payment from client Aug-16								
	Date	Transaction Type	Num	Name	Memo/Description	Account	Amount	Balance
Consulting Income	08/10/2016	Invoice	2026	Elaine Folsbee	Draft Summons and Compliant	Consulting Income	842.02	\$ 1,257.98
Total for Consulting Income							<u>\$ 842.02</u>	<u>\$ 1,257.98</u>

Figure 8-3: Payment allocations after partial payments (Source - QuickBooks™Online)

This approach is not compliant with the required and desired hierarchical allocations. The costs must be satisfied prior to taking income. In this scenario, and for all partial payments against invoices that include a combination of liabilities, costs, and fees, the user is required to manually break the invoice into the different parts in order to pay according to the formula. Unless you know in advance there will be a partial payment, splitting the invoice will happen at the time the payment is received. This means creating an invoice for costs with all pertinent particulars and paying it in full, and then applying the remaining payment to the invoice with fees. In our example, create an invoice for \$394 for

costs (depending on your software, you may be able to unlink these costs from the existing invoice and create a new one) and then apply the payment of \$394. The remaining funds from the client is \$606. Second, remove the costs from the original invoice, creating an invoice for fees \$2100. Apply the \$606 payment from the client, leaving an outstanding balance of \$1494 of unpaid fee income.

This process is time-consuming and fraught with errors. If the firm fails to do this, the financial statements are not correct; cost reimbursements are understated, and income is overstated.

Automatic Allocation of Payments

Legal-specific accounting software solutions are built with the allocation logic internally. When a payment is posted the accounting system automatically follows the allocation hierarchy

as outlined in section **Hierarchy of Payments**. Using the example above, note how the invoice allocations are made using a legal-specific software such as CosmoLex.

INVOICE

Date: 06/20/2016
 Invoice #: 1013
 Matter: Contract
 File #:

Bill To:
 Kay Jones

Due Date: 07/01/2016

Payments received after 11/30/2016 are not reflected in this statement.

Professional Services				
Date	Details	Hours	Rate	Amount
06/08/2016	AF Complaint Prepare Complaint	3.00	\$400.00	\$1,200.00
06/18/2016	AF Certificate of Incorporation Order and File Certificate of Incorporation	4.00	\$400.00	\$1,600.00
		7.00		\$2,800.00

Additional Charges				
Date	Details	Quantity	Rate	Amount
06/10/2016	AF Print/Reproduction	1	\$478.00	\$478.00
		Total additional charges		\$478.00

Invoice Amount	\$3,278.00
Payment Received	\$2,700.00
Remaining Balance	\$578.00
Balance Due	\$578.00

Figure 8-5: Payment allocations after partial payment (Source - CosmoLex)

Breakdown	
Label	Value
Legal Fees	2,800.00
Cost	478.00

Applied Payments					
Deposit Date	Reference Number	Payee Name	Amount	Memo	CC Info
07/30/2016		Jones, Kay	2,700.00		

Account Allocations		
Account	Debit	Credit
4100:Fee Income (Income)		2,222.00
4200:Reimbursed Client Costs (Direct) (Income)		478.00

Figure 8-4: Invoice showing partial payment (Source - CosmoLex)

Posting of Reimbursed Expenses

In the **Matter Expenses** chapter, we discussed how direct and indirect costs are posted to the chart of accounts and billed to clients. As invoices containing these expenses get paid (partially or fully), funds are allocated following the hierarchy as shown previously.

Indirect costs, upon reimbursement, are posted as “Inhouse Reimbursed Client Costs (Income),” and they impact the firm’s profit and loss. The reimbursement increases the income and effectively offsets the firm’s office expense, as in our example about the maintenance of the copier. This results in an improved bottom line for the firm because the revenue generated is for expenses of the firm (not the client), i.e. reducing the bearing of overhead/general expenses.

However, direct costs are handled differently when it comes to a law firm’s income. In instances where costs were expensed as a “Reimbursable Client Cost (Expense),” reimbursement should post as “Reimbursed Client Costs (Direct) (Income)” in the firm’s Profit and Loss, and will offset a specific client expense “Reimbursable Client Cost (Expense).” However, in instances where the direct cost was applied as an “Advanced Client Cost (Asset),” which is on the balance sheet, reimbursement reduces the client’s liability on the firm’s balance sheet.

Tracking direct and indirect costs accurately could give the best law firm a headache. We highly recommend you consult a legal accounting expert to determine how your firm will handle these costs.

The Chart of Accounts must include the different accounts you are going to use. In generic software, this requires customization of the chart of accounts and, depending on the software, the service items used for invoicing and expenses. For example, a personal injury firm uses Advanced Client Costs and its accounting software is QuickBooks Online™. To do so, it simply sets up Advanced Client Costs (ACC) on the Chart of Accounts as a “current asset.” That’s easy. The firm wants to identify the types of costs, e.g. filing fees, medical reports, etc. and creates “child” or sub accounts under ACC. Using “Products and Services,” the firm creates services mapped to each of the sub-accounts on the COA. The other essential function is linking each transaction to the client matter, or in QuickBooks™, “job.” Failure to handle ACC in this matter results in mis-posted expenses either on the Chart of Accounts or to the client’s ledger.

NAME	Exhibit 1	TYPE	DETAIL TYPE	QUICKBOOKS BALANCE
Client Expense Account		Bank	Checking	12,654.42
Firm Account		Bank	Checking	130,649.72
Trust Account		Bank	Trust account	1,057,241.85
Accounts Receivable		Accounts receivable (A/R)	Accounts Receivable (A/R)	-265.00
Advanced Client Costs		Other Current Assets	Loans to Others	152,523.12
CD/DVD Copy(ies)		Other Current Assets	Loans to Others	200.00
Child Support Search		Other Current Assets	Loans to Others	170.00
Couriers/Delivery Fees		Other Current Assets	Loans to Others	3,162.01
Defense Experts		Other Current Assets	Loans to Others	0.00
Depositions		Other Current Assets	Loans to Others	13,137.61
Expert-Deposition		Other Current Assets	Loans to Others	20,609.15
Expert-Report		Other Current Assets	Loans to Others	12,620.52
Expert-Review		Other Current Assets	Loans to Others	69,041.26
Filing Fees		Other Current Assets	Loans to Others	5,445.00
Imaging/X-Ray Films		Other Current Assets	Loans to Others	469.35
IME		Other Current Assets	Loans to Others	5,338.00
Investigation		Other Current Assets	Loans to Others	482.54
JACS		Other Current Assets	Loans to Others	6,500.00
Loans to Others		Other Current Assets	Loans to Others	0.00
Mediation		Other Current Assets	Loans to Others	3,892.50
Medical Records		Other Current Assets	Loans to Others	6,645.18
Medical Records Review		Other Current Assets	Loans to Others	1,343.00

Figure 8-6: Chart of accounts showing advanced client costs (Source - QuickBooks™Online)

Life Care Resources Client Expense Account Balance \$12,654.42 \$3,558.16

Online banking matches Exhibit 2

Mailing address: Life Care Resources, PO Box 319, Cedar Bluff, VA 24609. Payment date: 05/10/2016. Check no.: 1005. Print letter.

Account details:

#	ACCOUNT	DESCRIPTION	AMOUNT	BILLABLE	CLIENT
1	Advanced Client Costs-Expert-Review		3,558.16	✓ View	[REDACTED]
2					

Add lines Clear all lines

Figure 8-7: Client expense account entry (Source - QuickBooks™Online. Client data is redacted from this example.)

Client Expense Account Balance \$12,654.42 Date: 05/16/2016 \$450.00

Online banking matches Exhibit 3

Add New Deposits

#	RECEIVED FROM	ACCOUNT	DESCRIPTION	PAYMENT METHOD	REF NO.	AMOUNT	BILLABLE	CLIENT
1	[REDACTED]	Advanced Client Costs-Expert-Deposition	[REDACTED]	Check	4943	450.00		[REDACTED]
2								

Add lines Clear all lines Track returns for clients New Deposits Total \$450.00

Figure 8-8: Note the transaction is posted to the client matter (Source - QuickBooks™Online. Client data is redacted from this example.)



Your firm can alleviate a lot of stress associated with the accurate tracking of costs and their reimbursements by employing a legal-specific accounting program.

ADVANCED CLIENT COSTS FOR (CLIENT)			
Exhibit 4			
All Dates			
DATE	TRANSACTION TYPE	CLIENT	AMOUNT
- Advanced Client Costs			
- Couriers/Delivery Fees			
04/30/2016	Expense		8.80
05/31/2016	Expense		8.52
05/31/2016	Expense		8.52
06/24/2016	Expense		9.45
06/30/2016	Expense		7.54
06/30/2016	Expense		7.54
07/01/2016	Expense		9.45
07/31/2016	Expense		28.80
Total for Couriers/...			\$88.62
- Expert-Deposition			
06/16/2016	Deposit		-450.00
Total for Expert-De...			\$ -450.00
- Expert-Review			
05/10/2016	Check		3,558.16
05/25/2016	Check		10,000.00
Total for Expert-Re...			\$13,558.16
- Filing Fees			
04/28/2016	Expense		35.00
Total for Filing Fees			\$35.00
- Service of Process			
05/10/2016	Check		160.00
Total for Service of...			\$160.00
Total for Advanced Cl...			\$13,391.78

Figure 8-9: Full client ledger card – with all transactions posted by ACC sub account (Source - QuickBooks™Online. Client data is redacted from this example.)

Using a generic software, such as QuickBooks™, for Reimbursable Client Costs (both soft and hard) allows the use of items since revenue reimbursements can be posted to an income account, generally labeled “Reimbursed Client Costs.” This automatically posts the reimbursement from the invoiced items to the income account. (Please see **Hierarchy of Payments** and **Automatic Allocation of Payments** above for explanation regarding partial payments). The same diligence to ensure proper matter linking is required in order to produce a client ledger card.

In legal-specific accounting software, the expense is posted to the correct Client Cost account, without risk. Commonly the expense card is generated from the

matter (or can be linked at the time the check is cut or when a credit card expense or statement is entered). The associated account — either ACC or RCC — is debited. When payment is received, the appropriate account is credited. The client ledger card always reflects the expense and reimbursement accurately.

It is always best to consult a legal accounting expert when determining whether to use ACC or RCC, and how to post revenue received when soft/indirect costs are passed through to the client. However, your firm can alleviate a lot of stress associated with the accurate tracking of costs and their reimbursements by employing a legal-specific accounting program.

Reimbursements to the costs examples shown in the Matter Expenses chapter will look as follows:

Matter Costs	Cost Posted to Expense	Payment Allocation
Filing Fees: \$57	Reimbursable Client Costs (Expense)	Reimbursed Client Cost (Income)
Transcription Fees: \$1,125	Reimbursable Client Costs (Expense)	Reimbursed Client Cost (Income)
Photocopying: \$23	None (Indirect Cost)	Inhouse Reimbursed Expenses (Indirect) (Income)
Auto Mileage: \$65	Non-Reimbursable Client Cost (Expense)	None

Example: Hourly matter where direct cost is being posted as reimbursable client costs

Matter Costs	Cost Posted to Expense	Payment Allocation
Filing Fees: \$57	Advanced Client Costs (Asset)	Advanced Client Costs (Asset)
Transcription Fees: \$1,125	Advanced Client Costs (Asset)	Advanced Client Costs (Asset)
Photocopying: \$23	None (Indirect Cost)	Inhouse Reimbursed Expenses (Indirect) (Income)
Auto Mileage: \$65	Non-Reimbursable Client Cost (Expense)	None

Example: Contingency matter where direct cost is being posted as advanced client costs

Income Categories

Practice Area

Segregating fee income by practice area provides the firm with a granular perspective on how each practice area impacts the firm's financial well-being, including cash flow, overall profitability, rainmaking capacity, etc. Look at this

comparison of two P&Ls. One posts all income to fee income, which gives the firm a good understanding of fee income and profitability, but look at how much more management information is easily obtained in the second P&L.

Finch & Mason LLC Profit and Loss 01/01/2016 - 08/31/2016	
	Total
Income	
4100:Fee Income	\$79,594.31
4120:Income	(\$78.00)
4200:Reimbursed Client Costs (Direct)	\$598.00
Total Income	\$80,114.31
Cost Of Goods Sold	\$0.00
Total Cost Of Goods Sold	\$0.00
Gross Profit	\$80,114.31
Expenses	
6050:Automobile Expense	\$2,000.00
6200:Dues and Subscriptions	\$312.00
6300:Insurance	\$1,216.00
6350:Legal Library	\$726.00
6470:Salary & Benefits-Gross Payroll	\$37,103.00
6601:Professional Fees-Accounting	\$1,899.00
6610:Reimbursable Client Costs	\$1,076.00
Total Expenses	\$44,332.00
Net Operating Income	\$35,784.31
Other Income	\$0.00
Total Other Income	\$0,114.31
Other Expenses	\$0.00
Total Other Expenses	\$0.00
Net Income	\$35,784.31

Figure 8-10a: Example of Profit & Loss with single income accounts (Source - CosmoLex)

Finch & Mason LLC Profit and Loss 01/01/2016 - 12/31/2016	
	Total
Income	
4100:Fee Income	\$79,594.31
4101:Fee Income-Competition	\$487.00
4102:Fee Income-Corporate	\$920.00
4120:Income	(\$85.50)
4200:Reimbursed Client Costs (Direct)	\$598.00
Total Income	\$81,516.31
Cost Of Goods Sold	\$0.00
Total Cost Of Goods Sold	\$0.00
Gross Profit	\$81,516.31
Expenses	
6050:Automobile Expense	\$2,000.00
6200:Dues and Subscriptions	\$312.00
6300:Insurance	\$1,216.00
6350:Legal Library	\$726.00
6470:Salary & Benefits-Gross Payroll	\$37,103.00
6601:Professional Fees-Accounting	\$1,899.00
6610:Reimbursable Client Costs	\$1,121.00
Total Expenses	\$46,377.00
Net Operating Income	\$37,139.31
Other Income	\$0.00
Total Other Income	\$81,516.31
Other Expenses	\$0.00
Total Other Expenses	\$0.00
Net Income	\$37,139.31

Figure 8-10b: Example of Profit & Loss with multiple income accounts (Source - CosmoLex)

While generic accounting software can accomplish this task, it's either linked to an item/task, e.g. HUD-1 review linked to the real estate practice income account, or input at the time the invoice is created. The former requires planning and customization of all tasks, and the latter requires diligence to ensure the

correct income account is selected. A legal-specific accounting software allows the user to choose the practice area income account when setting up the matter. This one-time selection prevents revenues from posting to any other income account as matter invoices are paid over the course of legal work.

Other Business Income

While the primary source of a law firm's income is from fees, many have other sources of income. For example, some boutique firms rent space to solo practitioners or attorneys may receive honoraria for their expertise. It is important to distinguish this income from fee income. Generic accounting software easily provides the ability to

post other business income. Having all income sources, or better yet, all financial data that impacts the firm within the same accounting software is a necessity. A few legal accounting software packages provide the same functionality, so that all financial data is included.

The screenshot shows a transaction entry form for a bank account named 'Bank of America-Operating Account'. The form includes the following fields and options:

- Date ***: 08/01/2016
- Amount ***: 2,300.00
- Type***: Deposit
- Ref #**: (empty)
- Payor**: Kent Newhard
- Memo**: Rent
- Account ***: 4150:Other Business Income (Income)

Additional options include radio buttons for 'By Check' (selected) and 'Charge Credit Card', and a 'More Info' dropdown arrow. There are also yellow 'Y' and blue '?' icons at the bottom right of the form.

Figure 8-11: Example of posting other business income (Source - CosmoLex)



CREDIT CARD EXPENSES

Using credit cards for both business and matter-related expenses continues to expand. It is important for firms to understand how to appropriately track and categorize credit card expenses. Utilizing the appropriate technology can make the process run much more smoothly and eliminate errors.

Tracking Credit Card Expenses

More and more law firms are using credit cards for client costs, not just business transactions. Credit cards have become an essential tool for businesses.

Credit cards are customarily listed on the chart of accounts as a current liability. The transactions are handled exactly like

bank transactions — charges (credits, thus the name) increase the balances and payments (debits) decrease it. Since bank accounts are asset (cash) accounts, software that has credit card accounts grouped with bank accounts will have a negative balance as charges are accrued.

Chart of Accounts				
SHOWING CREDIT CARD ACCOUNT				
ACCOUNT	TYPE	DETAIL TYPE	DESCRIPTION	BALANCE
Accounts Payable	Accounts payable (A/P)	Accounts Payable (A/P)		0.00
Bank of America CC	Credit Card	Credit Card		-7,921.89
401k Payable	Other Current Liabilities	Other Current Liabilities		0.00
Accrued Expenses	Other Current Liabilities	Other Current Liabilities		0.00

Figure 9-1: List of credit cards on the chart of accounts (Source - QuickBooks™ Online)



Matter Expenses

With the advent of electronic filing, firms are using credit cards for various matter costs such as filing fees. Many of these fees are not posted to the matter until the statement is received, with the risk of posting to the wrong matter, or even forgetting which matter to post and the cost “leaking” as the firm incurs the unposted expense. Additionally, delay in

posting the expense will delay billing the client and may cause collection issues. The most effective way to ensure the expense is correctly posted to the matter is to input the transaction in the credit card account in the accounting software at the time the expense is incurred and link it directly to the client matter. Be sure to post it properly to either ACC or RCC.

Add Transaction [X]

Date * 10/25/2016 Amount * 25.00
Type* CC Charge Ref #
Pay To * Court Office ▼ More Info
Print as: Court Office 123
Memo Commercial Closing
Memo2
Account * 135:Reimbursable Client Costs (Expense) Y ?

Post as matter expense

New expense card Choose existing expense card

Matter Bouchard, Loyd-traffic
Expense * Filing Fees

Remember Payee [Cancel] [Save and New] [Save]

Figure 9-2: Entry of a credit card charge used for a client cost (Source - CosmoLex)

With the advent of electronic filing, firms are using credit cards for various matter costs such as filing fees.

If the accounting system provides contemporaneous downloading of credit card transactions, this type of mishap can be reduced or eliminated but be wary of credit card company errors. When the

expense is imported to the software, the transaction should be verified before linking it directly to the matter by creating an expense card.

Status	Date	Ref #	Memo	Statement Payee	Payee	Matter	Amount
Add	12/01/2015		SUSTAINED OD Service Charge	CitizensBank	CitizensBank	Davis, Jane-test	(6.99)
Add	12/01/2015		Formica Williams, P.C.	Formica Williams, P.C.	Formica Williams, P.C.		200.00
Add	12/07/2015		DDA DEBIT Online Transfer	Formica Williams, P.C.	Formica Williams, P.C.		(125.00)
Add	12/07/2015		DDA DEBIT Online Transfer	Glenn Formica	Glenn Formica		(60.00)
Add	12/10/2015		Deposit	RNF LOAN DECEMBER	RNF LOAN DECEMBER		25,000.00
Add	12/10/2015		UCS ONLINE Preauthorized De...	Glenn Formica	Glenn Formica		(3,785.91)
Add	12/11/2015		OVERDRAFT (1 AT \$39) Fee	CitizensBank	CitizensBank		(39.00)
Add	12/14/2015		FROM CHECKING 2232366795...	Formica Williams, P.C.	Formica Williams, P.C.		(2,000.00)
Add	12/14/2015		DDA DEBIT Online Transfer	Glenn Formica	Glenn Formica		(500.00)
Add	12/14/2015		DDA DEBIT Online Transfer	Glenn Formica	Glenn Formica		(300.00)

Figure 9-3: Downloaded transactions linking to client-matter prior to completing import (Source - CosmoLex)

Operating Expenses

With an integrated accounting system, the firm can charge operating expenses to a credit card. The accounting system should provide a full chart of accounts in order to accurately post to operating expenses. Again, both downloading and importing transactions into the software and reconciling the credit card statements are vital features to have available in the accounting software. Caution should be exercised to verify both the accuracy of the transaction and that it is linked to the correct matter.

Chapter Tips:

1. Use separate a credit card for matter transactions, e.g. all filing fees, courier fees, etc. on one card, and a separate credit card for business transactions. Reconcile the credit card account as you would a bank account. This is worthwhile to ensure transactions have been posted to matters and can be billed contemporaneously and to discover errors and transactions that may not be matter related.

10

BUSINESS ACCOUNTING

A major mistake made by many law firms is that their business accounting or bookkeeping requirements are no different from any other business. Just as there are many requirements associated with trust accounting in the legal industry, there are also many legal-specific requirements associated with bookkeeping or back office accounting for law firms.

1

To properly manage all the financial activities of the firm, all functionality — legal accounting and business accounting — should be maintained in one accounting software.

General Operations of the Firm

Obviously, the general operations of the firm are affected by income and expenses. Income from fees, as discussed previously, is the primary source of income for the firm. The more granular your accounting, within limits, the better you will be at revenue management. Another source of revenue that can impact the P&L is the reimbursement of indirect client costs, expenses that the firm incurs regularly. These are legitimate, often overlooked, sources of revenue. This type of revenue effectively reduces firm overhead. Lastly, monitoring firm expenses impacts the profitability of the firm.

To properly manage the financial activities of the firm, all functionality — legal accounting and business accounting — should be maintained in one accounting software.

Assets, Liabilities, Equity from Principal(s) Activities

Using a single software for both the legal and the business accounting enables the firm to have a complete picture of all aspects of the firm's finances. Revenue management and profit are important; equally important in the financial picture of the law firm are the balance sheet items: Assets, Liabilities, and Equity.

It is called a balance sheet because $\text{Assets} = \text{Liabilities} + \text{Equity}$.

How do these impact the financial picture of the firm? We spoke briefly about ACC and how some firms obtain financing secured by the ACC on the balance sheet. The value of hard assets enhances the financial strength of the firm. Liabilities are not a "negative" in the financial assessment of a firm. If a line of credit is secured by ACC, that is a good cash flow strategy. Mortgages are viewed against the asset value. Equity is the value the owner(s) have in the business. Consult your accountant or bank to determine if the ratio of assets to liabilities for your firm is strong.

Category	Examples
Assets	What the firm owns: Bank Accounts, Accounts Receivable, Furniture, Equipment (including computers & electronic equipment), Buildings, Land, etc.
Liabilities	What the firm owes: Accounts Payable, Leases, Mortgages, Lines of Credit, Credit card expenses, other forms of debt.
Equity	Owner's infusion of cash, retained earnings from operations.

Accounts Receivable

Law firms in the United States generally use cash basis accounting and accounts receivable are not tracked on the balance sheet. However, a good financial system provides a report on outstanding invoices, with aging, in order for a law firm to manage cash flow. The aging is always from the due date of the invoice, not from

its inception. In addition, invoices should always include outstanding balances. This keeps your client informed and is an excellent trigger for the attorney in managing receivables. For the firm, the aging of invoices is necessary since the longer you wait the harder it will generally be to collect.

Finch & Mason LLC						
Account Receivable Aging Summary						
(Aging Calculated from Invoice Due Date)						
Client-Matter	Current	Aging 1-30	Aging 31-60	Aging 61-90	Aging>90	Total Owed
Brooks, Pablo - Corporate	2,087.80	0.00	0.00	0.00	0.00	2,087.80
Coleman, Gloria - Contract	0.00	1,007.50	0.00	0.00	0.00	1,007.50
Collins, Jim - Family Law	455.00	0.00	3,039.17	0.00	0.00	3,494.17
Jones, Kay - Contract	0.00	0.00	0.00	0.00	3,278.00	3,278.00
Walker, Lillian - Estate Planning	0.00	0.00	0.00	1,335.35	0.00	1,335.35
Total	2,542.80	1,007.50	3,039.17	1,335.35	3,278.00	11,202.82

Figure 10-1: Accounts Receivable aging report (Source - CosmoLex)



Accounts Payable

When law firms use cash basis accounting, accounts payable are not tracked on the balance sheet. Expenses are not recognized on the Profit & Loss when bills are entered, only when the payment is made. This makes it difficult to manage cash flow. While cash basis accounting does not post accounts payable to the financial statements, it is important to have this functionality in your accounting software. This includes posting bills when received along with their due date, monitoring bill aging, the ability to track bills that offer a discount if paid early or charge interest for overdue payments, and memorizing reoccurring transactions for expenses, such as rent, that are paid regularly. It is important that the software allow the user to select individual bills from a specific vendor for payment rather than batch these bills.

Some unique features are helpful when managing payables for client costs. It is common that client costs are charged to a single vendor, e.g. courier charges such as FedEx. A good system will allow the aggregation of costs from multiple matters in a single payment. An additional feature

is the ability to “flag” or “hold” a client cost for payment so that the firm can invoice the client for costs prior to incurring the expense. For example, the firm issues an invoice for the retainer and an appraiser at the inception of a real estate matter. The bill for the appraisal is created, linked to the matter, but flagged to hold being paid while waiting for the client payment.

Since this is cash basis accounting, it is imperative that the system provide accounts payable reports for management purposes. There should be an “aging” report that provides detail such as the bill date, due date, unpaid amount, associated matter (if any), and the number of days after the due date the bill has not been paid. If the “hold” feature is available, this report should identify and be able to filter to include or exclude bills being held. Future reoccurring transactions should not appear on the aging report. Some software will provide both an aging summary (total amount owed, grouped by vendor) and an aging detail (listed chronologically by invoice). Both reports are helpful in managing cashflow.

A/P AGING SUMMARY						
As of August 21, 2016						
	CURRENT	1 - 30	31 - 60	61 - 90	91 AND OVER	TOTAL
Brosnahan Insurance Agency			241.23			\$241.23
Fidelity					755.00	\$755.00
National Eye Care		405.00				\$405.00
PG&E					86.44	\$86.44
Robertson & Associates					315.00	\$315.00
United States Treasury			1,435.00			\$1,435.00
TOTAL	\$0.00	\$405.00	\$1,676.23	\$0.00	\$1,156.44	\$3,237.67

Figure 10-2: Accounts Payable aging report (Source - QuickBooks™Online)

Third-Party Accounts Payable

There are many practice areas that require payments to third parties that are not advanced by the firm. These may be liens and third party claims for reimbursement to be paid during settlement. There are many legal and ethical requirements for attorneys on how to deal with lien claims, which are beyond the scope of this book. From an accounting perspective these disbursements are paid from settlement funds, and the transactions (settlement deposit/disbursements) are processed through the trust account. In most cases, these third-party payables are not a fiscal liability of the law firm and do not impact the financial statements.

Law firms are advised to keep track of all such lien claims, prepare itemized client costs statements, and, depending upon the practice area, may have to keep the client informed about these accumulated obligations, which are to be satisfied prior to any funds being disbursed to the client.

In some practice areas the firm must provide an itemized cost statement to the Court, which evaluates the costs and determines reimbursement. It is also not uncommon for the original third-party claim amount to be negotiated during settlement.

Many attorneys utilize a spreadsheet application to track, manage, and prepare reports for costs associated with a matter. This is a cumbersome task with a high probability for errors or omissions. A law firm accounting software, with an accounts payable module that flags third-party payables, should be able to prepare a settlement statement that includes client costs advanced by the firm and third-party payables appropriate for Court review and approval or case settlement discussions. If any adjustments are made, the report will show the original amount, the negotiated amount, and the value difference.

Finch & Mason, LLC Matter Cost Statement						
Client	Albert Fenneman					
Matter	Fenneman v. Johnson					
Matter File #	M12345					
Firm's Cost						
Date	Payee	Category	Amount	Balance		
1/2/2017	Finch & Mason, LLC	Photocopies	\$27	\$27		
1/7/2017	Private Investigator, LLC	Private Investigation	\$450	\$450		
1/12/2017	Court House of Essex County	Court Fees	\$150	\$150		
1/17/2017	Private Investigator, LLC	Private Investigation	\$200	\$200		
Total			\$827	\$827		
Firm's Cost Summary						
	Charges	Balance				
Court Fees	\$150	\$150				
Photocopies	\$27	\$27				
Private Investigation	\$650	\$650				
Total	\$827	\$827				
3rd Party Claims						
Date	Payee	Category	Original Amount	Waived/ Write-off	Final Charges	Balance
2/1/2017	Chiropractor	Medical	\$150	\$0.00	\$150.00	\$150.00
2/5/2017	Hope Hospital	Medical	\$450	-\$120.00	\$330.00	\$330.00
2/9/2017	The Property Corp	Insurance Claim	\$1,200	-\$400.00	\$800.00	\$800.00
Total			\$1,800	-\$520.00	\$1,280.00	\$1,280.00
3rd Party Claim Summary						
	Charges	Balance				
Insurance Claim	\$800.00	\$800.00				
Medical	\$480.00	\$480.00				
Total	\$1,280.00	\$1,280.00				
Total Case Cost \$2,107						

Figure 10-3: Matter Cost Statement (Source - CosmoLex)

Payroll

When a firm has employees there is payroll. How to process payroll, e.g. calculation of gross pay, taxes, FICA, and discretionary deductions, is beyond the scope of this book. The processing can be handled in many ways, including outside payroll services, by an accountant, or utilizing tax tables promulgated by the IRS. Entering payroll expenses and payroll liabilities into your accounting software at the time they are processed is a necessary accounting function required for managing the business of a law firm.

Payroll expenses are those incurred by the firm. These include gross payroll, employer portion of FICA, employer contributions to employee benefits, such as retirement plans, etc. Payroll liabilities are the monies paid on behalf of the employee(s) and commonly include employee taxes to all taxing authorities, employee and employer combined FICA, garnishments, payments held by/paid by the employer for benefit of the employee, etc.

Many payroll processing companies will prepare a payroll download file to be uploaded into your accounting software. If not, the entry should be done using a journal entry. This is an example of a simple payroll.

Account	Debit	Credit
Gross Salaries	24,237.75	
Employer Payroll Liabilities	2,060.87	
Employee Discretionary withholding		1,899.94
Payroll Liabilities (employee+employer)		7,912.48
Cash account (this is the net payroll)		16,486.20
Total	26,298.62	26,298.62

After completing the journal entry, expenses have been posted to the Profit & Loss Statement and the payroll liabilities have been posted to the Balance Sheet. There is an additional step that is often overlooked, especially when a payroll service company is paying the liabilities directly. The liabilities still have to be paid from the cash account. This can be done either by check, electronic transfer, or, when paid directly by the payroll processing company, in a journal entry. Note: if the liabilities are paid on the date of the payroll, the entries can be included in the journal entry above. An example of the journal entry for payroll liabilities:

Account	Debit	Credit	Name*
Payroll Liabilities (employee+employer)	7912.48		
Cash Account		7,912.48	
Employee Discretionary withholding	1545.64		IRA Fiduciary
Employee Discretionary withholding	354.30		Garnishment
Cash Account		1,899.94	



BANK RECONCILIATIONS

Bank reconciliations are a necessary activity for all attorneys. At the same time, it can be a difficult task. In an environment that requires multiple bank accounts and credit cards both inside and outside of a law firm; automating portions of the process can go a long way in creating a less tedious process while reducing human error.

Purpose of Reconciliation

The process of reconciling bank statements accounting software entered bank transactions is an essential if sometimes tedious activity. While it is a required activity to meet compliance standards for trust accounting, it is a vital function for the business bank accounts. Through reconciling, the firm can locate mistakes in the books or the bank, track problematic transactions, e.g. deposited funds not cleared after an extended time, or checks that are not cleared, and ensure the firm's financial reports are accurate. This is vital in managing trust accounting as well as matter transactions.

While not the exact purpose of reconciling accounts, the process is an opportunity for the firm to catch matter expense "leakage," i.e. expenses that were not posted to a matter, as well as auditing transactions to prevent user fraud. To reduce the likelihood of fraud, a senior partner should always open and review the bank statement.



Role of Deposit Slips & Credit Card Batching in Reconciliations

When you go to the bank with a dozen checks, do you hand each check to the teller so that each one is deposited separately? Does the bank statement show each deposited transaction separately? Generally, you take the checks and write up a deposit slip to group them together, and go to the bank. This is important to do in your accounting software as well, especially to facilitate the bank reconciliation. Generic software, such as QuickBooks™ uses an “other current assets” account called “undeposited funds” to group these transactions. When revenue is posted to undeposited funds, they are held there until the user goes to “Bank Deposit” which brings up a screen to select and batch the transactions. Legal-specific software, such as CosmoLex, uses a deposit slip

to accomplish the same thing. Credit card batching, as described in **Internal Concerns Associated with Law Firms Accepting Credit Cards**, should be done on a daily basis to ensure that grouped client payments are correctly posted to client invoices and match the merchant services provider’s deposit notification, i.e. combining multiple payments from multiple clients in one deposit. Note: be sure the merchant services agreement deducts fees from your operating account once per month, not from each transaction or daily. This will help avoid a major reconciliation headache, as you will need to account for the fee portion deducted from each deposit.

Whichever software you are using, make it routine to create deposit slips within the system.

Client	Matter	Date	Payor	Amount
Barry Diehl	Estate Planning	06/16/2016	Diehl Barry	2,565.00
Albert Fennerman	Adoption	06/16/2016	Fennerman, Albert	1,125.00
Monika Jones	Divorce	06/16/2016	Jones, Monika	591.25

Figure 11-1: Batching deposits into a single deposit slip (Source - CosmoLex)

Timeline for Reconciliation of Bank/ Credit Card Accounts

Operating bank accounts should be reconciled at least monthly. Frequently, especially with a high volume of transactions, this activity gets pushed off for many months, making reconciliation even more labor intensive. Good fiscal

management includes monthly bank reconciliations. If errors are found, they must be reported in a timely manner. Delays in reconciliation could transfer liability for the cost of errors from the bank to the firm.

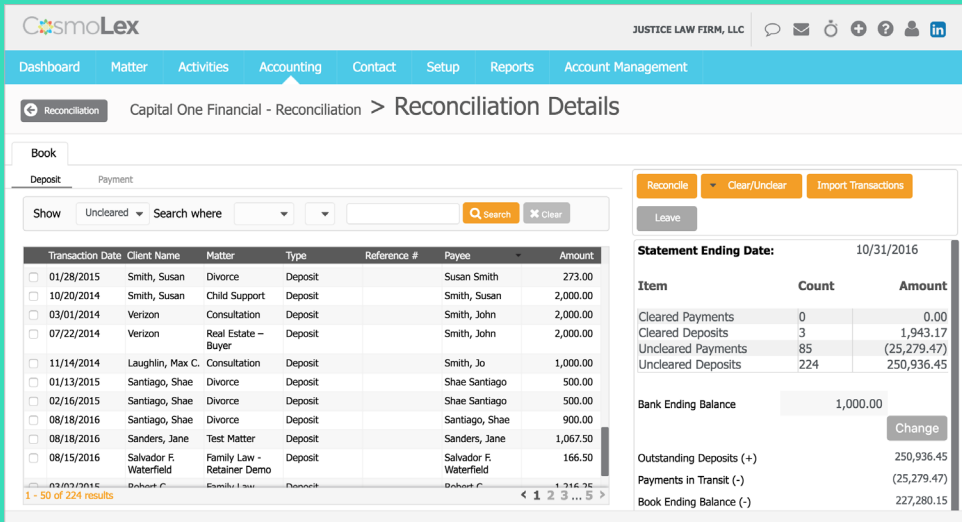


Figure 11-2: Operating bank reconciliation (Source - CosmoLex)

Trust bank accounts must be reconciled monthly. For a few practices, such as Real Estate Settlements, you might need to reconcile daily to meet CFPB guidelines. Trust bank reconciliation activity is required to remain compliant with **IOLTA regulations**.

As with bank transactions, **credit card** reconciliation should also occur at least on a monthly basis, when the credit card statement is received. This provides the opportunity to catch matter expenses that have not been posted to a matter. As mentioned previously, a best practice would be to have a separate credit card for matter expenses, including electronic filings, and a second credit card for general business expenses.



Downloading Transactions and Reconciliation

Downloading bank/credit card transactions throughout the month can facilitate the reconciliation process. It provides the opportunity to verify the transaction, catch errors, and link expenses to matters. It also offers management an audit tool against possible embezzlement or fraud. Frequently, especially in larger firms, by the time the statement is received the quantity of transactions makes both discerning matter expenses and the reconciliation process difficult and time-consuming. A good financial management software will provide this option.

On the other hand, automatic matching of trust transactions is often not recommended or allowed for trust account reconciliations. Trust activities are closely monitored as a liability of the firm. It is a prudent practice to manually match each trust transaction to ensure that no bank mistakes go unnoticed and there are no alterations to the checks. To be cautious, use this convenient tool of downloading transactions for your operating bank account and any credit card accounts but not for trust accounts, unless it is acceptable in your local jurisdiction.

Always make sure all downloaded transactions are verified against receipts or other documents to avoid accepting errors.

12

FINANCIAL REPORTS

Financial reports are essential to every business. They provide great insight as to where the firm has been, where it is going, when the firm is — or will be— in need of cash, and what changes need to be made to secure success. In the legal world, not only are these financial reports helpful, but being able to produce them when needed will ensure a firm's compliance in the event of an audit.

Balance Sheet

The balance sheet is a “snapshot” of the firm’s financial position at a specific moment in time, unlike other financial reports that provide information over a period of time. It provides the data on what the firm owns and what it owes, as well as net worth. It includes financial information from the inception of the firm. The balance sheet has three components — Assets, Liabilities, Equity. The generally accepted formula in analyzing the value of the business is Assets minus Liabilities equals Equity.

The balance sheet is of particular importance to a law firm in light of assets and liabilities it carries on behalf of clients. Good financial software should be capable of including all the financial data of the firm when producing report.

Components of the Balance Sheet:

- Assets, e.g. cash, advanced client costs, property (buildings, furniture, equipment)
- Liabilities, e.g. monies in trust, notes payable, wages payable, taxes payable
- Equity, i.e. book value of the firm, e.g. paid in capital, retained earnings, net income

NOTE: Owner’s equity on the balance sheet is not an indication of the firm’s market value.

Finch & Mason LLC Balance Sheet 12/31/2016	
ASSETS	Total
Current Assets	
Bank Accounts	
1609:Trust Bank Account	\$27,766.53
1609:Operating Bank Account	\$46,659.31
Total Bank Accounts	\$66,405.84
Other Current Assets	
1709:Advanced Client Costs	\$11,562.00
Total Other Current Assets	\$11,562.00
Other Assets	
Total Other Assets	\$6.00
Fixed Assets	
1629:Furniture and Equipment	\$77,963.00
Total Fixed Assets	\$77,963.00
TOTAL ASSETS	\$157,936.84
LIABILITIES AND EQUITY	
Liabilities	
Current Liabilities	
2305:Client Trust Funds	\$27,766.53
2329:Client General Retainer (operating)	\$3,520.00
Total Current Liabilities	\$31,286.53
Credit Cards	
1116:RF Bank-Credit Card	\$16,953.00
Total Credit Cards	\$16,953.00
Other Current Liabilities	
Total Other Current Liabilities	\$6.00
Long Term Liabilities	
2609:Notes Payable	\$72,572.00
Total Credit Cards	\$72,572.00
TOTAL LIABILITIES	\$126,791.53
Equity	
3509:Income and Expense Summary (e.g. Net Income)	\$37,139.31
TOTAL EQUITY	\$37,139.31
TOTAL LIABILITIES AND EQUITY	\$157,936.84

Figure 12-1: Balance sheet (Source - CosmoLex)

Profit and Loss

The Profit and Loss, a.k.a. Income statement, is the statement of revenue and expenses incurred during a specific period of time. The report provides the gross and net profit of activities. The resultant formula is $\text{Income less Expenses} = \text{Net Profit}$. Customarily, the Profit and Loss is generated on a

periodic basis, i.e. monthly, quarterly, yearly. Variations of this report include period by period comparisons.

Management uses this report to gain valuable information on areas of revenue generation and growth, and expense analysis.

Justice Law Firm, LLC				
Profit and Loss				
01/01/2016 - 12/31/2016				
	<u>2016</u>	<u>2015</u>	<u>Difference</u>	<u>Percent</u>
Income				
4100:Fee Income	\$35,212.22	\$87,815.11	(\$52,602.89)	-59.90
4101:Fee Income-Family Law Income	\$5,845.00	\$845.00	\$5,000.00	591.72
4102:Fee Income-Real Estate Income	\$438.00	\$0.00	\$438.00	0.00
4104:Fee Income-Estate Planning	\$4,900.00	\$390.00	\$4,510.00	1,156.41
4106:Fee Income-Test Income	\$100.00	\$0.00	\$100.00	0.00
4125:Discounts	(\$575.00)	(\$304.25)	(\$270.75)	88.99
4150:Other Business Income	\$600.00	\$7,396.80	(\$6,796.80)	-91.89
4200:Reimbursed Client Costs (Direct)	\$2,478.00	\$294.09	\$2,183.91	742.60
4250:Inhouse Reimbursed Costs (Indirect)	\$944.25	\$14,453.07	(\$13,508.82)	-93.47
4103:Fee Income-Criminal Law	\$0.00	\$1.00	(\$1.00)	-100.00
Total Income	\$49,942.47	\$110,890.82	(\$60,948.35)	-54.96
Cost Of Goods Sold				
5000:Cost of Goods Sold	\$0.00	\$100.00	(\$100.00)	-100.00
Total Cost Of Goods Sold	\$0.00	\$100.00	(\$100.00)	-100.00
Gross Profit	\$49,942.47	\$110,790.82	(\$61,048.35)	2,334.46
Expenses				
135:Reimbursable Client Costs	\$3,240.00	\$1,235.00	\$2,005.00	162.35
6010:Advertising and Promotion	\$100.00	\$1,187.58	(\$1,087.58)	-91.58

Figure 12-2: Profit & Loss statement (Source - CosmoLex)

Statement of Cash Flows

Profitability and cash flow are not synonymous. Cash flow refers to when the business needs money, i.e. the cash that is generated and used during a certain period of time. The time interval can be monthly, quarterly, yearly.

One might ask if the Profit and Loss Statement satisfies this need in cash basis accounting. While the activities on the Profit and Loss show revenue and expenses, the need for cash goes beyond this. The Profit and Loss does not include changes that occur on the balance sheet such as purchases of equipment, loan principal payments, new loans, advanced client costs, etc. Firm management needs to be cognizant of how all activities of the firm impact cash. For example, the firm has a mortgage with principal repayment of \$1000 and interest of \$300. Interest is posted to the profit and loss as an expense; the principal repayment decreases the loan amount on the balance sheet. Both amounts come from operating cash, but only the interest expense impacts the profit and loss statement. A cash flow report captures all cash used by the firm.

STATEMENT OF CASH FLOWS	
January 1 - August 21, 2016	
	TOTAL
- OPERATING ACTIVITIES	
Net Income	91,471.34
- Adjustments to reconcile Net Income to Net Cash provided...	
Accounts Receivable	-45,692.14
Advanced Client Costs	288.11
Advanced Client Costs:Filing Fees	-500.00
Advanced Client Costs:Recording Fees	-270.00
Advanced Client Costs:USPS Postage	-15.33
Bank of America CC	5,810.13
Client Trust Liability	9,500.00
Total Adjustments to reconcile Net Income to Net Cash pr...	-30,779.23
Net cash provided by operating activities	\$60,692.11
- INVESTING ACTIVITIES	
Computer Equipment	-4,382.04
Furniture & Fixtures	-5,366.68
Net cash provided by investing activities	\$ -9,748.72
- FINANCING ACTIVITIES	
Capital Contributions	26,500.00
Opening Balance Equity	100.00
Net cash provided by financing activities	\$26,600.00
NET CASH INCREASE FOR PERIOD	\$77,543.39
CASH AT BEGINNING OF PERIOD	419.69
CASH AT END OF PERIOD	\$77,963.08

Figure 12-3: Statement of cash flows
(Source - QuickBooks™Online)

Collection Reports

With cash as king, it's most important that all revenue generators be invested in collection of revenue and expenses from clients. To this end, additional reports are required, viz.

- Client Balance
- Unbilled Client Balance (a.k.a. "Work-In-Progress" or "WIP")
- Balance by Matter
- Billing Balance by Matter
- Aged balances
- Last payment relative to balance
- Invoice Status report
- Matter with Receivable and Retainer Balance

Budget

An essential component in managing firm resources is creating and managing a budget. Developing projected revenues takes considerable time and is often not done in solo and small firms. It requires analyzing revenues by matters within a practice area, detecting trends, and applying this logic to open matters. Budgeting also allows the firm to control business expenses. Reviewing prior year/accounting period expenses and determining reasonable costs enables the firm to recover some of these costs by billing the client. Looking at general business expenses, especially employee expenses, is also important. The decision to hire additional staff, for example, may be adversely impacted by both cash flow

and budget considerations, e.g. can the firm afford a full-time paralegal or only part-time?

Inputting budgets into financial software and employing budget vs. actual reporting is helpful in cash flow management.

A note about budgeting for and managing advanced client costs. Having analyzed other matters in the same practice area, an attorney can effectively budget and obtain a retainer to cover these costs or bill costs immediately, even if apart from fees. Another method is to expense them on the profit and loss statement, if your tax advisor allows. If none of these will work in your firm, be aware of their bearing on cash.

Budget vs. Actuals: FY 2016 - FY16 P&L

January - March, 2016

	First Quarter 2016			
	Actual	Budget	over Budget	% of Budget
Income				
Legal fee Income	40,861.25	32,000.00	8,861.25	127.69%
Discounts given	-120.00	-90.00	-30.00	133.33%
Total Income	\$ 40,741.25	\$ 31,910.00	\$ 8,831.25	\$ 2.61
Gross Profit	\$ 40,741.25	\$ 31,910.00	\$ 8,831.25	\$ 2.61
Expenses				
Advertising and Promotion	1,236.00	1,500.00	-264.00	82.40%
Automobile Expense	2,296.00	1,950.00	346.00	117.74%
Communications	450.00	450.00	0.00	100.00%
CLE	500.00	0.00	500.00	
Insurance Expense	3,829.85	3,829.85	0.00	100.00%
General Liability Insurance	3,829.85	3,829.85	0.00	100.00%
Reimbursable Client Costs	6,285.00	4,800.00	1,485.00	130.94%
Total Expenses	\$ 18,426.70	\$ 16,359.70	\$ 2,067.00	112.63%
Net Operating Income	\$ 22,314.55	\$ 15,550.30	\$ 6,764.25	143.50%
Net Income	-\$ 22,314.55	\$ (15,550.30)	-\$ 6,764.25	143.50%

Figure 12-4: Budget vs. actual report (Source - QuickBooks™Online)

Period-to-Period Comparisons

A significant fiscal advisory tool is producing all reports with comparisons to a prior period, most commonly year to year. Good financial software will provide this capability for the balance sheet, profit and loss, and cash flow, as part of its repertoire of reports.

Trial Balance Report

This report lists the balances in each of the general ledger accounts. The balance is either a debit or credit shown in two separate columns, and the column totals should be identical. A trial balance is an internal report used by auditors and accountants to show general ledger balances prior to any adjustments made. Once made, the adjusted trial balance will be used in the year-end financial statements. The general ledger account balances are also used as “opening balances” for the new fiscal year.

Finch & Mason LLC		
Trial Balance		
11/29/2016		
ACCOUNT NAME	DEBIT	CREDIT
1050:Trust Bank Account	\$27,746.53	
1000:Operating Bank Account	\$40,659.31	
2300:Client Trust Funds		\$27,746.53
2320:Client General Retainer (Operating)		\$3,520.00
4100:Fee Income		\$79,596.31
4101:Fee Income-Consultation		\$487.50
4102:Fee Income-Corporate		\$920.00
4125:Discounts	\$85.50	
4200:Reimbursed Client Costs (Direct)		\$598.00
6050:Automobile Expense	\$2,000.00	
6250:Dues and Subscriptions	\$312.00	
6300:Insurance	\$1,216.00	
6350:Legal Library	\$726.00	
6476:Salary & Benefits-Gross Payroll	\$37,103.00	
6601:Professional Fees-Accounting	\$1,899.00	
6610:Reimbursable Client Costs	\$1,121.00	
TOTAL	\$112,868.34	\$112,868.34

Figure 12-5: Trial balance report (Source - CosmoLex)

13

PRODUCTIVITY & COMPENSATION REPORTS

Law firms are a unique business. They need to measure productivity and design appropriate compensation models, while accounting for uncollected revenue and cash flow issues. Successful law firms not only need to understand what work is being produced, but which work that has been produced and creates positive cash flow for the firm.

Productivity Reports

Productivity reports provide essential information on how the productivity of individual timekeepers impact revenue and matter expenses. It isn't abnormal for an attorney to work for a fixed fee, but even in these situations, it can be helpful to track all time. By tracking the time spent on fixed fee and contingency cases your firm will be able to understand your

rate of productivity and the ratio of work to income gained by your firm on different case types.

- Timekeepers' Time Report
- Timekeepers' Expense Report
- Timekeepers' Weekly Summary Report
- Billable time as a % of time

Finch & Mason LLC					
TimeKeepers Time Report (Summary)					
01/01/2016 - 12/31/2016					
TimeKeeper	Hold Hours	Unbilled Hours	Billed Hours	Billed Amount	Paid Amount
Amicus Finch	00:00	00:00	11:54	4,760.00	0.00
John Smith	00:00	00:00	13:24	7,069.17	1,267.50
Perry Mason	00:00	00:00	03:42	1,480.00	1,480.00
Grand Summary					
Total Hold Hours	00:00				
Total Unbilled Hours (Billable)	00:00				
Total Unbilled Hours (UnBillable)	00:00				
Total Unbilled Hours (UnBillable-No Charge)	00:00				
Total Billed Hours		29:00			
Total Hold Amount	0.00				
Total Unbilled Amount (Billable)		0.00			
Total Unbilled Amount (UnBillable)		0.00			
Total Billed Amount		13,309.17			
Total Paid Amount		2,747.50			

Figure 13-1: Timekeepers time report (Source - CosmoLex)



Collection-Based Compensation Report

The compensation of the firm's attorneys — partners, associates, and “of counsel” — is frequently tied to a combination of “rainmaking” and productivity — who brings in the client and who works on the matter. Some firms implement allocation formulae based upon originating attorney, responsible attorney, and timekeeper. There is no “one size fits all” approach as law firms determine what models to use and how to use them. We've seen firms use simple, straightforward percentages. And we've seen formulae wherein the percentages appear to total more than 100% of collected fees. While innovative, firms frequently lack an understanding of what's required to collect and utilize the data.

Compensation model complexity arises from various factors:

- Compensation must be based on collected fee, not the billed fee. Expense reimbursements should not be included in any distributions.
- Models must be able to distribute partially collected fee income if invoice is being paid in stages.
- Models must be able to handle fixed fee invoice payments.
- Law firm accounting systems should be able to segregate collected fees from all other invoice components such as reimbursed costs etc.
- If the firm provided discounts on invoice amounts, model must be able to allocate those discounts, either proportionally or to specific individuals.
- A law firm accounting system should automate the process, or the calculation process should not be burdensome.

Being able to generate the reports within an integrated billing and accounting software, provides management with the necessary resources to monitor and appropriately compensate those who work on a matter as well as associated parties such as originating attorney.

Compensation Model Setup

Compensation is normally tied to both rainmaking and productivity. It should be designed to reward those who help grow the firm. There may be different allocations for bringing in a new client and bringing in a new matter from an existing client. For example, an originating attorney who also works on the matter should be compensated for both bringing in the client and the work done on the matter. Timekeeper's compensation rates are generally the same regardless of which matter is worked on,

while those such as originating attorney and responsible attorney can be specified for each matter along with their compensation rates. A strong compensation model should provide both global (firm-wide) settings and matter-specific settings. It is vital that compensation settings be done as part of the new matter setup process.

As an example, a firm has elected the following default allocations as their global settings:

Collected Fee Allocation Settings ?		
Originating Attorney's Default Fee Allocation	<input type="text" value="15.00"/>	% ?
Responsible Attorney's Default Fee Allocation	<input type="text" value="25.00"/>	% ?
Timekeeper's Default Fee Allocation	<input type="text" value="40.00"/>	% ?

Figure 13-2: Global compensation model setup (Source - CosmoLex)

Yet, for a specific matter the allocation for the responsible attorney may differ from the global default.

+ Add 🗑️ Delete		
Role	Party	Percentage
Originating Attorney	John Smith(Attorney)	<input type="text" value="15.00"/>
Responsible Attorney	Perry Mason(Attorney)	<input type="text" value="35.00"/>

Figure 13-3: Matter specific compensation model override (Source - CosmoLex)

Compensation Reports

Many firms use compensation reports as part of performance reviews and a bonus structure. Others compensate their attorneys based upon the results shown in the report. Therefore, specifying allocations when the matter is set up is essential. In addition, while some firms handle this function monthly — usually disbursing compensation for one month prior, e.g. March compensation allocation is disbursed in May — others choose to do so on a quarterly basis. Whichever timeline is chosen, the report

should be generated after the month is closed to ensure no revenue is received and appropriated to the month after the allocation has been determined.

As you can see from the report below, the first section provides the breakdown of collection allocation within each invoice; the second section is the total allocated for each invoice; the third section will show the total allocated by matter; and the last section total allocations by party. This report is especially useful as a management tool when multiple matters/invoices are listed.



Many firms use compensation reports as part of performance reviews and a bonus structure.

Collected Fee Income Allocation Report							
Matter Owner: ALL I Fee Collection Date Range: 08/01/2016 - 08/31/2016							
Allocation Net of Fee Discounts/Writesoffs (if any)							
Invoices							
Invoice#	Date	File#	Party	Role	Billed Fee	Collected Fee	% Allocated Fee
31	08/15/2016		Douglas Brackman	Originating Attorney	\$1,312.50	\$1,312.50	15.00%
31	08/15/2016		Douglas Brackman	Responsible Attorney	\$1,312.50	\$1,312.50	25.00%
31	08/15/2016		Pamela Rozza	Timekeeper	\$1,312.50	\$1,312.50	40.00%
32	07/31/2016		Roxanne Meiman	Timekeeper	\$1,500.00	\$666.67	40.00%
32	07/31/2016		Douglas Brackman	Timekeeper	\$975.00	\$433.33	40.00%
Invoice Summary							
Invoice#	Client-Matter	File#	Matter Owner	Billed Fee	Collected Fee	Allocated Fee	
31	Albert Ferrenman-Adoption		Douglas Brackman	\$1,312.50	\$1,312.50	\$1,050.00	
32	E. Folmsbee-Litigation		Douglas Brackman	\$2,475.00	\$1,100.00	\$440.00	
Total				\$3,787.50	\$2,412.50	\$1,490.00	
Matter Summary							
Client-Matter	File#	Matter Owner	Billed Fee	Collected Fee	Allocated Fee		
Albert Ferrenman-Adoption		Douglas Brackman	\$1,312.50	\$1,312.50	\$1,050.00		
E. Folmsbee-Litigation		Douglas Brackman	\$2,475.00	\$1,100.00	\$440.00		
Total			\$3,787.50	\$2,412.50	\$1,490.00		
Party Summary							
Party	Role	Billed Fee	Collected Fee	Allocated Fee			
Douglas Brackman	Originating Attorney	\$1,312.50	\$1,312.50	\$196.88			
Douglas Brackman	Responsible Attorney	\$1,312.50	\$1,312.50	\$328.13			
Douglas Brackman	Timekeeper	\$975.00	\$433.33	\$173.33			
Pamela Rozza	Timekeeper	\$1,312.50	\$1,312.50	\$525.00			
Roxanne Meiman	Timekeeper	\$1,500.00	\$666.67	\$266.67			
Allocation Net of Fee Discounts/Writesoffs (if any)							
Total						\$1,490.00	

Figure 13-4: Compensation allocation based on collected fees (Source - CosmoLex)

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YEAR-END ACTIVITIES

There are certain activities that happen at year-end. These activities are usually completed by the firm's accountant after a review of the financial activities and the trial balance.



Depreciations & Amortizations

Depreciation and amortization are methods used to proportionally expense an asset's cost based upon the time period over which the asset will be used. Tangible (physical) assets are depreciated each year according to a depreciation schedule specific to the type of asset, e.g. buildings will depreciate on a longer schedule than equipment. Most law firms take advantage of this at year-end.

Less common for law firms, amortization is the method used for intangible assets such as intellectual property.

Bad Debts

Since cash basis accounting does not recognize income until it is received, there is no accommodation for bad debt for unrealized revenue. However, expenses incurred on behalf of a client on the balance sheet (ACC), may be expensed as bad debt if they will not be recovered.

Posting of Net Income to Retained Earnings

The Profit and Loss Statement returns back to zero at the beginning of the fiscal year. Some financial software automatically moves net income at year-end from the P&L to the Balance Sheet as retained earnings. In other financial software,

a journal entry is required to move net income. Based on the type of firm there may also be allocations to partner capital accounts. You should be advised by your accountant regarding posting net income at year-end.

The screenshot shows a software window titled "Add Journal Entry" with a close button (X) in the top right corner. Below the title bar is a warning banner: "Journal entry is a sophisticated accounting activity; please check with your accountant before proceeding." The main area is titled "Journal Entry Info" and contains the following fields and controls:

- Entry# *: 7356 (with a help icon)
- Date *: 10/25/2016 (with a calendar icon)
- Buttons: + Add, Delete (trash icon)
- Adjusting Journal Entry:
- Difference: 0.00

Below these fields is a table with the following data:

Account	Debit	Credit	Name	Memo
3500:Income and Expi		35,000.00		
3400:Retained Earning	35,000.00			

At the bottom of the window are "Cancel" and "Save" buttons.

Figure 14-1: Journal entry for net income to retained earnings (Source - CosmoLex)

CONCLUSION

Many attorneys are mystified by the intertwined requirements for managing the accounting practices of their firm. This book attempted to unravel some of the mystery and provide straightforward solutions to the daily transactions that are an integral part of the practice of law. While generic accounting software may offer solutions, customizing the setup and training attorneys and staff is time-consuming and expensive, as well as more prone to errors. Reports are limited

to basic financial reports and are not geared to the legal field. Most attorneys have not been satisfied using generic accounting software. This book may help to configure generic accounting software to better handle transactions, trust accounting, and customizing reports. Attorneys may find using a legal-specific accounting software, integrated with its time and billing and practice management software, a more viable and valuable solution.



RICK KABRA PH.D.

Rick Kabra, Ph.D., is the CEO of CosmoLex Cloud, a web-based law practice management system designed for small law firms. Rick has a Ph.D. in Electrical Engineering and has over 12 years of experience in the legal software industry catering to the specialized technology needs of small law firms. Rick is the co-author of the book *Law Firm Accounting Demystified*, has given over 100 seminars, and has published numerous articles on legal technologies related to law office management, cloud computing, and legal billing, business & trust accounting compliance issues.

Rick's passion is helping attorneys use technology to simplify their law firm operations. Under his watch, the CosmoLex platform has grown to include practice management, billing, business accounting and trust accounting functions and is being used by small law firms across the nation.



PAMELA ROZSA

Pam is a management consultant with over thirty years in the legal industry. She has hands-on experience managing small to medium-sized law firms as a Managing Director, during which Pam worked with legacy practice management packages that included accounting modules. Pam began evaluating cloud-based practice management applications in 2010 and was one of the first consultants to adapt and promote cloud-based legal practice management software. Pam is one of the country's foremost experts on legal accounting. She is a Certified Consultant with several cloud-based practice management applications, a Certified QuickBooks Pro Advisor for Desktop, Enterprise, and Online editions, and a Certified Xero Consultant. As a strategic accounting advisor, Pam was instrumental in CosmoLex's development of the first fully integrated practice management and accounting cloud-based application.



Law Firm Accounting Demystified is a one of a kind reference guide for legal professionals looking to manage their accounting. We have attempted to take a comprehensive look into the many subtleties and nuances of legal accounting.

This book takes legal accounting topics that would otherwise be easily misunderstood by both lawyers and accountants, and simplifies the into a common language that can be understood by anyone involved with a law firm's accounting.