Perils and Pitfalls of Legal Accounting

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CEO, CosmoLex

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Danger: Deep Waters

- We will be taking a deep dive into Law Firm Accounting
- We anticipate many questions; they will be answered at the end of the presentation.

What is Legal Accounting

- Business Accounting
- Matter Cost / Income Accounting
- Fee Advances/Retainers/Client Funds Accounting
Law Firm Chart of Accounts

- Active use of Income and Expense Accounts
  - Generate revenue by providing service to clients
  - Disburse payment associated with matters
  - Collect compensation for “overhead” or “in house” expenses
  - Pay expenses for firm’s activities

P&L Items
Balance Sheet Items

- Active use of Balance Sheet Accounts
- Bank and Credit Card Accounts
- Trust Activities *
- Advanced Client Costs *
- Partner Draws and Equity

General Ledger

<table>
<thead>
<tr>
<th>DATE</th>
<th>TYPE</th>
<th>REF #</th>
<th>PAYEE</th>
<th>ACCOUNT</th>
<th>AMOUNT</th>
</tr>
</thead>
<tbody>
<tr>
<td>01/01/2015</td>
<td>Debit</td>
<td></td>
<td>landlord</td>
<td>1001 Capital One Financial-Capital One Oper</td>
<td>2,000.00</td>
</tr>
<tr>
<td>05/02/2015</td>
<td>Debit</td>
<td></td>
<td>landlord</td>
<td>1001 Capital One Financial-Capital One Oper</td>
<td>1,000.00</td>
</tr>
<tr>
<td>07/07/2015</td>
<td>Debit</td>
<td></td>
<td>landlord</td>
<td>1001 Capital One Financial-Capital One Oper</td>
<td>100.00</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Total</td>
<td>3,100.00</td>
</tr>
</tbody>
</table>
## Management Reports - Balance Sheet

Justice Law Firm, LLC  
**Balance Sheet**  
3/3/2016  

<table>
<thead>
<tr>
<th>Assets</th>
<th>2016</th>
<th>2015</th>
<th>Difference</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$88,00</td>
<td>$88,00</td>
<td>$0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Accounts</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Other Current Assets</td>
<td>$2,000,000</td>
<td>$2,000,000</td>
<td>$0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Total</td>
<td>$2,000,000</td>
<td>$2,000,000</td>
<td>$0.00</td>
<td>0.00</td>
</tr>
</tbody>
</table>

## Management Reports - Profit & Loss

### Income

<table>
<thead>
<tr>
<th>Category</th>
<th>2015</th>
<th>2016</th>
<th>Difference</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from Operations</td>
<td>$500,000</td>
<td>$600,000</td>
<td>$100,000</td>
<td>20.00</td>
</tr>
<tr>
<td>Interest Income</td>
<td>$100,000</td>
<td>$120,000</td>
<td>$20,000</td>
<td>20.00</td>
</tr>
<tr>
<td>Total Income</td>
<td>$600,000</td>
<td>$720,000</td>
<td>$120,000</td>
<td>20.00</td>
</tr>
</tbody>
</table>

### Cost of Goods Sold

<table>
<thead>
<tr>
<th>Category</th>
<th>2015</th>
<th>2016</th>
<th>Difference</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of Goods Sold</td>
<td>$500,000</td>
<td>$600,000</td>
<td>$100,000</td>
<td>20.00</td>
</tr>
<tr>
<td>Total Cost of Goods Sold</td>
<td>$500,000</td>
<td>$600,000</td>
<td>$100,000</td>
<td>20.00</td>
</tr>
</tbody>
</table>

### Gross Profit

<table>
<thead>
<tr>
<th>Category</th>
<th>2015</th>
<th>2016</th>
<th>Difference</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Profit</td>
<td>$600,000</td>
<td>$1,000,000</td>
<td>$400,000</td>
<td>200.00</td>
</tr>
</tbody>
</table>
Other Management Reports

- Trial Balance Reports
- Statement of Cash Flows
- Collection Reports
- Revenue by Timekeeper Report

Classical Billing & Accounting Gap

I Love Billing
I Love Accounting
Law Firm Accounting Pitfalls

#1 - Customization for Legal Accounting

Legal Specific General Ledger 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)
Law Firm Accounting Pitfalls

#2 - Double Data Entry

Law Firm Accounting Pitfalls

#3 - Handling Client Funds
Handling Client Funds

- Operating Retainers
  - Balance sheet account -- liability of the firm
  - Revenue not yet earned

Handling Client Funds

- Trust Accounts
  - Balance sheet account -- liability of the firm
  - Monies held on behalf of clients
  - Revenue not yet earned
  - Funds for the benefit of clients, e.g. real estate escrow, estate probate funds
Types of Trust Funds

- Settlement funds (Personal Injury, Real Estate Settlements...)
- Unearned Income (aka “Fee & Cost Advances” or “Retainers”)
- Advances for Cost
- Judgment Funds
- Third-Party funds

Types of Funds Not In Trust

- Personal Funds
- Earned Income
- Payroll
- Where you are not Fiduciary Trustee
Trust Accounting Is Easy

- No Profit or Loss
- No Depreciation or Amortization
- No Interest Accumulation
- No Tax Accounting
- No Account Management Fees/Bank Fees

Trust Accounting Is Hard

- You MUST track funds for each matter.
- You MUST reconcile books monthly.
- Must provide three-way reconciliation – liability account, bank account, client ledger
- You MUST maintain audit trail
So What Goes Wrong?

1. Lack of trust-specific knowledge & rules
2. Small Law Firm Challenges
3. Manual Systems
4. Trust Funds Gets Co-Mingled
5. Trust Ledger Overdrafts
6. Absence of Safeguards to Prevent Common Trust Mistakes
7. Un-cleared Funds Not Addressed
8. Bank Reconciliation is Sloppy
9. Separate Billing & Trust is kept separate
10. Lack of Controls & Data Protection

Trust Accounting Records

- Bank Ledger
- Receipts Journal
- Disbursements Book
- Client Ledger Balances
- Individual Client Trust Ledger
- Bank Reconciliations
- 3-Way Reconciliation
### Keep Client Funds Separate

**Sample Law Firm**

**LEDGER CARD BALANCE REPORT**

**Balance as of: 06/30/2014**

<table>
<thead>
<tr>
<th>TD Bank</th>
<th>Account</th>
<th>Client Matter</th>
<th>Matter Owner</th>
<th>Cleared Balance</th>
<th>Uncleared Balance</th>
<th>Balance</th>
<th>Current Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>123456</td>
<td>789012</td>
<td>Richardson</td>
<td>Tom</td>
<td>0.00</td>
<td>340.00</td>
<td>340.00</td>
<td>Open</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Matrimonial</td>
<td>Erika Riviter</td>
<td>0.00</td>
<td>90,450.00</td>
<td>90,450.00</td>
<td>Open</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Smith, Joan</td>
<td></td>
<td>0.00</td>
<td>90,450.00</td>
<td>90,450.00</td>
<td>Open</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Divorce</td>
<td></td>
<td>0.00</td>
<td>5,950.00</td>
<td>5,950.00</td>
<td>Open</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Smith, Bob</td>
<td></td>
<td>0.00</td>
<td>5,950.00</td>
<td>5,950.00</td>
<td>Open</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Smith, Sue</td>
<td></td>
<td>0.00</td>
<td>5,950.00</td>
<td>5,950.00</td>
<td>Open</td>
</tr>
</tbody>
</table>

**Summary**

LEDGER CARD BALANCES TOTAL: 105,740.00

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### Individual Client Ledger Cards

**Sample Law Firm**

**LEDGER CARD DETAIL**

For All Accts.

<table>
<thead>
<tr>
<th>Trans Date</th>
<th>Trans Type</th>
<th>Payee</th>
<th>Description</th>
<th>Amount</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/2014</td>
<td>Income</td>
<td>Law Office</td>
<td>New Matter</td>
<td>10,000.00</td>
<td>10,000.00</td>
</tr>
<tr>
<td>1/1/2014</td>
<td>Income</td>
<td>Law Office</td>
<td>Existing Matter</td>
<td>5,000.00</td>
<td>5,000.00</td>
</tr>
<tr>
<td>1/1/2014</td>
<td>Expenses</td>
<td>Smith, Joe</td>
<td>Legal Expenses</td>
<td>2,500.00</td>
<td>2,500.00</td>
</tr>
</tbody>
</table>

**Summary**

5,000.00

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Flushing Balances for EACH ledger card is critical.
### Reconciliation Report

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>3/1/2014</td>
<td>Beginning Bank Balance</td>
<td>$1,000.00</td>
</tr>
<tr>
<td>3/1/2014</td>
<td>Ending Bank Balance</td>
<td>$2,000.00</td>
</tr>
<tr>
<td>3/3/2014</td>
<td>Cleared Transactions</td>
<td>$500.00</td>
</tr>
<tr>
<td>3/4/2014</td>
<td>Uncleared Transactions</td>
<td>$300.00</td>
</tr>
</tbody>
</table>

### Three-Way Reconciliation

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>3/1/2014</td>
<td>Beginning Balance</td>
<td>$1,000.00</td>
</tr>
<tr>
<td>3/3/2014</td>
<td>Ending Bank Balance</td>
<td>$2,000.00</td>
</tr>
<tr>
<td>3/4/2014</td>
<td>Cleared Payments</td>
<td>$500.00</td>
</tr>
<tr>
<td>3/5/2014</td>
<td>Uncleared Payments</td>
<td>$300.00</td>
</tr>
</tbody>
</table>

**Difference Balance Sources being tied:**

- Amount $800.00
- Balance as of 3/4/2014
- Client Ledger Balance

**SUMMARY**

<table>
<thead>
<tr>
<th>Item</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ledger Card Balances Total</td>
<td>$1,000.00</td>
</tr>
</tbody>
</table>
Law Firm Accounting Pitfalls

#4 - Client Costs Recovery

Leakage

Accounting Issues

Matter Costs Accounting Issues

- Types of Matter Costs
  - Hard Costs (Direct)
  - Soft Costs (Indirect)
Matter Cost Accounting

Hourly Matter

<table>
<thead>
<tr>
<th>Matter Costs</th>
<th>Cost Posted to Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>Filing Fees: $57</td>
<td>Reimbursable Client Costs</td>
</tr>
<tr>
<td>Transcription</td>
<td>Reimbursable Client Costs</td>
</tr>
<tr>
<td>Photocopying:</td>
<td>Indirect Reimbursable Client Cost</td>
</tr>
<tr>
<td>Auto Mileage:</td>
<td>Non-Reimbursable Client Cost</td>
</tr>
</tbody>
</table>

Law Firm Accounting Pitfalls

#5 - Allocate Revenue Receipts
Allocation of Revenues

- Allocation of Payments from Clients
  - Sales Tax payables
  - ACC
  - RCC – hard costs
  - RCC – soft costs
  - Finance charges and late fees
  - Fee Income

Matter Cost Accounting

<table>
<thead>
<tr>
<th>Matter Costs</th>
<th>Posted to Expense</th>
<th>Payment Allocation to Income Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>Filing Fees: $57</td>
<td>Reimbursable Client Costs</td>
<td>Reimbursed Client Cost</td>
</tr>
<tr>
<td>Transcription Fees: $1,125</td>
<td>Reimbursable Client Costs</td>
<td>Reimbursed Client Cost</td>
</tr>
<tr>
<td>Photocopying: $23</td>
<td>Indirect Reimbursable Client Cost</td>
<td>Reimbursed Client Cost (Indirect)</td>
</tr>
<tr>
<td>Auto Mileage: $65</td>
<td>Non-Reimbursable Client Cost</td>
<td>NONE</td>
</tr>
</tbody>
</table>
Law Firm Accounting Pitfalls

#6  - Track Income By Practice Area

Law Firm Accounting Pitfalls

#7  - Challenges of Credit Card Processing
Challenges of Credit Card Processing

1. How will your accounting system know whose invoice is paid?
2. How will you manage credit card “batching”?
3. How will you handle voids/chargebacks?

How Can We Bridge The Gap?

Practice Management + Law Firm Accounting

COMPLETE LAW FIRM MANAGEMENT
Integrated Practice Management, Billing AND Accounting System

- All transactions have impact on financial position of firm
  - Legal obligations are met within one General Ledger system
  - "Unique" nature of law firm activities are recognized and managed
  - Mitigate issues relevant to firm's bottom line

How Can It Work?

System Driven Solution
YOUR OPINION MATTERS!

Please take a moment now to evaluate this session.

Thank You!