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Strategically Successful: How to Tell if You and Your Firm are Making Money

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Measure your firm's financial health and profitability! Dig deep and realize your profitability potential by determining your financial indicators including your most profitable files and your realization rates. Leave with the tools you need to be financially successful!

[1] This paper was adapted from materials originally written by Bilinsky, Calloway and Freedman for the American Bar Association's TECSHOW, Chicago, Illinois and subsequently adapted by Messrs. Bilinsky, Sanghera and Gonsalves.

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Taking Your Financial Pulse: Meaningful Financial Analysis for a Profitable Solo and Small Firm

I. Introduction – Why do you need a financial system?

If you are a typical lawyer, you look to your law practice to provide you with a reasonable income in a manner that is also a challenge to your intellectual abilities. However, in recent years we not only have seen an overall decrease in lawyers' satisfaction with the practice of law, but also an increased dissatisfaction in the financial returns resulting from that practice. Perhaps the two are correlated – it would not be surprising to read a study that said so.

The purpose of this paper (and corresponding Solo and Small Firm presentation) is to focus lawyers' attention on how their existing computerized accounting systems can be used to increase their financial returns from (and hopefully their happiness with) the practice of law by concentrating on certain fundamentals of financial management. This is not meant to be a line-by-line tutorial on how to use any specific financial package – rather it is an exploration of how you should be able to use your current accounting system to take you from where you are to where you wish to be.

Along the way you may determine that your existing accounting system does not support the depth, quality or number of reports that you need. At that point you have a decision to make – continue to tough it out with your (admittedly) deficient system, undertake a study to see if you can get the needed information by supplemental spreadsheet analysis, or bite the bullet and invest in a more sophisticated financial system. Of course the ultimate decision is a cost-benefit one – arrived at by weighing the hard and soft costs of conversion against the expected long-term financial benefits.

This type of analysis is just what we are advocating – having the ability to look at a management problem from not only an *expense* position (the typical partner question: What will this cost us?) but also from a *revenue* position (What can we expect by way of greater income and profitability as a result?). The difference, we submit, is profound – it is taking charge of your destiny and moving from merely monitoring financial performance after the fact to implementing tools to chart and measure your progress towards stated financial goals.

II. Maintaining Control of the Accounting Function

In order to utilize the full potential of your accounting system, you must invest time and resources to ensure that all financial information is accurately reflected in the accounting system in a timely manner. Accurate and timely financial reporting will not only help you assess the financial health of your practice – it is also a requirement of your regulatory body.

Provincial law societies require all law firms to maintain a minimum set accounting records, regardless as to the size of the firm or its level of activity. While these required records are not going to tell you much about your firm's profitability on their own, they are the foundation for sound financial analysis. Without a solid understanding of record keeping requirements and some basic controls over your accounting function, you will be unable to assess the financial health of your firm and minimize any associated risk.

Some sole practitioners and small firms find it difficult to maintain control of their financial records due to a lack of time, staff or resources. In Appendix One, we provide solutions to some common problems faced by small firms in maintaining control over the accounting function. Removing obstacles that prevent you from maintaining timely and accurate financial records is the first step in developing an approach to measuring your firm's profitability.

III. Standard Financial Reports – Balance Sheet, Income Statement, Statement of Shareholder's Equity or Statement of Change in Partner's Capital, Statement of Cash Flows, Budget.

There are some basic informational reports and terms that are common to accounting for all businesses. Before you can begin to understand your firm's finances, and financial technology, you need to be familiar with these terms.

Balance Sheet – Also known as a statement of assets, liabilities and owners' equity (capital), the balance sheet reflects everything a firm owns (assets), everything it owes (liabilities), and the value of the owners' equity. The owners' equity is the accumulated ownership value in the business, which may potentially be withdrawn or sold by owners. It grows through initial investment, retaining earnings in the business, or buy-in by additional owners. Total assets always equal total liabilities and owners' equity. This is the way the statement "balances."

Thus, in a healthy firm the owners' equity will be greater than the debts. If a firm has "negative" equity, you know that the owners of the firm have withdrawn more than they have invested. The balance sheet is a "snapshot" of a firm's position at a specific point in time. The balance sheet changes every time assets are acquired, debt is incurred, or capital is paid into or removed from the firm.

Income Statement – The income statement is sometimes called a statement of revenues and expenses. This statement covers a specific period of time, such as a week, a month, a quarter, or a year, which is usually written at the top of the statement. It reflects all of the income a firm receives from all sources during that period, all of the expenses that are incurred during the period, and by how much one exceeded the other. Obviously, a firm would like to see revenues exceed expenses. Income statements allow a firm to compare profitability during one period of time to profitability during another.

Statement of Shareholder Equity/Partnership Capital Change – This statement reflects each owner's relative ownership in a business, and how that ownership has changed during a stated period of time as a result of the changes in the assets and debts or profitability of the firm. For example, when the liabilities (debts) of a firm go up without a related rise in value of the firm's assets (such as when a large malpractice judgment is awarded against the firm), the value of the owners' equity goes down.

Statement of Cash Flows – This statement shows all cash receipts and all cash disbursements during a stated period of time. This doesn't mean "cash" as we usually think of paper money and coin. Instead, it means all receipts and expenditures during a given period of time. If a firm is on a "cash" accounting basis, the Income Statement and Statement of Cash Flows for a given period will be close if not identical. For firms that follow the accrual method (discussed in greater depth, below), the income statement and statement of cash flows for a given period may look nothing alike.

Budget – Often a dreaded word, a budget is simply a projection of how much revenue a firm believes it will receive during a given period of time, and how much it believes its expenses will be. The preparation of a carefully thought-out budget is important because it gives a firm information on which to determine whether its proposed activities are feasible, and information against which to judge actual progress.

IV. Custom financial reports - What they can tell you and why you should be using them.

In addition to the standard financial reports discussed above, custom financial reports are essential to managing a law practice. Custom reports focus on the particular needs and concerns of a legal business. Although there are many other reports that can be generated to help focus attention on critical aspects of a law practice, custom financial reports should include, at a minimum, the following:

Typical Accounting Reports:

These are the reports that are most-often generated by a majority of firms and presented to partners or associates:

- Accounts receivable, by client file, typically on a comparison basis against the same time period last year
- Disbursements incurred by client file (usually aged – showing total disbursements and how long they have been outstanding)
- Accounts receivable (again aged – typically 30/60/90 and over 120 days outstanding
- Accounts-due collection activity
- Time written down or off
- WIP (work in progress - again aged, since “turnover” of WIP into accounts receivable is an important indicator of future cash flow. Some firms go further and show both billable time and non-billable time breakdowns for comparison purposes)
- Accounts collected (showing breakdowns by fees, disbursements and lawyer)
- Accounts written off
- Disbursements written off
- Trust activity reports (broken down by client file)
- Line-of-credit amounts outstanding
- Draws/salaries/bonuses awarded/capital account balances
- End of month summaries (aggregations of the above reports, showing breakdowns typically by lawyer, by client, by file, by practice area and by office)

Financial Reports:

These reports give you a quality indicator as to how you are doing:

- Write-up/.Write-down report. For a specified time period (typically a month) this report shows:
    - the hours billed by each lawyer,
    - the dollar amount billed by each lawyer,

  - realized billing rates (hours billed multiplied by the lawyer's standard billing rate), and
  - the variance between actual billings and the standard billings (write-ups, write-downs)
  - the resultant effective hourly-rate billed by the lawyer (EHR).

- Client Activity report. This report helps to distinguish high fee and high EHR clients over a set time period:
  - Clients ranked by fees billed from highest to lowest
  - Clients ranked by EHR from highest to lowest
  - Clients ranked by accounts receivable from highest to lowest
  - Clients ranked by fees collected from highest to lowest
  - Clients ranked by trust balances, highest to lowest
  - Clients ranked by WIP, from highest to lowest
  - Clients ranked by outstanding disbursements, from highest to lowest

Cash Flow Reports:

How do you assess how you are really doing? One key is cash flow management - you must understand what funds are coming into your practice, and where money is flowing out. The ten monthly cash flow managerial reports you should be getting from your accounting system (and what they mean) include:

#1 - Overall and projected monthly billings: What are your overall monthly billings, measured against your projected billing? This tells you if your gross income is meeting projections. A related question is what percentage of their collected monthly billings should a lawyer's income be? According to James D. Cotterman, a consultant with Altman Weil, the figure should be 55-60%.[2]

#2 - Projected billings versus cash flow: Compare collected billings to your budgeted cash flow needs for the month. This tells you if you are in a projected positive or negative cash balance for the month. Studies have indicated that you will have approximately a 105 day 'lag' between the date you incur an expense and the day you recoup that expense from your client. Accordingly, it is important to keep a handle on your potential cash deficit.

#3 - Actual versus budgeted costs: What are your actual expenses compared to your budget? This will tell you whether you are managing to run your office

[2] Cotterman, James D., Fiscal Management of a Law Firm, Altman Weil, Report to Legal Management, September 2001.

within the financial constraints that you anticipated. If your costs are high compared to your budgeted amounts, then you must cut other costs to compensate, or increase your collected billings. For immediate impact, look at controlling your costs before trying to increase your income, as cost cuts take effect immediately, but income is subject to the collection 'lag.' This is often difficult, however, because salaries and real estate costs are usually a firm's largest expenses, and they are difficult to cut quickly.

#4 – Work In Progress: Is your WIP increasing or decreasing? What does the trend mean? If WIP is increasing, is it due to time being put into contingency files that have the potential of paying off at some point in the future? Or is it building because you have not been billing regularly? On files that can be billed monthly, you are doing yourself a disservice (and potentially digging yourself into a financial hole) if you fail to bill for the work done. WIP over 180 days ÷ Total WIP = 20 to 40%.

#5 - Unbilled Disbursements: These represent credit that you have extended to your clients and, therefore, capital that is unavailable for you to operate your practice. Whenever possible, bill these immediately in order to recapture this operating cash for your firm. Disbursements can be one of the biggest components of total firm debt. Total debt ÷ net fixed assets = 50-80% .

#6 - Accounts Receivable: Are they increasing or decreasing? What percentage are they of your annual billings? Fifteen percent is high – 5% is within the range of acceptability. How old are they? Uncollectible accounts represent holes in the bottom of the financial boat; they will sink the ship if not plugged. If you do have unpaid accounts that have been outstanding for more than 30 days, do something about them– quickly! Remember that aging only benefits cheese and wine. Make early attempts at collection and determine whether or not further time and energy is warranted. Also remember that attempting to collect an unpaid account from an unhappy client often leads to professional misconduct complaints and malpractice claims – both of which can be emotionally and financially draining as well as PR nightmares. By acting quickly and decisively, and staying within your written client credit policy, you can minimize your exposure to bad debts.

#7 - Realization Rate: The realization rate is the percentage of actual income paid to the firm for the billable hours of each timekeeper. For example, Partner X bills 200 hours per month at $200 per hour for a total amount billed of $40,000. Of that amount, 10 hours are written down (taken off the books) for various reasons, and clients pay a total of $30,000. Partner X's realization rate is 75% ($30,000 ÷ $40,000). Partner Z bills 150 hours at $200 per month, but she has no "write downs", and her clients pay 95% of that for a total of $28,500. Although

Partner X bills more hours, because of the low realization rate, Partner Z is generating almost as much income for the firm with far fewer hours billed.

Your computer-based time & billing program should be able to create this report for you. Examine the results and use it to help guide any discussion of compensation for partners and associates. A low realization rate indicates that a lawyer is using resources of the firm inefficiently – which is usually a sign of poor client or file selection. Realization rates should be no lower than 90% .

#8-– Unbilled Fees and Disbursements: This report should be compiled by lawyer, client and area of practice. Although some members may not like it, firms should look at unbilled fees and disbursements aggregated separately by lawyer, client and area of law. Look for results which are starkly out of line with the other members of the firm, and take steps to correct them as soon as possible.

#9 -– Daily Time Summaries: Daily time summaries by lawyer are also important. To make this analysis accurate, all lawyers should be accounting for *all* of their time – billable, firm administration or management, marketing, mentoring, education, pro bono, vacation etc. Look for aberrations or time summaries that don't make sense or indicate poor time management or failure to meet minimum billable time requirements.

Here's a quick way to determine how many hours you should be billing. Take your desired annual personal gross income (say $150,000). Collected billings will need to be approximately twice that – $300,000. Factor in bad debt at 10%. This indicates that you will need to bill approximately $330,000 per year. There are approximately 231 working days per year (365 minus 21 days vacation, 104 weekend days, and 9 statutory holidays). Therefore, you must bill approximately $1,400/day ($330,000÷231). If you bill at $250 per hour, you must log 5.6 billable hours per day – every day – to reach your income goal.

#10 Client Trust Balances: Review the trust account balances for all clients. Are there funds in trust that can be applied against unbilled time or disbursements? Are there clients or files that are approaching the exhaustion of their retainers or cost deposits? Write to these clients and warn them that they need to bring in additional funds

A well run firm will have a solid system in place to maintain control over all client trust account activity. This is an area that should receive special attention and focus. Not only must the firm and its lawyers abide by stringent fiduciary and ethical obligations to be able to fully account for all client funds held in trust at all times. In addition, careful management of retainers and cost deposits can provide substantial working capital savings to the firm. However, for the purposes of this program, the management of trust accounts, while essential, lies outside the scope of this paper.

Associate Reports:

In addition to the cash flow reports noted above (which apply to both partners and associates), associates are also typically measured by “the rule of three.” Here is how it works.

Take an associate’s salary and multiply it by three. The idea is that a reasonably productive associate will cover his or her salary and overhead and will also make a contribution to the partnership. This “triple the salary” amount should be equal to the annual billable hours for the associate multiplied by his or her standard hourly rate (not collections since partners are notorious for writing off associate time, which may be more related to the partnership compensation system than anything the associate did). The factor of three however, is only a guideline and firms have been increasing that to 4 in some cases. This calculation can also be used to determine if you are compensating an associate adequately. If the ratio is 4 or greater, perhaps the associate deserves a raise.

“Leakage Reports”

Here is an interesting exercise. Take all fee-billers in the firm. Multiply their standard hourly rate by their budgeted billable hours. The product is the ‘ceiling’ or maximum fees expected from each fee-biller in a year (not accounting for windfalls). The total of these numbers is the highest expected annual revenue for the firm.

Now do an analysis to determine the amount of “leakage” in each step of the process in converting billable time into received revenues. (Leakage is just what it sounds like – those sums which “leak” out of the firm’s bucket. It’s sometimes referred to as “shrinkage.”)

The first area of leakage is failing to record billable time. If your timekeepers record *all* time in the office (in categories such as client work, administration, marketing etc.) against the actual time they are in the office, you will see that there is a certain amount of time each day that is simply unaccounted for. Some of this unaccounted-for time has certainly been spent on client work, such as time spent on cell phones while out of the office or taking client calls at home, but, for one reason or another, it failed to make it into the billable time records.

The second area of leakage is writing off billable hours when preparing the client invoice. Determining the total value of time that was recorded but never billed gives you an indication of the level of this leak.

The third area of leakage is writing off fees and disbursements well after the bill has been rendered as a compromise made in order to receive partial payment on the account.

The final area of leakage occurs when an invoice is written-off as a bad debt.

By comparing actual collections against the highest expected annual income, you can quantify the total value of these leakages at your firm.

There is one further area of leakage that is not caught by these calculations. It results from waiting for payment. If you render a bill Jan 1 and payment is not received until April 30, you have financed this invoice for your client for a third of a year (unless your invoices carry a financing charge that is equal to or greater than the firm's financing costs – and the client pays it). Many lawyers dislike charging their clients interest, but a reasonably stiff finance charge on unpaid bills can be a good way to encourage those of your clients who have good credit ratings to borrow from professional lenders, such as banks, rather than from your firm.

Miscellaneous Reports:

- Referral report: This report shows fees billed and fees paid by referral source. You should know not only how much business your referral sources are sending, but how much of it is good business, and how much of the fees from each source are past due or charged off.

- Vendor report: This report shows disbursements incurred by vendor.

- Exception reports: These reports show those fees which are over a certain amount and unbilled over a certain number of days, and those receivables which are over a certain amount and unpaid over a certain number of days. The object of these reports is to minimize the data which must be reviewed in order to get to the essential information which requires attention.

- Strategic report: A listing of clients, sorted by practice area, listed in descending order, based on fees received and compared to at least two previous year's data. This report provides an essential snapshot of trends in growth or decline of practice areas.

- Profitability reports: Your last, but certainly not least important, task is to take the firm's financial information and use it to determine standard overhead rates to be applied to lawyers, practice groups, individual matters, and clients to determine their overall profitability. This is commonly referred to as "cost-center" or "profit-center" accounting. Many law firms today only look at revenues; the concepts that are inherent in virtually all businesses (determining not just revenues but cost-of-goods sold and client/file/product profitability) have yet to receive overall acceptance in law firms. As law firms continue to adopt professional managerial concepts and procedures, it is only a matter of time before the majority of law firms are able to determine profitability over a number of key categories. The long-term effect that such profitability measure will have on law firms is yet to be determined. The information obtained is best used by firm management though, as it can become dangerously divisive if shared generally but not fully understood.

V. Cash v. Accrual Accounting Considerations – The choice is yours.

Your accounting method determines when you recognize revenues and expenses. Depending on which method you choose, you will get a different answer to the question, "How much was my profit?"

If you are on the cash basis (which is the system typically used by U.S. law firms), revenues are not recognized until the check is in your hand. Under the accrual system (which is the system typically used by Canadian firms), revenues are recognized the moment the invoice is sent, and most expenses are deducted at the time they are incurred (capital costs are treated differently via depreciation and other capital cost adjustments). If you operate under the accrual system (as are most Canadian firms and a growing number of US firms), then you need methods to monitor your cash inflows and outflows – and convert your accrual financial data back in order to correctly and properly manage the cash in your business.

The last method to calculate income is the one used by the revenue authorities in determining the income taxes to be paid; their system may include adjustments that result in the calculation of your taxable income to be higher (rarely is it lower!) than your financial system. How the income tax code affects your financial well-being is a matter for you to discuss with your accountant, but, you should be aware of the subtle differences between the cash and the accrual systems, and how they can affect the outcome of your calculations.

A. Cash Basis:

The advantages of cash-basis accounting are many. The mechanics are simple, since only transactions in which money changes hands are recorded. When you receive payment from a client, you record revenue. When you pay expenses, such as rent or salaries, those are recorded as well. Your check register reflects all income and outflow. This doesn't mean that you don't have to keep up with work in progress or expenses that you owe but have not yet paid. It just means that only funds that have actually been received or spent are considered when determining the firm's profit or loss.

Many law firms, whether intentionally or otherwise, finance a good deal of their clients' legal matters by carrying receivables which are too large, for too long. This often creates a cash flow problem. But just imagine having to pay income tax on those outstanding invoices before the cash actually arrived. That's what commercial businesses, most of which operate on an accrual basis, have to do.

Another advantage of cash-basis accounting is the ability to bring the books to "zero sum" at year end merely by paying more or less of the outstanding payables, and often distributing bonuses to partners. This is a common methodology to ensure there is no taxable income for professional corporations, and no K-1 income without matching cash to pay taxes within partnerships.

Cash basis accounting does have some drawbacks, though. When law firms operate on a cash basis, the accounts receivable and accounts payable do not show on the balance sheet. Therefore, they do not require any type of "audit" in order to produce a financial statement. Unfortunately, in many firms errors abound on these reports, and there is little incentive to spend the non-billable administrative time needed to clean them up. Likewise, in a cash basis business there is no inventory appearing on the balance sheet; therefore, errors on work-in-process reports are often overlooked for the same reason. These reports tend to give partners a false sense of potential income when they are inflated due to sloppy time keeping and other errors. Accrual-basis companies must "prove out" or audit their balance sheet items (of which accounts receivables is one), to ensure accuracy over the long term.

Perhaps the most serious disadvantage of cash basis financial reporting is a misalignment between income and the expenses incurred to produce that income. Simply put, your monthly cash basis financial statement does not give you an accurate picture of your actual profitability.

For example, consider a month in which the firm is particularly busy. Billable hours are much higher than usual. Typically, expenses will also be higher to support the additional productivity. So expenses will be high during this month.

But the income derived from this increased activity will not be reflect in the same month. It may not be reflected for several months, until it is billed and, ultimately, collected. This creates the illusion of low income, or even a loss, on the profit and loss statement for the month in which productivity is higher than usual. Months later, when the cash receipts arrive, the firm will show a larger monthly profit than it actually has, because receipts will be up but the expenses on the profit and loss statement will be for the current period, not the period in which those increased receipts were created.

Typically at year end, most firms push hard to collect as much of their outstanding receivables as possible, so that bonuses can be distributed to partners. Profits become distorted as cash receipts collected from prior accounting periods far outstrip expenses during the current period. It is not uncommon for partners to be lulled into a false sense of security, because they equate bank account cash balance increases with increased profitability, when in fact they have only to do with collection efforts.

The problem with the mismatch of income and expense is that it does not let a firm know each month how they are really performing financially. In fact, a firm will not usually realize it is not doing well until it is too late to do much about it - that is, when the cash flow stops or slows to a crawl, and vendor bills or payroll cannot be paid.

Consider a scenario where a firm's lawyers have significantly slowed in productivity. Perhaps certain practice areas are flat or declining. Maybe there's an attorney out on disability or maternity leave. If the attorneys or firm administrator have been working hard to collect the past due receivables, and maybe even hold back on paying some outstanding bills, the profit and loss statement will reflect a healthy profit despite the decline in productivity. Continued activities along the same vein will effectively "mask" the firm's actual monthly losses until months later, when the decreased inventory (WIP) results in decreased billings, decreased receivables and, eventually, a tight cash situation. And, of course, eventually the vendor bills will have to be paid. At that point, assume that all of the attorneys are now back in the office and working hard. They will be bewildered by the loss on the income statement when they are all working at peak productivity. Often they will conclude that there is "something wrong" with the numbers on the financial reports, because they just "don't make sense".

By the time the income statement actually starts to show a loss, it will take the typical firm months to rebuild the inventory, bill it, and begin to collect it in order to turn the financial situation around. Firms which do not closely monitor all the key statistical factors, including amounts billed, hours worked, and so forth, can be easily misled by cash-basis financial reports and fail to take action when the timing is most critical.

There are two ways your firm can avoid the situation described above. First, you can produce modified financial reports which include increases or decreases to receivables, work-in-process and payables, as if you're looking at your income statement on an accrual basis. Although this method is for internal use only, and not for tax reporting, it will match revenues against expenses for a given period and provide a realistic view of how well the firm is doing each month. It will not necessarily match the firm's cash position but, like an accrual business, you will come to realize that profits will only match cash if you properly manage your receivables and work-in-process.

If you do not have a good controller, however, the chances are you will not be successful in producing a modified income statement unless your accountant assists regularly, and that can be expensive.

A second choice is to produce a monthly snapshot through the Key Statistics Report. This report should show your current month, year-to-date, prior year's current month and prior year's year-to-date for all numbers which are key to monitoring the firm's financial health. In no time you will develop a comfort level with this report, and in a matter of minutes will be able to assess how the firm is *really* performing. You'll have the best of both worlds — cash-basis accounting and regular review of accrual–type information. And you'll be able to recognize problems and make course corrections long before your cash flow becomes problematic.

For a sample of a Key Statistics Report, see Appendix Three.

B. Accrual Basis:

The most commonly used accounting method, it reports income when earned (even if payment has not yet been received) and expenses when incurred. Thus, the timing of the "booking" of income and expense more closely matches each other, that is, expenses booked match the revenues they generate in the same time period. Using cash-basis accounting, income and expenses are credited and debited only when cash is received or paid out. But when using accrual-basis accounting, receivables are debited and payables are credited (and, for tax purposes, a profit or loss is thereby determined), even though as yet, no cash has changed hands.

Under the accrual method, firms do have some discretion as to when income and expenses are recognized, but there are rules governing the recognition. In addition, accrual-basis firms are required to make prudent estimates against revenues that are recorded but may not be received, called a bad debt expense.

If a company uses accrual basis accounting, there are four cases where revenue and expense recognition may not coincide with cash transactions:

1. Revenue is recognized before cash is received. This is called Accrued Revenue. As an example, a product is sold at $5,000 on May 1, 2004 and cash is received on August 10, 2004. Revenues would be recognized on the May financial statement, even though the cash is not received until several months later. Accounts receivable is an asset account.

2. Expense is recognized before cash is paid. This is called Accrued Expense. As an example, on May 1, 2004, Firm “A” borrowed $100,000 from a bank and promised to pay 12% interest at the end of each quarter. The interest expense is recorded as of May, 2004, but the cash is actually paid as of June 30, 2004. Interest payable is a liability account.

3. Revenue is recognized after cash is received. This is called Deferred Revenue. As an example, on May 1, 2004, Firm “A” entered into a new lease contract with a tenant and received $6,000 for two months’ rent. The cash is received as of May 1, 2004, but the revenues are recorded as of the end of May and the end of June. Unearned rent revenue is a liability account. "Unearned revenue" accounts are liabilities of the company, because they should be paid back to the other party if service is not provided in the future.

4. Expense is recognized after cash is paid. This is called Deferred Expense. As an example, Firm “A” purchased an insurance policy for a period from May 1, 2004 to April 30, 2005, and paid $16,000 in insurance premium. Cash is paid immediately, but the expense is recognized at the end of May, June and July. Prepaid insurance is an asset account.

Note that in all instances where there is a disparity in timing as to when revenue and expense recognition does not coincide with cash transactions, the impact flows to the balance sheet through an increase or decrease in an asset or liability account.

The most significant asset and liability accounts in law firms are accounts receivable and accounts payable. In cash-basis firms, these accounts do not appear on the balance sheet. In an accrual-basis firm, virtually all transactions will impact these accounts.

One final note in recognizing the difference in the accounting methodologies, is that accrual-basis accounting often requires multiple year-end adjustments before the final determination of profitability and tax liability can be made. You would need to enter adjustment transactions to record accrued or arrears income received and income received in advance, arrears expenses, prepaid expenses, provisions for bad debts, etc. These adjustments may be in addition to the normal adjustments to correct errors, to record depreciation, to write off bad debts, etc.

VI. The ABCs - How do you keep track of this financial info using your accounting system?

All computerized legal accounting systems will deliver the basic reports noted in Part II of this paper. Many computerized legal accounting systems will give you at least some of the custom reports in Part III. You must develop the remainder of the reports, either by customizing your accounting system or by making use of a spreadsheet program such as Excel. In either case, in order to obtain the financial information you need, you must be able to analyze the data – which means tracking it and entering it into your financial system.

The first, and usually foremost, obstacle to overcome in producing accurate financial data is tracking billable (and non-billable) time. There are many proposed solutions to overcome lawyer reluctance to recording time; however, the most effective one appears to be that invented by Richard B. Turnbow, Executive Director of Capell and Howard, PC, of Montgomery, AL. His solution is to pay lawyers $7 per day provided that they turn in their billable time records for the previous day by 4 pm of the next billable day. After implementing this system at four different law firms, he advises that he has achieved a nearly 100% success rate. At 4:02 pm each day he takes the billable hourly data and adds it to the firm's financial system. What could be easier?

The second obstacle to producing accurate financial information is realizing that examining financial performance will affect the power structure in any organization A law firm is no different in this regard. Accordingly, people who feel that they stand to gain from greater financial analysis will line up in favor of new financial systems and the collection of the data necessary to undertake the resultant analysis. Those who feel threatened (even if unjustifiably so) by the new reports may undertake a campaign to discredit them or even prevent the data from being collected in the first place. Therefore, any implementation of greater financial reporting and analysis within a law firm should be preceded by management procedure changes to ensure the ultimate success of the venture.

The third obstacle to producing accurate financial information is dealing with the potential divisiveness that can occur when looking at revenues and profitability, and their effect on lawyer compensation, since no discussion of revenues and profitability in a law firm can be wholly separated from compensation. It is advisable to have a policy and a procedure in place surrounding the effect(s), if any, on the compensation formula in the law firm well before the introduction of and release of the results of any financial information.

VII. The Next Level – How to use your financial system to improve your financial performance.

All the parts of your firm's management model - the financial reporting system, the strategic business plan (including budgets and stated financial and non-financial objectives) and the compensation system - should work together. If these systems are in alignment, then your firm will be collecting information, encouraging lawyers to act on that information, and rewarding them because they are acting in the best strategic interests of the firm.

As we all know, though, compensation systems are never seen as being perfect; at best you will find that your partners view their own system as being only slightly less objectionable than all other possible alternatives. Regardless of the various methods that can be used to determine compensation of equity owners, there are basic principles which will remain relevant in all situations:

- ❑ The rules and procedures governing the decision-making process related to compensation determinations must be consistently applied and well understood by those subject to the system.

- ❑ Compensation decisions should only be finalized after a sincere effort has been made to collect and present all pertinent information.

- ❑ When judgment must be applied to allocate the profit pie, the people being judged must have complete trust in the judges for the system to work properly.

- ❑ The total efforts and contributions of each individual subject to compensation determinations are unique to the individual, and in many instances will be difficult to fully measure, particularly with objective formula-driven systems.

- ❑ Formula-driven systems can never fully encompass all of the intangible factors important to the success of the practitioner and the firm. Adequate allowance must always be provided for these subjective factors in order for the core values of the firm to be advanced.

- ❑ In the final analysis, most professionals subject to a specific system for compensation determinations will tend to compare their respective shares to their peers, both inside and outside the firm, to validate their level of acceptance thereof[3].

For these reasons, your financial reporting system should be collecting data and reporting results that feed into the firm's strategic business plan. Your financial system should be able to answer questions such as 'Are we achieving the objectives that we set for ourselves in our strategic plan?" Is our compensation system encouraging the behavior(s) that we feel are necessary and desirable to achieve our business objectives OR are we rewarding behaviors that are counter-productive to our stated goals for success?

The details of law firm compensation systems are the subject of books[4] and are outside the scope of this paper. The point we wish to make by mentioning them is that, in order to take your firm to the next level, your compensation system must be the point at which you close the circle - meaning that your compensation system should encourage the behaviors that you deem necessary and desirable to drive your firm forward.

Your governing body (be it a beneficial despot, a management committee or board of directors in the case of a law corporation) should be setting goals that are incorporated into a strategic plan. That plan should have specific measurable goals. Those goals should be placed into the context of your financial system and results measured accordingly. Those results should be reported to the governing body and the partners as a whole. Finally, your compensation system should be spurring everyone to act in accordance with the stated strategic goals.

VIII. Conclusion

Financial reports play a critical role in the analysis of any law firm's health, particularly if the firm is examining comparative statements that reflect current standings against past years or in the case of a budget, both past years and forecast amounts. Ratio analysis is integral to that process. However, for a law firm to thrive it needs more than a diet of standard financial statements.

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[3] Ron Seigneur and David Bilinsky, Growing the Bottom Line - Profitability Planning Workshop for the Small Firm, Colorado Springs, CO, Nov. 5, 2004.
[4] e.g. Cotterman, James D., Compensation Plans for Law Firms, Fourth Edition, ABA Publishing, 2004.

Law firms, like all other business, will stand or fall on their ability to generate and manage cash flow. Accordingly, law firms need the ability to forecast, monitor and see how cash is being generated and used in the firm, and whether that cash flow this is sufficient to meet the needs of the business. Lastly accurate management reports (which are expanded financial reports) will allow lawyers and law firms to plan for the future and determine if the legal enterprise is indeed meeting its stated strategic objectives. Rather like Maslow’s hierarchy of needs, this highest and best use of the financial reports elevates the firm’s accounting system from simply reflecting past activities (and, often, the repetition of past mistakes) to allowing a law firm to plan its future and know that it is taking control of its destiny.

IX. Appendix One -

Common Problems with Accounting Systems in Sole and Small Firms

Problem Description	Why is it a problem	How to prevent
Not maintaining all source documents[A] or **Source documents kept by an accountant or bookkeeper offsite** A – Source documents include: duplicate cash receipt slips, invoices, deposit slips (in particular ABM deposits), cancelled cheques, including certified cheques, and bank statements, including GIC and term deposit certificates.	These are the initial records that document your transactions with clients and third parties. If you don't maintain them, how can you prove a payment was made or support the correction of a bank error? If you don't retain control of all of your original records, it is possible that they could be lost or withheld. <u>Example:</u> A bookkeeper who had taken a lawyer's source documents off site to update the accounting system left the deposit books for a whole year on the top of her car and drove off without noticing – it can happen!	1. Understand what records you are required to maintain by the rules in your jurisdiction, what records your financial institution will make available to you and for how long they will make them available 2. Keep all documents organized by type and date, making it easier to find and therefore easier to enter into your accounting system. 3. Protect all documents from damage. Keep them in a place safe from fire and/or flooding. 4. It is best if you maintain your own accounting system in your office rather than having to rely on an external bookkeeper or accountant who has maintains the system offsite. You should retain control of your system and documents at all times and have your bookkeeper attend your office to input the source documents 5. If you absolutely have to send records offsite to be updated, please give your bookkeeper copies of the originals.

Problem Description	Why is it a problem	How to prevent
Not preparing required journals and/or sub-ledgers or **Journals and sub-ledgers are missing sufficient details (i.e. sub-ledger accounts but no journals and/or journals do not contain full details such as method of payment)**	Makes it more difficult to track errors and make corrections. When you are trying to look back at a transaction, whether at the request of a client or to track an error, it is much easier to go to the journals, ledgers etc rather than to rely solely on your source documents. Going back to your source documents may be easy if you have very few transactions, but difficult if you have a high volume practice with many transactions in a month. If records only contain partial information, you still have to go back to the source document to get the whole picture.	1. Understand what records you are required to maintain by taking the time to review the appropriate regulations. Check with your Bar Association and/or Practice Management Advisor or on your Bar Association's web site. 2. Ensure that those responsible for maintaining records (on staff or retained) have either an understanding of your regulatory requirements or have adequate access to resources that will enable them to stay informed of requirements and changes. 3. Assess your accounting systems and whether it is capable of producing those records in a format that contains all information as required by your regulations. 4. If someone outside of your firm maintains the accounting system it is wise to maintain a manual ledger for each client matter which shows all of the activity for a specific client to ensure you can account for all receipts and disbursements of trust money.
Accounting system does not keep all information	Certain software packages may alter, or delete, information from	1. You must ensure that you gain a solid understanding of the retention capabilities of your

Problem Description	Why is it a problem	How to prevent
for transactions for the required period of time	your system if a client file is closed, or remains inactive for a period of time. You may have a hard drive crash that causes partial transaction information to be lost.	software 2. Perform back up functions prior to any fiscal period closings and maintain paper copies of your books and records. Your computerized system should be able to produce a copy of all original reports which you can maintain for the specified period in your jurisdiction. 3. Print and retain all journals, trust reconciliations on a monthly basis and client sub-ledgers before you close a matter. That way, if data is lost, you always have your paper copies as a back up to reconstruct your records. 4. Do a regular backup of your entire computer accounting data and store it off-site in a secure location. Alternatively, enter into a ‘buddy’ system with another law firm in a different city...you agree that you will exchange backup media..they will store yours and you will store theirs and you both agree not to view the data and to send it back in the event that the other firm requires it.

Problem Description	Why is it a problem	How to prevent
Not maintaining records on a current basis – only updated when a bookkeeper or accountant is retained (often monthly and sometimes only annually)	Makes it difficult to track and correct errors. Limits your ability to use the analysis tools and management reports that are available in some computerized accounting programs Possible to make additional errors such as overdrawing a trust account through double payment of invoices. <u>Example:</u> One firm noted that the cost to retain a bookkeeper, to bring the records of a small firm current for the purpose of an audit, exceeded the total billings of the firm for a month.	1. Post transactions as they occur rather than waiting for a monthly visit from your bookkeeper. 2. Learn your system or ensure that at least two people in your office are capable of posting transactions properly and are somewhat fluent in your system. This will cut down on bookkeeping costs, if you have a third party coming in to assist you. 3. Keep a manual ledger for each client and to track all client related transactions as they occur. This way, you can at least have a current balance of what you hold in trust or what you have billed a specific client without having to update all of your accounting records.

Problem Description	Why is it a problem	How to prevent
Improper signing authorities and/or Poor controls over password access to trust and operating accounts and bank accounts.	You are abdicating your trustee duties when you give signed blank trust cheques to your staff or give unauthorized staff members passwords to transfer trust funds electronically, Example: A litigation lawyer "teamed up" with a paralegal who had real estate experience to add some additional revenue to the lawyer's practice. The paralegal accessed trust funds by faxing instructions to the bank using the member's letter head.	1. Ensure that signing authority and access to withdraw trust funds on trust accounts is limited to those permitted to draw trust funds. 2. For sole practitioners - If you go on vacation, or take an extended leave and need to issue payments from trust while you are away, make arrangements with another lawyer to sign cheques on your trust account. You can have one of your staff co-sign those cheques as an extra security. Banks have power of attorney forms that can be used for this purpose. 3. While it may be okay for your staff to sign general cheques for small disbursements (i.e. $100.00 or less), you should ensure that only you/your partners have signing authority for all large dollar payments out of your general account. You can implement co-signing controls (you and a staff member). 4. Do not give out your bank passwords out to anyone, even your most valued employee except

Problem Description	Why is it a problem	How to prevent
		on a ‘read only’ basis. Contact your bank to ensure that this can be done.
Failing to reconcile and review trust bank accounts and client trust obligations as required	Required to be done in accordance with your regulations. Some financial institutions stipulate that you only have 30 days to notify them of any errors, otherwise you may be on the hook to cover them yourself. Possible shortfalls in trust due to uncorrected items such as ongoing bank errors, posting errors, or fraud may go undetected if this is not done regularly. Example: One lawyer who failed to reconcile his trust accounts for over 12 months learns of a shortfall consisting of several thousand dollars as a result of a double payment of a refund to a client. Since it had been so long since the duplicate payment was issued, the lawyer was unable to	1. The sole practitioner or partners of the firm are responsible for the amount of funds held in trust. If the reconciliation report is not prepared by a member with signing authority on the trust account, someone with signing authority should personally review the trust reconciliation, and client trust listing every month. 2. Question all reconciling items that are not fully explained to you or that you do not have personal knowledge of. 3. Ensure that the person reconciling your trust account is <u>not</u> the same person who receives payments and/or issues cheques. This is an internal fraud control procedure. 4. Although it is not required, you should also reconcile your general operating account on a monthly basis. 5. Online access to your account balances can assist you with identifying and addressing bank errors in a more timely manner, especially if you get your

Problem Description	Why is it a problem	How to prevent
	locate client to retrieve payment and had to replace the shortfall personally.	statements late in the month or you have a lot of activity in a month.
Failing to review and address inactive[A] client trust balances and/or stale-dated[B] cheques A - no change in balance/no activity in trust for over 12 months) B - issued for over 6 months and not yet cashed by the payee	Money belonging to you or your clients is tied up in your mixed trust account, earning minimal interest, for the benefit of the Law Foundation – not for you or your client. The longer inactive balances sit there, the more time it takes to deal with them - lost billable time!! Cheques not cashed after 6 months have likely been lost or misplaced by the payee. Money held back in trust could also represent registration fees for documents such as discharges that need to be registered Example: A firm with several hundreds inactive client trust balances totaling tens of	1. Review your client listing regularly and determine the reason why any funds held in your trust account are there. 2. Ensure that clients are made aware, in writing, of balances that have been held for several months, insist on getting their direction(s) as to how to handle the funds. 3. Promptly bill and transfer out any funds to for work you have completed. 4. Review all outstanding cheques on a monthly basis and follow up on any that have been outstanding more than a couple of months. 5. Follow up with calls to clients who do not cash cheques after a couple of months – it is likely they have forgotten them. Same with the payees of large dollar cheques. 6. Follow up on outstanding mortgage discharges and any other matters that pertain to money held

Problem Description	Why is it a problem	How to prevent
	thousands of dollars realized over half of the balances were billable (once they took the time to research the files)!	in trust promptly and in writing. As a last resort, consider applying to the court to have the obligations discharged or released, if this is possible.
Payment of fees and/or disbursements from trust for which an invoice has not been delivered to the client or for disbursements that have not yet been incurred (a.k.a "pre-taking").	This is typically strictly prohibited by most jurisdictions. If not, it is a bad practice and should be avoided at all costs. This practice can result in a delay in sending out invoices to clients – a cause for potential complaints. Combined with poor accounting practices, you may end up issuing double payments out of trust, causing shortfalls.	1. Prepare and deliver invoices promptly upon completion of a matter and prior to writing a cheque or transferring funds from trust. 2. Prepare interim fee bills on ongoing matters for work completed to better manage cash flows. 3. If cash flow issues are the reason you have to "pre-take" fees or disbursements, discuss getting overdraft protection on your general operating account to cover client related disbursements. 4. Ensure that you obtain an adequate retainer to cover all disbursements and fees for a particular matter if you cannot cover disbursements upfront. Overestimating costs in determining a retainer amount is better than trying to collect from the client after the fact, or "surprising" the client with additional costs after the matter is complete.

X. Appendix Two – A Listing of Legal Accounting Systems

This list of legal accounting software developers is by its very nature incomplete – there are many developers which have local or regional markets and which do not appear herein. We have attempted to list those developers who have a national or international focus and a large installed user base. Always ask for installed user references and talk to other lawyers who use a product before deciding it's right for you and your firm.

The complete list can be found on the Law Society of British Columbia's web site:

http://www.lawsociety.bc.ca/practice_support/articles/practice_intro.html under the hypertext link: List of companies offering accounting or case management packages (Excel spreadsheet)

XI. Appendix Three — Specimen Key Statistics Report

KEY STATISTICS FOR 2003

Current Mo/ Current Yr	Billable Hours	Fees Billed	Fees Received	WIP	A/R	Costs Write Off	Fees Write Off	A/R Write Off	Cash on hand	Change in cash bal.
JAN										
FEB										
MAR										
APR										
MAY										
JUN										
JUL										
AUG										
SEP										
OCT										
NOV										
DEC										
TOTALS										

Previous Year	Billable Hours	Fees Billed	Fees Received	WIP	A/R	Costs Write Off	Fees Write Off	A/R Write Off	Cash on hand	Change in cash bal.
JAN										
FEB										
MAR										
APR										
MAY										
JUN										
JUL										
AUG										
SEP										
OCT										
NOV										
DEC										
TOTALS										

XII. Bio

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David J. Bilinsky is the Practice Management Advisor and staff lawyer for the Law Society of British Columbia. He is a Fellow of the College of Law Practice Management and the Editor-in-Chief of ABA's Law Practice Magazine and co-writes the regular *Profitability* column with Laura Calloway.

Dave is a prolific writer on practice management and writes regularly for many publications in the USA and Canada. His articles have been reprinted across the globe and translated into several languages including French, Mandarin, Spanish and Portuguese.

Dave is the founder and current Chair of the Pacific Legal Technology Conference, a past Co-Chair of ABA TECHSHOW, and he has been active in an advisory role for other legal technology programs.

Dave's mission in life is to empower lawyers to anticipate the changes, realize the opportunities, face the challenges and embrace the expanding possibilities of the application of practice management concepts to the practice of law in innovative ways that provide service excellence.

Dave's service offerings focus on enhancing law firm practice group profitability, strategic business planning and the application of technology to the practice of law. Dave is a gifted international public speaker and is frequently called upon by law firms and legal associations from Shanghai to New York City, from the Yukon to deep in the heart of Texas, to address personal productivity, technology, career satisfaction and leadership development.

You can read his blog at: www.thoughtfullaw.com.