How to straighten out your jumbled financial records

It was once explained to me that that there is no rocket science to law firm finances. It is as simple as getting the work in, getting the work out, getting the bills out, and getting the cash in. So then why is there a whole issue of GPSolo dedicated to the theme "What to Do When Things Go Wrong"?

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The simplest and most direct reason is that attorneys make the mistake of not giving the firm's record keeping sufficient priority. As in many other types of small businesses, failure to use proper bookkeeping software is a prime contributor to paperwork snafus. Attorneys in this area of their practice need to avoid the trap of being penny wise and dollar foolish—using a screwdriver as a hammer is rarely effective. It is critical that the software selected has been developed for some of the nuances of a professional services practice, particularly trust accounting.

The second most frequent contributor to attorneys getting offside with financial and trust accounting is the failure to hire a bookkeeper with the knowledge and skills necessary to complete their books quickly and accurately. Whether the practice can afford an internal or only an external bookkeeper, this bookkeeper needs to be versed in the software that has been chosen to support the practice.

Trust Accounting Mistakes

Of the two accountings—trust and financial—trust is the most critical to an attorney's professional life. There is no challenging the fact that mismanagement of trust accounts continues to be a top reason why attorneys get into disciplinary situations with their state bars every year.

As not all the state bars have identical trust regulations, the mistakes addressed below will be somewhat generic in nature but still relevant to all readers.

The number-one mistake attorneys make is not to have spent the time with their bookkeepers to develop trust accounting policies and procedures with the proper systems and controls in place to comply with the applicable trust regulations.

In 2015 Rick Kabra, CEO of CosmoLex Cloud, **published a list** that captures many of the more common mistakes that sole practitioners and small firms make with their trust. The list below is adapted from his suggestions.

1. Manual systems. Solos and small firms often lack the robust (and expensive) IT systems of big firms, not to mention well-trained, dedicated IT staff. But ad hoc, manual systems pose their own problems. Human error is all too common when manually recording trust transactions.

2. Commingled trust funds. Not only can the manual recording of transactions lead to simple accounting errors, it also can give rise to the potentially more dangerous commingling of trust funds with business operating funds and billings. Law firms are required to keep these funds separate; mingling them is a serious violation.

3. Trust ledger overdrafts. This mistake is common, but it's a natural consequence of the other errors listed here.

4. Lack of controls and data protection. Once again, manual systems lead to more than simple accounting errors — they can increase the threat of data loss and data theft. The lack of automation also removes the opportunity to automate checks that the firm is meeting all trust requirements.

5. Unaddressed account anomalies. You can't simply ignore trust account anomalies such as uncleared funds and hope they straighten themselves out on their own. Firms must regularly review their trust activities and follow up on problems.

6. Sloppy bank reconciliation. The lack of dedicated staff and systems can also lead to sloppiness with bank reconciliation. Reconciliation must be done monthly. And if possible, someone other than the regular reviewer should take a peek from time to time.

The quickest and most effective way to deal with these problems is to call upon a certified public accountant (CPA) firm to conduct a trust account audit. The benefits of such an approach include:

- identification of the problems that contributed to the trust accounting problems;
- identification of the steps that need to be implemented by the attorneys to avoid a repeat of the problems in the future;
- assurances of a starting point where the trust accounts are in balance;
- a timely and full resolution to the problem; and
- an independent report providing external assurances to the bar that the trust accounts are now in order.

Don't ignore trust fund anomalies and hope they straighten themselves out on their own.

Seeking external assistance results in an outlay of cash, but it is cash well spent, especially given that the alternative is to lose revenue-producing time while struggling to work through the complex trust account issues.

Financial Accounting Mistakes

Although not as potentially devastating as trust accounting mistakes, errors in financial accounts also can have dire consequences. After all, a lawyer's understanding of the firm's finances serve as the basis for all business decisions going forward. Below is a list of the most common causes of bookkeeping errors for solos and small firms.

1. Error of principle in accounting: correct amount, wrong type of account (e.g., recording of partner's capital contribution as a loan; recording personal expenses as business expenses).

2. Error of omission: entry missed from accounting records (e.g., forgetting to post a check; failure to record an expense incurred).

3. Error of commission: correct amount and type of account, wrong account (e.g., posting the correct total payroll expense to health benefits).

4. Compensating error: two or more errors balance each other out (e.g., a new computer purchase for $1,000 is entered as an expense at the same time a $1,000 expense item for maintenance of the carpets is entered as a fixed asset).

5. Error of original entry: correct accounts, wrong amounts (e.g., transposition error where a number is transposed in the initial entry, like 49 is posted as 94; if the error found is divisible by nine, you have a transposition error; if the error is divisible by two, it can mean that a credit got entered as a debit or vice versa).

6. Complete reversal of entries: correct amount and account, entries reversed (e.g., a deposit is booked as a credit to the bank account and a debit to the accounts receivables).

Errors are going to happen. However, there are preventive measures you can employ both to minimize the risk of occurrence of these errors and to aid early detection in the event they do occur:

- Separate bank accounts for personal, business, and trust.
- Use bank accounts with month's end cutoff.
- Keep daily records rather than saving up to month's end or longer.
- Reconcile all accounts (bank, accounts receivable, accounts payable, partners' draws, payroll, etc.) monthly.
- Back up the accounting system monthly.
- Leave a trail of any adjustments made to records.
- Set up a filing system that both you and the bookkeeper understand.
- Obtain a receipt for everything no matter how small.
- Develop a monthly checklist for the bookkeeper to review at monthly meetings.
- Use an independent accounting firm to review your books and records annually with you. (You wouldn't ask a doctor to act as a legal advisor, so why ask an attorney to act as an accountant?)

While there are a few shortcuts for resolving errors like transposed numbers or reversed recordings, it is critical that attorneys do not compound the error by getting behind in their record keeping while trying to resolve the issue. To this end, it is not uncommon to utilize a suspense-clearing account. This account allows you to reclassify the amount in order to finish the reconciliation or analysis that you are working on. The clearing account will have a running balance until you investigate and resolve the specific problems you used the account for. It is best practice to zero out this account (by doing reclassification entries/ adjusting entries) on a timely basis, but certainly it must be done by the end of the fiscal year.

The last preventive measure is communication. Schedule monthly (or, at a minimum, quarterly) meetings where your bookkeeper can take you through each of the reconciliations; don't finish until you understand them all to your own satisfaction. Remember, bookkeeping is not rocket science. Your bookkeeper should be able to explain everything in layperson English.

Financial Management

Like an understanding of the law, all the financial knowledge in the world is meaningless if you cannot apply it. That's where financial management comes in.

There are two very distinct aspects to financial management.

1. Budgeting. The first critical component of financial management is budgeting, or the setting of the financial goals for the practice. A budget is critical to building a feasible financial plan. Having pre-set financial goals not only allows you to see whether your practice is meeting expectations, but it gives you something to compare your financial records against, providing another early detection tool to reveal that there might be something amiss in the accounting data.

Your budget should detail not only all the anticipated expenses on a month-bymonth basis but also the anticipated fees that will be generated by the practice. You should include an amount for unexpected expenses, as they will always be greater than anticipated and they will vary as the volume of work varies. And don't forget to include in your budget the amount you anticipate drawing out to support yourself personally. Many small business owners forget the old adage, "If you don't look after yourself, no one else will."

Your budget should be a constant companion and not some exercise you do annually and then forget about. The budgeted amounts should be incorporated into your monthly financial reporting package. See the **sample budget spreadsheet** available at Practice PRO; see also "**The GPSo10 Guide to Opening a Law Office**" by Jocelyn Frazer and Nerino J. Petro Jr.

2. Monthly financial reporting. The second critical aspect of financial management is monthly financial reporting. Like budgeting, if done properly it also can act as a "heads up" to problems with the underlying accounting data.

Good budgeting helps "less be more" when it comes to monthly financial reporting. Unfortunately, many accounting software packages and bookkeepers generate reports that are both bulky and convoluted—and thus doomed to be ignored from the outset. The aim should be financial reports that are succinct and that flag the specific items you want and need to follow up on with your bookkeeper.

All the financial knowledge in the world is meaningless if you cannot apply it.

At the outset, sit down with your accountant/bookkeeper and determine what information will enable the effective financial monitoring of the practice. A suggested framework could include:

- **time frames:** current month; current year to date; same month prior year; and prior year to date;
- **categories of data:** actual and budget data for current month and current year to date; actual for same month prior year and prior year to date; and
- **types of accounting data to be reported (not limited to):**
  - billings;
  - effective hourly rate (billings divided by the hours taken out of unbilled inventory);
  - hours worked (obvious assumption here —can divide by timekeeper type if applicable);
  - cash collected (expressed as an amount per day);
  - total expenses;
  - net income;
  - total accounts receivable;
  - total unbilled fees;
  - total accounts payable;

- bank balance; and
- operating loan balance.

This one-page document must be reviewed monthly, and any questions raised from this review should be discussed immediately with the bookkeeper.

In addition to this one-pager, the bookkeeper should prepare an income statement and balance sheet, and if time permits they should be reviewed monthly but certainly at a minimum in detail on a quarterly basis.

Conclusion

It is impractical to think that errors won't occur in your accounting records. But if attorneys apply common sense and the same degree of judgment that their clients pay for, they can detect such errors quickly enough to deal with them in a timely and effective manner.

Creating accurate records isn't rocket science. The key is open and direct communication with your bookkeeper/ accountant.

Comments or Questions?

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