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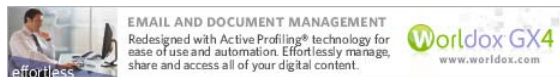
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## Five Pitfalls of Legal Accounting

BY RICK KABRA ON FEBRUARY 12, 2016 ·



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



Consider why accounting is so important to law firms. First and foremost is 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, or even disbarment for its lawyers.

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 the firm. If a firm effectively manages its accounting, it can begin to form extremely valuable business intelligence surrounding some of its more successful practice areas, and allocate the appropriate resources to ensure the greatest levels of success for the firm.

Given the importance of accounting to law firms, it is useful to understand where firms most commonly fall short in their accounting practices. Here are the five most common legal accounting pitfalls.



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## Client Trust Fund Accounting

Using retainers to secure cash flow 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 account. Law firms need to ensure that one client's funds are not commingled with another, and that these client funds are not used to pay for the law firm's expenses.

One way firms can avoid issues often associated with client trust fund accounting is to use legal-specific accounting software. In addition to preventing commingled client trust funds, legal specific accounting software can help a firm prevent pitfalls such as:

- Overdrafting the client ledger at the transaction level
- Posting transactions to an inappropriate account, such as an income or expense account
- Falling out of compliance by neglecting the three-way reconciliation process

## Proper Accounting of Case Costs

When practicing law, costs are incurred from the outset of every case. Eventually all of these costs are billed to the client. All costs must be accounted for properly. This sounds simple enough, until you understand that not all costs can be treated the same.

This is where law firms can run into trouble. Depending on the case type, your accountant may advise you to treat case costs as "Advanced Client Costs" or "Reimbursable Client Costs." Advanced client costs need to show up as an asset on the firm's balance sheet, while reimbursable client costs need to be recorded on the profit-and-loss statement. Failure to do this accurately and consistently every time you book an expense can result in IRS compliance issues.

In addition, law firms need to make sure any cost incurred—be it by cash, check or credit cards—gets allocated to the appropriate matter contemporaneously, or it will not get billed, resulting in net loss to the firm.

## Differentiating Income and 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 that 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.

## Data Entry Errors While Syncing Legal Billing & Accounting Systems

It is imperative 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 disparate systems for their accounting and billing. This means that all financial data must be entered twice, but must be done accurately across both systems. Failure to accurately sync these two systems will create bookkeeping issues, resulting in billing complications or ethics violations.

One way that firms can avoid these issues rooted in billing and accounting systems not being in lockstep with each other is to use a practice management system that includes both billing and accounting functions in a single data set.

## Understanding Where the Money Came From

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

Simply tracking income without understanding which practice areas it came from is really a major disservice to the firm. Making decisions about the business of your firm without accurate data can lead to serious missteps that result in a loss in revenue. When firms are able to track their income by case type, it can open new business



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opportunities by creating valuable business intelligence around different case types, enabling the firm to spend its marketing dollars and resources more effectively.

Making the jump from attorney to managing a law firm can bring on new challenges. Legal accounting is surely one of the largest. While it can be one of the largest and most intimidating challenges a firm faces, if the right solutions are put in place to help manage a firm's accounting it can easily transition from a challenge to an opportunity to grow the firm.

## About the Author

*Dr. Rick Kabra is the CEO of Cosmolex, a leading provider of web-based legal practice management software.*

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