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AICPA

**CONSULTING SERVICES
PRACTICE AID 92-4**

Industry Consulting

Law Firms

Management Consulting Services Division

AMERICAN

INSTITUTE OF

CERTIFIED

PUBLIC

ACCOUNTANTS

NOTICE TO READERS

This practice aid will be integrated into a manual for consulting services issued by the AICPA and is numbered for that purpose. It is designed as educational and reference material for Institute members and others who provide *consulting services* as defined in the Statement on Standards for Consulting Services (SSCS) issued by the AICPA. It does not establish standards or preferred practices.

Consulting Services Practice Aids continue the series of MAS Practice Aids. The change in the numbering system of these series reflects the change of the division name from Management Advisory Services (MAS) to Management Consulting Services (MCS), rather than the discontinuing of any publications in a series.

The Management Consulting Services Division expresses its appreciation to the authors of this practice aid, Joseph R. Jacques and Ronald L. Seigneur. Mr. Seigneur began work on this project prior to his subcommittee service.

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Various members of the 1990-1991 AICPA MAS Technical and Industry Consulting Practices Subcommittee provided information for this practice aid and advised the authors and staff. The subcommittee members are listed below.

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AICPA

Industry Consulting

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PRACTICE AID 92-4**

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PREFACE

This practice aid is one in a series providing practitioners with information about a particular industry, its typical consulting services engagement opportunities, and additional information on the sources of industry and technical engagements. The practice aid's purpose is to assist practitioners in identifying pertinent issues as well as the resources needed for engagements involving a particular industry.

Although these practice aids often deal with aspects of consulting services knowledge in the context of a structured consulting engagement, they are also intended to be useful to practitioners who provide advice on the same subjects in the form of a consultation. Consulting Services are defined in the Statement on Standards for Consulting Services (SSCS) issued by the AICPA's Management Consulting Services (MCS) Division. The SSCS appears in appendix 81/A of this practice aid.

This series of Industry Consulting Practice Aids should be particularly helpful to practitioners who are considering (a) offering initial or additional consulting services to clients in an industry, (b) offering consulting services to clients who are entering or considering entry to the industry, (c) expanding their practice by marketing services to potential clients in the industry, and (d) undertaking a cooperative engagement by arranging for an industry specialist from outside the firm to assist a client. For readers employed in the industry, Industry Consulting Practice Aids may be useful in providing advice to management.

The practice aids do not purport to include everything about an industry that a practitioner needs to know to become expert in providing services to that industry. Current conditions in an industry may vary from those at the time the practice aid was prepared.

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LAW FIRMS

81/105 INTRODUCTION

.01 Public accounting firms and law practices have similar business objectives and methods of operation. This similarity furnishes an ideal basis for practitioners to provide knowledgeable and effective support to law firm clients. Individual attorneys, as well as law firms, are frequent consumers of traditional CPA financial-reporting and tax-related services. In addition, attorneys are engaging CPA practitioners more frequently as consultants on management, technology, and litigation matters and as expert witnesses. Additional opportunities exist to provide consulting services to law firms through engagements to address administrative and practice-management issues.

81/110 SCOPE OF THIS PRACTICE AID

.01 The information in this practice aid applies primarily to private-practice law firms, the organizations through which most attorneys in the United States provide legal services. The term *private-practice law firm* refers to a firm whose attorneys undertake legal representation of clients for a fee. Clients may have an ongoing relationship with a law firm or may call on a firm only once to handle a particular matter.

.02 The information in this practice aid may also be helpful to CPA practitioners who provide consulting services to other organizations, such as community legal agencies funded through government grants and private foundations, corporate law departments, and groups representing labor unions.

.03 The primary purpose of this practice aid is to describe private-practice law firms and the trends and critical operating issues that the CPA practitioner may address during an engagement. The practice aid may also help the practitioner working in a legal services organization to address various practice-management and administration issues. The aid is not intended to include *all* facts and circumstances CPA practitioners may need to consider during specific engagements.

.04 This practice aid does not cover specific consulting matters that are addressed in other Technical Consulting Practice Aids. For example, practitioners will find help in preparing an engagement letter in MAS Practice Administration Aid No. 5, *Communicating With Clients About MAS Engagement Understandings* (New York: AICPA, 1988). Other Consulting Services practice aids that CPA practitioners may find helpful during a consulting services engagement for a law firm client are listed in appendix 81/C, "Selected Sources of Law Practice Information."

81/115 INDUSTRY PROFILE**Practice Organizations**

.01 Attorneys in private practice are divided into three general categories: (a) those who practice independently, (b) those who share a suite of offices but maintain separate practices, and (c) those in group practice. The legal form of a law office—sole proprietorship, partnership, or professional corporation—is not necessarily the same as its organizational form. For example, a sole proprietor who employs other attorneys at salary is in true group practice, while some law offices that file partnership tax returns may be organized as space-sharers. This practice aid focuses on the actual organizational structures of law offices regardless of their legal form.

.02 The organizational structure of a private-practice firm is determined by its size, its specialties, and the personalities of the principal attorneys and may range in character from very casual to very formal.

.03 **Independent Practice.** Independent practitioners usually develop an organization of administrative support staff and paralegals, who report directly to them. Other than employee-employer relationships, sole practitioners require no organizational formalities, because, in addition to practicing law, they often perform all the functions of owner, salesperson, office manager, and bookkeeper.

.04 **Office-Sharing Arrangements.** The office-sharing arrangements among attorneys are diverse. At one end of the spectrum these arrangements closely resemble independent practices. At the other end, they are near partnerships.

.05 The office-sharing arrangement generally evolves when an independent attorney needs the help of other attorneys but decides not to increase the payroll or enter into partnership. Instead, to get the required help, the attorney makes office space available to additional attorneys. These attorneys do some work for the owner in exchange for space, some compensation, secretarial services, use of the library, and so forth. Office-sharing arrangements also result from economic considerations. For example, an independent attorney may be obliged to pay the rent for excess space under a lease commitment and therefore sublets it.

.06 Problems may arise when an independent attorney's practice expands into a space-sharing arrangement or even a quasi-partnership. This growth may increase capitalization and overhead requirements but provide fewer economic rewards than an alternative organizational structure that encourages a greater community of interests.

.07 Some space-sharing groups contain not only sole practitioners, but also small partnerships. Some groups may also share the costs of associate attorneys and support staff and may jointly own library facilities, copying equipment, and the switchboard, all of which independent practitioners could not afford alone. One attorney may often refer work to

other attorneys in the group, determining the value of their contributions and distributing fees accordingly.

.08 As a rule, little formal organization exists among office-sharing groups. However, one of the participating attorneys may be designated office manager and become responsible for managing joint facilities, including the library, supervising a receptionist, and handling landlord relations. If there are joint bank accounts, this individual may also be the disbursing agent.

.09 In office-sharing groups, adequate and timely disclosure among attorneys of new and continuing client projects is a critical consideration. Serious conflicts may arise among the attorneys, particularly in smaller communities. For example, the attorneys may represent opposing clients in a legal matter. Therefore, CPA practitioners whose attorney clients are considering a space-sharing arrangement need to advise them to contact their local or state bar association ethics committee for guidelines and opinions, as well as answers to specific questions.

.10 Group Practice. In small law firms, informality is often the rule of operations. Firm meetings may be informal breakfast or lunch meetings. The partners may make decisions about their practice without much planning. Usually, all partners actively participate in decision making. Employees are few; hence personnel and operating policies can be flexible. A close professional relationship may simplify billing and general client relations, and the partners may know their basic financial situation quite well without formal reports or much discussion. Despite this informality, there is a constant need to maintain accountability over billing and collections for each attorney's client base.

.11 This style of management is called the *committee of the whole*. Within the committee of the whole, partners usually know the limits of their authority. As a firm expands in size to more than three or four attorneys, it becomes difficult to maintain this informality. More complex communications, as well as more time for discussions, are required. This time may be costly for attorneys because they cannot bill for it.

.12 As a firm expands, the partners need to delegate authority and responsibility to manage it effectively. The transition to a formal management structure often meets resistance and is therefore difficult to implement. The alternative, however, is a firm in which a large number of partners remain not only independent but also largely unmanaged. Such a firm tends to be inefficient and expensive for clients and less financially rewarding for partners.

.13 In general, group practices with a formal organizational structure may be classified into three types: (a) the strong-senior-partner organization, (b) the committee structure, and (c) the quasi-corporate structure. Each type has minor variations. Often, a law firm evolves through each type as it grows.

.14 *Strong-senior-partner organization.* Many small firms, and a few very large ones, prosper under strong, authoritarian leadership. Successful strong senior partners, however, are rare. In an organization led by a strong senior partner, this individual makes all or

most of the decisions. This partner not only commands respect without demanding it but also successfully delegates day-to-day decisions to others while retaining meaningful control. Often this individual also attracts the most clients, but the marketing and service efforts required to do so may deplete the time needed for management activities.

.15 The most significant danger in the strong-senior-partner style of organization is the void that may result when the senior partner retires. A period of drift may follow if no successor has been groomed or is recognized by others in the firm. Sometimes a few of the remaining partners without the retiree's experience or status will campaign to become the authority figure. Unless a strong leader is selected, management responsibilities may be abdicated because partners are often reluctant to reduce their work as attorneys to fulfill them.

.16 *Committee structure.* Many firms, both large and small, rely on a committee structure for their general management. They may augment the committees with a support professional, often the office administrator, who helps to coordinate the committees. A few firms allow associates (non-partners) to serve on certain committees. The terms of committee members are usually limited to allow several partners to be involved in the management of the firm. In some firms, a managing partner is responsible for coordinating all of the committees and ensuring that they function.

.17 Several problems may arise with the committee structure. Closely related committees may duplicate efforts or be in conflict. Some committees may not function at all, thereby leaving important matters unattended. Scheduling of and attendance at meetings may require a great deal of professional and staff time, often at a cost out of proportion to the matters under discussion. For an office administrator, the committee structure also creates a difficult environment in which to function effectively. The office administrator's areas of jurisdiction may overlap those of some committees. As a result, the office administrator may report to several people rather than a single individual as required by good management practice. In addition, an office administrator who is not an equity owner often encounters difficulty in persuading owners who are reluctant to relinquish control.

.18 *Quasi-corporate structure.* The quasi-corporate form of law firm organization is somewhat similar to the common corporate form of business organization. The shareholders' and directors' functions may be combined or shared by the partnership in full meetings, with a committee of partners designated as an executive committee. These two entities, the partnership in joint session and the executive committee, apportion between them the basic policy-making powers of the firm. Their policy decisions affect such major matters as the admission or expulsion of partners, merger of practices, compensation of partners, and large expenditures of funds or allocation of resources.

.19 A firm may also have a structure for the performance of legal work that co-exists with the general management structure. Large firms often organize departments according to legal specialty or the work of specific clients. Each partner often has particular clients and billings as well as responsibility for supervising the associates and others who work on specific matters.

Related Industries

.20 Corporate Legal Departments. In recent years, many corporations, especially large industrial, manufacturing, and other public-sector companies, have increased the staffing and capabilities of their legal departments. Such departments offer an efficient, cost-effective alternative to the exclusive use of outside counsel, particularly when routine and repetitive legal services are required. Corporate legal departments often work jointly with outside counsel when they require skills absent from the department.

.21 Sometimes, corporate legal departments serve primarily to monitor the cost and direction of services provided by outside counsel. In these situations, corporate attorneys usually do little or no substantive legal work.

.22 Government Legal Departments. Government legal departments range from those staffed by a single attorney representing a small municipality or district to larger city and state legal departments, such as offices of state attorneys general, and legal departments in city, county, and state administrative agencies. Federal agencies, such as the Department of Justice, the Internal Revenue Service, and the Environmental Protection Agency, employ large numbers of attorneys and supporting staffs to represent their interests. Other governmental entities require the services of attorneys to address more focused objectives.

.23 Many government legal entities provide services similar to those rendered by corporate legal departments. The primary difference is that the government groups are nonprofit operations.

.24 Public-Interest Legal Entities. Recently, the number of nonprofit public-interest legal organizations in the United States has increased substantially. These organizations typically provide legal support to address the specific issues of a group of constituents. Examples of these organizations include local, regional, and national environmental action groups, such as the Environmental Defense Fund and Citizens Against Toxic Waste. Other nonprofit organizations are chartered to represent those who cannot afford to pay for legal services. Many attorneys and law firms in private practice provide staffing and support for such endeavors. Their objectives are to assist in meeting the legal representation needs of their community and to support specific legal issues they consider worthwhile and appropriate. These activities are commonly referred to as *pro bono work*.

.25 Legal Clinics and Prepaid Legal Plans. The delivery of legal services is evolving in several directions. One direction is the provision of limited legal services to consumers through lower cost legal clinics specializing in a limited range of issues. Another direction is the provision of legal benefits to participants in prepaid insurance plans in a controlled and defined fashion for an affordable fee. Such services may be a supplemental benefit for employees of an organization or members of other groups such as credit unions and associations. The legal organizations usually provide limited services. When the consumer need is complex or requires substantial time, other private legal practitioners become involved.

Standard Industrial Classification Code

.26 The Standard Industrial Classification Code (SIC) maintained by the Department of Labor for legal services is 8111. This code is required on certain governmental filings and can be used to obtain demographic information regarding the legal services industry from the Department of Labor and from private sources that use SIC codes for industry classification.

Historical Background

.27 In 1926, Dwight McCarty, an Iowa attorney, wrote the first book on legal management principles. Although some of these basic principles are dated, many still pertain today. However, the organized bar paid little attention to applying management principles to law firms until the early 1960s. During the intervening period, the incomes of attorneys slipped greatly: In the twenties, the law was the highest paid of professions; by the sixties, it was one of the lowest paid. Eventually, the bar generally recognized that management techniques needed to improve if attorneys were to maintain a reasonable economic position in their communities and if the quality and timeliness of client service were to be improved.

.28 The first organized movement to foster effective management practices in law firms took place in Illinois in 1960. Gerald Snyder, then president of the Illinois State Bar Association, arranged the first meeting dealing with law office management, which hundreds of Illinois attorneys attended. To continue this educational effort, the Illinois Bar formed an Economics Committee. Shortly after, the American Bar Association (ABA) formed a Committee on the Economics of Law Practice. This committee has become a separate section of the ABA and represents more than 22,600 members. Furthermore, other state bar organizations have emphasized effective practice management, and educational programs on this topic are commonplace.

Industry Trends

.29 **Economic Trends.** Since the mid-1970s, the legal profession has experienced phenomenal growth. Several factors, such as increased governmental legislation, overall economic expansion, emerging technologies, and world trade, fueled this growth. Salaries, gross revenues, numbers of branch offices, and numbers of associates at major firms have skyrocketed. Much of this growth was unexpected. From 1975 to 1985 alone, on average, starting salaries for associates rose 119 percent, associate compensation increased 116 percent, and partner compensation increased 90 percent. Average gross receipts increased 123 percent, and overhead (excluding associate compensation) increased 161 percent.

.30 Critical overhead costs, such as associate salaries, occupancy costs, and professional liability insurance have been increasing faster than gross receipts in firms of all sizes, in all areas of the country, and in all practice specialties. These increasing overhead costs are squeezing profits in many segments of the profession.

.31 Demographic factors also are having an impact. From 1970 to 1985, the number of licensed attorneys in the United States grew from approximately 350,000 to almost 700,000. As a result of this growth, the legal marketplace has matured. In an embryonic marketplace, demand for services or products exceeds supply, the opposite of what is happening in the legal profession today. The oversupply of attorneys has, in turn, produced several trends. The following trends are illustrative:

- Law firms are growing in size, some through mergers.
- Price competition is increasing.
- Clients are increasingly able to discern differences in the quality of services provided by different law firms.
- Corporations are moving from institutional to transactional relationships with law firms and selecting attorneys or firms based on expertise, specialty, and price.
- More than ever, attorneys are emphasizing client retention, public relations, and marketing.
- Unprofitable practitioners and practice groups are receiving increased attention from their managers.

.32 In light of these trends, law firms unable to adjust and remain profitable can expect failure. Law firm growth will probably continue but at a slower rate. The demand for sophisticated legal services is generally expected to continue to increase, but at a much more modest rate. This means total business volume will increase in most firms at lower rates. Firms may encounter mounting resistance to higher billing rates from their clients. Their associates may also increasingly resist pressures to bill more hours. In many cases, associates cannot or will not work more hours; or worse, they may not have enough work to do.

.33 Structural Trends. Law firms are changing their structure and management. Successful managing partners are now required to have the attributes of a good firm leader, particularly the ability to develop a consensus. Managing partners, in today's complex and competitive environment, also need to have—and to revise continually—a vision of the firm and a strategic plan to accomplish that vision. Many firms are becoming more corporate in structure, with professional management by individuals who have been trained in management and administration at business schools. Law schools and business administration programs are developing curriculums for law students and others interested in specific legal management techniques and skills.

.34 The profit squeeze will continue, forcing firms to increase demands on partners to expand business volume. Partners who do not contribute sufficiently to the economic well-being of the enterprise will usually be asked to leave the firm. Professionals will find admission to equity partnership increasingly unlikely unless they can expand the business

or they have a capability for managing. Firms will make exceptions for key specialists and superior legal technicians who are necessary to serve important clients.

.35 New law school graduates hired as associates should not presume that they can achieve advancement to equity ownership in a firm in eight to twelve years. But in the future, the legal career path does not have to be up or out. Firms will use creative means to retain trained attorneys. They are likely to establish senior attorney positions, tiered partnerships, and various levels of employee-attorneys.

.36 Specialization. Specialization by attorneys and law firms will increase. The specialties will become narrower as major firms direct attorneys into specialties immediately upon hiring. Boutique firms will continue to form to provide specialties in high demand, but may die quickly as their clients' needs change. The major firms may begin to eliminate certain practice areas in order to concentrate on the firm's strengths. Many of these changes will be influenced by business economics.

.37 Some law firms are attempting to maintain or improve their competitive positions through associations and affiliations with other law firms. They formed these early networks to enable managing partners to share information on how to manage their firms more effectively. Some firms are forming newer networks for various reasons, including increasing the expertise available to clients, referring work among members, and publishing newsletters that member firms send to current and prospective clients.

.38 As firms strive to specialize while seeking a competitive advantage, some are adopting a multidisciplinary approach and creating non-law subsidiaries. These subsidiaries, if handled correctly, may benefit a law firm in several ways: by strategically positioning the firm, by adding new business contacts and prospects, and by providing cross-selling potential. The types of non-attorney professional personnel employed by these law firms may be diverse. Librarians, economists, accountants, engineers, nurses and doctors, lobbyists, experts in computer systems and public relations, financial planners, probate and trust specialists, and others may add their expertise to analyzing and solving legal problems.

.39 International Expansion. The changing world economy is giving many U.S. law firms an opportunity to develop an international practice. Substantial barriers still limit the development and activities of the foreign offices of U.S. law firms; however, the demands of clients and the potential for profit are leading many firms to explore the prospect of providing legal services in normally restricted markets.

.40 Many law firms may need to assist their U.S. clients in acquiring foreign firms and expanding to overseas markets. The changing environment, characterized in the 1990s by such buzzwords and phrases as the *Pacific Rim*, *Europe 1992*, the *privatization of Eastern Europe*, and the *U.S.-Canada Free Trade Agreement*, offers a complex and provocative group of opportunities, constraints, and options that can be expected to continue.

.41 Relations With Corporate Counsel. The balance of power in the relationship between corporate and outside counsel is generally tilting toward the in-house attorneys. In some instances, however, decisions have been made to minimize the overhead burden

associated with in-house legal staffs. Corporations are becoming increasingly cost-conscious and law firms more competitive. Consequently, a buyer's market has emerged for outside legal services. General counsel are shopping around for outside counsel, laying down ground rules for billing and staffing, asserting themselves more in day-to-day dealings with firm attorneys, and bringing more work in-house.

.42 Alternative Dispute Resolution. Alternative methods to resolve legal disputes are available through various dispute-resolution techniques. They provide a cost-effective and expedient alternative to the litigation of disputes through the judicial system. One common technique is arbitration. In arbitration, all parties agree in advance to certain terms and procedures leading to the resolution of a dispute before a recognized panel of one or more qualified arbitrators. Arbitration can settle disputes in entirety or address specific issues in a larger claim. Depending upon the agreement reached between the parties, such arbitration proceedings can be binding and final. The American Arbitration Association is the most prominent group of arbitrators. It maintains offices throughout the country and requires members to train extensively to ensure their competency. In addition, many attorneys in private practice use the services of arbitration panels consisting of retired judges.

.43 Consultancies. Many national and regional law firms are diversifying into other businesses. Some of these businesses, such as lobbying efforts on behalf of client constituencies, are directly connected to other legal services. Others, such as employee benefits and personnel consulting services, are, at best, indirectly associated with law. This trend is receiving significant attention because of the impact such services may have on the attorney's ability to fulfill obligations to other clients. Such services may impair the attorney's objectivity and create conflicts of interest.

Impact of Technology

.44 Computers have had a major impact on law office management and productivity, and advances in their capabilities may well be the most significant change in legal practice operations during the next decade. Until recently, law offices used technology primarily to automate their administrative and production activities. The first stage of office automation and technology was word processing. The second stage in the technology evolution was enhanced client-accounting applications for such functions as accounts receivable and trusteeship.

.45 Law firms also used different peripherals, such as optical scanners, private telephone systems, laser printers, and microfiche systems. They installed computer terminals to access remote computer data bases maintained by service bureaus. Toward the late 1970s, systems were available to log long-distance telephone costs, photocopier charges, and similar costs.

.46 The various technologies usually constituted discrete systems within the law office, each for its specific purpose. Frequently, these systems did not communicate with one another and were incompatible.

.47 With the arrival of personal computers in the early 1980s, technology evolved to the second generation, bringing with it several elements of strategic importance to attorneys. First, small firms could use personal computers to handle administrative, accounting, and support functions. Second, law firms could integrate their computer software to link such administrative functions as word processing, client accounting, and information retrieval. The networking of hardware and expensive peripherals and the sharing of textual data gave firms the opportunity to standardize their systems and to establish a level of control that was previously difficult to enforce. Third, the gradual decline in its cost prompted management to meet the pressures of competition by using technology to increase productivity and to control overhead costs.

.48 The first and second generations of technology were driven primarily by the need to streamline back-office and secretarial operations. The third generation of law office automation and technology gave attorneys the capability of using desktop computers in the substantive practice of law. With desktop computers, attorneys can reduce their dependence on administrative support by creating and editing documents without assistance. Attorneys also have at their fingertips applications for case management, litigation support, docketing and calendaring, brief banks and work-product retrieval systems, and expert witness lists. In addition, they can research online the legal databases maintained by service bureaus. Substantive computer software programs exist for almost every area of practice including personal injury, bankruptcy, probate, and real estate. These software programs provide form documents, checklists, spreadsheets, and more. Part of an attorney's specialization in an area will require using such advanced automated programs.

.49 For litigation matters, attorneys use computers to categorize, control, and retrieve case-related documents; organize a chronology of events; track judge history and scheduling; record and store notes regarding telephone conversations; maintain personal case notes; and track witness backgrounds and testimony. Spreadsheet programs can perform specific litigation risk analysis and provide dramatic courtroom graphics. Decision-support programs enable attorneys to determine the probability of certain outcomes and to quantify the results in dollars.

.50 Law firms can use computerized systems to avoid conflict-of-interest situations. Computers are also replacing the manual card catalog in law libraries, and laser optical disks are displacing some books. Massive work-paper files may become obsolete through the use of imaging technology that stores millions of pages of information on a small laser optical disk.¹

.51 Expert systems are programs designed to solve problems based on rules and inference techniques supplied by experts in a particular field. Expert systems have been designed for specific questions in the practice of law. These systems capture the thought process of experts in the industry or within a firm, enabling other attorneys to retain a computerized counsel. The systems guide associates through a set of questions providing direction in the approach to a specific matter. Programs are also available that allow

¹ More detailed information about technology for processing and storing large amounts of data is available in an MAS Special Report, *Mass Storage Technology* (New York: AICPA, 1990).

attorneys to develop an expert system without the assistance of a knowledgeable engineer or a computer programmer.

.52 Artificial intelligence is the basis for advanced expert systems that not only use the rules and inference techniques supplied, but also, over time, develop their own rules based on the results from earlier situations. In other words, the computer will "think" like its particular attorney-user given certain client situations.²

.53 Voice-activated computers will enable users to ask and get answers in voice or print to questions about a case or a specific point of law. Attorneys will use such systems to manage cases, prepare for trial, and predict potential settlements.

Capital Requirements

.54 Private-practice law firms vary substantially in their capital structure and philosophy of equity ownership. Tactical decisions regarding types of clients and related services have an impact on decisions about firm capitalization. The variables that affect a firm's capital requirements include the value of receivables and work in process, the needs for working capital, and the plans to acquire equipment or expand facilities and services.

.55 **Receivables and Work in Process.** The revenues of most private-practice law firms depend predominantly on the efforts of professional staff and the ability to bill and collect from clients for services. In addition to professional fees, law firms bill for additional costs incurred on behalf of clients. To capture these professional fees and costs, most firms use automated time- and cost-accounting and -billing systems. The capabilities and sophistication of such systems vary substantially. The accumulated time and costs are considered work in process, pending review by individuals authorized to adjust fees and costs in specific situations.

.56 Other firms and individual attorneys in larger firms may be due compensation based on a share of client recoveries or of the economic benefits obtained from fixed-fee arrangements and transactional work, such as incorporations, the creation and execution of wills, and so forth.

.57 Over time, a firm will accumulate a substantial investment in time and costs for services. Depending upon the billing status of such services and costs and the billing relationships with clients, the firm categorizes the investment as work in process or outstanding accounts receivable. These asset balances are similar to the inventory of a manufacturing enterprise. The firm needs to make important decisions about financing the direct and indirect costs involved in creating these "inventory" items. This is because certain practice areas and clients require the commitment of funds far in advance of collection of the billings.

² More information is available in an MAS Special Report, *An Introduction to Artificial Intelligence and Expert Systems* (New York: AICPA, 1987).

.58 Working Capital. A law firm's working capital typically consists of cash and other liquid assets required for operation, together with a working line of credit. A firm's requirements depend partly on its philosophy regarding bank debt and other obligations, such as leases, as well as its position on billings and collections and distributions of earnings. It is common for six or more months to elapse between the accrual of the work effort and the collection of fees for the effort.

.59 Working-capital requirements also depend on expansion plans, as well as requirements for making advances for client-related expenses and maintaining equipment and physical facilities. In many instances, a law firm will either fund cash needs through credit, using accounts receivable primarily for collateral, or require contribution and retention of owner equity.

.60 Most law firms request client advances to cover fees and costs or to secure payment of ongoing charges. Most state bar associations have regulations requiring that these cash advances, which may be substantial, be placed in bank trust accounts separate from operating funds and be used only after they are earned. The proceeds of client funds held in interest-bearing accounts inure to the benefit of the clients or are disbursed to nonprofit funds that support community activities.

.61 Equipment. Law firms require capital to acquire and maintain equipment and software applications. They often finance these assets through lease contracts or other debt instruments. In making decisions about capital requirements for computer technology, management needs to consider that hardware and software standards often change rapidly, thereby causing some acquisitions to become obsolete.

.62 Expansion. Law firm expansion may involve adding office facilities, opening facilities in new locations, or diversifying into new practice areas. Expansion requires start-up funds before a law firm realizes a return on the investment. In a geographic expansion, each branch office has its own capital requirements, depending on its location, real estate, leasehold improvements, and operating-capital needs. Diversification into new practice areas may require the firm to commit substantial financial resources for specialized equipment, professional and staff training, and marketing and library costs.

Financing Methods

.63 Law firms vary widely in their approach to debt financing. Their sources of borrowed funds may be traditional bank loans, third-party leases for equipment and fixtures, and, to a lesser degree, trade payables. The level of owner equity that the firm retains for capital and operating requirements has a direct impact on the need for debt financing. A firm's ability to borrow may be affected by whether it uses cash- or accrual-basis accounting.

.64 Accrual Versus Cash Basis of Accounting. Because of the transactional nature of legal services, firms traditionally use the modified cash basis of accounting for income tax purposes. By doing so, they avoid early recognition of accrued-but-unpaid-fee accounts

receivables. These receivables are often the major asset of the enterprise, and therefore the firm's balance sheet typically reflects such balances as an asset offset by a deferred-income or accounts-receivable-capital line item. On the balance sheet, this item usually is located between liabilities and equity. It is possible that future legislation may require that professional service entities adopt the accrual basis of accounting for tax purposes.

.65 Partner Entry or Exit. The addition or departure of a partner can have a substantial impact on a firm's financing needs. Often, such a change requires adjustments in the underlying support and staffing of practice areas and client groups. In addition, a partner is often bound to certain contractual obligations. These obligations usually involve personal guarantees of firm debt and lease obligations and partnership agreements about access to and payout of accumulated equity.

.66 Lease Obligations. Lease obligations for space and related leasehold improvements can be one of the largest financial commitments a firm makes. Depending upon the terms of such obligations, the individual owners or partners may be personally obligated for lease commitments.

.67 To acquire capital equipment, law firms often use lease arrangements of three to five years in order to conserve cash and other available debt, such as operating lines of credit. When a firm is acquiring certain technological systems, management needs to perform a lease-versus-purchase analysis, considering the impact of obsolescence and the support offered by each option.

Industry Characteristics

.68 Private-practice law firms in the United States range in size from sole practitioners to firms with more than 1,000 attorneys. The larger law firms vary considerably in terms of the number of offices, the style of practice, and the relationships between offices.

.69 Areas of Law Practice. Private-practice law offices range from large full-service firms that handle most, if not all, legal matters encountered by consumers to small and mid-sized boutique firms that limit their legal specialties. The need for specialized training and support systems, together with the increase of malpractice claims against attorneys, dictates that the individual members of a firm limit their practice to a specific area of law. This specialization, in turn, may dictate that the smaller firm carefully control client intake to ensure the delivery of competent service. A full-service law firm most typically consists of a collection of specialized practitioners who can meet the needs of most current and prospective clients.

.70 Consumers' legal requirements are evolving over time, and therefore certain legal specialists continually need to shift the focus of their specialization. Because firms will continue to merge to form large full-service firms and specialty firms at an increased pace, small and mid-sized firms attempting to offer complete coverage of all legal needs will be at a disadvantage. To compensate for this drawback, these firms are affiliating to meet client-service needs across geographic and practice specialty boundaries.

.71 Firm Size. Approximately 700,000 attorneys were in private practice in the United States in 1990. Their numbers are expected to approach 1,000,000 in the year 2000. Most practitioners are in firms of fewer than five attorneys. At the other end of the spectrum, in 1990, three firms in the United States had more than 1,000 attorneys, 30 firms had more than 300 attorneys, and 300 firms had over 100 attorneys.

.72 The services provided differ substantially depending on firm size. Practitioners decide which clients to take and which services to provide based upon the sophistication, support, and resources required to provide the services competently and profitably. For example, some small firm practitioners cannot compete effectively for large antitrust cases and complex commercial litigation because they lack the support and capital required for such engagements. On the other hand, large firms probably will not market services to individuals and small closely held businesses with limited transactional needs because the cost of processing such matters through the firms' sophisticated systems makes them unaffordable for most of these clients. Firm size will continue to be an important factor in determining each firm's characteristics.

.73 Referrals. Successful market expansion involves the ability to diagnose and serve more than a single legal need of a particular client. Attorneys often refer significant amounts of legal work between departments within a firm, if the expertise required is available in-house, and to outside counsel, if necessary. When attorneys refer clients outside the firm, they consider whether matters will be handled in the desired fashion, whether existing client relationships for other continuing matters will be at risk, and whether the recipient law firm will reciprocate with referrals.

Business Cycles

.74 The practice of law depends largely on consumers' needs for specific legal services. New practice areas are always emerging, while others decline and others remain stable. Examples of emerging practice opportunities include environmental litigation, bankruptcy, intellectual property, and mergers and acquisitions. On the other hand, in several parts of the country, opportunities to practice law involving real estate development, tax shelter formation, and oil and gas exploration are declining. Stable practice areas include estate planning and commercial transactions. These changes in demand have both positive and negative impacts on practitioners and law firms.

.75 In many law firms, work loads vary because of seasonal factors such as year-end tax planning and securities- and finance-related engagements under legislature-imposed deadlines. In addition, summer periods tend to be slow because both clients and attorneys take vacations.

81/120 TYPICAL ACTIVITIES**Delivery of Legal Services**

.01 Law firms provide legal services to their clients in various ways. Many services require that attorneys work directly with clients while others, such as those involving judicial practice and legal aid, serve a support role in the overall legal process.

.02 Office Practice. The typical activities of private law practices focus on using available resources to provide quality client services. These include human resources consisting of attorneys, paralegals, law clerks, and support staff. The law firm needs to properly integrate and use other resources, such as word-processing equipment, to achieve maximum productivity. In addition, the firm must be able to track and document the use of these resources on behalf of clients in order to generate the data necessary to bill for services and costs incurred, and to produce the management information required to evaluate individual and firm performance.

.03 Law firms require numerous support systems to maintain an organized practice. These systems include financial and management accounting, legal research tools, client reception, internal and external communications, and file retention. The ability to integrate the components of the service delivery process is critical for success.

.04 Judicial Practice. Activities related to judicial law practice typically consist of those that ensure that the scheduling, handling, and controlling of legal issues advance through the judicial system in conformity with procedural standards. In effect, the courts exercise an oversight function for private-practice law offices by requiring compliance with court-imposed deadlines and prescribing document format and content as well as the qualifications required to practice before various judicial bodies.

.05 Similarly, private law practices may interact frequently with the administrative law departments of regulatory agencies. To deal with such agencies as those that regulate public utilities and the Securities and Exchange Commission, attorneys need specialized skills and must comply with established procedures.

Practice Management

.06 Law firm practice management involves applying a wide range of skills to several interrelated disciplines. The firm's success in achieving its operational goals and its members' objectives depends on its ability to coordinate and control the use of its resources.

.07 Support Personnel Management. Support staff costs are the largest single expense item after compensation costs of the firm's attorneys. Formal personnel management policies and procedures are required to control direct personnel costs and related benefits. The ability to attract, adequately train, and retain competent personnel at all levels is also

necessary to achieve profitability. In addition, personnel management may involve using counseling and intervention skills to ensure high morale.

.08 Time Management. Important to a law firm's success is its ability to bill and collect fees for the services of its people. Consequently, law firms need to manage their timekeeping functions proactively. Automated and manual systems need to be in place to capture and process information about time expended and its value. Management's attitude toward maintaining procedural standards in this area directly affects the firm's ability to capture, bill, and collect for services effectively. Law firms with weak controls in this area offer an opportunity for CPA practitioners to provide guidance and support.

.09 A key concept in effective time management is deployment of all personnel involved, directly and indirectly, in the delivery of client service. The firm needs to evaluate professional staff and, to a lesser degree, support staff on the basis of the time they devote to billable client efforts in relation to the time they spend on all firm matters.

.10 Billing and Collections. The ability of a firm to realize a return on its investment in client services depends largely upon its investment in and compliance with systems to organize and control billing and collections. Most firms use automated systems to facilitate this process. These systems provide an efficient approach to monitoring the performance of individuals, departments, and the firm. They may also produce important management information, such as effective billing rates, aging of accounts receivables, work-in-process balances, and other productivity, utilization, and realization statistics for analysis and action. Several software packages are available for these functions. These packages differ in important features, such as general ledger integration and management-reporting capabilities.

.11 Cash Flow Management. The ability to forecast and budget cash receipts and disbursements reliably is an important aspect of law firm management. The reliability of cash-flow forecasting methods often varies according to the types of services offered and clients served. For example, a law firm involved in contingent-fee work often needs to commit substantial resources and expenditures without much basis on which to predict resulting revenues. Usually, the firm cannot determine the fee until the matter is finally disposed. Nonetheless, objective planning methods can provide substantial analytical support in this area.

.12 Trends in legal practice, as well as changes within client industries, can also have a significant impact upon the ability to manage cash flow. Within a firm, growth, shrinkage, and other changes, such as turnover, affect the ability to monitor and forecast cash flow.

.13 Docket and Calendaring. Law firms rely on the docket and calendaring functions to support their litigation efforts. The docket function provides a summary of all matters currently pending before judicial bodies, including the dates of court appearances and document filings, the nature of issues, the names of responsible parties, and information about opposing counsel. The calendaring function sends reminders of critical deadlines to the responsible parties on an ongoing basis. Other practice areas, such as mergers and

acquisitions and tax, also depend on a calendaring system to ensure compliance with judicial and self-imposed deadlines and requirements.

.14 Conflict-of-Interest Identification. In most instances, law firms cannot represent clients whose legal interests are in conflict. Therefore, these firms need to maintain screening procedures at the point of client intake to ensure that conflicts of interest are identified and addressed adequately and in a timely way. Such conflicts arise for different reasons, including common ownership, common management and control, relationships between client personnel and firm personnel or other clients, and knowledge obtained by firm members on unrelated issues. Firms that lack effective screening procedures risk investing substantial resources inappropriately and irrecoverably. Additional risks are malpractice claims and the appearance of disorganization to the client community.

.15 Work Scheduling. Work-scheduling procedures are needed to ensure that attorneys meet their deadlines, and that personnel handle the work most appropriate for them. The ability to effectively train people and delegate the specialized or reoccurring tasks for which they are best suited can significantly enhance profitability and firm performance.

.16 Profit-Center Analysis. A law firm can analyze a significant portion of its operating activities by using the profit-center approach. Examples of profit centers include specific clients and client groups, specific attorneys and attorney groups, practice areas, office locations, and support activities or items, such as photocopying. For larger firms, this approach involves allocating revenues and costs to the profit centers. Determining appropriate allocation bases often requires sophisticated financial analysis.

.17 Malpractice Avoidance. Because of the nature of their work, attorneys are at risk of malpractice claims. Recent studies have shown that most claims result from administrative and clerical errors and often involve missed deadlines and client conflicts. Law firms need to evaluate their procedures continually to avoid exposure to such claims. Law firm professional liability insurance costs depend largely on the incidence of claims, the areas of law practiced, and the insurer's assessment of risk-avoidance procedures and compliance with them. Firms and insurance providers are accepting the risk-management audit conducted by an independent third party as a legitimate method to minimize exposure to malpractice claims. In addition to the costs of claims and insurance, other negative effects of malpractice suits are damaged reputations and poor morale.

.18 Quality. Perceptions about the quality of a firm's services have a direct impact on the ability of the firm to establish value for these services and generate fees. Clients may base their judgment of the quality of services on several variables, such as the timeliness of delivery, the effectiveness in achieving their objectives, the currency of the case law applied, their ability to understand the results obtained, and the firm's ability to deliver services that meet imposed standards.

81/125 AREAS OF BUSINESS RISK

.01 Law firms are exposed to business risks associated with malpractice claims and conflicts of interest, which were discussed previously in the "Practice Management" section. Other areas of risk are associated with collections, firm reputation, personnel, capital formation, contingency fees, partnership agreements, and pension plans.

Collections

.02 Actions taken to collect unpaid client accounts create exposure to various types of business risks. Collection activity typically involves spending firm resources and often results in returns lower than originally forecast. Formal action to collect a specific account requires additional resources and may increase the firm's exposure to malpractice claims.

.03 In many instances, firms can avoid expensive collection activities by taking sufficient initial and continuing steps to ensure payment for services rendered and costs advanced. Law firms need to develop an effective process of accepting, negotiating, and documenting engagement relationships with clients to secure collection success.

Client Retainers

.04 Client retainer agreements can reduce business risks. Many state bar associations require that law firms keep advanced funds separate from business operations funds until they are earned. Also, firms often request retainers from new clients who have not established a sufficient credit history.

Reputation

.05 Law firms and attorneys gain prominence and recognition for the types of services they provide and the results they obtain. Law practices have evolved into a collection of specialties, and, to achieve recognition in these specialties, they need to maintain visibility and a reputation for meeting the highest professional standards. Firms and attorneys who fail to do so risk losing current clients and opportunities to attract new clients.

Recruitment and Retention of Professionals and Staff

.06 Competent staff is the key to a firm's ability to consistently provide high-quality service to its clients. In addition to productive recruiting methods, law firms need to use effective retention methods. Firms benefit from the continuity that long-term employees provide, as well as their ability to learn new skills quickly. Longevity is particularly

important in firms that require specialized skills and adequate knowledge of the clients' business and personal affairs.

.07 Effective retention methods are also needed because attorneys and attorney groups are moving laterally between firms in increasing numbers. These moves often result in the loss of business that may follow these individuals or groups.

Capital Formation

.08 Adequate capitalization is necessary to ensure a firm's ability to satisfy its obligations. Firms can obtain capital from equity contributions, the retention of earnings, or debt financing. Law firm expansion, in both geographic and practice areas, is often capital-intensive. An inherent risk is that expended capital will not attain an adequate return on investment.

Bank Debt

.09 Law firms depend to varying degrees on bank credit for operations. Debt extended as an operating line of credit is typically secured primarily by the firm's accounts receivables and work in process and secondarily by fixed assets. Some lenders rely on personal guarantees by the owners when extending credit. Firms also may use term lending and third-party leasing for specific equipment needs.

.10 Inequities involving bank debt often arise when the composition of equity ownership and sharing ratios changes over time. The inequities usually occur when the firm uses taxable revenues and related cash flows from a prospective period to liquidate debt related to effective equity distributions made in prior periods.

Contingent Fees

.11 Certain legal issues are routinely handled on a contingent-fee basis. Under such an arrangement, the attorney agrees to handle a legal matter in return for a percentage of court-awarded damages or settlement proceeds. In most instances, the attorney is committed to providing service over an extended period before final disposition and realization of proceeds, if any. The timing of recovery of costs advanced on behalf of contingent-fee clients depends on the terms negotiated between the attorney and client, and in many instances, such costs are billed to and paid by the client.

Mergers, Acquisitions, and Dissolutions

.12 Private-practice law firms are combining or dissolving at ever-increasing rates. Firms often enter new practice areas or expand geographically by acquiring practice units or targeted practitioners. The attorneys targeted for these acquisitions are changing firms

on a lateral basis in increasing numbers to accommodate their goals and client needs. Many law practices experience serious problems because of attorney turnover and the loss of clients who follow these attorneys.

Unfunded Pensions

.13 Provisions for pensions or retirement funds in many law firms are unenforceable promises. An appeals court has recently held that a partnership agreement may expressly decree the death of the plan upon the dissolution of the firm. Consequently, many retired partners are vulnerable to loss from unfunded retirement plans. As well as leaving older attorneys vulnerable, and, ultimately, younger partners resentful, unfunded retirement plans can be a barrier to a much-needed merger. One way out of the pension plan predicament, of course, is to set aside enough money each year, regardless of the tax consequences, to fund adequate pensions for partners.

81/130 PERFORMANCE STANDARDS

.01 All law firms, regardless of size, need adequate financial controls to manage their practices effectively. For some firms, overhead costs, such as associate salaries and occupancy costs, continue to escalate at a rate that is greater than that of the increase in fees. Consequently, the achievement of profitability and financial success requires increased management attention and sophistication.

.02 Financial success in a typical law practice requires a sufficient volume of business to keep the attorneys and paraprofessionals productively occupied on billable client matters. According to various surveys, during 1988, the national average of client hours worked per year was 1,730 hours for partners-shareholders and 1,835 for associates. It is becoming more commonplace for billable hours to exceed 2,000 per year for attorneys in large law firms in major metropolitan areas. Surveys of the legal profession are available that provide statistics on various aspects of law firm operations, such as billable hours, staffing and compensation ratios, capitalization, aging of accounts receivable and work in process, and standard billing rates. These studies are detailed by firm size, geographic area, and practice specialty. Some sources of these studies are listed in appendix 81/C.

.03 Productivity controls and risk avoidance begin at the point of client intake. At this point, the firm screens clients to avoid conflicts of interest and to ensure that the work undertaken is appropriate to its operating and practice objectives as well as the client's objectives. By using engagement letters, the firm can make its objectives and expectations clear to the client.

.04 Other requirements for financial success include regular billing, minimal discounting of the value of services, prompt follow-up on client bills, and the establishment and monitoring of a realistic profit plan and expense budget. In addition, the firm needs to manage cash resources by investing excessive cash balances.

.05 Adequate accounting and financial-management-reporting systems need to provide the following management controls that help to ensure financial success. Management needs to understand the importance of each of these controls, have the information necessary to measure its effectiveness, and act on such information.

Control of Attorney and Paralegal Time

.06 Effective control of professionals' time requires monthly reporting of the total chargeable time and unchargeable time for each timekeeper. Comparison of this time to a goal is beneficial. Classification of unchargeable time by major categories is also beneficial. Examples of major categories include firm management, associate recruiting, pro bono work, and client development and marketing activities. This information should be reported for the current month, fiscal year-to-date, and prior year-to-date.

Control of Unbilled Work in Process

.07 To control work in process, management needs to track work performed for clients for billing purposes and guard against excessive—and possibly unbillable—time and costs on each matter. Unbilled work-in-process reports for each case, or detailed billing worksheets or pro formas, as they may be called, need to segregate and age billing data for each attorney and each client. Client cost advances also need to be segregated from unbilled fees on each matter and aged to help attorneys understand the need to bill for these amounts.

Control of Billing Variances

.08 A billing variance is the difference between the value of time worked at standard rates and the fees billed for that time. The difference can be kept to a minimum if the firm establishes realistic hourly billing rates that reflect the target each timekeeper is expected to achieve. The rate needs to be appropriate to the timekeeper's experience and specialty as well as the firm's geographic area and client base.

.09 Vital management information tools for controlling these variances are the percentages of billing and collection realization, which are calculated by dividing the fees billed and collected by the value of the time billed based on standard rates. Typical overall realization performances are in the 70 percent to 80 percent range. Well-run firms achieve 80 percent to 90 percent realization, and very well run firms exceed 95 percent realization. Other important statistics are effective hourly rates. These rates are calculated by dividing actual fees billed and collected by the hours worked by individual timekeeper, in each practice area, for each client, and so forth. These statistics can point out profitable and unprofitable timekeepers, cases, and practice areas.

Control of Accounts Receivable

.10 An effective accounts receivable system can generate an aged schedule of all cases according to billing attorney. On the schedule, the system also separates costs advanced from fees.

Control of Administrative Operations and Cash Flow

.11 A revenue plan is a projection of fees that will be collected during the fiscal year. It is based on assumed levels of chargeable hours, billing, and collections for all the professional timekeepers in the firm. An expense budget is an estimate of expenditures for ongoing operations, such as the costs associated with occupancy and with recruiting new associates and acquiring and maintaining technology. To achieve effective control of operations and cash flow, the firm needs to have information to alert management that trends adverse to these plans are developing. For example, revenues may be below plan or expenditures above plan. With the appropriate information, management can correct the problem. A reporting system can provide this information in a monthly income statement that compares revenues for the current month and through the fiscal year-to-date with the plan. In addition, a current-month and year-to-date cash-flow statement provides management with control over resources and uses of cash funds received and disbursed.

81/135 TYPICAL MCS ENGAGEMENT OPPORTUNITIES

.01 Engagement opportunities can arise from a current or prospective client's need for an operational audit, the design or redesign of an accounting system, or an analysis of administrative systems and procedures or of computer systems. Current and prospective clients may also need assistance with long-range planning, administrative management, and partnership and shareholder arrangements.

Operational Audit

.02 The operational or management audit can be compared to a periodic physical examination. Typically, the audit procedures constitute a review of the health of the financial and other operations of the law practice. As part of the review, the CPA practitioner compares the firm's experience with corresponding statistical indicators available from national and local annual economic surveys.

.03 Depending on the engagement agreement with the client, the CPA practitioner interviews a cross section of key attorneys and other personnel to identify issues of concern. The practitioner also surveys administrative systems to identify troublesome areas, such as poor controls, bottlenecks, and inefficient and redundant activities. The major administrative systems to be surveyed include client accounting, client expense recovery,

billing, financial management reporting, critical date control, file opening, conflict-of-interest avoidance, and technology use. The questionnaire provided in appendix 81/B can be used to gather initial input on critical issues and problem areas.

Accounting System Design

.04 Engagement opportunities for accounting system design may arise when new law firms are formed or when existing systems become inadequate. Firms of any size may reach a stage when their existing systems are insufficient to handle the volume of transactions, process data in a timely way, or provide adequate operational reports. CPA practitioners can assist client law firms in selecting accounting software and upgrading computer hardware.

.05 Computer software vendors frequently view law offices as an untapped and lucrative market for accounting systems. Some vendors, however, lack an understanding of law firm accounting requirements and consequently may recommend unsuitable equipment or accounting systems. Opportunities exist for CPA practitioners to assist law firms in salvaging some or all of their hardware investment and replacing or supplementing their systems in ways that are consistent with their operating objectives.

.06 A common need of law firms of all sizes is the integration of traditional accounting systems with legal-practice time and billing systems.

Analysis of Administrative Systems and Procedures

.07 The purpose of systems and procedures for the administration of a law office and for the performance of legal work itself is to ensure appropriate collection and storage of necessary management information, effective communication, and timely performance. Effective and efficient systems require careful development by a trained individual who can obtain answers to these key questions:

- (a) Why are you doing this?
- (b) Can it be done more quickly?
- (c) Can it be done less expensively?
- (d) Can the same information or result be derived from another source?

.08 The systems used in a law office require written plans that instruct and remind users. Once a firm implements its systems, it needs to audit the procedures periodically to ensure that attorneys and staff do not add unnecessary additional steps.

- .09** The following are typical administrative systems:
- *Case-intake control systems* include those used to record pertinent information about prospective new clients and matters; accept, or formally reject, new clients and matters; screen to avoid conflicts of interest; and provide engagement-fee-agreement letters.
 - *Case-management systems* are used to assign cases, monitor attorney workload, track and report the progress of cases, and monitor and remind attorneys of pending critical dates.
 - *Word-processing systems* include document drafting, editing, and revising; work-product retrieval; and document-assembly systems. These systems allow efficient repetitive use of research and forms.
 - *Communications systems* include the systems used for voice and data communications among attorneys, clients, and remote offices.

Analysis of Computer Systems

- .10** Opportunities exist for CPA practitioners to assist law firms in analyzing computer system needs, selecting systems and applications software, negotiating contracts, and implementing new computer systems as well as updating existing ones.
- .11** The practitioner's first steps during a computer system consulting engagement are to gain an understanding of the existing systems and to determine current and future requirements. Appendix 81/C of this practice aid lists additional resources to assist the practitioner in this activity.
- .12** The practitioner interviews key personnel and documents existing systems and procedures, and reviews them with client management. Based on this review, the practitioner revises the requirements until they accurately represent the client's priorities, growth assumptions, and short- and long-term needs.
- .13** The requirements then become an integral part of the request for proposal (RFP). The RFP is a technical document that communicates the client's requirements to computer system vendors, requesting that they provide specific information about their systems' capabilities. The practitioner assists in selecting vendors, who are invited to submit written proposals. Often, the practitioner assists in developing forms for submitting responses. Law firms may require confidentiality agreements regarding requirements and technology plans.
- .14** The practitioner may assist in evaluating each vendor's proposal, which can involve the preparation of analytical charts and matrix schedules to facilitate comparison. This process will eliminate the less responsive systems or vendors from further consideration. If

appropriate, the client may wish to have the practitioner prepare deficiency letters for proposals from vendors selected for further evaluation.

.15 Before scheduling equipment and software demonstrations, the practitioner calls or visits other law firms provided as references to confirm satisfactory service and support. It is advisable for the practitioner to prepare a structured agenda to foster equality in the demonstrations of equipment and software features. This approach also affords the opportunity to observe the features that are important to the client as opposed to the capabilities vendors typically suggest be viewed.

.16 After vendors complete their demonstrations, the practitioner prepares an evaluation report. The report addresses the advantages and disadvantages of each proposed system, compares the estimated costs, and recommends a course of action. During a discussion of the report with management, the practitioner further explains complex technical matters.

.17 A law firm client may then request the practitioner's assistance in implementing the recommended technology. Such assistance may take the form of negotiating an equitable agreement with the selected vendor and subsequent installation and staff training.

.18 To ensure that the equipment and software operate in conformance with the agreement, the practitioner performs acceptance testing. The practitioner notes any deficiencies during acceptance testing and compares them with the terms and conditions of the agreement. Upon successful completion, it may be appropriate to issue a letter of acceptance.

.19 A final task in the implementation is to assist in preparing a comprehensive conversion plan and timetable and to monitor the efforts of the client and vendor to ensure that implementation goals are achieved. In planning these efforts, the practitioner considers such items as proposed numbering systems, form and paper workflow, conversion approach and controls, organizational changes, and physical site plan and environmental requirements. The practitioner monitors the progress of the conversion and provides progress reviews to the client.

Long-Range Planning

.20 Because of increased competition, members of the legal profession are paying substantial attention to long-range planning. Such planning can range from informal discussions to objective planning and forecasting, using substantial resources and input by third parties. The typical opportunities associated with law firm planning involve strategy, profit planning and budgeting, capital requirements, support-staff needs, lease evaluation, space planning, facilities design, technology planning, and market and practice development.

.21 Strategic Business Planning. CPA practitioners can assist law firms in developing and implementing strategic business plans. Strategic business planning includes developing a mission statement and defining goals and objectives and a strategy to implement them.

The cornerstone of a law firm's strategy is the identification of appropriate services to be provided and the clients to be served.

.22 Strategic planning requires preliminary discussions among firm management, with the possible involvement of the CPA practitioner as a facilitator in a retreat-type setting. If the plan is to be effective, firm owners must agree on the strategic vision before proceeding. Firms also often require assistance in making a transition when they have experienced a shift in ownership, client base, or practice areas.

.23 Profit Planning and Budgeting. Critical components of long-range profit planning are operational budgeting and cash-requirements forecasting. A typical engagement would include the development of twelve-month and three-year projections, using statistical analyses to predict production and the associated costs. In a final report, the practitioner presents detailed scenarios to reflect various courses of action and events.

.24 Capital Requirements Planning. Additions and retirements of capital assets are important components of the budgeting process. Changes in size, location, and practice areas may, in turn, change the firm's capital needs. A firm's investment in advanced client costs and its ability to recover these costs also have an impact on its capital needs. In addition, automation strategy and technology use have a significant effect on capital requirements.

.25 Analysis of Support-Staff Requirements. Law firm staffing will vary according to the nature and volume of the firm's work, and the facilities and equipment available to produce the work. The proper application of technology and training programs will have a significant impact on overall staffing requirements.

.26 Lease Evaluation, Space Planning, and Facilities Design. Strategic decisions about firm expansion and the diversification of practice areas will have an impact on the firm's physical space needs. The general perception of a law firm as a distinguished tenant may help the firm to negotiate favorable lease terms and thereby offset the costly rent resulting from its need to maintain a high-profile office. Other external factors, such as location and real estate development trends, may also impact space-planning and leasing decisions.

.27 Technology Planning. The use of technology in the practice of law is expanding. Therefore, law firms need to plan the direction and integration of their automated systems. Current trends indicate an increased emphasis on interactive court filings via electronic media and on database applications. In addition, since optical scanners have become more reliable and such storage media as optical disks have become cost-effective, many smaller firms are applying these technologies. Electronic and voice mail are also suitable for law firms.

.28 In planning for a law firm's use of technology, the CPA practitioner needs to consider several major objectives: integrating the various components of the systems, enabling the firm to charge clients for use of the technology, and improving work-product efficiency and quality.

.29 Marketing and Practice-Development Planning. Practitioners can help clients to determine the focus of a marketing strategy, identify the procedures needed to execute the strategy, and evaluate results. The operations and business objectives of law practices and public accounting firms are similar in many ways. Therefore, CPA practitioners may wish to draw on successful marketing strategies used by their firms to assist their law firm clients.

.30 A law firm may need guidance in identifying practice-development strategies appropriate to its practice mix, and in determining the impact on its financial performance. Future marketing initiatives may target clients that the firm has identified as needing its practice specialties.

Administrative Management

.31 Opportunities to assist law firms include engagements that involve improving organizational structure and analyzing policies and procedures and staffing, compensation, and benefits.

.32 Improving Organizational Structure. CPA practitioners can assist law firms in defining appropriate organizational structures and positions and responsibilities, and in recruiting administrative staff. Historically, law firms have maintained rather informal organizational structures to manage operations. In many instances, they formed ad hoc committees to deal with specific issues as they arose. However, the increasing complexity of current professional practice dictates that firms take a more formal management approach. Many law firms are now using a traditional corporate structure, with executive committees and managing partners serving in capacities quite similar to those of a board of directors and chief executive officers.

.33 Delegation of management to non-attorney staff is gaining rapid acceptance. Individuals with appropriate management skills are often better suited for day-to-day operational administration. This approach also allows attorneys to focus on client service and production.

.34 Policies and Procedures Analysis. Along with adopting a corporate type of organizational structure, attorneys have recognized the need for a more formal approach to defining policies and procedures. The goal of a policy statement is to establish a uniform way to address reoccurring issues. Written policies and procedures are also useful tools in training personnel. Business risks, such as malpractice claims, together with the need to consistently provide quality work, dictate that law firms ensure accountability by documenting various tasks and responsibilities.

.35 Analysis of Staffing, Compensation, and Benefits. Direct and indirect personnel costs typically constitute the largest cost category of law firm operations. Law firms need to pay particular attention to this area for two reasons. First, starting salaries for attorneys and support staff have risen dramatically in recent years. Second, attorneys and staff are moving between firms more frequently. To recruit and retain qualified staff, law firms need to offer competitive compensation and benefits. Several published legal industry

compensation and benefit surveys provide information about current practices in this area. Effective administration of compensation and benefit plans also requires defined performance-review procedures.

Partnership and Shareholder Arrangements

.36 About half of existing law partnerships lack written partnership agreements. In some older law firms, precedents often take the place of formal signed documents. The lack of a written agreement, however, can give rise to serious disputes and inequities such as those associated with the compensation of partners' widows or the disbursement of capital when a partner withdraws from the firm.

.37 The changing expectations of younger attorneys and the trend toward larger law firms have caused many firms to prepare written partnership agreements. Although a single partnership agreement may cover all of the subjects necessary to regulate a group of partners, a professional corporation requires a variety of legal instruments. Both organizations, however, must resolve similar problems.

.38 CPA practitioners need to recognize that many law firm partnerships essentially form a new entity each year as they admit new partners and as partners withdraw or retire. A fundamental consideration in drafting a partnership agreement is whether the agreement will be revised annually to include the allocation of income in precise terms or will be constructed to accommodate any annual reconsideration by amendment. The partnership can handle recurring matters, such as the admission or withdrawal of partners and the compensation of attorneys, by adopting the minutes of partnership meetings and executing supplements or amendments.

.39 When assisting a law firm client in developing a partnership or shareholder agreement, the practitioner considers several basic issues associated with revenues, partner separations, capital interests, management, the outside activities of personnel, expenses, and compensation plans.

.40 **Revenue Definition.** The agreement needs to define what constitutes revenue to the firm. The practitioner asks questions such as these: Does the firm include as revenue directors' fees for service on a corporate board, part-time salaries for teaching at a law school, and compensation for serving as a commissioner or assistant prosecutor? Are fees paid to guardians and trustees? If a partner writes a book, are the royalties considered legal fees?

.41 **Partner Separations.** The agreement needs to define the terms of compensation and disbursement of capital in the event of a partner's death, withdrawal, or expulsion.

.42 **Death or withdrawal.** The death or withdrawal of a 50-percent-or-more partner terminates the partnership. The agreement needs to define the financial arrangements regarding the death of a partner. Usually, the capital account is payable to the partner or estate upon death or withdrawal. In addition, the partner's spouse needs to be told of the

entitlement from the firm because it may be less than expected. In a corporation, a shareholders' stock-purchase agreement needs to allow the firm to recapture the shares of a withdrawing stockholder.

.43 *Withdrawal to compete.* When an attorney withdraws from a firm to establish a competing practice, certain terms may apply to further restrict capital-account disbursements and retirement benefits that are not vested.

.44 *Disability.* The agreement includes a disability clause in order to limit the term during which payments are continued. Through insurance covering long-term or permanent disability, firms can avoid the responsibility of continuing to provide for a former partner or employee. Law firms need to require their attorneys to be insured under disability insurance programs such as those available through most bar associations. Larger firms can negotiate their own group plans, sometimes at considerable savings. In professional corporations, group-plan premiums are deductible expenses.

.45 *Retirement.* Retirement is a form of withdrawal from a law firm. Sometimes, however, law firms are reluctant to deal with the problem of planning for retirement. One problem is the natural conflict of interest that exists between the younger and senior partners of law firms with respect to retirement. A plan that reduces the compensation of partners after a certain age may provide an incentive to voluntary retirement. Such a plan is most effective if it bases post-withdrawal payments on an average of the last few years' annual earnings.

.46 *Expulsion.* Most law firms provide for some protection to a partner whose expulsion is proposed. Generally, such action requires a vote that is greater than a simple majority. Capital distributions to such individuals are often restricted to a stipulated percentage of net income, thereby stretching out the payout period and protecting the individuals remaining with the firm.

.47 *Life insurance.* Life insurance can fund the payments due a partner on death or withdrawal or the repurchase of shares, or other obligations due a shareholder in a professional corporation. The partnership agreement may tie the cash value of life insurance policies to early withdrawal.

.48 *Ownership.* The agreement may need to specify the effect of partner separations on the firm's name, depending on the firm's history and state regulations. The names of some law firms have real value in themselves. These are usually institutionalized firms that bear the names of long-dead founders. Many jurisdictions require firms to change their names as the partners change. Consequently, the name identity of the firm becomes less valuable.

.49 Another issue to be addressed in the agreement is the ownership of client files. The ethics of the legal profession provide that a client is free to release an attorney at will. The partnership agreement needs to specify that client files are the property of the firm and that they will remain in its custody until a client has paid the bill in full and discharged the firm. Only the client may then direct that legal files be turned over to another attorney.

.50 Capital Investment. In a law firm, capital is invested to finance furniture and fixtures (library, computers, furnishings, leasehold improvements, and real estate) and to provide the cash required for operations and the financing of receivables and work in process. If voting rights or percentage interests in income are based on contributed capital, then the partnership agreement needs to limit the capital amount.

.51 Some partnerships require equal capital contributions from all partners. Some establish two or more classes of capital interests. Still others have noncapital partners. The capital interests of partners usually amount to a small fraction of the annual earnings of the attorneys.

.52 Management. The partnership agreement needs to make clear by whom, and on what basis, important decisions are to be made. At a minimum, the agreement specifies the number of votes required to admit or expel new members, dissolve the firm, or merge the firm with another. Usually, the firm may be dissolved only by a two-thirds vote. In an unsuccessful ballot, those voting for dissolution often have the right to withdraw. A merger of the firm with another usually requires a unanimous (or appropriate percentage) vote.

.53 Voting. The voting power of each partner is also a matter for agreement. Many small firms give each partner an equal vote, regardless of earnings or contributed capital. Some firms give extra voting power after an individual has been a partner for a specified number of years. Practically speaking, the natural leadership process often makes the formal voting structure unimportant. Strong partners tend to dominate firms, regardless of formal agreements. However, written agreements on these matters are important when difficulties arise.

.54 Admitting new partners. More than a simple majority vote is usually required to admit new partners. Some firms require a unanimous vote. Unanimity may be justified in the smaller firm, but it is difficult to defend in large law firms. As a firm grows, contact between the departments becomes insufficient to enable every partner to personally know each candidate for admission. Therefore, the partners may rely on their colleagues' evaluation of a prospective partner.

.55 Disputes. Agreements between attorneys generally include provisions that settle arguments conclusively by majority vote or by submitting to impartial arbitration, such as that provided by the American Arbitration Association, available to any party or the successor in interest of any party.

.56 Outside Activities. A law firm should have some control over the activities of its attorneys and staff. If it is fair to assume that all the working energies of attorneys belong to their firms, then the partnership agreement needs to require firm approval of any projects, offices, chairmanships, or committee assignments that may take a substantial amount of attorneys' working or free hours.

.57 Expenses. A law firm needs to have an understanding about fees for membership in professional organizations, such as the ABA and state and local bar organizations. The number of memberships paid for each attorney may be included in an agreement. The

agreement needs to establish the principle of control, and annual policy determines the amount.

.58 Compensation. Every law firm needs to develop a compensation plan for partners that all understand. An appropriate compensation plan recognizes the need for equity of the attorneys, the financial health of the enterprise, the competitive factors of the labor market, and the goals and objectives of the organization. The firm implements the plan only after considering its objectives carefully, developing the essential features, discussing them, and ensuring they are well understood by those affected.

.59 The late Reginald Heber Smith of the Boston Bar stated the following important objective of a law firm compensation plan:

The whole purpose is to let the work in the office flow where it will be done best, most quickly, and at lowest cost. The . . . [attorney] having too much business must not be afraid to part with it; he must be encouraged to do so, and when he does so, the system must protect his natural and proper interest in the case and the fruits thereof.

.60 When developing a compensation plan for partners, CPA practitioners need to consider several factors. The importance of these factors varies from firm to firm. Therefore, practitioners need to determine with the client the significance of each. The legal work of each partner that is billed and paid for is, of course, a fundamental determinant of partner compensation. Another important factor is the profit derived from legal work supervised or managed by the partner. In addition, almost all law firm compensation plans give weight to obtaining new clients or "rainmaking." Doing excellent work on time is also an important aspect of keeping clients and of obtaining new clients. The contributions attorneys make to the firm by virtue of special technical skills also affect their compensation.

.61 Some compensation plans consider the degree of clients' loyalty to an attorney. Therefore, the answer to the question "Who will follow if the attorney leaves the firm?" may influence compensation. Some firms also weigh the production of raw hours, which may or may not be billed and collected. Firms may reinforce the importance they attribute to having an office environment in which things run smoothly and pleasantly by rewarding partners who contribute to keeping it so. Firms with a strong feeling of obligation to the law as a profession may give credit to partners who participate in bar association activities. Some firms may also weigh community activities, especially as they contribute to obtaining new clients.

.62 In many firms, the compensation plan gives credit to attorneys who delegate properly so that their time is profitably spent, and to attorneys who contribute to the future of the firm by helping young associates to develop. Because law firms require effective general management to prosper, compensation plans need to recognize its importance by including incentives for partners to be involved in management. Seniority may count as a factor in determining compensation in some law firms. More commonly, law firms consider

the risk and investment of partners as a compensable factor. Firms in which the founding attorneys are still active may also consider the risk these attorneys took in starting a firm.

.63 Law firms can use several approaches to compensating partners. The most common approaches involve the use of percentage or point systems, formulas, the lockstep system, and peer evaluation.

.64 *Percentages and points.* A simple method of income division among partners is to allocate a percentage of the earnings of the firm to each partner. This system works well in many small law firms. Problems may arise, however, when a partner joins the firm. If the firm wants to remain on a percentage basis, each partner gives up some percentage of interest to allocate income to the new partner. This can be emotionally difficult for some partners and may result in complex ownership structures.

.65 An alternative to allocating percentages of earnings is the point system. According to this system, the firm assigns varying amounts of points to partners based on seniority, technical skills, profit contributions, and similar criteria. To determine the value of each point, the firm divides its available profits by the total number of points. The advantage of the point system is that it reallocates the relative interests of existing partners equitably according to their contributions. Such periodic reassessments are needed to keep the firm healthy.

.66 *Formula systems.* Several law firms have compensation systems that use formulas based on the production and profitability of work. Firms that use these formulas sometimes function more like groups of individual practitioners than as law firms. These systems require that firms maintain careful records of the contribution of each partner and associate. The shortcoming of these systems, however, is that they usually measure contributions in terms of clients obtained, work done, and profitability of assignments, while ignoring other important contributions, such as management, planning, and training. Consequently, some partners may be unhappy because they make valuable contributions to the firm without receiving any recognition in the form of income. The result of such systems can often be the neglect of functions that are critical to the firm's growth.

.67 *Lockstep system.* Firms with a lockstep compensation plan generally assign interests on an annual basis, based on the number of years each attorney has been a partner, up to a maximum number of points after fifteen or twenty years. Some firms operating under the lockstep system find that it serves them well and avoids controversy. In other firms, however, the lockstep approach causes high partner turnover because it may reward mediocre partners with the same amount that those far superior in talents or work habits receive.

.68 *Peer-evaluation system.* The peer-evaluation system values the worth of a partner by using criteria that the firm as a whole determines are important. Each partner rates each of the other partners using these criteria. The system can work well in small firms when each partner has sufficient knowledge of the other partners' contributions. In larger firms, however, it becomes difficult, if not impossible, to have a good understanding of the contribution of each partner.

Other Engagement Opportunities

.69 Other opportunities exist for CPA practitioners to provide consulting services to law firms. In many instances, engagements will encompass several disciplines and issues. For example, law firms may require assistance in the following areas:

- Development of cash management and controls
- Lease versus purchase analysis
- Analysis of banking relationships and lending proposals
- Practice valuation
- Merger, acquisition, and dissolution assistance
- Billing-rate studies
- Profit-center analysis
- Internal control/risk-management reviews
- Capitalization studies
- Compensation studies
- Executive searches for administrative and financial/accounting staff
- Preparation of personnel and policy-and-procedures manuals

APPENDIX 81/A

STATEMENT ON STANDARDS FOR CONSULTING SERVICES

CONSULTING SERVICES: DEFINITIONS AND STANDARDS

Introduction

1. Consulting services that CPAs provide to their clients have evolved from advice on accounting-related matters to a wide range of services involving diverse technical disciplines, industry knowledge, and consulting skills. Most practitioners, including those who provide audit and tax services, also provide business and management consulting services to their clients.

2. Consulting services differ fundamentally from the CPA's function of attesting to the assertions of other parties. In an attest service, the practitioner expresses a conclusion about the reliability of a written assertion that is the responsibility of another party, the asserter. In a consulting service, the practitioner develops the findings, conclusions, and recommendations presented. The nature and scope of work are determined solely by the agreement between the practitioner and the client. Generally, the work is performed only for the use and benefit of the client.

3. Historically, CPA consulting services have been commonly referred to as management consulting services, management advisory services, business advisory services, or management services. A series of Statements on Standards for Management Advisory Services (SSMASs) previously issued by the AICPA contained guidance on certain types of consulting services provided by members. This Statement on Standards for Consulting Services (SSCS) supersedes the SSMASs and provides standards of practice for a broader range of professional services, as described in paragraph 5.

4. This SSCS and any subsequent SSCSs apply to any AICPA member holding out as a CPA while providing Consulting Services as defined herein.

Definitions

5. Terms established for the purpose of the SSCSs are as follows:

Consulting Services Practitioner. Any AICPA member holding out as a CPA while engaged in the performance of a Consulting Service for a client, or any other individual who is carrying out a consulting service for a client on behalf of any Institute member or member's firm holding out as a CPA.

Consulting Process. The analytical approach and process applied in a Consulting Service. It typically involves some combination of activities relating to determination of client objectives, fact-finding, definition of the problems or opportunities, evaluation of alternatives, formulation of proposed action, communication of results, implementation, and follow-up.

Consulting Services. Professional services that employ the practitioner's technical skills, education, observations, experiences, and knowledge of the consulting process.¹ Consulting Services may include one or more of the following:

a. Consultations, in which the practitioner's function is to provide counsel in a short time frame, based mostly, if not entirely, on existing personal knowledge about the client, the circumstances, the technical matters involved, client representations, and the mutual intent of the parties. Examples of consultations are reviewing and commenting on a client-prepared business plan and suggesting computer software for further client investigation.

b. Advisory services, in which the practitioner's function is to develop findings, conclusions, and recommendations for client consideration and decision making. Examples of advisory services are an operational review and improvement study, analysis of an accounting system, assistance with strategic planning, and definition of requirements for an information system.

c. Implementation services, in which the practitioner's function is to put an action plan into effect. Client personnel and resources may be pooled with the practitioner's to accomplish the implementation objectives. The practitioner is responsible to the client for the conduct and management of engagement activities. Examples of implementation services are providing computer system installation and support, executing steps to improve productivity, and assisting with the merger of organizations.

d. Transaction services, in which the practitioner's function is to provide services related to a specific client transaction, generally with a third party. Examples of transaction services are insolvency services, valuation services, preparation of information for obtaining financing, analysis of a potential merger or acquisition, and litigation services.

e. Staff and other support services, in which the practitioner's function is to provide appropriate staff and possibly other support to perform tasks specified by the client. The staff provided will

¹ The definition of Consulting Services excludes the following:

- a.* Services subject to other AICPA Technical Standards such as Statements on Auditing Standards (SASs), Statements on Standards for Attestation Engagements (SSAEs), or Statements on Standards for Accounting and Review Services (SSARs). (These excluded services may be performed in conjunction with Consulting Services, but only the Consulting Services are subject to the SSCS.)
- b.* Engagements specifically to perform tax return preparation, tax planning/advice, tax representation, personal financial planning or bookkeeping services; or situations involving the preparation of written reports or the provision of oral advice on the application of accounting principles to specified transactions or events, either completed or proposed, and the reporting thereof.
- c.* Recommendations and comments prepared during the same engagement as a direct result of observations made while performing the excluded services.

be directed by the client as circumstances require. Examples of staff and other support services are data processing facilities management, computer programming, bankruptcy trusteeship, and controllership activities.

f. *Product services*, in which the practitioner's function is to provide the client with a product and associated professional services in support of the installation, use, or maintenance of the product. Examples of product services are the sale and delivery of packaged training programs, the sale and implementation of computer software, and the sale and installation of systems development methodologies.

Standards for Consulting Services

6. The general standards of the profession are contained in rule 201 of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 201.01) and apply to all services performed by members. They are as follows:

Professional competence. Undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence.

Due professional care. Exercise due professional care in the performance of professional services.

Planning and supervision. Adequately plan and supervise the performance of professional services.

Sufficient relevant data. Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

7. The following additional general standards for all Consulting Services are promulgated to address the distinctive nature of Consulting Services in which the understanding with the client may establish valid limitations on the practitioner's performance of services. These Standards are established under rule 202 of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 202.01).

Client interest. Serve the client interest by seeking to accomplish the objectives established by the understanding with the client while maintaining integrity and objectivity.²

² Article III of the Code of Professional Conduct describes *integrity* as follows:

"Integrity requires a member to be, among other things, honest and candid within the constraints of client confidentiality. Service and the public trust should not be subordinated to personal gain and advantage. Integrity can accommodate the inadvertent error and the honest difference of opinion; it cannot accommodate deceit or subordination of principle."

Article IV of the Code of Professional Conduct differentiates between *objectivity* and *independence* as follows:

"Objectivity is a state of mind, a quality that lends value to a member's services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Independence precludes relationships that may appear to impair a member's objectivity in rendering attestation services."

Understanding with client. Establish with the client a written or oral understanding about the responsibilities of the parties and the nature, scope, and limitations of services to be performed, and modify the understanding if circumstances require a significant change during the engagement.

Communication with client. Inform the client of (a) conflicts of interest that may occur pursuant to interpretations of rule 102 of the Code of Professional Conduct,³ (b) significant reservations concerning the scope or benefits of the engagement, and (c) significant engagement findings or events.

8. Professional judgment must be used in applying Statements on Standards for Consulting Services in a specific instance since the oral or written understanding with the client may establish constraints within which services are to be provided. For example, the understanding with the client may limit the practitioner's effort with regard to gathering relevant data. The practitioner is not required to decline or withdraw from a consulting engagement when the agreed-upon scope of services includes such limitations.

Consulting Services for Attest Clients

9. The performance of Consulting Services for an attest client does not, in and of itself, impair independence.⁴ However, members and their firms performing attest services for a client should comply with applicable independence standards, rules, and regulations issued by the AICPA, the state boards of accountancy, state CPA societies, and other regulatory agencies.

Effective Date

10. This Statement is effective for engagements accepted on or after January 1, 1992. Early application of the provisions of this Statement is permissible.

³ Rule 102-2 on Conflicts of Interest states, in part, the following:

"A conflict of interest may occur if a member performs a professional service for a client or employer and the member or his or her firm has a significant relationship with another person, entity, product, or service that could be viewed as impairing the member's objectivity. If this significant relationship is disclosed to and consent is obtained from such client, employer, or other appropriate parties, the rule shall not operate to prohibit the performance of the professional service . . ."

⁴ AICPA independence standards relate only to the performance of attestation services; objectivity standards apply to all services. See footnote 2.

APPENDIX 81/B

LAW FIRM OPERATIONAL ANALYSIS
AND PLANNING QUESTIONNAIRE

Purpose To help the law firm client and practitioner to identify opportunities for improving operations.

Client Instructions Please review the questions that follow and check the response to the right that best describes your interest in discussing it with your CPA. Comments may be included at the bottom or on the reverse side of each page.

A. Business Formation and Structure

	<i>Not a Concern</i>	<i>Need to Discuss</i>	<i>Priority</i>
1. What is the proper form of organization for your practice (e.g., professional corporation, Sub-S, proprietorship, or partnership)?	_____	_____	_____
2. How should your firm be managed? Do you need a managing executive or executive committee?	_____	_____	_____
3. Should the firm have a formal written mission statement? a business/strategic plan?	_____	_____	_____
4. Should ownership or partnership be offered to key performers? Is adequate information available to evaluate performance?	_____	_____	_____
5. Should the firm sponsor a retirement plan for its employees? Is a buy-sell agreement or withdrawal policy appropriate?	_____	_____	_____

Comments:

B. Internal Controls

	<u>Not a Concern</u>	<u>Need to Discuss</u>	<u>Priority</u>
1. Does the firm require written policies and procedures? a personnel manual?	_____	_____	_____
2. Do employees know their responsibilities and understand what is expected of them? Should position descriptions be developed?	_____	_____	_____
3. Does the firm adequately identify its business risks? Is exposure to litigation or malpractice claims managed and controlled?	_____	_____	_____
4. Are sufficient data compiled at least monthly to allow an ongoing operational performance evaluation? Are adequate statistics generated on accounts receivable and work-in-process aging? billable hours? cash collections? expense variances?	_____	_____	_____
5. Are the firm's financial activities adequately managed? Are client trust funds properly segregated and accounted for?	_____	_____	_____
6. Does the firm require a client engagement letter? Does this letter cover all appropriate engagement matters?	_____	_____	_____
7. Are client files managed and maintained properly?	_____	_____	_____
8. Are adequate procedures in place for conflict-of-interest screening?	_____	_____	_____
9. Is a system in place to monitor critical dates?	_____	_____	_____

Comments:

C. Revenue Enhancement

	<i><u>Not a Concern</u></i>	<i><u>Need to Discuss</u></i>	<i><u>Priority</u></i>
1. Should the firm develop new practice areas? Can current practice areas be exploited? How fast should the business expand? Have unprofitable practice efforts been identified?	_____	_____	_____
2. Does the firm have a pricing strategy? Are value-billing opportunities recognized?	_____	_____	_____
3. How can client payments be accelerated? Should late charges be assessed? Are delinquent accounts receiving sufficient attention?	_____	_____	_____
4. Is it appropriate to establish individual and firmwide performance targets? Should an incentive compensation plan be developed?	_____	_____	_____
5. Are revenues in line with peer-group medians?	_____	_____	_____
6. Are key producers devoting sufficient time to billable and client-development opportunities as opposed to administrative tasks?	_____	_____	_____

Comments:

D. Expense Controls and Cost Recovery

	<i><u>Not a Concern</u></i>	<i><u>Need to Discuss</u></i>	<i><u>Priority</u></i>
1. Are expenses and staffing ratios in line with peer-group medians?	_____	_____	_____
2. How can overhead costs be controlled and reduced? Should certain written procedures be developed?	_____	_____	_____
3. Is the firm organized appropriately to minimize income taxes?	_____	_____	_____
4. Are salaries, wages, and draws reasonable?	_____	_____	_____
5. Are employees' compensation and benefits reviewed at least annually?	_____	_____	_____
6. Are leasehold and equipment lease terms in line with business needs and industry standards?	_____	_____	_____
7. What employee benefits should the firm offer? How should the costs of such benefits be shared? Do your employees realize the value of the benefits they receive?	_____	_____	_____
8. What costs can be passed on to clients? How are the appropriate elements of such costs captured and quantified?	_____	_____	_____
9. What is the cost/benefit of using an outside consultant?	_____	_____	_____

Comments:

E. Management Information

	<i><u>Not a Concern</u></i>	<i><u>Need to Discuss</u></i>	<i><u>Priority</u></i>
1. What type of financial and operating reports are most useful in evaluating performance?	_____	_____	_____
2. Can the firm benefit from financial projections and models to plan its future direction?	_____	_____	_____
3. How does the financial performance compare with that of other law firms?	_____	_____	_____
4. Have the most (and the least) profitable practice areas been identified?	_____	_____	_____
5. Does the firm have adequate computer and word-processing capabilities?	_____	_____	_____

Comments:

F. Marketing

	<i><u>Not a Concern</u></i>	<i><u>Need to Discuss</u></i>	<i><u>Priority</u></i>
1. Does the firm participate in the appropriate professional and trade associations? Are referral sources identified and exploited?	_____	_____	_____
2. Does the current office location make sense?	_____	_____	_____
3. Does the firm have individual, practice-area, and firmwide client development goals? Are such goals properly articulated and monitored?	_____	_____	_____

Comments:

APPENDIX 81/C

**SELECTED SOURCES OF LAW
PRACTICE INFORMATION**

Many sources of information are available to help the CPA practitioner to provide services to law firms. They include the following associations and publications.

Associations

American Bar Association (ABA)
750 North Lake Shore Drive
Chicago, IL 60611
(312) 988-5000

The ABA's Economics of Law Practice section consists of various management and technical-support committees and groups. The Legal Technology Advisory Council provides detailed and summary reviews of software for the legal industry.

In addition to the ABA, many state and local bar associations maintain management support staff and resources.

Association of Legal Administrators (ALA)
175 East Hawthorn Parkway, Suite 325
Vernon Hills, IL 60061-1428
(708) 816-1212

The ALA has sections dedicated to management and administration, marketing management, and systems and technology. Each section publishes a quarterly newsletter. Local area chapters are typically well represented by individuals involved in law firm administration, with active involvement in many areas of personnel, systems, and financial management. Local chapter surveys often address compensation and benefits for non-attorney staff; billing practices, such as average charges for photocopies and word processing; and vendor usage.

American Arbitration Association (AAA)
140 West Fifty-First Street
New York, NY 10020
(212) 484-4000

American Corporate Counsel Association (ACCA)
1225 Connecticut Avenue Northwest, Suite 302
Washington, DC 20036
(202) 296-4522

Publications

Books

American Bar Association. *Compensation Plans for Lawyers and Their Staffs: Salaries, Bonuses, and Profit Sharing*. Chicago: ABA, 1986.

Altman, Mary Ann, and Robert I. Weil. *How to Manage Your Law Office*. Albany, N.Y.: Matthew Bender, 1973.

Arndt, Robert J. *Identifying Profits (or Losses) in the Law Firm*. Chicago: American Bar Association, 1988.

_____. *Managing for Profit*. Chicago: American Bar Association, 1991.

_____. *A Model Chart of Accounts*. Chicago: American Bar Association, 1990.

Arndt, Robert J., and James F. Rabenhorst. *Cost Accounting for Law Firms*. Chicago: American Bar Association, 1984.

Burke, William J., and Carl W. Bradbury. *Accounting Systems for Law Offices*. New York: Matthew Bender and Company Inc., 1978 (periodic supplements).

Giuliani, Peter A., and Duane E. Watts. *Financial Management of Law Firms*. Chicago: American Bar Association, 1979.

_____. *Management Controls and Reporting*. Chicago: American Bar Association, 1979.

Henning, Joel. *Maximizing Law Firm Profitability*. New York: Law Journal Seminars-Press, 1991.

Hillebrandt, Brandford W., and Jack Kaufman. *The Successful Law Firm: New Approaches to Structure and Management*. San Diego: Harcourt Brace Jovanovich, 1984.

Hillman, Robert W. *Law Firm Breakups—The Law and Ethics of Grabbing and Leaving*. Boston: Little, Brown and Company, 1990.

Indiana Continuing Legal Education Forum. *Managing the Small and Medium-Sized Law Firm*. Indianapolis: Indiana Association of Legal Administrators, 1988.

Legal Procedures, Inc. *Relative Values: Determining Attorneys' Fees*. New York: McGraw-Hill, 1990.

Quinn, John. *Law Firm Accounting*. New York: Law Journal Seminars-Press, 1986 (periodic supplements).

Streby, John A. *Let's Talk Money—A Lawyer's Guide to Setting and Collecting Fees*. Wilmette, IL: Callaghan & Co., 1987.

Periodicals

ALA News. A bimonthly newsletter published by the American Association of Legal Administrators, 175 East Hawthorn Parkway, Suite 325, Vernon Hills, IL 60061-1428.

The American Lawyer. A monthly journal published by American Lawyer Media, 600 Third Avenue, New York, NY 10016

Law Office Economics & Management. A quarterly journal published by Callaghan & Company, 155 Pfingsten Road, Deerfield, IL 60015.

Law Office Management and Administration Report. A monthly newsletter published monthly by the Institute for Office Management and Administration, Inc., Five West Thirty-Sixth Street, New York, NY 10018.

Law Practice Management. A journal published eight times a year by the Economics of Law Practice section of the ABA.

Legal Management: The Journal of the Association of Legal Administrators. A bimonthly journal published by the Association of Legal Administrators, 175 East Hawthorn Parkway, Suite 325, Vernon Hills, IL 60061-1428.

Legal Tech. A newsletter published monthly by Leader Publications-New York Law Publishing Company, 111 Eighth Avenue, New York, NY 10011.

Marketing for Lawyers. A newsletter published monthly by Leader Publications-New York Law Publishing Company, 111 Eighth Avenue, New York, NY 10011.

National Law Journal. A weekly trade newspaper published by Leader Publications-New York Law Publishing Company, 111 Eighth Avenue, New York, NY 10011.

Surveys

Annual Law Department Spending Survey. Bethesda, Md.: Price Waterhouse.

Annual Law Firm Compensation Survey. Bethesda, Md.: Price Waterhouse.

Annual Law Firm Statistical Survey. Bethesda, Md.: Price Waterhouse.

Compensation Survey. Vernon Hills, Ill.: Association of Legal Administrators.

Law Department Annual Salary Survey. Ardmore, Pa.: Altman Weil Pensa Publications Incorporated.

Survey of Law Firm Economics. Ardmore, Pa.: Altman Weil Pensa Publications Incorporated.

In addition, many state and local bar associations and ALA chapters publish surveys that may be useful to CPA practitioners. Various compensation surveys are also published by the Committee on Continuing Professional Education of the American Law Institute, 4025 Chestnut Street, Philadelphia, PA 19104.

AICPA Consulting Services Practice Aids

The following Consulting Services Practice Aids, which address specific issues common to law firms, will be helpful to CPA practitioners.

Small Business Consulting Practice Aids

- No. 9 *Diagnosing Management Information Problems*
- No. 10 *Developing a Budget*
- No. 14 *Assisting Professional Clients in Pricing Services Using Budgeting Techniques*
- No. 92-2 *Developing and Improving Clients' Recruitment, Selection, and Orientation Programs*

Technical Consulting Practice Aids

- No. 1 *EDP Engagement: Systems Planning and General Design*
- No. 2 *Financial Model Preparation*
- No. 4 *EDP Engagement: Software Package Evaluation and Selection*
- No. 6 *Assisting Clients in the Selection and Implementation of Dedicated Word Processing Systems*
- No. 7 *Litigation Services*
- No. 8 *Mergers, Acquisitions, and Sales*
- No. 10 *EDP Engagement: Implementation of Data Processing Systems Using Mainframes or Minicomputers*
- No. 11 *Conversion to a Microcomputer-Based Accounting System*
- No. 12 *Assisting Clients in Developing an Employee Handbook*

Practice Administration Aids

No. 3 *Written Communication of Results in MAS Engagements*

No. 5 *Communicating With Clients About MAS Engagement Understandings*

GLOSSARY

alternative dispute resolution (ADR) A process of resolving civil disputes through means other than the judicial system, such as through the services of the American Arbitration Association.

brief bank A collection of routinely used forms or documents.

client costs Costs advanced by a law firm on behalf of clients and billed to the client for reimbursement. They include soft costs, such as in-house photocopying and long-distance telephone charges.

conflict of interest A situation in which an attorney represents both parties in a dispute.

docket-calendar system A system to remind attorneys of upcoming critical dates.

Lexis A third-party legal research database accessed by remote computer terminals via telephone modem.

pro bono Legal work performed without compensation for the good of the community.

rainmaker An attorney skilled in attracting new clients to the law firm.

transactional A term referring to matters and cases that a law firm handles on an occasional basis as opposed to providing continuous services for a client.

Westlaw See **Lexis**.

READER'S RESPONSES TO LAW FIRMS

Your assessment of this practice aid will help to ensure that future publications of the Management Consulting Services Division will be valuable to practitioners. Please photocopy this questionnaire and complete and mail or fax it to **Editor/Coordinator, Management Consulting Services Division, AICPA, 1211 Avenue of the Americas, New York, New York, 10036-8775**, facsimile number (212) 575-3846.

Thank you for your assistance.

1. How familiar were you with this subject before you read this practice aid?
0 1 2 3 4 5
Unfamiliar Somewhat familiar My area of expertise

2. How useful is the practice aid to your practice?
0 1 2 3 4 5
Not useful at all Extremely useful

3. Is the level of detail sufficient for this practice aid? Yes ____ No ____

If no, please explain _____

4. Is there additional information that you think should have been included or information that should be modified in this practice aid? Yes ____ No ____

If yes, please explain _____

5. Do you think that an advanced level practice aid on this subject should be available?
Yes ____ No ____

6. Are you a member of the AICPA's Management Consulting Services Division?
Yes ____ No ____

If no, would you like information about becoming a member? Yes ____ No ____

If no, how did you learn about the availability of this practice aid? _____

7. What other subjects would you like to see covered in Consulting Services Practice Aids?

Additional comments and suggestions _____

Name and Address _____

CONSULTING SERVICES PRACTICE AIDS

<i>Title</i>	<i>Product Number</i>
Small Business Consulting Practice Aids Series	
<i>Assisting Small Business Clients in Obtaining Funds</i>	055018
<i>Identifying Client Problems: A Diagnostic Review Technique</i>	055253
<i>Assisting Clients in Maximizing Profits: A Diagnostic Approach</i>	055268
<i>Effective Inventory Management for Small Manufacturing Clients</i>	055272
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<i>Cash Management</i>	055342
<i>Evaluating and Starting a New Business</i>	055357
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<i>Assisting Professional Clients in Pricing Services Using Budgeting Techniques</i>	055376
<i>Developing Management Incentive Programs</i>	055377
<i>Improving Organizational Structure</i>	055378
<i>Developing and Improving Clients' Recruitment, Selection, and Orientation Programs</i>	055133
<i>Assisting Closely Held Businesses to Plan for Succession</i>	055134
Technical Consulting Practice Aids Series	
<i>EDP Engagement: Systems Planning and General Design</i>	055022
<i>Financial Model Preparation</i>	055037
<i>Financial Ratio Analysis</i>	055041
<i>EDP Engagement: Software Package Evaluation and Selection</i>	055056
<i>EDP Engagement: Assisting Clients in Software Contract Negotiations</i>	055060
<i>Assisting Clients in the Selection and Implementation of Dedicated Word Processing Systems</i>	055075
<i>Litigation Services</i>	055080
<i>Mergers, Acquisitions, and Sales</i>	055094
<i>Improving Productivity Through Work Measurement: A Cooperative Approach</i>	055107
<i>EDP Engagement: Implementation of Data Processing Systems Using Mainframes or Minicomputers</i>	055111
<i>Conversion to a Microcomputer-Based Accounting System</i>	055126
<i>Assisting Clients in Developing an Employee Handbook</i>	055127
<i>Microcomputer Security</i>	055128
<i>Microcomputer Training</i>	055129
<i>Disaster Recovery Planning</i>	055130

(continued)

Practice Administration Aids Series

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<i>Cooperative Engagements and Referrals</i>	055906
<i>Written Communication of Results in MAS Engagements</i>	055910
<i>Starting and Developing an MAS Practice</i>	055925
<i>Communicating With Clients About MAS Engagement Understandings</i>	055930
<i>Human Resources Planning and Management for an MAS Practice</i>	055131

Industry Consulting Practice Aids Series

<i>Restaurants and Food-Service Establishments</i>	055132
<i>Law Firms</i>	055135

To obtain any of these practice aids, call the AICPA Order Department: 1-800-334-6961 (USA) or 1-800-248-0445 (NY).

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