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**LAW OFFICE ACCOUNTING
PROCEDURES AND
INTERNAL CONTROLS,**

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Kay Lyons once said: "Yesterday is a canceled check; tomorrow is a promissory note; today is ready cash—*use it!*" It is with such a philosophy that we approach today's accounting systems in general.

From a financial-accounting viewpoint, a law office is in most respects no different from any other business organization except that it relies totally upon professional services rendered for the production of its income. Conceptually, therefore, while a financial-accounting system is generally designed for accurate and current financial information, as well as the necessary checks and balances to minimize the possibility of fraud or embezzlement, it is imperative that we concentrate on accounting for service hours rendered and expenses incurred.

Achieving the ultimate objectives of an integrated system requires the full cooperation and understanding of the partners, staff and secretaries. This in itself is no insignificant accomplishment, considering the individual personalities and practices of the various partners of any law firm, and particularly when a firm is considering a substantial change in its procedures.

The following discussion makes no attempt to distinguish between manual and computerized systems. The basic principles are applicable to either.

INTERNAL CONTROL

The system should provide for a separation of duties so that, for example, persons who handle receipts, whether cash or checks, are not responsible for controlling records of client receivables, the general ledger, bank reconciliations or combinations thereof. Checks received should be endorsed and deposited promptly with cash received intact.

Invoices should be approved by the appropriate partner prior to disbursement, and persons responsible for preparing checks should not have access to receipts nor should they perform the bank reconciliation. The bank reconciliation itself should be reviewed by a partner responsible for administration. Credit memos canceling statements rendered should require approval of another partner.

Some of these comments may seem quite basic. However, the well-publicized fraud perpetrated upon the New York law firm of Simpson, Thacher & Bartlett shows what can happen when the basic accounting system does not provide for such checks and balances and division of duties, so that one person has complete control over an entire transaction.

A firm should assign the responsibilities for administrative matters to one partner, who need not be the managing partner. Most medium-size law firms would do well to consider employing an office manager/accountant for supervision of internal financial accounting. He could process the less-significant and more-detailed items that would otherwise require interrupting a partner.

BASIC ELEMENTS OF THE SYSTEM

For each new matter received in the office a "new matter report" or "engagement memorandum" should be prepared. This should provide adequate client and engagement information, any special fee or billing procedures and such information as source of the engagement, lawyers to be assigned and any special instructions.

Control of many engagements for the same client, as well as for many different clients, is facilitated by assigning an alphanumeric code to each client and adding an engagement number as a suffix. A number should also be assigned to each of the firm's personnel.

To provide effectively for comparative financial information it is essential to establish a chart of accounts, particularly for expenses so that there will be clear definitions and consistent application of expenditure classifications for future statistical analysis. Similarly, it is possible to code the income from engagements to facilitate measurement of income from various classes of work performed, such as real estate, domestic relations, corporate and criminal.

Measurement of net income can be improved by abandoning the standard calendar month as a basis for the reporting system. Most firms pay their employees on a weekly or biweekly basis, and each month has a different number of days and paydays so that typical "cash-basis" accounting is distorted depending upon how many payrolls fall within a given month. Also, depending upon how many business days there are, income may be distorted because of variations in bank deposits. Consideration should be given to using thirteen four-week periods for the accounting system or, alternatively, adopting quarterly reporting of financial information. Either of these

methods will give more reliable comparative information for evaluating the firm's progress.

The heart of any accounting system for a professional office lies in the performance of services. The most effective way of measuring such performance, whether for architects, accountants or lawyers, is in terms of service hours. Too often there is inadequate consideration of the number of productive service hours being generated and whether the appropriate amount of time is being expended on administrative matters or in professional development. To control the use of time effectively it is important that the firm establish a standard number of hours to be accounted for each work week, such as thirty-five or forty, and that all members of the firm, partners and staff alike, report on how these hours are spent, whether on a per-service basis (e.g., on real-estate matters) or on an hourly basis. Similarly, standard hours should be established for secretarial and other clerical personnel in order to evaluate performance completely.

Most accounting systems in professional offices use the "cash basis," i.e., the basis adopted for tax purposes. However, because of various kinds of time lags from the period of work performance through billing to eventual payment, effective measurement of results for a year or any given period of time can best be accomplished through accrual-basis accounting, which can be established in "memorandum" form in parallel with the cash-basis system. Only the accrual basis can properly account for work in process unbilled or recognize unrealized receivables when determining the firm's net worth, which is necessary to deal with such matters as changes in interests of partners.

To complete the cycle of basic information we must now establish standards for the primary elements of input to the system. The most important is the establishment of standard rates per hour for partners, professional staff, secretarial and other clerical personnel. Most firms establish the rate on the basis of a multiple of the figure derived by dividing the individual's annual salary or fixed compensation by the expected number of direct productive hours during a year. Typical multiples are $2\frac{1}{2}$ and 3. For example, assuming a 40-hour standard work week and providing for annual vacations of two weeks, eight paid holidays, nine average days of illness and/or some form of time off and ten days of nonproductive time spent at conferences, seminars, staff training and the like leaves 1,784 hours of productive time per year. Dividing a staff lawyer's annual salary of \$18,000 by 1,784 hours results in a direct cost of \$10.09 per hour. Using a multiple of 3 gives a standard hourly rate of \$30. Similarly, applying the formula to a

secretary whose annual compensation is \$7,000 results in a billing rate of \$12 per hour.

Indirect expenses, such as telephone, travel and reproduction costs, are often absorbed by the firm's overhead rather than charged to client matters. The accounting system should provide for accumulation of such expenditures and their allocation directly to clients so that they can be considered in billing. We should not expect to realize every penny so expended, since the accounting system and net income would be overburdened by the cost of recordkeeping. However, we should expect to realize at least 75 to 80 percent of such costs through the basic system. The easiest way to do this is to establish a lower limit above which the client will be charged—e.g., a minimum number of pages reproduced or actual telephone charges incurred in excess of one dollar.

USING THE SYSTEM

Some or all of the elements we have discussed are available in most law-office systems, but little use is made of the composite results. The system should be the basis for providing management reports, that is, the necessary tool for managing, directing and, it is to be hoped, controlling the profitability of the firm. From such reports the firm should be able to evaluate its effectiveness and control costs and client funds.

The standard accounts-receivable data can, of course, be developed to facilitate collection through aging of receivables billed and unbilled. However, this same bank of raw data could also help in developing listings of "inactive" matters where no time charges or disbursements appear and yet, perhaps, where the client is expecting service long overdue. Also, such data might provide a list of clients for whom no material amounts have been billed in over a year and who, therefore, should perhaps be contacted.

By summarizing most of the statistical data generated from such a system the firm can develop average hourly rates by class of personnel or types of engagements, as well as average hourly costs for indirect expenses and salaried personnel. By comparing these statistical rates for the current year or period with those of the corresponding prior period it should be possible to determine more accurately the direction in which the firm is heading before year-end results are available. This should result in more timely analysis, giving the opportunity to make management decisions, such as changing billing rates and curtailing or adding staff.

The information provided by a well-designed accounting system has other important uses, such as the determination of marginal or unprofitable clients.

There are times when a firm appears to have realized a few hundred dollars from a few hours of work, but it subsequently develops that several hours of secretarial time were consumed in the process and a significant amount of telephone, travel or reproduction expenses were incurred, so that the result is a billing significantly lower than standard.

Another common use of such information that is of vital interest is in the ultimate determination of compensation for staff and/or partners. If the system is adequately designed and controlled and the information is effectively reported, the firm should be able to measure gross earnings and profits attributable to each partner or staff person and thus determine any imbalances by individuals or by clients.

FILING SYSTEM

Any completely integrated system must provide for uniform procedures for filing completed matters and work in process. The alphanumeric client-identification system discussed above makes this possible. Consideration should be given to coding methods, such as use of color codes, that automatically age files for subsequent housekeeping and transfer to storage. Files should be purged periodically of all outdated completed matters.

CONCLUSION

It is often said that an attorney spends fees earned four times: when he takes on the new client, when he does the work, when he bills for the job done and when he collects the fee. With a system containing much of what we have covered here, a law office should be able to improve billing and collection performance and evaluation of results, thus spending the fee a fifth time. ●