

Legal Management Services, Inc.

Helping attorneys create financial independence

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Law Office Economics – Apply your Discovery Skills to Finances

By: Jerry Schwartz, President of Legal Management Services, Inc.

A. THE BALANCE SHEET....

Almost every law office generates manual financial reports, prepares computerized financial reports or pays an accountant to prepare the financial statements. The Profit and loss statement which reflects the results of operations for the period is scrutinized in every law office. Everyone wants to know the gross revenue and the overhead percentage. The Balance Sheet, if prepared, hardly gets any notice. Many law firms have their bookkeeper or accountant prepare the report only at year end. It is a standard report of all business organizations, but is the most under utilized report in law offices. The Balance Sheet or Statement of Financial Position is defined as a financial report showing the assets, liabilities and equity of an enterprise on a specific date. This statement shows the net worth of the law office and should be reviewed on a monthly basis. It is hard to understand why lawyers do not review the assets, liabilities and equity of the business.

What is included in the various categories? What should the lawyer look for on the Balance Sheet? How should the Balance Sheet be reviewed? A few minutes each month will bring peace of mind to the reviewer if a few basic analyses are completed each month.

The first section of the Balance Sheet is the asset section. It includes everything that is owned by the law office and normally the first group of assets is the cash accounts which might include an operating account, a money market (investment) account, a payroll account and the law office trust accounts. The Balance Sheet reviewer should compare the cash balances to the bank

reconciliations and cash report balances to insure that the accounts are in balance with the statement received from the bank.

The trust cash balances must also be equal to the trust liability account which appears in the liability section of the Balance Sheet. This practice also promotes good internal control by having a more than one person review the cash transactions of the office.

The section following the cash accounts is normally the various accounts receivable accounts, which may consist of receivables from employees and from costs advanced to clients both billed and unbilled. The reviewer should compare the balances in the accounts to a list of employees and list of clients on an accounts receivable listing for the billed costs advanced and a list of clients on a work in process listing for the unbilled costs advanced. The total of the employee and the client lists must be equal to the balance of the various accounts receivable accounts on the Balance Sheet.

The remaining accounts in the asset section are usually leasehold improvement and related amortization accounts and fixed asset and related accumulated depreciation accounts. Normally these accounts do not frequently vary from month to month. The amounts should be compared against a depreciation schedule to insure that all new asset acquisitions are recorded for tax purposes. The fixed asset section of the Balance Sheet will show the book value of the assets the law office uses to earn income. The next section of the Balance Sheet is the liability section. A liability is a claim that another party has in the assets of the law office or simply stated, an amount that is owed. The accounts should include notes payable for equipment and furniture or a mortgage payable on the building if owned by the sole practitioner or partners. Copies of the notes should be placed in a file for the reviewer to examine during the Balance Sheet review. Other liabilities will include payroll tax payable and pension and profit sharing plan payable which can be verified by examining the latest payroll records. All balances should be reviewed for reasonableness. The trust liability account should have an opposite but equal balance with the trust checking account. A list of client trust balances should be verified to ensure that the list balances with the liability and trust checking account balances.

The last section of the Balance Sheet is the equity section. This section shows the claim on assets of the sole practitioner or the partners of the law office and the owner draws unless the law office operates as a corporation. Because net income increases your equity in the law office, it is shown as current income in the equity section of the law office Balance Sheet. The Balance Sheet is directly related to the Profit and Loss Statement and should be prepared and reviewed on a regular basis. To be fully informed on the financial progress of the law office adopts the monthly review of this very important financial statement.

B. THE PROFIT AND LOSS STATEMENT...

Most individuals are aware that there are a few financial reports that are routinely prepared by individuals and businesses. One of the financial reports is the profit and loss statement also referred to as the income statement or the statement of operations. If they have not prepared a profit and loss statement during their lives, one was prepared for them at one time or another either by an accountant at tax time or by their banker at the time of a loan transaction. The banker can prepare an income profile, sufficient to make some credit decisions, for an individual by asking questions about income and expense and by reviewing credit bureau reports.

Lawyers at one time or another are asked to provide the bank or leasing company with a personal financial statement and a business financial statement to obtain fixed asset or other financing. These reports for external use need only have the total of all individual income and expenses with a net result for a period of time. Unfortunately these same profit and loss statements are used for analysis of the business side of the practice and they leave much to be desired for adequate analysis.

For analysis purposes the following suggestions for presentation will produce a profit and loss statement that will give more information to the lawyer:

1. **INCOME** should be for the business side of the law firm only and should include income from professional fees separate from income received from client recovery of disbursements and interest. Professional fees broken down by category of work is ideal, however, a separate report with a breakdown of this information is sufficient.

All other income not related to the practice of law should be included in a section at the bottom of the profit and loss statement called Other Income and Expense. It is important that the lawyer know the income generated from professional fees.

2. **EXPENSES** should be categorized to provide the lawyer with specific information about the cost of operations and should include all expenses associated with the category of expense.

Associate Compensation: Should include salary, payroll taxes, group insurance - health and disability, profit sharing, pension contributions and any other benefits such as parking, dues, etc.

Paralegal Compensation: Should include salary, payroll taxes, group insurance - health and disability, profit sharing, pension contributions and any other benefit such as parking, dues, etc.

Support Staff Compensation: Should include salary, payroll taxes, group insurance - health and disability, profit sharing, pension contributions and any other benefit such as parking, dues, etc.

Other Employee Costs: Should include unemployment taxes, casual labor, personnel agency fees, classified want ads and worker's compensation premiums.

Occupancy: Should include rent, amortization and maintenance of leasehold improvements, utilities, cleaning and outside maintenance.

Equipment: Should include lease and maintenance of equipment and depreciation on equipment owned by the firm.

Library: Should include the cost of books, subscriptions, computer research and the depreciation on books that are capitalized.

Professional Liability Insurance: Should include the premium for errors and omissions insurance.

Professional Expenses: Should include association dues, professional meetings and seminars, continuing legal education and business development.

Other Expenses: Should include all expenses not mentioned above such as coffee, soft drinks, office

supplies, insurance, professional services, telephone, travel and client reimbursement of disbursements.

All too often the expenses of the law office are listed in alphabetical order or some manner unrelated to a meaningful presentation and analysis. By preparing the profit and loss statement by category, the owners can focus attention and provide control over categories of law office expenses.

C. SEPARATE ACCOUNTS...

The firm should establish business cash accounts for the operation of the law office and personal charges of the owners should be paid from their personal checking accounts. Any charges paid by the firm should be charged to an owner draw or receivable account.

The cash accounts which are common in law offices include:

1. Operating account – used for all law firm deposits and payments of both firm and client expenses
2. Money market (investment) account – used for short term excess funds
3. Payroll account – used for clearing of payroll deposits and payroll checks and charges – should be an imprest account funded for each payroll
4. Trust or escrow accounts. The law firm should open an interest or dividend bearing IOLTA trust account for client funds. Unless an amount is quite large or is to be held for a long period of time it should be deposited in a general IOLTA trust account. Large amounts or amounts to be held for an extended period can be placed in interest bearing trust accounts for the benefit of a particular client. The lawyer or law firm is not allowed to benefit from the earnings on the IOLTA account.

Know and follow Rules of Professional Conduct when handling trust accounts.

The trust account should appear on the balance sheet as a cash account with a corresponding liability account and reconcile to a list of clients with balances.

D. AUDITING PRACTICES...

With the exception of large firms and year end reviews for preparation of tax returns, I am not aware of regular independent audits of law offices. One procedure that is helpful to a law office is to have their CPA periodically perform an internal control audit to ensure the division of duties to protect against embezzlement. It should be noted that the main embezzlement problem occurs from loss of trust funds wrongly appropriated by lawyers.

E. BUSINESS GOAL SETTING...

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Vision

To create vision, you must develop a mission statement:

What kind of person will you be? (Character, Spiritually)

What kind of spouse, parent, or friend will you be?

What kind of professional will you be?

What will be your community or church involvement?

Other?

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Goal Setting

You should create a future for yourself. It is amazing what can happen when goals are set. There is tremendous power in setting goals and committing to them.

You should work on three types of goals:

1. Personal development (spiritual, physical body, etc.)
2. Material
3. Economic

1. Personal Development

Who would you like to become?

What would you like to create?

What abilities and skills would you like?

Put down anything you would like to do or be in the next 20 years.

Personal Development Goals

Now go through each goal and put a time line of when you want to accomplish it by:

E.g., 1,3,5,10,20 years

2. Material Goals

What do you want to have? Things are a part of life. Put down anything you would like to have in the next 20 years.

Now select the top three that you would like to accomplish in the next year.

3. Economic Goals

What do you want to earn each year? What do you want your net worth to be? Do you have some investment goals? Put down anything that is related to money. What do you want in savings? What real estate holdings do you want? What retirement plan do you want? Where do you want to be at different ages of your life, financially?

Go through the financial goals and number them as you want to achieve them.

Now write the top three financial goals for one year.

F. FIRM FINANCES - BUDGETING...

Many articles and books have been written on law firm financial management over the last twenty years and each of them basically has told us that the responsibility of management in the financial area is in planning and control. Noted accounting authors Philip E. Fess and Carl S.

Warren define the two terms as follows: Planning is the process of selecting realistically attainable business objectives and formulating the general policies and the specific directions needed to achieve the objectives. Control includes the procedures designed to assure that actual operations conform to management's plans. The budgeting process is an integral part of planning and control. On the planning side it provides for the establishment of financial goals and on the control side it provides for the comparison to actual results.

There are three major components to a law office budget: Fee and Other Income; Expenses; and Net Income. Most law offices make light of the budgeting process, because they say it is difficult or impossible to budget for fee income. However, it is a figure in the budget which can be arrived at through process of elimination and then tested for reasonableness.

The budget process can start from the bottom up by having each owner submit a plan to reach a satisfactory level of personal compensation within the firm's compensation plan. This forces some personal planning on the part of the owners and helps to adjust the expectations of the firm's income generation capacity. The next step is to review the expenses of the office and make projections for the next year based on the information at hand. Once the amounts from the personal plans and the expenses are compiled, an amount of Fee and Other Income needed to provide for the two components can be determined. The reasonableness of the Fee and Other Income needed to support the personal plans and expenses can then be tested. Billing rates, billable hours, realization rates, other cash requirements and non-cash expenses can be analyzed to determine if the Fee and Other Income budget is reasonable. If the Fee and Other Income component is reasonable, all three components, the budget, are in place for proper financial planning and control for the next fiscal year.

Budgeting is like a good wine or aged cheese, it improves with age. Initial budgets are generally weak; however, they do improve each year. The time to begin the process is now, so the plan is in place before the year begins, so control of the law office finances can begin from day one of the new fiscal year. Effective planning and control are requisites of successful operations.

For many firms, compensation issues are some of the most difficult issues to deal with in

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a law firm. The difficulty is not entirely a law firm issue. Many of the problems stem from an unrealistic expectation of the amount of distributable income that the firm can generate to pay the partners. The best place for a law office to start when considering the adoption of a new compensation system is to ask the partners to do some soul searching regarding their expectations for income from the firm. Have the partners purchased houses or land that requires high mortgage and maintenance payments? Do the partners have second houses in the country or at the beach? Have the partners leased or purchased vehicles that have high monthly payments? Do the partner, partner's spouse and children spend freely on credit cards with no control? Are the partner's children enrolled at the most prestigious schools? Do the partners personally travel frequently? These expenditures are not bad but they contribute to the pressure of the partners to expect a higher distributable income from the firm than it may be able to generate.

In order to become realistic about distributable income, the individual partners should prepare a personal financial plan or a budget to determine their needs. This plan should not be discussed with fellow partners because it is not their concern, but it does establish a benchmark for the individual partners when they begin the process of developing a new compensation system. It can determine that the problem with compensation is not a firm problem but a problem of the individual.

Once the partner's expectations are determined and providing that the law office is profitable, each group of lawyers must face the task of determining how to distribute the profits. This can be a very simple or a very complicated procedure and probably should fall somewhere between. One of the main criteria of the profit distribution system should be to strengthen the partnership. A partner is defined by Webster's New World Dictionary as 1: one of two or more persons in the same business enterprise, sharing its profits and risks and 2: a player on the same

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side or team. Lawyers that fail to give any weight to the second definition are creating problems for themselves and the law office. Many compensation systems are designed to compensate lawyers solely on a formula basis. Some of the formulas are as follows:

- Equal: Each partner receives an equal share of profits and losses.
- Ownership: Each partner receives the same portion of profits and losses as the ownership percentage.
- Production and Origination: Each partner receives a percentage of profits and losses based on an average of lawyer's percent of production and origination as compared to the total law office production and origination.
- Fees to Gross: Each partner receives a percentage of profits and losses based on the percent of the lawyer's fees to gross fees.
- Production less Expenses: Each partner receives an amount of profit and loss equal to the lawyer's production less the expenses of the law office distributed equally or in some other proportion.
- Seniority: Profits and losses are distributed based on firm longevity.

Formula systems do accomplish the goal of distributing profits and losses; however, they do not encourage the development of partnership as a team. The following are problems of using formula systems:

- They do not properly value the individual strengths that each partner brings to the partnership.
- They focus the partner on individual compensation and not on the good of the firm.
- They do not recognize the value of management, training or compatibility.
- They do not promote sharing of work or cross selling of services to clients.
- They tend to invite manipulation of the compensation system.

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The following criteria are important to the law office as a partnership and should be considered in any compensation system. Different weights may be given to the various criteria, but all should be considered.

- Production and Profitability of Work - Lawyers have an obligation to the firm to accept profitable work for the firm. The decision to do "pro-bono" work should be made by the partnership and not the client. Lawyers should also be paid based on the collections produced from their work product.
- Asset Management - Lawyers should manage the work in process and bill the client when appropriate. Proper follow up should be accomplished to ensure collection of the accounts receivable.
- Client Origination and Client Retention - Lawyers must develop business and maintain their client base if they are to be successful.
- Management and Training - Lawyers that have the ability to manage and train should be compensated for the time they spend on firm management and training which would have been spent on client matters.
- Risk and Investment - Lawyers that have a contributed capital balance should be compensated for their investment in the firm and the founding partners should be given consideration for the sacrifices made in the start-up of the firm.
- Technical Contributions - Lawyers with special skills and talents should be recognized.
- Outside Activities - Lawyers that spend time working in professional and community activities to further the name of the law office should be credited for the time which could have otherwise been devoted to client matters.
- Compatibility - Lawyers that contribute to a smooth running office should be recognized for their cooperation and the good working atmosphere they help to create.

- Delegation - Lawyers that transfer work to the highest level of competency and those that complete the delegated task should be properly compensated.
- Seniority - The wisdom that only comes with experience should be acknowledged in the compensation system.

These are many of the criteria that should be reviewed as contributing to the overall success of the law office. The main idea should be to give credit to the strengths people bring to this association. Some lawyers will take the opportunity to use the subjective criteria as a means to discipline their partners. Discipline should take place at a meeting of the managing partner and the individual not at the time of determining compensation. This process requires an open and fair mind and should be a method to encourage and compensate the strengths of the people we call "PARTNER".

As a first step in the development of a new compensation system, I will ask the partners to rank each of the above criteria. I average the responses to see what criteria ranks the most important to the partners and build a compensation system around the areas of importance to the firm. I add salary and/or interest on capital balances as an additional component and hold out five to ten percent of distributable income for the partners to make subjective judgments for distribution of those funds set aside for that purpose. Pocketbook issues are difficult issues to decide, however, if all keep an open mind it can be a method to build the partnership.