

**I. FINANCIAL MANAGEMENT (30%)**

**A. GENERAL ACCOUNTING (16%)**

**Financial Accounting Standards Board (FASB)**

**Generally Accepted Accounting Principles (GAAP)** - overall intent is establishment of uniform methods and vocabulary and full disclosure in financial reports. **GAAP** is traditionally accrual basis accounting.

\*Law firm accounting does not follow GAAP but is usually on a **modified cash basis**. Modified cash basis recognizes some accrued transactions:

- Client Disbursements Receivable
- Capitalization and depreciation of property and equipment
- Prepaid insurance premiums
- Loans payable
- Accrual of profit sharing contribution

**Type of Financial Statements**

- Statement of Net Assets (Balance Sheet)
- Statement of Revenue and Expenses (Income Statement)
- Cash Flow Statement
- Changes in Owners' Equity (Retained Earnings)

Statement of Net Assets

- |                |   |
|----------------|---|
| Current Assets | cash and other resources which can be converted to cash within current accounting period (one year)<br>Fees receivable and unbilled fees (accrual basis only)<br>Cash and short-term investments<br>Prepaid expenses<br>Client disbursements receivable<br>Property and equipment |
| Fixed Assets   | long-term assets subject to depreciation. Land is a fixed asset that does not decrease in value and is not depreciated  |
| Other Assets   | deposits, patents, trademarks and goodwill  |

### Statement of Revenue and Expenses

Revenue (Fees and commissions)  
Operating expenses (salaries, payroll taxes, rent, insurance, depreciation)  
Operating profit  
Other income  
Other expenses (interest)  
Net income/loss

### Cash Flow Statement

### Changes in Owners' Equity aka Partners' Capital Statement

### Business Entities

Sole proprietorship	single owner, Schedule C and SE tax return. Unlimited personal liability
Partnership	partners are jointly and severally liable for debts and legal liabilities. Also personally liable for negligence or potential malpractice of all partners. <b>A new partner's liability is from the date he/she becomes a partner.</b>
Limited Liability Partnership (LLP)	
Limited Liability Company (LLC)	treated like partnership for income tax purposes. Limited personal liability of company debts and legal liabilities to equity owners
*Professional Corporation (PC)	can be single or group of shareholders. Shareholders receive salary like employees. Some states call a PC a PA (professional association). A PC continues after a shareholder leaves.
Corporation	States generally do not permit law firms to operate as a general corporation

### Banking Concepts

Lockbox - check collection service

Zero Balance Account (ZBA) - relationship between 2 accounts where balance in ZBA is brought to zero at end of each day allowing funding account to earn interest on more money each day

Sweep Account - Collected balances over predetermined amount are automatically swept to line of credit or investment account daily

Controlled Disbursement - Bank notifies you early in day of amount of checks that will be clearing that day

### **\*Financial Controls**

\*Separation of duties = internal control

### **Tax and Reporting Requirements**

Retirement plans with more than 100 participants are required to be audited by an independent auditing firm

\*3 factor formula for foreign source income: People/Payroll, Revenue, Occupancy Costs (PRO)

\*Nexus - IRS term for multi-state taxation

\*In order to get deduction for charitable contributions it must be under Section 503(c).

\*Allowable deduction for food and beverage - 50%

\*Difference between book and tax:

meals - 50% deductible in tax return

partner parking - not deductible on tax return

gifts - \$25 per client on tax return

### **Trust Accounts**

Client funds are not to be co-mingled with any other law firm accounts. Retainers should be deposited in trust account until fees are earned.

IOLTA (or IOTA) - interest bearing trust account where interest is transferred to state bar association and used for charitable purposes such as representing the indigent; clients do not need to be notified their funds are in an IOLTA.

\*Interest in trust account never goes to the law firm.

### **Billing Practices**

Contingency - firm receives fixed percentage of settlement; not allowed in criminal or family law cases

Alternative Billing Practices - reduced rates during case; premium or bonus based on conclusion

### Types of Legal Fees

Activity hourly rate	based on kind of activity performed
*Blended hourly rate	one rate (blends partner, associate and paralegal rates)
Case retainer	billed at beginning of case; non refundable to client
Client hourly rate	one rate charged regardless of who works on matter
Court awarded fees	based on federal and state laws
Earned retainer	amount that can be transferred to operating account after fees are earned
*Flat fee	predetermined regardless of hours worked; excludes disbursements (clients wish to manage costs)
Hourly rate fees	fees agreed upon by attorney and client
Prepaid legal services	
Pure retainer	exclusive representation of client; never represent competitors
Unearned retainer	advance payment deposited to trust account
*Value billing	billing rates for specific tasks; task codes (micro managing by clients)

**All legal fee agreements should be in writing signed by responsible attorney and client.**

### Cost Recovery

*Hard disbursements	not treated as expense when incurred; recorded as asset (client disbursements receivable). <u>May be expensed when determined to be uncollectible</u> (written off). Examples: filing fees, deposition transcripts, outside copying costs
Soft disbursements	Expensed when incurred, i.e., costs of copiers and fax machines.

## B. FINANCIAL MANAGEMENT AND ANALYSIS (14%)

### R-U-L-E-S Acronym

R	<b>Realization</b> of billing rates
U	<b>Utilization</b> of attorneys; timekeeper productivity
L	<b>Leverage</b> of lawyers
E	<b>Expense</b> control
S	<b>Speed</b> of billings and collections

### Financial Ratios

#### Liquidity Ratios

Current Ratios (aka “working capital ratio” or “banker’s ratio” or “net current assets”) indicate if firm has enough assets to pay current liabilities. Formula: current assets ÷ current liabilities

Cross-sectional analysis compares company’s performance to industry standards (compare to other law firms)

Time-series analysis company’s performance is compared over time

Combined Analysis uses both cross-sectional and time series

Quick Ratios aka Acid Test Rules used to indicate relationship of cash and A/R to current liabilities; indicate instant debt-paying ability of company

Profitability Ratios show return on equity. Net income earned on every \$100 of revenue.

Gross profit to revenues	=	Gross profit margin
Operating profit to revenues	=	Operating profit margin
Net profit to revenue	=	Net profit margin

Activity (Productivity) Ratio indicates how quickly firm’s activity is converted to cash

\*Average collection period = A/R ÷ average monthly billings for 12 months

Debt Ratios relationship between liabilities and equity and EBIT (expenses before interest and taxes) to expense of interest.

Equity Ratio percentage of firm’s assets provided by partners. Provides indication of long-range solvency. Formula: owners’ equity ÷ total assets

**Current ratio** indicates short-term solvency. **Equity ratio** indicates long-term solvency.

\*Check A/R on cash basis for (a) cashflow and (b) utilization analysis

### Leases

<u>Full-service lease</u>	lessor pays all maintenance costs
<u>Net lease</u>	lessee pays maintenance costs
<u>Operating lease</u>	short-term and cancelable
<u>Financial lease</u>	long-term and non-cancelable

### Sale and leaseback

#### Direct leasing

Leverage leasing funding through several sources usually for big-ticket items, i.e, airplanes

**Full lease payment can be deducted if lessee can purchase item at end of term for fair market value (this is an Operating Lease); not for a nominal amount - this is a Capital Lease**

Equity financing based on partners' capital, undistributed earnings and realizable value of unbilled fees less accrued liabilities. Equity financing lowers interest. i.e., secured credit; partner guarantees

\*Cost accounting helps define financing options

### Criteria for a Capital Lease - GAAP

- Ownership transfers to lessee at conclusion of lease agreement
- Lease contains a bargain purchase option
- Lease term is equal to at least 75% of the economic life of the lease property
- Present value of the minimum lease payments are equal to at least 90% of the fair market value of the lease property

### Criteria for a Capital Lease - Tax

- Minimum investment equal to at least 20% of the cost of the property
- Minimum investment must remain equal to at least 20% of the cost of the property at all times through the entire lease
- At the end of the lease term, the longer of one year or 20% of the remaining estimated useful life must exist

**Operating Lease Definition** - any lease that is not a capital lease

### \*Capital Lease Implications

\*Full value of asset on the balance sheet; depreciable property

\*Liability on the balance sheet; current and non-current debt

\*Expenses on the income statement; depreciation and interest expense

\*NPV (net present value) = discount rate

\*Question on prior exam

\*When would net present value not matter? For taxes, which must be paid now

\*What are circumstances for capital lease vs. operating lease?

Capital lease includes purchase option (bargain purchase option)

Operating lease - equipment must be returned at end of lease term (or purchase at FMV)

### **Budgets**

\*Master Budget - comprehensive includes projected income and cash disbursed for budgeting period. \*A comprehensive budget is necessary to plan, analyze and control operations.

\*Operating Budget - projects income to be derived during period; excludes partner compensation

\*Cash Budget includes partner compensation

Financial Budget - projects inflows and outflows of cash during period

Static Budget - for specific level of activity

Flexible (Variable) Budget - for range of activities

Long-Range Budget - multi year

Zero-Based Budget

\***Financial Controls** protect an organizations's resources. A good accounting system has a good audit trail, proper approvals and reported in proper period. Controls with division of duties.

Internal control

Divided responsibilities

Oversight

Conscientiousness

Security

Consistency

\*What is the overall purpose of financial controls? To ensure integrity of financial statements and other reasons such as preventing theft.

### **Depreciation**

\*MACRS (modified accelerated cost recovery system) shortens life of assets and uses DDB which converts to straight line and denotes rapid write off.

Leasehold improvements depreciate over 39-1/2 years.

\*Customized software depreciates over 36 months. Off-the-shelf software is expensed.

### Depreciation / Amortization

If permanently affixed, then it's a leasehold improvement and it is amortized over 39 years.  
If it can be taken with you, it's a furniture or fixture, and it is depreciated over 5-7 years.

When spending money on leasehold improvement, amortize over 39 years, but if move sooner, write off the balance the year that the premises are abandoned.

*Operating Lease* – at end of term, the firm does not own it. It's just like renting space, you pay as you go.

*Capital Lease* – must meet one of following terms:

If you own the equipment after the term.

If you have a bargain purchase option.

If the lease term covers 75% of the useful life.

If the PV of payments = 90% of the value of the equipment.

If install equipment worth \$400,000 financed through capital lease, \$400,000 is added to assets, as does liabilities. No effect on equity.

### Depreciation – three methods

Using an example of a \$10,000 asset over a life of 10 years

*Straight line* – equal amount each year over the life of the asset - \$1,000 / year.

*Double declining balance (accelerated)* – results in more rapid depreciation under the theory that the asset loses more value in the earlier years, so more closely “matches” revenue with expenses.

First Year,  $\$1,000 \times 2 = \$2,000$

Second Year,  $\$8,000/10 \text{ years} \times 2 = \$1,600$

Third year,  $\$6,400/10 \text{ years} \times 2 = \$1,280$

*Sum of the digits* – denominator becomes sum of digits of year of live.

First Year,  $10/55 \times \$10,000 = \$1,818$

Second Year,  $9/55 \times \$10,000 = \$1,636$

Third year,  $8/55 \times \$10,000 = \$1,455$

Modified Accelerated cost Recovery System (MACRS)

3 years – “Off the Shelf” software

5 years – autos, trucks, computers, phone systems, and software developed for own use

7 years – office furniture and fixtures

39 years – leasehold improvements

### Other:

“179 Election” Depreciation – Expense up to \$108,000 for 2006 (adjusted annually for inflation), for items purchased in a given year.

#250,000

2010

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# Law Firm Accounting FOR DUMMIES

(Or How to Talk to New Lawyers About Money)

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BY EDWARD H. FLITTON

Young lawyers tend to measure their contribution to the firm on the basis of billable hours alone. But if your firm wants its associates to develop into profitable lawyers—and eventually partners and leaders of the firm—it's important that you teach them some basics of law firm finance from the get-go.

**S**tart with a glossary of the accounting methods used by your firm, then explain the basics behind the statistics you use to measure their contribution. Over time, smart associates can learn to pick the practice groups, teams and partners they want to work with, so they can do their best at turning billable time into maximum revenues. You can use the following as a crib sheet for mentoring associates in the ways of law firm dollars.

## ESSENTIAL TERMINOLOGY

### Partnership Accounting

Most law firms are organized as partnerships, either general or limited liability. A partnership does not pay taxes as an entity. Instead, all of a partnership's taxable income (revenues less expenses other than payments to partners) flows through to the partners, so that each partner has taxable income in the amount of his or her share of the firm's taxable income.

Because there are no taxes at the partnership level, even if the partnership retains income for its future needs, each

partner must pay tax on his or her share of that income. For this reason, most law firms distribute all taxable income.

Each partner also must make a capital contribution upon admission to the firm, and there are occasional capital calls as well, which provides working capital for the firm. Since no earnings can be retained, the partnership must raise any further cash needs by borrowing.

### Cash Basis of Accounting

Most businesses use the accrual method of accounting. However, law firms almost universally (at least in the United States) use the cash basis of accounting. Here is the primary difference in the law firm context: Using the accrual method, income is determined by the amount *billed to* clients. Using the cash basis, income is determined by the amount *paid by* clients. The reason that law firms use the cash basis is so that no more is distributed to the partners than has been received in cash. The accrual basis can lead to borrowing against receivables, a concept anathema to conservative lawyers.

The cash basis, however, does not provide an accurate measure of performance because it can be distorted by unusual patterns in client payments. For example, if a law firm has a very busy year in which it bills a great deal but is paid little, followed by a year in which work is down but the firm is paid more as a result of the past year's billings, the cash basis method would indicate that performance was better in the second year than in the first. A firm could thus appear to be on a rising curve when it is actually going down the tube.

Fortunately, law firms are generally alert to this distortion and rely on hours and billings, versus revenue, as the more reliable indicators of performance.

## Receivables

Most partners are terrible about collecting receivables because they do not want to annoy their clients. But when receivables are paid slowly, the firm is basically acting as a bank to its clients. If the bills are paid more quickly, it lowers total outstanding receivables. If total receivables are too low, there is no source of cash available to pay the next month's expenses. So the pressure is to get the receivables paid quickly.

It is well established that the older the receivable is, the harder it is to collect. Most law firms categorize receivables by age, such as less-than-30-days old, 60-days old, 90-days old and so forth. The key is to keep the cash flowing.

## Billable Hours and Realization Rates

Most fee arrangements continue to be based on the hours expended on the project. Therefore, each lawyer's financial contribution to the firm's income is usually measured by his or her billable hours. This creates an inventory of unbilled time, which is in turn billed out to become receivables, which—one hopes—are paid to produce those beloved revenues.

However, there are two other factors in the calculation: billing rates and realization rates. The income being generated by any lawyer is calculated by the product of hours, billing rates and realization rates. Very few lawyers are paid 100 percent on time billed, and realization rates gauge that adjustment. Most law firm accounting systems track three kinds of realization rates:

- **Standard realization.** This tracks adjustments of billing rates when the file is first opened—that is, when special deals regarding billing rates are made with a client at the start of the engagement.

- **Billing realization.** This measures adjustments made at the time of billing—that is, when the partner reviews all hours charged to a particular matter and makes decisions to modify the totals in some cases.

- **Collection realization.** This tracks adjustments made after the bill is rendered, either because a client is unwilling or is unable to pay the entire amount of the bill.

## ADVICE FOR ASSOCIATES: CREATING STRONG EVALUATION STATISTICS

Once associates are familiar with the preceding financial principles, it becomes easier for them to see that there is more to profitability than simply accumulating hours. You can now discuss with them their billing rate and how, for

example, it can be increased by developing a unique specialty, as well as how the lawyer's realization rate is affected by efficiency and the choice of strong and sophisticated clients.

Many firms, in fact, measure lawyers' contributions by their "revenue received"—which means the dollars of revenue associated with the work the lawyer performs. (The precise term varies from firm to firm.) This measure brings the variables of billing rates, realization rates and actual payment of the bill into the equation.

Of course, if billable hours are all that matter in your firm, you can just tell everyone to rack up the hours in the safe knowledge that they are in a financially unsophisticated firm. But if the revenue received concept is being used, or if realization and billing rates are otherwise considered, advise associates that measuring their personal contributions will depend on the following factors:

- **Efficiency.** It doesn't help to spend lots of hours if the billing partner will have to write them off. (In fact, this can really hurt a young lawyer's reputation with that partner.)

- **Billing rates.** Most firms set standard billing rates for each class of associates. But some associates develop sufficient expertise or experience that a higher rate can be charged for their time. Associates who feel they have such expertise should argue for a higher rate.

- **Strong, sophisticated clients.** Weak, unsophisticated clients typically complain about the amount of the bill, leading to write-offs, which affect the realization rates of all who worked on the case. Almost invariably, such clients also want the bill discounted because of financial difficulties, which has the same effect.

- **Billing arrangements.** Some larger clients negotiate discounts, which affect revenue received and realization rates. Payments are sometimes deferred by agreement in advance. Working on contingent-fee cases can result in a long delay in receiving the revenues, although a successful result can produce high realization rates and revenue received. A loss can have the opposite effect.

Of course, it is the partners who control many of these variables. So it isn't easy for young associates to freely pick and choose their cases with these factors in mind. Over time, though, smart associates can gain the knowledge, freedom and authority to make the kinds of choices that maximize revenues. The firm's job is to help them understand the ins and outs of the systems that will get them there. ■

Edward H. Flitton (eflitton@hollandhart.com) is Managing Partner of the Colorado law firm Holland & Hart and a member of the *Law Practice* Editorial Advisory Board.

## Forms of Ownership

Form	Taxes	Liability	Continuity	Comments
Sole Proprietor	Schedule C to Form 1040	Unlimited	Limited Life	Just one person, not incorporated. Simple to create, easy to discontinue.
Partnership	Partnership files an information Form 1065, and K-1s filed with partner Form 1040.	Unlimited	Limited Life	
Corporation		Limited	When shareholder leaves, corporation continues.	
	C Corporation, taxes paid at corporate level, double taxation.	Limited		
	S Corporation, same as partnership. 1065/K-1	Limited		Disadvantages: -limited to 75 shareholders. -U.S. Citizens or residents. -distributions must be taken by all at the same time Out of favor now.
Limited Liability Company (LLC), Limited Liability Partnership (LLP)	Same as partnership, 1065/K-1	Members not personally liable.		Hybrid between partnership and corporation. In vogue now.
Professional Corporation	Can be S or C.	Shareholders not personally liable.		Shareholders paid salaries and receive dividends. No longer in vogue. Changing from C to S causes built in capital gains.