

Technology—Property: Follow the Money: An Interview with Accounting System Expert Caren Schwartz

Technology—Property provides information on current technology and microcomputer software of interest in the real property area. The editors of Probate & Property welcome information and suggestions from readers.

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In deciding to write a column on legal accounting software, I have turned to my colleague with 35-45 Consulting, Caren Schwartz, a nationally recognized legal accounting software expert. Caren Schwarz has an MBA in finance and worked at IBM for 14 years. After leaving IBM, she started a business doing bookkeeping for small businesses, including law firms. She became one of the first consultants in the emerging field of legal accounting software implementation and has worked in the field for over 25 years. Caren has been a Top 100 QuickBooks Pro Advisor every year since the program started in 2015. In that year, Caren won a Top 10 Legal QuickBooks Pro Advisor award. Caren even wrote a book entitled *QuickBooks For Law Firms*, and her articles have been published by *The American Lawyer*, Technolawyer.com, and *ABA GP Solo*.

In this interview, Caren and I discuss the distinct ways law firms do their accounting and review the requirements for trust accounting, as well as law firms' specialized billing and reporting requirements. As this is a technology column, we focus on how you should evaluate current cloud-based practice management systems to determine whether they will meet your law firm's accounting needs.

Our readership includes attorneys who specialize in real estate law and estate planning. What is unique about their accounting requirements?

Law firm trust accounting. Though other industries do take money in escrow for clients and client work, only attorneys use Interest on Lawyer Trust Accounts (IOLTA). These accounts have special requirements. In some jurisdictions, there is a prohibition on the assessment of bank fees, as well as a provision that any bank interest is to be paid not to the account holder but the local state bar association's legal aid fund. Also, legal retainers have a distinct structure. Lawyers can negotiate evergreen retainers in which a client must replenish the funds in a lawyer's trust account if they go below a certain amount.

Not only do lawyers take in funds for their services at variable hourly rates (or fixed fees), but they also hold money on behalf of their clients until the money is distributed according to various requirements?

Right. Trust accounts come in two flavors: segregated and IOLTA. In a segregated trust account, money must go into an account tied to just one client. The determination of which type of trust account to use is based generally on the amount of money in the trust and how long that money will be held. This is especially common in trusts the law firm is administering for a client and that money is in a trust account purely for that one law firm client. An IOLTA account, by contrast, includes funds from multiple clients. The firm needs to be able to track the money that belongs to each client. With an IOLTA account, the firm must be able to do the reconciliation reports required by different bar associations to ensure that trust funds are not misappropriated or commingled with the firm's operating account.

Also, the IOLTA account should not incur any bank fees, and overdrafts must be avoided. The bank fees for the IOLTA account, if any, should be taken out of the law firm's operating account. If the bank cannot set up the account to take operating fees out, then the firm must make sure there are sufficient funds to cover expected fees in advance of the fees being incurred. These fees should be tracked just like a client's funds. When needed, additional funds should be transferred to avoid legal malpractice liability and to ensure that neither the IOLTA account nor an individual client's account is ever overdrawn.

Each client's money must be accounted for as belonging to that client, and the funds *cannot* be comingled. So, the firm cannot take money that belongs to Client A and use it to pay for Client B's expenses. That is why if a client's money is all used up, and the bank charges a fee, but the law firm is going to absorb that fee, the firm must have enough of its own money in the account to cover that fee.

Are trust accounts regularly audited by the local bar associations?

It depends on the state where the law firm is located. I am based in Connecticut where the bar association has been doing a lot of random audits lately. Other states rarely audit. Some states only audit if there is a report of a problem or a question.

A problem, though, could be caused by something that the firm has no control over. For example, I had one client who had an IOLTA account in a bank, and the bank accidentally overdrew the account, which triggered a notice to the State's Bar Association. The bank admitted its mistake and quickly fixed it. The attorneys did nothing wrong, and the bank signed letters admitting the mistake and sent it to the Bar Association. The Bar Association still did an audit, which found nothing wrong, but it took hours of partner time to resolve. It is important to make sure that your law firm's books are up to date and have exactly the information you need because you never know what is going to happen.

Is there any requirement to have two sets of books?

There is not a requirement that I know of to have two sets of books. Generally, there is a requirement to be able to run a three-way reconciliation, and that means that you have to show that the amount of money in the bank account is equal to the amount of money that is on your books. The money should be in the trust account and equal to the amount of money held in trust for each client. Of

course, you make the appropriate adjustments in your bank account balance for uncleared checks and deposits, but you must be able to show that these three numbers are the same.

If money is received in advance of the provision of legal services, are there ethical rules that forbid attorneys from claiming the money as their own until the services are performed?

That depends on the state where the attorney works. Some states allow lawyers to accept a general retainer, and the retainer goes into the operating account. Sometimes, lawyers are permitted to write their letter of agreement with the client, so that that money can be recognized as income when it is received. However, in many states, any money that comes in for services to be performed must go into the trust account and cannot be treated as a general retainer.

Some software accounting systems are cash-based and other systems are accrual-based. What does that mean and how does that affect law firms?

That is one more area where law firms are unique. Law firms will often lay out money for expenses for clients that will be reimbursed when the case is settled. Depending on the type of case and the type of expenses, the IRS considers that money to be a loan to the clients. So, rather than putting that on the profit and loss statement, the law firm may need to have that money on the balance sheet and may not be able to take a deduction for the advanced costs unless they have to write it off. These advanced costs do not affect their income or their firm expenses; it is purely on their balance sheet. This is often referred to as modified cash-based accounting.

The difference between cash and accrual accounting has to do with when the firm recognizes revenue. Manufacturing firms must be on an accrual basis. Professional services firms, like law firms, tend to be on a cash basis. That means the firm recognizes revenue at the time it receives the money, and it recognizes expenses at the time it pays them out. On an accrual basis, the firm's revenues are recognized when the client or customer is billed, and the expenses are recognized when an invoice is received from the vendor, regardless of when it is paid.

From a tax point of view, cash and accrual accounting are very different. If the firm bills a client in 2020 on an accrual basis but does not get paid until 2021, the firm's income accrued in 2020. But on a cash basis, the firm will not show income until 2021. With modified cash accounting, the firm is on a cash basis, except for advance costs, and is going onto a balance sheet. A firm may be on a cash basis for tax purposes but keep its books on an accrual basis for internal reporting purposes. On a cash basis, a firm does not have accounts receivable or accounts payable entries and would therefore not have to write off a bad debt.

Lawyers routinely absorb all sorts of expenses on behalf of their clients. Are there other types of costs that are unique to law firms that should be tracked in legal accounting software?

There is one other type of cost that is more common in law firms than in other firms: billing clients for soft costs. Soft costs are costs that the firms incur on behalf of a client but does not write a direct check out for – such as charging the client for copies on the copier machine or postage on the postage machine. The firm never writes a direct check out for those expenses because the firm

absorbs the copier or postage expenses in its general account and then charges the client often at a different rate for use of the service. Most industries do not charge for those “soft” costs, but a lot of law firms do. Alternatively, some law firms charge a portion of their overhead by adding an administrative fee onto the bill. If the firm charges an administrative fee, the firm needs to make sure that its billing system or accounting system can appropriately handle the tracking of that administrative fee.

Some areas of practice, such as bankruptcy, have massive reporting requirements. Can your typical accounting software handle those types of reporting or do you need something special?

It depends on the area of practice. Costs laid out on behalf of a client can be tracked on most billing or accounting software. If you have special reporting needs, however, such as bankruptcy accounting reports or real estate settlement statements, those typically cannot be handled by general accounting systems. These types of reports are too specific. Most general accounting systems are also not able to produce the required format for a personal injury settlement or a property settlement. Some practice management systems allow you to run a custom report that meets the requirements. Others may require software specific to the specialty, such as a dedicated real estate closing system.

What about the nature of how law firms run their collections or compensate their partners? How do the methods of billing and compensation dictate the accounting requirements?

Most law firms track the hours worked by their staff and attorneys. But even when billing on an hourly basis, they do not bill strictly by the hour. There will be adjustments—to the rate, the number of billed hours, or the total bill—made at different points in the process. Also, compensation may be based on more than just work done or hours worked. Apart from adjustments, the baseline hourly rates or fixed fees for the same type of work may vary by client or matter. Law firms need the accounting system to provide information on how the firm values billable time, charges for that time, and allocates the revenue received for the work. Law firms are not selling widgets at a fixed price. They are selling their time and knowledge.

Until recently, hourly billing was the prevalent method with flat fee billing becoming more common. Firms need to be able to attribute revenue to fees and costs and then into buckets such as an area of practice or who did the work. Then, they need to measure the productivity and the profitability of the individuals in the firm, based not only on the hours worked, but how those hours were spent and billed, and on the work an individual attorney brings into the firm. The law firm needs to run productivity reports and profitability reports from their billing and accounting systems based on measurements of both billings and collections.

A lawyer may work a certain number of hours, but the partner who is managing the bill may decide that it took too long and adjust the bill. Or the law firm may bill for the time, but the client will demand an adjustment, forcing the firm to write off the time. There are multiple places where the time can be adjusted down. The law firm must decide how that revenue is allocated; what was originally a \$300 per hour bill is now effectively a \$200 per hour bill.

Firms also compensate based on business generation. The arrangements will vary from attorney to attorney, and even from matter to matter. The calculation of the “origination fee” percentage can even be split among multiple attorneys. There may also be a management fee allocated to department heads or the manager of the matter. In many corporations, shareholders are paid when the corporate entity is paid. But in most law firms, the owners are the partners, and they are compensated on what is left in the firm after paying expenses and costs. Partner compensation reports can be extremely complex. A well-designed billing and accounting system can reduce the time to generate these reports from weeks to mere minutes.

So, you need to analyze not only how much time is billed, but how much revenue is received and when?

The firm needs to know how much of the firm revenue went to expenses and how much of that revenue went to fees. Then the partners need to allocate the fee revenue across the people who worked on the case, the person who brought it in, and, maybe, the person who managed the case.

You are a top 10 Legal QuickBooks Pro Advisor. Considering these special requirements for lawyers, do you believe that a law firm with several partners would be able to run their practice out of QuickBooks?

Generally, no. You can make QuickBooks do trust accounting, but it’s not designed for it. One of the biggest issues in trust accounting is ensuring the firm does not overdraw a client’s trust account. A fully integrated billing, accounting, and practice management system can send out alerts when the firm is close to exhausting the funds in a client’s trust account. By contrast, QuickBooks has no concept of what a trust account is; it is just another bank account. Good legal accounting software with proper trust accounting will not let you overdraw a client’s trust account.

Furthermore, QuickBooks does not have a good way to track soft costs. You can bill them back to the client, but it’s a very intensive manual process because you cannot easily enter them until the time you are going to be billing.

The biggest issues with using QuickBooks for a law firm are not accounting issues; they are billing and reporting issues. QuickBooks cannot easily handle the variety of billing arrangements and bill layouts used by many firms. There is no concept of pre-bills. In QuickBooks, once a bill is created it can be edited, but removed items do not automatically go back to being billable, and there is no way to track changes. QuickBooks does not offer the flexibility of rates that most firms want, especially if more than one or two people are billing. It is difficult to do a true batch of billing in QuickBooks. Getting productivity reports and revenue allocations is also not practical.

Are there more limitations in QuickBooks Online (QBO)?

Yes. The biggest difference between QBO and QuickBooks desktop is the reporting. It’s even harder to get the right reports out—for example, QBO doesn’t support summary reports.

If our reader has persevered to this point in the interview, she is probably eager to know what new products you have seen that might meet some of these special needs of lawyers.

The two biggest developments are more cloud-based accounting systems and more options that offer integrated accounting. It used to be that all the cloud-based practice management systems just integrated with QBO. One of the biggest limitations of that approach was an inability to properly allocate revenue because most links sent invoices to QBO and applied the payments in QBO. In both QuickBooks desktop and online, if you get partial payment, it gets allocated proportionately. In a legal accounting system, the user can choose to allocate the partial payment first to expenses and then to fees and may be able to control the allocation to fees by timekeeper as well.

How do you validate the claims of cloud-based practice management systems that claim they do accounting? What features should someone look for that might be in one program but not another?

If a practice management system says that it integrates with QuickBooks and you are going to try to go that way, you need to understand what it means by integration. There are degrees of integration, but most of them do not do a really good job. For legal accounting software, the factors you should research include:

- (1) Where do you print your trust and operating checks from?
- (2) Where do you do your bank reconciliation from?
- (3) Where do you record the received payment and run all of the reporting for the bank account?

If your accounting system, in addition to billing and trust accounting, can also do your bank reconciliation for your operating and trust account within the program, and you can print a profit and loss statement and a balance sheet, then it's probably full legal accounting software. If you can only do one of those—maybe it does the trust accounting, but the operating accounting is still with QuickBooks—that's not full accounting, that is half accounting. Furthermore, there is a distinction between trust tracking and trust accounting. In the former, there is no ability to print checks.

Is the benefit of full integration fully integrated reporting on every phase of the billing and fund receipt process?

That's one benefit. The other benefit is that you have only one product to manage, maintain, and learn. You do not have to worry about integrations breaking or who is responsible for maintaining the integration.

What are some other new features of cloud-based legal accounting systems?

The rise of integrated merchant accounts is big. And that is becoming more and more available with the rise of integrated accounting software. It involves the ability to securely send invoices to clients that include one-click payment on the invoice itself. This brings revenue directly to the firm's account and reduces the need to send invoices into collection.

What about integrating directly with feeds from banks?

Many of the new integrated accounting software systems have bank feeds. One of the other things I'm seeing, which is nice for law firms that want to accept credit cards, is that some of the cloud accounting solutions are absorbing the monthly merchant account fee. This makes it more economical for the law firm to have a merchant account. For example, Zola Suite and CosmoLex absorb the LawPay fee.

How do you answer the old school accountants who say they need QBO or a QuickBooks file?

I present them with the benefits to the law firm of using integrated accounting and those usually override their objections. I offer to give them a balance sheet, a profit and loss statement, and the general ledger. Many practice management systems offer a free or discounted login fee for accountants to access the system directly.

I will show them how they can get the same things they can get from logging into QBO. If the accountant is still reluctant, I will talk with the law firm about the benefits to them and ask them if it is worth it to give up the benefits of integrated legal accounting software to stay with their current accountant. A law firm that recognizes the benefit of integrated legal accounting software will often change accountants rather than give up their new accounting system.

Author's Note: Now that you know what to look for in legal accounting software, here is a shortlist from which to begin your research. Note, these are in alphabetical order, not in order of recommendation:

ActionStep – A practice management system with billing and full integrated accounting. A QBO link is optional. (<https://www.actionstep.com>)

Centerbase – A practice management system with billing and full integrated accounting. A QBO link is optional. (<https://centerbase.com>)

Clio – A practice management with billing and trust tracking and a link to QBO. (<https://www.clio.com/>)

CosmoLex – A practice management system with billing and full integrated accounting. (<https://www.cosmolex.com/>)

LeanLaw – Billing integrated into QBO. Bills are sent through QBO. (<https://www.leanlaw.co>)

LEAP – Practice management with billing and trust accounting. Expenses are sent to QBO for GL accounting. (<https://www.leap.us>)

My Case – Practice management and billing with trust tracking, with a link to QBO. (<https://www.mycase.com>)

Rocket Matter – Practice management and billing with trust tracking, with a link to QBO. (<https://www.rocketmatter.com>)

Soluno – Billing and full integrated accounting. (<https://www.soluno.legal>)

Timesolv – Billing with link to QBO or QuickBooks desktop. (<https://www.timesolv.com>)

Zola Suite – Practice management, billing and full integrated accounting. A QBO link is optional. (<https://zolasuite.com>).

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