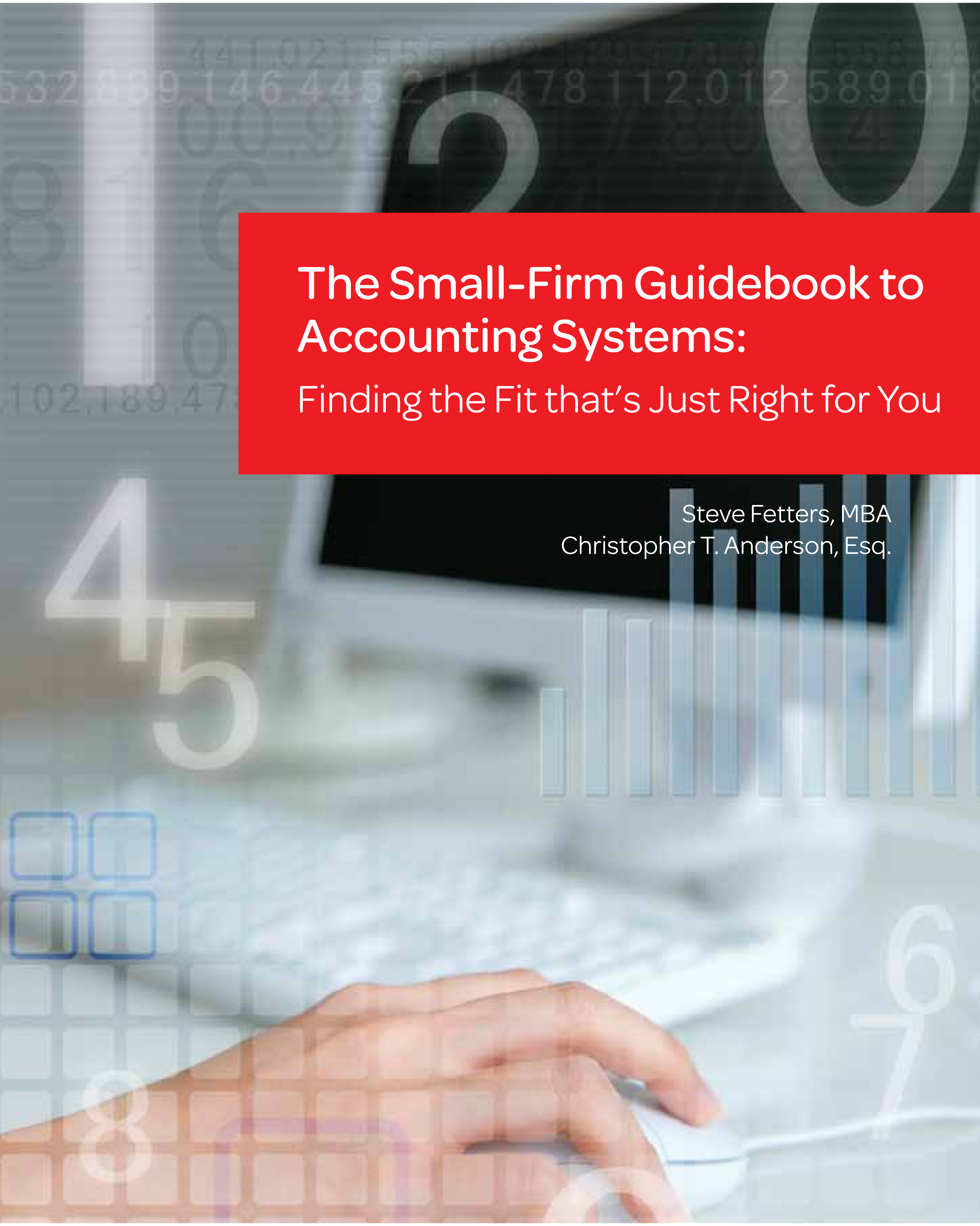

The Small-Firm Guidebook to Accounting Systems:

Finding the Fit that's Just Right for You

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As much as anyone may try to tell you differently,
there is no one law firm accounting system that fits every practice.

Just like Goldilocks, it's sometimes necessary for you to investigate multiple options to discover the one that's just right for your particular needs. Some may feel too complex for where you are at present; others, too simple, perhaps not sophisticated enough to help you reach your firm's financial goals.

In order to reach your decision about which accounting system is "just right" for your firm, you'll need to know what the options are, the pros and cons of each and the level of sophistication each requires from your law firm. We've listed four options here, from the most basic to more sophisticated:

1. Manual Recordkeeping (Checkbook or General Ledger)
2. Small-Business Accounting Software
3. Legal-Specific Accounting Software
4. Legal-Specific Software plus consultation with a Legal Accounting Firm

Choose an accounting system for the firm you want to be, not necessarily the firm you are today

Though you may initially be reading this to help discern which method is right for your firm right now, you should also consider a year or even five or more years down the road if you want to be well-positioned for firm growth. Once more clients start coming in the door, you'll find it much easier to make adjustments to the front office if your accounting people don't also have to reorganize and learn new software.

Having to make such sudden and dramatic changes all at one time can bring cash flow to a grinding halt, the last situation a law firm wants to face during a growth spurt. Better to choose an accounting system that you can grow into gradually, even if it seems a bit more than you need at the moment.

Deborah J. Schaefer is a CPA who specializes in the selection and implementation of computerized accounting systems, along with the employee training that follows. She's seen many law firms struggle with choosing the right accounting software, and she's a big advocate of choosing a more sophisticated system than may initially seem necessary.

"An investment in time and money is required whenever a law firm changes their back-office billing and accounting system," Schaefer says. "Therefore, it's best to invest in a solution that can grow with the practice."

While the somewhat higher upfront investment may create some temporary challenges, it can pay substantial dividends as you grow in the future and have the reporting, analytics and other advanced financial tools at hand to help turn your front-office growth into higher profits, too.

And yes, your choice of accounting tools can affect your profitability – but more on that in the final section.

Until then, here's a rundown of the four basic law firm accounting methods.

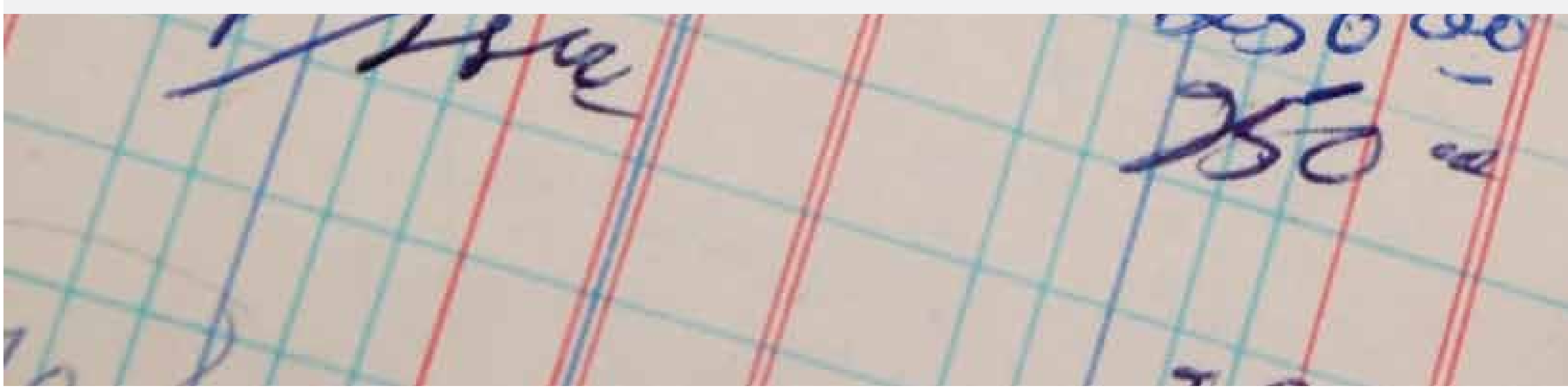
Manual Recordkeeping
(Using checkbooks or general ledgers)

While it is outdated to rely entirely on checkbooks or general ledgers to keep track of firm finances today, it's entirely possible for established solos to survive and even meet their financial goals if they have a good accountant and/or bookkeeper they're willing to trust with their financial future. Whether it's a spouse, a temporary bookkeeper or an accounting firm, it's essential to have someone with in-depth financial and tax-law knowledge to:

- Make sure the books are balanced
- Stay on top of payables and receivables
- Provide the attorney with the reports that s/he needs to run the law firm
- Project cash flow, and identify any issues before they become crises
- Organize and keep track of tax matters

Notice that we make a distinction for established solos, which we mean as those already using manual recordkeeping. Banks today offer secure online banking with transactions that can be downloaded directly into accounting software, so there's simply no good reason for firms seeking the best choice now not to computerize their accounting.

Computerized accounting allows you to stay updated on account balances and cash flow at a moment's notice, catch any potential bank errors as they occur and save the bookkeeping hassles and human error potential of writing and keeping track of transactions manually.



PROS:

Using checkbooks to track firm finances is reasonably simple and requires no special accounting skills other than being able to keep your registers balanced with your monthly bank statements. Firms that use old-style general ledgers – writing every transaction by hand in large bound books – generally stick with that style of accounting for one primary reason: It's what they've always used in the past and they're not willing to change, no matter the price.

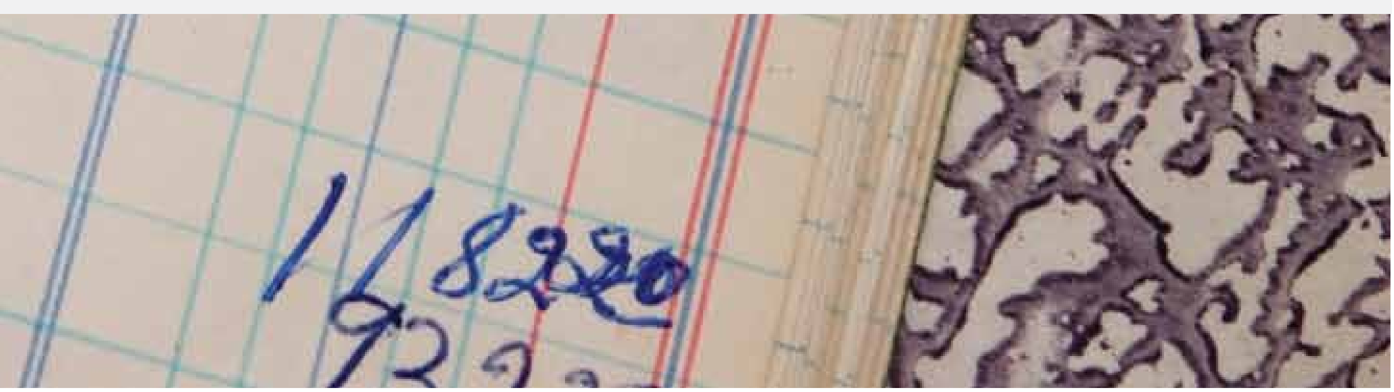
CONS:

It's much more difficult to get a big-picture view of where your firm stands financially with manual recordkeeping. Every report, every income statement, every financial statement of any kind has to come from your accountant, so the only time you can get a real overview of where your firm stands is when your accountant does the analysis for you.

Tax time, too, is made more difficult and expensive when recordkeeping is done manually. Since your accountant is almost certainly going to have a computerized system for preparing your tax and financial statements, every transaction still has to be entered into a computer. Firms relying on manual recordkeeping simply pass on that responsibility to their outside accountant, a relatively simple task for which they likely pay a disproportionately high price.

Even getting a small-business loan becomes more cumbersome with paper records. Once again, firms with paper records have to get them updated by the accountant first, then give him or her time to create up-to-date financial statements to help the lender determine eligibility.

Finally, while it might initially seem less expensive to keep financial records manually, the greater likelihood is that paper records will cost you far more in outside accounting fees and potentially lost tax deductions than buying simple small-business accounting software.



WHEN IT'S TIME TO MOVE ON TO THE NEXT LEVEL

For most firm owners or managers, the decision to move on to a computerized accounting system is made the first time they add up the real cost of trusting their firm's financial future to what is closely akin to an overflowing shopping bag full of paper receipts and scratched-out notes.

Besides having to pay an accountant to sort through and key in all your paper records, and potentially losing thousands of dollars in small-business deductions because you lost or forgot to save a receipt (or didn't realize its significance), consider all the wasted time worrying about something that would be securely under control with even the most bare-bones accounting software.

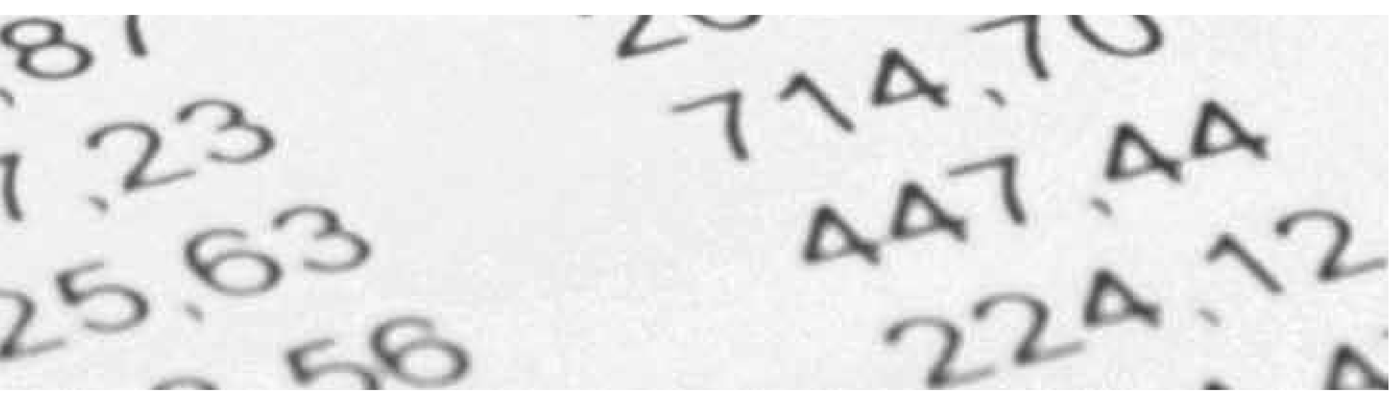
And even all that lost time doesn't compare to the potential cost of losing an entire year or more of paper financial records in a disaster such as fire or flood. Computer records aren't infallible to disaster, but it's much easier to duplicate them on portable storage media such as CDs or DVDs that you can store in multiple locations, or to back them up to cloud storage services. That way, you'll always have a back-up copy in the event of trouble.

Small-business accounting software

There are some very good small-business accounting programs on the market today that are suitable for some one- or two-person firms. The programs are generally inexpensive, easy to compare and buy online or at an office-supply store, and offer good visibility into your finances without requiring that you wade through an enormous amount of detail. You may be able to take advantage of limited-time free trials of different programs to try them on for size, or even find an open-source program that fits your needs.

Some small-business accounting programs also claim to have special accounting features just for law firms, including the somewhat limited ability to track Lawyer's Trust Accounts (IOLTA).

If your firm does handle trust accounts, though, we strongly advise looking into legal-specific accounting software. Bar association regulations concerning trust accounts are enormously complicated, full of ways to trip up your firm and cause trouble down the road if not addressed specifically. Legal-specific programs such as PCLaw® have built-in protections to alert you if you attempt to perform an action that might violate trust or other bar association regulations.



PROS

One- or two-attorney firms can get by with small-business accounting programs as long as they don't have clients with specialized needs, such as trust. They allow firms to easily track revenues and expenses, have good basic reporting and are simple to learn and use. Many accountants who are not focused on the specific needs of law firms are familiar with these programs and may recommend or even require you to use one.

CONS

Small-business programs are only suitable for serving the general accounting needs of some one- or two-attorney firms with relatively simple needs. Perhaps more importantly, starting with such programs is just that: a start.

Once firms grow past the solo/duo stage, they're usually forced into switching their software to a more sophisticated legal-specific solution with specialized reporting and analytics capabilities. Once that change is made, data for existing clients usually has to be re-entered into the new software.

Connecticut CPA Deborah Schaefer has even more reasons for steering her software consulting clients past small-business accounting software and into more specialized legal accounting programs:

1. Legal-specific accounting software includes the required detail reporting necessary to pass state and insurance audits.
2. Law firms must ensure that they track and account for all costs expended for the benefit of clients to ensure proper reimbursement and to prevent such costs from adversely impacting profits. Tracking client costs is a very important component of legal-specific software.
3. Legal-specific billing requirements are typically not accounted for in small-business programs, so law firms that send invoices to clients requiring e-billing have to manually re-enter them into electronic billing websites. Specialized accounting programs for law firms can create LEDES-compliant invoices automatically, so there's no need for manual re-entry.

Another pitfall you should approach cautiously with small-business software is using two different programs for billing and accounting. General small-business software, because it is often oriented toward businesses that sell "things," typically lacks the level of billing customization a law firm requires to produce the professional-style bills that attorneys expect. This means that bills must be prepared manually (typewriter or word processor) or in a separate legal billing software, creating an opportunity for data entry errors.

There have been instances where certain billing programs claim to be integrated with popular small-business accounting programs, but simply are not. The result is a double-entry nightmare that not only requires manually re-entering data from the billing software into the accounting program; but doubles the potential for human error.

If in doubt, stick with one program that provides both the billing and accounting you can depend on.

WHEN IT'S TIME TO MOVE ON TO THE NEXT LEVEL

When growth in client work necessitates having more than two attorneys, or when a particular client's needs grow to the point that attorneys consider building a more specialized niche practice, it's time to make the move to legal-specific accounting software.

Small firms that merge should also establish their combined practice with more sophisticated legal-specific financial software. As a firm grows to have multiple partners, practice areas or office locations, it becomes necessary to track the amount of revenue each partner brings in to determine fair compensation. That requires the kind of reporting and analytics capabilities better handled with a higher-level financial management program such as Juris®.

Legal-specific accounting software

Small firms may initially feel intimidated by making the jump to accounting software with the "legal-specific" label, but in reality, quite the opposite should be true.

Assuming you compare options to find the program that best fits your firm size and system needs, you should be able to find legal accounting software that feels more "at home" than small-business accounting because it's better suited to the way a law firm works. For example, legal-specific software may have particular financial reports that can reveal the hidden information you need to run your firm more profitably.

In much the same way, programs created for legal accounting can help alert you to potential problems before they turn into real problems. PCLaw, for example, will warn you if you inadvertently start writing a check that could overdraft a trust account, an action that could violate bar association rules if the transaction was completed.

Legal-specific software also maintains accounting records using the method of accounting that law firms require. Cash accounting, though the least complex, allows client costs to be classified as either assets or expenses. Accrual accounting is more complicated but often more appropriate if your firm is structured as a corporation.

Legal-specific billing and accounting systems will support a "modified cash" accounting method as well. This is a hybrid of cash and accrual and offers the small to mid-sized firm the simplicity of the cash method with the somewhat more powerful reporting and revenue recognition methods of an accrual system.

PROS

Attorneys and other law firm staff members often find that they feel more comfortable with legal-specific accounting software because it works the way they do, giving them the reinforcements they need to make sure they meet all their professional, legal and ethical obligations.

Clients that require e-billing, for example, can be a cash-flow nightmare for law firms that don't have software such as Juris or PCLaw that alerts them to the specific billing requirements of particular corporations.

In the same way, financial reports geared toward answering the requirements of legal firms can be especially helpful in determining, for example, which clients or areas of your practice are more profitable than others, or which associates are bringing in more revenue and thus deserve greater compensation.

CPA Deborah Schaefer sees still another important benefit to using more specialized accounting software: "Legal-specific software affords law firms more flexibility in billing presentation and preparation. Lawyers need the ability to create multiple rate schedules and billing options, and programs like PCLaw are ideal for answering those needs."

CONS

Legal-specific financial software is more expensive initially than small-business accounting programs. That being said, you can certainly expect legal accounting programs to "pay back" that extra cost many times over, and in fairly short order.

According to Michael Wasco, a CPA in the Pittsburgh area who specializes in consulting with law firms on process and business improvements, growth issues and new personnel training, the reporting alone makes legal accounting software more than worth the price of admission.

"Any law firm-specific software must have basic revenue-recognition analysis," said Wasco. "So many things are derived from that single number, and in small-law that is even more pronounced. Thus, a firm that is considering making a purchase or an upgrade absolutely should factor profitability reporting into the decision."

WHEN IT'S TIME TO MOVE ON TO THE NEXT LEVEL

The next level after making the move to legal-specific software is a little more difficult to quantify since it is more than just a technology solution.

When your firm reaches the point of needing more than just legal-specific software to maximize profitability, you may need to look at organizational changes to streamline workflows and processes and ensure that you're getting the most from your financial software.

At that point, you may need to consider replacing your "general" accountant with a CPA firm that specializes in helping law firms maximize profitability. Not only can it be very difficult to determine when it's time to move to this next stage of law firm accounting and consulting, but finding the right CPA partner and actually making the move can be tricky as well.

Michael Wasco knows better than almost anyone how difficult that decision can be because he's seen the results of those struggles as they've played out in law firms across the country.

"Law firms in the 10- to 20-attorney range are in a tough spot because they're often in transition," says Wasco. "They may have some needs that require expert knowledge, but not all. They may have enough revenues to support that kind of expert knowledge, but not enough to really justify it."

Wasco often sees partners from those same 10- to 20-attorney firms who feel at an absolute loss about where to turn next: "Every decision a law firm makes in this tier is magnified because there is that danger of overreaching," he explained. "These firms begin to grow out of small-law solutions, and just the IT infrastructure alone can create daunting decisions.

Law firms in the 10- to 20-attorney range are in a tough spot because they are often in transition.

"But it is also these firms that may have lines of credit, possible IOLTA problems and cost-advance issues that are not easily addressed. They may make bigger decisions such as lease-versus-buy for major office products. They may have partners who run their cars through the business. They may be S-Corporations who have to start looking at wage-versus-distribution issues to maintain tax compliance."

Ultimately, if your firm is in that difficult 10-20 attorney stage where almost every decision is a struggle, it's probably worth your while to seek help from a CPA firm with extensive law firm experience. They can help advise you on next steps, whether the partners' choice is to seek out further growth opportunities in a particular specialty, to put the brakes on further growth until a later time, or even to break the larger partnership off into smaller niche firms.

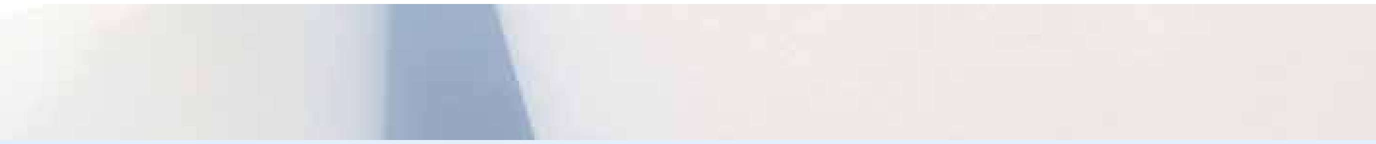
Legal-Specific Software plus consultation with a Legal Accounting Firm

It's important to realize that law firms in the 20-50 attorney range are entirely different animals than other types of businesses. Part of that is the specific rules law firms encounter, but an even larger reason for the difference can be the partner-owner leadership that law firms typically have in place.

"A complicated law firm partnership that mixes draws and guaranteed payments for various reasons can make even a CPA who works in that area scratch his head," says law firm CPA Michael Wasco. "20- to 50-attorney firms probably sport from 10 to 30 partners. That alone can be a massive headache for the firm's accountants. The 'Big Four' people have the experience and breadth of knowledge necessary to tackle these bigger problems, but personally, I think if you can find an industry expert for these types of firms, the service would be the same as that of the Big Four."

Too often, generalist CPA firms make the mistake of assuming that profitable, well-managed law firms simply don't need extensive business-consulting advice, or they may be hesitant to risk losing a good client by stepping outside their comfort zone and making suggestions that can potentially make them appear less than expert about the specific concerns of law firms.

"The bottom line is that once a law firm has $5M in revenues, the nature of the practice changes," said Wasco. "The firm cannot survive on small-law software, small-law concepts and small-law vendor support. The billing is varied, the time-entry needs are varied, and the software has to be powerful and flexible."



PROS

CPA firms that specialize in law firm accounting go beyond everyday accounting into consulting issues that affect big-picture profitability. High-level specialists may work with your firm to improve process and workflow issues, train employees to maximize firm productivity, make recommendations on accounting and financial management software and more.

Law firm experts understand the essential contribution of strong financial reporting in helping a firm analyze its own data to understand which areas are contributing the most to profitability, which may need to be streamlined or improved in some other way to improve their contribution, and even spotlight specific practice areas that may be a detriment to the larger firm's profitability.

CONS

Accounting firms that specialize in law firm consulting will cost more out-of-pocket than non-specialist firms, but assuming the law firm is large enough to benefit from the in-depth consultation, their contribution to bottom-line profitability should pay dividends many times over the extra expense.

Once again, Michael Wasco cautions firms to keep the big picture in mind: "Most firms probably look at the black-and-white dollars to make a decision about hiring a CPA with extensive law firm experience and miss the opportunity to consider wider ideas that can positively impact overall productivity."

Summary: How your choice of accounting tools can affect profitability

The more sophisticated your accounting system, the more likely you are to have the high-level reporting and analytics capabilities built into your software to help you maximize profitability. While there are certainly general reports in small-business accounting software, such programs can't usually give law firms the depth of insights necessary to adequately analyze the financial performance of the overall firm, in addition to that of the individual attorneys, and, in larger firms, different areas of practice.

According to CPA Michael Wasco, it's essential for even the smallest firms to have some way of tracking the source of firm revenues back to the originating attorney: "If the accounting software is capable of supporting that analysis, it brings a great deal of strength to the firm," he says. "The users in the firm will spend valuable time on analyzing the data and reporting back to the partners rather than wasting time collating the data."

In the end, that can make your final decision about accounting systems less about the up-front cost of the best solution, and more about what the wrong choice can cost you down the road. This decision is a prime example of "what you don't know can hurt you!"

Key Learnings

When choosing your firm’s accounting system, make sure you:

- Realize that trying to save money on your system today may translate into greater outside accounting costs down the road
- Understand that small law firms have entirely different accounting needs than small businesses that sell “things”
- Choose for the firm you want to be, not necessarily the firm you are today, so your system can handle sudden growth spurts without throwing cash flow into disarray
- Look for a system that gives you the legal-specific reinforcements you need to make sure you meet all your professional, legal and ethical obligations
- Evaluate your software at regular intervals to make sure it still provides the level of sophistication necessary for your firm today
- Evaluate your outside accounting firm as you grow to make sure they’re giving you the level of service that helps you convert that growth into greater profitability
- Realize that the best accounting systems don’t just measure profitability; they improve it

About the authors

Steve Fetters, MBA

Currently Senior Product Manager for PCLaw® and Time Matters®, Steve previously served in the same capacity for Juris® financial management software during his five years with LexisNexis®. As product manager, Steve is responsible for continually analyzing market conditions to discover and quantify the problems that the product must solve to successfully meet current and future customer needs.

Steve has held product management and other management roles in the small to mid-sized billing, accounting and financial management software industry for over 25 years. That time includes eight years serving as an independent software consultant for small to mid-sized professional services organizations, as well as a stint as Controller for a rapidly growing professional services company.

Christopher T. Anderson, JD

Prior to his present position as Senior Product Manager for LexisNexis Firm Manager®, Christopher Anderson built a distinguished legal career during which he developed the expertise he now uses in his job at LexisNexis, and in frequent seminars on this and other topics related to helping attorneys build better practices through technology.

Anderson's legal background includes stints as:

- Managing Partner for an eight-attorney full-service law firm in Georgia, at which he specialized in family law and business litigation
- Assistant District Attorney in New York City, and in Athens, Georgia
- Associate General Counsel and Director of Client Services for RealLegal (Law.com)

Christopher graduated from Cornell University and earned his Juris Doctorate from the University of Georgia School of Law in 1994.

He is admitted to practice in the federal and state courts of New York and Georgia.

LexisNexis® Law Firm Practice Management Products

PCLaw® software is an all-in-one matter and financial management program for small to mid-size law firms. PCLaw 13 dashboards give you a lawyer's-eye view of what's most important to your practice, your clients and your business, so you can get on top of your entire day over your first cup of coffee.

Juris® software is a legal-specific billing, accounting and financial management program that not only helps firms take control of their everyday billing and accounting needs; it can actually help increase profitability by giving practice owners and partners the in-depth insights they need to measure and improve firm operations.

LexisNexis Firm Manager® web-based software is an easy, secure, online practice management program made for solo attorneys and small law firms that enables you to be the lawyer you dreamed of being. The LexisNexis Firm Manager program includes WatchDox® technology for enterprise-secure, drag-and-drop easy document sharing.

Time Matters® software is an award-winning practice management program that maintains and connects all of your client, case and document data in one instantly searchable database. The latest version includes WatchDox® technology, which gives small and mid-size law firms enterprise-secure online file-sharing at no extra charge with their annual maintenance plan subscriptions.

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