

Creating and Implementing an Internal Controls Program for Small Law Firms

Practicing law involves many skill sets – logic, intuitive understanding of the law, drive and intellectual prowess are a few of those skills. With the exception of attorneys whose practice focuses on business transactions, most lawyers do not spend a lot of time dealing with accounting issues.

We all remember the Enron, Tyco, and Worldcom scandals, financial debacles that led to the passage of the Sarbanes Oxley Act in 2002. While Sarbanes forced many large public companies to tighten up accounting controls, it gave smaller organizations that are exempt from the new regulations – including many law firms – a wake-up call about the need to establish and maintain better accounting practices.

Why should law firms pay attention to this?

Because law firms are at particular risk for financial mismanagement, or worse, fraud.

Most small and mid-sized firms focus their energy and structure on practicing law, often at the expense of other administrative functions including accounting. It is common for a firm with a dozen attorneys to delegate accounting functions to a junior-level administrator. In these situations, a partner has oversight responsibility, but when that attorney becomes embroiled in a hot issue with his or her practice, the supervisory function can get short-changed.

So what's the answer for law firms who can't overhaul their accounting departments? One possibility is to develop a set of internal controls, a system of checks and balances that can help prevent financial mismanagement.

An internal controls program can help just about any type of law firm prevent accounting mistakes and avoid problems caused by financial fraud, but the benefits do not end there. A strong internal controls program will increase the reliability of the financial statements on a day-to-day basis and reinforce management's understanding of the relationship between a company's financials and management decisions.

Incorporating an internal controls program into the day-to-day routine of a firm is easy to do with minimal disruption. In most cases, a strong internal controls program will add about an hour a day to most firms' administrative functions.

Our accounting firm routinely designs custom programs for our law-firm clients, but the majority of the programs include these 10 steps.

1. Reconcile your cash accounts monthly

Many firms let reconciliation slide for months at a time. If fraud occurred, these firms would not know until months later. It is essential that firms balance cash accounts monthly. Firms should compare the total number of withdrawals and deposits, and each line item in the transaction report, to the firm's internal records.

Uncashed checks should be noted on a reconciling schedule and if any checks remain uncashed for an extended period, such as 60 or 90 days, call the payee to see if there is an issue.

Keeping a tight reign on cash accounts also helps keep track of lost payments, or vendors who are not depositing checks. Most well run firms routinely cancel checks not cashed within a set period of time, typically 180 days.

All things considered, it is important for your firm to have a check cashing policy that is clear and consistent. This creates a standard operating policy you can enforce with all clients, no matter how good—or bad—the relationship.

By paying close attention to any abnormalities, you can fix accounting errors before they get out of control. This simple step saves time and money down the road.

2. Establish closing procedures

Once each month or quarter, make sure you match third-party documentation to the balances shown on the balance sheet.

Ideally, the closing document should consist of a bound folder, for example, a two-hole punch manila file. The first page should show a list of procedures or programs for preparation of the reconciliation, followed by the balance sheet or trial balance with account numbers next to each account. All subsequent pages need to show the corresponding account number in the lower right-hand corner.

For example, if the firm has a bank loan, the closing documents should include a copy of the most current bank statement showing the bank's calculation of the account balance. In the lower right-hand corner, write down the trial balance account number showing which account the statement is tied to on the financials (the account number is from the company's financials, not to be confused with the bank's account number). The page should also show whether the closing balance on the statement matches the trial balance, if it does not, it should include a short reconciliation explaining the difference.

Going back to the example of a bank loan, each payment on the loan consists of one-part interest and one-part principle. If the amount applied to the loan balance is not correct, the firm would have missed a deductible interest expense. For example, the trial balance could show a zero balance due, but the bank still shows a balance on their records.

By having an in-house bookkeeper deal with accounting problems as they occur, the firm can effectively reduce the cost of using expensive CPA's. This will allow the firm to transfer some of its tax preparation budget to more value-added services or even reduce the number of billable hours required to prepare the return.

3. Have a senior-level manager review financials on a monthly basis

When a managing partner reviews the financials, they should be looking at whether the balances match third-party documentation or that the reconciliations are reasonable.

By taking this step, management stresses the importance and perception of control to those responsible for reviewing the books.

Requiring management to review the financials on a consistent basis also brings the financial picture to the attention of the firm's partners. You have more options on how to deal with a problem on the front-end before it becomes a crisis. For example, if a specific case is incurring a higher level of costs, and therefore a greater accounts payable balance than the firm normally incurs, it is important that upper management recognize that it has a number of vendors who are expecting payment. This problem is avoidable by managing cash flow to ensure payment through pressing outstanding accounts receivable, arranging for a line of credit, or arranging for progress billing on the job.

Accurate and dependable financial records allow management to focus on controlling its resources and maximizing its opportunities.

4. Review accounts payable and accounts receivable for accuracy

Regular monitoring of the detail listing of both accounts payable and accounts receivable will alert you to anything unusual. Look for anything out of the ordinary. If an account is delinquent for an extended time, have someone other than the person who records the payments contact the client or vendor.



Having someone double check the accounts will ensure accurate reporting. Misapplied payments can be a tremendous source of frustration for both the firm and its clients.

The bookkeeper should review the accounts receivable details on a regular basis, usually monthly, and all accounts should be considered for the ability to collect payment. Historically, if you have collected your accounts within 90 days of billing, delinquent accounts are marked for direct procedures, such as sending to a collection service. If it is truly not collectible then you should write it off.

It is important for management to create a clear policy for paying vendors. Paying vendors on time engenders loyalty, but to do that, law firms need an efficient way to validate invoices.

We recommend that the invoice first go to the attorney or paralegal who was responsible for the expense to validate it, and sign off on the payment. After the invoice is for payment, we often suggest that the firm's accounting staff contact the vendor to see if the vendor is interested in expedited payment in exchange for a discount.

5. If possible, separate the duties of signing and recording checks

The person that prepares the checks should not sign them. The signer should be the person who bears ultimate responsibility for the firm's financial dealings. Since the signer has responsibility, he or she should have backup material for each check, be it an approved invoice or purchase order.

Additionally, each check should be stamped "deposit only." The firm should also issue a receipt for all money it receives. This preventive measure not only provides the client with proof-of-payment, but it also ensures the security of the funds. It is important to number the receipts and keep them in sequential order. Receipt records should be reconciled monthly.

6. The person that opens the mail should be different than the person who records the checks

This simple step is effective in preventing fraud. Put simply, a partner or someone with oversight responsibility should be the one to physically open envelopes sent by the bank and review the bank statements, including cancelled checks. Keep an eye open for handwritten checks or payees that look unusual.

Second, the person opening the mail – or someone he or she designates – should keep a log of the checks. At the end of every day, week, or month, the person responsible should review this log and compare it to a separate log the bookkeeper maintains. Any discrepancies will be immediately apparent. If there is a difference between the number of documented checks received and the deposits made, a reconciliation needs to happen. For any missing checks, the client or vendor needs to know immediately so that they can void the check and reissue a new one.

7. Ask your banker to pull a credit report on your firm to check for unknown lines of credit

Many law firms don't recognize the value of a good banker. Some view banks as simply institutions that supply money and credit, but in reality, the business banking community consists of professionals who have relationships with business leaders throughout the local business community. A good business banker is always looking for opportunities to meet with their clients and gain a better understanding of their clients' business.

To that end, let your banker know who has ultimate financial authority in your firm, and have the banker contact that person directly when certain events happen, such as a request for a line of credit. Also, ask your banker to do a regular review of your banking activities every quarter.

8. Review your financial history

Evaluating data from previous years will help management detect anything out of the ordinary. Create categories for items that will remain static from year-to-year. For example, if you have a category for "client lunches" you should not rename the category in future years as "relationship management." It will only cause confusion when making comparisons.



Look for consistency from one year to the next on things such as office supplies, rent, etc. These categories should remain similar from year-to-year without much variation. You should be able to identify patterns and you will see if anything looks disharmonious. Reviewing past records will alert you to potential fraud, and it will give you a greater understanding of your business' cost structures.

9. Establish a yearly budget for your firm

Budgeting and managing cash flow is essential to remaining in business. Using your financial history will help you to forecast future budgets and tell you if you are staying on track with your goals.

Compare benchmark ratios from management to make sure the budgets you create are realistic. For example, if your labor is 40 percent of revenue then you can budget based on that expectation. If the actual numbers drastically deviate, then you will need to reconcile the difference. Knowing if you are meeting, exceeding, or falling behind in your goals will enable you to take corrective action before it is too late.

10. Consult a CPA

While your firms' in-house bookkeeper might be good at handling the day-to-day accounting functions, a CPA can offer greater insight to help you decipher the numbers. Establish a regular interval meeting with your CPA to review your finances. He or she will keep your books on track and alert you to any problems. You should regularly discuss the financial state of your firm with a CPA, and any adjustments made at the end of the year. A CPA can help make sure those adjustments are reflected appropriately in the books.

Following these simple steps can help ensure accurate reporting for your small law firm. Precise financial data helps avoid costly mistakes, and it helps management secure assets. It also gives the top-level manager that reviews your financial records the reference point they need to quickly identify any unusual expenses or revenues.

