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Attorney's Report

CPA's Report to the Legal Profession

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Fraud Watch

Seven Internal Controls for Law Firms

By their very nature, law firms are vulnerable to embezzlement and fraud. Attorneys are, first and foremost, trained in the practice of law. Focused on revenue-generating activity, they may consider it easier to delegate day-to-day business and financial duties to other employees instead of managing these duties themselves.

Without strict segregation of duties and strong internal controls, unscrupulous employees can take advantage of a lawyer's lack of attention and perpetrate fraud. Compounding the matter, theft at a law firm is not limited by title and stature. In particular, senior and managing partners as well as senior staff members often find themselves immune from oversight, leaving the door open for malfeasance.

Essential Internal Controls

The good news is that appropriate oversight and supervision can help detect and prevent embezzlement of firm and/or client funds. Consider these seven essential internal controls for preventing fraud at your firm:

1) Carefully screen potential employees. Law firms that do not perform complete background checks open themselves to the risk of internal fraud. In addition, they may open themselves to liability for any damage to third parties that is attributable to those unscreened employees. Consult with an experienced employment law attorney and then develop screening procedures that look for the warning signs of past embezzlement or fraud.

2) Establish reporting mechanisms. Provide formal anti-fraud training to all employees of the firm. At the same time, create a confidential means for them to report suspected fraud. It could be a trusted partner with whom employees can share reports of suspicious activity or even an anonymous reporting process such as a "fraud hotline." Provide this reporting opportunity to your clients and suppliers, as well.

3) Segregate duties. This is the Golden Rule of fraud prevention — spreading the firm's business processes, bookkeeping and reconciliation duties among at least two different employees. So, an account manager should not have custody of client trust funds and also be responsible for maintaining the related records. In addition to segregating duties, formal operating procedures should include appropriate supervision and review.

4) Review and reconcile promptly. With the proliferation of online banking, there's no need to wait on monthly paper statements to reconcile your bank accounts. Periodically check the firm's transactions online so you can quickly address any discrepancies. Likewise, consider establishing individual trust accounts for clients and allowing them to review their account activity online.

5) Watch your trust accounts. Misuse of client funds is one of the most common reasons for disbarment. Obviously, there is no legitimate way to borrow from a client trust account, but even "innocent" mishandling of such accounts can cause problems.

Sometimes lawyers simply fail to understand that they can't pay bills such as their office overhead expenses directly out of a client trust account, even when the checks are being written out of funds that have already been earned. Consult *The ABA Model Rules for Client Trust Account Records*, which replaced the *Model Financial Recordkeeping Rule* on August 9, 2010, for further guidance.

6) Monitor regularly. Establish predefined financial parameters for your firm and regularly monitor that you are within them. For example, create

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Law Firm Profitability

Benchmarking and Key Performance Indicators

Companies of all sizes have long utilized statistical guidelines to identify best practices in managing their business.

Law firms are no different. The appropriate benchmarks can help management make informed decisions about the firm's financial performance — and what adjustments can be made to improve it.

Edward Poll, author of *Attorney and Law Firm Guide to the Business of Law: Planning and Operating for Survival and Growth, 2nd ed.*, notes that lawyers who understand financial benchmarking can better assess the value they provide to clients, and also better reflect the value of the service in their bills. Poll notes that these attorneys develop an appreciation of those areas where costs can be controlled and where costs are inherent. In short, he says, they do a better job for their clients.

Of course, you'll need to establish benchmarks that are compatible with your firm's culture, capabilities and goals. The following four-step process is a good place to start.

Step 1: Establish KPIs

To be effective, your firm should choose as key performance indicators (KPIs) the measurements or statistics that are important to the firm's success, and those that are readily quantifiable.

So while you should certainly measure things such as Associates-to-Partners Ratio and Billing Realization, you might want to consider digging a bit deeper with KPIs that meet your firm's specific goals. These might include:

- **Net Realization** – This is the ratio of the sum of the value of time actually billed minus the amount written off after billing as uncollectible, versus the value of this same time had it been carried in the firm's work-in-progress.

What it reveals: Takes realization one step further and captures the percentage of lawyers' time that is actually collected and time that is written off.

- **Billable Hours per FTE Timekeeper** – This is the gross number of billable hours worked by timekeepers in a particular category (partners, associates or paralegals) divided by the number of full-time equivalents in that particular category.

What it reveals: Is an indicator of utilization, another key lever of profitability.

- **Average-Billed to Average-Worked Rate** – This is the ratio of the average billed hourly rate for a timekeeping category to the average worked hourly rate.

What it reveals: Helps firms extrapolate the likely effect of rate increases on their billed fees.

Step 2: Create a "Dashboard"

A dashboard provides an easy-to-read snapshot of your KPIs, typically in a graphic format. Using data from your firm's financial statements and related reports, a well-designed dashboard can help management see how the various elements relate and form patterns over time. Your firm's accounting applications may already provide a module for producing dashboard reports.

Step 3: Benchmark

The next logical step is benchmarking — comparing your firm's specific performance measures against the wider legal marketplace and your competitors. The trick is to find accurate and relevant comparable data.

Here, you may want to turn to one of the more reliable sources of benchmarking data:

- **Incisive Legal Intelligence's Annual Survey of Law Firms**
  www.almlegalintel.com

- **Hildebrandt Peer Monitor Economic Index**
  http://legalexecutiveinsights.com

Step 4: Keep It in Context

Computerized accounting and billing systems can put an almost overwhelming array of financial data at your fingertips. The key is to determine which elements of that data you should pay attention to.

Remember that no single number or KPI tells the whole story. Data must be viewed collectively. For example, your firm is probably tracking billing rates and realization. But have you looked at whether your premium rates are resulting in having to write off or discount services? The key is to look at it all in context. ■

Our accounting professionals can provide sound guidance on establishing KPIs and benchmarking your firm's performance.

Understanding FTEs

Full Time Equivalents (FTEs) are a critical denominator in several key performance indicators, so it's important to get this number right. Ultimately, FTEs should reflect how many actual lawyers you had for the month, quarter or year. For example, a lawyer who was with your firm for six of the past 12 months would be treated as one-half of an FTE in determining your lawyer count. ■

"Quick, What Do We Do?"

First Steps When Fraud Is Detected

The whole thing unravels on a Monday morning as you painfully learn that an associate lawyer has stolen more than $100,000 in a false invoicing scheme. Your firm has been defrauded. What now?

- **First: Establish your objectives.** Are you seeking only to recover the losses? To prosecute and deter others? Your answers will help determine whether you involve the police or handle the investigation internally. In either case, consider consulting with external attorneys specializing in the relevant areas of employment, criminal and/or securities law before taking further action.

- **Second: Make the necessary notifications.** Consult with the firm's insurance agent to determine applicable coverage and reporting obligations under your fidelity bond or employee dishonesty rider. You may also need to contact appropriate regulatory authorities, depending on the situation. And think through the firm's obligations to notify potentially affected clients or third parties.

- **Third: Deal with the perpetrator.** Depending on the situation, you may decide to suspend the suspected individual and remove him or her from the premises until you know more. In the end, a suspended employee may be more helpful to the investigation than a fired ex-employee. Of course, change passwords, locks and other sensitive areas the employee has access to.

- **Fourth: Secure the evidence.** A Certified Fraud Examiner and/or a forensic accountant can be invaluable here. In addition to knowing what to look for, this experienced professional knows what type of fraud evidence is required by the courts.

- **Fifth: Manage the fallout.** Consider the need to manage public relations in the event the fraud or theft becomes public. Premature disclosure of information could be damaging, so ensure confidentiality among those impacted by the loss or involved in the investigation. ■

In the event of fraud at your practice, please contact our office immediately for guidance in investigating and recovering your losses.

Fraud Watch

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a simple report that monitors adjustments and write-offs by attorney so that adjustment percentages can be tracked, and any inconsistencies quickly become obvious. Also consider regular "surprise" inspections throughout the year — such as having your CPA receive and review the firm's monthly bank statement before it is delivered, or sending the payroll control master directly to your CPA for review.

7) Insure against fraud losses. Make sure the firm has the appropriate level of fraud loss insurance coverage. Employee dishonesty coverage (also called fidelity insurance or bonding) is a good place to begin. Ask your insurance provider whether you can purchase a "blanket bond" that will cover everyone in the office — this will keep you from having to update the names on the policy every time someone new comes on board.

Going a Step Further

Some firms take fraud prevention a step further by having a trusted accounting or consulting firm brought in for an external review of their internal controls. In addition, an operational audit may be commissioned to help ensure that the firm is enjoying efficient operations while minimizing the risk of fraud loss. ■

Our firm is experienced in fraud prevention and internal controls studies. Call us to discuss your firm's needs in these areas.

Fraud, For Real

Fraud and theft in a law firm? You bet — and at all levels. Consider these recent real-world examples:

- In Pennsylvania, a former paralegal was arrested for allegedly stealing more than $100,000 from a law firm and using the money to pay restitution in a case where she was found guilty of stealing $285,000 from another law firm. SOURCE: *USLaw.com*

- For almost six years, an associate at a large Atlanta law firm regularly performed work for clients and submitted fraudulent invoices to the firm's accounting department. He deposited some $500,000 of the funds into his personal checking account. SOURCE: *Atlanta Journal Constitution*

- A long-time partner at an esteemed Minneapolis law firm was charged with stealing as much as $2 million from several clients and using the money for extensive renovations on a historic mansion. SOURCE: *St. Paul Star Tribune* ■

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Three Steps for Boosting Profits

How do you improve profits without hiking fees or asking employees to work more hours? Paying close attention to these three key law firm metrics can help.

1) Realization: You'll bring in more money any time you can improve on factors related to realization. So, if you were able to decrease write-offs by 5 percent, you'd bring in an extra $5,000 for every $100,000 you bill. Another way is to specialize in areas where there is less competition and/or more complex legal issues. Here, clients may be more willing to pay your full rate or hours — and sometimes even willing to pay an increased rate.

2) Leverage: The next business metric you can adjust is leverage. The key here is to appropriately delegate as much work as possible to lower-paid associates and support staff. Freeing up experienced partners to seek more business and work on existing client relationships should naturally boost profits. Of course, a higher partner rate is still a major contribution to profitability, so you'll need to determine the appropriate business mix for your firm.

3) Margin: Finding ways of doing things more efficiently will help cut costs and increase margins. Take a look at processes that are being performed manually and see if there is a technology or tool to do them more efficiently. The goal is to help the staff spend more of their time on billable activities instead of administrative tasks.

Bonus cash flow tip: Are you advancing substantial costs to your clients? Consider amending engagement agreements and asking for retainers to pay client-specific costs from the trust account. This will decrease the amount you are financing on behalf of your clients. ■