Lessons Learned from the Trust Accounting Battlefield

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Armanino LLP - Law Firm Services Group
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Client Trust Accounting

Demographics –

**Size of Firm:**
- 1 – 25 Lawyers
- 26 – 100 Lawyers
- 100 + Lawyers

**Defense:**
- 100 % Plaintiff
- PI
Agenda

• What is Client Trust Accounting?
• IOLTA vs. Segregated Accounts
• Minimum Required Recordkeeping
• Common Mistakes
• Assessment Checklist – How Are You Doing?

If we have time, we’ll also cover:
• War Stories (these things really happen)
• Common Threads

A Client Trust Account

What you **Have**

(and it’s not really **yours**)

Client Trust Accounting

What you **Do**
What’s so special about Client Trust Accounting?

• It’s NOT just another bank account.
• Having a Client Trust Account creates a FIDUCIARY DUTY which, if ignored or carried out improperly, can put an attorney at risk for disciplinary action, fines, sanctions, suspension and, worse case scenario, disbarment.

Most attorneys with Client Trust Accounts think everything is going fine….

…until they receive a client complaint or an inquiry from the State Bar.
How does this happen?

Because many attorneys don’t know what’s required to be done in order to be in compliance with State Bar Rules & Guidelines.

And because they don’t know what should be done or how it should be done...

They pass it off to someone else in the office.
The problem with this is twofold -

1. Often, the person this is delegated to does not have the necessary training or supervision to properly handle the task.

2. Passing this off to someone else does not relieve the attorney of his/her fiduciary responsibility.

What attorneys don’t realize is that this is a 100% non-delegable duty

Regardless of who does the work, the attorney is responsible for it being done correctly
How many of you do Client Trust Accounting?

- The Client Trust Bank Reconciliations
- Supervise someone else doing the accounting and reconciliations

If you employ others to help you fulfill your responsibility ...

... you must provide

- adequate training
- adequate supervision
- adequate controls
IOLTA vs Segregated Accounts

Client Trust Accounting – IOLTA vs Segregated

- What client funds do you put into an IOLTA bank account?
- What client funds do you put into a segregated client trust account?
- Whose taxpayer identification number is on the segregated account?
- Are the recordkeeping requirements different for an IOLTA account vs a segregated account?
Minimum Required Recordkeeping

Client Trust Accounting – *Minimum Recordkeeping*

1. **Client Ledger**
   - one for each and every client
   - like a “check register” for the funds belonging to one client
   - should show every transaction for the client, along with a running balance
   - should NEVER have a negative balance
   - It is NOT a Settlement Sheet. The Settlement Sheet is what SHOULD happen. A Client Ledger is what DID happen.

2. **Account Journal**
   - should show all transactions processed through the account for **all** clients
   - this is the “check register” for the whole account and must include all deposits, checks and adjustments for everyone
   - should also show a running balance for the account as a whole and should NEVER have a negative balance
   - The Account Journal balance should be the sum of all the Client Ledger balances
Client Trust Accounting – *Minimum Recordkeeping*

3. **Bank Statements and Cancelled Checks**
   - *Must be retained for a minimum of 5 years after the funds are paid out*
   - *Best practice – keep for 5 years after the case is closed*
     - Consideration – since an IOLTA account covers so many clients, how long should you really keep bank statements for?

4. **Reconciliations (monthly)**
   - *Three part process*
     1. Bank Statement to General Ledger Trust Cash Account
     2. Bank Reconciliation to Account Journal
     3. Account Journal to Client Ledger total

5. **Journal of other Property (if any)**
   - *What you're holding*
   - *Who you're holding it for*
   - *When received/distributed and to/from whom*

6. **Audit Trail**
   - *Very important in case questions arise later*
   - *Copies of all executed documents/agreements*
   - *Accurate and complete ledger showing all funds received and disbursed (never make a check payable to “cash”)*
   - *Cancelled checks, deposit tickets*
Common Mistakes

Client Trust Accounting – Common Mistakes

1. Delegation of all client trust accounting functions to administrative staff or bookkeeper without adequate training, supervision or controls

2. Little or no “review” of the client trust accounting by anyone else (if you’re relying on your CPA to review, most CPA’s are not familiar with these detailed trust accounting rules)

3. Untimely, incomplete or non-existent reconciliations

4. Reconciliations that reflect “miscellaneous adjustments”
   This bank account MUST balance to the penny.
   There are no “miscellaneous” adjustments permitted.

5. Bank reconciliations that reflect old outstanding checks (or old deposits in transit)
Client Trust Accounting – *Common Mistakes*

6. Client ledgers / account journals that reflect old inactive balances (Escheatment issue).
   *The list of client balances should be checked monthly for inactive holdings so that someone can follow-up and determine why the funds are still in the account.*

7. Client ledgers / account journals reflecting a negative balance for a client
   *A client ledger should be run/printed every time checks are drawn for a client, to make sure the balance in the account does not fall below zero. Also, checking the list of client balances every month as part of the reconciliation process will quickly bring to light any issues.*

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Client Trust Accounting – *Common Mistakes*

8. Signing blank checks or using a signature stamp
   *Checks should only be signed “live”, and careful consideration should be given as to who will have signature authority. It should not be the same person who is writing all of the checks.*

9. Keeping “slush funds” (firm money) in the Trust Account to protect against the account being overdrawn.
   *This amounts to “co-mingling”, which is a violation of State Bar rules.*
What you can do to protect your Client Trust Account and yourself –
(at a supervisory level)

• Don’t just delegate these responsibilities and assume someone else will handle everything.
  
  *Be involved.*
  
  *Ask questions.*

• Review reports and bank reconciliations at least periodically, if not regularly, to look for signs of trouble.
• Sign checks yourself, or have another individual, maybe an attorney sign trust checks.
• Have someone do the bank reconciliation (along with the account journal to client ledger reconciliation) that is outside the trust accounting function.
In order for you to assess how your Trust Account is doing, here is a high-level list of questions to ask and things to review.

While not all encompassing by any means, this checklist can assist in spotting some of the more common problems.

### Client Trust Accounting – **Checklist**

Answer the following questions for your Trust Account(s)

<table>
<thead>
<tr>
<th>Does the individual that performs the Client Trust Accounting functions have the necessary:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Training</td>
</tr>
<tr>
<td>Supervision</td>
</tr>
</tbody>
</table>

| Does someone other than the individual doing the Client Trust Accounting review the bank statements and bank/trust reconciliations? | □ Yes □ No |

Review a detailed listing of all open clients/matters in the Client Trust Account, along with the balances for each:

| Are there any clients/matters with negative balances? | □ Yes □ No |
| Are there any clients/matters with positive balances, but which have had no activity in over 6 months? | □ Yes □ No |
| Are there any client names or matters that you don’t recognize? | □ Yes □ No |
| Are there any clients/matters that may have erroneous charges? | □ Yes □ No |
Client Trust Accounting – *Checklist*

<table>
<thead>
<tr>
<th>Review the bank and trust reconciliation reports:</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Are monthly bank reconciliations up to date?</td>
<td></td>
<td></td>
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<tr>
<td>On the bank statement, there is a “daily balance” figure. Is there one or more negative entries here?</td>
<td></td>
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<tr>
<td>Are there outstanding checks more than 6 months old?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Are there any deposits in transit older than 1 month?</td>
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<td></td>
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<tr>
<td>Are there any “miscellaneous” adjustments on the bank reconciliation?</td>
<td></td>
<td></td>
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<tr>
<td>Does the bank reconciliation balance agree to the Client Trust Account journal?</td>
<td></td>
<td></td>
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<tr>
<td>Does the Account Journal Balance agree to the Client Ledger total balances?</td>
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</tbody>
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**War Stories**
Most attorneys think their Trust Account is fine.
Nobody thinks they have Trust Account problems.

*Until there is a problem.*

Following are brief summaries of actual situations we have encountered with clients, along with a summary of our findings and what had to be done to bring the client into compliance with State Bar requirements.
Client Trust Accounting – *War Stories – Client #1*

**Client Background**

- Small personal injury firm
- Client believed they had always kept good records
- They had no complaints from clients and made what they believed to be complete disbursements
- They switched banks, and realized their trust account had a balance of over $75,000 they were unaware of
- Worse, they had no idea who these funds belonged to

**What we found –**

- An attorney had done all of the bookkeeping. There was no bookkeeping staff because of a lack of trust.
- All of the firm’s Trust records were on paper, consisting of a hand written check register and copies of hand written deposit tickets, going back 5 years.
- There was NO bank register, showing deposits, disbursements, or a running balance in the account.
Client Trust Accounting – War Stories – Client #1

What we found –

• The bank account had NEVER been reconciled to the bank statements.
• There were NO client ledgers. That is, there was no record/list/register of actual deposits and disbursements that had been made for each client.
• Since there were no client ledgers, a Trust Reconciliation (separate procedure from the bank reconciliation) had never been done.

Client Trust Accounting – War Stories – Client #1

What we found –

• Disbursements were typically made the same day the deposit was received.
• A number of old outstanding checks (client didn’t know they were outstanding since reconciliations were never performed)
• Disbursements issued in incorrect amounts, resulting in incorrect client balances, undisbursed attorney’s fees and recovered costs, and forgotten disbursements due to clients and providers pending lien reductions.
Client Trust Accounting – War Stories – Client #1

Client mistakes -
• Having someone with limited knowledge of bookkeeping/accounting handle the bookkeeping.
• Failure to perform bank and trust reconciliations.
• Failure to maintain an account journal of all transactions.
• Failure to maintain client ledgers to reflect balances.
• Failure to allow sufficient time for funds to clear before making disbursements.

What we did –
• Existing hard copy records were transferred to an electronic file so that transactions could be posted to individual clients and client balances could be determined.
• For checks/deposits with missing information, we pulled Settlement Sheets to piece together and match transactions using time frames and transaction amounts.
Client Trust Accounting – *War Stories – Client #1*

**What we did –**

- Once all known transactions were entered, the bank reconciliations had to be performed back to the opening of the account.
- Unknown transactions (those that showed up on bank statements, but for which no hard copy evidence was provided by client) had to be investigated (copies of documents obtained from the bank/client files pulled).

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Client Trust Accounting – *War Stories – Client #1*

**What we did –**

- Once bank reconciliations were complete, we were able to identify which clients still had funds remaining in the trust account.
- Settlement Sheets/files were pulled for all of these clients to determine why funds were still being held and how funds should be disbursed.
Client Trust Accounting – War Stories – Client #1

Final Result & Current Status -
• All transactions were able to be traced to specific clients.
• All balances were cleared and disbursed to clients, providers, lienholders and the firm
• Client now has a complete electronic file reflecting all Trust Activity since the bank accounts were opened
• Monthly bank AND Trust reconciliations are now performed

Client Trust Accounting – War Stories – Client #1

Final Result & Current Status -
• A full-time bookkeeper was hired to take over the day to day bookkeeping and monthly reconciliations
• We check in with client every 3-4 months to review reports to make sure everything is in balance and procedures are being followed
Client Trust Accounting – *War Stories*

Client #2

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Client Trust Accounting – *War Stories – Client #2*

**Client Background**

- High volume personal injury firm
- *Client had been in business for 20+ years and believed they had always kept good records*
- *Client had 2 “old” inactive Trust Accounts and 1 new Trust Account.*
- *When the “old” bank accounts were closed, a lump sum entry was made in bookkeeping system to transfer the funds, with no client references*
- *Client wanted to clear up old matters, but didn’t know how*
Client Trust Accounting – War Stories – Client #2

What we found –

• Cash and liability balances in old and new trust accounts did not tie out.
• Bank accounts had been reconciled in the past, but were several months behind.
• There were outstanding checks that had never been investigated and were dated up to 20 years ago.
• Several client ledgers had NEGATIVE balances

Client Trust Accounting – War Stories – Client #2

What we found –

• The person in charge of the Accounting Dept. had been with the firm from the beginning and had a lot of historical knowledge as well as good knowledge of day to day procedures, but did not have accounting or bookkeeping training and was not familiar with State Bar regulations regarding Trust Accounts. This person was also the Office Manager with a myriad of other duties and could not devote full time and attention to the Accounting.
Client Trust Accounting – *War Stories – Client #2*

**What we found –**

- Accounting Dept. staff were likewise untrained.
- There were no formal processes or procedures in place for the Accounting Dept. When a new employee came on board they were verbally “trained” by existing employees.
- One of the Accounting staff was stealing from the firm by using company credit cards for excessive personal purchases. This went undetected because nobody was reviewing/auditing the credit card statements.

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**Client Trust Accounting – *War Stories – Client #2***

**What we found –**

- There were many vendor issues and the firm was often on the verge of being “cut off” by some vendors because payables were so far behind.
- A Trust Reconciliation had never been performed because nobody knew about it or how to do it.
- Disbursements were being made the same day funds were being received (big State Bar violation).
Client Trust Accounting – War Stories – Client #2

Client mistakes -

• Having someone with no/limited knowledge of bookkeeping/accounting handle the bookkeeping.

• Failing to keep up with bank reconciliations.

• Failing to perform regular Trust Reconciliations.

• Failing to review/audit credit card statements.

• Failing to investigate and clear outstanding checks.

Client Trust Accounting – War Stories – Client #2

Client mistakes -

• Failing to clear old balances in individual Client Trust Ledgers by disbursing funds to appropriate payee.

• Failing to allow sufficient time for funds to clear before issuing disbursements (resulting in co-mingling of client funds)
Client Trust Accounting – War Stories – Client #2

What we did -
• Brought bank reconciliations up to date to ensure records were current.
• Located transactions that did not have clients attached to them and determine who client was so that transactions could be linked to appropriate client ledgers (had to go through case management software and settlement sheets, sometimes pulling old files to determine client).
• Ran client ledger reports to determine where there were still balances remaining in client accounts.

Client Trust Accounting – War Stories – Client #2

What we did -
• Checked accounting records against Case Management software and settlement sheets to determine how remaining funds should be disbursed.
• Voided all older outstanding checks and had client contact payees to verify address so that checks could be reissued.
• Tracked down and corrected entries that caused trust cash and liability accounts to become out of balance.
Client Trust Accounting – War Stories – Client #2

What we did -
• Drafted processes and detailed procedures for the Accounting Dept. and training staff in appropriate steps.
• Assisted in hiring of Accounting Manager with the skills necessary to properly run the Accounting Dept.
• Reorganized the accounts payable process to ensure bills were paid in a timely manner.
• Worked with vendors to bring accounts up to date and implement better procedures for receiving and paying bulk invoices to avoid credit issues.

Client Trust Accounting – War Stories – Client #2

Final Result & Current Status -
• Client cash and liability accounts are balanced and final funds from all accounts are being disbursed to the appropriate parties.
• Where clients cannot be located, funds are being escheated to the State.
• Monthly bank AND Trust reconciliations are now performed
• Accounting Manager ensures that all tasks and reporting is properly and timely performed.
Client Trust Accounting – *War Stories – Client #3*

*Client #3*

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**Client Background**

- *Small, boutique law firm handling a limited number of high dollar cases*
- *No Accounting Department due to the size of the firm. A longtime paralegal was in charge of the client trust accounting and was implicitly trusted by firm partners*
- *There was an older trust account with a few balances and a newer trust account with about twenty client balances*
What we found -

- The person in charge of the client trust accounting had no training in bookkeeping or accounting
- Bank reconciliations were performed but were a few months behind
- Bank reconciliations had been performed improperly, resulting in items being cleared in the bookkeeping software that were never cleared by the bank, and items that cleared the bank not being cleared in the accounting software

What we found -

- A Trust reconciliation had never been performed
- A few client ledgers had NEGATIVE balances
- The trust cash and liability accounts were not balanced
- There was an outstanding check in an amount over $300,000, but there was less than $130,000 in the bank
- The firm’s fees and costs had been double paid on several occasions because the bookkeeper made posting errors and didn’t know how to read the reports from the accounting software
Client Trust Accounting – War Stories – Client #3

Client Mistakes

- Untrained bookkeeper
- Complete delegation of duties with no review of reports
- Incorrect bank reconciliations
- No trust reconciliations

What we did -

- Tracked down errors that caused negative balances in client ledgers
- Pulled bank statements to confirm that double payments to firm that appeared to have been made were actually made
- Convinced attorneys that mistakes had been made and the firm would have to pay back the double payments made to the firm (more than $400,000) to reconcile the trust account
Final Results & Current Status -

- All overpayments were paid back to the trust account by the firm
- Trust cash and liability accounts are in perfect balance
- A part-time, experienced bookkeeper was hired (with training by Armanino) to handle all weekly bookkeeping and perform monthly reconciliations
- Reconciliations are performed every month

Client Trust Accounting – War Stories – Client #3

Client Trust Accounting – War Stories – Client #4

Client #4
Client Trust Accounting – *War Stories – Client #4*

**Client Background**

- Client had been in business for many years, was an extremely high volume practice, and had a very active client trust account.
- An Executive Director was in charge of the Accounting Dept.
- There were several entities existing under one client umbrella, each with its own bank accounts and some with separate trust accounts.
- Due to a potential sale of the firm, Armanino was called in to review all aspects of firm management and accounting processes.

**What we found -**

- The Accounting Dept. was understaffed and existing staff had no formal bookkeeping training. Staff was struggling to keep up with day to day transactions.
- Although bank reconciliations had been performed, they were not up to date and included monthly “adjusting entries” to balance to the Trust Account to the bank statement.
Client Trust Accounting – *War Stories – Client #4*

**What we found -**

- There were over 20,000 clients with balances in the Trust Account and over a million dollars of entries posted without a client name.
- Client had an “older” semi-inactive Trust Account that had funds that had not been tied to specific clients.
- Because of multiple trust accounts for different entities, in several instances, funds were deposited to one account and disbursements were made from another.

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Client Trust Accounting – *War Stories – Client #4*

**What we found -**

- Recovered costs had not been paid to the firm in years in order to maintain a cushion of cash. As a result, millions of dollars sitting in the Trust account actually belonged to the firm.
- As the firm needed funds for large expenses, bulk transfers were made from the Trust Account to the Operating Account without any client reference.
Client Trust Accounting – War Stories – Client #4

What we found -
- Client Trust cash and liability accounts were severely out of balance.
- Several client ledgers had NEGATIVE balances.
- There were over $6,000,000 in uncleared checks in the Trust Account, going back 4 years.
- There were many clients for whom funds were being held pending lien reductions, including Medicare. These issues had been forgotten/fallen between the cracks and had not been followed-up on in years.

Client Trust Accounting – War Stories – Client #4

Client Mistakes
- Untrained and insufficient accounting staff
- Complete delegation of duties to others with no oversight of person in charge/review of reports
- Incomplete bank reconciliations
- No trust reconciliations
- Major co-mingling of funds
- Neglecting outstanding client balances
- Failure to follow-up on outstanding checks
Client Trust Accounting – *War Stories – Client #4*

**What we did -**

- Tracked down all recovered costs left in the Trust account and made thousands of lines of journal entries to transfer the funds to the firm operating account and clear Client Ledgers.
- Investigated and voided all uncashed checks more than 6 months old.
- Investigated and tracked down the “no name” entries to determine which clients they should be allocated to.

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**What we did -**

- For remaining clients with balances, we reviewed case management records and settlement sheets to determine who the remaining balances belonged to and instructed firm personnel in disbursing the funds to the appropriate parties.
- Assisted in hiring a Controller and additional accounting staff.
- Put together process documentation for existing accounting staff and for assisting with training new staff.
Client Trust Accounting – **War Stories – Client #4**

**Final Result & Current Status -**

- Controller and staff are following newly implemented procedures to complete clean-up and ensure the books stay up to date going forward.
- Monthly bank and trust reconciliations are performed in a timely manner.
- Trust cash and liability accounts are completely in balance.
- All funds have been tied to specific clients, so there are no “mystery” balances.

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Client Trust Accounting – **War Stories – Client #4**

**Final Result & Current Status -**

- Final disbursements are still being made, but what started as more than **20,000 clients** with balances has been reduced to **246 clients** with balances.
- In the process of tracking down the remainder of the providers/clients to reissue the checks. Some funds may need to be escheated to the State.
Common Threads

You have probably noticed a few common threads in all of these War Stories.

- Accounting personnel who don’t have adequate training
- Failure to supervise/review accounting staff and client trust and other accounting records
- Failure to perform regular and timely bank/trust reconciliations
- Ignoring client trust ledgers once initial disbursements are made