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We Wonder Where The Money Went: A Guide To Internal Controls In Law Firms

Prepared by The Department of Audit and Investigation, Law Society of Upper Canada

Introduction

Whenever two or more lawyers enter into a partnership arrangement, the administrative procedures followed by the partners will be governed by a policy of the firm. The larger the firm becomes, the more likely that management duties will be delegated to one of the partners, or to a business manager who is not a lawyer; such duties require some form of control.

The objective of this paper is to apprise firms of areas of potential financial management problems and to present suggested remedies. Although these guidelines are intended to be of general application, some provisions may apply more to larger firms.

Suggested Internal Control Considerations

1) Failure To Practise Internal Control

A firm may have a sound internal control system in place, but may fail to require all members to follow its requirements. These exceptions may lead to instances of inappropriate financial transactions.

It is recommended that all members of a firm be required to follow the internal control system in place.

2) Separation of Accounting Duties

It is fundamental to good internal control that separate persons handle bank deposits and the making of entries to the accounting records. This practice will prevent the manipulation of the accounting records to reflect improperly made bank deposits.

3) Third Party Verification

It is common practice in the accounting profession to verify financial transactions with third parties. This important action permits the accountant to verify intercompany transactions to ensure that records properly reflect appropriate entries.

It may be appropriate to make periodic third party verifications with clients to ensure that proper fees and disbursements are billed. This measure may be particularly applicable in respect of foreign exchange transactions or in circumstances where a number of docket transfers have occurred.

4) The Importance of Vacations

Good internal control requires that a person in a position of responsibility be absent from the office for at least two consecutive weeks. During this period, matters which come to light that are inconsistent with established practice will be detected by others; thus this measure creates the opportunity to detect problematic areas.

5) Monthly Trust Comparisons

Section 15 (2) of Regulation 573, made pursuant to the Law Society Act, requires that the trust bank account be balanced against the client trust ledgers within 15 days from the end of a month. This important requirement should be strictly enforced in a firm to ensure that client funds are intact.

Management should test check entries in the reconciliations and the client trust ledgers to ensure that the reconciliation has not been manipulated by the accounting staff member responsible for this activity.

Individual solicitors in the firm could be provided with a periodic detailed printout of each of their client trust accounts in order to conduct a review of the trust account entries to identify any entries that appear to be at variance with those approved by the solicitor.

6) Regular Billing of Disbursements

A member may incur personal disbursements that are allocated as client disbursements. By failing to follow a practice of insisting on regular billing of disbursements, these inappropriate expenditures will not readily come to the attention of a client for review. It is suggested that a practice of a periodic review of unbilled disbursements be undertaken by a management committee.

The managing partner and those in charge of the accounting function should be wary of a request to transfer disbursements from one client to another based on an explanation of an incorrect original entry. A review of the original expenditure to confirm that the original entry was in error should be conducted.

This measure could prevent an inappropriate disbursement from being transferred to a different client docket, thus deferring the billing of such amounts. It is important that the disbursement be placed before the client for vetting at the earliest date.

7) Personal Expenses Philosophy

It should be recognized that a law firm is a business enterprise. As such, it is advisable to formulate a business policy of the firm that discourages the use of the firm's accounting records and financial resources for the payment of personal expenses of the solicitor. With such a policy in place, personal expenditures will not become part of the law firm's accounting system, thus removing the potential for the solicitor's personal expenditures being allocated as a client disbursement or an operating expense of the law firm.

8) Foreign Currency Billing Control

The firm may have been engaged by clients resident outside of Canada. The managing partner and accounting staff may not be familiar with the financial arrangement with the client, thus client payments in funds that are at a premium in relation to the Canadian dollar may be recorded at an amount that is less than the market value of the converted rate, creating the potential for an appropriation of the excess ("premium") amount. In such an instance, the client would not be aware that a credit balance exists in the trust account, consequently providing the opportunity for this credit balance to be used for some purpose not authorized by that client.

This matter can often be addressed by reviewing the engagement letter to determine the currency to be used for billing purposes. Additionally, a review of the bank deposit slip can determine the currency in which the payment was made. With this information, one can determine if all recordings were properly made and appropriate follow up action taken.

9) Significant Changes

A member of a firm may experience a sudden significant increase in advances, entertainment expenditures or a large increase in unbilled disbursements. A threshold test should be in place to require a review of such significant changes to ensure they are supported by events acceptable to the firm.

10) Account Write-Offs

A member may attempt to improperly collect a client billing directly from the client by "writing off" the client receivable and collecting the account personally. This activity would require providing a plausible explanation to the firm to support the "write off".

The firm could address this type of event by third party verification in circumstances where the member has engaged in this type of practice on a regular basis or the amount at issue is relatively significant.

A firm may also consider appointing a partner of the firm or a committee of partners to review all write-off amounts. The assignment of this task to partners, because of their vested interest in the performance of the firm, may be desirable.

11) Last Minute Need For Funds

The law firm's management should review the practice of any solicitor who regularly requires cheques drawn from trust or general accounts on a priority basis. This practice may not permit the usual checks and balances of the internal control system to function, and may be an indication of disorganization or an indicator of an attempt to purposely thwart the internal control system.

Management should discourage a member from engaging in this practice. Additionally, the authenticity of the transactions should be periodically reviewed.

12) Valuable Property Controls

Section 15 (1)(i) of Regulation 573 requires that the Law Firm maintain a record showing all negotiable or other valuable property, other than money, held in trust from time to time for clients. This requirement exists in order to ensure that the firm's holding of clients' negotiable instruments and valuables is accounted for in an orderly manner.

Management of the law practice should periodically test verify the physical existence of these negotiable instruments and valuable property to ensure a member of the firm has not taken the instruments or property for personal use until such time the client may require them to be returned. Additionally, an annual verification with the client about the particulars of the instruments or property held, including confirmation of the return of the instruments or property, would assure the firm's management of the integrity of the inventory records of these items.

Negotiable instruments in "bearer" form may be taken by a solicitor and pledged as security against personal borrowings at financial institutions. Although the instrument may be returned to the law firm at such time the client requires its return, the use of these instruments as personal collateral is a misapplication of the client's property.

Likewise, valuable property of a client may be used for similar purposes: for example, expensive jewellery pledged as collateral.

If this practice is not controlled, a law firm may find that the negotiable instruments or valuable property improperly pledged as security on personal borrowings by a solicitor have been retained by the financial institution following a default in repayment of the loan.

13) Estate File Controls

It is not uncommon in the larger firms to find that an individual solicitor maintains control over an estate's trust account and record keeping duties, quite apart from the normal accounting functions of the firm. This lack of independence between the control of the estate's expenditures and the maintenance of the estate's records exemplifies weak internal control over the preservation of the estate's resources.

It is recommended that estate expenditure controls/approvals and record keeping be subject to the same rigorous internal control measures as is other client trust money.

Summary

The Law Society of Upper Canada recommends that law firms review their internal control systems to ensure that adequate controls are in place. These controls should be periodically reviewed and revised as appropriate. The firm should apprise all members of the firm of the internal control policy and procedures to ensure that all persons appreciate the significance of such controls.

The Society is unable to provide a standardized internal control recommendation that could be adopted by all firms as numerous accounting systems and management styles must be considered in such a recommendation. It is suggested that the law firm consult with its accounting professionals to review internal controls specific to the needs of the firm.

Adequate Insurance On Stored Files

As a result of a recent fire in a public warehouse, a number of members stand to suffer serious financial loss (mainly as a result of water damage), because of insufficient insurance on their stored files.

It is suggested that members review their warehouse storage agreements for their insurance provisions, the financial ability of each warehouse to discharge its obligations, and each member's own insurance, to ensure that the member will be fully compensated should similar unfortunate events occur in the future.

Facsimile Transmissions

The Law Society has received a number of complaints regarding the use of facsimile machines to send voluminous documents that could easily be sent by courier or by mail. Usually both the senders and receivers make a charge for the service and as a result clients' legal costs are often unduly inflated by facsimile charges incurred involuntarily.

Before sending a fax of more than two or three pages, as a courtesy, please obtain the recipient's consent. Remember also, however, that if you send by

facsimile, you receive by facsimile. We draw members' attention to Rule 14 of the Rules of Professional Conduct.

Provincial Legislation Amendments — Land Transfer Tax Affidavits

The Law Society has been requested by The York Region Roman Catholic School Board to bring to the attention of our members the provisions of Ontario Regulation 157/91 regarding the payment of Land Transfer Tax. The regulation, and consequent changes to the Land Transfer Tax Affidavit, permit clients to direct school support to the separate school board, should they wish to do so. Members are reminded to bring this provision to the attention of their clients, in the execution of Land Transfer Tax Affidavits.

"Notice" Mixed Trust Bank Accounts

It has recently come to the Society's attention that certain Chartered Banks are attempting to alter their banking relationship with members in private practice with respect to members' trust accounts. Specifically, these banks are requesting that the solicitor sign an agreement that would change the status of the law firm's mixed trust account from that of "on demand" to that of with "notice". The effect of a change in the account's status to one of "notice" status is that in order to draw money on the account, the solicitor may be required to provide the bank with advance notice of the withdrawal, usually up to 24 hours in advance.

The inducement offered by the bank is a higher interest rate paid on the money on deposit in the mixed trust bank account. The bank is able to make such an offer as its reserve requirements are much more favourable on "notice" accounts, thus enabling the bank to enhance its earning capacity on money on deposit in such an account.

Members are advised that it is the Society's position that "notice" mixed trust bank accounts are unacceptable as the clients' trust money must be available on demand for the benefit of the client. To enter into banking arrangements contrary to that premise would compromise the solicitor's relationship with the client.

Members who have entered into an "on notice" arrangement with their bank should immediately take steps to restore their trust account to "on demand" status.