



ACCOUNTING 101 for LAWYERS

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Introduction

Lawyers and law firms must have a general appreciation of basic business accounting to successfully evaluate their firm from a business management perspective. In this article, we will examine the basics of accounting for lawyers.

Program

- Basic Accounting Overview
- Understanding Team Productivity
- Software
- Budgeting

Purpose of Accounting

The purpose of Accounting is simply to know your firm's financial performance, to prepare tax returns and to abide by relevant ethical and regulatory guidelines. More often than not, this writer encounters lawyers who either turn a blind eye to accounting and rely on their accidental success as a means of continued firm expansion and growth, or too much trust is levied onto the firm's CPA or bookkeeping staff to understand and simply explain the firm's financial well-being.

Further, basic tenets of accounting are required for a complete understanding and appreciation of your firm's banking relationships.

Lastly – if and when your firm ever wants to sell to another firm, initiate a partnership buy in our buy out, understanding accounting and evaluating the worth of your firm is required.

Know the Terminology

1. **G.A.A.P.:** Generally accepted accounting principles (GAAP) are the standard framework of guidelines for financial accounting used in any given jurisdiction. These include the standards, conventions, and rules that accountants follow in recording and summarizing and in the preparation of financial statements.

Writers note: The most important GAAP principle is consistency – Following an unvaried approach to your firm's finances is highly important

2. **Accounting Method:** There are three basic accounting methods which your firm may choose to follow. Methods are often selected when your firm starts up and changing methods may require special tax filings with the I.R.S.
 - a. **Cash Basis:** Cash basis accounting is simple. Revenue is recognized when cash (i.e. payments from clients) is collected. Expenses are recognized when cash is disbursed;
 - b. **Accrual Basis:** Accrual basis accounting recognizes revenue upon billing and recognizes expenses upon "payables" being booked into the software system.
 - c. **Modified Cash:** Modified cash is the "hybrid" of cash and accrual. Modified cash recognizes revenue upon collection, but may recognize some expenses when booked in as payables. For law firms, modified cash is a popular method because client costs are not considered expenses when paid, but rather "client costs receivable" and are never "expensed" at the end of the tax year. As you may imagine, this is the IRS' preferred method for professional businesses (like law firms). Although not an official statement of the IRS, you may want to refer to the IRS' attorneys-audit technique guide at http://irs.gov/pub/irs-utl/attorneys_atg.pdf

3. General Ledger Accounts

- Assets = What Your Firm "has/owns"
- Liabilities = What Your Firm "owes"
- Equity = Assets (*minus*) Liability

- Income = Revenue/Income over a time period
 - Expenses = What you spend over a time period
4. **Chart of Accounts:** The chart of accounts is list of the General Ledger Accounts from the first asset account through the last expense account in your firm's accounting books. Below, I'll give you examples.
 5. **Debits and Credits:** If the words "debits" and "credits" sound like a foreign language to you, you are more perceptive than you realize—"debits" and "credits" are words that have been traced back five hundred years to a document describing today's double-entry accounting system. Under the double-entry system (also called G.A.A.P. see *item 1 above*) every business transaction is recorded in at least two accounts. One account will receive a "debit" entry, meaning the amount will be entered on the left side of that account. Another account will receive a "credit" entry, meaning the amount will be entered on the right side of that account. The initial challenge with double-entry is to know which account should be debited and which account should be credited.

Because every business transaction affects at least two accounts, the current U.S. accounting "system" is known as a double-entry system. (You can refer to your firm's chart of accounts to select the proper accounts. Accounts may be added to the chart of accounts when an appropriate account cannot be found.)

6. **Examples:** For example, when your law firm borrows \$1,000 from a bank, the transaction will affect the company's Cash account (an Asset) and the company's Notes Payable account (a liability). When the company repays the bank loan, the Cash account and the Notes Payable account are also involved, but the transaction is reversed (we reduce cash to pay back the note).

If your law firm buys supplies for cash, its Office Supplies expense account and its Cash account will be affected. If the firm buys supplies on credit, the accounts involved are Supplies and Accounts Payable.

If your law firm pays the rent for the current month, Rent Expense and Cash are the two accounts involved. If your law firm provides a service and gives the client 30 days in which to pay, the company's Service Revenues account and Accounts Receivable are affected.

Although the system is referred to as double-entry, a transaction may involve more than two accounts. An example of a transaction that involves three accounts is your law firm's loan payment to its bank of \$300. This transaction will involve the following accounts: Cash, Notes Payable, and Interest Expense.

7. **Balance Sheet:** Every company has both a balance sheet and an income statement. The former is a statement of your Assets (what you have/own), your Liabilities (what you've borrowed/owe) and your Equity (A.K.A. Capital /

Retained Earnings). The basic formula is that your total assets must always equal your liabilities plus your equity. Said another way, Assets, less your liabilities, is what your firm is worth. The balance sheet tells the overall story of your firm's business health.

8. **Income Statement** (A.K.A. Profit & Loss statement). The income statement shows periodic changes to income and expenses and demonstrates (Income or Revenue – less expenses results in net profit (or net loss)
9. **Other Financial Statements**
 - Trial Balance (shows all debits and credits as of an end date across all GL accounts and in the end, must equal ZERO)
 - Cash Flow Statement – Cash Flow shows current financial state and expected revenue, expenses and for the most part, helps firms plan in the short and long term for future business growth.
 - G/L Detail Report – Shows the details of in/out of each GL account no matter if it is an asset, liability, equity, income or expense account.

Accounting Issues Unique to Law Firms

Client Advances/Costs/Expenses

Expenses Paid by the Firm on Behalf of the Client (and not from Trust Account);

These amount to Non-Interest Bearing Loans to Client. A good example is your firm advancing a filing fee and then billing the client for it later.;

The IRS wants any client advances to end up as a "cost receivable" (an asset on your balance sheet and not a deductible business expense of your firm). The "type of client advance" makes this rule a bit murky. Clearly if you advance funds (write a check from your operating account) the I.R.S wants that booked in as a Cost Receivable (Asset). But if you incur a "non-cash" expense (like photocopies on your internal photocopy machine) – that entry could, in some circumstances, be booked in only when collected and/or booked in as a "contra-expense" to show the offset of the cost of maintaining the photocopier in your office.

IOLTA (IOTA) Trust Accounts

IOLTA = Interest on Lawyer's Trust Account;

Critical activity of law firm accounting. Must account for every penny in trust and know which client/matter's money is being held in trust. In other words, the bank balance must be able to be accounted for matter by matter (at all times).

Normally, funds paid in advance by a client for a matter you're handling for them is deposited to Trust and only transferred to operating upon you demonstrating that you've earned a fee or need to be reimbursed for a cost advanced.

Held until work is performed or order comes from outside authority (court);

- Governed by Rule Illinois Rules of Professional Conduct Rules 1.15
- Cannot include funds that belong to the firm – subject to audit
- Monthly Reconciliations are required
- Three Way Reconciliations (Client Trust Ledger v. Adjusted Bank Balance v. Check
- Register)

- Make very quick remediation of shortfalls
- Document everything fastidiously.

Timekeeper Productivity

When it comes to timekeeper productivity, we're really worried about the following areas. Different firms place value on different key pieces of data.

- Worked v. Billed v. Collected
- How many hours did each timekeeper work?
- How many dollars were collected?
- Who billed – hours and dollars?
- Who collected, and how much? (in most systems will tie out to the Income Statement)

Productivity v. Profitability:

How productive is your staff?

v.

How much are they collecting v. what it costs us to keep them in the firm?

A/R & WIP

- A/R = Accounts Receivable
- WIP = Work in Process a/k/a unbilled time & expenses
- Both of these numbers will play into both cash flow and productivity analysis

Budgeting

- Forecasting and Keeping Score
- Motivates Performance
- Productivity Budgeting: How many hours expected to bill v. amount collected v. cost to keep you in the firm;
- GL Budgeting: Mostly reviews your expenses on the books (over/under budget analysis)

SOFTWARE CONSIDERATIONS

Below is a list of some recommended software for your consideration. This list is not an exhaustive list by any means. You may find an excellent product *not* on this list as well.

Small Firms (1-15 attorneys)

Integrated General Ledger:

PCLaw (LexisNexis) www.pclaw.com

Tabs3 (S.T.I.) www.tabs3.com

CosmoLex (CosmoLex) www.cosmolex.com

Actionstep (Actionstep) www.actionstep.com

Billing with a Data Link to QuickBooks:

Rocket Matter (www.rocketmatter.com)

CLIO (www.goclio.com) (also links to www.xero.com)

MyCase (www.mycase.com)

Practice Panther (www.practicepanther.com)

Medium Sized Firms (15-50 attorneys)

Integrated General Ledger

Tabs3 (S.T.I.) www.tabs3.com

Orion (www.orionlaw.com)

Coyote Analytics (<http://coyoteanalytics.com/>)

ProLaw (www.prolaw.com)

Actionstep (Actionstep) www.actionstep.com

Larger Firms (51+ lawyers)

Orion (up to 150) (www.orionlaw.com)

Rippe & Kingston (www.rippe.com)

3E by Thompson Reuters (<http://www.elite.com/3e/>)

Aderant Total Office (www.aderant.com)