

## BASIC ACCOUNTING INFORMATION YOU NEED TO KNOW

Legal accounting is a little different than standard business accounting, as there are unique financial issues within a law firm environment, including trust accounting and client costs advanced. Retainers and trust funds are particularly important to understand, as attorneys have an obligation to adhere to the Rules of Professional Conduct and ethics opinions that govern them. These materials will discuss the fundamental concepts of a legal accounting system, including various rules that directly affect the management of client funds.

### COMPONENTS OF A LAW FIRM'S FINANCIAL SYSTEM

There are four or five main components to every law firm's financial system, and it is important for you to understand how everything ties together.

#### TIME & BILLING

Every business has a product or service they are selling, and this is the heart of their income. In a law firm, that commodity is your time. You may also have costs that you bill your clients for, but ultimately the bulk of your income comes from time spent servicing client's legal needs. Accordingly, the time & billing portion of your financial system is what tracks your time, including flat fee and contingency work, and keeps a running tally of what is owed by each of your clients. Unbilled time and costs (also known as Work in Progress or "WIP" for short) are kept track of until they are billed, at which point they move from WIP to Accounts Receivable (aka "A/R"). Payments are posted against the Accounts Receivable, thus reducing the balance owed. These payments may be in the form of trust monies or regular payments.

#### TRUST

Law firms are required to keep client funds separate from their firm operating bank account until such time as it is earned. Accordingly, these monies are typically kept in a separate trust bank account. This is also referred to as an IOLTA account.

We will discuss trust regulations in greater detail later in these materials. For the purpose of explaining how it affects your legal accounting system, you need to understand that client funds will be deposited to a trust account that will be kept separate from the operating account, and that as the firm earns their fees, you will need to transfer money from the trust account to the firm in payment for those fees (and potentially costs as well). Those payments will reduce the accounts receivable balance in your time and billing system and the income will post to your general ledger.

#### ACCOUNTS PAYABLE

The concept of Accounts Payable is fairly simple. It equates to the money owed by your firm to various vendors or payees. It may be easiest to think of this as your check register or checkbook of outbound monies; when you pay an invoice, the expense posts to your general ledger. When you pay an invoice for a client cost, it also posts to your time & billing as a billable cost.

#### GENERAL LEDGER

The general ledger is what brings all of these other components together and gives you the financial statements for the firm. For instance, when a payment is posted to the Time & Billing system against accounts receivable, it flows through to the general ledger as income. When you pay a bill in Accounts Payable, it posts as an expense to the general ledger. When all is said and done, the various transactions that post to the general ledger allow you to see the overall financial health of the firm on the Balance Sheet and Income Statement.

## PAYROLL

Payroll is the last component to most financial systems. If you have an external payroll service, then you may just post journal entries on your general ledger to account for the payroll transactions. If you do the payroll in-house, then the likelihood is that you have software setup to automatically calculate the taxes, etc. This software should post the journal entries for you back to your general ledger for you.

## TIMEKEEPING AND BILLING SYSTEMS

As discussed above, there are a number of factors involved with managing the overall financial picture of a firm. Time and billing is only one piece of that. Many software applications on the market are specifically designed to manage your time and billing only, not your overall ledger. In other words, they take care of your Accounts Receivable, but what about the rest of your accounting? If you choose a program that does only time and billing, it is important to be aware of whether or not it integrates with your other accounting system, or else you will find yourself unable to run the financial reports you desire, and worse, potentially double-entering data. This increases room for error, as well as being inefficient.

Likewise, if you are looking at case management software, it is important to think about its ability to integrate with your time and billing system and overall accounting package. If your firm is forced to enter financial data in more than one system, or open matters in more than one system, then it may be time to think about a more streamlined and integrated approach, because over time that duplicate entry becomes a huge source of lost productivity.

Your time & billing software, as well as your accounting software are collectively known as your “back office” and they are the core of your business and cash flow. One of the strengths of a legal back office program is that it is geared specifically to the needs of a law practice and can be customized for the way different practice areas run. For instance, the ability to customize the way invoices look is critical for many firms. An attorney who does primarily flat fee work won’t necessarily format their bills the same way an hourly attorney will.

Other examples of customization may include the ability to use fee compensation rules or “splits” to break out the way attorneys are credited for time on their files. Some firms may want finance charges assessed for past due balances and others may not. Likewise, some firms need the ability to split bills between multiple clients (e.g. estate work that needs to be split equally between four beneficiaries) and that feature is available in legal time & billing packages.

## USING YOUR TIME & BILLING EFFECTIVELY

One of the key elements within your back office product, particularly in this economy, is to know where you are making the most money and where you are making the least or losing money. If you don’t know the types of matters that make the firm the most profit, perhaps you need to review your back office procedures more thoroughly.

Many lawyers who practice flat fee and/or contingency work feel it is unnecessary to keep track of their time; we would respectfully disagree with that theory. If you do not track time on these files, how do you know your effective hourly rate? For instance, if an attorney at your firm agrees to a \$5,000 flat fee on a matter, and spends 10 hours working on the file, versus spending 50 hours working on that file, there is a huge difference in his or her effective hourly rate. That information is valuable to making financial decisions for your firm, particularly if you are not a boutique firm, but rather practice several areas of law.

An additional argument for tracking your time on all files, including flat fee and contingent files, is the obligation to provide an accounting of your time if the “reasonableness” of your fee is ever questioned.

Most time and billing software packages have a report identifying profit by Area of Practice as well as timekeeper. These reports will help you to see if you are consistently losing money on certain Areas of Practice. If you are, then perhaps you need to raise your flat fee rate for some things, or shift your practice to more profitable practice areas, particularly if you are a firm that handles many matter types.

Having this type of information may also give you the knowledge to make better marketing decisions. For example, if you practice Family Law, Criminal Law, and Personal Injury Law, and your effective hourly rate is highest in Family Law, you may want to spend more marketing dollars in the Family Law area.

Time and billing software will also give you information about your timekeepers and allow you to set better goals for them. Don't assume everyone is functioning at the same level. The most productive timekeepers should not be rewarded at the same level someone operating at a substandard level is. Use your back office reports to determine which timekeepers have the highest overhead to income ratio, which timekeepers are bringing the most new clients to the firm, etc.

You can also track monthly billings and see trends like increasing or decreasing Work in Progress and Accounts Receivable. This can help the firm plan better from a cash flow perspective and redirect resources as necessary. If billables are consistently decreasing in a particular area of practice, don't wait until it is too late to spot that trend and do something about it.

## CLIENT COSTS ADVANCED

It is extremely important that a firm maintain a system of accounting for case disbursements. Not only do the rules of professional responsibility require that a lawyer accurately account to his client for funds expended in furtherance of the case, whether paid from the client trust account or advanced by the firm, but it is also in the firm's best interest to keep tight controls on all expenses advanced since they are, essentially, unsecured, non-interest bearing loans made by the firm to the client.

Any firm that advances costs for a client should maintain an unbilled client disbursements ledger. Each matter should have a listing for the costs which have been advanced, indicating the date the advance is made, to whom, the check number, and the purpose for the advance.

Each cost incurred on behalf of a client should be posted to the appropriate client matter as an unbilled disbursement as soon as the advance is made. Remember that there are internal expenses (sometimes know as soft costs) as well as external costs (sometimes referred to as hard costs) which must be accounted for. Examples of internal costs are things like photocopies, postage and long distance charges. External advances are items like filing fees, court reporter fees, and medical records.

When it is time to bill the client, the bookkeeper/billing clerk runs a statement combining lawyers' time records with the unbilled costs, for a full accounting of the activity since the last bill.

Because advanced costs are really like a loan to your clients, it makes sense for the firm to try to obtain repayment or retainers for cost advances from its clients whenever possible. Before advancing costs from the firm's operating account to pay a bill issued in connection with a client's case, the bookkeeper should always check to determine whether the client has a trust balance with the firm, and instead look to cut the cost payment from trust if they do.

Most CPAs advise law firms to show the running balance of unpaid costs on their general ledger as an asset to comply with IRS regulations (the [Attorney's Audit Technique Guide](#)). That asset represents the "loans" you have outstanding to your clients. When a check is cut from operating to pay for costs, it increases this loan and when a client pays you back for their costs, it decreases that loan. Therefore, at any given point in time, the outstanding balance in the asset account should equal the accounts receivable plus the unbilled costs (aka WIP costs). It is a best practice for firms to make this "check and balance" part of their month end procedures, to assure that those numbers do, in fact, balance. If costs are written off, then an adjustment should be made to the general ledger crediting the cost advance asset account and debiting an expense account called "Unrecovered Costs Advanced" or something along those lines. This allows your accountant, at year end to easily see what is deductible to you for lost costs on your taxes.

## CLIENT TRUST FUNDS

As we discussed earlier in these materials, client funds are required to be kept separate from the firm operating account(s). If you wish to review the requirements in greater detail you may do so at the following links:

- [Arkansas Rules of Professional Conduct](#) (Rule 1.15);
- [Colorado Rules of Professional Conduct](#) (Rules 1.15A – 1.15E);
- [Illinois Rules of Professional Conduct](#); (Rule 1.15);
- [Ohio Rules of Professional Conduct](#) (Rule 1.15);
- [Missouri Rules Governing the Bar and the Judiciary](#) (4-1.145);
- [New Hampshire Rules of Professional Conduct](#) (Rule 1.15);
- [New Jersey Rules of Professional Conduct](#)(Rule 1.15);
- [Tennessee Rules of Professional Conduct](#) (Tenn. Sup. Ct. R. 8, RPC 1.15); and
- [Virginia Rules of Professional Conduct](#) (Rule 1.15).

It is highly advisable that you or anyone handling trust funds make yourself familiar with these regulations and confirm that everyone in the office is complying with these procedures.

A summary of the duties include:

- Do no comingle firm funds with client funds; keep client funds separate and apart in a trust account
- Maintain accurate and complete records of all trust transactions
- Promptly notify clients of activity and pay client funds they are entitled to
- Reconcile accounts regularly (recommended 3 way reconciliation monthly)

## IOLTA PROGRAMS

IOLTA stands for Interest on Lawyers Trust Accounts – this is a program founded in the 1980's for the purpose of raising money for charitable purposes (primarily providing legal services to indigent persons). Often, the amount of money that a lawyer handles for a single client and deposits to the trust bank account is quite small or held for only a short period of time. It cannot earn interest for the client in excess of the costs incurred to collect that interest. Banks instead forward the interest earned on these accounts to the state IOLTA program, which uses the money to fund a variety of charitable causes. In Virginia, lawyers participate in the IOLTA program unless they [specifically opt-out](#).

In 2013, state IOLTA programs generated more than \$151.8 million nationwide. These funds, together with state and federal appropriations as well as private grants and donations, enable many non-profit legal aid providers to help low-income people with civil legal matters such as landlord/tenant issues, child custody disputes and advocacy for those with disabilities.

## BUDGETING AND ACCOUNT MANAGEMENT

For many law firms who do not have a trained bookkeeper or accountant on staff, the general ledger is the portion of accounting that confuses them the most. Debits and credits, journal entries and the chart of accounts are foreign concepts to them. For that reason, these materials will attempt to simplify the concepts.

## CHART OF ACCOUNTS

The chart of accounts is the listing of all accounts within your general ledger. There are typically five or six main types of accounts:

- Asset accounts
- Liability accounts
- Equity accounts (sometimes grouped with liability accounts)
- Income accounts

- Expense accounts
- Retained Earnings accounts

**Assets** are things like your bank accounts, your furniture, your equipment, and any other assets the firm may own.

**Liabilities** are things like credit cards and bank notes owed by the firm.

**Equity accounts** are accounts that show the amount of capital a partner or shareholder may have in the firm. These are grouped with liabilities as they represent the equity due to the shareholder or partner.

**Income accounts** reflect the amount of fee income, interest income, etc. that has come into the firm in a given period.

**Expense accounts** reflect the various expenses incurred by the firm for things like payroll, rent, supplies and other overhead related costs.

**Retained earnings** are automatically calculated within the accounting system, based upon how all other accounts on the financial statements add up. Essentially, retained earnings represent the cumulative net worth of the firm. Some firms may wish to have Current Year Retained Earnings broken out from Prior Year Retained Earnings, and then subtotal them together. By doing that, it is easier to make sure the net income year to date on the Income Statement matches the Current Year Retained Earnings, as it should.

## JOURNAL ENTRIES

Every entry on the general ledger is a two-sided journal entry – a debit and a credit. Most journal entries are made automatically by the accounting software, based upon the transaction you entered. Occasionally, however, manual journal entries may also need to be made.

An example of an automatic journal entry may be when you enter a payment from a client into the system. The payment is for fees only. The accounting system sees that and automatically debits the bank account and credits fee income. Another example may be when you cut a check to the landlord for rent. That would automatically credit your bank account and debit the rent expense account.

The hardest thing for most people to understand is when something is considered a debit versus when it is a credit. Hopefully, this will assist you in remembering:

**Asset accounts and Expense accounts are Debit accounts by nature.** That means when their balance is going up (or money is going into them), the transaction is a debit to that account. If money is coming out of them, or their balance is being reduced, then the transaction is a credit to that account.

**In contrast, Liability/Equity accounts and Income accounts are Credit accounts by nature.** That means when their balance is going up (or money is going into them), the transaction is a credit to that account. If money is coming out of them, or their balance is being reduced, then the transaction is a debit to that account.

That can be challenging to remember, so here is an even easier way to think of it. Most transactions somehow affect your bank account. **If you can remember that money going into the bank account is a debit, and money coming out of your bank account is a credit, then the other side of the transaction is always going to be the opposite.**

## FINANCIAL STATEMENTS

An **Income Statement**, sometimes referred to as a Profit & Loss (or P&L) is basically the net income of the firm for the current fiscal period. It shows the Income versus the Expenses, and the difference between them is the net income for the period. At the end of every fiscal year, the income and expenses zero out and the new fiscal year

starts fresh. The net income is used for tax reporting and it moves over to the balance sheet, as part of total retained earnings.

A **Balance Sheet** instead compares the Assets to the Liabilities/Equity. The difference between the two is the total retained earnings. The assets and liabilities do NOT zero out at year end, but rather carry from year to year. The current year retained earnings should always match the net income year to date on the income statement.

A **Trial Balance** represents a combination of all accounts on the chart of accounts, giving the full financial picture (essentially combining the Income Statement and the Balance Sheet). It typically gives a starting balance for each account, shows the net change to the account, and the ending balance for it. For some accounts the net change will be a debit and for others it will be a credit. Therefore the total net change for all accounts during a particular period should equal. If they are not, then somehow your General Ledger has gotten out of balance and should be corrected. Checking the trial balance at the end of each accounting period should be a standard procedure.

### BUDGETING

Budgets are very important, particularly with the economy in such disarray. Any good back office software product will allow you to budget expenses and income, realistically mapping out your cash flow for the year. As you print your financial statements month to month, you can see how your firm is fairing compared to the budget number, and compared to prior months or years. This will again help you to identify trends before it is too late.

### CONCLUSION

We all know that lawyers go to law school and passed the bar to practice law, not to be an accountant. But it is a fact of life that part of owning any business is cash flow and billing/accounting. Further, the firm has a duty to responsibly manage your client's funds and provide proper accounting of your services to each client. Hopefully, with the help of a good accountant, good staff and a little basic know how, you will make it through any potential billing and trust pitfalls. Follow the guidelines above, familiarize yourself with the Rules of Professional Conduct, and make sure you have some checks and balances in place. By doing this, your firm will be able to focus on the practice of law, rather than worrying about finances.