

## 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.