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Accounting 101 for Law Firms

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When firms are asked, “How do you want to define growth,” the leading response is always through **revenue**. This response consistently outranks growing a larger client base, expanding staff or hiring more attorneys, and adding more practice areas or geographical locations.

However, not every firm is growing. Today, there are three groups of law firms in the industry that are actively working on open matters. Those are firms that are growing, firms that are stable, and firms that are shrinking. The biggest hurdle that solo, small, and even medium firms are facing is finding billable work. In a typical 8 hr workday, most law firms have trouble billing more than 2.5 hours of work per day (we call this utilization rate, this is important for later). And even then, once the actual bill goes out, firms are only collecting about 1.7 hours worth of billed time. So, not only are firms having a hard time finding and focusing on billable work, but they’re having a hard time collecting on the time they do bill.

A firm’s utilization rate is calculated by dividing the number of billable hours by the number of hours in your workday day. So for example, if you’re billing 4.3 hours of work in an 8-hour workday, your utilization rate is 54%. When we look at the utilization rates of each of the three types of firms, this is what we see: stable firm’s utilization rates stay very similar throughout the course of time. Growing firms are experiencing increased utilization rates, meaning they are finding more time they can bill for, while conversely shrinking firms face lower and lower percentages over the course of time. The takeaway here is there’s a paradox that is happening between law firms and growth, and it’s something the industry needs to figure out how to tackle.

The Basics



Before we jump in, it is important to note that you're not supposed to know everything we cover in this blog. If you do great! But if not, that is okay, you're lawyers, not accountants. However, as a business owner or as someone heavily involved with the revenue projections and future evaluations, it is important that you have a foundational concept to improve your firm.

A third of an average attorneys day is spent doing what makes them money. So that means a whole ? is spent on tasks that don't bring in money, really think about that. The problem with this is that the industry has seemed to settle. These rates have become normal and standard and because of that, we have seen little change. But the real problem stems from the fact that we cannot manage what we do not measure.

Let's go through some basic [accounting](#) terms that everyone should be familiar with:

- Income/Revenue - Cash collected for services rendered. Earlier we mentioned that this metric is the most regarded to track growth and that is simply because it is the easiest to track and report on. (Please note that this is true on a cash basis)
- Expenses - Cash spent for business operations. The highest expense most firms incur is for wages.
- Profit and Loss (P&L) - Financial statement representing the cash earned minus the cash spent during a set period of time.
- Balance Sheet - Financial statement representing the Assets, Liabilities, and Equity of a company as of a specific date, not over a period of time.
- Ledger - Detail listing of individual (accounting) transactions. Your general ledger feeds into the Profit and Loss statement and Balance Sheet.
- IOLTA - Interest on Lawyer Trust Accounts. This account is where lawyers hold client funds that do not currently belong to them.

Some common questions that come up include:

- How are financial statements typically structured?
- Why do we use financial statements?
- What is a chart of accounts?
- What are the basic elements of a chart of accounts?
- Why is the right chart of accounts so vital?

Financial statements are typically structured by columns and rows, with comparative periods, and the overarching reason we use them is to tell better stories. The accuracy to which you can tell your firm's story relies solely on your record keeping. Your chart of accounts is a list of categories to record business transactions. The transactions recorded within these categories are listed in detail on your general ledger. Financial statements summarize those details entered in your general ledger. The basic elements of a chart of accounts is the account name, account number (if used), the account type, and balance. The right chart of accounts is so vital because it will provide a picture on your financial statements of your firm's financial health.

Now that you have all this information, the next question you may be asking is why is this important to me and my firm? Why do we even need these things?

Of course, law firm's are businesses, and financial statements provide the best way to manage a business. Oftentimes, we see firms who do not have heavy experience with accounting or finances turn a blind eye to the numbers because they simply do not know how to use them. And with accounting particularly, it is second nature for people to shift the ownership of the task versus jumping head first into doing it. If your firm's number one priority is to grow revenue, how are you tracking that? Are you setting targets? How are you [measuring your progress](#)?

Profit Margins

Your profit margin essentially illustrates (by percentage) how many cents on the dollar are being generated for your business. And this can be determined by dividing your net income (income after taxes) by your income.

Profitability by Practice Type

If you have multiple practice areas within your firm, you may be tempted to blend your profit margins together. It is best practice to keep these margins separate between practice types to provide you with a better picture. Bad numbers have incredible power to give you bad advice. You could have one practice area that is considerably underperforming, but if you're blending your margins, it would be unlikely that you would be able to see that. Without that information, you

would have no idea where to best shift your resources to either continue bolstering your more profitable areas of practice, supplement the areas that are falling behind, or even eliminate an area that continues to be unprofitable.

Balance Sheet

This data on your balance sheet shows the assets, liabilities and owner's equity at a specific point in time for your firm.

Types of assets include:

- Cash such as bank accounts, money market accounts, and trust accounts,
- Current assets, such as accounts receivable (if using accrual accounting), notes receivable, security deposits and other prepaid expenses,
- Non-current assets such as furniture and fixtures, computer equipment, long-term investments and intangible assets.

Liabilities include:

- Current liabilities such as accounts payable (if using accrual accounting), lines of credit, notes payable, and other accrued but unpaid liabilities,
- Trust liability which includes any funds being held in trust or retainer for your clients, and
- Long-term liabilities which includes all long-term debt.

Lastly, equity is synonymous with net worth. It is the ownership interest in a business. It includes:

- Both contributed capital from the owners of the company, plus retained earnings which is the net income that has been invested or retained in the business since the start of its existence.

When all is said and done, your assets must equal your liabilities plus the ownership's equity. If they don't there is something wrong.

It is important to note that although equity and debt are ways to fund your business, both are vastly

different in the way they affect your business' financial health. When using equity, you are either giving away future earnings or purchasing future earnings of the business. When using debt, your business borrows from another party, with the condition that it is to be paid back, usually with interest, at a later date. When taking on debt, you are assuming that you will be able to pay it back within a certain period of time, but you are also taking on the risk of default.

By looking at the balance sheet, you can quickly identify your current cash on hand, as well as what your firm currently owes to its creditors.

Balance Sheet Hot Tip

On your balance sheet, your IOLTA cash is represented both as an asset (IOLTA bank account) and a liability (client retainer liability). These funds belong to your clients and should never touch your operating account or profit and loss statement until you actually earn that money. IOLTA accounts are heavily regulated and the misuse of these funds could potentially cause a multitude of problems for you and your firm, up to and including disbarment. Because of this, IOLTA accounts and the balancing client retainer liability accounts have a unique place on the balance sheet.

This is incredibly unique to law firms. So much so that it is advisable that when you are hiring an accountant or expanding the team who controls your bookkeeping, you ensure that they are very familiar with law firm accounting.

If you believe you may be running into issues with your trust accounting, review your current balance sheet. Your IOLTA bank account balance should always be the same as your client retainer liability account balance. If it is not, first determine if your trust account has been reconciled with your bank statements. During reconciliation, you can very often identify a missing transfer or other transaction that will bring your accounts back into balance. If that doesn't rectify the problem, then a deeper dive into your [billing](#) and accounting transactions may be necessary.

Trust Accounting Essentials

[Trust accounting](#) is the most critical part of bookkeeping for firms. If we were going to explain it to a 5-year-old, we would say that money that is given to you in trust is money that is not yours. So, you should keep all money that isn't yours in a separate account. Simple as that. These accounts are governed state-by-state and are an incredibly high-risk area for your firm.

Trust Accounting Dos

- Get separate bank accounts (this is required by most states and it is important to note that banks have to set the IOLTA account with unique regulations, interest bearing, etc. - not all banks can provide this)
- Minimize your risk by leveraging technology (stop doing this on the back of a napkin)
- Always record the transaction the day the money goes into or out of the trust account
- Perform a monthly 3-way reconciliation

One of the harder things about trust accounting is the 3-way reconciliation. First, your balance sheet, trust asset account, and trust liability account balances must match each other. Next, the trust asset account (or IOLTA bank account) must balance back to your bank statement. And lastly, if you have multiple clients for whom you are holding funds, you will need to have a way to determine whose money is whose.

A sub-ledger that details all trust transactions by client or matter is necessary to provide an accurate current balance of the trust funds being held for each client at all times. The total of all the client trust balances should balance back to your trust liability account. That is a 3-way reconciliation.

Trust Accounting Don'ts

- Mix trust funds with any other funds within your business
- Borrow money from the trust account
- Record trust funds as income
- Watch out for credit card fees (clients these days do want the ability to pay by credit card. With [LawPay](#), you can make that happen without the risk and hassle.)
- Record interest income or interest expense for the interest earned on trust funds.

Get Paid More

The Risk

There is risk around firms getting paid by their clients. In most service industries, you do the work but money must leave your hands to ensure that timekeepers and other vendors get paid to properly provide services to your client. Next the client is billed, but it takes time to collect on those bills.

Cash outflow occurs first, then the cash inflows come next, if you're lucky enough to collect on them. So immediately out of the gate, you're spending money before the guarantee of being paid back on it.

Mitigate the Risk

This is where trust accounting comes in. It helps to mitigate the collection risk by taking funds (retainers) upfront from your clients. By doing so, you have the ability to match the cash-out and in flow. Trusts do require more work on the front end, but they can really improve your cash flow through this process. Additionally, you can better filter out the clients in your book of business who will reliably pay you versus those who will short change or delay paying you.

Run A Few Tests

The first thing you should do if you're not already doing this is take a step back and look at it holistically. Is trust accounting right for your practice type? Is this something necessary for you to do? If the answer is yes, then your step 1 should start by putting in place the proper internal processes. Think about what happens when a client walks through your door and hands you a check for \$10,000 to do work across a 3-month period. What then does your firm do? How would you handle that? Step 2 should be making sure you have a proper separate trust account. And lastly, don't do everything all at once. Start small, ask for one new client to pay half your estimated bill upfront.

The Takeaway

Today, it isn't enough to just be an expert attorney. You need to have some business savvy too.

But that doesn't need to be a huge hurdle. By familiarizing yourself with what we discussed in this blog and ensuring that your trust accounts are set up properly and accurately, you will move your firm from the static stage to the growth stage. Sustaining profitability is no easy feat, but with the proper tools and accounting skillset, you are one step closer to making that a reality for your firm.

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