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How to Navigate the World of Law Firm Accounting

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Most law firm leaders do not enter the legal industry with an accounting background, but a basic understanding is important to ensure the proper management of your [law firm's finances](#). Decisions about [billing processes](#), the acceptance of payments, and [trust accounting](#) form the foundation for a firm's financial success. Therefore, it is critical for law firms of all sizes to properly position their financial systems. It will not only save time and boost profitability but will also prevent several potentially serious compliance issues.

A lot goes into navigating the world of [law firm accounting](#). Let's explore some of those vital components:

Choosing the Right Bank

Every firm is different, so identifying the best banking option depends on your specific needs and goals. The wrong bank could create financial complications for your firm and result in serious legal problems.

When choosing a bank, consider the following:

- Is the bank approved to handle client trust and IOLTA accounts under applicable state guidelines and regulations?
- What security and fraud protections does the bank have in place to protect firm and client funds?
- What fees and limitations are associated with the banking accounts, including ATM, minimum balance requirements, and transfer fees?

After conducting this research, you can make informed decisions about your best banking options and make plans to open the necessary accounts.

Law firms typically need a business checking account for the management of general business revenue, a savings account to set aside money for taxes or emergencies, and an IOLTA account for holding client funds in trust.

Some law firms also choose to open a money market account to take advantage of a higher interest-earning rate, as well as a business credit card for strategic practice growth.

The Intricacies of Trust Accounting

For law firms that hold client funds in trust, the IOLTA account comes with its own set of detailed accounting rules and tasks. Noncompliance can result in severe penalties, so it is important to understand the complexities of trust accounting.

With so many different rules in place, it can be challenging to stay on top of all of them. Even still, some mistakes show up more often than others, with the most common stemming from these IOLTA rules:

- **No co-mingling of trust and business account funds** – Attorneys need a clear understanding of the types of funds they can and cannot deposit into an IOLTA account under their state’s rules. For instance, certain states may prohibit the use of IOLTA funds for the payment of office expenses. Other rules may forbid attorneys from leaving earned funds in an IOLTA account for a designated period of time.
- **No borrowing of money from the IOTLA account** – There is no such thing as borrowing client funds held in trust. Under most state rules, attorneys cannot withdraw those fees until they have been earned, even if the funds will be quickly replaced. Doing so may even lead to disbarment.
- **Avoiding misapplying service fees** – For attorneys that accept electronic payments by ACH or credit card, the associated fees could cause problems. They may be charged to the wrong client’s account or improperly deducted from an IOLTA account. Firms must have systems to ensure the proper handling of payment processing service fees.
- **Keeping inaccurate records** – No matter how small, every transaction into or out of an IOTLA account must be tracked and accounted for, without exception. This is done through practices like including client reference numbers on trust account checks and keeping separate ledgers for each client.
- **Maintaining adequate reconciliations** – Regular account reconciliations must be a part of IOLTA account management. This includes three components: the entire trust account, individual client ledgers, and the account banking statement. Under some circumstances, a firm may be required to submit these records to the Bar, so it is imperative that they be kept up to date.

Tax Obligations

As businesses, law firms must stay on top of their federal, state, and local tax obligations. The specifics of the obligations vary based on the type of practice, but most firms have a responsibility to pay the following types of taxes:

- Income taxes on law firm profits
- Payroll taxes for all firm employees, to include Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA)
- Federal self-employment tax for attorneys who are self-employed

This is not an exhaustive list and firms may have a variety of additional tax obligations. As such, firms need a tax professional in their corner to help them navigate these vital responsibilities.

For firms that do not have an accountant on staff, a contracted Certified Public Accountant (CPA) can offer valuable guidance for meeting tax obligations and limiting tax liability. Accounting professionals can also help firms with financial forecasting, reporting, payroll needs, and trust accounting.

Payroll

It is not an easy task to calculate legal [time](#), so law firm payroll poses challenges that do not exist within other industries. Firm members may have varied pay structures, which requires a payroll process that offers flexibility.

Payroll accounting includes such components as:

- Federal, state, and local payroll requirements
- Employee withholdings
- Reporting and depositing payroll taxes
- Disability and worker's compensation insurance
- Employee benefits

The rise in outsourced legal work adds another layer to payroll duties. Law firms should carefully categorize employees and independent contractors for payroll and taxation purposes. Incorrect classifications could lead to fines and legal consequences.

Invoicing

Invoicing is arguably the most important part of law firm accounting, as it is the mechanism by which firms bill for the legal services they provide. Improper invoicing can have many negative consequences, including unbilled tasks, sporadic billing, and unpaid invoices.

Law firms can choose an independent legal billing system to handle invoicing tasks, but the most streamlined option incorporates [legal billing into a legal practice management system](#). With these platforms, firms benefit from advantages such as simplified approval processes, tracked invoice changes, and the ability to process numerous types of fee arrangements.

Some [legal practice management systems](#) include extensive data reporting capabilities so firm leaders can quickly access [financial reports](#) with just a few clicks of the mouse.

Payment Processing and Collections

Once the invoices have been sent out, law firms need processes in place to actually receive payments and manage collections. After all, there is nothing to manage if revenue is not going into the firm! While most firms still accept cash and checks as payment from clients, electronic payment methods have become more common within the legal environment. This requires having a system in place to accept these payments, and the choice of provider could mean the difference between accounting success and failure.

Law firms should utilize a payment processor that recognizes the specific rules that attorneys are obligated to follow. Standard payment processors typically maintain a percentage of each transaction as their fee. When these fees are deducted, it can potentially break state trust accounting rules.

Lawyer-friendly payment services provide law firms with the option of paying processing fees directly from the firm's operating account instead of the trust account, which significantly lessens the possibility of non-compliance with IOLTA accounting rules.

Tips for Successful Law Firm Accounting

Mastering law firm accounting is no easy feat. However, if you keep the above components in mind and put them into practice, in addition to following the tips below, you'll be well on your way to navigating your firm's finances successfully and without penalty.

- No mixing of personal and business financing. All business-related payments and expenses should be handled through the firm's operating account. Co-mingling these funds can lead to personal, professional, and tax-related problems.
- Use a paperless record system. Digitized record-keeping makes law firm accounting much easier to manage with greater organization, tracking, and secure storage of financial documents.
- Choose the right accounting software options. With so many accounting duties, law firms need an accounting system that meets these needs efficiently and effectively. While options like QuickBooks are helpful for general accounting needs, they are not designed to handle law firm client invoicing, legal trust accounting, or big law firm needs. Firms need accounting tools that are specifically designed for the legal industry.
- Consult an accounting professional and outsource when appropriate. Accounting errors should not prevent law firm success. Advice from an accounting professional or outsourcing accounting tasks can help law firms stay on top of finances and remain compliant while also promoting profitability, as attorneys spend more time on billable tasks and less time navigating accounting.

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