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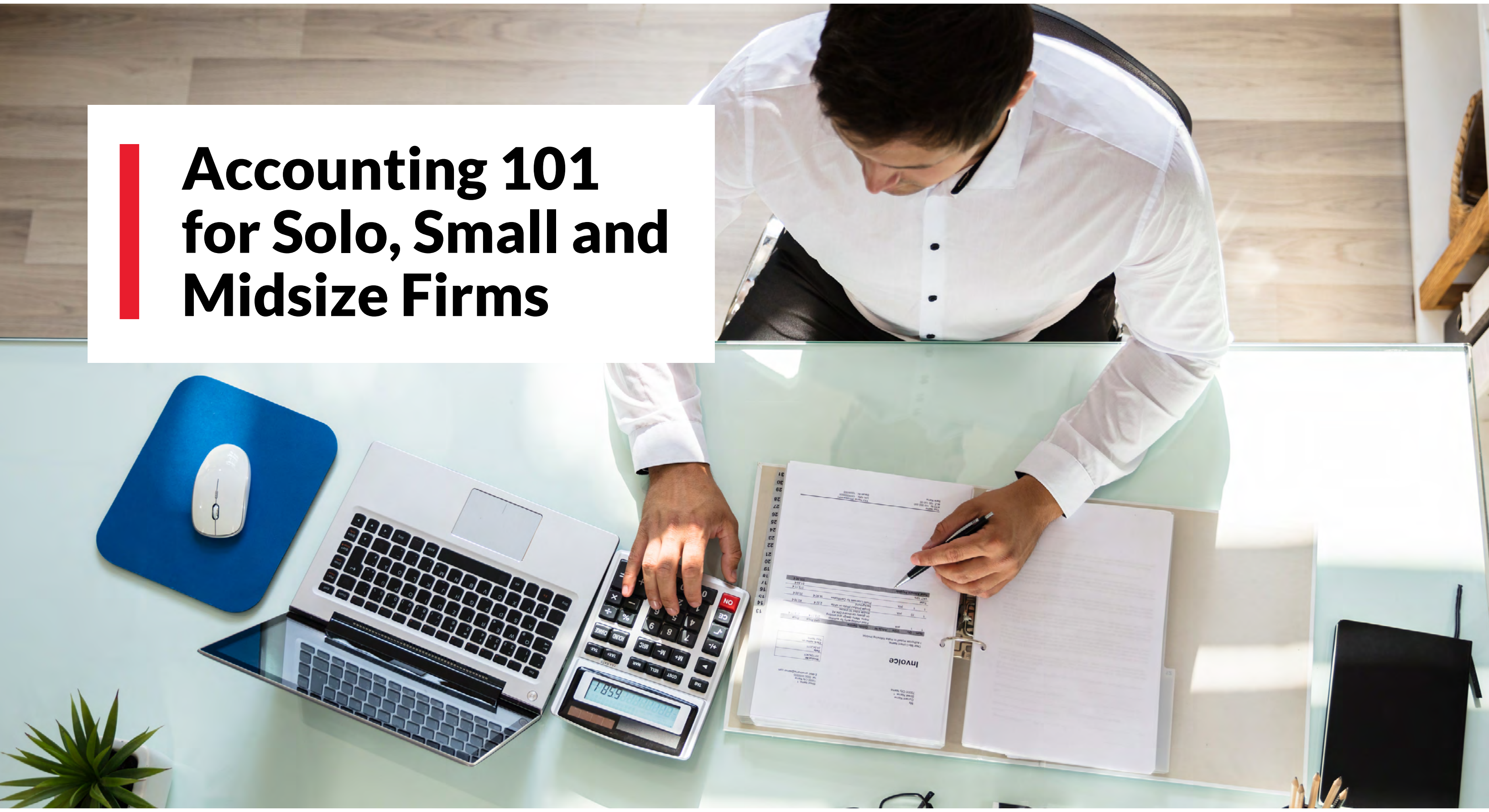
Accounting 101 for Solo, Small and Midsize Firms



During those long days in law school, you may have kept yourself going by imagining yourself in action as a lawyer—negotiating deals, examining witnesses, perhaps even nabbing that corner office. It's unlikely that at any point in the process you imagined the glamour of going over the accounting statements at your solo, small or midsize firm. It is not, in fact, a glamorous task. It's not a subject they teach you about in law school. And yet, sound financial administration is one of the most critical components of a successful law practice.

Any law firm partner—particularly those at relatively small firms—should make it their business to understand the financial health of their firm. To gain that understanding, one needs a foundation in the form of some basic accounting knowledge. Accounting, of course, is a big topic, and we are not pretending to cover it all in this article. But in this primer, we'll touch on three concepts that will get any partner grounded in this important area. Those concepts are: (i) understanding accounting reports; (ii) taxation issues; and (iii) year-end closeouts.

UNDERSTANDING ACCOUNTING REPORTS

Financial statements are the Rosetta stones for law firms, as they hold all the answers about the financial health of your business—how much you've earned, how much you owe others and how much you can spend.

The Balance Sheet

One easy way to remember the balance sheet and what's on it is by a simple formula: Assets = Liabilities + Owner Equity. The balance sheet includes your bank balances, assets, debt and an equity section that shows partner capital as well as accumulated profits or losses.

The Income Statement

Your income statement displays revenue, expenses and a profit or loss. Most law firms report on a cash basis, and therefore, the revenue shows what has actually been received. Your firm's revenue minus the expenses result in a positive or negative number, i.e., profit or loss.

Cash Flow Statement

One common misconception in reading an income statement is that the profit should be equal to the amount of cash in the bank, which shows up on your balance sheet. This is not true. Cash flow is not easy to see using only a balance sheet or income statement. That's why a cash flow statement is important; it combines the income statement and balance sheet and shows the detail of the activity by period.

TAXATION ISSUES

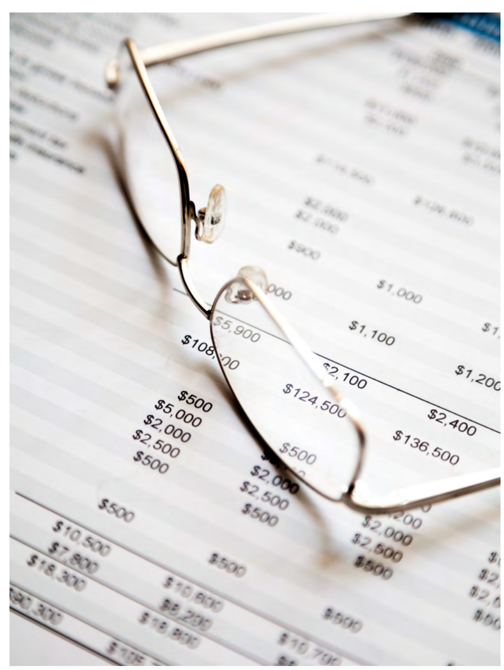
If you have a large case and are spending money for things like filing fees, court recording fees and an expert witness, you can't claim these as your law firm's expenses because they are considered reimbursable costs for which the client will eventually pay you back. Essentially, you are loaning this money to your clients, which means these expenditures are not tax deductible. Loans to and from your firm do not show up on the income statement; they show up on your balance sheet.

Law firms occupy a niche of corporate tax law in which determining when income becomes taxable is not an easy matter. Here are three typical trouble spots.

- **Constructive receipt**—Your fees are subject to tax when you have earned, billed and can access them, even if you leave them on deposit in your law firm IOLTA account.
- **Advance expense payment**—This is a huge issue for plaintiff attorneys working on contingency. Often a successful case means a huge tax liability. Firms can moderate that liability by pre-paying law office expenses within certain IRS guidelines.
- **Employee benefit plans**—Tax can be reduced by employee benefit plan expenses. But be careful! Tax will not be reduced if you violate any of the anti-discrimination rules the IRS places on benefit plans.

YEAR-END CLOSEOUTS

In many states, keeping financial records up to date and accessible is not an option. State bar associations mandate attorneys keep their trust accounts current and accurate. But having your trust accounts audited isn't the only reason why keeping clean books is important; they also lead to better business decisions, a better lending profile and lower accounting costs.



The bookkeeping process culminates annually with the year-end closeout. This process occurs in two stages: closing the books on individual months and closing the year itself. The end-of-month process should occur throughout the fiscal year. When the last month of the fiscal year is closed, the end of year can be run, zeroing out income and expense accounts while updating the capital/ equity accounts for the new year.

Before closing a year, the following conditions must be met:

- All bank accounts have been reconciled
- The accountant's adjusting entries have been received and entered
- Financial statements have been printed and compared
- The last month of the fiscal year has been closed

Here is a list of best practices that will help your firm prepare for—and properly close—the end of your fiscal year.

1. **Back your system up throughout the year**
   - Check with your local bar association—external backup might not be regulated, but it's always a good idea.
2. **Reconcile all financial reports and transactions, month to month**
   - Use budgeting features from your financial software to analyze and prepare budgets and make adjustments for the following year.
   - Close the last month of the fiscal year.
   - Close the year.
3. **Produce 1099 forms**
   - Your accounting software can automatically create 1099s for vendors, including law firms you have hired during the year.
   - Review your 1099 listings for the year and produce 1099 forms for all vendors by January 31 (U.S. only).

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