



Legal Accounting 101

A simple guide for law firms from Bench Accounting

Intro— duction

Choosing how to structure and manage your law firm's finances is one of the most important business decisions your practice will make. How will you accept payments? How will you manage trust accounts? And what accounting practices will you use to cut down on taxes and costs?

You didn't get into law to do accounting. But taking the time to properly set up your finances won't just make it easier to file your taxes each year. It'll save you time, money, stress, and potentially legal headaches. You'll have accurate financial statements on hand, which can show you how your practice is performing at any given moment. And it will be a lot easier to work with bookkeepers, accountants, new partners, and buyers, if you ever decide to sell the business.

Follow the steps in this guide, and put your law firm on the path to financial clarity and success.

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Chapter One

Hire a CPA



If you're serious about growing your business, you need to team up with a Certified Public Accountant (CPA) early on.

Beyond filing your tax return, an experienced CPA can help you with:

- Financial strategy
- Tax planning
- Tax compliance
- Lease negotiations
- Treasury management
- Financial reporting

A CPA can also help you make long-term, big picture decisions about the future of your business.

How to hire the right CPA

It's best to work with a CPA who has experience working with law firms. Ask other attorneys you know or ask your State Bar for referrals. Once you have a few leads, contact them individually. Any CPA should be willing to sit down with you for a free consultation.

Questions to ask your CPA

Once you've chosen an accountant to work with, use these questions to guide your initial conversation. Make sure you're clear on all of the accounting obligations related to managing and growing your business.

- What business expenses can I deduct?
- How does the legal structure of my business affect tax filing?
- Do I need to register for a payroll service?
- What are the trust accounting rules in my state?
- Do I need payroll insurance?
- What other types of business insurance do I need?
- What are my tax obligations?
- Do I have to collect sales tax?
- How will work with clients in other states affect my income/sales taxes?
- What can I do throughout the year to reduce my tax bill?
- What records and paperwork do I need to keep on file?
- How should I set up my banking structure in terms of trust accounts, payroll accounts, checking, savings, etc.?
- How much money is required to get started?
- Should I set up a line of credit to help get my firm off the ground?

Chapter Two

Open a Business Bank Account



Choose a bank

Every business is different, and the “right bank” for you will depend on the nature of your practice and the way you prefer to get your banking done. Here are some guiding questions to consider while you’re comparing options:

- Does the bank support your Point of Sale (POS) system?
- Does the bank offer IOLTA and other trust accounts?
- What does the bank offer in terms of security and fraud protection?
- Does the bank’s online banking option let you designate separate users (for business partners, if necessary)?
- What kind of fees are they going to charge you?
- Does the bank also offer business savings accounts and business credit cards?

“ A business savings account is a good place to store money you’re setting aside for taxes and unforeseen emergencies.”

Open a business checking account *and* an IOLTA trust account

Once you've chosen a bank to work with, you'll want to open a business checking account, a savings account, and an IOLTA trust account. (For more on trust accounting, skip ahead to chapter three.)

Manage business revenue in your checking account, and set aside money you'll need at a later date (for emergencies, to pay taxes, etc.) in a savings account.

Even though interest rates on business accounts are traditionally low, having a cash surplus in a business savings account can improve your likelihood of being approved for a loan. It's also a good place to store money you're setting aside for taxes and emergencies.

Depending on your needs, opening a money market account for savings might be a smart move. It's an interest-bearing account that offers a higher yield than traditional business savings accounts (interest rates for money market accounts sit at an average of 0.11% nationally). The catch? You'll be required to maintain a higher minimum amount in the account, and have limited check-writing options.

To open any kind of business bank account, your practice needs to be registered with the state in which you are operating, have a registered business name and have an Employer Identification Number (EIN).

Call ahead and ask what paperwork you need to bring to your initial appointment before meeting with a representative of the bank.

Consider a business credit card

Let's be clear: it's a bad idea to fund your business with credit cards. Credit card interest rates are unfavorable, and the amount of funding you can get from a credit card is not as high as a line of credit or a business loan.

But if you're confident that you can strategically use a credit card to grow your business and pay off your bill in full each month, having a business credit card can be helpful.

Smart use of a business credit card can:

- Improve your business's credit rating over time
- Earn you benefits like cash-back rebates or travel points
- Give you access to fraud protection and additional warranty on purchases
- Give you an annual summary of your business expenditure, and help you stay organized

Get a breakdown of the cards available to you with [Nerdwallet's Credit Card Comparison tool](#).

Chapter Three

Get Clear on Trust Accounting Rules



In addition to their business chequing and savings accounts, most law firms are required to hold client funds in a separate trust account—often called an “IOLTA”.

IOLTA accounts are tricky, because they have very specific rules around what you can and can’t do with them, and the penalties for breaking these rules can be severe, including disbarment.

Every state has an IOLTA program, and it’s likely that the bank where you opened your regular business checking account also offers IOLTA accounts. But rules do vary by state, so consult your State Bar Association and a professional accountant before finalizing your accounting setup.

While mismanaging an IOLTA account carries stiff penalties, many law schools offer little to no training when it comes to managing trust accounts. As a result, attorneys often find themselves making several common mistakes again and again. Here’s what you can do to avoid them.

Don't borrow money from an IOLTA

Attorneys may not under any circumstances withdraw fees from an IOLTA account before earning those fees. Doing so is referred to as “borrowing,” and attorneys do it for many reasons: because they have cash flow problems, unexpected expenses, or simply because they've told themselves they'll replace the funds soon afterward.

Whatever the reason, borrowing from an IOLTA is one of the most common ways to get disbarred.

Always keep your trust and business accounts separate

Because of poor training, lack of accounting help, or differing IOLTA rules across state lines, many attorneys are unfamiliar with what they are and aren't allowed to put into an IOLTA account.

You can't, for example, pay for your firm's operating expenses directly out of an IOLTA account. You'd need to move those funds into a business account first.

Some firms will also intentionally use their IOLTA accounts to hide assets, or will leave funds in their IOLTA even after they've been earned, using it as a savings account.

Regardless of which state you're in, you cannot under any circumstances use an IOLTA account as a savings account or an operating account, even if the money you withdraw from the IOLTA has already been earned.

Avoid misapplying filing and service fees

Many attorneys prefer to get paid by credit card (online or in-person), which incur their own special fees.

Sometimes these fees can become hard to track, causing you to charge the wrong client's account.

To prevent misappropriating funds from other clients, remember to only charge your clients for fees directly relating to their trust account.

Never record a trust deposit as income

Some firms find it tempting to record a trust deposit as income in their accounting software, for simplicity's sake. But they shouldn't.

The funds deposited in your client's accounts don't belong to you—in fact, they are funds you owe your clients. Recording them as anything but that could land you in hot water with regulators and mess up your taxes.

Keep good records

Every single transaction in and out of your IOLTA must be accounted for, no matter how small.

Failing to keep good records for each client's account—by forgetting to write your client's reference number on their trust account checks, not keeping a separate ledger for each client, or simply by misplacing a record—is another common way that attorneys break IOLTA rules.

Who to go to for help

Let's say you've mismanaged your IOLTA—what do you do?

The first thing you should do if you think you've messed up is to contact a practice management advisor in your state. These consultants usually have experience dealing with IOLTA, and rules in most states don't require them to report ethics violations to the bar.

If you're just starting out and think you've set up your accounting the wrong way, talk to a professional accountant or bookkeeper with experience dealing with IOLTA.

Be prepared to perform a three-way trust reconciliation

If your firm operates any trust accounts, the State Bar will require you to perform something called a three-way reconciliation every 30–90 days, and have them on hand in case they ever want to review your finances. (Check your [State Bar's website](#) for the exact rules in your state.)

If you've ever balanced your checkbook, or simply compared the balances in your bank account and your company books to make sure they match, you've already performed a two-way reconciliation.

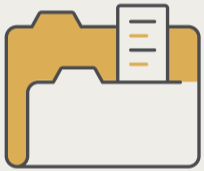
A three-way trust reconciliation is similar, but involves three components instead of two:

- The ledger for the entire trust account
- The sum of the individual client ledgers
- The trust bank statement

If any of these balances don't match each other, that means there's a mistake in one of your ledgers. To fix it, you have to go over each transaction to make sure it was entered into your accounting system properly.

Chapter Four

Separate Your Finances



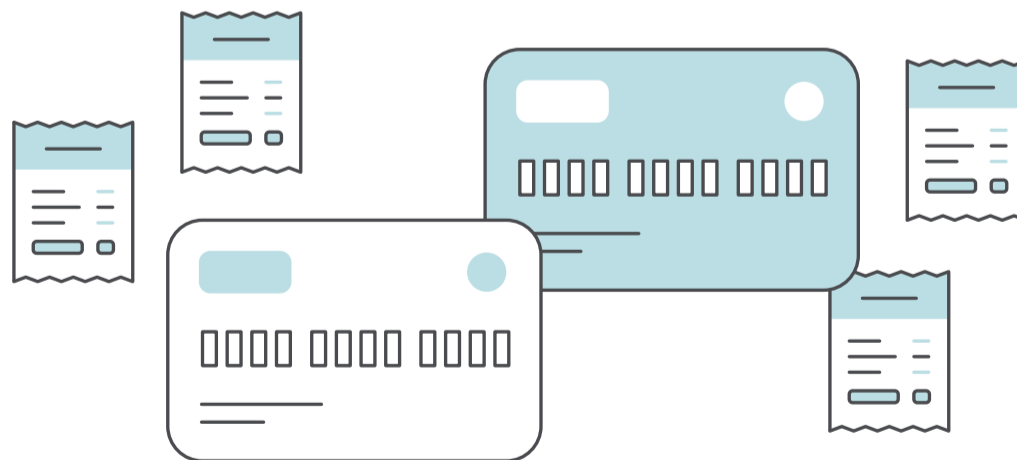
We can't stress this enough. Once your business bank accounts are up and running, you should avoid mixing your personal and business finances.

This means:

- Don't pay for business expenses using your personal bank card
- Avoid transferring money from your business accounts to personal accounts

Granted, if your bookkeeper and accountant are on board with it, and you take care to flag transactions properly, using your business account for personal transactions (or vice versa) isn't the end of the world.

But mistakes can happen. Business expenses can get buried in personal bank accounts. And when you commingle your personal and business finances, the following problems can arise.



It overcomplicates your accounting

Managing all of your business transactions in a separate account makes it easier for you, your bookkeeper, and your CPA to manage your accounting. If everything is jumbled into one account, come tax time, you or your CPA will have to go through your bank records to figure out which expenses are related to your business. This will cost you time, money, and probably a few headaches.

You may lose money

When a business expense gets lost in your personal account and you don't claim it on your tax return, that's a tax deduction you're missing out on. And if your CPA has to spend time separating your personal expenses from your business expenses, you'll end up paying them more in accounting fees.

You may lose legal protection

One reason why people incorporate their businesses in the first place is that it provides a legal separation between them and their company. Accountants sometimes call this the "corporate veil," and it's what protects owners and their assets from any legal action taken against the company.

Courts will ignore this layer of legal protection if the corporate veil is pierced in any way, and one of the most common ways that business owners pierce the veil is by mixing their personal and business expenses.

Chapter Five

Choose an Accounting Method





Law firms can elect to use one of two accounting methods: **cash accounting** or **accrual accounting**.

You'll need to choose an accounting method before your firm files its first tax return, and then stick with it on all subsequent returns.

Which method you choose will affect cash flow, tax filing, and even how you do your bookkeeping.

Make sure to consult with a CPA before settling on the method you'll use.

Here's a basic overview of how each method works.

Cash accounting

Cash accounting recognizes revenues when cash is received, and expenses when they are paid. This method does not recognize accounts receivable or accounts payable.

Most law firms opt to use cash basis accounting because it's simple to maintain. Cash accounting makes it easy to determine when a transaction has occurred (the money is either in the bank or out of the bank) and there's no need to track receivables or payables.

The cash basis method is also beneficial in terms of tracking how much cash the business actually has at any given time; you can look at your bank balance and understand the resources you have at your disposal. (Minus outstanding checks or deposits in transit.)

Also, since transactions aren't recorded until the cash is received or paid, the business's income isn't taxed until it's in the bank.

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Accrual accounting

Accrual accounting records revenues and expenses when they are earned and incurred, regardless of when the money is actually received or paid. For example, when you send an invoice to a client, you'll mark it as revenue, even though you might not get paid for 30 days.

The upside of this method is that it gives you a more realistic idea of income and expenses during a period of time.

The downside is that accrual accounting doesn't clearly indicate a business's true cash flow; a business using accrual accounting can appear to have money at its disposal, while in reality, it has empty bank accounts. To offset this risk, it's important to carefully monitor cash flow with accounts receivable (AR) and accounts payable (AP), which appear on your balance sheets.

So, which method is right for you?

There's no easy answer to this question. Unless the IRS requires you to use the accrual method—for law firms, this rule only kicks in once you start making \$10m a year—which method is best will depend on your accounting needs.

Benefits of cash basis accounting:

- It allows you to defer taxable income on client accounts receivable at the end of the year, decreasing your tax burden for this year
- It gives you more flexibility for end of year tax planning (for example, it lets you accelerate or delay client invoicing)

Benefits of accrual accounting:

- It's more accurate and timely, allowing you to make better financial decisions for the long-term
- It's better for firms that experience large, rapid changes in their revenues (for example, by securing a large settlement)

Ask a CPA to help you determine which accounting method is best for your business, and stick with it.

Chapter Six

Develop a Bookkeeping System



For a CPA to work effectively, they will need you to provide accurate, up-to-date financial statements. This is where bookkeeping comes in.

Whether you're good with numbers and spreadsheets or not, every lawyer needs to understand the basic role that bookkeeping plays in their business.

Bookkeeping is the process of recording daily transactions in a consistent way and is a key component of building long-term financial success.

Bookkeeping is comprised of:

- Recording financial transactions
- Posting debits and credits
- Bank reconciliations
- Producing customer invoices and recording sales
- Receiving vendor invoices and recording expenses
- Maintaining and balancing subsidiaries, general ledgers, and historical accounts
- Completing payroll

The act of “bookkeeping” produces financial statements, which your CPA then uses to file your taxes and make strategic financial decisions that help your business grow.

Bookkeeping is an ongoing task which can be performed daily, weekly, or monthly. Whether you do the task yourself or outsource it to a pro, the goal is to make sure your books are accurate, up-to-date, and useful to you and your CPA.

Here are your options for getting your books done accurately and on-time:

- **Do it yourself:** If you're up to the task, you can use spreadsheets or simple accounting software to manage your books. This method is great when you're just starting out and your bookkeeping isn't too complex.
- **Outsourced bookkeeping:** When it makes sense for you to focus your time on other parts of your business, hand over your bookkeeping to a pro. An online bookkeeping service like [Bench](#) will give you a team of dedicated bookkeepers who do your books for you, and software to monitor your finances.

- **Hire an in-house bookkeeper:** When your business is big enough to justify it, you can put a bookkeeper on payroll. They can also handle things like receivables for you.

To choose the right bookkeeping method for your needs, consider the volume of bookkeeping you need to do, your budget, how much time you can devote to the task, and how confident you are in doing the books yourself.

Chapter Seven

Master the Art of Recordkeeping



Everyone from your bookkeeper to your CPA and the IRS needs you to keep documents proving the income, credits, and deductions you put on your tax return.

That means you'll need to hold on to:

- Receipts
- Bank and credit card statements
- Bills
- Canceled checks
- Invoices
- Proof of payments
- Financial statements from Bench or your bookkeeper
- Previous tax returns
- W2 and 1099 forms
- Accounts Receivable journal showing billed receivables
- Case time records per client
- Time summary reports, sorted by attorney and by client, listing the time, dates of work, billings and/or charges (legal software like Clio can help you track this)
- Register of cases in progress, often organized by client's name

You should also keep any other documentary evidence that supports an item of income, a deduction, or credit shown on your tax return.

Each of these records should be kept for a specific length of time—some for 10 years, some for as few as three. You can learn more about record retention periods in our [guide to business recordkeeping](#).

The IRS doesn't require you to keep records of certain expenses under \$75, but we still recommend that to be safe, you keep digital copies of all records. The IRS accepts digital copies of receipts, and apps and online services make it relatively easy to scan and save them.

Other deductions to track

The types of expenses you can deduct on your tax return will depend on the expenses you incur in the course of doing business.

Deductions commonly available to law firms include:

- Meals and entertainment
- Out-of-town business travel
- Vehicle-Related Expenses
- Business gifts
- Home office expenses
- Conferences, seminars, training
- Self-education expenses
- Supreme Court library fees, and other professional library fees
- Subscriptions to professional publications

For a longer list, check out [The Big List of Small Business Tax Deductions](#).

Note: The 2018 Trump tax reforms eliminated or decreased certain deductions previously available to law firms, including certain transportations fringe benefits (transit passes, employee parking) and client entertainment. For more, check out our [guide to how the Tax Cuts and Jobs Acts \(TCJA\) affects your business.](#)

Go paperless

Digitizing your records is a great way to make sure you don't lose them. Here are some tools that can help:

- [Bench](#)—you can upload all your receipts and store them digitally in the Bench app.
- Secure cloud storage services like Dropbox, Evernote, or Google Drive. Any of these websites will support scanning and storing.
- A dedicated business document scanner, like Fujitsu's [ScanSnap](#) and the Kodak Alaris (these machines can process large numbers of documents at once and take care of the filing process for you, saving you hours of work).
- A dedicated receipt app such as [Receipt Bank](#) or [Shoboxed](#)

Chapter Eight

Determine How Your Firm Will Get Paid



We've talked a lot about how to manage money once it's in your hands. But how will your practice receive money from clients?

Though rules vary from state to state, most state Bar Association rules permit debit, credit and other electronic payment processing for law firms. For an in-depth discussion about the rise of electronic payments in the American legal profession, check out [this guide to payment processing](#) from the American Bar Association.

Once you've determined what kinds of payments your firm will accept, you'll then need to choose a payment provider to work with.

Every payment provider will have a different fee structure. Before you commit, make sure you do the math to determine the impact a provider's fees will have on your bottom line.

Pick a lawyer-friendly merchant processor

Despite the rise of online payments in the legal profession, some of the current Bar Association rules around law accounting were created back when everyone was still paid by check. This means that attorneys have to take extra care when selecting a merchant processor for their business.

It's important to remember that a standard payment processor will keep a certain percentage of each transaction as a fee. Because of this, you run the risk of breaking certain trust accounting laws (those transaction fees need to be immediately paid back into the trust account).

Certain legal-friendly services like [LawPay](#) and [LawCharge](#) give you the option of charging fees directly to the operating account instead of the trust account, which means you don't have to worry about shuttling money back and forth between accounts.

If you're not dealing with trust accounts, and just want to accept payments online or in-person, we recommend using [Square](#). It's intuitive, reliable, and the industry standard for accepting payments online.

Automated invoicing

As an attorney, you'll spend a lot of your time invoicing your clients. Picking an invoicing solution that automates the legwork can save you time and money.

Cloud services like [FreshBooks](#) let you set up recurring invoices and record project expenses while also letting your clients pay outstanding invoices online using their credit card.

Chapter Nine

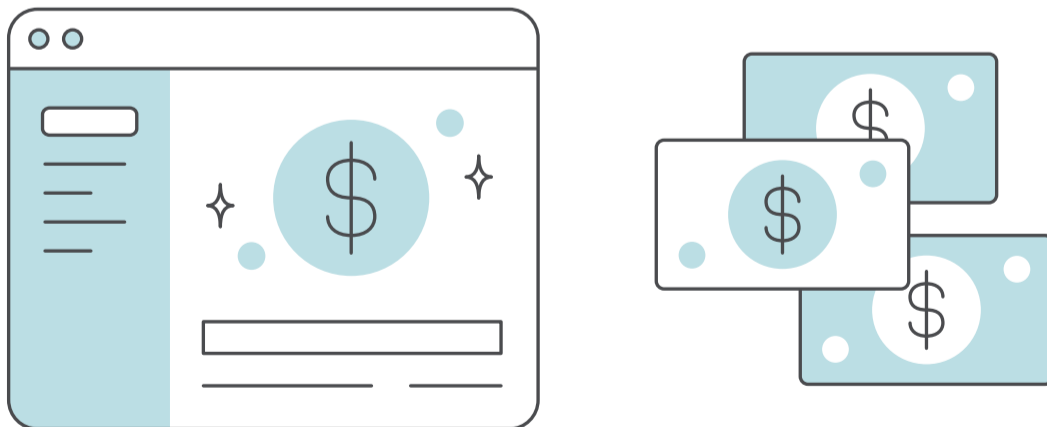
Set Up Payroll



If you're going to hire employees, you will need to set up payroll. Gusto is an online service that automates a lot of the work involved in managing payroll and employee benefits.

Before adding anyone to your payroll, make sure your workers are categorized correctly as either employees or independent contractors. Get this wrong, and you may be fined by the IRS.

You will also need to understand your obligations in regards to employment law and employment tax. This is especially important when it comes to paying mandatory disability or worker's compensation insurance. You can research this on your state government's website, and consult with your CPA.



Chapter Ten

Get Clear on Your Tax Obligations





Paying taxes is relatively straightforward—until you start a business.

Businesses need to pay several different kinds of taxes across all levels of government: federal, state, and local. And your business’s tax obligations are determined by a variety of factors, including geographic location, legal structure, the services or products you provide, and how you conduct business.

Here are the taxes legal practices commonly need to deal with.

Income tax

Your business will have to pay income tax on its profits. How your business pays income tax is determined by your business's legal structure.

If you're an attorney, you'll probably set your firm up as a Limited Liability Partnership (LLP). Unless you elect to be taxed as a corporation, your LLP will be taxed like any other partnership. The tax forms for partnerships are Form 1065, the U.S. Return of Partnership Income, and Schedule K-1, which shows each member's share of the profit/loss for that tax year.

Your business may also be required to pay state taxes in both your home state (where your business is registered) and in any states where your business has nexus.

Employment tax (payroll taxes)

If you have employees, you'll have to pay Federal Insurance Contributions Act (FICA). Federal insurance contributions consist of the social security and Medicare taxes you withhold from your employee's pay and match with your own contributions.

The Federal Unemployment Tax Act (FUTA) tax provides payments of unemployment compensation to workers who have lost their jobs. It is an employer-only paid tax. The FUTA tax rate is 6%, which taxes wages up to the first \$7,000 earned by the employee during the year.

There are also state and sometimes municipal payroll taxes to be collected. Speak to your accountant to make sure you are correctly withholding each payroll tax. Also, ask if you are eligible to receive a tax credit for paying timely state unemployment taxes.

Employment taxes are reported using a Form W-2 for each employee, and Form 940 and Form 941 if you withhold any taxes from an employee's paycheck.

Self-employment tax

If you are self-employed, you will need to pay federal self-employment tax. This is essentially FICA and Medicare, only your payment covers both a withholding from your wage and the matching contribution from your company.

Check for “other” tax obligations

Your business’s tax obligations may extend beyond the above list.

And just when you think you’ve got it all figured out, future changes to your business—such as buying property or hiring employees—can also change your tax obligations!

Work with your CPA to determine how you will meet your sales tax obligations before you do business.



You run your business. We'll do your bookkeeping.

Bench is the online bookkeeping service that does your law firm's bookkeeping for you.

Each month, a team of professional bookkeepers with experience in legal accounting gathers your data for you and turns it into accurate financial statements.

You also get smart software to help you monitor your finances and stay in control of cash flow.



**Refer friends.
Get \$150 and free bookkeeping**

[REFER A FRIEND](#)