

Developing a Business Plan for the Start-up Law Firm: Financial Statements

Key Terms:

Assets: Law firms accumulate assets that represent the economic resources used in the operation of the firm. Types of assets include property and equipment used by the firm and amounts receivable from clients (representing the value of the time and expenses incurred in serving the client). When recording an asset, the entry is a debit to one of the asset accounts. Reductions to assets are recorded as credits to the asset accounts.

Liabilities: Liabilities represent the firm's commitments to vendors, lenders, or others that have provided services or financial support to the firm. When recording a liability, the entry is a credit to one of the liability accounts. Reductions in liabilities are recorded as debits to the liability accounts.

Equity: Equity represents the accumulated investment by the owners of the firm, or put another way, the difference between the assets and the liabilities of the firm. Financial contributions by owners are recorded as credits to equity accounts, while withdrawals by owners are recorded as debits to equity accounts.

Revenues: Revenues in law firms are derived from the charges to clients for services rendered, whether those services are determined on an hourly basis, or as a percentage of a settlement. Revenues are recorded as credits to revenue accounts.

Expenses: Expenses represent the costs incurred for the operation of the firm. They are recorded as debits to expense accounts. Reductions in expense accounts are recorded as credits.

Accrual basis: The accrual basis attempts to match earned revenues (whether collected or not) with expenses (whether paid or not) in the same period. Accrual accounting is sometimes referred to as "generally accepted accounting principles", or GAAP. The rules for measurement and presentation of financial information under GAAP are promulgated by the Financial Accounting Standards Board. This method is required of all publicly traded companies and may be used by any entity to record its financial transactions. Accrual accounting seeks to provide information concerning all the economic activity during an accounting period, without regard to the cash flow of the business. This method can help in firm management, but is not normally used by law firms because of the tax effects of recording revenue prior to receipt.

Cash basis: The cash basis with modifications for recording property, depreciation, and debt, records transactions when cash is exchanged. Revenues are recorded when received, rather than when earned and expenses are recorded when paid, rather than when incurred. To accounting purists, pure cash basis requires each transaction involving cash to be recorded as a receipt or disbursement of cash. Under a pure cash approach, purchases of property and equipment would be cash disbursements, issuing debt would be a cash receipt, and repayment of debt would be a cash disbursement. Firms normally use a modified cash basis, which records debt as a liability and property and equipment as assets. There may be other appropriate modifications to the pure cash basis besides debt and property. This approach provides the firm with cash flow information that isn't as clear when using the accrual basis. Many law firms adopt the modified cash basis because of the rules concerning recognition of taxable revenue.

Balance sheet: The assets, liabilities, and equity of the firm at the close of business on a specific date. The statement balances when total assets = total liabilities plus total equity. The accounting framework determines which accounts are included and how financial activity is measured. For example, in a pure cash format, the only asset is cash and it is offset by equity. All cash transactions are recorded as receipts or disbursements and any non-cash financial transactions are not recorded.

Income statement: The revenues and expenses of the firm during a specified period of time. Again, the accounting framework determines which accounts are included and how activity is measured. For example, in an income tax-cash basis format, accrued liabilities for goods or services received but not paid would be excluded, as would revenue earned, but not collected.

Additional Resources:

“Law Firm Accounting and Financial Management” by Quinn, Bailey & Gaulin

“How to Start and Build a Law Practice, Fifth Edition” By Jay Foonberg

Checklist for Starting a Law Practice: <http://members.mobar.org/pdfs/lpm/checklist.pdf>

<http://practice.findlaw.com/how-to-start-a-law-firm/>

http://www.abajournal.com/legalrebels/article/a_primer_on_starting_your_own_law_firm_in_the_new_normal/

<http://www.alanet.org>