Accounting For Contingency-Fee Income

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This article addresses practitioners with large contingency-fee practices, *i.e.*, 40 percent or more of fee income. Contingency-fee income poses special accounting and cash forecasting problems rarely discussed in legal accounting literature. Neil Shayne, writing in the *New York State Bar Journal* (June 1979), said, "A contingency, personal injury firm can be compared to a retail establishment turning over merchandise once every two to three years.... For the contingent retainer attorney to survive, it is necessary that he or she be deeply concerned with law office economics." The purpose of this article is to alert the reader to the importance of accounting controls for contingency-fee income and to suggest several methods for understanding and managing a contingency-fee practice in an informed way. Suggested timekeeping, bookkeeping, and financial reporting practices follow.

The Problems

Perhaps the largest problem facing a firm with contingency-fee income is how to make *cash-flow projections.* Capital expenditures, *e.g.*, word processing or data processing equipment, must be funded out of projected income. Alternatively, if the firm goes to the bank to fund these capital expenditures, the bank is interested in the firm's projected income. Both scenarios require the ability to forecast cash flow.

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Philip Corboy observed in the ABA journal *Litigation* (Vol. 4, No. 2): "Cases were once tried with little or no discovery before trial. Now, even the simplest automobile accident case can generate the scheduling of a deposition for every person having knowledge of facts about the occurrence or injury." Because contingency-fee work can involve large cost advances (particularly when complex litigation is involved), this type of firm has a greater need for working capital than firms whose income is derived primarily from retainer or hourly-fee clients. Again, cash flow projections are necessary.

Perhaps the largest problem facing a law firm with contingency-fee income is making cash-flow projections. Capital expenditures must be funded out of projected income.

Another problem is the bite the *passage of time* takes on a contingency-fee award or settlement, not to mention the costs advanced to clients. A simplified, before-tax-discounted, cash-flow analysis appears in Fig. 1.

A four-year projection of the *ABC* case has been made for an award or settlement amount, including costs, of $75,000, for which costs advanced were $2,000. The whole has been discounted at the firm's likely cost of capital, *i.e.*, the alternative use for its funds if invested in any of the many financial instruments available to small businesses. The *DEF* case is hourly-fee work in which a total of $75,000 is collected over four years, less $2,000 in costs advanced over four years. Clearly, the *DEF* case is more profitable from the standpoint of timing of cash flow. The challenge to the contingency-fee attorney is to work the case quickly and economically.

The ABC Case — Contingent Fee

Year	0	1	2	3	4
Costs advanced	-1000	-500	-500		
Award (fees & costs)					75,000
Total:	-1000	-500	-500	0	75,000
Net Present Value @ 11%/yr. is	$42,837				

The DEF Case — Hourly Fee

Year	0	1	2	3	4
Fees and costs rec'd		18,250	18,250	18,250	18,250
Total:	0	18,250	18,250	18,250	18,250
Net Present Value @ 11%/yr. is	$51,009				

Fig. 1

Strategies

The following sample reports should be adapted to your firm's specific factual situations. A traditional discussion of accounting methods in law firms would focus on the annual budget and the aging of accounts receivable. Neither of these techniques is particularly useful in the firm we have defined as being largely dependent on contingency-fee income. Instead, the focus shifts to the contingency-case history, cash-flow statements, and work-in-process inventories.

(1) Maintain a Reserve

One of the most obvious ways to deal with cash-flow projections is to make them for only predictable hourly work. The conservative approach is to be sure that enough hourly-income work is done each month to cover fixed costs. The alternative is to closely husband contingency-fee income; that is, invest surpluses in financial instruments and carefully limit the amount of income distributed on a yearly basis. In other words, the firm that wishes to continue to rely on contingency-fee income must have a very good idea of its working capital needs.

Working capital reserve is by far the most important and most neglected

Continued on page 12

Contingency-Fee Income

Continued from page 4

area of legal economics. Typically, law firms retain almost no earnings in the partnership. Where a steady stream of income is grounded in a strong client base, this may be appropriate. For the firm largely dependent on contingency-fee income, a working-capital reserve is exceedingly important. The reserve is an amount of cash or cash-like assets that are continuously replenished before other uses for funds are considered. It is, therefore, an amount not distributed to shareholders or used for purposes other than operation of the business. Understanding one's contingency-fee case income history simplifies the task. Many firms have never collected data regarding their contingency-fee practice or are relatively new practitioners who must estimate conservatively. The amount of money required for working capital is the firm's fixed and variable costs for a representative month multiplied by the number of months the firm might go without substantial contingency-fee income, less the amount of hourly-fee income the firm generates. See Figure 2.

Calculation of Working Capital Reserve

	Fixed monthly cost
+	average monthly costs advanced
−	average monthly hourly fee income
	Monthly Shortfall
x	number of months between significant contingency-fee receipts
	Working Capital Reserve

Fig. 2

In addition to a working capital reserve, the firm should develop a capital expenditure budget. Ideally, both needs are fundable from the firm's own resources. Whether or not this is the case, a line of credit should be arranged, based on the calculation of reserve required.

(2) Collect History

Because of the difficulty of fine-tuning a business plan in large part governed by contingency-fee income, many firms elect to simplify timekeeping and bookkeeping methods to the point of collecting essentially no data or history on their contingency-fee practice. This is a mistake. The essence of contingency-fee income cash flow is to get better and better at forecasting results in individual cases. The form in Figure 3 is suggested for monthly — if not weekly — use to update the status of all contingency-fee cases.

This type of data collected over a period of two or three years, plus the attorney's memory for the facts of the case, will begin to have predictive power and, most important, demonstrate clearly to the busy advocate whether the effort is being rewarded. The contingency-case history described above is a more complete form of the familiar work-in-process summary available on many computerized time and billing systems. A sample work-in-process summary is shown below in Figure 4. The principal purpose of this document is the bookkeeping function of detailing the amount of costs advanced and the billing value. Sorted by attorney, it provides some indication of caseload.

(3) Calculate Realization and Turnover

Two of the most important measures of profitability for law firms are realization and turnover.

Realization is a measure of how the value of the billable time put into a case compares with the amount of fee collected. Contingency-fee cases should average 200% of billable value to compensate for the risk the attorney is sharing with the client. The calculation is:

$$\text{realization \%} = \frac{\text{fees billed} - \text{write-off of billed fees and write-off of billed and unbilled costs}}{\text{actual hours} \times \text{standard billing rate}}$$

In essence, realization measures how successful the attorney is in winning or settling contingency-fee cases.

Turnover is the measure of how long it takes to convert a billable dollar into cash. Contingency-fee firms may find that this period stretches into several months or sometimes years. Better case management may help, but generally the solution is a large inventory of cases. The calculation is (for a particular period, such as a month):

$$\text{turnover} = \frac{\text{ending work-in-progress} \times \text{ending accounts receivable}}{\text{ending work-in-progress} - \text{beginning work-in-progress} + \text{billings for the period}}$$

(4) Compile a Cash-Flow Statement

A cash-flow statement can be com-

Contingency-Fee Case Cash Flow Estimate and History

Responsible Atty: __________

Date of estimate: __________

File No.	Case Name	Type of Case	Date Opened	Est. Settle. Date	Hours to Date	Value of Hours to Date	Est. Fee	Act. Fee & Date	Est. Cost Advanced	Act. Cost Advanced to Date
34	Smith	PI	5/81	7/84	112	$11,200	$20,000		$1,500	

Fig. 3

Responsible Partner Work-in-Process Summary as of ______________

Client/ Matter	Current Charges: Hours	Current Charges: Billing Value	Current Charges: Costs Adv.	Unbilled Balances: Hours	Unbilled Balances: Billing Value	Unbilled Balances: Costs Adv.	Unbilled Balances: Total	Last Active
Responsible Partner Total								

Fig. 4

piled from the contingency-fee case history (Figure 3). The statement consists primarily of a three-month rolling estimate. Estimates should be made monthly by all billing attorneys in the office and broken out into contingency-fee income and hourly-fee income. Space is also provided on the form for the firm's average fixed expenses. See Figure 5. Once this is subtracted from the estimated fee income, the firm's ability to build a working capital reserve can be addressed. Bookkeeper entries regarding what was actually realized for past months and consequent adjustment to actual cash on hand provide a check on attorneys' forecasting ability. In a brief monthly session, attorneys can complete a cash-flow statement and get some perspective on the immediate future.

Following the division below, the firm's monthly *income statement* should separate contingency-fee from hourly-fee income. Note that costs should never be included in income, because the often high costs advanced in contingency-fee work would decidedly skew the results.

Logistics

With the exception of the cash-flow statement, redirected or additional bookkeeping effort is required to complete the above management reports, either manually or with data processing assistance. The other necessary change in practice administration is that each case file must be identified as hourly- or fixed-fee versus contingency-fee work. Timekeepers, and we are assuming that time is kept on all cases, must identify the matter as either hourly or contingent.

Trends

In this year of "megatrends," two of more than minor consequence are:

(1) The age of the personal computer has brought *substantive systems*. Practitioners themselves, recognizing the risk in contingency-fee agreements, have turned to valuing, *e.g.*, personal injury cases, etc., with computer modeling on a given set of facts.

(2) Computer-assisted *probability analysis* helps calculate the likelihood of several different outcomes (sometimes called decision tree analysis).

Whatever the means, these approaches seek to reduce the risk of litigation (whether for hourly or contingent fees). Their effectiveness has not yet been evaluated. ■

Three-Month Cash Flow Projection

	MONTH 1 Contingent	MONTH 1 Hourly	MONTH 2 Contingent	MONTH 2 Hourly	MONTH 3 Contingent	MONTH 3 Hourly
Cash on Hand, beginning	______		______		______	
Atty #1 estimated fees	______	______	______	______	______	______
Atty #2 estimated fees	______	______	______	______	______	______
Atty #3 estimated fees	______	______	______	______	______	______
Atty #4 estimated fees	______	______	______	______	______	______
Atty #5 estimated fees	______	______	______	______	______	______
Total expected:						
less average oprtg. expenses						
PROJECTED CASH AVAILABLE or PROJECTED AMT. OF LOAN						

Actual realized: ______________________________

Fig. 5