

# Realization & Compensation

By

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In the United States, the key statistic in managing a law firm and compensating its timekeepers traditionally has been revenue (except perhaps during recessions when expenses receive heightened attention). What is the key metric law firms use to measure one against another after profits per equity partner – Revenue per ... partner, lawyer, timekeeper, and person... take your pick. What is the key metric used to gauge suitability for partnership – book of business measured by fees collected (revenue). What is the distinguishing ranking for compensation purposes – originations and personal production both measured in fees collected.

That is beginning to change. Firms are examining the profitability of practices, clients and partners. Managing to margin is the new initiative law firm leaders are talking about. Firms are developing profit tools internally or acquiring analytics packages to bolt onto their financial systems. Partners get these tools to assist them with pricing, staffing and other aspects of managing their practices. Once accepted, the metrics generated by these tools are integrated into compensation programs along with the other factors considered when making those decisions. Margin (also referred to as profit margin) looks at the relationship between profit or contribution to profit and revenues.

This article looks specifically at realization, one of the three components of revenue, and how realization can be factored into compensation decisions.

## **Realization Background**

Let us begin with a bit of background. There are three components that make up revenue — demand, pricing, and realization. The recession ravaged all three of these metrics. Demand for lawyers' services collapsed in some practice areas and weakened elsewhere. The demand recovery has been inconsistent, with demand for litigation continuing to lag largely as a result of a shift in client approach and the use of alternative service providers. Rising hourly rates, once the driver of revenue growth (with increases easily outstripping inflation and expense growth year over year), now barely match inflation. A decline in realization, which had been very gradual over the

long-term, accelerated and, combined with slowing price increases, has resulted in nearly no net gain on a realized rate basis since the recession.

A good working definition of realization is fees collected divided by the standard value of the time worked. It is a conversion metric telling us how well one converts time value into cash receipts. Time value is the product of demand (billable hours) and pricing (hourly rates).

These metrics are interdependent. For example, we had a law firm client that was thrilled with their near perfect overall realization. However, upon examination we discovered that their high realization was due to unbelievably low billing rates resulting in lost revenue overall. At the other end of the spectrum, large accounting firms have been known to have realization figures in the low 80% range due to routinely large discounts off high standard rates. These are two examples, one unintended and the other planned, where realization is affected by pricing decisions.

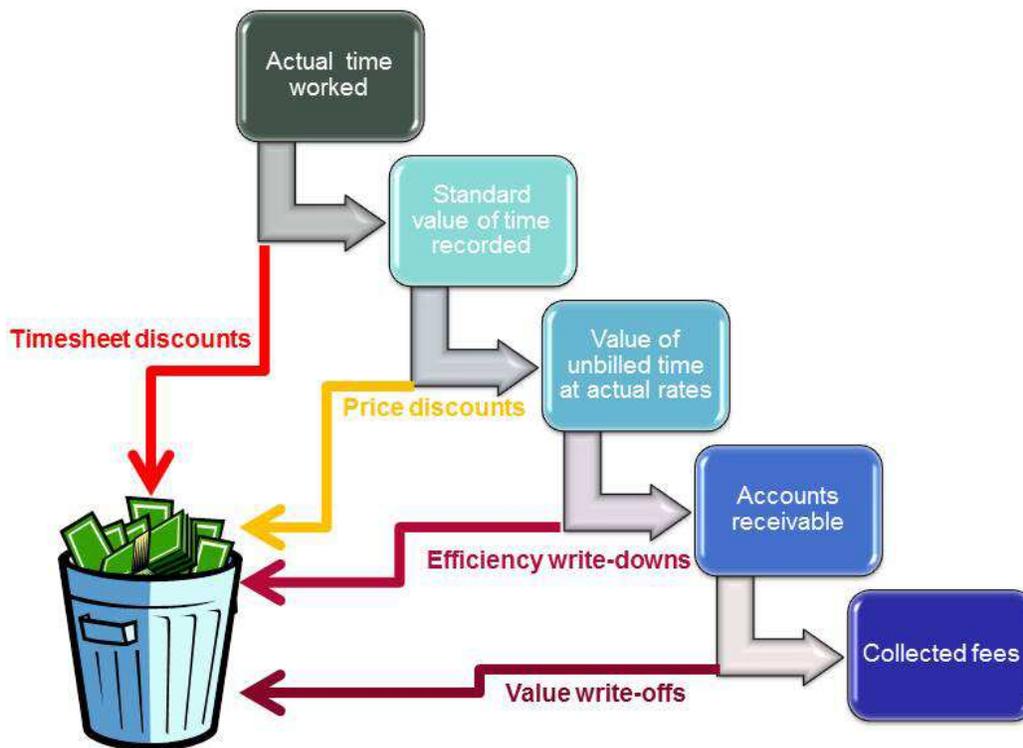
Another law firm we worked with operated with an aggressive time capture philosophy—throwing every interaction with or thought about a client into the time and billing system. In other firms low work volumes may lead to a slower work pace designed to stretch the work to meet time recording expectations. Both of these choices will affect realization later in the cycle.

Realization is also affected by staffing decisions. When work volume is down, some timekeepers hold onto their work to keep busy rather than assigning it to the individual with the most appropriate experience and expertise. Other times when assignments are made, there may be poor delegation or case management decisions, which lead to the wrong people doing the work. If the partner does not adjust the bill, the clients will most assuredly push back.

### **Realization Components**

Some firms treat realization as a monolithic metric. However, realization is anything but. To improve this metric, one must first understand its various components.

The metric most often published in surveys and law firm reports is overall realization, which is the product of billing realization and collection realization. There are also two versions of realization that many billing systems track—realization using actual billing rates and realization using standard billing rates. Finally, there is an insidious hidden realization factor of un/under-reported time. Let us explore each of these sub-groups — but first a pictorial overview of realization.



1. Timekeeper discounting at the timesheet: Sometimes an inexperienced individual may reduce the amount of time recorded, believing that he/she took too long to complete a task. Other times, sloppy time capture habits, such as waiting until the end of the day (or longer) to record time, result in fewer billable hours recorded than actually were worked.

It is hard to quantify something that exists only in its absence. The availability of electronic time capture and recording software should, if used properly, greatly reduce sloppy time capture habits as well as some of the un/under-reporting. The higher realization resulting from this phenomenon leads to false conclusions about process efficiency, timekeeper skills and equally faulty decisions regarding pricing. All of these can be deadly to good profitability.

2. Pricing discounts: The client asks for a 10% price discount. A common request, it appears innocuous. Therefore, it is done. However, what does a 10% discount mean? It means likely 40% to 60% of the profit for work assigned to others under such an arrangement is given away. When expressed in those terms, it is no longer innocuous. The table below shows that discounting has increased. More and more clients are asking for larger and larger discounts, depending on the work and the circumstances.

### Pricing Discount Trends: 2001 - 2013

	2001	2007	2013
Pricing Discounts	2.4%	4.7%	4.9%

Source: Based on analysis of data from 2002, 2008 and 2014 Surveys of Law Firm Economics, ALM Legal Intelligence

Generally, standard billing rates are used to calculate realization. Law firm time and billing systems also maintain alternate/actual billing rates for each timekeeper and matter. Standard rate realization reflects the results of pricing decisions as well as the consequences from matter management, service efficiency, staffing decisions and client perceptions of value for the matter. Actual rate realization only reflects the matter management, service efficiency, staffing decisions and client perception of value for the matter. One can report both realization figures (standard and actual rate) and calculate the difference between the two realization rates. The pricing variance is the result of that calculation.

In tackling a pricing variance problem, consider the following questions.

- Is pricing clearly communicated to clients?
- Is there a mechanism to adjust pricing (periodically or if material facts of the representation change)?
- Does the pricing reflect risks assumed by the firm?
- Is pricing competitive to what others charge for similar services?
- Does the pricing consider constraints imposed on the firm (time requirements, exclusivity in representation, use of developed work product and the like)?
- Does the pricing consider the client's payment history?
- Do you employ the large CPA firm model of high standard pricing with significant contractual discounts?

3. Write-downs of unbilled time: Our experience indicates that realization suffers the most during billing. We have found lawyers reluctant to bill fully for fear that the client will not perceive the value of the work done and push back on the amount or not pay for it in its entirety. However, a lawyer's perception of value may not comport with his or her client's or with what the client will accept after a conversation explaining what work was done and why.

Each firm should establish and enforce policies that limit adjustments taken, without additional authorization, prior to billing. Moreover, the policies should address how to record write-downs. The typical methods that affect how adjustments are allocated among timekeepers are specific time-entry identification, pro-rata reductions based on proportional time value, and billing subordinates at full value while the billing partner takes the full adjustment. Methods of adjusting the accounting records include lowering billing rates (adjusting pricing), reducing time (adjusting utilization) or reducing fees. This last one is preferred as it more accurately reflects what has happened.

Consistency across billing professionals facilitates analysis and control. By isolating the write-downs of unbilled time, the firm can calculate billing realization (the percentage of the time value recorded lost at the time of billing).

The table below depicts billing realization data for the U.S. legal profession in 2001, 2007 and 2013. It shows the deteriorating trend in realization. Both standard rate and actual rate realization declined, however, actual rate realization held up longer and dropped less while discounting took off. This is the result of increasing client pressures on pricing and value. Data will be different for different law firm size ranges as well as for different practice specialties.

### Billing Realization Trends 2001 - 2013

Billing Realization for year	2001	2007	2013
Realization off of standard billing rates	93.2%	91.2%	88.2%
Realization off of actual billing rates	95.6%	95.7%	93.0%

Source: 2002, 2008 and 2014 Surveys of Law Firm Economics, ALM Legal Intelligence

Efficiency variance is the difference between 100% realization and the realization rate calculated with actual billing rates. This measure looks at non-pricing issues affecting realization. It includes staffing decisions involving experience and expertise as well as the efficiency of the process used to deliver the services. It also reflects the nature and success of supervising the matter.

In taking on an efficiency variance problem, consider the following questions:

- Does the firm have the proper staffing profile (expertise and experience) for the work it does?
- Is there a work plan/budget against which you compare actual progress?

- Are those supervising the matters trained and proficient in project management techniques?
- Are you leveraging technology effectively?

4. Client adjustments resulting in write-offs of receivables: Aggressive billing practices may result in greater client oversight of the invoices. This can slow down payment and increase the adjustments as clients wade through each time entry and cost item. Client adjustments provide the basis to calculate collection realization (the percentage of the bill actually paid by the client).

Clients do not like surprises, especially a surprise in the invoice amount. Firms need to keep clients informed of what is happening and why. If the firm has established a plan and budget, then it must discuss significant changes as they arise, update the plan and budget based on material changes and secure the client's agreement to proceed.

If the invoice contains items the billing attorney believes the client may not be expecting, it will be important to discuss the reasons in a cover letter or have a conversation with the client about the status of the matters before sending the invoice.

Also, if the pre-bill has been adjusted, show those adjustments on the invoice. Clients generally understand that not all goes according to plan and appreciate the partner's consideration of what an appropriate charge should be. This can smooth the way to request some additional consideration from the client for those items that the firm feels should be paid.

The table below depicts collection realization data for the U.S. legal profession in 2001, 2007 and 2013. Realization for adjustments taken after billing the client have improved marginally, but are likely within the survey's margin of error. As above, sub-groups within the profession will have different collection realization rates.

### Collection Realization Trends 2001 - 2013

Collection Realization for year	2001	2007	2013
Realization off of actual billing rates	96.7%	96.9%	97.4%

Source: 2002, 2008 and 2014 Surveys of Law Firm Economics, ALM Legal Intelligence

### Overall Realization

The overall picture is one in which the law firm market is experiencing declining realization. Realization has been slipping over the long-term, and, the pace has

accelerated with the recent recession. The recession brought with it greater price discounting and greater scrutiny of matter management, service delivery and staffing.

The table below depicts overall realization data for the U.S. legal profession in 2001, 2007 and 2013. Some might wonder at the significance of this. So what if realization dropped from 88% to 85.7%? It is only a 2.3-point decrease. However, it is 2.3 points off the equity partners' margin (the money available to the owners). And it significantly blunts the effect of billing rate increases – leaving net rate increases below inflation. Remember that pricing has been the primary driver of revenue and profit growth in the profession—with year over year increases well in excess of inflation. (As stated earlier, sub-groups within the profession will have different collection realization rates.)

### Overall Realization Trends 2001 - 2013

Overall Realization for year	2001	2007	2013
Realization off of standard billing rates	90.1%	88.0%	85.7%
Realization off of actual billing rates	92.5%	92.7%	90.6%
Pricing Variance (Actual vs. Standard)	2.4%	4.7%	4.9%
Efficiency Variance (Actual vs. 100%)	7.5%	7.3%	9.4%

Source: 2002, 2008 and 2014 Surveys of Law Firm Economics, ALM Legal Intelligence

Aside from the basic elements of realization already discussed, the speed of collections is an important factor directly affecting collection realization. Slower billing and longer payment cycles result in less money collected, lower realization rates, and higher working capital requirements. Two additional metrics that indicate the speed of collections are turnover of unbilled time and turnover of accounts receivable.

1. Turnover of unbilled time: This measure looks at how many months of revenue are sitting in unbilled time inventory. Typically, we see about 1.75 to 2.5 months of revenue locked up in unbilled time inventory. This includes about a quarter to a half month locked up in contingent fee matters.

If a firm is trying to effectively manage its unbilled time value inventory, the following questions may help:

- What provisions are there for retainers and advance billings?
- What percentage of fees is determined on a contingency or end of matter or some other basis?

2. Turnover of accounts receivable (AR): This measure looks at how many months of revenue are sitting in fees receivable. Typically, we see a pattern similar to unbilled time, with about 1.75 to 2.5 months of revenue locked up in fees receivable.

Most lawyers will say that the only issue they dislike more than telling a client how much the service will cost is asking the client to pay for that service once a bill has come due. These are questions to ask in working through a buildup of older accounts receivable:

- What policies are in place to follow up?
- Are there stop work thresholds (within the constraints imposed by legal ethics and responsibilities)?

Consider this example of how working capital is affected by the speed of collections: a 500-lawyer law firm averaging \$650,000 in revenue per lawyer would save approximately \$13.5 million in working capital needs with a half-month reduction in inventory.

Examining realization is important to maintaining good fiscal health in a law firm, and it is essential to examine realization at its component level. The appropriate remedy will vary based on the cause. The only way to get to the cause is to get into the details.

### **Using Realization in Compensation Decisions**

Once a financial management tool is developed, rolled out to a test group, refined and ultimately instituted across the firm; it is ready to be introduced into the compensation program. This is a best practice to achieve Pay Proportional to Performance<sup>®</sup>. It is not advisable to use financial metrics in compensation decisions until they are fully integrated into firm operations.

How important is realization in the overall compensation decision? Currently financial metrics (other than collected fees) are relatively minor factors in most law firm's compensation decisions. Each firm will need to decide for itself. The weight accorded realization in compensation decisions should parallel its importance in firm operations and the overall success of the firm.

The following questions will assist a firm to position realization into a compensation program:

- Does the firm want to put this metric into a formula?
- Should it be part of a formal scoring system?
- Should it be considered as a ranking or rating?

- Will it be combined into a broader basket of factors such as speed of billing and collections?

### Partner Scoring System

One means to consistently determine relative performance is to assign each partner to a performance profile. For example, a partner scoring system for realization and management of the value of unbilled time and accounts receivable might look like the following:

**5**—This partner is considered a valuable resource on fee and financial issues. This person regularly realizes premiums above standard rates and overall collects above 95% of standard rates. Only 10% of unbilled time and 5% of receivables are over 90 days outstanding. He/she uses retainers and advance payments on a consistent basis to reduce working capital requirements. Maintains time records contemporaneously and submits daily. Pre-bills are returned to accounting within 48 hours of receipt each month.

**4**—An effective and efficient manager of fiscal matters, this partner averages 90% to 95% of standard rates. 20% of unbilled time and 15% of receivables are over 90 days outstanding. Maintains time records contemporaneously and submits with a one-day lag. Pre-bills are returned to accounting within 72 hours of receipt each month.

**3**—A competent fiscal manager, this partner discusses the economic arrangement with clients before a matter is undertaken, including establishing budgets and milestones. The partner averages 85% to 90% of standard rates. 30% of unbilled time and 25% of receivables are over 90 days outstanding. Time is recorded contemporaneously with two days lag except at month end. Pre-bills are returned to accounting within 72 hours of receipt each month.

**2**—A struggling fiscal manager, this partner regularly has realization challenges and client payment issues. The partner averages 80% to 85% of standard rates. 40% of unbilled time and 35% of receivables are over 90 days outstanding. Time is submitted weekly and may or may not be maintained contemporaneously. Pre-bills are returned to accounting promptly after they ask for them.

**1**—This person does not adequately discuss economic arrangements or budgets with clients such that clients are regularly surprised by the costs being incurred, staffing and other factors that affect their bills. Realization is below 80% of standard rates. 50% of unbilled time and 45% of receivables are over 90 days outstanding. Time is not maintained contemporaneously and the accounting department regularly chases the partner for time submission and to return pre-bills.

While the above scoring system provides a consistent rating of each partner across the firm, it may be advisable to modify it with more nuanced considerations of performance versus budget, performance progress and performance against market. Of course, adding these considerations raises the effort required. The following questions provide the basis for a more nuanced look at a partner's efforts and results managing realization:

- Does the firm have sufficient information to set practice, client or partner realization budgets?
- What is current condition of each realization component for each practice, client and partner?
- What are the short, intermediate and long-term targets for each?

As law firms move to measure profitability – revenues less allocated expenses – it is important to take the same efforts to understand the impact on profits from pricing, efficiency and value adjustments to the revenue stream.

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