Issues in Realization

By

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There are three metrics that make up timekeeper 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. 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. Much of these patterns continue as the profession transitions beyond the recession. This article examines realization more closely to aid firms in managing this economic lever.

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 we convert time value into cash receipts. Time value is the product of demand (billable hours) and pricing (hourly rates).

These metrics affect each other. For example, we had a law firm client that was thrilled with their near perfect overall realization. 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%s 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 suffers, some timekeepers hold onto their work to keep busy rather than assigning the work to the appropriate individual based on 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.

Some firms treat realization as a monolithic metric. However, realization is anything but and 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 two components—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 a insidious hidden realization factor of un/under-reported time. Let us explore each of these sub-groups.

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 the 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 of activity. 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. Write-downs of unbilled time: Our experience indicates that realization suffers the most during billing. We have found lawyers reluctant to bill 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 the 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, you 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 legal profession in 2008 and 2010. It shows the deteriorating trend in realization. Both standard rate and actual rate realization declined and the spread between the standard and actual realization has increased. These are the result of increasing client pressures for discounts, greater lawyer sensitivity to the size of the bill and greater concern that the client expects more efficiency than the firm is delivering. Data will be different for different law firm size ranges as well as for different practice specialties.

Billing Realization for year	**2008**	**2010**
Realization off of standard billing rates	90.8%	87.5%
Realization off of actual billing rates	95.4%	93.8%

Source: 2009 and 2011 Surveys of Law Firm Economics, ALM Legal Intelligence

3. <u>Client adjustments resulting in write-offs of receivables</u>: 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. Keep clients informed of what is happening and why. If you established a plan and budget, discuss 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 you believe the client may not be expecting, 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 you adjust the pre-bill, show those adjustments on the invoice. Clients generally understand that not all goes according to plan and appreciate the practitioner’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 you feel should be paid.

The table below depicts collection realization data for the legal profession in 2008 and 2010. Adjustments taken after billing the client are deteriorating, although the decline is minimal. This is an indication of further client scrutiny of what the law firm has done, how long it took and who did it. As above, sub-groups within the profession will have different collection realization rates.

Collection Realization for year	**2008**	**2010**
Realization off of actual billing rates	96.8%	96.7%

Source: 2009 and 2011 Surveys of Law Firm Economics, ALM Legal Intelligence

4. Pricing variance: 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 and staffing decisions for the matter. Actual rate realization reflects just the matter management, service efficiency and staffing decisions for a 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.

If you are 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 (and typical medical pricing model) of high standard pricing with significant contractual discounts?

5. Efficiency variance: An 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.

To tackle these challenges consider if your firm has the proper staffing profile (expertise and experience) for the work it does. Is there a work plan/budget so that variances are quickly identified? Are those supervising the matters trained and proficient in project management techniques? Are you leveraging technology effectively?

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 legal profession in 2008 and 2010. Some might wonder the significance of this. So what if realization dropped from 88% to 84.5%? It is only a 3.5-point decrease. The problem is rates went up only 7.7% for the same period. Thus, realization wiped out 45% of the pricing increase, leaving 2.1 points per year, roughly annual 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 for year	**2008**	**2010**
Realization off of standard billing rates	88.0%	84.5%
Realization off of actual billing rates	92.4%	90.6%
Pricing Variance (Actual vs. Standard)	4.4%	6.1%
Efficiency Variance (Actual vs. 100%)	7.6%	9.4%

Source: 2009 and 2011 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.

6. Turnover of unbilled time: This measure looks at how many months of revenue are sitting in unbilled time inventory. Typically, we see about 1¾ to 2½ months of revenue locked up in unbilled time inventory. This includes about a quarter to a half month in contingent fee matters.

The following questions are helpful in sorting out how well you manage your time value inventory. 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?

7. 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 1¾ to 2½ months of revenue locked up in fees receivable.

Ask many lawyers and they will say that the only issue they dislike more than telling a client how much the service will cost is to ask the client to pay for that service once a bill has come due. What policies are in place to follow up? Are there stop work thresholds (within the constraints imposed by legal ethics and responsibilities)?

We mentioned before that working capital is affected by the speed of collections. Consider this: 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. Nevertheless, be sure 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.

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