Realization Rates in Law Firms

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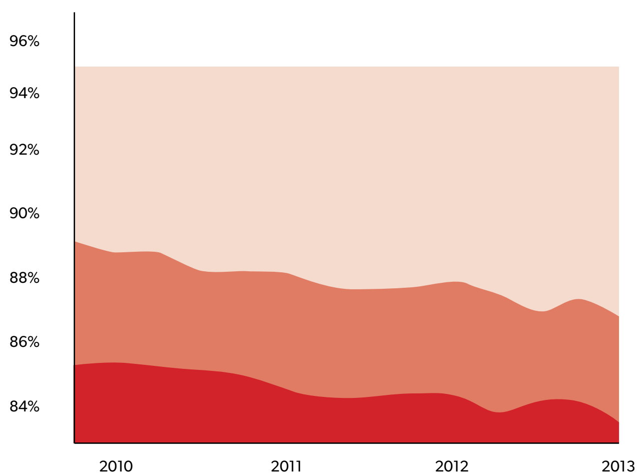
Introduction

Realization rates – the measurement of the difference between recorded time and the percentage of that time paid by clients – are a reasonably accurate indicator of a law firm's profitability. However, recent studies show that realization rates for law firms have been declining for the past few years. According to the Georgetown Law's 2014 Report on the State of the Legal Market[1], the average overall realization rate in 2013 was 83.49%, down 8% from 92% recorded in 2007. Based on survey data, an overall realization rate target is 95%, and firms have been steadily falling below that level.



Since the economic crisis of 2008, law firms of all sizes have been under increased pressure regarding their realization rates and the overall decrease of firm profitability. While there are a number of factors that influence realization rates, one in particular is the growing popularity of alternative billing. But despite this growth, legal industry surveys indicate that hourly billing still accounts for over 94% of total billings[2] and realization continues to play a key part in analyzing a law firm's financial results and profitability. In light of this ongoing trend, law firms must continue to find ways to maximize profitability under standard billing arrangements, the hard data behind realization rates.

The economic crisis of 2008, however, has made hard data only one component. The other component law firms must now take into account is soft data, the kind of activities, touch points and idiosyncrasies that cannot be easily measured, yet still impact the bottom line. As with many businesses post-recession, the questions that have become most prevalent are:

> *"What value is to be measured in conjunction with the hard data of cash and hours billed?"*
>
> *"What value-based means can lawyers employ that will also impact firm realization rates?"*

This paper will address both, and explore the hard numbers of determining realization rates before providing guidance on how to create value-adds that will positively impact both the client experience and firm realization rates.

[1] *Georgetown Law 2014 Report on the State of the Legal Market*, 5.
[2] 2013 CounselLink Enterprise Legal Management Trends Report,"13.

HARD DATA:
DEFINING AND CALCULATING REALIZATION

Generally speaking, realization rates are a good, rough correlative of law firm profitability. Legal industry surveys mainly use the following simple formula to calculate and track realization rates:

$$\textit{Overall Realization Rate} = \frac{\textit{Cash in}}{\textit{Value of time recorded at standard charge-out rates}}$$

But this formula takes into account only a fraction of what a law firm needs to be tracking in today's competitive market. In order to understand hard realization rates in a post-recession world, law firms need to look at other variables, specifically the Five Levers of Profitability.

Five Levers of Profitability

David Maister explains the Five Levers of Profitability in his book, *Managing the Professional Service Firm*.[3] Realization is just one lever, but for a firm to be profitable, all five levers need to be considered and adjusted accordingly. Here is a modified version of Maister's profitability formula, showcasing the five profitability levers:

Utilization

Standard Hourly Rate

Billing Realization Rate

Margin

(Leverage + 1)

x (+ adjusted for collection realization rate)

Profit per Partner (PPP)

For a law firm, the components are calculated in the following manner:

$$\textit{Utilization} = \frac{\textit{Billable Hours Recorded}}{\textit{\# of Lawyers}}$$

$$\textit{Standard Hourly Rate} = \frac{\textit{Value of Time Billed at Standard Rate}}{\textit{Billed Hours}}$$

$$\textit{Billing Realization Rate} = \frac{\textit{Billings}}{\textit{Value of Time Billed at Standard Rate}}$$

$$\textit{Margin} = \frac{\textit{Net Income}}{\textit{Billings}}$$

$$\textit{Leverage} = \frac{\textit{\# of Associates}}{\textit{\# of Partners}}$$

$$\textit{Collection Realization Rate} = \frac{\textit{Cash In}}{\textit{Billings}}$$

[3] David Maister, *Managing the Professional Service Firm*, 42.

To help illustrate the meaning of these equations, the following is a breakdown showing how the five profitability levers operate together. For simplicity, the example has been restricted to a single month, and what follows is an explanation of each component.

Utilization

$$\textit{Utilization Rate} = \frac{\textit{Billable time recorded}}{\textit{Available time}}$$

$$\textit{Utilization} = \frac{\textit{Billable hours recorded}}{\textit{\# of lawyers}}$$

Lawyer A records six hours, on average, out of an available eight hours per day. That represents a 75% utilization rate (6 recorded billable hours / 8 available hours=75%). Lawyer A records 120 billable hours for the month (6 hours x 20 days = 120). Lawyer A's utilization is 120 billable hours.

Standard Hourly Rate

$$\textit{Standard hourly rate} = \frac{\textit{Value of time billed at standard rate}}{\textit{\# of lawyers}}$$

Lawyer A bills his 120 billable hours during the month. His standard hourly rate is $200 per hour ($24,000 value of time billed / 120 billed hours).

Effective Rate

$$\textit{Effective rate} = \frac{\textit{Billings}}{\textit{Billed hours}}$$

Lawyer A, having self-discounted for various reasons, bills all of his 120 billable hours during the month for a total of $20,000 in billings. Therefore, his effective rate is $166.66 per hour ($20,000 billings / 120 billed hours = $166.66).

Three Types of Realization

There are three realization formulas shown in the example:

1. Billing realization rate
2. Collection realization rate
3. Overall realization rate

All three are important for different reasons:

Billing Realization Rate

$$\textit{Billing realization rate} = \frac{\textit{Billings}}{\textit{Value of time billed at standard rate}}$$

In the example, Lawyer A's standard hourly rate is $200 per hour. If he had billed out all of his hours at his standard hourly rate for the month, he would have billed $24,000 (120 hours x $200 standard rate=$24,000). However, as we saw above, he self-discounted in this instance, and only billed $20,000. Therefore, his billing realization rate for the month is 83.3% ($20,000 actual billings / $24,000 value of time billed at standard rate).

Collection Realization Rate

$$\textit{Collection realization rate} = \frac{\textit{Cash in}}{\textit{Billings}}$$

Collection realization tells you how efficiently you are converting billings into cash. In the example, Lawyer A collected $18,000 of the $20,000 billings that he issued during the month. Therefore, his collections realization rate is 90% ($18,000 cash in / $20,000 billings) for the month.

Overall Realization Rate

$$\textit{Overall realization rate} = \frac{\textit{Cash in}}{\textit{Value of time recorded at standard charge-out rates}}$$

As reviewed in the introduction, overall realization combines the effect of billing and collection realization rates into one number, and tells you how efficiently you are converting work in progress into cash. In our example, Lawyer A's overall realization rate for the month is 75% ($18,000 cash in / $24,000 value of time billed at standard rate).

Note: For the rest of the paper, any references to "realization" refer to overall realization rate unless noted otherwise.

Leverage

Leverage = *Number of associates* / *Number of partners*	Lawyer A's firm has three partners and seven associates. Therefore, the firm's leverage is 2.3 (7 associates / 3 partners = 2.3). Leverage can also be measured as Total Staff / Partners. For instance, a firm with three partners, seven associates, two non-equity partners, and five paralegals has a Total Staff leverage of 4.7: (7 + 2 + 5) = 14 total staff / 3 partners = 4.7 total staff leverage.

Margin

Margin = *Net income* / *Billings*	Lawyer A's firm has $200,000 in billings and $120,000 in expenses for the month. The firm's net income (profit) is $80,000. Therefore, the firm's margin for the month is 40% ($80,000 net income / $200,000 billings).

Profit Per Partner - PPP

Profit per partner (PPP) = *Utilization* x *Standard hourly rate* x *Billing realization rate* x *Margin* x *(Leverage + 1)*	The firm's Profit per Partner (PPP) for the month is $26,666 ($80,000 net income / 3 partners). Here's how the profitability formula operates to produce a $26,666 PPP in the example: $26,667 PPP = 120 hours utilization x $200 standard hourly rate x 83.3% billing realization rate x 40% margin x (2.3 leverage + 1)

HOW THE FIVE LEVERS AFFECT PROFITABILITY

Now that you have an understanding of the Five Levers of Profitability, let's look at how each lever impacts law firm profitability. Realization, along with utilization and margin, helps to increase short-term profitability, while leverage and effective rates drive long-term profitability. Except where work is highly leveraged—for example, over 1.5—realization provides a good rough correlative with short-term profitability. Properly applied leverage can allow firms to process files in a profitable way even with lower-than-average realization rates.

Each of the five levers is affected by changes in the other levers. For instance, if you increase leverage, you increase overhead and reduce margin. If you reduce effective rate, you reduce realization—and so on. You can't increase or decrease one lever without affecting one or more of the others.

For every one percentage point of overall realization rate, profit is affected by two percentage points at a 50% margin. For example, at a 50% margin, billings of $100,000 produce profit of $50,000 (50% margin x $100,000 billings = $50,000 profit). An increase of 1% in overall realization rate increases profit by $1,000 ($100,000 billings x 1% overall realization rate increase = $1,000 profit). This increases profit by 2% ($1,000 profit from increased realization / $50,000 profit = 2%). (*Note: the same 1:2 relationship between realization rate and profitability applies to billing realization rate and collection realization rate*).

Pricing

Billing is the realization component that has come under the most scrutiny in recent years. Since the financial crisis of 2008, most companies have had to cut costs, and CEOs are pressuring outside counsel to cut their fees as well. Clients are also routinely asking for price discounts of 10%-50% or more on their legal bills. All these factors put a huge strain on profitability, as a 20% cut in fees at a 40% margin is equal to a 50% cut in profit.

For instance, let's say that a law firm's current billings are $200,000 and its current margin is 40%, which results in $80,000 profit (40% margin x $200,000 billings = $80,000 profit). A large automobile insurance client, for whom all of the firm's lawyers perform work, asks the firm to discount its fees by 20%. If it agrees, the firm experiences a reduction in profit of $40,000 (20% fee discount x $200,000 billings = $40,000). This equates to a 50% drop in profit ($40,000 fee discount / $80,000 profit = 50%).

Clients are also looking for certainty in legal costs, and law firms have responded with alternative billing arrangements, including fixed fees, pushing realization down even further. Realization rates can quickly drop to 60% or less until law firms adjust to fixed-fee billing techniques. To put this scenario into perspective, a 60% realization rate at a 40% margin will wipe out most of the firm's profit.

Considering the above example again, let's say that the firm's current billings are $200,000 and its current margin is 40%, which results in $80,000 profit (40% margin x $200,000 billings = $80,000 profit). This time, the large automobile insurance client that all of the firm's lawyers perform work for asks the firm to discount its fees by 40% (100% fees - 40% discount = 60% billing realization rate). At a 60% billing-realization rate, the firm experiences a reduction in profit of $80,000 (40% x $200,000 billings = 80,000). This equals a 100% drop in profit ($80,000 fee discount / $80,000 profit = 100%).

Leverage

Another major factor in realization management is staffing mix. For decades, large law firms have been leveraging work down to associates to maximize profitability. However, in recent years this strategy has failed, as clients are increasingly refusing to pay high billing rates for work performed by untrained junior associates. As a result, firms are now leveraging more work down to contract lawyers or outsourcing the legal work, which produces higher realization rates. They may also be automating the work, using technological leverage to improve their realization. As work is leveraged down to the optimal staff level, realization rates increase.

Here's an example of how realization rates and profitability changes when leverage is applied. Partner A spends 10 hours on a project at a charge-out rate of $400 per hour on a fixed-fee project that is billed at $2,000. This produces a 50% billing realization rate. ($2,000 billings / $4,000 value of time billed = 50%). General overhead is $1,000. Profit per partner hour is $100 ($2,000 billings -$1,000 overhead = $1,000 profit / 10 billed hours = $100 profit per partner hour).

Profit per partner hour (PPPH), a concept popularized by David Maister, takes leverage as well as realization into account. The full calculation of PPPH is more complicated than this, but has been simplified for illustration purposes here:

For the next project, Partner A decides to utilize her associate to do the bulk of the work instead – at a rate of $100 per hour. The associate takes longer to complete the work than Partner A, a total of 15 hours, and Partner A spends 1 hour supervising the project. The project is billed at $2,000. Total value of time worked = $1,500 associate time + $400 partner time = $1,900. This produces a 105% billing realization rate ($2,000 billings / $1,900 value of time billed = 105%). General overhead is $1,000. Associate salaries are $525 ($35/hr x 15 hours = $525). Profit per partner hour is now $475 ($2,000 billings - $1,000 overhead - $525 associate salaries) / 1 partner hour = $475 per partner hour).

In the above example, billing realization rate is increased from 50% to 105%. At the same time, Partner A's profit per partner hour goes from $100 per hour to $475 per hour, simply by levering most of the work down to an associate. This example illustrates how leverage can have a much more dramatic impact on profitability than the other four profitability levers.

Most firms are comfortable enough with realization calculations to provide a “quick and dirty” idea of how profitable a client is. Again, it all depends on your practice. If you have a highly leveraged practice (more than 1.5), as is common, for instance, in residential conveyancing with low realization and a high volume of staff hours involved, a profit-per-partner-hour calculation may be worth exploring. But if you have a low-leverage practice focusing on tax law, for example, with high realization and few staff hours involved, then overall realization rate will provide a pretty good indicator of the profitability of your practice. The point is that when determining how profitable a service is, you need to take into account the impact of leverage as well as realization levels.

We’ve seen how leverage can impact profitability in a 10-person law firm. Firm A has three partners and seven associates for a 2.3 leverage ratio (7 associates / 3 partners = 2.3). Firm B has five partners and five associates for a 1.0 leverage ratio. Reducing the leverage ratio from 2.3 to 1.0 reduces Profit Per Partner (PPP) by 25%, assuming all other factors remain constant.

Firm C has one partner and nine associates for a leverage ratio of 9.0. Increasing the leverage ratio from 2.3 to 9.0 increases Profit Per Partner (PPP) by 127%, assuming all other factors remain constant.

A leverage ratio of 1.5 or more is considered “highly leveraged.” In certain cases, this is desirable – for example, if the work can be easily delegated down and supervised. Leverage ratios as high as 15.0 or more are not uncommon in small boutique and class-action law firms. The advantage is that it can be extremely profitable to use very high leverage when work can be levered down to lower-paid associates and staff, increasing realization and profitability and at the same time keeping client costs down.

Billing-realization rate should be tracked at multiple levels, including:

- Client
- Matter
- Type of service
- Timekeeper

Tracking billing realization at the matter level can give you a good idea of how to improve realization by applying more leverage, and you can also see how applying automation to file operations can improve realization. These findings can then be applied at the client, timekeeper and type of service levels.

One way to analyze your realization levels is to run a report showing all clients with billing-realization rates below 80% so that you can critically assess whether this lower realization rate can somehow be justified. If it can’t, try to figure out ways to increase realization by using technology to automate tasks, varying staffing mix, applying more leverage, etc. If no viable alternative exists, then decide whether you should replace this client with another who offers higher realization and profitability.

Efficiency

You also need to figure out how to work the file in the most efficient manner possible to optimize your realization and profitability. Start this analysis by reviewing historical time-sheet data to budget your time more efficiently and effectively. Many clients are looking for cost certainty, so high efficiency is very important if you are to achieve your desired profit margin. Learn how to accurately budget the time required to efficiently manage a file while still satisfying the client's budget demands.

Some firms automate their document production process to reduce the amount of time required to produce documents. Under fixed-fee billing, this is one way to increase your realization and profitability. If you can reduce the amount of time it takes to produce a document from 10 hours to five hours, while keeping the same price as you charged under hourly billing, then you will double your billing realization rate from 100% to 200%.

For example, let's say that Lawyer B charges $200 per hour and it takes 10 hours of her time to produce a document. She bills her client $2,000 (10 hours x $200 = $2,000). Billing realization = Billings / Value of time worked. Her billing realization is 100% (($2,000 billings/ (10 hours x $200/hr))=100%). With the help of automation, she is able to produce the same document in five hours. She negotiates a price of $2,000 up front and bills her client that amount. So billing realization now equals 200% (($2,000 billings/(5 hours x $200/hr)) = 200%).

Many firms will split the difference with their client as they move to fixed-fee billing, creating a win-win situation where the law firm can achieve a higher realization and profitability while the client pays a lower overall cost for the document or service received.

Effectiveness

Above all, in order to optimize realization, you need to focus on the client's goals when delivering legal services. Some ways that you can do that include:

- **Put the client's profit targets first, and your profits will follow.**
- **Focus on the client's satisfaction by meeting their needs for turnaround time and budgeted legal costs.**
- **Be effective in ensuring that the client's goals are met.**
- **Develop a long-term strategic partnership with clients, and don't worry if not every file is profitable – it will average out in the end as you gain more experience with value pricing and fixed-fee billing techniques.**

Studies show that 80% of your profits will come from the top 20% of your clients, so try to focus 80% of your time on the top 20% of your clients. If you do this on a regular basis, you will find that your realization rates and profitability will increase significantly.

Hidden Realization[4]

If lawyers and staff are not recording their time properly, there can be a hidden realization issue. The appearance of a very high-realization practice may in fact be inaccurate if lawyers and staff are under- recording or failing to capture their time. This often happens if the files are being billed on a fixed-fee basis and timekeepers stop recording time when they think it isn't necessary for billing purposes. You must impress upon timekeepers that it *is necessary*, or you'll end up with skewed statistics when comparing realization results among different types of services.

One way to avoid this problem is to employ what is known as full-day time accounting in which timekeepers record all time, billable and non-billable. This helps ensure that time is being recorded in a consistent fashion, and it has the added bonus of higher time-capture rates. Accounting firms have practiced full-day time recording for decades and have reaped these benefits, and these practices apply equally well to law firms.

This single policy change can easily increase your billings by 10% to 20% or more, and those extra revenues go straight to the bottom line. Your realization rate may go down slightly, but will be more than offset by the extra cash realized at the end of the day. If your partners consider keeping track of all time to be too burdensome, consider doing pilot projects for a month at a time to gather the necessary information to compare clients, services and timekeeper realization.

Some consultants advise their clients not to track time if they're doing fixed-fee work. However, failing to track time deprives you of vital realization data that can be the key to your firm's efforts to optimize profitability. Your time and billing system plays a central part in costing, pricing and helping you estimate fees in hourly or fixed-fee situations. All of this helps to ensure that you are achieving desired net-profit margins.

The appearance of a very high-realization practice may in fact be inaccurate if lawyers and staff are under-recording or failing to capture their time.

[4] James D. Cotterman, *Issues in Realization*, Altman Weil 2010.

Collection Realization Rate

The faster you bill and collect, the more your realization rates will go up at all levels, and less partner capital will be needed to fund the firm's operations. Here are some ideas on how to improve collection realization rate, focusing on speeding up billing and collections:

In speeding up billing and collections, concentrate on these metrics:

Work-in-progress (WIP) turnover = *Total WIP* / *Average billings per month or day*

Accounts receivable (A/R) turnover = *Total A/R* / *Average billings per month or day*

Lockup = *WIP turnover* + *A/R turnover*

WIP Turnover measures the amount of time it takes from when the work is done until it is billed. A/R Turnover measures the amount of time it takes from billing to collection date.

For example, Firm X has WIP of $200,000 and A/R of $300,000. Average billings per month are $100,000. Therefore, WIP Turnover is 2 months ($200,000 WIP / $100,000 average billings per month = 2 months). A/R Turnover is 3 months ($300,000 A/R / $100,000 average billings per month = 3 months).

Combining these two metrics provides you with a metric referred to as "lockup." It can be expressed in months or days. In the above example, lockup is 5 months (2 months WIP Turnover + 3 months A/R Turnover = 5 months of Lockup).

The objective is to reduce lockup as much as possible to increase speed of billing and collections. According to the 2012 Lexis Firm Insight survey, the industry median for lockup is 139 days, which is equivalent to 4.6 months of billings in lockup. If you're lockup is longer, you probably have more capital tied up per partner than you should have. A lockup target of 105 days or 3.5 months of billings is reasonable for most firms.

The faster you bill and collect, the less partner capital will be needed to fund the firm's operations.

MOTIVATING PARTNERS TO BILL AND COLLECT PROMPTLY

Collection realization rate can be tracked monthly. One way to motivate partners to collect their accounts more quickly is to vary partners' compensation according to their performance as billing timekeepers. Billing timekeepers have day-to-day responsibility for the file and make sure that the accounts get billed and collected promptly. Some firms hold billing timekeeper partners responsible for A/R over 90 days by delaying quarterly or year-end distributions, or by requiring additional capital contributions to cover accounts receivable over 90 days.

Consider starting a quarterly income-distribution system for partners. Bill everything out over a certain minimum dollar amount, say $100, and get all members of the firm involved to bill and collect everything possible at quarter-end, just as you do at the year-end. Motivate the partners by rewarding them with generous quarterly-income distributions if they bill and collect their accounts promptly.

System-Wide Controls for Speeding up Billing and Collections

If your law firm wants to speed up billings and collections and increase its overall realization rate, here are some useful strategies:

Create a file-opening approval system in which all new clients are evaluated based on their ability to pay, potential profitability, and fit with the firm's strategic goals. The focus here is on prevention, not collections. Why spend a lot of time collecting accounts when you can solve the problem up front?

The ideal person to do the new-client assessment is either the managing partner or a partner responsible for the finance function. Centralize new-client approvals, put a credit-checking system in place, and be consistent about enforcing the system. Also require renewable retainers up front for one-third to one-half of the expected work, whenever possible. With the certainty provided by fixed-fee billing, clients are much more willing to pay an upfront retainer for 100% of the expected work.

Institute a credit-limit system. Set credit limits up front when taking on new clients, just like Sears or Macy's does. Once clients go over their credit limit, implement stop-work orders after 30 days. Build the stop-work policy into the firm's engagement letter, so that clients are fully aware of the consequences of not paying their accounts in a prompt manner. Communicate your policy verbally to the clients as well, to ensure that there is no confusion later on if work on their files is stopped due to nonpayment.

Send out bills automatically five days after the month's end. Then send out regular reminders at 30, 60, and 90 days. Put a staff person in charge of calling clients 14 days after the bills are sent out. If you have the right person making the calls who is capable of developing strong relationships with clients, this can help reduce your A/R by 40% or more fairly quickly.

SUMMARY

As clients push more and more for lower legal costs, the problems facing law firms today are numerous, and declining realization rates reflect that pressure. However, by using the ideas outlined in this white paper, law firms have a fighting chance to maintain or increase their realization rates and profitability in the face of today's fixed-fee billing and pricing pressures.

Edited by Jan Hill