Omega

White Paper

Follow the New RULES

A Guide to Leveraging Your Financial Software to Measure & Increase Profitability

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Table of Contents

Introduction

In Major League Baseball, conventional wisdom has long dictated that success comes from having the strongest hitters with the best batting average or pitchers with the best ERA. In 2002, however, that wisdom was put to the test by Billy Beane, general manager of MLB's Oakland Athletics, who was trying to win against teams with much larger budgets. Using statistical data interpreted by two Harvard MBAs, Beane defied tradition by putting together winning teams consisting of, for example, hitters with high on-base percentages and pitchers who get significant ground outs. Age didn't matter, according to the statistic, but affordability and non-traditional talent did.

What does this have to do with law firms? Law firms traditionally have looked at similar statistics to measure success: Which attorney billed the most fees? Which attorney has put in the most billable hours? Who brought in the most new clients? Which clients are bringing in the most money?

While these statistics are important, do they really make a difference to the success of your firm? Have they helped your firm be profitable? Are you getting the best out of your "players" each year and rewarding them appropriately? Basically, are you looking at the type of statistics that will best help your firm compete in the increasingly competitive market? This parallel had a strong impact on James S. Schnieders, Jr., controller of New Orleans' Stone Pigman Walther Wittmann L.L.C. In an increasingly competitive market, Schnieders was looking for a way to help his firm be more profitable.

After reading about Billy Beane's view of statistics in the book "Moneyball" by Michael Lewis, Schnieders decided it was time to modify the way he was following the RULES of law firm profitability: Realization of billing rates; Utilization of attorneys; Leverage of lawyers; Expense control; and Speed of billings and collections.

So, how did *Moneyball* really change how Stone Pigman looked at profitability? Like many firms, Jim Schnieders has traditionally looked at realization from billing attorney, client or working attorney. *Moneyball* challenged Schnieders to evaluate statistics that might mean more. For Schnieders, that meant looking more closely at the *type* of law and the *type* of clients his firm was taking on. This analysis showed a strong relationship between write-downs/write-offs and the firm's ultimate realizations in certain areas that had nothing to do with working and billing attorneys. Some areas of law tended to be unprofitable and some types of clients tended to have the highest percentage of write-offs (Stone Pigman found it was most likely to write-off time of closely held entities, and those from out of state who were also more likely to default on their bills).

By relating the two trends, Schnieders was able to see that certain types of clients and types of law were hurting firm profitability. As a result, the firm now thinks twice before working with clients more likely to have their work written-off – and it's paying off.

Environment

As we will explain in this white paper, the billable hour doesn't provide sufficient data to determine a firm's profitability nor real guidance as to how to look at profitable practice areas or how to improve a firm's profitability. Since the 1980s, a major shift has occurred in law firm management with a new focus on managing law firms like a business.

As competition increases, law firms are continuously trying to differentiate themselves. The acceleration of mergers and acquisition of firms is a result of increasing globalization and the need to provide a "one-stop shop" for large corporate clients. Although billable rates continue to go up with these mega-firms, it causes a downward price pressure on billable rates for more routine cases, creating almost a commodity pricing.

Corporate clients are also demanding greater accountability and cost control from their law firms, putting downward pressure on billable rates. Corporations are demanding better ability to predict legal fees, driving activity toward more fixed rates. In 1995, a consortium of legal service providers and consumers created the Uniform Task-Based Management System (UTBMS) with standard code sets for litigation, counseling, bankruptcy, and projects, adding greater consistency and more control over fees.

The RULES: What Do You Really Need to Measure?

Does your firm routinely evaluate the following?

- Which attorney billed the most?
- Which attorney collected the most?
- Which attorney has the greatest utilization?
- Which attorney has the greatest number of billable hours?
- Which attorney has the greatest billable fees?

You can see that a single metric doesn't adequately define a firm's profitability or provide a good predictor. A combination of metrics will provide the greatest value.

The RULES, developed by the late Robert J. Arndt[1] in the 1990s, demonstrate the importance of good management as the foundation for success in the business of practicing law. Basically, they look at multiple data points to help firms understand what needs to be improved to ultimately increase a firm's profitability.

Realization: Billing Hours versus Billing Rate

Realization of billing rates equals the gross fee collections per attorney divided by the "standard value" of that attorney's time (hours x billing rate). Simply put, it is "how much is ultimately collected" versus the "effort expended". Over-realization can happen when a client received a unique service or when billing for a case required extra time. Under-realization can occur when the firm offers a discount because of firm/attorney inefficiencies, for example. The American Bar Association says most firms' realization rates are at about 90 percent of the projected budget[2]. This under-realization can directly impact a firm's profitability.

[1] Robert J. Arndt. Managing for Profit: Improving or Maintaining the Bottom Line.
Chicago: American Bar Association, Section of Law Practice Management, 1991.
Quoted in James A. Eidelman. "Your Next Billing System: What You Should Consider Before You Buy." Law Practice Management. Apr 2000. pp.45-49

[2] Ward Bower. "Pricing Legal Services." ABA Law Practice Today. January 2006.

When Stone Pigman decided that its realization rates were lower than what they should be, they took at look at several factors, including courtesy discounts. Firm management decided to lower the dollar amount of courtesy discounts that attorneys could give to clients without prior Section Head approval. As a result, they now have fewer and lower courtesy discounts. Their client satisfaction ratings have remained as high as ever. In addition, while it did not happen overnight, this whole process contributed to an increase in the firm's overall realization rate.

Let's look at another example: When Hurricane Katrina tore through New Orleans, Stone Pigman and hundreds of other law firms had to shut down for various lengths of time. As a result, attorneys on payroll were unable to work, so cases were stalled. Because Stone Pigman has always evaluated how much the firm ultimately collects based on the number of hours these attorneys work, it was able to determine the cost that the business interruption had on the firm financially and file a business interruption claim accordingly. The firm had many ways to show the value of revenue loss during the downtime. Unfortunately, many firms do not collect the data to evaluate this type of realization, so they were unable to measure expected decreases in revenues and modify their budgets. Firms not able to document and show their attorneys' realization and utilization are having a much more difficult time proving their claims under business interruption insurance.

Firms should determine a firm-wide composite hourly realization rate during the budgeting process. This composite rate may or may not be the same as the firm's standard rate, but it establishes an overall target rate for individual timekeepers and helps to guide negotiations. You'll know if you need to raise your rates for clients when you've negotiated too steep a discount or that you are able to establish fixed fee billing with a long-term client who values the firm's efforts.

While realization can be viewed from myriad perspectives, it basically comes down to the following: How close are your realized rates to the standards set in your budgeting process? You must first look at the value of your hours worked then look at what you've collected. You can then look at your realization in the following ways to show how close to your budget you are:

Billing Attorney

Reports showing current month and year-to-date amounts for hours and fees billed, fees relieved, net mark-ups and markdowns, and average billing rate will show how matter rates and rates billed differ from standard rates by billing/working attorney.

For example, a firm has a simple matter that an attorney decides to handle on his own. His standard rate is $150 an hour but he agrees to do the job at $125 an hour. He works 10 hours. At this point, the standard rate of $150 would have netted $1500, yet his matter rate only generated $1250. Feeling especially nice, he discounts the bill by another $250, so he sends the bill at $1000. This means his billing rate is now $100 an hour. When client pays the bill, it disputes 30 minutes of work, which means they only send $950. As a result, the attorney that supposedly has a $150 an hour standard rate only realizes $95 an hour. Ouch!

Billing Attorney and Working Attorney

While they can be evaluated together, using a "Working Attorney Realization" report separately can help firms determine how matter rates and rates billed differ from standard rates at the working attorney level. Looking at working attorney realization is actually the easiest to use to get firm-wide realization information.

Combining working and billing attorney data in a single report becomes an analytical tool to evaluate whether you have a realization problem at the billing attorney level or at the working attorney level. For example, if one billing attorney is writing off the work of a young associate but no other billing attorney is writing off that associate's work, is there a relationship problem between the billing attorney and associate? Is the associate unsuited to practicing a type of law for the first billing attorney? If all three billing attorneys are writing off this associate's work, then it's more likely a performance problem.

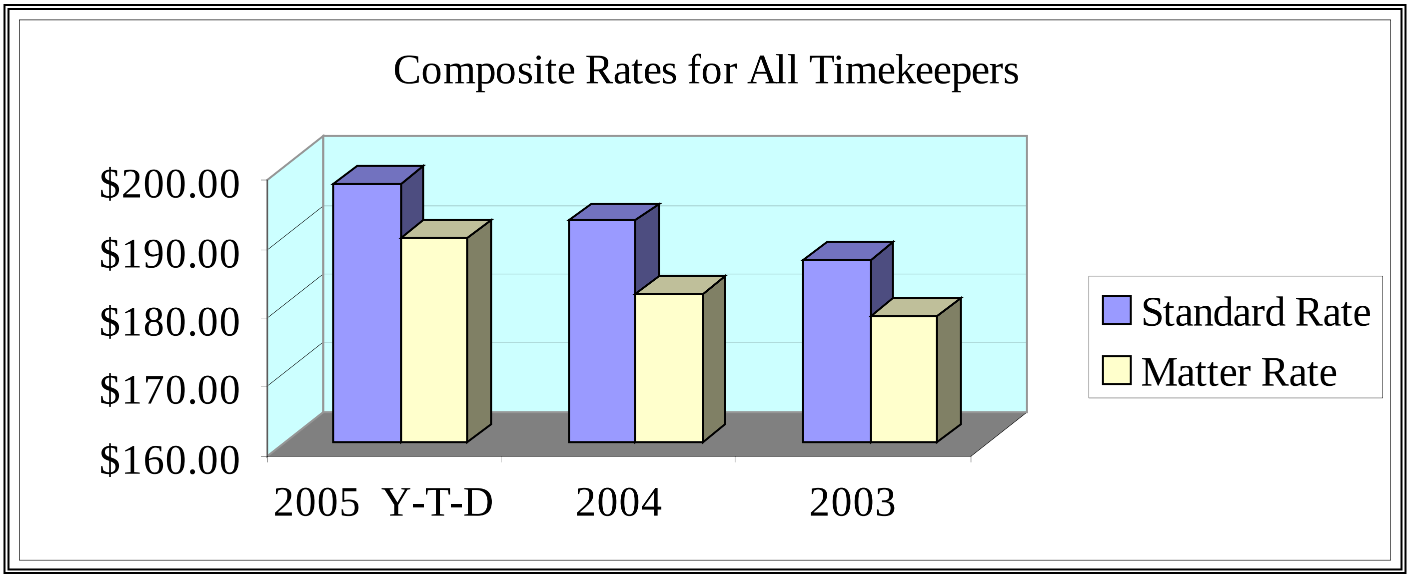
Client or Individual Matter

By generating a report showing detailed actual and billed hours and fees and markups and markdowns, you can determine how matter rates and rates billed differ from standard rates at the client and matter level. You should also evaluate how matter rates and rates billed are affected by the Type of Law.

Figure 1: Matter Rates vs. Standard Rates

Composite Rates for All Timekeepers		
	Standard Rate	Matter Rate
2005 Y-T-D	$ 197.54	$ 189.76
2004	$ 192.25	$ 181.65
2003	$ 186.55	$ 178.32

Matter Rate Variance from Standard Rate
$ (7.78)
$ (10.60)
$ (8.23)



Utilization: Billable Hours Per Timekeeper

Utilization of timekeepers, or firm professionals who charge for their time, such as attorneys, paralegals and administrative staff, refers to statistics on how timekeepers use their time on billable vs. non-billable activities. If they spend their time effectively, they will be generating revenue for the firm.

Getting attorneys to promptly enter time is a thorn in the side of every person—management, accounting staff, and timekeepers—who are responsible for tracking and billing time. To accurately measure—and eventually increase—utilization, however, the firm must monitor and enforce prompt time entry. Without compliance from all timekeepers, law firm management reporting is basically useless. By entering ALL time, billable or otherwise, the firm can also accurately judge all of the factors that determine what should be billed on certain matters and help evaluate the efficient use of the timekeeper's time.

To measure utilization, firms should set goals and measure them against actual billable hours. Billable hour goals are general expectations and are usually set by groups. For example:

Example of Billable Hour Goals

Partners	1,750 billable hours per year
Associates	2,000 billable hours per year
Paralegals	1,800 billable hours per year
Staff Attorneys	Set by contract, or if less that full time, by length of workweek or other agreed-upon criteria

By using group-based goals, there is never a perception that a firm expects more from one attorney than another. However, when the firm wants to judge utilization at the firm-wide level, it may want to use a different standard. It might develop a budget of hours based on the following examples:

- Current economic conditions including billing rate changes
- Status of large non-recurring matters
- Impact of contingency fee matters in firms where most work is non-contingency
- Impact of other alternative billing arrangements
- Other factors (i.e. health issues) affecting staff performance
- Staff turnover (new attorneys may have the hours but collections will lag initially for 1 to 3 months)

These factors would be used to develop a firm-wide revenue budget and will be used to project the best estimate of what the firm's revenue would be for the coming year. This revenue goal uses a combination of the firm's composite rate with expected number of timekeeper hours. For example, a firm might allow Partner A 1800 hours per year and Partner B 1700 hours. Partner B might have a higher bill rate and generate more money, but Partner A uses more associates and paralegals with lower billable rates but generates a greater per case revenue. You'll always find some good news and some bad, and a much better basis for judging how you are doing with your revenue plan. When an individual sees how well – or not so well -- they are doing against their goal, they'll want to try even harder**.**

To measure and ultimately increase utilization, look at billable hours by:

- Budgets and goals. How close are you?
- Individual timekeeper
- Firm-wide

Leverage: Associate vs. Partner

Leverage of attorneys refers to the ratio of associates or non-equity partners to equity partners in the firm. Understanding your ratio of net income to revenue (realization) has a lot to do with your ratio of partner to non-partner timekeepers (leverage). As the ratio (leverage) goes down, a greater percentage of net income must go to partners to maintain or increase their income.

If a firm has 10 associates and 10 partners, it has a leverage of 1:1. If the firm has a ratio of less than one, it has more partners than associates. If a firm is "highly leveraged," it means that fewer partners are sharing the firm's net income.

Leverage

Firm A:	**Firm B: (highly leveraged)**
10 Partners Gross Revenues: $ 10 M Net Income = 50% revenues: $ 5 M Each Partner income: $ 500,000	2 Partners Gross Revenues: $ 10 M Net Income = 25% revenues: $ 2.5 M Each Partner income: $ 1.25 M

If Firm B adds additional partners without increasing the firm's gross revenue, the individual partners' income will decrease. The firm has to expand the revenue they are bringing in either directly by increasing work hours or by generating new business. The new – and even the old – partners aren't going to be happy if they have been promised that they will make more income as partners. Being a partner has an inherent risk of ownership which demands an increase in income.

How does measuring leverage help your firm? If you manage your payroll correctly and continue to bring in work, you can be highly leveraged *and* have associates at the lowest levels working at the highest productivity, which can generate more income for the equity partners.

Expense Control: Evaluating Both Payroll and Non-Payroll Expenses

The key to expense control is a strong budget process. Expense control should be a planning process that supports a firm's short- and long-term goals, not a reactionary process of correcting past spending mistakes.

The payroll budget should be related to the revenue budget and be as detailed as possible. All timekeepers should be budgeted as close to expected periods of employment as possible, and firms should relate levels of support staffing directly to timekeeper level. Basically, you should maintain an efficient timekeeper-to-secretary ratio and then consider how other services are impacted by staff changes.

All non-payroll items should be as detailed as possible and not just adjustments based on prior year experience. As much as the size of the firm allows, assign responsible supervisors to monitor parts of the budget.

Evaluate your firm's ability to control expenses in the following ways:

- *Management Level Reports*—Income statements with comparison to budget for month and year-to-date should be in enough detail so management feels comfortable, yet not overwhelmed by detail. Add value with good groupings and subtotals.
- *Supervisor Level Reporting*—Provide supervisors with focused reports, and use the accounting systems' automatic report generator to deliver reports on a regular schedule.
- *Account ranges/groupings*—A budgeted amount may cross a range of accounts. For instance, you may budget a lump sum for client entertainment for all attorneys in G/L group 6456, yet record the expenses by individual attorney in accounts 6456-xxxx.

Educating Partners: Don't Pinch Pennies

The issue that administrators and controllers have faced is educating partner on the fact that realization, utilization and leverage have a greater impact on income than does "penny pinching" expenses. This does not mean you should ignore expenses, but that many expenses are not as controllable as managing partners may think, so you are left trying to reduce the cost of coffee or toilet paper. Rent for office space is usually set in a lease covering several years. Non-attorney staff cuts may not be reasonable unless the number of attorneys is reduced also (remember Leverage above). Even controlling overtime, which is widely abused, can contribute tens of thousands of dollars to profitability, but not nearly as dramatically as changes in the elements that *create* revenue.

Impact of Billing Increases on Revenue

Assumptions:	
25 attorneys Average billing rate: $150/hour Average billing hours per year = 1,600	
Billing hours/attorney	**Billing rate**
Increase average number of billing hours per month per attorney by 1 hour	Increase average billing rate by 5% to $157.50
300 hours a year at $ 150 = $ 45,000	$ 7.50 times 40,000 hours = $ 300,000
Combined: 40,300 hours a year with an additional $ 7.50 an hour increase, nets the firm $ 302,250 gain.	

Is expense control even needed, then? Sure it is, but let the administrators and accountants do it. Managing partners should be focused on bringing in more work, which the above examples show will make the biggest difference. Firms should definitely evaluate certain factors in regards to expenses: What are the total compensation costs? What is the total number of personnel? What is the average compensation by employee category? What is the cost per lawyer of operating expenses and how does this compare to industry average?

In any case, expense control truly only makes sense in an environment where a firm has developed a detailed budget and included in its accounting system so it can produce reports on actual performance against the budget. If you aren't measuring expense control, which is tied to revenue, you can't build up the number of secretaries you have, buy computers or add extra phone lines, etc.

Speed: Time Until Payment

Speed of billings and collections refers to the gap from the time charges are incurred until the date payment is received. These statistics, when combined with monitoring of billing

Realizations, give a comprehensive view of the firm's billing performance and the performance of each partner.

Speed control usually looks at a monthly billing average. When firms begin putting emphasis on monthly billings they will likely penalize attorneys that don't bill on a monthly basis no matter *how much* they bill. This new way of looking at your data will likely encourage your attorneys to get their time in promptly so they can bill clients more often.

In a nutshell, time not billed to the client is like a free loan to the client. The sooner the firm can bill something, the sooner someone has the opportunity to pay the bill. The firm might have collected a lot of money (Realization), but it can have more than 12 months worth of inventory between WIP and A/R between any given time.

Another maxim of that: The sooner a firm bills the client, the more the client will remember about the details of work the firm has done for them. For example, if it takes three months to bill the client, the client is less likely to remember the 10 times they called their attorney during an 8-hour day.

Two especially helpful statistics are the number of months of billing currently in WIP, and the number of months the firm has in A/R. When added together it tells you how long it takes from when the billings are posted on the books to when money comes in the door. For example, 3 months in WIP and 2 months in A/R means there were 5 months from time on the books to when the money actually comes in.

Speed can be measured in several ways:

- *WIP Management*—Use reports that include aged WIP and billed fees & costs by billing and working attorney to monitor billing progress and quality of billing. If the firm has a mixture of contingent and non-contingent work, report each type separately.
- When clients require something other than a normal billing cycle, the firm should still use the same client reports. Basically, you still need to manage the WIP effectively so you know how much you have in inventory. If an attorney is putting a significant amount of time in a pure contingency case and the firm isn't going to get

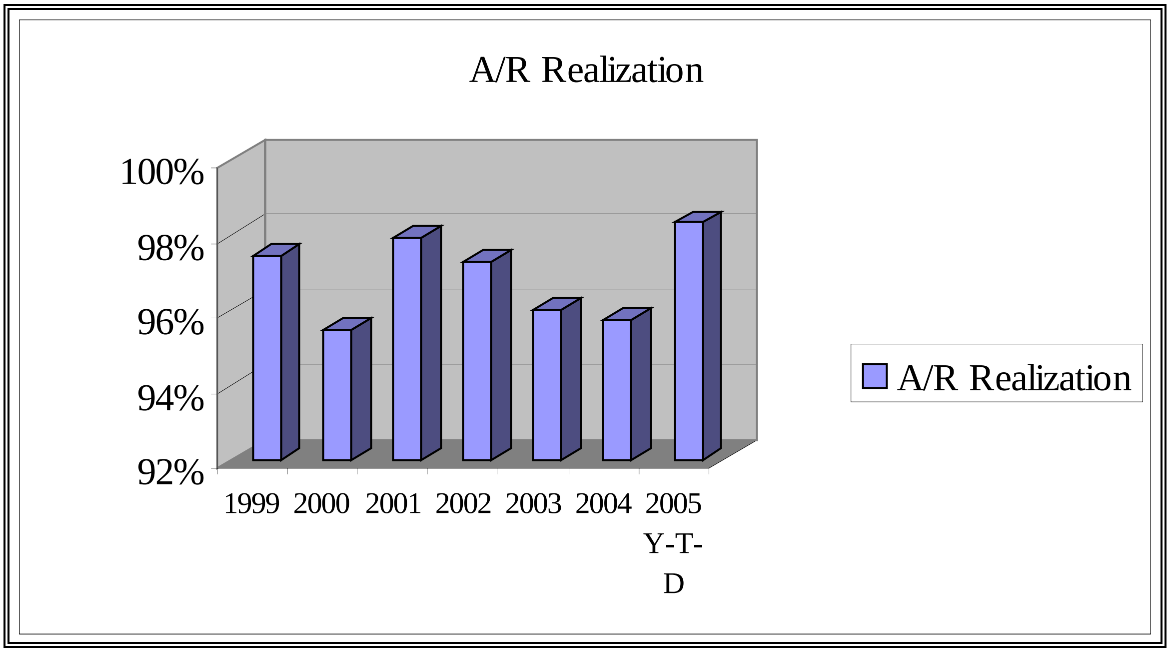
any additional payback when the case is won, you need to make sure you aren't working at a discount.

- *Costs*—Unbilled hard costs are a drain on cash requiring capital contributions and/or borrowing from a bank. Never ignore them.
- *A/R Management*—Use Aged A/R reports with detail to identify client/matters for which an attorney may need collection assistance. Even though advance deposit and trust balances are on drafts, this report gives the attorney a quick snapshot of the matters that need their attention. Every billing attorney should get a report of payments received on their matters at least weekly. This keeps them well aware of the changes in their receivables.

The following graph shows how to plot trends in WIP and A/R statistics:

Figure 2: Accounts Receivable Realization History

	Total Collected A	**Total Billed B**	**Beginning A/R C**	**Ending A/R D**	**A/R Realization A/(B+C-D)**
1999	$ 14,527,890	$ 14,187,890	$ 3,867,890	$ 3,256,789	98.17%
2000	$ 16,782,901	$ 17,891,234	$ 3,256,789	$ 3,589,012	95.58%
2001	$ 17,912,345	$ 18,912,345	$ 3,589,012	$ 3,678,912	95.16%
2002	$ 18,903,210	$ 19,456,123	$ 3,678,912	$ 3,789,456	97.71%
2003	$ 20,023,456	$ 20,789,456	$ 3,789,456	$ 3,612,345	95.50%
2004	$ 20,456,789	$ 21,123,456	$ 3,612,345	$ 3,989,123	98.60%
2005 Y-T-D	$ 14,567,890	$ 15,001,234	$ 3,989,123	$ 4,023,456	97.33%
1999 to Date	$ 123,174,481	$ 127,361,738			96.83%



Budget: Do I Really Need One?

Yes! You likely noticed that every single one of the RULES tie into a detailed budget in one way or the other. While we realize how hard it can be to get attorneys to budget billable hours, for example, it can be instrumental to firm profitability. Planning and setting standards for your firm will help increase profitability by enabling you to compare how you are doing with the budget you have established for your firm.

Impact of the RULES on a Partner Payment Plan

Everything a firm does with the RULES can be used to evaluate and structure compensation plans to make them fair and equitable – and to increase the profitability of both the partner individually and the law firm as a whole. How we ultimately bill clients has to do with how we pay partners and what we value. The two key issues that impact partner compensation plans are:

- Statistics provide an equitable and fair basis upon which to build a partner and associate compensation plan

- Compensation plan incentives should be aligned with the importance of profitability statistics. For example, if the firm highly values Realization, but the compensation plan awards attorneys based on billable hours without considering fees actually collected, then you will not be in synch.

Many of the issues identified above—Revenue realization, effective utilization, expenses (write-downs and write-offs), and speed (timeliness of reporting billable hours) should be incorporated into your compensation plan.

Conclusion: Moneyball and the Integrated RULES

What you need to ask yourself is: Am I asking the right questions? Am I evaluating—or emphasizing—the right statistics to help our firm be more profitable and compete with firms with bigger budgets? Are we still paying the attorney with the most billable hours the most money or have we started to pay attention to how efficient our attorneys really are and how fast they get their bills in so the firm can get paid?

While firms do not need to evaluate all aspects of the RULES at all times to increase profitability, none of them are totally independent of each other. You can't have any Realization unless you get some Utilization. Leverage doesn't make a lot of sense if you don't get Realization from non-partners to contribute money to the partners.

Following the RULES will enable you to look beyond the standard statistics to get the data that will help your firm build profitability and continue to compete with the big boys with the big budgets. It might take some time to figure out the trends unique to your individual firm, but it will be worth it.

Now play ball!

A Few Words about Omega Legal

Omega Legal is an integrated financial and practice management software system that comes with a full range of standard reports (more than 100) that allow a manager to extract valuable useful information about all aspects of operations. Firms can also build reports unique to their practice with Omega Legal's easy-to-use Report Writer. Omega Legal's Report Scheduler then offers the ability to generate reports at a predetermined time and have them easily and electronically distributed to those who need them. These reports keep managing partners and associates up to date on WIP or which clients are making payments.

At any point of the day, managers can determine the up-to-the-minute cash position and payment status of any client. Once accounting has posted cash, generated bills or posted transactions to trust accounts, Omega Legal provides current financial status. There is no 24-hour delay while waiting for data to be transmitted to the data warehouse.

Omega Legal's database, Caché®, is an open post-relational database, designed for high-volume transactions, like financial systems. Detailed current and historical financial reports can be generated any time, regardless of the number of users on the system.

All data mentioned in this white paper can be generated from Omega Legal. For instance, you can generate a report to evaluate how your regional offices compare on fees collected with just a few mouse clicks. You can easily analyze the RULES as well as fees, costs, write-offs and collections, and realization—all the tools the firm needs to determine profitability.

For more information, please call 800-356-1339 or visit www.omegalegal.com.

Glossary

Accounts Receivable—Amounts billed and unpaid.

Analytical Reports—Reports that are aimed at understanding the factors affecting profitability either at a point in time or over a desired time period. These reports usually will have more detail and need summarization in a spreadsheet for ultimate management use.

Billing Attorney—Attorney responsible for reviewing and approving the billing activity for a matter.

Billing Rate—How much your firm charges clients, usually per hour

Composite Standard Rates—Firm-wide effective standard rate usually derived in the budget process. Calculated by multiplying each timekeepers expected hours by their standard rate yielding expected billable fees. The sum of all timekeepers' billable fees is then divided by the total hours for all timekeepers to yield a firm-wide composite billing rate.

Diagnostic Reports—Reports with greater detail sufficient to isolate a problem and aid in investigating the problem in depth.

Effective Rate Billed—The rate actually charged to a client for the work performed

Effective Matter Rate—The composite rate of all timekeepers on a matter for any given period.

Leverage—Leverage of attorneys refers to the ratio of associates or non-equity partners to equity partners in the firm.

Management Reports—Easy-to-understand reports with sufficient detail to spot problem areas.

Realization Rate—Rate actually achieved once the client pays and all adjustments are made for write-downs during the billing process as well as adjustments clients make when making payment resulting in a write-off of billed fees.

Standard Billing Rate—Rate set as the expected billing rate for work performed by each timekeeper.

Working Attorney—a person who is assigned a billed rate and may record time to matters.

WIP—Work in Process (Work in Progress) the sum of fees and cost accumulated but not billed to clients.

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