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Pricing your work - for profit and risk

Accurately pricing legal services is often overlooked as a major dynamic of law firm profitability, more emphasis being given to the other factors which impact on profit. This is, I suspect, due in part to several factors –

- to the straightjacket lawyers have created for themselves by becoming slaves to what are perceived as market hourly rates (when they have no clear idea whether those hourly rates will make them a profit or a loss);
- lack of knowledge as to what is involved in carrying out work for a client and its cost to a firm; and
- in the case of many lawyers, an embarrassment in 'talking about money' with clients.

If we look at some of the typical problem areas in law firms today which are causing reduced profitability, it can be seen that they are all related in some way to and impact on the pricing of work. For example –

- A poor understanding of clients' needs
- Insufficient or a lack of work scoping – possibly one of the most serious financial management shortcomings in many firms today
- A lack of knowledge as to the 'costs of production'
- A lack of knowledge of how to accurately budget for work
- A lack of understanding by partners about the 'drivers' of law firm profitability
- A desire to 'win work' on any basis
- A lack of communication with clients 'about money'
- Inefficient management of work to an agreed or indicated price

Any one of the above can result in substantially reduced profitability, increased risk and damage to client relationships.

Profitability depends on a number of factors, including leverage, productivity, realisation, costs management and pricing. It is pricing and in particular hourly rates which have been put under pressure since 2008 when the recession first hit the legal profession.

There are two areas in particular which present profitability challenges for law firms today –

- Pricing work which requires in particular the need to develop techniques –
 - to profitably price and win the work
 - to negotiate prices with clients
 - to strengthen client relationships
- Managing work for profit, requiring the development of techniques –
 - to efficiently and profitably manage work to a price and by doing so
 - to better manage clients' expectations

These challenges go beyond just the immediate problem of making profit on a job – they are more importantly about successfully managing client relationships and always need to be seen in that context.

In this Briefing Note, I am going to focus on the first of these – pricing, and next month I will look at how to profitably manage work to a price and in doing so enhance client relationships.

Pricing work for profit

How does your firm price its work?

Do you just quote hourly rates and / or provide an estimate based on those rates? If so, it begs the question – *'How do arrive at your hourly rates and your estimate?'*

Or, do you consciously think about the profit you want to make on a job and then price that job with a view to achieving that desired profit margin?

And, do you exercise any controls over how your partners price their work or are they more or less free to agree with clients whatever they want?

Consider in particular your partners' prime objectives when quoting for a job. Are they –

- just to keep busy?;
- to meet their billing targets? (which measure only turnover rather than profit and may be the basis for reward); or

- to consciously build your firm's profitability by achieving a given margin in doing the work?

What are some of the essential elements to be taken into account when pricing work to make a profit?

In this Briefing Note I am going to look at the following –

- competitive pricing
- scoping of work
- budgeting of work
- negotiating prices with clients

Competitive pricing

I am not referring here to 'low balling' which is 'buying turnover' and can be a downward spiral ending in financial failure, but pricing to deliberately gain a competitive advantage over your rivals by providing your clients with the services they want at prices which they regard as '**value for money**'. This can be illustrated by what a client recently said to me about its law firm's pricing policy -

"They always try to sell to us on price, but what we really want is a good job done at a reasonable price"

Actively managing your firm's performance to provide clients with what **they** want is what will place your firm ahead of its rivals and is often referred to as providing 'added value' – that is, something which is regarded as *valuable in the eyes of the client* and which therefore has a 'worth' to the client.

Clients are increasingly knowledgeable and sophisticated nowadays when buying legal services –

- they know the results they wish to achieve and so law firms must provide their clients with those results;
- they understand the value or 'worth' to them of their lawyers' services as well as being knowledgeable about the cost bases of law firms. Accordingly they require those services to be priced on a basis which is in their eyes 'value for money' relative to the results you achieve for them; and
- they will require their chosen law firm to do each of the above 'better' than their competitor law firms.

It is for these reasons that it is important that law firms should listen more to their clients, because clients have the clearest perspective of what they value and what a firm will need to do to secure a client's business and its competitive edge. However, there is often a

'perception gap' between what clients and law firms think as to whether law firms are 'adding value' in the way clients require.

It is clear from feedback obtained from clients of law firms that they expect partners to engage with them to find out about their needs and to seek feedback about their performance, often in the context of pricing and the provision of 'value for money' services. Clients want their law firms to ask for feedback and they want them to use that information to provide more 'added value'. This can have a direct impact on how a law firm should price its work.

Clients tend to view added value in the following ways -

High value added services

These tend to be bespoke services which are generally wisdom and experience driven and which can have an important impact on clients by delivering them the **results** they require. They are services which identify and recognise the needs of the decision makers within a client's organisation and crucially depend upon understanding the client's needs. Those lawyers who perform the role of 'trusted advisor' will often be perceived by clients as providing such high added value. The more clients recognise that certain work is complex and not capable of being processed, then the higher price they will be prepared to pay, particularly if very few law firms are able to provide that advice.

In moving to or to maintain an ability to provide such high value added services will also require a firm to be very focussed on specific types of work or clients and to seek leadership in a few segments of the market. So high added value services are likely to include so – called 'top end' work in a number of areas of law, for example in the corporate, financial services and banking sectors but also many niche firms will be providing their clients with advice which clients regard as high added value, and as a consequence are able to charge accordingly. In these ways such firms tend to differentiate themselves and as a result, to build their 'brands' and, as consumers know, the branded variety tends to command a higher price than the unbranded.

Low added value services

However, to sustain a high added value proposition requires a firm to always ensure that its services are perceived by its clients as valuable **to them**. If that value or worth is seen by clients to have been eroded or devalued then they will only want to pay a lower price.

An example of this is house conveyancing where over the past thirty or so years law firms have allowed the notion to gain acceptance in the minds of clients that conveyancing is a commodity which can be purchased 'off the peg', and as a result prices quoted by many firms are uneconomic and loss – making. The fact that claims in relation to conveyancing are in the top three heads of claims against law firms indicates that conveyancing is not easy. However, the legal profession has allowed this perception to become reality in the minds of the buying public and as a result conveyancing is no longer regarded as valuable, even though it usually involves the largest purchase a client will ever make.

In particular, if work is seen to be a commodity by clients then they will only wish to pay a commodity price. As a result, in areas of work including legal aid and some areas of personal injury and defendant insurance work, clients regard these as merely processes and have driven down the price to a point where many firms have decided they can no longer do these types of work.

'Value' in the eyes of the clients purchasing these 'low value added' services is created by ensuring the lowest cost to the client. However, to ensure a firm can remain competitive in this type of market will require that it –

- constantly squeezes out more value to the client for the same or lower cost. These clients want 'more for less'.
- will have the financial strength to stay the course. These types of work need to be technology – driven which requires ever more investment in standardising processes. Deep pockets are needed and this is the space now being filled by newly formed ABSs with large investors.

In reality, many legal jobs will have a mix of both complex and difficult work requiring highly valued knowledge and skills and some work which is process driven. This is where scoping the work to competitively price that work, followed by budgeting and managing that work to the price, become necessary if work is to be profitable.

Scoping the work

This is the aspect of pricing where, from my experience with law firms, much more work needs to be carried out, because at the moment it is simply not being done, or at least not being carried out in any systematic or methodical manner.

Why is scoping work so important?

- To begin with, it is necessary if a firm is to both win the work on a basis which will make it a given profit rather than a loss, and to indicate to the client precisely what will be done for that price. How often have we heard of law firms quoting a price to a client only to then be confronted by the client saying that a rival firm has quoted 'x times less' but when that lower price is analysed it is like comparing 'chalk with cheese'. Detailed scoping of work is an important part not only of managing profitability but also of managing client expectations and ensuring continuing client loyalty.
- Scoping a job in detail will enable a firm to better manage its financial risks by reducing the risks of under - pricing its work and so help to ensure it does not make a loss on that job and on every similar job. And if price is the major factor for the client, it will provide the firm with the parameters and flexibility within which it can work when negotiating the price to win that work.

- Something which is often ignored when pricing work is the risk involved in doing certain types of work or acting for certain clients or types of clients. Adequately scoping the work will reveal factors which are unlikely to be taken into account by a standard hourly rate applied within a firm across the board. These factors may include for example –
 - The amounts involved in relation to a matter and, on a worst case basis the potential loss to the client if it all goes wrong relative to a firm's P I cover?
 - Is it novel work?
 - The firm's expertise / experience on a daily basis of carrying out that kind of work?
 - How busy are the partners / other fee earners who are involved in that type of work and is there available manpower to deal with the matter?
 - The identity / nature of the client?

If the risk / reward correlation shown by factors such as these indicates that the risks involved are too high in relation to the potential fee then these risk factors should be built into the price to reflect those risks if the firm is to safely and profitably take on the work. Alternatively, a firm might decide, given the risks highlighted by the scoping exercise, not to take on that work.

- Scoping work in detail will also enable a firm to identify for example any caveats it may need to build into an estimate or a fixed price to be given to a client, in order to protect it in the event of a costs overrun.
- By scoping the work and providing a detailed quote to a client based on that scoping exercise will enable a firm to better anticipate a client's expectations and help drive up satisfaction levels. It is also likely to be a means to avoid arguments later if there is an issue as to what work the client expected from the law firm and the bill delivered for that work.
- Scoping work will also enable a firm to ascertain precisely those areas of work involved in a transaction on which it cannot or is unwilling to advise. It can then agree with the client those matters which are to be excluded from its advice
- Scoping work will help a firm to plan and budget for the work it is to do (see below) which will also help it to meet its compliance requirements under the SRA Code of Conduct. Outcome 1(13) requires that clients receive the best possible information, both at the time of engagement and when appropriate as their matter progresses, about the likely overall cost of their matter. It is difficult to achieve that unless a job has been adequately scoped and budgeted.

One of the techniques which firms can develop to help them better scope work is to 'dissect' a number of earlier files on similar matters in order to find out exactly what is involved to

execute that type of job. Having done that, a firm should 're-engineer' the work required to carry out the matter, by questioning the necessity and effectiveness of each step with a view to arriving if possible at, from a client's point of view, a better and more cost effective way of carrying out the work. Templates to then guide future scoping of similar jobs can be produced and these should in turn facilitate easier and more effective budgeting of the work.

Budgeting for the work

Scoping a job effectively as explained above should enable a firm to know what will be involved in executing the work. That will make it easier to plan how the work is to be carried out, the expertise and experience required and who will need to be involved. An understanding that work is likely to involve several levels of expertise and experience (with corresponding cost differentials) is required if work is to be effectively budgeted. This will in turn require that when managing the work, strong delegation skills by partners are applied if the full benefits of 'leverage' are to be achieved and profit maximised.

The natural places to look when considering scoping and budgeting for a job are as explained above, previous files involving similar matters. However, previous files need to come with a 'health warning' in relation to budgeting.

The lack of full recording of all matter related time on files is a problem with which most law firms seem to struggle. The reasons for lack of time recording are varied and the 'leakage' attributable to this can make a serious dent in profitability. From the feedback I receive from managing partners and finance directors, that leakage figure is often between 15% and 25% of all time which should be properly recorded on a client matter.

Accordingly, to avoid budgeting for work based on the 'discounted' pricing shown by earlier files, if earlier files are to be used then they should be used with caution and consideration should be given among other things to –

- every step to be taken in a matter (for example based on 'dissected' files as referred to above)
- the level of expertise required for every step in the matter and therefore which partners / fee earners need to be involved and their relative pricing
- the risks involved in carrying out the work as shown by the scoping exercise or by a firm's risk assessment procedures required on file opening
- any potential problems or delays which may arise and which will require contingencies to be built into a price

In many ways budgeting for legal work is similar to what a quantity surveyor will do when producing a bill of quantities. If possible, the cost of every single component item of work required to complete the job needs to be carefully measured and included and then the desired profit element added.

Who are the best people to put together budgets for legal work?

Ideally working with people expert in costing bills (traditionally called costs draftsmen), whether they are within a finance group in a firm or are freelance is likely to be one of the most effective and safe ways of budgeting.

Negotiating a price

In your firm, how do you approach discussing money with clients? Is it –

- face to face?
- on the telephone?
- by email?

And who discusses pricing with clients? Is it individual partners / other fee earners, or in relation to more important matters, is it the managing partner, finance director or a group head?

There seems to be evidence in many firms that there is a need for stronger negotiating skills on the part of some individual partners. Sometimes this may simply be a matter of helping certain partners to develop useful negotiating techniques with clients to help them achieve desired pricing outcomes. More often however, it can be an issue of some partners feeling embarrassed to talk to clients about money. Other partners may also consider that to discuss money with clients will damage their relationship with clients, although the opposite is usually the case as clients are likely to have far more respect for a partner's abilities if that partner is able to engage in a robust pricing discussion. Coaching on a one to one basis can be highly effective to deal with these hurdles to effective price negotiation.

Preparation for a pricing discussion is also key. A discussion as to price should not be treated as a casual chat. Doing your homework as to the scope of the work required and a budget based around that, and being clear as to how you will deliver 'value for money' are basic to that preparation, to help you to show clients why they should buy from you rather than from one of your competitors. Matters to be emphasised may include for example some of the following –

- the **results** you can show you have achieved for other clients and can achieve for them;
- your high levels of expertise / industry knowledge which put you ahead of your rivals;
- your highly developed and efficient processes you use to deliver 'more for less';
- your innovative and cost effective methods of internal working using for example, your team approach, as a way to deliver more value for money.
- Any alternative billing arrangements you have devised which can benefit both client and law firm and strengthen the relationship.

You will also need to have a clear idea of how far you can / are prepared to go if pushed by the client to reduce your price. This is where scoping work beforehand can be important as it can help you to offer a slimmed down scope of work if faced with a price reduction. On the other hand sometimes there comes a point where it becomes clear that notwithstanding all your abilities to manage work to a price and even though you would like to work for that client, it is not worth taking on that particular job at the price offered because you will only make a loss. You cannot run a profitable law firm on the basis of loss leaders.

'Mark up to mark down' should also perhaps be a guiding principle, particularly when dealing with certain clients who experience tells you, feel they always have to 'drive down the lawyer's fees'. Indeed part of the preparation process should be to find out with whom you will be negotiating, whether you have dealt with them before and how easy or difficult they are likely to be when discussing pricing.

In next month's Briefing Note I will be looking at how, having put forward a fixed price or an estimate, you can profitably manage the work to that price.

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