



Matter Budgeting: The Key Is Costing & Pricing...

NCCG Article Series

...but mostly *costing*

Several decades ago there started to appear on the agenda of legal management conferences sessions with a topic described as something like the “death of the billable hour”. These sessions would cover the topic of how clients wanted to migrate from time-based billing to value-based billing and that this would imminently result in the cessation of time-based charging.

Whilst the death of the ‘billable hour’ may have been greatly exaggerated, we are faced again (as we are in every recession-driven cost pressure period) with the much-vaunted migration away from time-based billing.

One of the reasons that this migration did not really gain much traction last time is the difficulty of lawyer and client determining and agreeing a relatively objective basis for measuring the ‘value’ of legal services provided.

Well; that difficulty appears to be going out of the window. Emboldened by the massive inequality of bargaining power, clients are simply saying that they no longer care about how to value the work, but that this is all that they are prepared to pay – take it or leave it. This trend was detectable initially in the US several years ago. Having, for years, been able to repel any advance towards value-billing (or indeed knowledge management) on the basis that the client was apparently willing to pay for the work to be done repeatedly anyway, they discovered that this recession has changed all the rules. Even in the US, they now recognise that there is an inexorable advance towards a variety of fee arrangements that UK firms have been living with for several years – fixed fee, flat fee, tiered discounts etc. These have become known ‘Alternative Fee Arrangements’ or AFAs.

Having lived with AFAs for a while law firms on both sides of the Atlantic are having to get to grips with three key

issues, two of which appear to be somewhat obvious, and another one that appears not to be:

- in order not to lose a lot of money fast; they must:
 - learn how to cost and price work accurately - ideally by reference to previous similar work
 - treat matters as projects and instil some project (or matter) management skills into their lawyers
- realise that – as opposed to their initial reaction – accurate time recording for such work becomes more important, not less important.

Lawyers are not good at costing, are even worse at pricing, and are even worse at managing the WIP throughout the life of the matter in order to match the expectations they have set with the client, and – last but not least – are even worse than that at managing the expectations of the client as to the progress of and final resolution of the firm’s fees.

All these things are very bad when it comes to non-time-based charging systems – as they mean that a law firm can stand to lose a lot of money if they get any of these sums wrong.

How does a lawyer price a job? Is there a scientific mechanism for analysis it and breaking it down? Is there a library of previous similar work that they can refer to? Is here an arcane and mysterious process that magically come up with a suitable number? Unfortunately, none of these things are true. What they do is either come up with the number that they came up with last time (whether or not it is what was actually billed), or what

they think it ought to cost. Again, unfortunately, neither of these things results in a particularly good guess.

Why does this happen? Because most lawyers what mathematicians call “heuristics”, or what the rest of us might characterize as a “finger in the air” methodology when it comes to reckoning how much a job will cost. They are disinclined to engage in any sophisticated research or analysis.

They will “take a view” that the work will cost about \$50,000 – sometimes on the basis of cost (i.e. how much time it will take by which resource), sometimes on the basis of price (i.e. what they think the client will bear) – without necessarily thinking of the relationship between the two different things.

All research and experience shows that they will be optimistic – that is, they will figure on how long it *should* take – rather than how long it is *likely* to take, bearing in mind the vagaries of the client’s (or other third parties’) behaviour and not including two other key factors: firstly, the overall transaction management overhead that is likely to fall on the firm, and secondly, contingency.

As a result the fee estimate is very likely to be too low. This means that at the end of the matter, when the firm has racked up \$70,000 in fees as opposed to the \$50,000 that the partner told the client it was going to cost – much of that time ends up being written off. This – naturally – has a direct effect on a firm’s overall fee realization, straight off the bottom line.

One of the problems is the inability to learn from previous inaccurate guesses, of which more later, and the other problem is that lawyers do not get the first step right. The first step is this: costing must be totally distinguished from pricing, and that costing comes first. Instead they appear to conflate the two and come up with a ‘cost’ or a ‘price’ as if the words are synonymous. They are not synonymous, and the difference between the two is more commonly known as ‘profit’.

Best practice is that a lawyer should first consider how much legal effort needs to be applied to getting the work done; this should be done by breaking the matter up into discrete logical elements (stages, phases or whatever

words they prefer) and then estimate the amount of work that needs to be performed by each type of lawyer (partner, associate, trainee etc). On the basis of this the *cost* of the work can be calculated.

Then, and only then, they can work on the *price*; what the market in general, and the client in particular, is willing to pay. This is something that cannot be calculated as logically as the cost, but an experienced partner should have an idea what it will be. More often than not, nowadays, the client will already have indicated what they are prepared to pay in any event. Naturally one would hope that the difference between the cost (at standard fee rates) matches the price, or is lower; however, that is decreasingly the case. If the price is lower than the cost, then one would hope that the firm has guidelines about how much discount can be applied to fixed fee work, and at what stage they need to be subject to peer or supervisor review. Whatever the projected fees are, the right rates should be set into the system so that the fees are correctly valued on draft bills, and so that the firm has a more accurate estimate of future fee levels and cash flow.

Some partners may also need educating in the fact that some work simply is not worth doing and needs to be politely turned away.

In order to help with the process of more disciplined costing some firms have developed Excel spreadsheets which allow the partner to break down effort to simple stages and add the cost of the various required resources. However, these stages do not easily merge with the matter ‘bucket’ in the firm’s practice management system to enable tracking and analysis. Fortunately, both the popular Elite and Aderant PMS software systems have recently developed additional modules to help with this process. They are functional systems and some thought has been applied to their user interface such that – given their complexity – one can imagine that partners will be able to get to grips with them in practice. The fact that they are integrated with the firm’s main system means that time can easily be recorded against each separate stage so that an *ad hoc* analysis of actual effort against budget throughout the life of the matter can

easily be undertaken. This is vital, as it means that potential overruns can very quickly be identified and dealt with.

For example, if a job is expected to cost about \$100,000 over ten months at present a conscientious matter partner might review WIP every month expecting to see an accumulation of about \$10,000 a month. If, after four months, he finds about \$40,000 on the matter he might be forgiven for thinking that all is well. However, if the job was costed on the basis of five separate overlapping stages (and time is recorded against each stage), it may be that even at that point it is possible to see that two stages are behind budget (due to delays) and that one stage is already way over budget. This means that the partner can get in touch with the client and explain the situation while it is fresh in their mind and is much more likely to agree to pay for additional fees. The earlier you warn a client that the estimate will be exceeded (and why) – the more likelihood you will be able to recover accumulated fees. Doing it at the last minute engenders suspicion at best, and resentment at worst. If more such additional work can be justified and billed, then realisation will increase. Furthermore, regular perusal of such WIP analysis should enable partners to manage the work to meet the agreed budget in the first place. As further assistance against overruns, most PMS systems can even be set to warn the partner when WIP has reached – say – 70% of the budget for any stage of the work.

In terms of the initial fee estimate, other research that it would be useful to do would be to look up the last several similar matters that the firm, or even they, have dealt with and finding out how long it usually actually takes to do this kind of transaction.

To be fair, this is not easy to do, as most law firms' PMS systems do not classify matters with enough granularity to find "matters like this one" without presenting them with some 4,000 other matters.

However, outside of the PMS it is possible to devise ways to attach better and more specific classification (or taxonomy) to matters, using an external data hub like

Intapp Integration Builder or the like. Then matters can be more tightly classified and quite specific previous examples can be identified; this could also help with the retrieval of relevant bid materials, industry expertise, documents, know-how, expertise and so on.

In these ways you can chip away at the matters with low levels of realisation due to mis-estimation, or mismanagement of client fee expectations – and slowly, your partners should be able to **learn** how to improve their fee estimation accuracy – either way, your margins should improve.

Finally, the issue of time recording. One consequence of undertaking fixed-fee work is that some lawyers will think that this releases them from the 'tyranny' of time recording – as the time actually expended will have no impact on the bills. Nothing could be further from the truth. In order to help measure the profitability of fixed fee work, the firm must be able to gauge the cost of undertaking such work accurately – this can only be done if the major element of cost (lawyer's time) is captured. Furthermore, this measure, retrieved and analysed over time using the classification methodology outlined above, will enable the firm to continually improve its fixed (or flat) fee calculations – another tool gradually to increase the firm's fee realisation.

What – in such economic climes – could be more important?