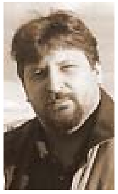
Hourly Billing: The Democracy of the Dead



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You are what you charge for. A business is defined by little else. Your price speaks volumes about your value proposition, more so than any other component of your firm's marketing.

Yet law firms seem to believe they are defined by their "hourly rates." It is as if we took our (and our firms') collective intelligence, experience, judgment, training, wisdom, knowledge, and commoditized them into a one-dimensional hourly rate. From a marketing standpoint, this is a mistake. Once you understand that clients, emphatically, do not buy hours, it becomes self-evident that pricing by the hour is precisely the wrong measurement to use to ascertain the value created for the client.

One of the main reasons professionals undervalue their services is because they are operating under the wrong theory of value. Value, like beauty, is in the eye of the beholder. What counts is what your client is willing and able to pay for your services. The subjective theory of value explains how transactions occur in the marketplace. **No client buys hours, and time is not money.** Hourly billing measures the wrong things.

Clients only buy one thing: expectations. In today's world, it is not enough to meet the client's expectations; you must exceed them. No two clients are alike, nor do clients want to be treated equally; they want to be treated individually. Always ask what the client expects up front.

Successful professional firms of today are pricing their services according to external value created—as perceived and determined by the client—rather than internal costs incurred in generating those services.

Changing the pricing culture in your firm will not be easy. It takes work, commitment, and a dedication of resources to education, constantly confronting the inherent challenges involved with pricing. But it's worth it.

Moving From Hourly Billing to Value Pricing

Not all pricers in a law firm are created equal, which is why I have been a strong proponent for years of firms establishing a pricing cartel, as well as appointing a Chief Value Officer, in order to centralize the pricing function and make it a core competency within the organization.

Think of the people currently in charge of pricing in your firm. Some are acceptable—attempting to correlate price with value—but most are mediocre or, dare I say it, wimps. Why would we let people price who aren't good at it? We wouldn't let people audit who weren't qualified.

Law firms know their costs to the penny, probably better than any other business on the planet. Being more accurate cost accountants does not make you a better pricer. If it did, professionals would be the best pricers in the world.

This is not to imply that a firm's internal costs are unimportant, or irrelevant, to the pricing decision, for they are certainly not. It is the *order* of those costs that is important. The profit-optimizing firm will only invest in those costs that can be recouped through the value created for the client, not the other way around. In other words, the firm explicitly understands that its price determines its costs, and does not let its costs dictate its price.

Firms that Value Price know they must perform cost accounting *before* they provide the service, not after. What's important to a pricer are *projected costs*, not *historical costs*, since pricing must take place in a world of risk and uncertainty. Further, marginal costs are far more relevant than average costs, or sunk costs, but the latter two is what we get from time and billing programs.

Besides, 90%+ of a law firm's costs are fixed; it doesn't take a rocket scientist to perform cost accounting in that environment, nor should a firm devote precious resources to such a low-value task. What's more, since the hourly rate has a built-in profit, it's not even cost accounting—it's profit forecasting. Once you remove the profit, and perform actual cost accounting, you realize it's pretty hard to lose money in a law firm.

If you were to diagram **hourly billing**, a form of **cost-plus pricing**, it would look like this:

Service → Cost → Price → Value → Client

Now, look at how **Value Pricing** inverts the above chain by recognizing the economic fact that, ultimately, it's the client who determines value:

Client → Value → Price → Cost → Service

By determining value first, which establishes the boundaries for a price, only then can a firm decide if the costs required to provide the service will return a desirable profit. If the project cannot be done at an adequate profit level, the service shouldn't be performed. All this analysis has to take place *before* the work is started. What possible good is it to know your costs to the penny if the client can't afford—or has a different value perception of—your price?

Costs are a fact, but pricing is a policy. What's happening in law firms is people are pricing services without a clue as to the *value* they are creating, not the costs they are incurring. Firms have ample data on their costs, hours, activities, efforts and other inputs, but a paucity of information on the value they create for their clients.

Costs are only relevant for determining if a service should be provided, and perhaps in what quantities. Costs certainly play no role whatsoever in determining value, or setting prices (except as a minimum). By following the Value Pricing chain above, Toyota is able to operate *without* a standard cost accounting system, a fact that should give pause to every professional alive.

How do they do it? They don't spend a penny on building a car until they know what its sticker price will be. The price is determined by studying value perceptions of customers. This forces them to invest only in costs below the target price to derive an adequate profit. Most economists call this *price-led costing*; Toyota calls it *target costing*. Call it what you want, it makes enormous sense, and is far superior to hourly billing.

Not Final Words

Hourly billing is, to borrow a medical analogy, an *iatrogenic illness*—a disease induced inadvertently by a physician while providing treatment. This model is perpetuated because it is risk-adverse and simplistic, and the theory supporting it has been taught for multiple generations.

Hourly billing is nothing but a tradition, which is nothing more than the democracy of the dead. We won't be able to adopt Value Pricing if we continue to denominate everything into hours, thus remaining mired in the mentality we sell time.

Before the famed consulting firm McKinsey & Company will accept a client, they claim they have to provide at least three times more in value than the price they charge. What would happen if all law firms were to use this approach?

They would have to focus on value *before* any work was performed. This is as it should be, since a service *needed* is always more valuable than a service *delivered*.

It's time to change your conversations with clients from hours to value. Do this up-front, *before* you begin any work. Appoint a CVO and establish a Pricing Cartel in your firm—a group of people who will become, over time, experts in creating and capturing value.

Your firm will become obsessed with value. Your clients will appreciate it, and then they won't bother with asking about hours. I guarantee it.

Biography

> ***Mission: "To, once and for all, bury the billable hour and timesheet in the professions"***

Ronald J. Baker started his accounting career in 1984 with KPMG in San Francisco. Today, he is the founder of VeraSage Institute, a think tank dedicated to advancing the posterity of the professions.

As an educator to professional knowledge firms on implementing Total Quality Service and Value Pricing, his work takes him around the world. He has been an instructor with the California CPA Education Foundation since 1995 and has authored twelve courses for them.

He is the author of many books, including: *The Firm of the Future: A Guide for Accountants, Lawyers, and Other Professional Services*; *Pricing on Purpose: Creating and Capturing Value*; *Measure What Matters to Customers: Using Key Predictive Indicators*; and *Mind Over Matter: Why Intellectual Capital is the Chief Source of Wealth*.

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