

## **DIFFERENT WILLINGNESS TO PAY FOR OUTSOURCING OF ADVISORY AND LEGAL SERVICES**

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It is common that small and medium entrepreneurs are not willing to pay for consulting services as much as for legal services. It was demonstrated that the prevailing risk aversion causes deviation between the willingness to pay and “fair” price. Quality of service may not be a necessary condition. The risk aversion associated with large uncertainty has a negative impact on the economic performance and development of enterprises and subsequently the whole society.

**Keywords:** Anchoring effect, Marginal utility, Risk aversion, Advisory, Consulting services

### **Introduction**

It is perfectly common that consulting companies face displeasure of small and medium entrepreneurs to pay for their services. These consulting firms are focused on improvement of economic results. On the other hand, payment for law services is taken for granted. Nobody is surprised by the amount of hourly rate. The question is why the willingness to pay differs even though the consulting services can be very useful for small and medium entrepreneurs.

### **Methods**

The article offers consideration of different willingness to pay using microeconomic theory apparatus. The key is the view through the expected utility model assuming risk aversion.

### **Results**

#### **Ignorance of the price level**

From the small entrepreneur’s point of view it is not common to have overview of consulting companies’ prices. The lack of knowledge of price level is one of the factors causing that entrepreneur is not able to make an idea of “the right” price for services or it is at least complicated for them.

If entrepreneur contemplates offer of consulting services, the idea of price level will then represent expected price of competitive offer. The ownership and management of the company are very closely connected in small companies [2] and likewise the effect of entrepreneurship has firm bond with affluence of entrepreneur.

In case that entrepreneur has neither experience with buying consulting services nor they got positive recommendation, they should not substantially prefer given offer to competition.

It is obvious **that perceived price level in the field of consulting services affects entrepreneur's demand for consulting services**. It can be simultaneously assumed that the entrepreneurs create their price idea rather lower than higher. Findings of the common price in law services is significantly easier because legal acts are more standardized and law services are generally used.

### **The Anchoring Effect and self-fulfilling price expectations**

In the Czech Republic, law offices are part of an industry that has expensive and prestigious image. Therefore, the perceived price level of legal services is exceptionally high. If price expectation is strong, then it can be used as an anchor. There is anchoring effect, which affects the further way of acting [3]. For legal services, the expectations of high prices are relatively strong. The high price expectations and the anchoring effect are factors that increase the average cost of legal services. **It can be assumed that the high price expectations supported by ignorance of price level shift the willingness to pay for legal services above the average.** Thereafter these expectations are fulfilled.

### **Business life cycle and budgetary constraints**

Despite the fact that expenditures on consultancy services are accounting costs, you can see them as an investment. The amount of money invested depends on the stage of the business life cycle of and its financial situation. [4]

Depending on the financial situation does not change only the amount of funds to invest, but also priorities. There's also a problem of choice among alternatives within budgetary constraints.

According to a research, small businesses' main priority is to ensure their survival, not to work on the company's growth or improvement of its economic performance. A businessman is therefore not governed only by the rules of profit maximization or maximization of expected utility, but his area of interest and concentration of power is different and decision making is affected by emotions. There is evidence that emotions have a large impact on the final decision. [i1] Given that the fear is a very powerful emotion [i2], it is not surprising that in bad times a lot of entrepreneurs do not think of the development of the company too much. On the other hand, the legal security of transaction is almost always necessary....

**Once the deterioration of company's financial situation occurs, the investment budget is getting more limited** in an effort to reduce costs. In such a situation, there is intense competition for resources within the company and from potential suppliers. **Legal and consulting services will thus become more substituent.** The ratio between the cost of legal and consulting services changes in favor of legal services.

### **The expected utility and the prevailing risk aversion**

The risk aversion dominates in a society. [1] Entrepreneurs are also more risk averse (it is said that they have a prudent approach to risk). They decide among the chancy variants not only on the basis of expected returns but also on the basis of perceived risks. Due to risk aversion, we can expect a concave utility function and thus the certainty equivalent is lower than the expected outcome [5]. Utility function of total wealth of entrepreneurs will tend to decrease its slope with

enlarging amount of money. "Subsequent getting the same amount of money is bringing smaller and smaller increment of utility." [1] It is true that the utility from obtaining additional sums of money or wealth increase are smaller than the decrease of

Applies [1, 5]:

$$EX = X_1 \cdot p_1 + X_2 \cdot p_2 \quad (1)$$

$$EU = U(X_1) \cdot p_1 + U(X_2) \cdot p_2 \quad (2)$$

$$RP = EX - CE \quad (3)$$

EX - The expected value of the outcome of risky action, decisions, etc. In this context the net effect of the use of services.

EU - The expected utility from the use of services.

$X_i$  - i-th possible result.

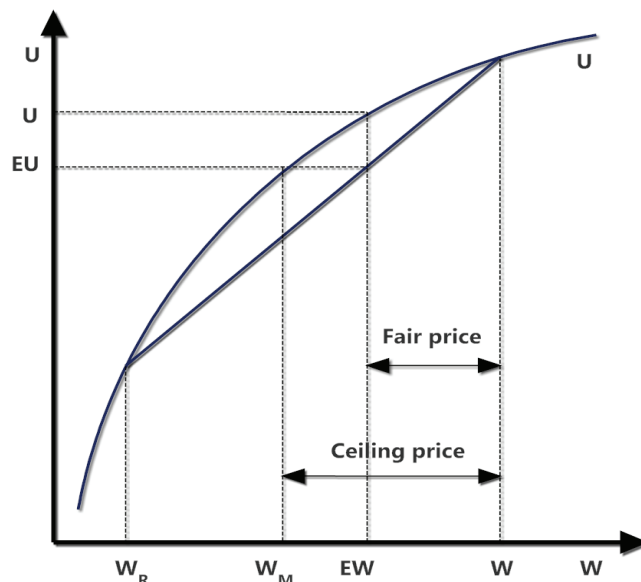
$p_i$  - Probability that i-th possible result will occur.

RP - Risk premium.

CE - Certainty equivalent.

The risk premium represents the difference between the expected value and its certainty equivalent. [5] The risk premium is positive in case of risk averse. In other words, for risk-averse entrepreneurs is not expected uncertain value as valuable as identical value obtained with certainty.

*The analogy with the willingness to insure*



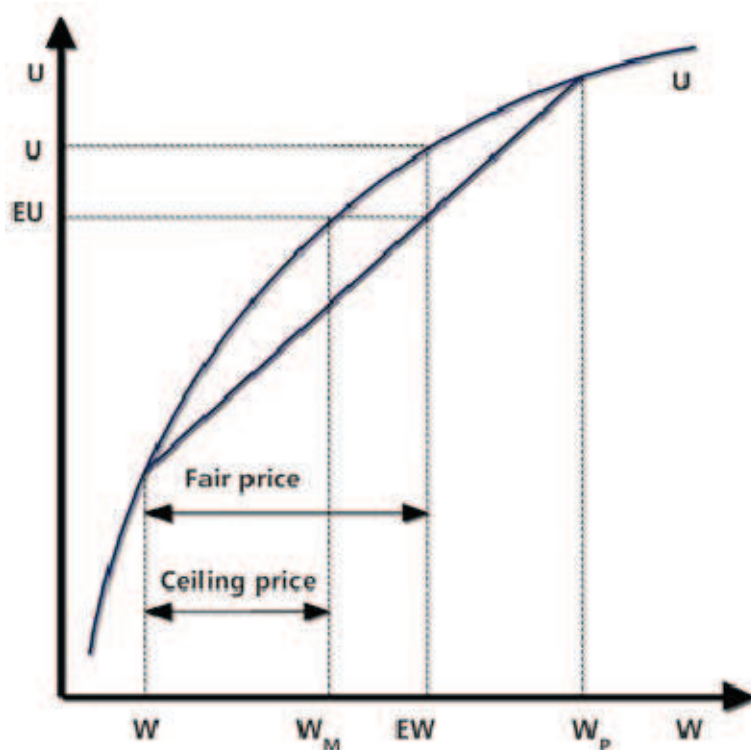
Picture 1. Legal services – an effort to reduce future losses.

The above is also reflected in the insurance market, where the client is willing to pay more than just "fair" insurance. The clients are satisfied with wealth which is lower than would be expected without insurance.

In case of the demand for legal services will be the willingness to pay higher ( $W - W_M$ ) than the corresponding "fair" price ( $W - EW$ ) for the treatment of potential losses in the future, which would result in a wealth decrease to the level of  $W_R$ .

In case of consulting services aimed at improving the economic performance of the company and thus enhance the wealth of the entrepreneur, the situation is reversed.

Because of the declining marginal utility, the maximum price that the entrepreneur is willing to pay ( $W_M - W$ ) is lower than the "fair" price ( $EW - W$ ), which would correspond to the expected result of consulting services.



Picture 2. Advisory services – increasing economic performance.

Existence of risk is a cause that consulting services are undervalued and on the other hand the services aiming to reduce future costs (ie risk reduction oriented), such as legal services, are overvalued.

Models in Figures 1 and 2 show the direction from the "fair" price the price negotiations will take.

For the customer (entrepreneur) to be satisfied, the price of service should be lower than the "fair" price. According to Kotler is the customer perceived value of a service is determined by the difference between expected benefits and costs that has to spent. [11]

### The concept of transaction costs

The discussion on transaction costs started the article "The Nature of the Firm" by Ronald Coase published in 1937. [7] His reflections on the company relied on the question of why firms exist. [10] Coase theorized that setting up the company is advantageous because only to rely on the price mechanism of the market would be costly. The first who described this kind of market failure as *transaction costs* was Kenneth Arrow in 1969. [a1] Coase mentioned that there is always a possibility to return to the market if internal execution fails.

#### *Outsourcing and influence on willingness to pay for legal services*

On a larger scale, it is possible to see legal services, respectively their price, as a transaction cost, regardless of whether they are provided internally or externally. They do not add anything to society and do not increase the welfare either. A typical example of the use of legal services is the treatment of risks that would increase future costs.

Typical advantage of outsourcing is flexibility. Therefore we can accept that the available time of internal staff does not match the current needs. Persistent overloading is not possible, therefore inefficient utilization is more common.

Entrepreneur would be willing to pay a bonus for flexibility.

$$PF = 1 / U_{tf} \quad (4)$$

PF- The premium for flexibility in multiple format.

$U_{tf}$ - The rate of utilization of available time fund of internal lawyer.

When mitigating the risk we have to compare the price not just with the expected value (1), but also with internal costs revalued by premium for flexibility. Furthermore, it is necessary to take into account the subjective probability.

$$\text{Price} \leq (C_R \cdot p_{int} - C_R \cdot p_{ext}) + PF \cdot C_{int} \quad (5)$$

$C_R$ - The amount of the potential costs that may arise during the risk occurrence.

$p_{int}$  - The probability of occurrence of these costs while internal fulfillment.

$p_{ext}$  - The probability of occurrence of these costs while outsourcing. We assume that

$p_{int} > p_{ext}$ .

$C_{int}$  - The costs of internal fulfillment done by company's staff. It is calculated as a number of hours devoted to the risk treatment multiplied by hourly cost per worker of the legal department, including indirect costs.<sup>1</sup>

Due to the premium for flexibility, the expected value of future risks reduction can be lower in case of outsourcing than in case of internal fulfillment. We assume that the entrepreneur decides rationally.

We can say that **higher quality may not be necessary condition** for use of external legal services.

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<sup>1</sup>For example, workplace equipment, energy consumed in the legal department etc.

## Conclusion

I tried to find an answer to the question why the entrepreneurs' willingness to pay for services of growth and transaction character is different. It was documented that importance of the perceived price level of comparable competing services is significant. Price expectations are increasingly important, if they begin to shape the prices. Both compared service branches are variously sensitive to the financial situation of clients. The consultant must consider in what financial situation and life stage the entrepreneur is and accordingly provide a suitable solution. In the bad times the consulting services offer can't be based only on rational arguments.

It was demonstrated that the prevailing risk aversion and the resulting declining marginal utility of money or total wealth cause deviation between the willingness to pay and "fair" price. Due to the flexibility of the relationship with external partner quality of service may not be a necessary condition. The acceptability of the price is affected by internal costs reduction and internal inefficiency elimination.

It is absolutely essential that the risk aversion associated with large uncertainty has a negative impact on the economic performance and development of enterprises and subsequently the whole society. In the Czech Republic there is high uncertainty especially in the area of legislation and subsequent law enforcement, as evidenced by various international comparative rankings (Opacity Index, Doing business ranking, WEF, ...). No wonder that lawyers utilize market opportunities and collect rewards that can be higher than would correspond to the environment without unnecessary uncertainty.

In such a situation, the entrepreneur spend a lot of energy and resources just to ensure the survival of the company, compliance with frequently changing and unclear legislation, deal with incompetent officials, etc. Therefore, it remains not enough time and resources to develop competitive advantages.

Entrepreneurs should be aware of this and since the beginning set the business model, so that reinsurance costs in the future are minimal. They have to devote time, resources and energy to develop a business and focus on achieving long-term goals, maximizing the value of the company. The key at the national is to stabilize the business environment.

This article is one of the outputs of the project Analýza uplatňování controllingových nástrojů a vyhodnocení rozdílů v přístupu ke controllingu v době krize a v postkrizovém řízení (Analysis of the use of controlling tools and the evaluation of different controlling approaches in crisis and after crisis) registered at the University of Economics in Prague under number IGA F3/26/2012.

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