

The Shift From Hourly Billing To Value Pricing

By Ronald J. Baker.

Challenging the status quo may very well be the greatest risk individuals can take both personally and professionally. The status quo in public accounting for more than half of a century has been the hourly billing pricing structure. The time has come to reflect on the basis for that paradigm, shatter it, and build a better; more efficient and profitable model based on value pricing.

Ideas have consequences. Indeed, individuals are ruled by little else. An idea that changed the history of civilization--and affected the lives of billions of people in the 19th and 20th centuries--recently marked its 150th anniversary.

For decades, The Communist Manifesto was the leading intellectual paradigm on several continents and commanded the destiny of many nations. This famous revolutionary treatise, published in 1848, by Karl Marx and Frederick Engels, still wields considerable power over the world's political systems, American universities and even the professional's pricing strategies.

Even though empirical evidence has thoroughly repudiated Marxist ideology and theory, we still pay Marx the ultimate compliment: His ideas are so deeply ingrained into our value paradigm that we don't even notice them, let alone analyze their validity. In the 19th Century, Marx posited what is now called the labor theory of value. In its simplest form it says that the price of an item is determined by the amount of labor used to produce it.

Taken to an extreme, the labor theory of value would predict that countries in which people work longer and harder should have higher standards of living. This is demonstrably false, since China should have the highest standard of living given its large amount of available labor hours.

If the labor theory of value is correct, then a diamond found in a mine would be of no greater value than a rock found right next to it, since each took an equal amount of "billable hours" to locate. Yet how many rocks do you see at a jewelry store in your local mall?

When you go to lunch today, perhaps you'll have pizza. Under the labor theory of value, you must necessarily value the 15th slice just as much as you valued the first, since each took the same amount of "billable hours" to produce.

The labor theory of value doesn't take into account the well-established law of diminishing marginal utility, which states that the value to the customer declines with additional consumption of the good in question.

A BETTER THEORY

Fortunately, the Austrian school of economists in the late 19th Century suggested an alternative to the labor theory of value by observing that value is subjective. The subjective theory of value concludes that goods and services have no inherent value. They are only valuable to the extent that someone desires them.

In 1748, Ben Franklin wrote, "Remember, time is money." However, time is not money. I have never seen a clock write a check. The results you create within the time you have is what creates value. The profession needs to replace the labor theory of value with the subjective theory of value.

IMPLEMENTING VALUE PRICING

There is a sensible replacement to hourly billing--value pricing. Today, many successful professional firms price their services according to externally created value that is perceived and determined by the customer, rather than by internal costs incurred while generating those services. One method that has been adopted to implement value pricing is the fixed price agreement. Essentially, an FPA requires meeting with your customers to determine the services they want and need in the upcoming year.

There are several advantages to FPA and value pricing. Following are some of the most important:

- * Prequalifying the customer. FPAs allow you to discover the customer's perception of value before your firm commits any resources. This is a better strategy than finding out afterward that no matter how you price your services, the customer's perception of value is lower than yours. Discussing price up front puts these issues on the table, and in the long run will save countless hours spent in pricing disputes, write-offs and other problems that could have been avoided had there been better communication at the beginning of the engagement.

- * Opportunity to cross-sell. Brainstorming with the customer regarding future goals and aspirations, inevitably will present many opportunities to cross-sell your firm's services. You can't expect to automatically receive additional work from the customer. You have to earn it by showing that your firm is better than the competition. By focusing on value, firms have found themselves to be more successful in obtaining additional work than when they billed hourly.

- * Value pricing gains "ego investment" from the customer. It's basic human nature that everyone wants control. By giving customers a sense of ownership over your firm's services, offering them choices and customizing your delivery to meet their needs, you will get their ego investment. Once committed, most people will behave in a manner a is consistent with their commitment.

- * Quoting fixed prices projects confidence and experience. Being able to quote a fixed price before the service is performed shows the customer that your firm is experienced and confident in its ability to perform, which is a trait valued by the customer, albeit subjectively. Imagine an airline not quoting airfares before the flight, but instead charging by the minute. How would you feel? Would you begin

to wonder if the pilot would deliberately slow down? Would it lower your confidence in the airline?

* Increases long-term nature of customer relationship. The more services you perform for the customer and the more you know about a customer, the more expensive it will be for the customer to defect. Creating a partnership with your customer links your destiny and prosperity.

* Forces your firm to be efficient. By offering fixed prices, you must delegate the work to those in your firm who can perform it most efficaciously. It also forces you to review every procedure and work review level as well as to ensure that each task adds value to the customer.

* Overcomes buyer's emotions. Price resistance (sticker shock), price anxiety (buyer's remorse) and payment resistance (not cutting the check) all will diminish by using FPAs. By discussing value, price and terms up front, you will diminish these emotions' negative impact on the customer, not to mention your firm's profitability.

* Prices can be increased each year. When was the last time you raised your hourly rate? Do you believe there is a concomitant increase in value to any one customer? I can assure you customers don't view the world that way. When you have customized services and pricing for each customer, it is easier to increase the price annually.

* Provides a competitive differentiation. Since each price is customized, the perceived value of your firm increases. In contrast, by using hourly billing, you treat all customers the same, which is not a prescription for success in today's marketplace. Customers prefer fixed prices, up front, and will continue to gravitate to firms which are willing to offer them.

DRAFTING AN FPA

It is important to keep in mind that any FPA you draft between your firm and a customer results from a negotiating process. This is your chance to provide the customer with a customized list of services to meet their specific needs and wants, to offer a fixed price for those services and to specify the payment terms as well as any other level of agreement reached. No two FPAs should look alike. Each FPA should be as unique and individual as your customers. In fact, the more customized the FPA, the higher its perceived value.

An FPA does not replace your firm's standard engagement letter. You still must use engagement letters for each major service you provide, in accordance with your professional liability carrier's guidelines. For example, CAMICO highly recommends an engagement letter for each audit, review, compilation, tax return or management advisory service.

Since every FPA is customized, there is no boilerplate from which you can simply insert new information for each customer. However, each FPA will include similar elements. On Page 20, you can find a sample FPA. Following are the critical elements that should be included in every FPA:

* Introduction--This describes the parties involved (ABC CPAs and XYZ Inc.) and why you are entering into the FPA (to avoid any misunderstandings and define the services you'll perform as well as any customer responsibilities).

* Detail of Services--Next, you'll want to detail the professional services (corporate tax return preparation, payroll tax reports, etc.) that you and your customer have agreed upon for the next year, as well as your price for these services.

Annual Consulting Service--ACS deals with the issue of customer phone calls and meetings to discuss business matters or any other topics of the customer's choosing. Rather than limit this type of contact, ACS should be unlimited as it provides an additional opportunity for cross-selling.

* Hourly vs. Fixed--In a short paragraph you can specifically address what it means to the customer that you bill on a fixed-price vs. hourly basis. (See sample FPA, Page 20.) This portion of your FPA is a strong selling point that positions your firm as a valued business adviser.

* Unanticipated Services--Discuss how you will deal with pricing for unanticipated services. In general, you will want to discuss and come to a mutually agreed upon price before providing any additional services.

* Service Guarantee--Stand behind your work. If a customer is not satisfied, discuss how you'll deal with it. For example, "We will at the option of XYZ, either refund the price, or accept a portion of said price that reflects XYZ's level of satisfaction." You'll also want to note that customer satisfaction is assumed based on final payment.

* Payment Terms--Break out your total professional price for the year into an agreed upon payment plan. You and your customer might choose a payment plan that is monthly, quarterly, 50 percent up-front or some other arrangement. Whichever plan you choose, you'll need to show what the customer will owe at the end of each payment period and when the bill is payable.

* Outline Meetings--Outline the parameters for meetings to be held as well as include a provision for revising or adjusting the scope of services.

* Allow for Termination--Detail that either party may terminate the agreement at any time, along with a timeframe for payment for any unpaid services.

* Closing--The final piece of your FPA is the closure that includes customer and firm representatives' signatures. (See sample FPA, end of article.)

Just as with your engagement letters, you absolutely should not start work for a customer unless the FPA is signed.

FINAL THOUGHTS

The inscription on Karl Marx's tomb at Highgate cemetery in London reads, "The philosophers have only interpreted the world in various ways. The point however is to change it." Marx was wrong. The real work of philosophers, historians, social scientists and economists is not to change the world, but to understand it. Only by first understanding people's behavior can one hope to change it. I have dedicated the last decade to studying the billable hour, and I am thoroughly convinced that the profession needs to eliminate this practice.

The labor theory of value, like the billable hour, is an idea from the day before yesterday. We need to forge a new paradigm of value with which to price our services as CPAs in the new millennium, and stop ritualistically (and perhaps unwittingly) accepting the false theory proffered by Karl Marx more than 150 years ago. Let us relegate the billable hour to the ash heap of history--along with carbon paper, the manual typewriter and the slide rule--right next to Karl Marx's The Communist Manifesto, as an idea which time has passed.

Ronald J. Baker, CPA, is a partner in Corte Madera-based Baker & Barnett CPAs. He is a frequent speaker at CPA events and conferences, and a consultant to CPA firms on implementing Total Quality Service and Value Pricing. Baker is the author of The Professional's Guide to Value Pricing.

Sample Fixed Price Agreement

November 1, 1999

Dear Customer:

To document the understanding between us as to the scope of the work that ABC CPAs will perform, we are entering into this Fixed Price Agreement with XYZ Inc. To avoid any misunderstandings, this Agreement defines the services we will perform for you as well as your responsibilities under this Agreement.

2000 PROFESSIONAL SERVICES

ABC will perform the following services for XYZ during 2000:

- * 1999 W-2s/1099s and 4th Quarter Payroll Tax Reports and Workers Comp Report
- * 1st, 2nd & 3rd Quarter Payroll 2000 Reports and Workers Comp Reports and Fiscal Year Sales Tax Return
- * 1999 XYZ S Corporation Tax Returns
- * 1999 Audited Financial Statements with PBC schedules to be provided by XYZ by March 15, 2000

* Annual Consulting Service 2000 [*]
TOTAL 2000 PROFESSIONAL SERVICES \$ XXX

* Included in the Annual Consulting Service are the following services to be provided by ABC to XYZ:

- * Unlimited meetings, to discuss operations of XYZ, business matters, tax matters and any other topic at the discretion of XYZ or its employees and/or agents.
- * Unlimited phone support for XYZ personnel and/or independent contractors and agents regarding accounting assistance, recording of transactions, etc.

Because our Fixed Price Agreement provides ongoing access to the accounting, tax and business advice you need on a fixed-price basis, you are not inhibited from seeking timely advice by the fear of a clock running endlessly. Our services are designed around fixed-prices, as opposed to hourly rates, and offers you access to the accumulated wisdom of the firm through CPAs with substantial experience, who can help enhance your company's future and achieve its business goals.

Unanticipated Services

Furthermore, the parties agree that if an unanticipated need arises (such as, but not limited to, an audit by a taxing agency, or any other exogenous service not anticipated in this agreement by the parties) that ABC hereby agrees to perform this additional work at a mutually agreed upon price before the service is provided. This service will be billed separately to XYZ, as part of a Change Order, and will be payable upon presentation [or payable upon terms mutually agreed upon].

Service Guarantee

Our work is guaranteed to the complete satisfaction of the customer. If XYZ is not completely satisfied with the services performed by ABC, we will, at the option of XYZ, either refund the price, or accept a portion of said price that reflects XYZ's level of satisfaction. We will assume you are satisfied upon final payment received under the terms of this Agreement.

The following payment plan is hereby agreed to by XYZ and ABC:

- * March 31, 2000 XX
- * June 30, 2000 XX
- * September 30, 2000 XX
- * December 31, 2000 XX

TOTAL 2000 PAYMENTS \$ XXX

To assure that our arrangement remains responsive to your needs, as well as fair to both parties, we will meet throughout [monthly, quarterly, or other time schedules agreed to by the parties] 2000 and, if necessary, revise or adjust the scope of the services to be provided and the prices to be charged in light of mutual experience.

Furthermore, it is understood that either party may terminate this Agreement at any time, for any reason, within 10 days of written notice to the other party. It is understood that any unpaid services that are outstanding at the date of termination are to be paid in full within 10 days from the date of termination.

If you agree that the above adequately sets forth XYZ's understanding of our mutual responsibilities, please authorize this Agreement and return it to our office. A copy is provided for your records.

We would like to take this opportunity to express our appreciation for the opportunity to serve you.

Very Truly Yours,

BY:

Your name, Partner

ABC CPAs

Agreed to and accepted:

BY: DATE:

Customer, President

XYZ Inc.

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