



Burying the Billable Hour

## ABOUT THE AUTHOR

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## DEDICATION

*To my colleagues, who understand that in order to move forward you must leave some things behind.*

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# Preface

**People of the same trade seldom meet together, even for merriments and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.**

(Adam Smith, *The Wealth of Nations*, 1776)

I have been conducting seminars around the world on the shift from hourly billing to Value Pricing, and if an observer from outside of the profession were to attend, Adam Smith's charge would certainly ring true. In a sense, this booklet is about how to raise your prices. But it is not a conspiracy against the public. In fact, the main message of this booklet is that the customer is the ultimate judge of the value that we, as professionals, provide. It is in that spirit we should charge the customer for the value they receive from our services. If we don't add value to the customer, we have no business being in business.

The booklet you are about to read is more theoretical than you may be used to if you're an avid reader of business books, or attend many practice management seminars. I make no apologies, for I truly believe that is the best way to learn. I have been studying pricing for over a decade, and I still consider myself a student of price theory, with much more to learn. There are no easy answers, no checklists you can follow to obtain the maximum price for your services. Price is an issue that all businesses struggle with every day and it is one of the most complex components of marketing. I am attempting to pass on some theories and concepts in the hope that your transition from hourly billing to Value Pricing will be easier – and less prone to failure – than mine was. That is, perhaps, the best I can hope for.

And make no mistake about it: Price is a major marketing decision for any business. Indeed, a business is defined by what it charges for. Pricing is an art, not a science, despite the profession's attempt to turn it into an objective process by multiplying Rate by Hours to arrive at Value.

I hope to change the way the accounting profession establishes its prices, by putting price back to its exalted position in the marketing strategy of your firm. It is time for the accounting profession to price on purpose.

I believe accountants add enormous value to the lives of their customers, and there is an inordinate amount of empirical evidence to support this claim. My goal is not to have you think *like* me, but to think *with* me. It is time we start to receive what our customers already believe we are worth. Let's begin.

Ronald J. Baker  
Petaluma, California  
April 27, 2001

# 1

## You are what you charge for

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**Ultimately, a business is defined by that for which it collects revenue, and it collects revenue only for that which it decides to charge.**

(Joseph Pine II and James H. Gilmore, *The Experience Economy: Work is Theatre and Every Business a Stage*)

**Like money, price talks. It changes perceptions. Price changes the actual experience of using the service: A high price actually improves the experience. Watch what your price says. Push price higher. Higher prices don't just talk, they tempt.**

(Harry Beckwith, *The Invisible Touch: The Four Keys to Modern Marketing*)

Why did Xerox fail to capitalise on the innovations – especially its computer technology that eventually led to the Apple computer – that its Palo Alto Research Center developed? In *Dealers of Lightning*, Michael Hiltzik hypothesises:

In the copier business Xerox got paid by the page; each page got counted by a clicker. In the electronic office of the future, there was no clicker – there was no annuity. How would one get paid? The hegemony of the pennies-per-page business model was so absolute that it blinded Xerox to an Aladdin's cave of other possibilities.

(Quoted in Hamel, 2000: 112)

*You are what you charge for.* Indeed, a business is defined by little else. Xerox's pricing paradigm blinded it to seeking new and emerging opportunities in the marketplace. I believe the same pricing myopia is inflicting damage on the accounting profession, worldwide. We seem to believe that we are defined by our "hourly rates". It is as if we took our (and our firms') collective intelligence, experience, judgement, training, wisdom and knowledge, and commoditised them into a one-dimensional hourly rate. From a marketing position, this is a mistake, as this booklet will attempt to prove. Once you understand that customers, emphatically, do not buy hours, it

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becomes self-evident that pricing by the hour is precisely the wrong measurement to use to ascertain the value created for the customer.

I want you to *price on purpose*. Pricing is an *art*, not a science. It is one of the four Ps – Product, Place, Promotion and Price – of marketing, and probably the most complicated of those four. It is the only P that deals with revenue, not by creating the value your firm delivers, but rather, by *capturing* it. The other three Ps deal with costs. Pricing sends a distinct message into the marketplace, signaling who you are, what you do, who you serve, and ultimately, how you perceive yourself – that is, your pricing strategies. Think of

the message that a Mercedes versus a Ford sends into the marketplace; a large part of that message is achieved through pricing.

After studying pricing in the accounting profession over the past decade, I have learned that we have not given it the intellectual creativity and resources it rightly deserves. Some have even removed it from the four Ps of marketing, relegating it to an administrative or organisational task to be delegated to the time and billing programme. This is a serious mistake. Pricing has always been, and always will be, an external issue, ultimately determined by your customer. It is

time to restore pricing to the exalted position that it deserves in the marketing strategy of your firm.

### **ARE ACCOUNTANTS COMMODITIES?**

One of the most pernicious effects of the hourly billing paradigm is the notion it has helped create that accountants are increasingly becoming commodities. I have heard this comment from accountants around the world, always spoken with conviction and certitude. In fact, this belief has become so endemic, it is worthwhile – and very important – to deal with it in a rigorous and analytical manner. When I hear someone repeat this conventional wisdom, I always ask, “What is

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the evidence that the customers of accountants view them as commodities?” If you share the belief in this conventional wisdom, let me say this: You are entitled to your *opinions*, but you are not entitled to your *facts*.

*The fact is there is no such thing as a commodity.* Indeed, it is the job of every marketing professional to differentiate their product or service from the rest of the competition. Believing that your firm is a commodity is a self-fulfilling prophecy. After all, if you think you are a commodity, so will your customers. How can a personal relationship between a customer and an accountant be a commodity? It is the equivalent of

saying your relationship with your doctor is a commodity. Consider this story from *The Tom Peters Seminar*:

Transformation. Breaking the mold. Anything – ANYTHING – can be made special. Author Harvey Mackay tells about a cab ride from Manhattan out to La Guardia Airport: First, this driver gave me a paper that said, “Hi, my name is Walter. I’m your driver. I’m going to get you there safely, on time, in a courteous fashion.” A mission statement from a cab driver! Then he holds up a *New York Times* and a *USA Today* and asks would I like them? So I took

them. We haven’t even moved yet. He then offers a nice little fruit basket with snack foods. Next he asks, “Would you prefer hard rock or classical music?” He has four channels. [This cab driver makes an above-average amount per year in tips.]

(Peters, 1994: 235–6)

If a cab driver can establish a rapport with the customer in a 15-minute cab ride with a stranger, what kind of relationship can an accountant develop with a customer over the course of a lifetime?

Consider what the *Harvard Business Review* has called the Starbucks Effect:

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Ten years ago, only 3% of all coffee sold in the United States was priced at a premium – at least 25% higher than value brands. Today, 40% of coffee is sold at premium prices. We've found plenty of evidence of the Starbucks Effect. When individual companies increase the perceived "premiumness" of a product through innovations in the product itself or the way it's delivered, the entire category can reap higher prices and profits.

(Vishwanath and Harding, *Harvard Business Review*, 2000: 17)

Accountants often blame becoming a commodity on the fact that

accounting is a mature industry. So what? Consider lettuce. Can you think of a more mature – not to mention prosaic – industry than lettuce? Yet once lettuce was put into bags, with some croutons and a side of dressing, a \$1.4 billion industry was created from the late 1980s to 1999. Have you ever purchased bottled water, such as Evian? Do you think the executives at Evian think water is a commodity? Perhaps that is why Evian is *naïve* spelled backwards. From taxicabs and coffee, to lettuce and seven-tenths of the earth's surface, *nothing is a commodity*. If these industries can achieve competitive differentiation in rather staid, mature and non-dynamic markets, what is our excuse?

You cannot create a loyal and delighted customer base by charging a "fair price", or catering to "discount shoppers". Once those customers find a cheaper alternative – and they will, especially in today's world of e-commerce – they will defect. But the idea that the majority of customers get excited over low prices – especially from their professionals – is not grounded in reality. Roy Williams in *The Wizard of Ads* offers this comical (but absolutely true) advice:

"I WAS CHARGED A FAIR PRICE" is not the statement of an excited customer, yet many business owners mistakenly believe they need only convince the public that they will be

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treated “fairly” to win their business. Phrases like “Honest Value for Your Dollar” and “Fair and Honest Prices” tempt me to say (with no small amount of sarcasm), “Yippee Skippy, call the press.”

If the most your customer can say when he walks out your door is “I was treated fairly,” your business is pitifully stale and you have virtually nothing to advertise. Why? Because the expectation of “fair treatment” is such a basic assumption in business dealings that most people take it for granted. What we really hope to find is the “delight factor”.

(Williams, 1998: 88)

Accountants around the world blame “price” for a lot of their problems – losing customers, not winning that request for proposal, slow payment, customer complaints, etc. I am convinced that blaming our problems on “It was our price”, has become the biggest excuse – perhaps white lie is a better phrase – of accountants today. Simply put, the conventional wisdom is more *conventional* than *wisdom*.

In their award-winning article, “How to Lose Clients Without Really Trying”, published in the *Journal of Accountancy*, August J. Aquila and Allan D. Koltin surveyed thousands of customers who had defected from their

accounting firm. Here are the top seven reasons why they left:

1. “*My accountant just doesn’t treat me right.*” (Two-thirds of the answers.)
2. They ignore them.
3. They fail to cooperate.
4. They let partner contact lapse.
5. They don’t keep them informed.
6. They assume they are technicians.
7. They use them as training ground for new team members.

To further corroborate this survey, the Rockefeller Corporation studied why customers defect and found the following:

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1% The customer dies.  
3% The customer moves away.  
5% The customer has a friend.  
9% The customer is lost to a competitor.  
14% The customer is dissatisfied with the service.  
**68% *The customer believes you don't care about them.***

What about the opposite side of the same coin, that is, what characteristics do customers use to select an accountant? According to William J. Winston in *Marketing for CPAs, Accountants, and Tax Professionals* (1995: 170):

- interpersonal skills
- aggressiveness
- interest in the customer

- ability to explain procedures in terms the customer can understand
- willingness to give advice
- perceived honesty.

What is conspicuously missing from these surveys? Price. It doesn't even show up. Most defections from accounting firms are the result of human failings, and perceptions of indifference, rather than price or technical quality. In other words, it is how people are treated – or mistreated – that determines their willingness to remain loyal.

Further empirical evidence of price insensitivity – or what economists call price inelasticity – is observed

when the average accounting firm increases its prices, revenues increase. Or, put another way, what would happen to the gross revenue in your firm if you cut prices by one half? My conjecture is your gross revenue would decrease, not increase. If accountants truly operated in a price-sensitive market, we would observe the opposite results in both of these examples.

*You are what you charge for.* And you will never receive more than you think you are worth. If you don't believe you are worth multiples of your (arbitrary) hourly rate, neither will your customers. The accounting profession needs to restore pricing to its exalted

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position in the four Ps of marketing. For too long we have let our price be largely – or solely – determined by the antiquated “billable hour” paradigm, or by our competitors. I have dedicated my life to a solitary mission: to bury, once and for all, the billable hour. It is a mission I take very seriously, and my goal in this booklet is not to have you think *like* me, but to think *with* me. It is time for this profession to begin to *price on purpose*. In order to accomplish that goal, it is necessary to understand the correct theory of value, which we will now examine.

# A tale of two theories

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**The philosophers have only interpreted the world in various ways. The point however is to change it.**

(Inscription, Karl Marx's tomb, Highgate Cemetery, London)

The above quote from Karl Marx has obvious appeal to young revolutionaries who set out to remake the world in their image. But as any serious social scientist, economist, psychiatrist or other student of human behaviour will tell you, before you can *change* the world, you must first *understand* it. Understanding human behaviour is, in itself, a Herculean task. To understand the dynamics of a profession is just as daunting. The aim of this section is to explore the pricing theory used by the majority of the accounting profession, prove why it does not adequately explain value in a free market, and posit the correct theory of value.

One of the main reasons accountants undervalue their services is because they are operating under the wrong theory of value. There is nothing more practical than a correct theory. The antithesis of that statement is: there is nothing as unenlightening as a fact not illuminated by a theory – we may as well read the phone book. Accountants around the world, for approximately the past fifty years, have been utilising the incorrect theory of value to price the intellectual capital they create.

Value, like beauty, is in the eye of the beholder. In 1748, Benjamin Franklin wrote *Advice to a Young Tradesman*, which was a letter to a

## A tale of two theories (continued)

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fellow interested in starting his own business. In that letter, Franklin wrote those immortal words that seem to be imbedded in the DNA of every businessperson, especially professionals: “Remember, that *time* is money.” That little sentence has affected the way professionals view the value of the services they deliver. Unfortunately, it is taken out of context. Here is what Franklin wrote in its entirety on the subject of time:

Remember that *time* is money. He that can earn ten shillings a day by his labour, and goes abroad, or sits idle, one half of that day, though he spends but

sixpence during his diversion or idleness, ought not to reckon *that* the only expense; he has really spent, or rather thrown away, five shillings besides.

(Krass, 1999: 283)

Franklin was not speaking about value, or price. He was articulating the concept of opportunity cost: the next highest valued alternative sacrificed by consumers or producers when making a choice. Opportunity cost is an important economic principle, but a seller's opportunity cost has little to do with value provided to the customer, and can hinder the pricing mentality when it comes to professional services.

One hundred years after Franklin wrote his letter to the aspiring tradesman, Karl Marx and Frederick Engels wrote *The Communist Manifesto*, the famous revolutionary treatise, published in February 1848. Ideas have consequences, and as John Maynard Keynes correctly observed, man is ruled by little else. In his writings, Marx posited a definition of value that has been subsequently called the labour theory of value: in its simplest form it says that the price of an item is solely determined by the amount of labour used in its production.

Since a theory should be able to explain, predict, and control, the true test of a theory is its ability to

elucidate human behaviour. When the labour theory of value is used to explain human behaviour, some anomalies occur. The theory would predict countries that work longer and harder should have higher standards of living. China is the most populous country in the world, and yet no one would argue that they have the highest standard of living, even with its large amount of labour hours available. The labour theory of value would also predict that a rock found next to a diamond in a mine would be of equal value; after all, each took the same amount of labour hours to locate and extract. But how many jewellers place rocks in their shop display cases?

Perhaps you will have pizza for lunch today. The labour theory of value would predict that your fifteenth slice be just as valuable as your first, since both took the same amount of labour hours to produce. Even if you were starved, however, the well-established law of diminishing marginal utility would occur, and your subsequent slices of pizza would decline in value as you became sated. It is self-evident that the labour theory of value does not fit with human behaviour.

### **A BETTER THEORY**

Fortunately, the correct theory of value was developed by the Austrian School of economists in the late nineteenth century, in the

tradition of Eugene von Bohm-Bawerk, Carl Menger, Ludwig von Mises, and F.A. Hayek. These thinkers posited the alternative to the labour theory of value – 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 there is a valuer desiring them.

Because of the entrenchment of the antiquated hourly billing paradigm, most professionals measure the value they produce by the amount of hours spent on a given service. And since the hourly rate has a “desired net income” (what I refer to as DNI, because it has become part of every

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accountant's DNA) built into it, professionals are satisfied when they achieve the magical goal of 100% realisation. But do those hours spent accurately measure the value provided to the customer? There is no doubt they can measure the *cost* of the labour inputs involved, but cost does not necessarily equate to *value*, especially in the minds of customers.

Efforts – that is, hours spent – emphatically do not equate to value. Results are what count to the customer. No customer would be satisfied with a car that “tried” to work. That is why I prefer Oscar Wilde's line to that of Benjamin Franklin's: “Time is a waste of

money.” Ultimately, value is in the eye of the beholder, not the labour time of the seller. What counts is what your customer is *willing* and *able* to pay for your services. The subjective theory of value explains how transactions occur in the marketplace. No customer buys hours, and time is not money. Albert Einstein once wrote, “Our theories determine what we measure.” Hourly billing measures the wrong things.

Karl Marx was wrong. The labour theory of value, like the billable hour, is an idea from the day before yesterday. We need to declare a new value paradigm for pricing the intellectual capital created by accountants around the

world, and stop ritualistically accepting the false theory proffered by Karl Marx over 150 years ago. It is an idea whose time has passed.

# What people really buy: The marketing concept

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**The business of business is getting and keeping customers.**

(Peter Drucker)

Let me ask a question, inspired by Gary Hamel's *Leading the Revolution*:

Thought: Have you ever had a house built? How long did it take? A year? Two years? A few years ago the San Diego-based Building Industry Association sponsored a seemingly ridiculous contest. Two teams were pitted against each other – each would try to build a house in less than four hours, using traditional materials. The teams planned every second of the building process with military precision. They struggled to invent new technologies, such as cement that would dry in a matter of minutes. They broke

the work down into subtasks that could be carried out in parallel. While one group was laying the foundation, another would frame the walls, and another would build the roof. The frame would get bolted to the foundation in large sections, and the roof would be lifted onto the framing with the help of a crane. Each team brought hundreds of construction workers to the site, and every tradesman was given an intricately choreographed role to play. Improbably, one team managed to build its three-bedroom bungalow, complete with landscaping, in less than *three* hours.

(Hamel, 2000: 77-8)

## What people really buy: The marketing concept (continued)

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Here's the question: would you buy this house? Before you answer, think hard. I suggest to you that this may be one of the finest houses ever built. Why? Because of the prior planning that had to go into it in order to construct it with such military precision. The logic for putting forth this thought experiment is simple, and it is this: customers don't buy hours, they buy *results*. Peter Drucker, the most profound management thinker ever, called this the *marketing concept*.

### **THE MARKETING CONCEPT**

Drucker has indefatigably pointed out that the purpose of a business is the creation and satisfaction of the customer, and that "no customer ever perceives himself as

buying what the producer or supplier delivers" (Flaherty, 1999: 133). What matters is not what the producer puts *into* the product or service, but what the customer gets *out* of it. Drucker is also tireless in pointing out that inside a company there only exist costs, efforts, problems, frictions, crises, and mediocrity, but never results. All results exist on the outside of any organisation, be it a government agency, a non-profit foundation, or a business enterprise. There are no such entities as "profit centres" inside of a business, only *cost* and *effort* centres. The only profit centre is a customer's cheque that doesn't bounce. Drucker's marketing concept is explained as such:

In the broadest sense, only marketing produced results; everything else in the business was cost. Drucker stressed that no product had any value until it found a customer. Customers were totally indifferent to the internal efforts corporations made in providing a product or service; they had only one concern – did the product or service give them utility? For example, according to Drucker, quality was not determined by how difficult or expensive it was to make a product. He equated excessive difficulties in the allocation of corporate cost with managerial incompetency. The factor of pricing a product

## What people really buy: The marketing concept (continued)

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or service was [erroneously] evaluated from an internal financial approach rather than from an external marketing perspective. Value constituted only one thing – how much the consumer was willing to pay for the product.

(Hamel, 2000: 88)

What do people really buy? Ask a group of accountants this question, and you will receive a myriad of answers, ranging from tax compliance, audits, consulting, advice, judgement, experience, wisdom, to peace of mind, knowledge, and time. Notice how most of these answers deal with the purchase from the accountant's viewpoint, not the

customer's. If you were to ask any other industry what the customer buys, most likely you would get a very clear definition: automobile salespeople would say "fun, style, performance, status, etc." Booksellers would answer "reading enjoyment, information and knowledge." Owners of 7-11s and McDonald's are selling convenience.

According to Michael LeBoeuf in his book *How To Win Customers and Keep Them For Life* (2000: 23), people spend their hard-earned money on only two things:

- Good feelings; and
- solutions to problems.

This is the utilitarian view – that is, we spend all our resources seeking pleasure or avoiding pain. It is the marketing axiom that you really don't buy drill bits, you buy a hole. Theodore Levitt, former *Harvard Business Review* editor and professor, expressed it even better by speculating that customers only buy one thing: *expectations*. Whether you buy a chocolate bar, a haircut, or a house, you are really buying a bundle of expectations. In today's world, it is not enough to meet the customer's expectations; you must exceed them. It is a difficult enough task to exceed the customer's expectations when you know them, it's nearly impossible if you don't know them.

## What people really buy: The marketing concept (continued)

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The first rule of Value Pricing is to exceed your customer's expectations. No two customers are alike, nor do customers want to be treated *equally*; they want to be treated *individually*. Before accepting a new customer, or beginning work for an existing customer, always ask what they expect. A CPA in California met for the first time a CEO of a company who needed financial statement compilations for his banking covenants. When the CPA asked him, "What do you expect from us?" the customer was delighted by the question. He explained that he wasn't really interested in the compilations, but wanted the CPA to develop a relationship with his banker, as he tended to breach his

loan covenants due to the cyclical nature of his business. He assumed that if his banker was comfortable with his accountant, *he would sleep better*. What was the CEO purchasing? Certainly not the financial statement compilations, but the relationship with the banker, and peace of mind. The CPA priced the engagement at several times "standard hourly rates" because he focused on exactly what the customer valued, not the labour time involved in completing the work.

Three excellent questions to ask customers as often as you can are:

1. How are we doing?
2. How could we serve you better?
3. How do you feel about working with us?

We ask customers about their feelings, rather than what they think, because thoughts can be intellectually challenged, but feelings cannot. Psychiatrists also note that when you ask for feelings you tend to get to the root of the truth sooner than when you ask for thoughts. Accountants need to place more of their focus on the customer, who benefits from what they do, rather than on the technical aspects of what they do.

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### THE DEATH OF COST-PLUS PRICING

Both Peter Drucker's marketing concept and the Austrian School's subjective theory of value spell the death knell for the billable hour, which is a derivative of cost-plus pricing. Contrary to what we were all taught in our cost accounting courses, cost does not determine price in a free market. In fact, cost may be the least important factor in determining a price, at the margin (except as a minimum). At first this appears to be a heretical statement; however, when analysed in the light of the two theories above, it becomes self-evident. Here is the internal logic, side-by-side, of cost-plus pricing versus Value Pricing:

### COST-PLUS PRICING

Product > Cost > Price > Value > Customers

### VALUE PRICING

Customers > Value > Price > Cost > Product

Notice how Value Pricing completely reverses the order of the strategic decisions necessary in offering products and services to the marketplace. The traditional cost-plus theory starts with a product and asks, "How much does it cost us to produce this product?" The answer dictates the price, which – it is hoped – is less than the perceived value to the customer. There are two pernicious effects from this mentality. First,

by merely inflating your overheads you can increase your firm's revenue – a very perverse incentive given re-engineering, benchmarking, business model innovation, and other management theories designed to achieve more with less. This is the main reason cost-plus pricing has died in defence contracts, construction, and most other industries (and never really applied to intellectual capital endeavours). Second, your customers don't care about your internal costs, nor do they care about how much money you want to earn (recall your DNI in the formula for your "standard hourly rate"). It is not the customer's duty to provide us with a DNI. It

## What people really buy: The marketing concept (continued)

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is, rather, our job to provide a service that is so good, they willingly pay us a profit in recognition of what we do for them.

The Value Pricing model, on the other hand, turns this process inside out, asking, “How much does the customer value this offering?” Only then is the price determined, and that price also dictates the costs that will be incurred in producing the final product, ideally at a profit-optimising level. Despite what your cost accounting professors preached, your costs do not determine your price. *Your price determines your costs.*

The business graveyards are full of companies who had internal costs and DNIs, who nevertheless went bankrupt because their offerings didn't satisfy the expectations of their customers. Simply having internal costs and desired levels of profit is not enough. All organisations have to create results outside of themselves, and that is why the marketing concept – along with the subjective theory of value – rules the business world, and always will. In the final analysis, businesses are not paid to *control costs*, but rather to *create wealth*. Putting price before cost is an important concept, one that will take some getting used to in the day-to-day operation of your firm. It requires all jobs to be priced

before the work is started, in order to ascertain that all-important value perception from the customer's viewpoint. Pricing up-front also has an effect on human behaviour, which leads us to our next topic, price psychology.

# Price psychology

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**If you are buying an automobile, do you really care how much time it took to install the hood of the car?**

(Richard C. Reed, *Billing Innovations*)

People tend to buy *emotionally* and justify *intellectually*, which makes the study of price psychology a worthwhile endeavour. Basically, there are two characteristics of price psychology:

1. Price leverage.
2. Pricing emotions.

## **PRICE LEVERAGE**

Price leverage does not mean an advantage possessed by one party over the other, but rather a question of who has the most (or least) price sensitivity at a given point in time. Before an engagement begins, the accountant possesses the price leverage. This is because the customer is willing and able to do

business with you (otherwise you wouldn't have made it this far in the process) and they desire (or badly need) the service.

Think of the psychological factors when the customer is confronted with an Inland Revenue audit. The time to negotiate and set the price for your representation is not *after* you have completed the audit, but *before*. Once you start, or complete, an engagement, the price leverage shifts to the customer and you are left trying to recoup any portion of your price the customer is willing to pay.

This is precisely one of the reasons why accountants around the world do not achieve 100% of their

## Price psychology (continued)

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“standard hourly rates”. They tend to set their price after the engagement has begun or after it has been completed. This is an inopportune time to discover that the customer’s value perception is different from yours. It is much better to learn that perception before you start the job, so you can either educate the customer as to your value, or withdraw from the engagement.

Hence, the second rule of Value Pricing is to set prices *before* the engagement begins, everywhere, every time (though there are some exceptions relating to Change Orders, which we will discuss in the next section). This is just common sense. Everything you

buy as a consumer you know the price before you purchase. Would you hand your car mechanic a blank cheque to tune up your car? Would you fly on an airline that wanted to charge you £5 per minute? Why do we think accounting services are any different? The fact is, accountants are subject to the same laws of supply and demand, customer psychology and pricing psychology as every other business.

The argument that you don't know how long it will take, and hence you couldn't possibly quote a price, is nonsense, and is redolent of Marx's labour theory of value. Not knowing the labour time does not obviate the need to price up-

front, and we ignore this rule at our own peril, resulting in write-downs, write-offs and dissatisfied customers. When you are taking on a job where you are unsure as to its scope, the burden is on you to define that scope, break the job down into measurable phases, and issue Change Orders when work falls outside of your defined scope.

Also, by pricing work up-front, you can command a risk premium, exactly the opposite of the hourly billing method. When you bill by the hour, you shift all of the transaction risk to the customer, thereby lowering your reward. However, when you offer fixed prices up-front, you share some of the transaction risk, and it is well

established that customers will pay to avoid risk (witness the \$1.5 trillion worldwide insurance industry). How much of a premium can you command by offering fixed prices? That depends on your customer, though I have seen anywhere from 10 to 50% premiums. If this sounds counter-intuitive, think about the mortgage market: which offers a higher rate of interest, fixed or variable loans? Why?

### **PRICING EMOTIONS**

There are three primary pricing emotions each customer will encounter at various times through the purchasing cycle. They are:

1. Price resistance.
2. Price anxiety.
3. Payment resistance.

Price resistance is the proverbial “sticker shock” – an initial reaction to cost. As long as you are dealing with people, you are likely to encounter this emotion. The best way to overcome it is by educating the customer as to the value you provide. Price resistance is usually encountered at the beginning of the negotiating process and thus it is easy to identify. I have found that in most instances accountants can overcome this emotion; if you can't, I would seriously suggest you not take the engagement. You do not want to work for people who don't understand, or refuse to

pay for, the value you provide. Also, don't worry about inducing sticker shock by quoting high prices for your services. Sticker shock is a healthy emotion, one that tunes you in to each customer's pricing points. If you fail to induce sticker shock, you may be under-pricing your services.

Price anxiety is also known as buyer's remorse. It is now well-known that luxury car advertisements are targeted at existing owners, more so than potential owners. This is because after such a large purchase, customers want reassurance that they have made a good decision. This is a significant psychological

## Price psychology (continued)

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emotion that all customers will go through, especially after entering into a Fixed Price Agreement (FPA) with your firm. You can overcome price anxiety by constantly staying in touch with your customers, assuring them they made the right decision in hiring you by exceeding their expectations, and offering total quality service. You can also offer a 100% money back guarantee, which dramatically lowers buyer's remorse.

Payment resistance is simply the customer's unwillingness to write the cheque. Who likes to pay their bills? Payment resistance is overcome by involving the customer in the design, price, and payment terms of your services.

Once people are committed to a Fixed Price Agreement, they are more likely to write the cheque, or authorise the credit card, in accordance with the agreement. All the accountants around the world who use Fixed Price Agreements have been very positive with respect to accounts receivable collections, and some firms do not even send monthly invoices to their FPA customers. In fact, the accounts receivable difficulties tend to be with customers who did not receive a fixed price before the work began.

We will now turn to implementing Value Pricing utilising the Fixed Price Agreement and Change Order concepts.

# Implementing Value Pricing

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# 5

**If you aim to profit, learn to please.**

(Winston Churchill)

Successful professional firms of today are pricing their services according to external value created – as perceived and determined by the customer – rather than internal costs incurred in generating those services. One method that has been adopted in implementing Value Pricing is the Fixed Price Agreement (FPA). Essentially, this requires meeting your customers to determine the services they want and need in the forthcoming year.

It is important to keep in mind that any FPA that is drafted between your firm and a customer is the result of a negotiating process. This is your chance to provide the customer with a customised list of services to meet their specific

needs, wants, expectations, and to offer a fixed price for those services, specify the payment terms, and any other level of agreement reached. Thus, no two FPAs should look alike – they should be as unique and individual as your customers. The more customised it is, the higher will be its perceived value.

The following sample FPA (see Figure 5.1) does not replace your firm's standard engagement letter. You must still use engagement letters for each major service you provide, in accordance with your professional indemnity insurer's guidelines (for accountants, this usually means an engagement letter for each audit, review,

## Implementing Value Pricing (continued)

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compilation, tax return, and management advisory service).

The FPA illustrated is only an outline – you will need to tailor it to make it suitable for your own company. I have seen hundreds of FPAs from accounting firms around the world, and no two look alike. It needs to be adapted to your firm's culture and personality, as well as to that of your customers.

### **ADVANTAGES OF THE FPA**

- **Pre-qualifies the customer**

Discovering the customer's perception of value – *before* your firm commits any resources – is a better strategy than finding out *after* the service the customer has a lower value perception

than you do, no matter how you price your services. 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**

By brainstorming with the customer regarding future goals and aspirations, you will inevitably learn of many opportunities to cross-sell your firm's services. You cannot expect to automatically receive additional work from the

customer – you have to earn it, by showing that your firm is a better alternative than the competition. Empirical evidence suggests with a Value Pricing relationship you will be more successful in obtaining additional work by focusing on value.

- **Value Pricing gains “ego investment” from the customer**

All of us want to be in control; this is basic human nature. By giving customers a sense of ownership over your firm's services, offering them choices, and customising your delivery to meet their needs, you will gain their “ego investment”. Once people make a commitment, by

## Figure 5.1, Sample Fixed Price Agreement

1 November, 2001

Dear Customer,

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

### 2002 PROFESSIONAL SERVICES

ABC will perform the following services for XYZ during 2002:

- 2001 Year End, and End-of-Year PAYE Forms
- 1st, 2nd and 3rd Quarter Payroll VAT Return
- 2001 XYZ Corporation Tax Returns
- 2001 Audited Financial Statements with Lead Schedules to be provided by XYZ by 15 March 2002
- Annual Consulting Service 2002\*

**TOTAL 2002 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 offer you access to the accumulated wisdom of the firm through accountants 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 tax authority, or any other 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:

January 31, 2002	XX
February 28, 2002	XX
March 31, 2002	XX
April 30, 2002	XX
May 31, 2002	XX
June 30, 2002	XX
July 31, 2002	XX
August 31, 2002	XX
September 30, 2002	XX
October 31, 2002	XX
November 30, 2002	XX
December 31, 2002	<u>XX</u>

**TOTAL 2002 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) 2002 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. **[Note: This clause can be used for new customers your firm is unfamiliar with, or veteran customers you are moving over to the FPA; either way, it lowers the risk even further for the customer].**

Furthermore, it is understood that either party may terminate this Agreement at any time, for any reason, within 10 days 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 authorise 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.

Yours sincerely,

BY: \_\_\_\_\_  
Partner  
ABC, Accountants

Agreed to and Authorised:

BY: \_\_\_\_\_      DATE: \_\_\_\_\_  
Customer, Director  
XYZ, Ltd.

## Implementing Value Pricing (continued)

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and large, they will behave in a manner that is consistent with that obligation.

- **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, a trait valued by the customer, even if subjectively. Imagine an airline not quoting air fares before the flight, but instead charging by the minute. How would you feel? Would you begin wondering if the pilot will deliberately slow down? Would it lower your confidence in the airline?

- **Increases a customer's switching costs**

The more services you perform for the customer, 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 both your destinies 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, and not let surgeons pierce ears. It also forces you to review every procedure, work review level, etc., and ensure that each task adds value to the customer,

otherwise it should be eliminated.

- **Overcomes buyer's emotions**

Price resistance (sticker shock), price anxiety (buyer's remorse) and payment resistance (not writing the cheque) will all lessen by utilising FPAs. By discussing value, price and terms up-front, you will reduce the negative impact of these emotions on the customer, not to mention raising 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

## Implementing Value Pricing (continued)

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increase in value to any one customer? I can assure you customers don't view the world that way. However, when you have customised services and pricing for each customer, it is easier to increase the price annually even if no services have been added to the FPA.

- **Provides a competitive differentiation**

Since each FPA is customised, the perceived value of your firm increases. In contrast, by using hourly billing, you are simply treating 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 those firms who are willing to offer them.

- **Bundling services results in higher prices**

Anytime you can bundle your services together, you can achieve higher prices because the customer is now focused on the totality of your service offering, rather than each line item.

This is obviously not an exhaustive list of the advantages of Value Pricing, just some of the most important ones.

### **IMPORTANT QUESTIONS TO ASK YOURSELF BEFORE SETTING A PRICE**

It is important to ask yourself, and the team who works on the customer, various questions in order to price every customer at the profit-optimising level. Here are some questions I have found valuable to consider within your firm before setting a price:

#### **Who on the organisational chart are we dealing with?**

The higher up, the less price-sensitive.

#### **Who referred the customer?**

If it's a warm referral, they'll be less price-sensitive because chances are you have already been pre-sold.

## Implementing Value Pricing (continued)

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### **What are the timelines/deadlines in selecting an accountant?**

This is the convenience factor; convenience stores and McDonald's charge for it, so should accountants.

### **Who's paying for the service?**

Is the customer spending their own money on themselves, or are they spending someone else's money? Airlines, hotels, rental cars, for example, take this into account in their pricing strategies.

### **Any competitors in the arena with you? If so, who are they?**

You probably know a lot about your competition. How are you differentiating your Value Proposition from theirs, thereby

justifying a higher price?

### **How profitable is the company and how long has it been in business?**

The theory here is the more profitable and longer they've been in business, the less price-sensitive they will be.

### **Who was the prior accountant and why are they changing?**

You don't want to be the fifth accountant in four years. Check with the predecessor and find out as much as you can about the customer. Do not take all comers, only those who value – and are willing to pay for – your services.

### **Who is the banker, solicitor, etc?**

Check their credit reports. As the Ancient Greek philosophers used to say, "Character is destiny." Only work with people of character.

### **What price do we desire?**

This is an important question. Although there is no doubt that it is the customer who ultimately sets the final price, the firm should have a "reservation price" for the services to be performed. Never go below this reservation price, and don't be afraid to ask for it. There is nothing holding you back except your own fears.

(Baker, © 2001 Aspen Law & Business, *Professional's Guide to Value Pricing, Third Edition*, questions reproduced with permission, p.173)

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### **QUESTIONS TO ASK THE CUSTOMER DURING THE FPA MEETING**

Here are some questions that should be asked of each customer during an FPA meeting or before setting any type of price:

#### **What do you expect from us?**

Exceeding customer expectations is critical in order to Value Price.

#### **What keeps you awake at night?**

There is not a businessperson alive who doesn't suffer from some affliction – cash flow, tax issues, competition, etc. Find out what it is and help them solve it.

#### **What don't you like about your current accountant? What do you like about your current accountant?**

These questions are not intended to denigrate the predecessor, but to assist you in not making the same mistakes, and to exceed what they did like about the predecessor.

#### **If price weren't an issue, what role would you want us to play in your business?**

This is an excellent question in order to discover cross-selling opportunities.

(Baker, © 2001 Aspen Law & Business, *Professional's Guide to Value Pricing, Third Edition*, questions reproduced with permission, p.176)

The letter reproduced in Figure 5.2 shows the experience of one UK accounting firm making the transition from hourly billing to Value Pricing, including abolishing timesheets, which I advocate in *Professional's Guide to Value Pricing, Third Edition*.

### **CHANGE ORDERS**

Change Orders are perhaps one of the most innovative pricing strategies ever developed. When a service arises that was not anticipated in the FPA, or when a service falls outside of the scope specified in the FPA, a Change Order should be issued. It is a wonderful communications tool, as it puts the customer in charge of authorising the engagement and

## Figure 5.2

Hi Ron

I read your book about six months ago – it is truly the best book I've read on the profession. At the time, I was doing some work for a client helping them buy a fairly substantial business, with turnover of \$2 million. We weren't doing due diligence, but even so it was fairly involved. The time-based price came to c. £4,500. With the confidence gained from your book, I doubled the price to £9,000. The client paid within a week, said they "couldn't have done it without us", and at our first client advisory board, held last week, commented that with us, you get what you pay for – if you pay peanuts, you get monkeys. It works! I actually believe we would have found it harder to collect the smaller, time-based price. But because we took the work seriously and charged accordingly, they treated it the same.

My co-director, Colin, and I both attended your London seminar a month or so ago [February 2000]. On the way back we committed to launching FPAs and abolishing timesheets.

Since then, we have begun the immense task of moving 750 clients to FPAs. It was interesting what you said about meeting with your "A" [best] customers, and tailoring the FPA to their specific needs. We absolutely want to do this, but currently don't have the time. I know how bad that sounds – we don't have the time to meet with our best clients. We have just taken on three extra people (we are a two-director firm) so that will definitely help.

The intention is that, over the course of a year, we will move all clients onto FPAs. We felt that we needed to cover all clients [rather than just the 20% who generate 80% of your revenue, as I advocate in my book, at least as a starting point], not just our "A's", for the following reasons:

1. It is administratively simpler. Once all clients are on FPAs, billing becomes automatic, with the only non-standard amounts being covered by Extra Work Orders [Change Orders].
2. Some benefits, such as no charge for phone calls, tax investigation insurance, and service guarantee are easier to offer to all clients rather than to be selective.
3. We believe that the benefits of FPAs as currently offered are of use to the vast majority of clients.
4. We can only abolish timesheets if all clients are covered [I take exception to this particular point].

Our intention is to roll this out to all clients so that by March 2001 they are all on FPAs and we can then abolish timesheets. From then on, we will sit down with our top 100 or so and tailor the FPA to include specific Business Development initiatives. By that point, they will be comfortable with the FPA concept, we should have freed up more time to deal with them on an individual basis, and we should better understand the Business Development product offerings.

Most of these new services will not cost us much to provide. But as we hope the clients will see real value from bundling, we are increasing the price compared to last year by an average of 20%. I feel the package is worth more, but am not convinced clients will necessarily agree. Feedback so far has been 100% positive about the principle, but we have had some moans about the price [that's just sticker shock, and if they moan too loud, it's probably a customer you shouldn't have anyway].

Regards, Stuart

## Implementing Value Pricing (continued)

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approving the price, all *before* the work is performed – precisely when the accountant possesses the most leverage and thus will obtain the highest price. Once again, the Change Order illustrated (see figure 5.3) is merely an example to be tailored to your firm’s culture, personality and that of your customer.

Change Orders can also be used in conjunction with innovative pricing strategies. One of the most innovative is the Retrospective Price, or what is also known as the “Tip” clause (To Insure Performance), as shown in figure 5.4.

This clause can be used when you are doing a significant project for a customer where you know the value you are adding is much greater than any “standard hourly rate”. Also, you must have a high level of trust with the customer, as when using the TIP clause you are relinquishing your price leverage. Also, if you perform auditing for the customer and cannot accept contingency type payments, simply base the TIP on their level of satisfaction with your service, rather than any financial outcome from the transaction. Consider the story (see figure 5.5) from a US CPA who utilised the Change Order with the above Retrospective Price clause.

### SUMMARY

Changing the pricing culture in your firm will not be easy. It takes work, commitment and a dedication of resources to training, continuously educating your team, and constantly confronting the inherent challenges involved with pricing. Pricing is far too complicated to be left to the antiquated “billable hour paradigm” of rate multiplied by hours, and deserves just as much attention, creativity and intellectual capital as the other three Ps of your marketing strategy (Product, Place and Promotion).

You will have to make the transition at a pace that is comfortable for you and your

### Figure 5.3 Sample Change Order

Customer:

Date:

Project Description (and estimated completion date, if appropriate):

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---

Price: £ \_\_\_\_\_

We believe it is our responsibility to exceed your expectations. This Change Order is being prepared because the above Project was not anticipated in our original Fixed Price Agreement, dated xx/xx/xx. The price for the above project has been mutually agreed upon by Customer XYZ, and ABC, Accountants. It is our goal to ensure that XYZ is never surprised by the price for any ABC service, and therefore we have adopted the Change Order Policy. The price above is due and payable upon completion of the project described [or, payable up-front, if agreed upon, or in instalments, etc. – whatever you and the customer agree to].

If you agree with the above Project Description and the price, please authorise and date the Change Order below. A copy is enclosed for your records. Thank you for letting us serve you.

Sincerely,

Partner  
ABC, Accountants

Agreed to and Authorised:

BY: \_\_\_\_\_  
Customer, Director  
XYZ

## Implementing Value Pricing (continued)

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customers. There is no need to make the change all at once, it can be done incrementally. Indeed, it has been my experience that most firms do just that. Test the FPAs with a few customers, develop some early successes, share them with the team in your firm, and your confidence will increase and speed your transition with other customers.

Including FPAs and Change Orders in the pricing strategy of your firm will allow you to develop better relationships with your customers, to increase your prices, to increase customer satisfaction, loyalty, and profitability, to cross-sell more services, to increase accounts receivable collection, to reduce

write-downs and write-offs, and to enable you to stop sacrificing profits on the Altar of the Almighty Hour.

### **Figure 5.4 Sample Change Order Clause – Retrospective Price (Non-Audit Customer)**

In the event that we are able to satisfy your needs in a timely and professional manner, you have agreed to review the situation and decide whether, in the sole discretion of XYZ, some additional payment to ABC is appropriate in view of the overall value of services rendered and/or the financial results achieved, and/or your satisfaction with our services, by XYZ for this transaction.

Adapted from Baker, © 2001 Aspen Law & Business, *Professional's Guide to Value Pricing, Third Edition*, reprinted with permission, p. 211

## Figure 5.5

Hello Ron,

Basically the large engagement was for a previous client that I had hired a controller for. He took over the tax work, at my suggestion, as he was a CPA. The engagement was an exit and management succession strategy which involved some fairly hefty income tax savings as well. The total time expended was about 100 hours, although a lot of the time was on unrelated things that I did not want to charge for due to the magnitude of the price (we quit using timesheets some time ago and have substituted “daily activity sheets” to make sure our clients get billed, based upon our perceived value of each engagement).

I used a flip chart in the presentation, pointing out the value of what they were getting. At the end of the presentation I asked how much they thought it was worth, and suggested \$300,000, \$500,000, a million? I wanted them to think in big numbers. The CEO was rather excited and said a million. Knowing that this would be difficult to obtain in one fell swoop I suggested \$400,000 down and a retainer of \$4,000 per month. They agreed but asked that I serve on the board of directors and attend quarterly meetings through 2008, when the note to the previous owners would be paid off. They were also kind enough to put me on salary so I could participate in their pension plan which is a 25% direct contribution from the company. This all adds up to a little bit over \$1 million.

Never once was the word time used or referred to by myself, or my client. They couldn't care less about time. In all of our engagements, I never use the word. By concentrating on value and encouraging the client to participate in the valuation of the engagement our prices have skyrocketed. You were absolutely on target when you said that accountants are terrible at valuing our services (myself included).

Keep up the wonderful work ....

Gus

# Final thoughts

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# 6

**No matter how far you have gone  
on the wrong road, turn back.**

(Turkish Proverb)

That Turkish proverb contains sage advice, and I truly believe the accounting profession has gone down the wrong road in the past fifty years by using hourly billing. Although it certainly is a simple pricing policy to maintain – not requiring much thought or creativity – the downside is enormous. It is preventing members of the accounting profession from getting paid what its customers already believe they are worth. It is an idea for which the French have the perfect expression: *fausse idée claire* – a terrific idea that doesn't work.

By focusing on the concepts in this booklet, you will begin to *price on purpose*. Pricing will always be a

marketing issue, meaning that it starts outside of the firm, with the customer. Inward-focused pricing methods, such as cost-plus pricing and hourly billing, create the problem of *making the wrong mistakes* – that is, you get no feedback from the external environment that enables you to adjust your prices to reflect the external value you provide. Lost pricing opportunities and mistakes simply don't show up on your financial statements, or in your hourly realisation reports, or in any Activity Based Costing reports – they simply vanish into thin air.

And the lost opportunities are enormous. A study by the consulting firm McKinsey & Co. in

## Final thoughts (continued)

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Cleveland, Ohio compiled data on over 1,000 companies and found that a 1% increase in price, at constant sales volume, would produce an average of 7.4% increase in profitability. In fact, the McKinsey study showed that pricing has a greater impact on profitability than either sales volume increases or cost reductions.

However, the accounting profession is mired in simplistic “me-too” pricing, pegging their prices based upon the competition and an internal focus, while ignoring the external value created for the customer. Let us, together, forge a new Declaration of Independence for the accounting

profession, and once and for all, free our profession from the tyranny of time. It is time to bury the billable hour. I do hope you will join us.

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