Pitfalls of Value Pricing – What you need to consider before you leap

Recent articles in the Journal of Accountancy asked whether you should 'Dump the Billable Hour?' and offered suggestions as to 'How can firms implement value pricing' as some accounting industry experts have suggested. The article offers compelling arguments why a firm should consider value pricing and we agree this makes sense in certain cases. However, we think there is more to the decision than the articles cover.

What is Value Pricing?

Value pricing means defining a fixed price for a particular service or range of services. Value pricing has the considerable appeal of simplicity: the fixed price is agreed upon before the work starts, it's what the payment terms are based on, and there's no haggling or reviewing the invoice line by line to understand exactly what was done and by which staff member and how long it took. Fixed price projects, when executed correctly, can produce gross margins exceeding those generated by time and materials based projects when the resources involved are experienced and knowledgeable and the available economies of scale have been identified and leveraged. In many cases, value pricing can even improve client relations by eliminating the tension sometimes associated with presentation of the time and materials invoice. We agree there are certainly instances when value pricing makes sense for the client and the firm; however, it is not appropriate for all cases. Firms should make informed decisions about value pricing after evaluating many different factors. Here are a few to consider:

Client Volatility

What you know about your current clients will help you decide whether or not they are good candidates for value pricing. For example, do they consistently keep their general ledger in good order year after year or do you have to do a lot of extra work in some years due to sloppy bookkeeping? Are the customer's accounting needs consistent year to year or are they volatile? Are they the type of customer that will be happy to let you do more of the work if they think "it's all part of the fixed price" even when your engagement letter spells out the client's responsibilities in detail? Has the client indicated an interest in switching from time and materials billing to value pricing? While value billing may make perfect sense for the firm, your clients may not want to switch. These are the kinds of questions you have to ask yourself about existing clients before you agree to value pricing. For new clients the questions are the same but the degree of risk is higher since you are not as likely to be as sure about the answers as you are with existing customers. Some industry experts say the best way to handle value pricing with new customers is to write a comprehensive engagement letter, which is never a bad idea, and to charge extra for anything outside the scope of the engagement letter. However, you should remember that you are setting the tone for your relationship going forward. If the client thinks you are nickel and diming them there is a good chance it will be a one year relationship.

Received Value

Value Pricing may also run afoul of client perceptions of received value. Your existing clients know the price and type of services they receive from your firm, and by virtue of their continued relationship with your firm, agree with the received value of what they're paying for. Furthermore, your potential clients also have a reasonable idea of what a specific service entails and what they can expect for their money. Value pricing runs the risk of upsetting that understanding.

If the proposed value price is higher than the historical time and materials price in an attempt to recapture some of the hourly leakage or uncharged out of pocket expenses, your existing clients may not perceive any added value in the higher price, and in fact, may see the value price as a thinly veiled gouge, as charging them for every possible billable minute and paper clip used. The firm in general and the specific partner may perceive the client's hostility as evidence of a lack of trust. This perception makes for both an unhappy client and an unhappy partner, and an uneasy working relationship that may not endure.

New clients may have no reference base for Value Pricing

New clients may see the proposed value price and immediately eliminate your firm from consideration because there is no understanding of the fixed price's historic basis. For example, your firm may pride itself on exceptional client service – outstanding turnaround time, complimentary coffee and pastries in the waiting room, free or cut rate messenger service for document pickup and delivery, calls to the partner are returned immediately, either by the partner or the partner's assistant, same day response to questions or even weekend appointments – new clients who have never experienced your firm's attention to detail or responsiveness to their needs may see the value price and conclude it's simply too expensive. A new client may also know your firm by reputation and conclude there are too many non-accounting extras incorporated in the value price for the cost to be considered reasonable.

You still need to know the project cost

Even if you decide to offer your clients fixed price or value price services, the value price must be based on *something*: historically an audit or a Schedule 1120 takes *n* hours using staff x, y and z, and based on the hourly rates, this is what we've billed our clients. But we don't have to tell you that tax law and IRS and state regulations change from year to year; for example, what in the past was a line on a form now requires a supporting schedule. Your clients and the complexity of their businesses or households change from year to year. Without accurate, detailed historic information the value price is nothing more than a guess and an ill-informed one at that.

In fact, while we may not be considered completely objective observers, based on our real world experience with numerous accounting and professional services-based clients, we are convinced that accurate fixed or value pricing requires ***more*** detailed information, not less. You and your employees will probably feel relieved when freed from filling out timesheets but eventually, within a year or two, you will lose sight of changes in your relationship with your clients. These changes, while individually small, will accumulate over time and may lead to poor decisions. A client's business may have slowly become more complex over the years and your value pricing may not have taken the increasing complexity into account. Or your staff may end up doing work the client neglects because the client thinks the fixed price covers everything. Without an accurate historical basis, firms run the very real risk of underestimating the value they provide and setting an unreasonably low price which will likely prove difficult to increase later on. Alternatively, the client may have invested in automation and become easier to work with and they may decide to leave you because they realize they are not getting the same value as they did in the past.

One of our favorite value pricing stories involves one large client in one particular office in a firm that didn't track employee time. After several years and for a variety of reasons, the firm implemented time tracking and what they found at this one office was very interesting: their net margin on all their clients, except one, was higher than virtually any other office in the firm. They achieved these high margins by excellent customer service and dedication to satisfying their customers. The one client, which accounted for over 35% of the office's total revenue, was the exception to the office's excellent performance and had an extremely low margin. When asked why their price to their biggest client was so low, the partner answered that he was afraid if he raised his fees he would lose the client. And since his office already had the best overall net profit margin in the firm, why 'rock the boat?' After much discussion, the partner went to the client and asked for a significant increase in their fees. The customer's response was remarkable: "We have been wondering all these years how you could afford to give us such great service at so low a cost."

Value Pricing can make sense

All of the above is not to say that Time and Materials billing is sacrosanct and should never be questioned or other billing methods are not to be used. The author makes a convincing case for value pricing and why it makes sense for firms to focus on a service's perceived value rather than the traditional cost plus pricing model. Our point is that value pricing is not a blanket answer for every firm in every case and there is more to the exercise than simply compiling a spreadsheet and calculating a price, or even as the author suggests, defining a price and working backward to ensure the service and options are deliverable at a realistic cost:

- The new value price model and options must be explained and understood as reasonable so your existing clients don't feel neglected or abused. Firms evaluating a switch to Value Pricing must consider carefully how the client may feel about a switch.
- Potential clients must be educated so they understand why your value price is set where it is, why it's equitable and has a good historic basis and isn't just a number picked out of the air
- Newer and brand new clients must be educated as to why value pricing is a value add for them rather than just an exercise in charging whatever the firm thinks the market will bear. One approach might be to onboard a new customer using the time and materials billing model with the understanding that after a couple of cycles, a move to value pricing might be beneficial for both firms.
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- Fixed or value priced services require detailed, comprehensive historical information or firms could undervalue the service and find that increasing the price later will be difficult. Firms could also find that clients have changed their own processes such that the value received for the price is not worth staying with the firm

We use value pricing ourselves, and generally achieve good results. However, we know some of our customers are receptive to value pricing and others are not. We make a decision to offer fixed price or time and materials pricing after detailed evaluation of multiple factors such as the client, the type of work, its complexity and whether or not we have done similar work. It's not a one size fits all model and firms should keep that in mind when evaluating the switch to value pricing.