PRICING ON PURPOSE: HOW TO IMPLEMENT VALUE PRICING IN YOUR FIRM, PART I

Ronald J. Baker, Founder, VeraSage Institute

Price is what you pay. Value is what you get. – Warren Buffett

You Are What You Charge

You are what you charge for. Indeed, a business is defined by little else. I believe our current pricing myopia is inflicting damage on the accounting profession, worldwide. We seem to believe that we are defined by our "hourly rates."

Accountants around the world blame "price" for a lot of their problems—losing customers, not winning that Request for Proposal, slow payment, customer complaints, services becoming commoditized, etc.

I am convinced that blaming our problems on price has become the biggest excuse 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* (May 1992), 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. Felt ignored
3. Firm failed to cooperate
4. Partner contact had lapsed
5. Firm didn't keep client informed
6. Assumed they [clients] were technicians
7. Firm used client as training ground for new team members

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*:

- 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, poor service quality, and perceptions of indifference, rather than price or technical quality. It is how people are treated—or mistreated—that determines their willingness to remain loyal.

Why Are We in Business?

When accountants in my seminars are asked why they are in business, more than 75 percent answer: "To make a profit."

Yet is the answer really that simple?

We must distinguish between the *purpose* of a business with its *goal*. Profit is a *lagging indicator* of customer behavior. The real results of any organization take place in the hearts and minds of its customers, because they have to earn a profit as well.

Economists use a different definition of profit from that of the typical accounting financial statement. They consider both parties to a transaction, because both parties must receive more value than each is giving up; otherwise no transaction would be consummated in the first place.

United States Representative Samuel Barrett Pettengill [1886–1974] gave an excellent definition of *profit* from an economist's perspective:

> The successful producer of an article sells it for more than it costs him to make, and that's his profit. But the customer buys it only because it's worth more to her than she pays for it, and that's her profit. No one can long make a profit producing anything unless the customer makes a profit using it.

The Marketing Concept

Peter Drucker explained the same idea by what he termed the *marketing concept*, in the early 1960s. The purpose of any organization—from a governmental agency or nonprofit foundation, to a church or a corporation—exists to create results *outside* of itself. The result of a school is an educated student, as is a cured patient for a hospital, or a saved soul for a church. A business exists to create wealth for its customers.

The things that exist inside of a business include costs, activities, efforts, problems, mediocrity, friction, politics, crises, and a grapevine. Yet customers are indifferent to the internal workings of your firm.

Nobody wants to hear about the labor pains—they want to see the baby. Any firm has to understand what customers truly value, since all economic value is in the eye of the beholder.

A Tale of Two Theories

In his writings from the 1800s, Karl Marx posited a definition of value that has been subsequently called the labor theory of value: In its simplest form it says that the price of an item is solely determined by the amount of labor used in its production.

If Marx's theory was correct, a rock found next to a diamond in a mine would be of equal value, since each took the same amount of labor hours to locate and extract. Yet how many rocks do you see in the local mall's jewelry store? If you were to have pizza for lunch today, under Marx's theory, your tenth slice would be just as valuable as your first, since each took the same amount of labor hours to produce.

The Marginalist Revolution of 1871

Fortunately, three economists refuted Marx's theory and developed the theory of marginalism: William Stanley Jevons [1835–1882], Leon Walras [1834–1910], and Carl Menger [1840–1921].

What made this new theory so revolutionary? As Carl Menger explains in his book *Principles of Economics*, written in 1873:

> Value is…nothing inherent in goods, no property of them. Value is a judgment economizing men make about the importance of the goods at their disposal for the maintenance of their lives and well-being. Hence value does not exist outside the consciousness of men…[T]he value of goods…is entirely subjective in nature."
>
> The value of goods arises from their relationship to our needs, and is not inherent in the goods themselves.

In other words, value is like beauty—it is in the eye of the beholder. This theory has enormous explanatory and predictive capabilities, because it explains how people buy things. Marx would say pearls have value because people dive for them (thus supplying labor). Menger would retort that people dive for pearls because other people value them.

Cause and effect is confused constantly on this principle. I remember taking a wine tour of Far Niente in Napa where the guide was explaining how one particular vintage had to be bottled by hand, which was why it was more expensive—due to the extra labor this entailed.

I could not help thinking of the Marginalists, who would retort: no, you are willing to invest in the labor necessary to bottle the wine by hand because some customers find it valuable (and delicious!) enough to cover the extra labor costs.

Until Next Time

No matter how far you have gone on the wrong road, turn back. –Turkish Proverb

That proverb contains sage advice, and I truly believe the accounting profession has gone down the wrong road in the past sixty years by utilizing 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 their customers already believe they are worth.

It is an idea for which the French have the perfect expression: *fausse idee Claire*—"a terrific idea that doesn't work." For a summary of the disadvantages of hourly billing versus the advantages of value pricing, see Exhibits 1 and 2.

In Part II, we will explain more about value pricing, establishing a Value Council, and appointing a Chief Value Officer.

Exhibit 1: Disadvantages of Hourly Billing

•	Hourly billing misaligns the interest of the professional and the customer—the customer wants their work done effectively, whereas the firm wants to log more hours.
•	It does not focus on what customers buy. Customers buy value, not hours.
•	It focuses on efforts, inputs, hours, costs, activities, rather than outputs, results, and value.
•	It places the transaction risk on the customer.
•	It fosters a production mentality, not an entrepreneurial spirit.
•	It transmits no useful information as to value, project management, the effectiveness of professionals, or the future behavior of customers.
•	It encourages the hoarding of hours and decreases delegation, leading to surgeons piercing ears.
•	It penalizes technological advances, lessening a firm's revenue if it performs work more efficiently.
•	It commoditizes the firm's intellectual capital into one inadequate hourly rate, denying a firm the opportunity to differentiate itself from the competition.
•	It does not take into account the risk the firm is assuming working for customers. Risk is not priced by the hour. Actuaries have an axiom: There is no such thing as bad risks, only bad premiums.
•	It places an artificial ceiling on a firm's net income, since there are only so many hours in a day—indeed, a lifetime.
•	It creates bureaucracy. Time and billing programs consume between 7 to 15 percent of a firm's gross revenue to maintain. These resources are better spent pricing on purpose—by establishing a Value Council, appointing a Chief Value Officer, pricing all work up-front, performing adequate project management, as well as After Action Reviews.
•	It does not set prices up-front, violating the laws of economics and consumer psychology. Customers want to compare value to price *before* they buy, not after.
•	It diminishes the quality of life. No one became an accountant to bill the most hours, but rather to help people. Knowledge workers resent having to account for every six minutes of their day, as if their leaders do not trust them to do the work and the right thing.

Exhibit 2: Advantages of Value Pricing

•	Value Pricing comports with the laws of economics and consumer psychology, aligning the interests of the firm with those of the customer.
•	It manages, clarifies, and offers the firm the ability to exceed the customer’s expectations.
•	It prequalifies the customer to ensure they are a good fit for the firm.
•	It provides the opportunity to cross-sell additional services.
•	It allows you to gain “ego investment” from the customer.
•	It improves communication throughout the relationship.
•	It projects confidence and experience, as opposed to being unable to inform the customer up-front of a price as with hourly billing; or offering a range of prices, which is done more for the benefit of the firm than the customer.
•	It increases a customer’s switching costs, increasing their loyalty and long-term profitability.
•	If forces the firm to be effective in project management and getting the work done within the time promised to the customer.
•	It overcomes customer’s pricing emotions and maximizes the firm’s price leverage.
•	It incentivizes the customer to complain—through triggering the service guarantee—giving the firm a second chance to win back the customer, and prevent similar problems from happening with other customers in the future.
•	Fixed prices can be increased each year, even if there are no changes in services. It is much easier to increase the price of a customized price rather than increasing your hourly rate by $10 per hour.
•	It provides a competitive differentiation for your firm when you offer customers certainty in price and reduced risk of billing surprises.
•	It specifies conditions for Change Orders that are usually value-added services that can command a premium price.
•	It utilizes price bundling allowing the customer to focus on the totality of the firm’s value proposition rather than the price of each and every service.

Published by: International Federation of Accountants®

International
Federation
of Accountants®

529 Fifth Avenue, 6th Floor, New York, NY 10017
T + 1 (212) 286-9344 **F** +1 (212) 286-9570
www.ifac.org