Chapter 1

Pricing Methods in the CPA Profession

There are many ways for certified public accountants (CPAs) to price their services:[1]

- Cost-plus pricing
- Fixed pricing
- Results pricing
- Value pricing
- Combinations of the above

Variations of *cost-plus* pricing are the most common in the profession. The CPA firm starts with its direct labor costs, adds an overhead factor and a profit factor, and assigns *standard chargeout rates* to each person in the firm based on the individual's hourly pay. *Owner* rates are set subjectively somewhat higher than the rates of the most experienced employees. A large local firm might set its newest partner's rate at 40 percent above the firm's highest manager. A medium-sized or smaller local firm might sets its lowest partner rate 30 percent above the highest manager. Other partners would go up from there.

Fixed-price agreements are contracts to provide specific services to clients for a fixed price, regardless of the time required to perform these services. These are often used for pricing bundles of related services such as bookkeeping, financial statements, investment management, and tax returns for a single client.

[1] All CPAs must comply with both the AICPA Code and local state accountancy board regulations regarding fee arrangements. The AICPA rules may be found at www.aicpa.org/Research/Standards/CodeofConduct/Pages/et_302.aspx and www.aicpa.org/Research/Standards/CodeofConduct/Pages/et_503.aspx. Links for state jurisdictions may be found at www.aicpa.org/research/externallinks/pages/stateboardsofaccountancylinks.aspx.

Results pricing is the practice of agreeing in advance to invoice the client based on the results you obtain, regardless of the amount of chargeable time invested. Commissions and contingent prices are examples of results pricing.

In value pricing, the CPA may wait until he or she finishes the engagement to set the price. That way, the CPA (and the client) can evaluate the CPA's contribution and invoice accordingly. Most CPAs have done this—at least when evaluating their contribution downward—for many years.

> **Key Point:** To clients, every price is a value price. Clients always adopt a value pricing approach. Unless they feel they received value from you that was greater than the price, they will be unhappy with your invoice.

These four pricing methods are not mutually exclusive. Most CPAs have always used hybrids of these methods, often without realizing it.

Types of CPA Firm Services

Accounting firms provide three types of service:

- Specialist and niche services
- Extension and advisory services
- Compliance services

Specialist/Niche Services

Specialist and niche services set a firm apart and provide opportunities to promote service(s) not offered by other local firms. These services may be to a particular industry, such as the health care sector, or they may be a specialty delivered across a range of clients (for example, estate planning, financial services, and so on).

With specialist and niche services, the firm commits to offer services beyond the traditional compliance offerings. These services entail special expertise and a dedication to service delivery. Such specialization commits the firm to additional personnel training, increased research and studying, as well as networking and other time commitments. These services have marketplace appeal and good pricing potential. They can often be sold with fixed pricing, results pricing, or value pricing.

Sometimes a specialist and niche service follows from compliance services. It is in these moments that you impress the client with your expertise and position yourself as a credible adviser who can bring solutions to clients in other areas of need.

Extension and Advisory Services

These services relate to what a client could or should do in the future. They relate to future planning and may encompass knowledge gained during compliance services.

Advisory services are not exclusively driven by compliance expertise. They have a wider scope because they do not depend solely on technical knowledge. Not all firms have succeeded in introducing advisory services.

Extension services are those which clients automatically associate as being provided by their accountant. These services extend the service into the present operating environment of the client. They include bookkeeping and other record keeping, computer and systems consulting, attendance at management meetings, estate planning, financial planning, and so forth.

What about *Type 2* or *value-added services*? These are just two of the names used to describe non-mandatory services. The term *value-added* implies that compliance services do not add value, which is not true. Clients entrust their tax affairs to their accountant, believing he or she will keep taxes down to the lowest amount consistent with the law.

Some extension services, such as bookkeeping, are quite similar to compliance services and are commonly sold under cost-plus pricing. Other extension services such as estate or financial planning might be better sold using fixed prices, results pricing, or value pricing.

Compliance Services

CPAs owe a debt of gratitude to governments, tax authorities, and regulatory bodies whose requirements bring clients back year after year. Some call these services *tax, audit*, or other *compliance* services. These services are normally sold with cost-plus pricing. Tax preparation is usually sold with a base of cost-plus and an added element of value pricing.

Having looked at services, let us consider the two key roles the accountant plays in service delivery—expert and adviser. Some CPAs default to one role with limited incursions into the other, while others specialize in only one.

Expert

We use *accountant* and *expert* as interchangeable terms. All your compliance services are delivered by you as an expert, and clients recognize you as the expert in these fields.

Your technical expertise and knowledge of compliance-related planning services position you as an expert. You have extensive, up-to-date knowledge and can provide solutions to your clients' problems. You tell clients what is best for them and recommend actions to take.

Although you could view this as advisory, this advice is integral to the compliance service itself (and not a separate advisory service) in the context of compliance services. Indeed, you must add advice to your compliance service offering to serve your client well. Otherwise, you leave the job half done.

With compliance services, you remain in control of the process and have the expertise to meet the clients' needs—you are the expert.

Adviser

The adviser role differs from that of an expert, although in practice no clear line separates them.

If you do not offer these expanded services, you have failed your clients.

Can you be an expert only? Yes, if you provide specialist and niche services or compliance services with minimal advice.

Can you be an adviser only? No. You develop your position as adviser from your compliance responsibilities. With compliance services, your primary role is that of expert.

Can you be both expert and adviser? Yes.

There are several concepts discussed in the text that follows that can help you price your services effectively. These concepts include cost-driven prices versus value-driven prices, pricing and risk, using chargeout rates as a benchmark, and investment versus value.

Cost-Driven Prices Versus Value-Driven Prices

Most accountants determine prices by multiplying the time spent by various persons in the practice times a chargeout rate for each person or for that type of service. Note that some accountants charge by the day. In this book, all chargeout rates refer to hourly rates. (In the Glossary, also see *effective chargeout rate* and *standard chargeout rate*.) These accountants set their chargeout rates by referring to the salary and overhead costs for personnel who perform the engagement, plus a desired profit margin.

> **Example:** A common practice in many firms is to set chargeout rates at three times salary cost, based on the assumption that the typical firm's operations should be one-third salaries, one-third overhead, and one-third profit.

We refer to these types of prices as *cost-driven* because the amount of cost incurred performing an engagement affects the amount invoiced.

Other CPAs base their prices on the value of the results obtained rather than on the costs involved to perform the service.

> **Example:** If the result is disappointing, the CPA will take a *write-down* or sometimes send no invoice at all, regardless of the amount of cost he or she invested in the engagement. If the results are very good, the CPA will invoice the client more than *standard fees*.

We call these prices *value-driven*, and they are common in other professions such as agency, brokerage, health care, optometry, and public insurance adjusting. The CPA profession has some cost-driven prices and some value-driven prices, with a predominance of cost-driven prices.

Example: A corporate law firm is predominantly cost driven for routine work for regular clients, basing prices on the amount of time required by the particular personnel at their individual chargeout rates. However, for closing a major transaction or handling an estate, it might base its price on a percentage of the amount involved and would thus be value-driven.

Example: A personal injury law firm's prices are mostly value-driven, based on a percentage of amounts collected for clients. But the firm might also charge clients for copies, travel, court reporters, and the like, based on the costs incurred.

Example: A real estate agent bases his or her charges on the price at which a piece of property sells. But certain types of listings might also provide for the reimbursement of advertising and other costs or a fixed price for facilitating a transaction.

Example: A surgeon's prices are primarily value-driven, based on the nature of the surgical procedure performed. But X-ray or CAT scan prices are highly affected by the cost involved, including labor.

Example: An accountant's price to prepare a routine financial statement is based principally on the time invested. But the price to represent a client in a dispute with tax authorities could be based on the amount of taxes saved.

The overwhelming majority of accounting practices record all time charges to clients as *work-in-progress (WIP)* at an amount based on standard chargeout rates for each person.

When engagements are completed and invoiced, any difference between the standard fee amount and the final amount invoiced is recognized as a write-down or *write-up*. Value-driven professions usually record revenue only when they send invoices to clients.

Pricing and Risk

Cost-plus pricing transfers risk to the client. This has advantages and disadvantages. Although accountants prefer to have clients take the risk for the job going over budget or for unforeseen engagement problems (which is what cost-plus pricing does), clients prefer the accountants take the risk. After all, accountants are the professionals and they should know what they are doing.

Profit comes from risk. No risk, no reward.

In return for the client assuming the risk, the accountant pays the client a reverse risk premium by agreeing to accept only the standard rate. This puts a comfortable floor beneath the CPA, but it also creates an artificial ceiling. This idea is manifested in national averages of CPAs realizing around 85 to 95 percent of standard. Larger local firms tend to have lower realization around 85 percent (and higher standard rates), while smaller local firms tend to have higher realization around 90 percent and lower standard rates. I have seen small practitioners with realization of 96 percent to 99 percent.

When you transfer risk to your clients, they will limit your rewards. That's only fair. If you adopt value pricing, you assume more risk, but you expect greater rewards. That's fair, too.

Just as cost-plus pricing transfers risk to the client, fixed-price agreements and, to various degrees, other value-driven pricing transfers risk to the accountant. Traditionally, accountants have preferred for clients to take the risk for unforeseen engagement problems (which is what cost-plus pricing does). Today, many clients prefer that their accountants take the risk.

In return for assuming the risk, the accountant charges the client a risk premium by pricing above standard rates. The client gains a comfortable ceiling on price.

Using Chargeout Rates as a Benchmark

One of my client firms in the East had net sales of 99 percent of its standard fees. Another client firm on the West coast had net sales of only 82 percent of its standard fees. Was the eastern firm better managed? No, because the western firm's partners earned twice as much as the eastern firm's. Why? Because the western firm set its standard rates 50 percent higher than those of the eastern firm, so even though the western firm's write-downs appeared excessive, its effective chargeout rates were significantly higher than those of the eastern firm.

Most CPA firms (particularly smaller firms) set their standard chargeout rates assuming that they will invoice normal engagements at near-standard fees and that any write-ups and write-downs will be exceptional. These firms do not anticipate write-downs in price negotiations, and write-downs measure their cost management skills. Standard fees reflect the true production of these firms because Standard fees represent what the firms expected to invoice before doing the work, and they are the benchmark by which the firms will judge their management results. We refer to this moderate pricing philosophy as *cost-driven*.

> **Example:** The eastern firm whose net sales were 99 percent of standard was a cost-driven firm. It was also much smaller than the western firm.

But some firms set optimistic, *best-case* standard chargeout rates. These firms base their standard rates on their highest value services. For most routine mandatory services such as bookkeeping, compilations and reviews, these firms would not expect to realize best-case rates because the market for such services will not support the higher rates. They plan for substantial write-downs (sometimes as high as 20 percent to 25 percent) over the course of a year. Such write-downs represent the CPA firm's pricing decisions which are planned in client negotiations for routine services before an engagement begins. Net sales (that is, amounts invoiced) represent the true production of these firms because that is what the firms expect to earn before doing the work, and net sales are the benchmark by which the firms judge their management effectiveness. We refer to this ambitious pricing philosophy as *target-driven*—the standard rates are the ideal scene that firms target, knowing that they will not achieve their ideal in every case.

> **Example:** The western firm mentioned earlier whose net sales are 82 percent of standard is a *target-driven* firm.

Most firms fall somewhere between these two extremes. Generally, the larger the firm, the more likely it will use ambitious, target-driven chargeout rates.

Some target-driven firms are even more extreme than the western firm. They interpret the target-driven pricing philosophy by setting their standard rates far higher than other firms—for example, using a four to five chargeout multiple as compared to a multiple of three or three-and-a-half. These target-driven firms rarely expect to get standard rates. They consider their chargeout rates as representing the amount of value they could deliver if they hit a "home run" for the client—meaning if they worked at their highest professional level on valuable services for clients that could afford that level of service and then achieved a dramatic result. In fact, home-run firms are often satisfied to get 50 percent to 75 percent of their higher standards. They may quote routine engagements for 65 percent of standard rates. Home-run firms use write-downs as a factor in pricing rather than in efficiently managing the engagement.

Regardless of which position you take on setting standard chargeout rates, the use of write-downs is an indicator of client management skill.

Investment Versus Value

Compare the following terms, and consider the contrasts:

Cost	Benefit
Effort	Results
Input	Output
Investment	Return on investment

Consider the first row in the previous table. In every personal and economic activity you pursue, you think that the benefit of doing something will exceed the cost. Whether it is having a child or going to college, you estimate that the benefit will exceed the cost (including time, money, and inconvenience).

Consider the second row. In everything one does in life, one expects the results will exceed the effort; else why do it? This applies to the undertakings in one's personal life, like going on a diet or quitting smoking, as well as with business activities.

Look at the third line. In every business activity, the output must exceed the input or the venture is uneconomic. The old Soviet socialist system liquidated the infrastructure left over from the Czars over a 70-year period. Each year, the output of the system was less than the inputs until it collapsed.

And look at the fourth line. Whenever one invests, one expects a return on the investment and a return of the investment.

The left side of the table represents activities; the right side represents outcomes.

- Which side of the table does a time-keeping system measure? That's right, it measures the left column, the activities performed.
- And which side of the table do clients care about? They care about the right column, the outcomes that CPAs obtain for them.

All activities exist within the CPA firm. They may not even be visible to clients. In fact, they are often invisible. All outcomes are valued by the client and such outcomes exist externally to the CPA firm and are usually apparent to the client.

A time-keeping system measures the cost, effort, and so forth, that a CPA invests in an engagement. But clients care about the right column. They care about their benefit, the results they obtain, the value of the service to them.

There is a myth that the amount on a CPA's time-keeping system indicates the fair price. The reality is that the amount on a time-keeping system indicates only what the firm invested in an engagement at standard rates. That amount has little to do with the value of the work to the client.

Often, accountants get caught up in their costs in the job because cost measurement is what they do. They often ignore what clients care about—value—because value is subjective and difficult to measure.

Cost-plus pricing creates an inevitable conflict of interest with clients. Cost-plus pricing means increasing the client's costs to increase the CPA's profits. In 12 years of accounting practice and over 30 years as a profitability adviser, I have never seen a CPA firm stretch their hours to make more money. Nevertheless, clients sometimes believe there is a risk their accountants will do so.

With today's emphasis on downsizing, reengineering, and doing more with less, cost-plus pricing is the exact opposite of efficiency. It creates what economists call *perverse incentives* on CPA efficiency. IBM once had a similar problem when it paid its programmers by the line of code they wrote. The programmers responded by increasing the number of code lines at the expense of efficiency.

By making hours important, you encourage the client to focus on hours instead of results. The myth that value is created from labor was popularized by Karl Marx. He called it the *labor theory of value*. It is ironic that so many accountants subscribe to this bedrock theory of socialism.

The alternate theory (on which capitalism is based) is the *subjective theory of value*, which holds that goods have no inherent value; instead, they are worth only what people are willing to pay for them.

But by charging a standard rate several times higher than your client makes per hour, you force the client to focus on your hours.

If your clients focus on hours, they constantly try to figure whether they can afford you and ignore the value you provide. The multi-dimensional value you create is turned, like gold into lead, into a one-dimensional, commoditized, easily compared price.

- Cost-plus pricing focuses on efforts, not results.
- Cost-plus pricing doesn't reward creativity and innovation; it rewards inexperience and inefficiency, even incompetence.
- Cost-plus pricing has its advantages. It's easy to explain to clients. It's easy to administer. It's easy to defend. And it is a great retail cost-accounting tool.

- Cost-plus pricing encourages people to work harder, not smarter, by reducing incentives to creatively increase productivity. It penalizes investments in technology. Many CPA firms originally hesitated to invest in software systems to mechanize the production of tax returns and financial statements because they were afraid their revenues would decline due to the decrease in chargeable hours. Cost-plus pricing encourages the hoarding of hours and discourages delegation.

Any time you use cost-plus pricing, you will have write-downs.