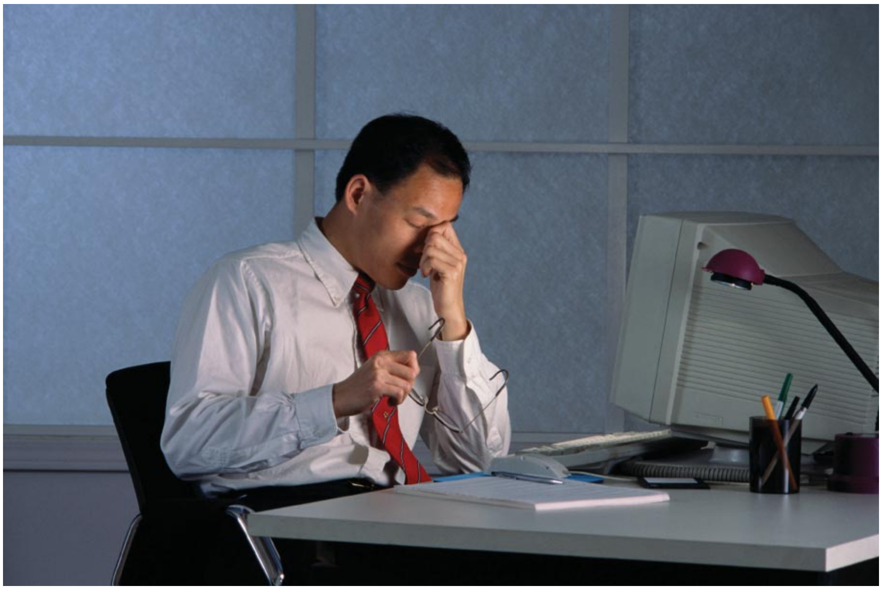

Pricing in professional services: the death of billable hours

Living and dying by time sheets and billable hours leads to de-motivation and, in the long run, stifles the innovative capability of the firm. Is there a better way?

Are professional services commodities?

Pricing is one of those areas that stirs up considerable controversy within the professions. Much of how professionals practice can be described as path dependent. In essence this suggests that what is done now is based on what was done in the past and this is particularly true when it comes to pricing.

In their ground-breaking book, *The Firm of The Future* (which is mainly targeted at the practicing CPA), Paul Dunn and Ron Baker describe a new paradigm for managing the professional service firm. There is considerable emphasis on pricing as they label the existing model of billable hours as both antiquated and potentially destructive. Any professional reading this article will be familiar with the following equation in some form or another:

Revenue = people power x efficiency x hourly rate

If one dissects this model, or one similar, it creates a paradox that is perplexing accountancy firms as well as other professional firms. For example, whilst leverage and billable hours are considered the crux of profitability within the professional service firm (PSF), to generate additional revenue requires either an increase in the hourly rate, an increase in efficiency (more output with less input), increased leverage and utilisation rates, or some combination of the above. Initially, this actually seems quite logical and even reasonable. However, when one considers the fact that research shows that productivity as measured by proportion of total hours charged to total hours available has not changed literally since the beginning of time, it seems then the existing model of revenue for the PSF is flawed.

If you prescribe to this labour theory of value, your firm may well be on the way to considering your services as commodities. Once this happens you cannot expect anything else from the customer except to be concerned with price. However, according to the Management of Accounting Practice (MAP) in the US, billing and pricing are one of the key issues facing the accounting industry. What this provides is evidence of a contradiction within the accounting profession, on one hand, many accountants roll their eyes at clients who only care about price, yet on the other hand, the same accountants do not fully understand what value they offer and resist marketing thought and practice in their operations even though more fulfilling work and better clients is what they want. As Tom Peters exclaims, shoot anyone who says their service is a commodity and cannot be differentiated.

Knowledge workers, time sheets and billable hours

Let's take some further examples. Professionals can be described as 'knowledge workers', a term coined by Peter Drucker some time ago, and as such the intellectual capital that exists within such firms is the only true asset or sources of competitive advantage. As societies and business in general become more complex, one would expect innovation in the form of analytic and advisory services to increase and a smaller percentage of so called commodity type services to decrease. Yet, this does not appear to be happening. Professionals seem willing to go after more and more low-level work and bid prices down. This has massive implications for the PSF and its people because such knowledge workers crave learning and development and this simply cannot be achieved by focusing on high realisation rates and the archaic practice of time sheet completion. Living and dying by time sheets and billable hours is like asking Picasso to paint by numbers. Eventually it leads to de-motivation and in the long run stifles the innovative capability of the

As societies and business in general become more complex, one would expect innovation in the form of analytic and advisory services to increase and a smaller percentage of so called commodity type services to decrease

firm. It also places an over emphasis on growth which may have nothing to do with profitability.

The whole issue of leverage and billable hours encourages professionals to value themselves by time and in fact encourages a lack of trust between client and firm as each becomes more concerned about how long something takes to do rather than the effectiveness of the job being worked on.

A new paradigm – value pricing

Value pricing is nothing new and it has been applied in numerous business sectors. In other words, instead of deciding price by calculating the number of hours needed to complete a job or arbitrary hourly rates, one should base pricing on the value created and delivered for the client. However, to do so means that the PSF must be able to deliver value that is perceived by the client as both meaningful and differentiated from other professional service providers. This comes back to the idea of realisation rates and the concomitant area of partner compensation. If one believes that their compensation is based upon the old model of revenue, it is unlikely that you would spend time on non-billable activities even though it is these times that are the lifeblood of creativity and innovation. Think about it like this, if the KCR wants you to ride their new route (such as the recently built West Rail), first they have to build the capacity and then await passengers. Yet in the PSF, this works in the complete opposite direction, new juniors and associates are not hired until expected utilisation is upward of 70%, this maybe great for billable hours but it does nothing to add to the innovation capacity of the firm which is where true long term success lies.

In their new book, *Client at the Core*, August Aquila and Bruce Marcus state that billable hours link value and time, yet in many cases, time has nothing to do with value. For example, a severe toothache in the middle of the night may only take the dentist five minutes to solve but the value to the person suffering the pain is considerable and they are willing to pay for it. For the PSF, it is imperative that they understand the value that clients seek and indeed even increase their fees based on the benefit that is provided.

Implementing value pricing

To adopt this new model in professional practice requires a re-thinking on the part of professionals about what they do and what their clients desire. Although these key issues are beyond the scope of this article, they are nonetheless very important. Here we will focus on some key points in implementing value based pricing from a client perspective and the impact that pricing has on other marketing activities and processes.

These fall into three broad categories:

1. *Understand what your clients need and the benefits they seek* – not all clients are the same. If you are working on complex issues for your client they may be more concerned about problem solving and intellectual capability than how much you are going to charge. Determine what they seek from you and charge accordingly. For example, by improving your client's business processes you may generate additional income for your client and you should be entitled to a proportion of this.
2. *Understand yourself* – no firm can be all things to all people. It is crucial that you understand what it is you are superior at and what you would like to be known for. Some large firms maybe be able to crank out low value commodity work in large quantities but if you cannot, then don't.
3. *Know the market* – it is not enough to know only what clients need as often client needs are shaped by market forces and indeed; they are often poor at expressing as yet latent needs. It is imperative for the PSF to have a solid understanding of both the professional services sector and what other firms are doing as well as their clients' industries so one can envision what new services and features maybe valued by clients. Innovation is often the key to charging premium prices and being perceived as different from your competitors.

There will be many instances where customers may not recognise the value that you offer and it will then put the onus on the firm to communicate this value clearly. Even then some customers are extremely price driven and if this is the case it maybe better just to let them go. Not all customers are good customers.

According to Thomas Nagle and Reed Holden, authors of the seminal book on pricing (*The Strategy and Tactics of Pricing*), there are five C's of value:

- Comprehend – what drives sustainable value for customers
- Create – value for customers
- Communicate - the value you create
- Convince – customers that they must pay for the value received
- Capture – value with appropriate pricing

Taking the value-based road is not an easy one but evidence suggests it is one that leads to greater long-term viability of the PSF and indeed contentment amongst partners, associates and clients. It may require losing certain customers and rejecting certain work but in essence, this means working fewer hours and making more money. If clients cannot perceive the value you deliver you may be better off passing them on.

Research by former Harvard professor and now consultant to the professions, David Maister, clearly demonstrates that increasing employee satisfaction causes increases in company financial performance. One key area related to satisfaction was challenging work and minimal repetitive-type work.

These findings suggest that time spent on non billable activities that enhance the position and reputation of the firm and its professionals can be crucial in being able to implement value based pricing approaches effectively

How satisfied do you think your people are likely to be when they are thought of as billable machines that live by their time sheet?

Pricing and marketing

Finally, it is important to point out how pricing affects other elements of marketing management within the PSF. Since services are essentially intangible, credence becomes a key factor as clients find it very hard to evaluate the quality of a service even after receiving it. Price can be a strong indicator of service quality and in different situations charging a higher price may in fact stimulate demand. For example, Valerie Zeithaml (a professor of marketing at the University of North Carolina and a recognised expert on services marketing) has shown that people will react to professional fees in different ways. These reactions will be based on the amount of uncertainty faced by the purchaser, limited information and time pressure. For example, if the need is urgent, buyers are less conscious of fees. She suggests that high fees may be preferred if customers perceive high risk and that customers will tolerate higher fees from professionals that have strong reputations and greater experience.

These findings suggest that time spent on non billable activities that enhance the position and reputation of the firm and its professionals can be crucial in being able to implement value based pricing approaches effectively. Additionally, spending time on innovation and being able to differentiate your firm will be time well spent over the mid to long term as the value of your work increases from a market perspective and your people will be doing what they truly enjoy. This will be reflected ultimately in the profitability of the organisation.

BOB SAWHNEY IS THE MANAGING DIRECTOR OF SRC ASSOCIATES, A STRATEGIC MARKETING CONSULTANCY THAT SPECIALISES IN THE MARKETING OF PROFESSIONAL SERVICE FIRMS. HE CAN BE CONTACTED AT BOB@SRCHK.COM, WWW.SRCHK.COM.