Value-Based Pricing

by Eoin Healy and Neil Hughes

A major downside of time-based billing is that it punishes efficient and highly skilled operators, who produce their work in less time than their less skilled competition.

What is Value-Based pricing?

Professional services firms face a number of challenges such as increased competition and advancements in artificial intelligence and automation which has squeezed margins and forced the industry into an introspective look at alternative pricing models. There are a number of alternatives that diverge from the traditional time cost pricing and one of the most popular is value-based pricing.

Value-based pricing sets prices based on the perceived value of services to customers or clients, irrespective of the time the delivery takes.

Critical information required:

- Knowledge of competitors historic pricing to ensure you are pitching at the right level
- Industry knowledge
- Specialised expertise to "add value"
- Do your homework on the client and assessment of their payment threshold

Put simply, it is a pricing strategy that tries to capture the extra value that a client associates with a particular aspect of the service you deliver. It ensures service differentiation, giving you a competitive advantage in your market.

How is this different?

Most professional services firms will use one, or a combination, of the following pricing strategies:

1. *Time Cost.* Hourly charge out rates (agreed with the client in advance of assignment via a signed engagement letter) multiplied by the number of hours performed. The hourly rate will vary depending on who is doing the work. Professionals with more experience tend to command a higher rate.
2. *Market Price.* This involves pricing a service at a level that is generally accepted in a competitive marketplace. Usually a generic service offering, which firms price low in an attempt to win greater market share through low margin, high volume.
3. *Fixed Price.* A fixed price service offering can be agreed up front with a client, irrespective of the number of hours, which is attractive to clients as it caps their potential exposure for ease of budgeting etc.

Example of Value-Based Pricing: Bookkeeping and Accountancy Services

In the competitive bookkeeping and accountancy services space, you could offer your clients a fixed cost of €2,500 a month for a basic bookkeeping service. Given the market, a rival firm may charge the same price, making it difficult to stand out from the crowd.

However, let's say you conduct market research and find your clients want a monthly financial reporting and advisory service, in addition to the basic service. You then add this service to your basic package as a bundle offering. This new service bundle may increase your time cost by €500 a month. Thus, the monthly fee would be €3,000.

However, if this additional offering doubles the value for clients (cuts down on double handling information and increases convenience and trust), a value-added pricing strategy would create a new price of €5,000 per month for the segment of the market that perceives the value added.

When is Value-Based pricing used?

It works well for companies with a strong brand identity or those who offer unique, specialised products or services, or offerings that have 'prestige' status.

Often, we may find ourselves paying more for a brand name and the value associated with its offerings over purchasing a similar product/service without the associated brand name (think Apple iPhones, IBM, Coca-Cola etc.).

In a professional services environment, this can translate to a client using a particular firm with a well-known industry specialisation who is willing to pay a higher margin for the increased expertise, but this is not typically suitable for heavily regulated compliance areas in the accounting profession, like audit.

Value-based pricing is best used when scarcity is involved, and it also suits processes where creativity is central. Companies that specialise in certain areas, niche markets and valuable services are also better positioned to take advantage of value-based pricing.

How do you implement a Value-Based strategy?

- You will require a deep understanding of what problem or solution your service is addressing and must determine whether or not clients would be willing to pay a premium for your service. For example, are you addressing a new regulatory amendment that your client needs urgent training on? Does the business face the prospect of insolvency? Does the client require urgent growth, or a cost cutting exercise to right size their profit and loss? Once your service is well defined and desired, you can start to offer clients this amended offering which takes into account the willingness of the client to pay a premium to navigate through these challenges.

- A greater understanding of your own cost structures will help you calculate a margin over and above your overheads and standard profit to charge the client.
- Determine whether or not your service is being offered to multiple clients. Do you need to tailor that service depending on their individual requirements? To know your clients and competitors, market research at this stage is critical.
- Determine the likelihood of success for your client and when pricing & billing, tie their success to your success. For example, if you are implementing a cost reduction analysis, you could link the level of successful cost savings to your fee, as long as this is adequately addressed in the scope and outcomes of the engagement letter.
- Meet with the client, explain your reasoning and show them why this is a service worth paying a premium for.
- Once the engagement is complete, seek constant feedback from your client to remain ahead of the curve.

Benefits

Considers different variables –
There are many factors to be considered when creating a price. It lets you distinguish yourself from the market so it can be more strategic than cost-based pricing.

Higher margins –
Returns generated are typically higher using this style of pricing strategy. Customers willing to pay premiums for services due to value obtained and uniqueness of the services offered is beneficial for businesses.

Client alignment –
In a typical hourly billing model, the focus is on the length of time it will take, who will do the work and the charge out rate. The client will also ask themselves: will it be worth the expense? In a value-pricing model, both the client and the service provider are aligned in their thinking, and more importantly, their interests are aligned which leads to increased consultation and results.

Billing predictability –
No client likes surprises when it comes to billing. Value-based pricing, when done correctly, is adequately priced and scope is agreed in advance of starting the engagement. The client has certainty and there are no unexpected charges at the end of the engagement. In time-based billing, clients are often reluctant to pick up the phone and ask more questions at the risk of being charged for the privilege.

Helps create higher quality services – It can help you research the market and competition which will in turn help you to adapt or refine your ideas to offer better customer solutions.

Issues

Price is harder to set / More Subjective –
It can be difficult to estimate the perceived value of a service.

The value-based pricing strategy is not an exact science and involves more planning prior to starting an engagement. It will typically take longer to agree a pricing and billing framework with the client and is heavily weighted towards the customer preferences and willingness-to-pay.

Requires a lot of resources –
A relentless commitment to continuous training of staff and keeping highly skilled professionals on the payroll can be expensive but is often offset by the higher margins derived from value pricing in the long run. Firms may come to the conclusion that a lack of investment in their staff and a generic service offering may be a better use of their time and resources.

Perceived value may change –
It requires consistency and dedication to maintain prices and determine the value of your differentiation. If the price is no longer accurate or reflective of the current market, you could end up losing business. Conversely, if a project takes longer than expected, you are not paid a premium for this extra time and you may also miss out on other opportunities.

Client push back –
Not everyone will appreciate the benefits of value pricing.

Clients may simply reject it as a concept, preferring a more traditional time cost and/or fixed price charging model. Competitive markets and price sensitive markets are not typically suitable for value-based pricing strategies.

Overall, it is clear the most successful professional services firms employ value-based pricing as often as possible. Time does not come into play with value-based pricing. Thus, if companies spend little time coming up with a unique idea, they can use the value-based pricing strategy to their advantage.

One of the major negatives of time-based billing is that it punishes efficient and highly skilled operators, who produce their work in less time than their less skilled competition, who take longer and charge more. This is perhaps the best reason to embrace a future where time cost is not the sole method of billing your clients.

Eoin Healy
Director

Eoin is a Director in the corporate advisory and restructuring team at Baker Tilly Ireland.

Neil Hughes
Managing Partner

Neil is Managing Partner at Baker Tilly Ireland, an insolvency practitioner and experienced examiner.

> **"Competitive markets and price sensitive markets are not typically suitable for value-based pricing strategies."**