

**CREATIVE PRICING ISSUES IN CPA FIRM PRACTICE
FOR ETHICAL AND PROFITABLE ACTIVITY**

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Abstract

The CPA office of “yesterday” was comparatively devoid of technology, relying on extensive labor, pencil pushing, manual spreadsheets, and green-bar printouts. A few adjusting journal entries could have taken several days to apply. The office of “today” still carries the traditional breakdown of total cost into raw materials, direct labor, and overhead. Significantly different, however, is the emergence of a swing in relative percentages of each cost to the firm. Client services are frequently spelled out in engagement letters, but some CPA firms are witnessing an increasing disadvantage of retaining the generally accepted approach of billing their work performed as a function of direct labor hours at the rate of the individual(s) performing the services. With increased emphasis on technology

applications in processing client needs for financial statement services, income tax returns, management consulting, and other work, overhead costs balloon over the labor costs. Accordingly, incremental true costs tend to avoid capture in the pricing formula for client work. This paper offers a creative value pricing approach as superior to any method relying on cost drivers, one which CPA firms may apply to either public or private clients.

INTRODUCTION

This paper illustrates the growing concerns over billing practices, addresses the relative advantages and disadvantages of billing by hour versus billing by value or price, and provides a means to evaluate and arrive at a more optimal method for a CPA firm under constrained conditions. Prior research is considered in formulating a set of guidelines for pricing client services. Ethical and public policy constraints are considered. Outcome and quality measures are seen to be of increasing importance over the traditional input measures of time and cost recovery. Some pricing models may even place a strong emphasis on external and environmental factors.

Narender (2014) observes that changes in numerous variables in attest work such as client size and entity complexity contribute to consideration of non-traditional billing methods. Others (Shepherd, 2010; Pryor and Elfrink, 2014) find that some form of invoicing based on client value received may even be appropriate in non-attest engagements. The authors of this paper caution the reader on the need to perform individual analyses on a situation-by-situation basis, and illustrate an example for a private entity client.

VARIATIONS IN PRICING APPROACH

The long-time traditional norm for professionals such as attorneys and CPAs has been to bill services on the basis of billable hours incurred by the firm. However, recently alternative pricing models such as fixed fees and value pricing have come into play, often at the request of clients. It is conceivable that these alternative models can result in a win-win situation for both the client and the professional firm. Fixed fees set a particular price on a particular service. Disadvantages of hourly billing were recognized as early as the 1970s and 1980s where there was growing experimentation with alternative billing practices (Tarr, 1973; Rachlin, 1984). Tarr notes that streamlined billing can save partner and staff time, and reduces the chances for errors. Rachlin argues that enhanced billing may be especially appropriate for off busy season engagements, engagements that are less price sensitive to clients, and to existing clients overall. In addition to the short-run profitability return, Baker (2009) offers a series of advantages to pricing for value, including the following items in Figure 1:

Figure 1. Advantages of Value Pricing

- Manages, clarifies and offers the firm the ability to exceed the client's expectations;
- Provides the opportunity to cross-sell additional services;
- Forces the firm to be effective in project management and to get the work done within the time promised to client;
- Overcomes the client's pricing emotions and maximizes the firm's price leverage;
- Uses price bundling, allowing the client to focus on the totality of the firm's value proposition rather than the price of each service.

Source: Drawn from Ronald J. Baker, Pricing on Purpose: How to Implement Value Pricing in Your Firm, *Journal of Accountancy*, June, 2009.

These and other qualitative factors may be important for long-run client retention and satisfaction, and ultimate mutual profitability. Podgers (2011) points to the 1989 considerations by the American Bar Association where potential benefits were outlined in *Beyond the Billable Hour*. Podgers concludes that service firms need to recover costs, but that formulas based on “chargeable time” may not be sufficient.

The traditional “billable hours” approach is based on inputs, whereas “value pricing” is based on outputs. Value pricing facilitates new business development for professionals, encouraging more contact between the accountant and the client, and fosters the development of extended professional services. While arguments can still be made for standard hourly billing in many instances, fees based upon alternatives of some fixed pattern, whether it be called value billing, value pricing, or something else (the authors of this paper prefer “creative pricing”), present interesting dilemmas for CPA firm management.

“Creative pricing” should not be confused with manipulation, or any fraudulent or illegal practice. The authors address later in this paper ethical and policy concerns that some may raise regarding the use of a creative value pricing as a standard business practice.

FORCES DRIVING CHANGES IN CPA FIRM PRICING

In *Accounting Office Management & Administrative Report* (Anonymous, 2009), the author reported that professional service firms were not letting the recession of the first decade of the 21st century stop their plans to increase their billing rates. The hourly rate was still the leading way that CPA firms bill, with *CPA Firm Practice Management Survey 2010* reporting 63.8 percent of billings being managed that way. The next most popular approach to billing described “at a very distant second is a set fee for complete engagements, cited by 14.9 percent of the respondents,”

and that “Value billed engagements are 11.4 percent of billings among responding firms.”

In recent years fixed fee and value pricing models are being used with heavier frequency in CPA firms. Drew (2012) finds that value pricing from 2010 to 2012 increased from 41% to 56% for firms under \$10 million in annual revenue. Baysden (2014) reports that accounting professionals have moved away from the billable hour approach to some kind of fixed fee model in order to improve client retention and also to increase profit margins. Baysden also notes that according to a 2012 survey, three quarters of U.S. accounting firms use some sort of fixed-fee pricing and that the percentage using value pricing jumped to 56% in the 2012 survey from 41% in a 2010 survey.

Some firms are engaging in innovative approaches to pricing. Drew (2015) notes how firms are experimenting and succeeding with new business approaches. For example, a Michigan firm has leveraged value pricing and niche specialization to offer consulting services to restaurants. As early as the 1970s, Tarr (1973) observed that value billing can be especially effective in tax examinations, reorganizations, and special rulings. Baldacchino and Borg (2015) recommend value pricing overtime-based billing to shift the focus away from internal costs of generating the service toward aligning the interests of auditor and client.

BARRIERS TO ALTERNATIVE PRICING IMPLEMENTATION

Without an understanding that the scope of work may change, fixed fee pricing could become expensive to professional firms, as accountants have to stick to the price even if the job ends up taking more time than expected. As Baysden (2014) indicates, fixed upfront pricing requires more upfront planning by CPA firms. With hourly billing, the meter is always running, protecting the service provider. Furthermore, the alternatives to hourly

billing require the investment of early planning where initial meetings with clients play a crucial role in the engagement's success. With questions focusing on value perceived by client, firms can understand the client's goals and objectives, and then both buyer and seller determine the definition of success. This works especially well in consulting engagements, but could also apply to tax and attest services.

Broomhall (2013) reports that a majority of law firm partners still favor the traditional hourly rate model approach to billing, despite pressure by clients to switch to a fixed fee or value pricing model. According to Broomhall, the survey results reveal that whereas 63% of respondents found it easy to place an accurate value on work delivered when using hourly billing, 80% found it difficult to do so when using fixed fees. As noted by Broomhall, when using fixed fees, only 12% of respondents said the final bill was about right— compared to almost half who said the bill was about right using hourly billing, and “More than 80% said fixed-fee deals undervalued the work carried out.”

To protect both service provider and client, the use of the “change order” has emerged and is extremely beneficial to implementing creative pricing. Having the ability to modify the engagement for increased work to the benefit of both parties—the CPA firm provider and the client being served—builds in reasonable flexibility. The CPA firm is much more likely to charge the additional fees for amounts that can be fairly clearly estimated, are seen to be needed in the short run, and can be billed and collected quickly. Baker (2008 and 2009) is a strong proponent of change orders and he sees them as a mechanism to align with the qualitative aspects of the CPA firm work beyond pure profitability.

Richard Lewis describes “the shift to fixed fees as inevitable, but added that value can be maintained by ensuring good communication and implementing project management-style strategies.” (Broomhall, 2013). Broomhall also quotes Clifford Chance global litigation head Jeremy Sandelson: “There has been

less of a move towards fixed fees in litigation than on the transactional side, simply because it is harder to predict what is going to happen. Providing you deliver value, many clients accept hourly billing. They recognize that it is extremely difficult to quote fixed fees in litigation.”

COMPARATIVE ILLUSTRATION

The traditional billing structure can be compared with a value or creative pricing structure in a manner that highlights differences that might occur in a small to mid-size local firm for a non-public client on an annual basis. Figure 2 shows the billing pattern based upon the rates of individuals who have performed the work. The rates are known in advance, but the hourly amounts depend upon the actual labor involvement to be expended later and charged to client.

Figure 2. Traditional Billing Structure

Individual Work	Labor Rate
Partner	\$250/hour
Manager	\$180/hour
Senior	\$120/hour
Junior	\$90/hour

With the client as a private company, the immediate issues of independence and ethical compliance for engagement of both attest and non-attest work over the year are less restrictive than for an SEC client, and for this illustration independence is assumed to not be impaired (AICPA, 2015). Accordingly, creative pricing requires good analysis, a foundation of a reasonable budget, and in cases where the client’s demands during the engagement exceed expectations, the ability to infuse a “change order.” Figure 3 shows how a fee can be established based upon strong estimates of the work to be performed.

Figure 3. Creative Pricing Structure

Client Project	Forecasted Amount
Sales and use returns and payroll returns	\$XXXX
Entity federal and state income tax returns	\$XXXX
Quarterly compilations	\$XXXX
Other attested financial statements	\$XXXX
Other/consulting	\$XXXX

To determine a forecasted amount, the mechanism of an implicit billing rate by individuals involved in each phase of the work or client project and the respective hours is still needed. However, one researcher emphasizes that the forecasting approach can become arbitrary, where similar transactions of similar value, but for different clients, could yield different amounts (Stanley, 2000). Creative pricing requires more front-end work based on solid estimates, both in terms of cost and value to the CPA firm and to the client. If communicated correctly to the client, the provision for change order may be included. The creative pricing structure then becomes one based on client outputs, not CPA firm labor inputs. Baker (2008) argues that accounting firms should abandon the time sheet, rather than attempt to find corresponding relationships between time labor and client value. With the view of serving the client on value delivered, budgeted information gathered in Figure 3 is only a “first efforts” starting point, possibly indicating minimums, but certainly containing amounts that would be tailored over iterations for the unique client or customer served.

Vien (2015) amplifies the Baker argument by stressing that the cost-plus model is oriented to service first, then to cost, price, value, and finally customer, while value pricing looks first to customer, then value, followed by price, cost, and finally service provided. What remains for the traditional billing scenario is to apply the input of the direct labor hours worked, sum over the products, arrive at grand total and present the appropriate

invoice(s) to the client. Figure 4 shows what might occur. For simplicity, it is assumed that there are exactly four individuals that worked on the client, when in reality, different individuals in the firm at the same work level/title may work on the client and carry different billing rates.

Figure 4. Traditional Billing Structure--Applied

Individual Work	Labor Rate	Hours Charged	Extension
Partner	\$250/hour	12	\$3,000
Manager	\$180/hour	25	4,500
Senior	\$120/hour	50	6,000
Junior	\$90/hour	70	6,300
Total			\$19,800
Additional work by Sr	\$120/hour	20	2,400
Billed Total			\$22,200

Figure 5 provides comparative amounts that would occur under the creative pricing model.

Figure 5. Creative Pricing Structure--Applied

Client Project	Forecasted Amount
Sales and use returns and payroll returns	\$800
Entity federal and state income tax returns	8,000
Quarterly compilations	1,200
Other attest financial statements	12,000
Other/consulting	2,000
Total	\$24,000
Additional work—Change Order	4,800
Billed total	\$28,800

ECONOMIC PROFITABILITY ASSESSMENT

Common to both traditional billing and creative pricing is the recommendation for monthly progress billings. Also recommended is outlining on the front end in an engagement letter to the client, the rationale for invoices, typically with as few of the details as needed, but with sufficient information to satisfy the client. With creative pricing the additional advantage of monthly billing the pro-rated amount exists. In the case of Figure 5, the amount of \$24,000 for the year would appear in the annual engagement letter prior to performing any work, but calling for monthly billing of \$2,000. If the change order requirement for increased engagement came through at the end of the tenth month, the amount of \$4,800 is communicated to client, and the additional \$2,400 for each of the last two months is tacked on for totals of \$4,400 for each of the last two months. Hopefully, collections would soon follow in the same amounts.

Which scenario is superior—hourly or value? Under any method, partner discretion and last minute discounting or write-downs could be a mitigating factor. The amounts shown above points to creative pricing as the winner. Even without the change order, the firm is clearly better off by \$4,200 (\$24,000-\$19,800). If the change order involved additional overhead, such as computer software, or perhaps by individuals in the firm at higher billing rates than the senior, or by outside consultants, then the creative pricing is especially appropriate because that can be put in place immediately for faster and fuller recovery.

This hypothetical scenario is based on the assumption of no exogenous factors, and it is recognized that the scenario might be criticized on the basis of not having precise amounts and the absence of information on all the variables that might be involved with each. However, the bottom line difference of \$6,600 (\$28,800-\$22,200) can be significant to the small firm and applying creative pricing over portions of the client list should be considered. Qualitative intangibles may also play a part in arriving at the optimal pricing structure. Firms may elect to pick and

choose which clients they want to convert to an alternative structure, and then may decide to have phase-in periods. The illustration is simply a “first efforts” scenario. Value to the client improves over time and with experience over the client base. Accordingly, creative pricing can be the winner when it comes to profitability.

ETHICS AND PUBLIC POLICY ASSESSMENT

Causholli and Knechel (2012) cite Zeff’s work in 2003 finding that excessive emphasis on profitability caused partners to lose focus on audit quality, and the earlier work of O’Keefe, Simunic, and Stein in 1994, where auditor’s speak of value-billing their services but that meaning profit maximization to the firm only. Attempts to deal with fee pressures may create unintended consequences such as reduction in audit hours and excessive reliance on “prepared-by-client” evidence and internal auditors. These issues and relationship between inadequate assessment of risk and over- or under-auditing is beyond the scope of this paper.

As previously discussed, the assumption continues that the attest and non-attest work performed for the non-public company do not by themselves raise the dilemma of conflict relating to independence. CPA firms may use different teams of individuals for attest and non-attest work. Also, non-attest and attest engagements may be separated sufficiently in time. However, ethical and policy considerations exist at three levels with respect to creative pricing:

- (1) Perception of contingent fee,
- (2) Perception of anti-competitive measures, and/or
- (3) Perception of biased practices when cost and billing ratios vary.

Contingencies

Public policy considerations must be examined when considering pricing practices. Some may be concerned that

creative pricing could be more susceptible to bribery and be in a violation of the contingent fees for CPAs on both attest and non-attest engagements. For example, “I will pay you more if you give a clean opinion.” Firms could alternatively simply inflate the hours worked as easily as inflate the creative price. Accordingly, the less detail in creative pricing versus traditional hourly billing does not make it any easier to be fraudulent. Serving the public interest is one of the fundamental principles of The AICPA *Code of Professional Conduct* (2015). In addition, under the provisions of the AICPA’s *Code*, the offer to be paid more for generating results of a greater refund to a taxpayer than what is actual based upon a true and accurate income tax return, is clearly unethical. Contingency does not exist in pricing services in advance regardless of outcome, as is the case with creative pricing.

Anti-competitive measures

Professional services in the 21st century should be priced on the basis of the service output provided, not the labor input. The notion that accountants are “piece” workers, producing a manufactured good, rather than a value information proposition, is an antiquated one, and a legitimate understanding of the accounting profession dispels the argument. When tied to overly strict rules for minimum percentage realization and utilization, firm management is overlooking the holistic nature of both the CPA firm’s business and the client’s business. In fact, more competition exists when various firms offer value packages where price is but one of many discriminating factors to the scrupulous buyer of the accounting services.

Cost to retail relationships

The third consideration surfaces when the argument contains the slippery slope of the need for due care in maintaining some correspondence between cost incurred by the firm and the amount charged to the client. Various cost systems can be used, and some can produce wild results when amounts are grossed up to

bill clients. For example, Activity Based Costing (ABC) in itself can become very time-consuming and expensive. Cost drivers and information should certainly be assessed and periodically evaluated by the firm, but there is no need to cling to the cost system when pricing the service. Pricing can be a function of more than just cost; it may be based on performance measures, how quickly a job is performed, client satisfaction, revenue generation per employee, and qualitative factors the leadership team deems relevant.

All three of the preceding perceptions are based on weak arguments as they are all grounded in a theory that CPA firms must base their client engagements, including those won away from other firms, on the basis of price alone, or perhaps price with some construct of quality. Firms cannot compete on price, as they cannot do a better job for less in the long run. Attempting to do this leads to price cutting and thin margins. Firms for the majority of their services are also not able to compete on quality, because other firms in this highly professional arena should be able to produce a high quality tax return, and high quality audit. This vision is consistent with the views of Baker (2009).

Where a firm can compete is on the basis of service; the holistic nature of the services provided is in the nature of the creative pricing model. Working with clients in assisting businesses to grow, to provide the valuable advice moving forward as trusted business advisor, as well as providing the traditional array of services, is the bundle that the winning professional CPA can and should offer. Creative pricing should not be tainted with thoughts of unethical practices, but rather be hallmarked as a methodology for profitability in the short run and overall firm sustainability and strategy in the long run.

CONCLUSIONS AND SUGGESTIONS FOR FURTHER RESEARCH

An experienced practitioner with over four decades of practice and consulting concludes that accountants are far more price conscious than are their clients, and the clients who are the most price-sensitive are frequently the clients the firm is better off firing anyway (Cottle, 2013). Griffiths (2014) finds the effectiveness of billable hours to result in defensiveness and silence, whereas the alternative of finding value for client and pricing accordingly prompts inquiry, understanding, and growth.

Creative pricing may not be appropriate for all CPA firms. For the CPA firms which utilize creative pricing, selection of the client base, and even types of projects (tax versus financial statement versus consulting work) for a given client might give rise to exceptions. A firm with a large number of individual income tax clients might easily justify traditional hourly billing. Also, some “older” clients, whether individuals or entities, may prefer the comfort level of seeing traditional labor time charged. Researching preferences on this “demand-side” part of the companies’ management may provide useful data to compare with the provider “supply-side” CPA value proposition and practices.

Given the assessment for ethical and public policy considerations, there should be no complaint that a firm tie its pricing to its cost system, nor to impair the firm’s ability to charge what the market will bear. The public accounting profession is changing. Technology is becoming increasingly inherent in all work—and for true profitability, that burden must be priced into the services provided. Client resistance to high labor rates is natural, and the concept of “bill” rather than “value price” may not be the image the practitioner wishes to leave with the client.

Furthermore, some progressive CPA firms themselves are doing away with traditional titles of “junior” through “partner,” replacing with concepts of “producer,” “in-charge,” and “responsible person,” where the new terms are not titles but simply labels for individuals who work with a particular client. The

producer on one client may be the responsible person on another, and so the firm is able to maintain its client-focus, hopefully with less politics of hierarchy. Research on such aspects of firm culture may render suggestions on how to improve pricing practices.

Those who see “creative pricing” as an unfair business practice driving unethical treatment of clients are less likely to be risk-takers and entrepreneurs. Surveys asking utility preferences could bear this out, and interesting comparisons could be drawn between practitioners, their clients, professional standard setters, regulators, and academics. Pricing a CPA firm’s services will remain a continuous hot topic among the partners and owners.

Whatever the ultimate billing mix in a particular firm’s practice, should traditional methods of time-keeping and work expended be continued? Regardless of the type of pricing or billing employed, firm management may believe strongly about the need to capture their labor cost information as well as supplies and overhead in order to perform their own cost controls and responsibility accounting. Accordingly, do firms need information about their own utilization as well as realization? Surveying firms for their level and depth of time-keeping as well as pricing would also make for interesting research.

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