

Pricing Consulting Services: An MBA's View

Ask any group of consultants how they set their fees and you are likely to get a variety of responses. They:

- ♦ asked a few friends what they charge.
- ♦ asked clients what they wanted to pay.
- ♦ researched surveys from professional associations to see what their members charged.
- ♦ estimated the income they needed for the month.
- ♦ guessed.
- ♦ threw a dart at a board.
- ♦ consulted a Ouija board.

Every consultant has tried one or more of these methods, or variations of them, at one time or another with differing degrees of success. Which is best? The answer depends on where consultants are in their careers, the type of practice they want to pursue, and the market for their services. An approach that works in the early years may provide a basic income but will limit the individual's ability to plan for the future; a strategy that was effective for one type of consulting may not apply to another.

We'll look at three types of pricing strategies. They are market price, cost-plus, and added value.

Market Price

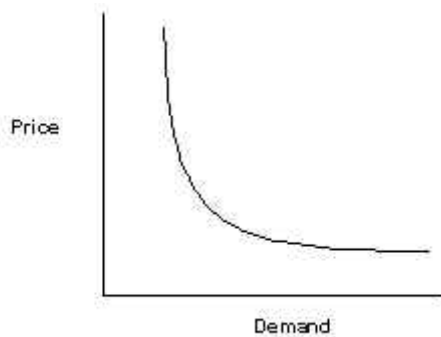
Market value is a price paid for consultants with similar experience in the same market for comparable services. The challenge is to discover the "true" market value. When starting out, most consultants ask a few friends and colleagues what the "going rate" is for a particular type of service, then they adjust the answers based on their own view of how they fit into this market.

While this approach may work for someone who truly has no concept of what to charge and must come up with a quote in a few hours, it is fraught with dangers. One that new consultants seem to fear consistently is quoting a high rate and losing the business; they set a low fee they think they can get.

Another problem is that some people assume they must set a low price for their services to break into a market. Then, they think, they can raise their prices when they are established. The difficulty is that they have put themselves into a niche and clients immediately start thinking of them as less qualified than their higher priced counterparts.

It is a human tendency to think that products and services are worth what we pay for them. For example, imagine yourself going into a store to buy a gift for a friend. You decide that, because this is a good friend, you will spend up to \$50. There it is, the perfect choice: a lovely glass paperweight. You think to yourself, "If that isn't too much over my budget, I'll get it." You pick it up, carefully turn it over and there's the price: \$14.95. "Oh, it's not what I thought it was," you decide, and put it back. That is the reaction of many clients when consultants underprice their services.

Another source of the problem may stem from a rather naive view of pricing. Some people assume that the old price/demand curve they saw in Economics 101 applies to all goods and services. In this model, the lower the price, the higher the demand, thus producing the familiar curve:



The pitfall with this model is that it assumes a perfect market in which both buyers and sellers are equally knowledgeable. All buyers know all sellers and agree on the value of each seller's services. Of course, that is where the model breaks down. There is no way for every buyer to know everyone providing a service; if you think it is possible for buyers to agree on the value of even one provider, try sitting on a committee whose job it is to select the carpet for a high rise condo building's lobby.

So, what to charge? Some consultants adopt the old maxim: whatever the market will bear. Years ago, some friends and I attended a panel on consulting. At the time, we were trying to screw up our courage to ask clients for the outrageous sum of \$50 an hour, up from the \$35 and \$40 many of us were making. One of the speakers, Dick C., was asked what he charged. Without blinking, he responded that he charged \$100 an hour. "Sure, I don't work as much as some people do," he explained, "But, then, at these rates, I don't have to."

But this type of approach won't work for everyone. Dick's advantage was that he was an expert in a narrow field and knew many people who needed his special skills. He also had the nerve to set a high price and avoid a nervous giggle when stating it to a client.

So, the Market Price approach works well if the consultant has no idea what to charge and will accept any rough estimate or if he knows what the right market price is.

Cost Plus

One method for more experienced as well as for those just starting out is to base the fee on what he or she would earn as a staff employee. However, this approach fails to take into account costs the consultant incurs as a businessperson. To make a fair comparison, he or she needs to consider:

- ♦ Salary
- ♦ Benefits
- ♦ Expenses
- ♦ Profit

Salary

Unlike staff jobs, consultants are not paid when they are not working. For example, the majority of employers pay their employees when they take time from the job to attend conventions, training programs, and meetings held during the day by professional associations (not to mention the time spent on the phone for non-billable calls, potty time, and long lunches with prospects). Unless an extremely generous (and perhaps unbalanced) client decides he will benefit by sending a consultant

to a seminar, she pays for it herself. Not only must she pay the cost of attending the seminar, she must also pay for her time for attending.

Experienced consultants estimate that, as a maximum, they can sell 1500 hours of their time a year (or 15-16 days a month). And that is in a good year. An average over several years is more likely to be 1200. For prudent calculating, financial planners recommend a base of 1000 hours a year. The rest of the time consultants are:

- ♦ Marketing
- ♦ Improving skills
- ♦ Making copies
- ♦ Researching clients
- ♦ Buying supplies
- ♦ Keeping records
- ♦ Invoicing clients
- ♦ Worrying

But using the annual salary is a good place to start. For example, assume a reasonable salary in industry for senior people is \$80,000. Setting the salary means, with no expenses or benefits, a consultant must charge at least \$80/hour just to offset the salary.

Benefits

Benefits include FICA and health insurance as a minimum. (I consider paid vacation, holidays, and paid sick leave as benefits with a separate price tag. They are factored into the base salary.) Many companies offer more extensive benefits such as education, disability and life insurance, and company-paid retirement plans. Ten or fifteen years ago, the value of fringe benefits was as high as 40-50% of the base pay. Today, a sizable number of companies have become less generous; employees now pay part of the cost of some benefits and forego others altogether. So, for prudent financial purposes, the value of fringe benefits is estimated at 30% of base salary. The benefits break down as follows:

FICA	7.65%
Insurance (Health, life, disability, Worker's Comp)	12.00%
Retirement	5.00%
Education, seminars, professional training	2.00%
Misc. (subscriptions, memberships, etc.)	3.35%
	<u>30.00%</u>

When these benefits are added to the consultant's base of \$80,000, the annual earnings become \$104,000. The hourly rate is \$104.00.

Expenses

Expenses include items like rent, computer equipment and supplies, secretarial, internet, telephone/fax, utilities, postage/UPS/ FedEx/messengers, and transportation, to name only a few. Again consulting our prudent financial advisor, a conservative estimate is \$25,000 a year. Adding

expenses to the base rate, the consultant needs to earn \$129,000/year, or \$129 an hour, to earn a comparable salary of \$80,000.

The Results

When a client asks a consultant to work for \$400/day, he or she is offering the same as a \$17,500 annual salary. This is slightly less than the starting pay for a guard at the Cook County, IL, Jail. (\$400/day = \$50,000 on an annual basis (1000 hours. Subtracting \$25,000 for expenses leaves \$25,000. After adjusting for benefits as 30% of base pay, the result is \$17,500.)

When a consultant asks for \$800/day, he or she is charging the same as a staff person making \$52,500 annual salary.

The calculations thus far do not include profit, although consultants are taking risks as any entrepreneur. As such, they have right to a profit; a typical business profit ranges from 5-15%.

Client Reactions

The real problem arises when clients ask for an hourly rate. The consultant, armed with an artful analysis, quotes a seemingly reasonable price of \$150. The client quickly multiplies the rate by 40, to get a weekly number, and multiply again by 50 to get a rough estimate of the annual fee. The result is more than the client's boss's boss makes!

The solution is to use the hourly rate to arrive at an estimate for the total project. The first step is to estimate the time required for the project, then multiply it by the hourly rate.

Jane's Quick & Dirty Guide to Estimating Time

Project estimates generally result in both happier clients and consultants. This approach lets the consultant discuss adding value to the client's operations rather than adding to the expenses. For example, I discovered the value of project fees 18 years ago when a prospective client balked at paying my hourly rate to design a training program for supervisors. I knew I could do the work and did not think my rates were out of line, but I was getting nowhere trying to convince the client of the rightness of my position. Becoming frustrated with the stalled negotiations, I asked her what she expected to pay for the whole course. When she quoted a figure higher than I had estimated, I knew we could strike a deal. I offered to produce all the deliverables at a little less than her quoted price to show my "good faith." Thus began a long, productive relationship that continues to this day.

In the training field, clients often prefer a fixed fee because it lets them better predict their costs. The challenge for the consultant is coming up with the fee. Following are examples of techniques many consultants use when estimating time. These guidelines assume that the consultant devotes most (at least 75%) of his or her time to one project. Stopping/starting and jumping from project to project can add 10% - 25% additional time.

Printed Training Materials

For printed matter, first estimate the number of pages, then how long it takes to complete a page, including the time spent researching, designing, writing, editing, and producing final copy.

- ◆ Front matter: 10-20 pages
- ◆ Introductions: 1 page per chapter/topic
- ◆ Individual procedures or subtopics: 1 - 3 pages each (plus sample forms)
- ◆ Reports: 1-2 pages per report
- ◆ Glossary: 3 pages per 300 pages of text
- ◆ Index: 10-15 pages per 300 pages of text

Multiply total pages by:

- ◆ 3 hours per page, including analysis, design, writing and editing
- ◆ Add 1 to 1.5 hours per page for desktop publishing
- ◆ Add .5 hours for usability test and editing

As a last step, multiply the total hours by the hourly rate to reach a product estimate.

Classroom Training

Here is another approach when estimating the amount of time needed for a variety of approaches used in the classroom.

1. Estimate number of topics to be covered.
2. Allow one to one and one-half hour per topic.
3. Add two hours for introductions and wrap-up.
4. Multiply topics by per hour time factor:

Self-contained training	50 hours
Technical training	30 hours
Management Development	25 hours
Multi-media	200 - 300 hours

These numbers are the rough rules of thumb. So many factors can cause the times to vary, such as experience and knowledge of developer, etc. Still, large numbers of consultants find these measures consistently provide them with accurate estimates.

In today's fast-paced business world, clients often put limits on the length of classes. They cannot free up participants for five days of training, no matter how valuable the content. This actually makes it easier to use an hourly factor to estimate fees for sessions that last a day or longer. Once a design is agreed upon, the client is less likely to request changes that will cause the session to run longer.

I have also learned that my estimates are very close to those of colleagues: for every hour of classroom instruction, I will need 20-25 hours if I am working for a new client in an area in which my own knowledge is limited. Over the years, many clients have told me that the numbers for internal staff is somewhat higher: from 25-40, depending on the level of experience, other demands, previous projects, etc.

Ten Quick Tips for Saving Time on Training Projects

When it is necessary to shorten the time needed for a training project, the following tips provide guidance:

1. Use a streamlined analysis. Rather than reinvent the wheel with each project, use existing analysis or documentation.
2. Combine analysis and design.
3. Incorporate materials already developed.
4. Incorporate commercial materials.
5. Develop job aids.
6. Use computer packages.
7. Team with a subject matter expert.
8. Team with a group of potential trainees.
9. Use prototyping.
10. Consider alternatives such as coaching.

Added Value Pricing

Market Value pricing presents many consultants with the risk of underpricing their services while the Cost Plus approach intimidates some with its emphasis on mathematical formulas. A third alternative, used by a number of more experienced consultants is to base their fees on the value they add to the client's operations. The trick is to set a price that reflects that value.

One of the best presentations of this approach is found in Alan Weiss's Million Dollar Consulting (McGraw-Hill, Inc., 1992). In it, Weiss argues persuasively that fees should be based on the value of the outcome to the client, the consultant's contribution to the outcome, the relationship with the client, and the consultant's costs to complete the assignment. Weiss points out that using such an approach requires discipline. Consultants must:

- ♦ Cite a fee only when ready. Offering an estimate too soon may box in the consultant to a bid that's too low for the work being considered.
- ♦ Be prepared to live with ambiguity.
- ♦ Build a relationship with all of the important decision-makers.
- ♦ Reduce fees only by removing services and, implicitly, value.
- ♦ Turn down business when clients insist on lower fees for the same service.

Conclusion

So, what to charge? Consider the following factors when setting a fee:

- ♦ Relationship with the client. Beware of trying to buy a client's loyalty by charging a lower fee. Many consultants have learned (to their dismay) that they have been dropped by a low-paying client in favor of a firm that is "more experienced."

At the same time, a consultant who has a pleasurable, ongoing relationship may want to hesitate before raising prices too much or too often.

- ♦ Experience. More senior people in a field generally earn higher fees.

- ♦ Professionalism. Some consultants see themselves as helpers who take detailed directions from the client. Those who see themselves more as experts or advisors will command higher fees.
- ♦ Field/industry/location. Some specialties, such as video writing, pay more than others do. In addition, some industries may offer a premium for experience. Last, consultants in large, urban areas are usually able to charge more than are those in smaller markets.
- ♦ Education. For the most part, consultants with PhDs earn more than do their counterparts without the degree. Also, specialized education or certifications may command a premium.
- ♦ Barriers to entry. If a field requires a hard-to-obtain license or certification, that requirement is a barrier to entry and consultants having it can charge more for their services. For example, a CPA gets a higher fee than do accountants without the designation.
- ♦ Chutzpah. Consultants often settle for lower fees because they lack the nerve to ask for more, while others with less talent and experience receive top fees simply by asking for them.

One reason for so many different rates charged by consultants is that we operate in a world of imperfect knowledge. The first step in achieving better fees is to understand the difference between working as a temp and running a business. When consultants realize that their positions are as valid as those of the clients they serve, they will be able to set fees and estimate time for projects that let both of them achieve your goals.

Sources:

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