Understanding a fee-for-service model

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A fee-for-service model is a system of pricing services. This system has been adopted by businesses providing a service where customers or clients pay for the service they receive.

From a client's point of view, they will pay a fee that represents the value they expect to receive from the service.

From a business' point of view, the fee charged incorporates:
> the time taken to complete the service;

> the degree of complexity and level of expertise and responsibility required to complete the service;

> any risk associated with providing the service; and

> what the client is willing to pay.

A fee-for-service model is very different from a commission model, which has been the traditional method of remuneration adopted by many financial planning practices. However, times are changing, and there is a move within the financial planning sector to provide greater transparency in remuneration, and this in some cases involves moving from commissions to a fee-for-service approach.

Why implement a fee-for-service model?

There are many advantages to implementing a fee-for-service model. For example:

> By separating the planner's fee from investment recommendations, the risk of conflict of interest is significantly reduced. The planner will generally receive the same fee regardless of the investment recommended.

> Clients are likely to attach more importance to advice they have to pay for.

> Clients control the fee payable to the planner. They can choose to pay more or less depending on the level of service required.

> A fee-for-service approach generates a fee that matches the skills of the financial planner, the degree of complexity of the advice and the time taken to provide the advice.

> Some financial planners have found revenues significantly increase under a fee-for-service model.

> Those financial planning practices that have implemented a fee-for-service model will not be affected if product providers reduce or remove their commission structure or if the government legislates for this to occur.

What are the difficulties of implementing a fee-for-service model

There are many difficulties associated with implementing a fee-for-service model. This may be why there are financial planning practices around Australia that are reluctant to make the transition. Each practice will need to assess the benefits of moving to a fee-for-service model against the costs of such a change. Here are some of the difficulties likely to be encountered with implementing a fee-for-service model:

> Probably the most significant difficulty with implementing a fee-for-service model within a financial planning practice is internal resistance from staff and owners. Staff could consider a fee-for-service approach to be an additional administrative burden that takes them away from doing the ‘real work’ of providing financial planning services to clients. Owners, also aware of the additional administration, may resist change because their business is profitable under the current system.

> Many financial product providers pay commissions to financial planners and it is a time consuming task to reconcile and rebate these commissions back to the client or offset them against their fee.

> Some financial planners receive commissions from insurance products, which are difficult or impossible to rebate to clients, thereby making compliance with section 923A of the Corporations Act 2001 unattainable.

> Commissions enable clients to pay for advice over a period of time, which benefits some people who can’t afford up-front fees.

> Some financial planners may not believe there is a level playing field if they have adopted a fee-for-service approach, while other financial planners with whom they compete for business may provide their services at no charge and receive commissions.

> Adopting a fee-for-service model may affect the sales value of a financial planning business because trail commissions received were a significant determinant of what a potential buyer would be prepared to pay.

> Administration is greater under a fee-for-service model because of the need to record and monitor time, bill fees and collect payment, and reconcile and rebate commissions (if required).

> There is the possibility of other financial planners undercutting fees because clients are able to compare the fees of one financial planner with another.

> Due to market force, the value of a client's portfolio may fall, yet under a fee-for-service model, the same or higher financial planning fee may be charged because the time required to service that client has not reduced compared to previous years. This may lead to some clients complaining about their fees.

> The time required to advise and service a small client is not much less than a larger client and, under a fee-for-service model, the fee charged for both clients should be similar. However, the actual fee charged by the financial planning practice to the smaller client would most likely be less than the larger client. Under this scenario, a financial planning practice will make less profit servicing smaller clients.

Factors that compel the successful transition to a fee-for-service model

As would be expected, the only way for a successful transition to a fee-for-service model to occur is for the owners or management to be committed to the move. Unless this is the case, the chance of a successful transition to a fee-for-service model is remote.

For a transition to be successful, it must be carefuly planned. Staff must be fully informed on all aspects of a fee-for-service approach and their concerns answered. This may be achieved through training sessions, meetings and individual counselling.

Key elements of a fee-for-service model:

planning, systems and training

Careful planning provides the foundation for a fee-for-service model. Each area below must be included in your planning schedule.

1. Transition period - this is the period it may take for all of your new clients and many existing clients to move to a fee-for-service approach. It may take two or more years to move existing clients to a fee-for-service arrangement.

2. Fee-for-service systems - there are many systems that need to be in place to implement a fee-for-service basis of charging clients. These include:

> Set chargeout rates for staff;

> Set pricing schedules for services;

> Additional standard forms may be required, such as an engagement letter;

> Time recording and monitoring systems; and

> Billing and cash collection systems.

3. Team training - where your firm has had little experience with fee-for-service arrangements, there is training involved to prepare employees for working within a fee-for-service system of charging clients. There is also a ‘management of time’ component, where employees must be mindful of completing jobs within the specified time as set out in the fee quoted to the client.

4. Your firm will have received commissions from many financial product providers. Each provider is likely to have different arrangements for the treatment of commissions under a fee-for-service approach. You will need to discuss with each provider the most convenient arrangement for dialling down or remitting commissions to clients that does not place a burden on your firm.

5. There will need to be discussions with existing clients on the benefits of moving to a fee-for-service basis of charging for your services and the impact on them. Initially, some clients may wish to stay with the commission arrangements while others may be suspicious of change. However, the overwhelming argument of transparency and reducing conflict of interest should see more and more existing clients move over to a fee-for-service method of payment. It should be noted that the Financial Planning Association recommends clients be given a choice of fee-for-service or commission as long as the Conflict of Interest Principles are adhered to.

6. For new clients, fee-for-service arrangements should commence when all systems are in place and staff training is complete.

Chargeout rates

There is a tendency to use market or industry hourly chargeout rates when pricing services performed by your paraplanners and financial planners. However, this would be a mistake.

Chargeout rates should be calculated specifically for your practice by including:

> the labour cost of employees;

> overhead costs on your practice;

> productivity and billable hours of paraplanners and financial planners;

> required net profit of your practice; and

> market or industry hourly chargeout rates.

Using incorrect hourly chargeout rates for the pricing of services may adversely affect the profit of your firm.

Pricing of services

There are two ways to price financial planning advice provided to clients under a fee-for-service model:

1. A fee for advice charged by the hour; and

2. A fixed fee for the service provided.

A fixed fee is the most appropriate method of pricing services because it allows the fee to be agreed up-front with the client. The client should receive an engagement letter outlining all the services included in the fixed fee. The fixed fee also incorporates an hourly rate component and may include allowance for the level of funds under advice.

When pricing each service you need to include:

> Which team members will work on the job and their chargeout rates;

> details of each task, who will complete that task and the time taken to complete the task;

> Details of the cost of disbursements (if any); and

> What you believe the client will pay for the service. This may allow you to increase the price above the time taken to complete the service. Conversely, you may have to decrease the price or the hours if you believe the client is unlikely to pay the price for the service.

Recording and monitoring time

There is a saying that applies to every business in every industry sector: “If you can’t measure it, you can’t manage it.”

This means, if you don’t have information to measure the performance of your business, there is no way of managing your business properly. The same is true for each job. If you can’t measure the hours taken to complete each job, there is no way of managing the job or knowing if it is profitable.

In other words, the profitability of your financial planning business when adopting a fee-for-service approach is dependent on completing the job within the time allocated in the fixed fee.

Recording and monitoring time is the most challenging part of implementing a fee-for-service approach. This is the area where you are likely to get the most resistance from staff and owners/senior managers because it requires the recording of time.

What are the consequences of not recording and monitoring time?

Consider the chart on the previous page, which shows the performance of seven services (A to G) completed by a financial planning firm during the year ended June 30, 2007. The average hourly rate of the firm is $100. This means any job when finished that achieves an average hourly rate below $100 may not cover labour or overhead costs or make a contribution towards the net profit of the firm.

Without recording and monitoring the time of each (or most) jobs, the firm will not know its profitable and unprofitable jobs and services. However, recording and monitoring time will show that services A, C and E are profitable, while B and F are not profitable. Of particular concern are jobs D and G, which may not have generated enough revenue to cover labour costs involved in completing the jobs, let alone overhead costs or contributing towards net profit.

Methods of recording and monitoring time

The methods available to record and monitor time vary from a manual time sheet to commercially available timesheet programs that integrate with your accounting system.

No matter which method is used, failure to record and monitor time under a fee-for-service model is like a leaking tap that drips dollar coins. You can ignore it and money (net profit) will be lost down the drain, or you can do something about it.

Partial recording and monitoring is better than no monitoring. This means benefits will be gained from recording and monitoring time on some jobs. Choose those jobs that are at high risk of exceeding their hours' budget or large jobs that may span several months.

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