PRICING ON PURPOSE: HOW TO IMPLEMENT VALUE PRICING IN YOUR FIRM, PART II

Ronald J. Baker, Founder, VeraSage Institute

I can't understand why people are frightened of new ideas. I'm frightened of the old ones – John Cage

A business is defined by the value it creates for its customers. Your price speaks volumes about your value proposition, more so than any other component of your firm's marketing. Price is also the number one driver of profitability for all businesses.

A study by the consulting firm McKinsey & Company in Cleveland, Ohio, compiled data on over 1,000 manufacturing companies and found that a 1% increase in price, at constant sales volume, would produce an average of 11% increase in profitability—far greater than the impact on profitability of reducing fixed costs by 1% (2.7%); increasing volume by 1% (3.7%); or reducing variable costs by 1% (7.3%). The impact on profitability is even higher for professional firms.

Today, there are thousands of professional firms that are pricing their services according to the external value created—as perceived and determined by the customer—rather than billing by the hour, based on internal costs incurred in generating those services.

Changing the pricing culture in your firm will not be easy. It requires constantly confronting the inherent challenges involved with pricing—all of which take hard work, commitment, leadership, creativity, innovation, and dedication of resources to continuing education. But it is worth it, as the McKinsey study proves.

All Change Is Linguistic

The word *value* has a specific meaning in economics: "The maximum amount that a consumer would be wiling to pay for an item." Therefore, ***Value Pricing*** can be defined as "the maximum amount a given customer is willing to pay for a particular service, before the work begins." This is not to suggest we can capture one hundred percent of maximum value, but rather that we have the potential to access some of it with strategic pricing.

This definition contradicts the popular term *value billing*. The difference is Value Pricing is always done *prior* to the work being started, whereas value billing is usually marking up—or more frequently, marking down—the invoice to the customer *after* the work has been performed.

There is a cardinal rule on behalf of customers in firms that value price: **No surprises**. This creates a much better customer experience, with less write-downs, write-offs, collection and financing costs, as well as greater customer loyalty, not to mention superior profitability for the firm.

Transitioning from Hourly Billing to Value Pricing

Not all pricers in a firm are created equal, which is why I have been a strong proponent of firms establishing a **Value Council**, as well as appointing a **Chief Value Officer (CVO)**, in order to centralize the pricing function and make it a core competency within the organization. (See Exhibit 1 for the Value Council and CVO role and criteria).

Think of the people currently in charge of pricing in your firm. Some are acceptable—attempting to correlate price with value—but most are mediocre. Why would we let people price if they are not good at it? We wouldn't let people audit if they were not qualified. Pricing is far too important to the profitability and health of a firm to accept anything less than excellence in this vitally important skill.

If you diagram **hourly billing**, a form of **cost-plus pricing**, it would look like this:

Service → Cost → Price → Value → Customer

Now, look at how Value Pricing inverts the above chain by recognizing the economic fact that it is the customer who is the ultimate arbiter of value:

Customer → Value → Price → Cost → Service

By first determining value, which establishes the boundaries for a price, the firm can then decide if the costs required to provide the service will return a desirable profit. If the project cannot be done at an adequate profit level, the service should not be performed. All this analysis has to take place *before* the work is started. What possible good is it to know your costs to the penny if the customer can't afford—or has a different value perception of—your price?

Costs are a fact, but pricing is a policy. What is happening in firms is people are pricing services based on the costs they are incurring without a clue as to the *value* they are creating. Firms have ample data on their costs, hours, activities, efforts, and other inputs, but a paucity of information on the value they create for their customers.

Costs are only relevant for determining if a service should be provided, and perhaps in what quantities. Costs certainly play no role whatsoever in determining external value to the customer, or setting prices (except as a minimum). Value Pricing reverses what is now an artificial ceiling on firm income, inverting the ceiling into a floor.

In Part III, we will explain the eight steps required for implementing pricing on purpose in your firm.

Exhibit 1: Value Council and CVO—Role and Criteria

Examples of strategy statements that define the role of the Value Council and Chief Value Officer:
• To ensure the firm prices on purpose, according to the value received by the customer, not the costs incurred in performing the work. • To make pricing for value a core competency within the firm. • To change the marketing culture within the firm from one that believes "we sell time" to one that comprehends, creates, communicates, convinces, and captures the value of the intellectual capital we provide to our customers.
The criteria to look for when selecting a CVO and appointing a Value Council can be summarized with the acronym **LACEY**:
• **L**eadership skills. Since pricing is a multi-disciplinary function that cuts across the entire firm, pricers need to be respected and have demonstrable leadership skills. • **A**ttitude. Leaders who believe there is nobility in being paid what the firm is worth, and who have an attitude of abundance and value creation, rather than a zero-sum view of the world. • **C**ommitment. A CVO and Value Council who do not have the support of the managing partner are destined to fail. • **E**xperimentation. Pricers have to be willing to experiment and cannot be prisoners of the past because "that is the way we have always done it." Excellence in pricing requires learning from both failures and successes. • **Y**outh. Organizations, like people, tend to calcify with age, and youth can keep the blood pumping at a more vigorous pace. Young professionals are not as tied to the billable hour as are the older generations.

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529 Fifth Avenue, 6th Floor, New York, NY 10017
T + 1 (212) 286-9344 **F** +1 (212) 286-9570
www.ifac.org