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The price is right: have costs and value come full-circle?

Abstract

Not that many years ago, marketers who researched pricing issues began calling for a focus on value rather than costs in pricing decisions. Many companies have heeded the call and shifted from some sort of cost-based approach to some version of a market-based approach. One of the most popular market-based approaches is to base the product's price on its value to users. There are unsettling anecdotal signs that in some instances this focus on value has led to a troubling loss of attention to costs. Have some marketers focused so strongly on understanding and effectively communicating their products' value propositions that they've forgotten that appropriate analyses of costs can also be important?

Keywords: pricing, value, costs, value proposition, market-based.

Introduction

Do you remember the over-reaction to what became known as the marketing principle? In the mid-1950's an executive of GE wrote in their annual report that the company must focus on customers so that the customers would guide them to provide solutions to their problems. Within 30 years you were hearing things like "the customer is always right" and "we must satisfy the customer." The height of this madness was reached in the late 1980's when in a television ad Lee Iacocca proclaimed that Chrysler now understood the "nine most important words in the English language." Iacocca explained to the rapt audience that those nine words were: "Satisfy the customer, satisfy the customer, satisfy the customer!" Marketers soon realized that this extreme focus on satisfying the customer was adversely impacting profitability. While businesses exist to generate profits, customers would be more satisfied if products were sold at prices that created losses for sellers. Thus began the evolutionary process of realizing that competing on price was a no-win proposition for business.

Nagle's seminal academic work on pricing (Nagle, 1987) and the shift from focusing on costs to focusing on value in pricing decisions sprang forth in this environment. Nagle, writing with various co-authors, as well as numerous other writers have been beating the "value" drum for over 26 years now (Nagle et al., 2011). Many businesses, as well as not-for-profit organizations, have bought into this mantra. They "fire customers" as well as engaging in the other behaviors that Nagle and others have prescribed. This begs the question of whether this intense focus on value rather than costs (a cost-based approach to pricing leads to derision by these evangelists of value) has now come full-circle? That is, are there now disciples of this value-based approach to pricing that ignore costs with the belief that a focus on value makes an understanding of costs less relevant or even irrelevant?

The extent to which this focus on value in some organizations has replaced the more traditional focus on costs is evidenced by an anecdote recently shared by a student in an executive MBA class. As the classroom discussion of an emphasis on analyzing costs versus an emphasis on analyzing value evolved, this somewhat frustrated student/executive expressed the view that the organization's choice to emphasize value has caused problems. The sales force had been encouraged for years to spend the time necessary to develop an appropriate managerial understanding of what drives production and other types of costs. In a recent sales meeting, however, one sales person was obviously disinterested in the discussion surrounding developing expertise in cost-related concepts such as activity-based costing, break-even analysis, etc. When challenged by the facilitator of the session on analyzing costs, the sales person retorted by saying, "We're selling value so why do we need to worry about understanding what's driving costs. Studying this stuff is a waste of my time when I could be out there selling more products!"

This work will not try to present an argument supporting the need for managers to understand costs. However, if readers believe that having a good grasp of what drives costs is important for managers, they should be interested in thinking about this challenge.

1. Extant literature

Nagle's seminal work on pricing (Nagle, 1987) challenged managers to think of pricing in some new and different ways. 2011's fifth edition (Nagle et al.) still contains many statements that challenge any pricing approach that does not focus on the value that an organization's products provide to its customers: "For many firms the pricing harvest is less than bountiful because they fail to understand and leverage their potential to create value through their products, services, and customer relationships."

Any manager who carefully reads the work of Nagle, et al quickly realizes that mastering the science/art of fully understanding value requires a tremendous commitment of time and energy.

This advocacy of a laser focus on value goes past manufactured goods. Williams (2011) focuses on firms whose products are services, such as advertising agencies who have traditionally priced those services based on the concept of "billable hours." Providers of services have struggled for years to develop competence in understanding the costs involved in providing those services. Much progress seemed to be made through development of such approaches as activity-based costing. However, when today's senior managers for these service providers see writers like Williams making statements such as, "Value bears no relationship to cost," they begin to question the need for any sort of focus on costs.

Today's managers have enormous time deficits and only so much time to devote to developing different types of analytical expertise. For years they have been exhorted to spend time learning how to appropriately understand the cost structures of their products. They are now being told by some that it's much more important to understand value and that this is also going to require a great commitment of their time. Williams make the statement that, "Becoming expert in … value takes the same kind of time and effort as becoming expert in your craft." It would be understandable for managers, sales people and others in an organization to feel as if it's practically impossible to develop competence in analyzing both costs and value while also staying abreast of rapidly evolving demands in their areas of professional expertise.

When faced with a choice between developing competence in cost-analysis versus value-analysis, statements such as, "In other words, you know the cost, but do you know the value? It's a different, and much more important, question (Williams 2012)." It would be understandable for a manager interacting with a consultant or other person professing expertise in the area of pricing who makes this sort of statement to begin to focus on understanding value and to de-emphasize their previous focus on costs. When you see writers quoting managers with statements such as, "It's almost embarrassing at times the way people don't understand all the ways they bring value" (Donnelly, 2011). It does make one wonder if managers need to spend any time thinking about their cost structures. There are even examples of national governments seeming to advocate a focus on value accompanied by a de-emphasis on the analysis of costs (Businesslink. gov.uk, August 2012). This vein of thought can be interpreted as an "either/or" approach to an organization's pricing decisions in which it will either focus on analyzing costs OR focus on analyzing value as it establishes its prices.

Using any web search engine and searching for writings related to pricing, costs and value leads to a plethora of article titles that indicate the direction of contemporary thought on basing prices on costs or value. "Value-Based Pricing Instead of Cost-Based Pricing (Sanders 2010)," "How to Sell Value Instead of Costs (Robertson 2009)" are two examples of web-based articles that clearly indicate that it's more appropriate to emphasize value rather than costs when making decisions about the pricing of an organization's products.

It is also informative to understand how demanding a sophisticated analysis of an organization's cost structure can become (AccountingCoach.com, 2009). While accurately analyzing and then effectively communicating a product's value proposition is also demanding, if a manager feels that the analysis of value in today's environment is of greater importance than analyzing costs, it makes sense that the additional hard work involved in analyzing costs will be avoided by many.

2. Research agenda

As has been mentioned, there is anecdotal evidence that in some organizations the focus on analyzing value as part of pricing decisions has caused a de-emphasis on fully understanding/analyzing the costs of products. This has the potential to be a troubling development in terms of the organizations' long-term viability. This concern begs the question of just how prevalent this shift in focus has become and to what extent it imperils the organization's future. Are there only a few organizations that have made such a dramatic shift in their analytics or are many organizations moving in this direction? In organizations that have shifted from a focus on costs to a focus on value, where did the impetus for making this shift come from (internal or external)? When examining organizations that have shifted their focus from costs to value, has their performance improved or deteriorated? If senior executives are challenged on the potential dangers of abandoning their traditional focus on costs, will they revert to a more balanced approach to understanding both costs and value? These are empirical questions that future research should attempt to address.

3. Closing thoughts

In defense of the "pioneers" of concepts such as the marketing principle and value-based pricing, one must return to the writings of these pioneers and examine what they were saying. If you look at the writings of the GE executive in the annual report of 1956, it becomes clear that he is advocating a focus on finding out from the customer what kinds of problems they need to have solved. However, he also indicated that you should use this market information to produce products that can be sold at a profit!

While a surface-level reading of Nagle's work on pricing might lead some to think that a thorough understanding of a product's cost-structure becomes unimportant once the price exceeds total costs, a deeper understanding will cause one to realize that analyzing costs in an appropriate manner is critically important to effective pricing strategies. It becomes quite clear that Nagle et al. (2011) indicate that there must *always* be a strong focus on understanding costs and their drivers as pricing decisions are made. However, it's much easier to reduce these extensive writings to simplistic phrases such as "Satisfy the customer" or "price on value rather than costs," than it is to expend the intellectual and managerial energy necessary to more fully understand the intent of the authors!

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