Value Pricing Technology: A dialogue

Recently, Doug Deane and I had an excellent dialogue via email on the subject of value pricing. Doug was kind enough to agree to allow me to create the following document of the exchange in the hopes it will assist anyone struggling with value pricing in the software implementation industry.

Instead of just publishing the emails, I arranged it to read like a Socratic dialogue. The **bold name** before the text indicates the writer of the following words. Doug's words appear in black and mine in green. Emphasis and quotations are all from the original exchange. Some words have been changed to facilitate reading. For example, all occurrences of the word *client* were changed to *customer*.

Enjoy!

Doug: In my experience, if most everything that you believe and hold sacred flies in the face of conventional wisdom, then you're definitely doing something right. The only "problem" I've ever had with your message is that sometimes the resellers are not ready for your ideas, because they don't have the infrastructure to support it. I think that's true of value pricing. I doubt that more than 5% of the technology channel really has the support system to be able to use value pricing profitably.

Those who try to pursue a value-pricing model without having the necessary infrastructure will do themselves more harm than good. They run the risk of:

- Underbidding engagements, risking a future loss
- Overbidding engagements, risking not getting enough business
- Under paying their salespeople, risking sales staff turnover
- Over paying their salespeople, risking profitability and future sales staff turnover when corrections are made
- Spending too much time and resources on preparing quotes, risking profitability

Any of these issues is potentially life threatening for businesses of our size. When I say "necessary infrastructure," I mean:

- A strong and easy-to-use project estimating system and standard boilerplate scope of work.
- Strong project management capabilities
- An existing project costing/accounting system, in order to track performance vs. estimates
- A commission structure that's well-suited for a VP-based sales model
- An in-house accounting system that can support the commission structure
- An in-house billing system that can handle a VP-based model

As I said, I doubt that more than 5% of the channel qualifies in this regard. I don't think that you have properly emphasized the importance of tacking these issues before attempting to use a value pricing model. The real problem is that most resellers do not have a proper project accounting system and commission system to support it.

Ed, I think that your message has always been completely on target, but it doesn't necessarily dovetail with the resellers' infrastructures. Maybe that's why you feel that you've been swimming against the current with the resellers. If you could help us create a set of reseller's enhancements to our systems that could allow us to implement the ideas that you've been advancing - well that would really be something!

Ed: First, thanks for your vote of confidence in my self-awareness! Like you, I am a big believer in questioning conventional wisdom. Mark Twain said, "If you ever find yourself on the side of the majority, it is time to pause and reflect."

With regard to value pricing, I think I should clarify a few things.

1. The risks you outline are absolutely correct. They are also the same risk that a reseller who does a time-billed engagement encounters. In fact, for all of those risks I can name at least three resellers that have fallen victim to them who bill by the hour. In short, while the list is good, it is irrelevant because the method of pricing has no relation to the risks or for that matter the degree of probability or impact based on the pricing method.

2. The necessary infrastructure is not much different either. I will agree with your point about projects, but not from a costing standpoint. It is not costs that are the issue; it is the lack of real project management skills. Most of resellers can't write a decent scope document. The major reason is that most resellers rush through the scope process because it is necessary to get the software sale. We have to change the mindset that the first chargeable engagement should occur only after the purchase of the software. To me selling software before writing a project plan (scope is one element of six in a plan) is like building a house and going to the lumberyard before you have the drawings from the architect. Who cares how much the lumber is? Don't we first have to know what the house is going to look like?

3. The litany of poor project management could go on, but here is my short list:
    a. Poor or ill-defined scope
    b. Poor expectation management of the customer personnel
    c. No risk plan
    d. No quality plan
    e. No communications plan

4. Value pricing in my mind is about organizational transformation. I have never said that hourly billing is not a profitable model, it is. It is just not optimal, especially for an organization that sells knowledge not service. It is my belief that the software implementation industry is one of the few truly knowledge-based industries. Even accountants and lawyers are more service-based than knowledge-based than we are. I believe the real problem with our industry has been the failure of its leaders on both the reseller **and** publisher side to recognize this. When you are selling service, it is easier (but still fundamentally flawed) to justify billing by the hour, when you are selling knowledge it is almost impossible to

> capture the real value. The main problem is that our revenue and costs are based on a faulty belief. The belief is that value = rate times hours. Think about it right now, today, somewhere in this country, a consultant has figured out a way to do something in three hours what used to take 10. He will be punished because the seven hour savings cannot be captured anywhere on his timesheet. As a result he will a) not make his "number" and get paid less or b) figure out a way to pad (lie) on his timesheet to get the recognition he deserves.

In short, I believe spending time more efficiently understanding time is a waste of time. Let's all begin to really concentrate on understand value, not just for us but for our customers.

Doug: I hope that you're not mistaking me for someone who doesn't believe in value pricing. I do. The problem is that I don't believe that right now, we have the infrastructure to support it. So, undeniably, one of two problems exist:

- We actually don't have the infrastructure to support it or
- I just don't believe that we do.

I'm not much different than your average reseller in this regard so you might want to use me as a test case. If you can get me to agree that we can do it, then you can probably get anybody to agree to it, and I'll help.

First of all, let me convince you that I'm earnest about my belief in value pricing. I think that charging by the hour for our work is one of the most depressing concepts in the industrialized world, to an entrepreneur. If you're billing by the hour, no matter what you do, your maximum earning capacity in any given year is capped. Basically, you're selling your life. It's for that and for other reasons that manufacturing is one of the few wealth-producing activities. It allows you to leverage your time by developing a product once, and then cloning it a thousand times. Software publishing allows you to do this, which is why we're in business. Our service-based business would be worth a fraction of its current value, if it weren't for our publishing activities. Value pricing is still not on the same wealth-building level as publishing or manufacturing, but it is a step in that direction, so I'm all for it.

Like you, I believe that project management expertise is a very important aspect of value pricing and of being profitable in this industry even if you're just billing for your time. Project management may be the most important single aspect of value pricing, but it's not the only aspect, and the others will kill you if you haven't addressed them. I think that other than competitive pressures, the single greatest challenge faced by resellers is staff retention and recruiting. If you are not compensating your people fairly and competitively, they're gone in a heartbeat and your profitability is in the trashcan.

Respectfully, I believe that you have glossed over the real problem with value pricing, and that you are convinced that you need only change people's mindsets in order to start a value pricing revolution. The real problem, in my opinion, is infrastructure. Without infrastructure, you can't track the benefit that VP brings to your organization. In addition, without tracking that benefit, you can't properly compensate that consultant in your example, who figured out a way to do an 8 hour job in 3 hours, or the salesperson who sold it as an 8 hour project. Moreover, without proper compensation, they become dissatisfied and leave.

Publishers have created accounting systems that force us into a rate x time mentality because it doesn't allow us to properly track the benefits of value pricing. Our system doesn't even come close to being able to perform the accounting for a value pricing model, yet I'm guessing that 75% of the channel uses the same program for their own in-house needs. As I said in my previous e-mail, our system needs the following gaps filled:

- Project accounting in order to track performance vs. the scope of work
- A way to track and pay commissions in a way that rewards salespeople who sell services and products at the highest ratio of selling price to expected cost
- A way to track and pay commissions to our consultants, in order to reward those who are the most efficient
- A billing system that handles a value pricing-based model

Trying to sell a value pricing based project in a complete vacuum is a great way to go out of business in this market. I believe that your price must necessarily lie between two fixed points. The low end of that range is defined by your cost, and the high end of that range will be what the end-user perceives the value of your solution to be. I don't think that you can realistically expect to get more than the perceived value, and if you get less than your cost, you are out of business. I believe that an intelligently run VP model does its best to calculate both of these points, and to fix the final selling price somewhere between them, hopefully close to the high end. *But, you must know where the bottom of that range is, in order to measure the performance of your salespeople, and of your consultants.* If you don't know where your cost is, then you really aren't sure if the perceived value to your customer is higher or lower than your actual cost. I'm sure that you know that there will always be customers whose shortsightedness always causes their perceived value of your products and services to be lower than your costs.

Your response to that might be that with a great scope of work, you know in advance what your costs will be. Well, in my experience, there's never been a scope of work that's been detailed or good enough to be able to predict every twist and turn of an implementation. You must have a great project accounting system in order to be able to track what's out of scope, and how much time was really spent, so that your scope of work's accuracy improves over time.

If you really want to put the value pricing acceptance curve into high gear, then address some of these issues, and give us a system and infrastructure recommendations that will support value pricing. Until then, you're going to be viewed with some amount of skepticism by the resellers as well as by your own staff.

But, I could be wrong about that.

Ed: In short, you are correct when you state, "Your response to that might be that with a great scope of work, you know in advance what your costs will be." This is absolutely the key. Your next sentence is where I think we part ways. "Well, in my experience, there's never been a scope of work that's been detailed or good enough to be able to predict every twist and turn of an implementation." I think there can be. The problem has been twofold:

1) some resellers do not know how to do this or
2) once shown they are unwilling to do it.

Doug: Actually, there is a #3, which I believe is the most common situation we encounter:

3) The competitive environment doesn't allow you to be able to sell a needs assessment or scope of work in advance.

When the another reseller has already given or promised your prospect a free product and services proposal, it's virtually impossible to be able to sell that same information. We always fight for it, and we'll try to discredit the other guy's approach, but we're only successful getting a paid assessment about 20 to 25% of the time. Maybe we aren't using the most effective sales techniques in trying to get paid assessments.

Ed: Ok, we will deal with that one as well. With regard to the first, I have delivered a session on scope at the last three conferences, at 10 project management boot camps and at 12 consulting academies, 25 times in all. I estimate that over 300 people have seen this presentation. Now the kicker, whenever I ask for a copy of the scope document from a reseller, I get a proposal with a range of hours for a standard set of services. This leads me to believe that #2 is the real problem.

The primary reason we don't do a great scope is that we don't get paid to do it in most cased because, once again we sell them lumber before we sell them the blueprint. If you accept the premise that we need to start selling blueprints first then I think I can address your other issues. If you do not accept this premise, skip the rest of this email.

Your concerns:

1. Project accounting in order to track performance vs. the scope of work
2. A way to track and pay commissions in a way that rewards salespeople who sell services and products at the highest ratio of selling price to expected cost
3. A way to track and pay commissions to our consultants, in order to reward those who are the most efficient
4. A billing system that handles a value price-based model

My responses:

1. The scope document (as I define it) feeds the Issues List. The Issues List is the primary document the project manager follows. It contains the following: a list of data to be manually input, all data to be converted, all required reports/inquiries, all external links to feeder or needer system, and business processes to be changed. Anything outside the stuff on this list has to be considered as a change request. This leads me to another problem. Most resellers are terrible at enforcing change requests for two reasons: 1) In the name of "good customer service" they agree to do more than was originally required and 2) because they never really

had a proper scope in the first place. The latter reason is primary and in reality does not cause scope creep, because scope never really existed. Once you have all this stuff, value pricing requires you to (in a sense) do your timesheets first! This establishes your low-end or walk-away price.

Doug: First of all, let me say that this particular issue is an equal problem for fixed price engagements or time and materials, so this set of challenges is not an argument for or against value pricing, it's more of a general reseller profitability issue. The crux of this issue is that if you have a system that requires a consultant (i.e. human) to recognize every situation that's out of scope, then you really have no system at all. You can get by, if your consultants are well-trained and extremely competent, but they won't recognize every out-of-scope situation. That requires a competent project accounting system, which I don't believe we have.

When an out-of-scope task is missed, it throws the actuals out of whack, as compared to the estimate, unless the consultant caught it and issued a change order. If they didn't do that, then you must be able to look at your weekly performance reports to catch the situation. We don't have one.

2. **Ed:** Compensation becomes easier at this point. For salespeople, I recommend a three-fold approach. First, reward them on a straight percentage of revenue. Forget, gross profit. If you are doing things right you really don't need it. (It is probably here that again we diverge in our thinking.)

   Doug: A commission structure based on revenues does not give your salespeople any incentive to sell products and services at the highest level of profitability. It just gives them an incentive to have the highest possible invoice amount.

   Ed: Second, have an incentive that rewards a salesperson after the fact when a customer returns a satisfaction survey at the end of the implementation with a high score on it. This will insure that the salesperson will remain in touch with the customer and provides a check and balance on the consulting team.

   Doug: Excellent!

   Ed: Third, and this is the most radical, some portion of salesperson compensation, I would suggest as much as 50% should come from the salesperson's ability to uncover value at a prospect. For example, if a salesperson uncovers $250,000 (I am making this number up as an example) with of value, we should reward to salesperson with $2,500 (1%) even if the deal does not close. The prospect, of course, has to sign off on what we call the Summary of Findings document that states this value. I am not suggesting 1% all the time, some minimum threshold needs to be established; this will stop salespeople from chasing bad deals in the first place.

   Doug: Interesting idea, I'll give it some thought.

3. **Ed:** Consultants would also be paid based on 1) a percentage of revenue credit (not hours). Each engagement would need to be broken down into five to 10 milestones and a revenue amount established. Once the milestone is complete (i.e., signed off by the customer) the revenue is credited to the person. If multiple people are involved either a) the practice manager splits it or b) (and I like this better and YES there is a reseller who is doing this) the consultants decide themselves who gets what portion of the revenue credit. Boy does this weed out bad consultants fast! 2) a customer satisfaction score.

   Doug: Good idea.

4. **Ed:** This is now easy since the billing as follows: a) first ask for 100% upfront **with** a service guarantee, b) customers not wanting to pay upfront are suggested to get financing from a leasing company (I hated being a bank), c) if you really like the prospect agree to 50% upfront, than 25% halfway between the start date and the established (in the scope document) go-live date, and 25% on the go-live date. If they select this last option, the service guarantee is limited to the last 25% only.

   Doug: I agree, and we already do this when we quote a fixed price. It's that #3 that kills you.

Ed: Whew! This is also not a complete picture. There are many other aspects of value pricing that need to be address such as how to you market it differently than you do today, offering three options on a proposal (not a range, but three distinct level of service options, and, of course, creating a real customer satisfaction survey system. One additional suggestion might be for you to read Alan Weiss' *Million Dollar Consulting*. This is a great book on all of these topics. Alan is very pro-value pricing and is not quite a caustic as my friend Ron Baker. PS – He knows he is caustic, by the way.

Doug: Thanks, Ed, I appreciate that very much. My team can and will carry the flag in this area, and I think that their thinking in all these areas has changed dramatically in the past year (with your help). I think that we've boiled this down to two major problems:

1. It's tough for us to get paid assessments and/or scope of works done in advance for more than about a quarter of our projects, due to competitive pressures. Maybe we need more sales training, but I tend to think that 20 - 25% is par for the course.
2. We do not have project accounting or management capabilities, which is a big problem for most of your reseller channel, whether quoting a fixed price or time and materials.

Ed: So, we are down to two issues:

1. The competitive environment does not allow you to sell needs assessments or scope of work in advance.
2. Your not have project management capabilities that enable you to quote prices or track out of scope tasks.

I think I have some potential answers (or at least responses) to both questions.

Issue 1 – My suggestion here is to do the following, start by giving them away. Not in the manner that you are doing now, but using a consultant (or salesperson, if they have the capability) to spend one to two days with a prospect writing a detail scope for free. (Ed, you are nuts.) No, I am serious. Here is my logic. Mahan Khalsa says the "how you sell is indicative of how you will solve." This is truly profound. If you are truly selling solutions, then start doing so. Stop trying to "get the deal" before you start solving problems.

Two resellers I am coaching started by doing this and we tracked the results very closely. Here is what we found. When we started doing a free detailed needs analysis and scope document (like we mean it) the close rate went up from 2 in 10 to 4 in 10! Run those numbers through your current process and see what **a 100% increase to close rate will do for you**. I bet is pays for a ton of free needs analyses. If this does not convince you, let me tell you what happened next.

We started charging for the needs analysis. At first, it was just a small fee $400 for a two-day engagement. We found that charging increased the customers (remember they are a **customer** now not a prospect) participation level in the process because they were paying money. In addition, we increase the close rate to 6 in 10. Now we have a **200% increase** to close rate, **plus** $400. Actually, that is not true, once the reseller gained confidence in doing the paid needs analysis and scope they increased the fee to $1500. They are both getting this on a regular basis.

This whole concept has been around since dirt, it is called a lost leader. Gillette calls it giving away the razor to sell the blades. I call is smart strategic business.

Doug: I agree and I've forwarded this idea internally.

Ed: Issue 2 – I think the tracking system is not the issue. The issue is project management skills and training. As you point out "The crux of this issue is that if you have a system that requires a consultant (i.e. human) to recognize every situation that's out of scope, then you really have no system at all. You can get by, if your consultants are well-trained and extremely competent, but they won't recognize every out-of-scope situation. That requires a competent project accounting system, which we don't have." *Can you explain to me how a "competent project accounting system" will help you recognize an out of scope situation?* I would argue that no technology system is capable of this. I believe this whole issue is one of a) having a rock-solid scope and b) educating consultants that if they do something out of scope, they should consider it as being done on their own time.

Doug: I don't agree at all. A competent project/cost accounting system will tell you if there's a phase of the implementation that is way over budget, so that you can zero in on it and determine if out of scope work is being done. If that's the case, you can quickly reign it in, and have a conversation with your customer (and with your consultant) about the additional work. If you have to depend on your consultants to raise a flag every time that there's out of scope work, it's going to cost you.

Additionally, without a competent project/cost accounting system, you never have the kind of feedback you need to make sure that your scope is accurate. You're living in a vacuum. These are both huge issues, which I think that you're understating the importance of.

Ed: Woo hoo! Down to one issue! I think we are down to semantics now.

Doug: Well, I don't think we're really down to just one issue. I'm still not comfortable that we have software or an accounting system that will allow us to compensate our staff using a fixed/value priced model, and the cost accounting issue is a big deal to me. I wish there was a solution to both of these problems. Previously, you had some ideas about commissions that were interesting, and I'll think about them, but they are not definitive solutions.

To be continued…

About the participants

Doug Deane founded DSD Business Systems in 1984. DSD Business Systems is one of the leading installers and providers of accounting, inventory, business management software, and Internet solutions. Doug manages the overall strategic direction of the company and participates in day-to-day operations, ensuring an ongoing commitment to continuous improvement, technical excellence, and participation in the community. Under Doug's direction, DSD has recently acquired two of its major competitors and is currently in merger talks with another leading provider. Most recently, Accounting Technology Magazine named DSD to the list of Top 100 VAR's and Resellers in the United States.

In the years since starting DSD, Doug has found time to start the Ethics in Business Program for the San Diego East County Regional Chamber of Commerce. This program exposes high school seniors every year to complex ethical dilemmas. These dilemmas and the associated discussion help these students to understand how important ethical behavior is to their personal and professional lives. In 2003, the California Chamber of Commerce selected this program for the California Foundation for Commerce and Education Award.

Doug is proud to be one of the Founding Members of the ITA. Doug can be reached via email at dougd@dsdinc.com.

Ed Kless joined Sage Software in July of 2003 and is currently the director of partner development and recruitment for the mid-market division. He also facilitates the Sage Leadership Academy, a yearlong program designed to assist Sage Software partners develop a continuous process of improvement in their organizations. In addition, he develops and delivers the curriculum for the Sage Consulting Academy.

Prior to joining Sage Software, Ed worked with Tipping Point Advisors, an organization dedicated to the growth and development of software implementation partners. Before that, he co-founded Third Wave Business Systems, a Microsoft Dynamics Partner, in 1996, which grew to 20 team members and 5 million in revenue. At Third Wave, Ed developed the implementation methodology and managed the front and back office consulting teams.

Ed is a Senior Fellow of the VeraSage Institute, frequent contributor to industry publications and blogs, and speaker at many conferences worldwide.

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