O
ver the past 40 years, we’ve read many things about value-based pricing and the benefits it can bring to the bottom line. Pricing scholars, consultants, and experts highly recommend value-based pricing as a pricing approach and praise it over cost-based pricing and competition-based pricing. The same people write about the dangers of formula-based pricing and, specifically, the evil that cost-plus pricing strategies can do to a firm’s profitability. And they’re not shy about it. They often refer to firms using cost-based pricing in harsh terms, at times make fun of them, and stop just short of insulting the millions of firms doing cost-based pricing and making money.

I’m writing this paper to play “devil’s advocate” and to bring some sense and some realities to the world of pricing. The truth is, many companies are doing cost-based pricing and doing very well. In my many years in the pricing field, I’ve witnessed very high profit margins achieved with cost-based pricing. The fact that 30 to 35% of companies de-facto adopt cost-based pricing because they don’t know anything else doesn’t mean that these firms are weak or doomed. It means that they might be leaving money on the table and not capturing their share of the value they create. But you can do cost-based pricing and have 75% gross margins.

This short essay aims to set the record straight and to bring humility to our pricing community. As a pricing discipline, we have to do a better job at demonstrating the value and impact of progressive approaches. While value-based pricing seems attractive when you read about it, it’s hard to execute, it takes time to reach excellence, it might be costly up front, and there’s no guarantee of payback. I discuss this in greater detail in the last section of this paper.

But first, let’s look at cost-based pricing in greater detail.

**What’s Wrong with Cost-Based Pricing?**
If you’ve been in pricing for many years and/or if you’ve read about pricing strategies, you’ll quickly agree that cost-based pricing has severe pitfalls. Figure 1 lists the advantages and disadvantages of this pricing approach. It’s definitely an approach for which data are readily available, thus rendering the price-setting process a bit more rational. That feels very comfortable in manufacturing and engineering cultures. It doesn’t require cross-functional collaboration and can be done easily in manufacturing and engineering cultures. It doesn’t require cross-functional collaboration and can be done.
quickly, assuming your data are available and right. Finally, cost-based pricing can be systematic, consistent, and automatic. That means it’s easy to deploy across a division or organization. As far as effort-to-benefit ratio, it’s a great story. This is why millions of firms do cost-based pricing—sometimes intentionally, because they have no budget or skills to do something else, and sometimes intentionally, because when pricing isn’t managed, cost-based pricing becomes the de-facto approach.

Of course, cost-based pricing isn’t ideal. Competition and customer considerations might not fully enter into the pricing decisions, and it’s extremely internally driven. The chances of leaving money on the table are very high. One pitfall not listed in Figure 1 is that finance and cost accounting teams often struggle to calculate costs and to design accurate cost models. There’s much uncertainty in cost budgeting and in the process of defining standard costs. As a result, these teams spend long hours calculating monthly variances and true costs to extract a real gross margin. That also means that a cost-plus approach or a gross-margin target pricing strategy is built on budgeted costs which might be wrong or inaccurate. This is a huge issue with cost-based pricing. The more project-based your business and customized your offerings are, the greater the chance of miscalculating your costs. This is also true for innovations and new ventures.

So I agree with most scholars, experts, and consultants. Cost-based pricing has serious limitations and might lead to missed chances to capture value. Despite these pitfalls, I would not go to the extremes of calling it evil or concluding that cost-based pricing can lead firms to their demise. Doing so would be disrespectful of the thousands of pricing professionals fighting to improve their cost-based pricing process and slowly changing their culture. It’s also a disservice to the pricing profession as a whole.

A Question of Balance
There are three commonly accepted pricing approaches: cost, competition, and customer value. Each of these involves specific pricing strategies, as shown in Figure 2. These approaches support my thesis that price setting should be done by paying attention to these three Cs. When I’m asked whether a company should move from cost-based to value-based pricing or not, I respond that it’s never a question of doing one or the other but of striking the right balance between the 3 Cs and eventually embracing customer value as a primary pricing approach. To set and execute pricing strategies, you’ll need to manage all Cs with intention and attention. You’ll need to track competitors and their pricing levels. You’ll need to design advanced cost models, and you’ll need to develop a discipline of dollarizing customer value.

Many firms invest heavily in the area of costing, less in the area of competitive analysis, and very little in the area of customer value. Some have an army of cost accountants and entire quoting departments running advanced cost models. For both competition and cost dimensions, processes are in place with dedicated teams and allocated resources. There’s a discipline in place. When it comes to customer value, this is generally where corners are cut. There is a lack of budget, skills, and discipline. Managers make decisions based on qualitative information or on intuitions related to customer willingness-to-pay.

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This is a fundamental shift in thinking from what consultants are saying. I often hear them state that cost-based pricing is wrong and that it’s necessary to move to value-based pricing. The bottom line is that you cannot do value-based pricing without competitive information. You cannot set your pricing without cost information if you want to be sure to make a margin. So costs are here to stay and are strongly needed in the pricing decisions eventually. Thus we are moving from basing pricing decisions solely on cost to informing pricing decisions with customer value, competition, and cost data.

This is not new. I invite you to read Kent Monroe’s 1990 book *Pricing: Making Profitable Decisions*. In this classic and still highly relevant publication, Dr. Monroe proposed the visual shown in Figure 3.

The 3Cs of price setting are clearly identified in this visual. Your floor is, hopefully, your cost. The ceiling is the maximum price your customer should be willing to pay based on the value you deliver versus the competition. Then your pricing discretion will be modulated based on competitive factors.

Moving to value-based pricing does not mean abandoning a cost-based pricing approach. It doesn’t mean that we do no longer care about cost. It doesn’t mean moving from one extreme to the next. It means being mindful and rebalancing the use of the 3Cs in the price-setting process and eventually adopting customer value as a primary orientation.

**From Basic Cost-Based Pricing to Advanced Cost-Based Pricing**

There is cost-based pricing and there is cost-based pricing. We’re no longer in the dark ages when folks calculated costs with rules and old machines and wrote them in a book. Over the years, cost-based pricing has improved tremendously. I propose five levels of maturity in cost-based pricing, as shown in Figure 4.

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**Stage 1: Static Unintentional Cost-Based Pricing:** When companies don’t manage pricing and the pricing process is fragmented among various functions, cost-based pricing becomes the norm. Because of the lack of formalization and pricing discipline, it’s therefore the worst situation possible. A cost-plus pricing strategy is adopted and price erosion might happen during the execution of the pricing tactics. The lack of pricing discipline and the sole focus on cost-based models can be a serious issue for a company depending on what they face in the market and which companies they compete against. That might be the worst static case scenario.

**Stage 2: Dynamic Cost-Based Pricing:** Since the 1990s, though, the concept of dynamic cost-based pricing has emerged in the literature to help companies better adapt in industries facing fluctuations in commodity prices. Some of these companies separate the materials side of their costs from the processing side of their costs. They’ve educated their customers about the need to dynamically re-price their commodity-driven products. For example, you might change your commodity prices daily, weekly, or monthly and publish an annual price list for your processing and service offerings. By doing this, you pass cost increases or decreases through to the market. There’s no doubt that you might still leave money on the table with this dynamic approach. But at least you move from static cost-based to dynamic cost-based pricing.

**Stage 3: Analytics-Driven Cost-Based Pricing:** With the emergence of better pricing tools, pricing, finance, and costing professionals can mine historical transactional data to better guide their future pricing decisions. By explaining the past, they can better predict the future. But if past pricing transactions are based solely on costs, then recommendations coming from any pricing tools will be anchored in costs. The difference here is that they might be able to find pockets of price improvements to increase their level of pricing realization. Some consulting and software companies call this “value-based pricing” but I think it’s a bit misleading. The value might be in your data, but it’s internally driven, as it doesn’t account for what you might have left on the table in the past. But it’s a step further along the cost-based-pricing maturity curve.

**Stage 4: Hybrid cost+value-based pricing:** The next step toward cost-based pricing excellence is to combine cost-based pricing quantitative science with qualitative and intuitive customer value information. By drawing from collective intuition, managers can develop a cost-based approach combined with an internally perceived premium that they might be able to justify to the market. These folks understand that they have differentiation and that they can

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Stage 5: Advanced Cost-Based Pricing: This fifth stage of cost-based pricing maturity combines the dynamic aspect of cost-based pricing supported by legacy and intuitive pricing knowledge with pricing analytics. The difference here is the formalization in pricing realization and the overall intention. This is where you can find companies delivering high EBIT results by embracing integrative and advanced cost-based pricing. I meet plenty of leaders who know about value-based pricing and who've tried it. They're not willing to make the investments at this time and are willing to use qualitative information based on soft data and legacy premium analysis. For them, making 40 to 50% margins is good enough and the cost of reaching the extra 3 to 5% of margin outweighs the benefits. I respect this point of view. I also encourage them to continue improving their pricing realization process to get the extra 1 or 2% of margins.

So here it is. If you’re mostly doing cost-based pricing in your company today, where do you think you stand along the maturity curve? Depending on where you stand today, is it more worthwhile to improve on this maturity curve or to begin a value-based pricing transformation? You have to walk before you can run. A firm cannot legitimately claim they can move from stage 1 of this curve to value-based pricing overnight. The first steps might be to improve to the level of dynamic pricing and to invest in cost-based pricing analytics.

Show Me the Money

A major problem we face today is that we haven’t demonstrated the full impact of value-based pricing even though Philip Kotler discussed the advantages of value-based pricing more than 40 years ago. We’re still reading anecdotes from consultants during pricing conferences and we’re expected to believe their research findings based on inadequate methods and blurry statistical analysis. So business leaders have to believe our words and claims without strong evidence. For the past six years, I’ve studied the field of value-based pricing and conducted quantitative analysis of the relationship between value-based pricing and profit. The papers I published are only the first step toward developing a theory of value-based pricing supported by many academic research projects and industry-wide inquiries. We need an army of projects documenting case studies, conducting research, and writing about it so that it eventually reaches the C-suite.

In addition, based on conducting many value transformation and value-based pricing projects, I propose the following:

1. Value-based pricing costs more upfront, especially for firms that lack customer intimacy and customer research data. They will have to invest in developing and executing customer intimacy programs, which can be costly.

2. The positive impact and payback of value-based pricing might take a while to appear in your gross margins. Pricing consultants often promise a 5 to 8% increase in margin within the first two years of a large value-based pricing project. In comparison, cost optimization programs can have an immediate impact.

3. Most firms claiming to do value-based pricing don’t do it fully. They often don’t conduct user-need segmentation or know their competitors very well. Value-based pricing might be used sporadically or partially as a result. Do you really do or adopt value-based pricing? Or do you slowly assimilate it? When do you know that you’re doing it? When you’ve created one value model or successfully launched an innovation using the methodology? The concept of doing isn’t clear to me in that context.

4. Value-based pricing requires dedicated budgets. Cost-based pricing often does not. It’s done instead by the finance and accounting folks in place. If you want to slowly deploy value-based pricing, you’ll need extra resources, including staff, travel dollars, training dollars, and so forth. You might need to bring in a consultant or a coach. I often joined teams as a coach as they started the process and quickly realized they lack skills and support. The issue is to be able to justify the investments without being able to calculate a payback and show a compelling ROI. This is often

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Figure 5: The Difficulty in Justifying Value-Based Pricing Investments

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the first question you'll hear from CEOs and top leaders when investments are requested, as shown in Figure 5.

Functions like R&D, maintenance, and manufacturing calculate their impact much better than we do.

5. Many companies conduct benchmarks to gauge the success rate of their peers or companies in other industries with value-based pricing. While conducting benchmarks is commendable, it’s irrelevant. Most of the secret sauce with the assimilation of value-based pricing is related to culture, confidence, and beliefs. It’s difficult to benchmark. In addition, value-based pricing will never be a copy-and-paste exercise of someone else’s approach. Each company will have a different approach and a different roadmap. So you might show a case study of a company reaching 20% EBIT due to value-based pricing, but you might not be able to duplicate it because of cultural considerations, external market dynamics, and differing maturity levels.

I could propose more of these statements, but I’ll stop here. The bottom line is that value-based pricing is hard and takes time to pay back. This is why many firms prefer cost-based pricing and move from a basic cost-based pricing approach to a more advanced and progressive cost-based pricing approach, leveraging their differentiation and qualitatively integrating value components. The effort-to-benefit ratio is much more attractive to them.

So the fundamental challenge remains that, as a profession, we need to further develop the value proposition for doing value-based pricing before we begin asserting that it’s a much better approach than cost-based or competition-based pricing. Because we haven’t yet fully conceptualized value-based pricing, learning from TQM, Six Sigma, or Lean, and because we can’t make the case for value-based pricing investments day-in and day-out, we have to be humble and softer in our claims and in our publications. As a value coach and pricing thought leader, I’m convinced that value-based pricing is a much better pricing approach as long as . . . you know the rest. Let’s be realistic about it. You have to learn to stroll before you can run. It’s all a question of pricing maturity in the end.