

THE PRICE NOBODY CHARGED · CHAPTER ONE

The Line Below the Invoice

The price a firm receives is settled below the invoice, in a dozen places nobody adds up.

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THE LICENCE

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A NOTE BEFORE YOU READ

This work is offered for education and leadership development. It is not legal, financial, accounting, investment, medical or psychological advice; take the advice of a qualified professional who knows your circumstances. Companies and events are described from the public record as the author understands it; characterisations are the author's analysis. Examples are illustrative, and no particular outcome is promised to any reader.

ABSTRACT

The price a firm receives is settled below the invoice, in a dozen places nobody adds up. It is ten to six on a Tuesday in February, and the commercial analyst at a distributor of plumbing and heating supplies has a year of one customer's transactions spread across two desks. She was asked on Monday a question that sounded simple: why has the margin on the firm's third-largest account fallen, when the price list has gone up twice? The account is the one the sales director mentions at every conference. Its buyer sends a card at Christmas. So she has printed everything. The invoices first, each one at the agreed discount from list, which is what everyone in the building means when they talk about this customer's price. Then the other paper, the kind that never reaches an invoice. The credit notes for stock returned unopened, refunded in full. The year-end volume rebate, paid in January, although the customer's volume fell below the threshold the rebate was written for.

CHAPTER ONE

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The Line Below the Invoice

HAUTE LUMIÈRE · THE PRICE NOBODY CHARGED · CHAPTER ONE

Ten to six, a customer's year

It is ten to six on a Tuesday in February, and the commercial analyst at a distributor of plumbing and heating supplies has a year of one customer's transactions spread across two desks. She was asked on Monday a question that sounded simple: why has the margin on the firm's third-largest account fallen, when the price list has gone up twice? The account is the one the sales director mentions at every conference. Its buyer sends a card at Christmas.

So she has printed everything. The invoices first, each one at the agreed discount from list, which is what everyone in the building means when they talk about this customer's price. Then the other paper, the kind that never reaches an invoice. The credit notes for stock returned unopened, refunded in full. The year-end volume rebate, paid in January, although the customer's volume fell below the threshold the rebate was written for. The early-payment discount, taken on every invoice, by a customer whose payments arrive on average at fifty-eight days. The freight on every order, including the half-pallets sent by van the same afternoon. A marketing contribution for a trade show the customer did not attend.

She adds it up for the product the customer buys most, a thermostatic valve. Then she does the same for a two-person installer in the next town, who buys four a month and pays on the day. The installer pays more for the valve. Not a little more. Her stomach tightens in the way it does before a meeting she would rather not have.

She is a composite, drawn from the way this afternoon is described in the pricing literature below and in the house's own practice, and no firm is meant. What she has found is ordinary, and it is ordinary in nearly every firm that sells to other firms.

Ammanuel Santa Anna's *High Frequency Workbook* is written for a person's own money, not a company's.[1] One of its sentences reads, on the analyst's two desks, as if it had been written for a finance director:

> *Financial avoidance is the money equivalent of emotional suppression. It feels protective in the short term and creates compounding damage in the long term. Every day you do not know your numbers is a day you are making financial decisions in the dark.*

This chapter makes one claim. The price a firm actually receives is decided in many places after the price is set, by people who each see one line and never the total. The leak below the invoice is rarely anyone's decision. It is the sum of reasonable concessions nobody revisits, and because nobody owns the sum, nobody sees it. Making it visible is the first and cheapest way a firm finds revenue it has already earned.

A waterfall, and a band

In 1992 two McKinsey consultants, Michael Marn and Robert Rosiello, published an article in the *Harvard Business Review* under the title *Managing Price, Gaining Profit*.[2] Its opening sentence is still the shortest argu-

ment for the subject: "The fastest and most effective way for a company to realize its maximum profit is to get its pricing right." The article is best remembered for two pictures, and both have been taught in pricing courses ever since.

The first is the pocket price waterfall. It begins with the list price and steps down, bar by bar, to the invoice price, through the discounts printed on the invoice. Then it keeps going. Below the invoice it subtracts everything else the transaction costs the seller: payment-term discounts, annual rebates, promotional allowances, freight paid on the customer's behalf, the cost of returns. What is left is the pocket price, the money that actually stays in the seller's pocket. The point of the picture is that most firms manage the top half of it, because the top half is on the invoice, and very few manage the bottom half, because the bottom half is scattered across ledgers that different departments keep.

The second picture is the pocket price band. Take one product, line up every customer who bought it, and sort them by pocket price. The band shows how wide the spread is. In the cases the article and its successors describe, it is often far wider than anyone in the firm expected, and it bears little relation to the size of the customer or the cost of serving it.

The article's own text was not reopened for this chapter beyond its opening; the account of the two pictures here is the one that has been taught from it, and the figures it gave for particular companies are not repeated. What can be done is the arithmetic that explains why the subject matters, and it is worth doing once, by hand. Suppose a firm earns an operating margin of eight per cent. On every hundred pounds of sales it keeps eight. If the price it actually receives rises by one per cent, and nothing else changes, it keeps nine. One pound on eight is a rise of a little over twelve per cent in operating profit. The same firm would need to sell many more units to make the same pound, because each new unit also brings its costs. That is the whole of the arithmetic, and it runs in both directions. A leak of one per cent below the invoice is an eighth of the profit, gone without a meeting.

Santa Anna's canon on value-stream mapping has a phrase for the kind of flow the bottom half of the waterfall describes. It writes of shadow streams, "value flows that exist below the surface of official process, unacknowledged by leadership, unmapped by conventional assessment, but essential to the system's actual functioning." The canon means the quiet work that keeps a firm alive, the mediating and mentoring that appear on no chart. The waterfall is a shadow stream running the other way. It is just as unmapped, just as essential to the system's actual functioning, and it carries money out rather than in.

Pricing is a capability

If the leak is so large and so simple to see, why does it persist? The most careful answer comes from three researchers who spent time inside one company. In 2003 Shantanu Dutta, Mark Zbaracki and Mark Bergen published a study of the pricing process of a large manufacturing firm in the American Midwest.[3] Their argument begins with a distinction that most strategy writing skips. A firm can create value, they wrote, and

still fail to keep it: "Even a firm that has created value, however, may not capture the potential rents associated with that value." To capture it, a firm must set and hold the right prices, and most theories simply assume it can.

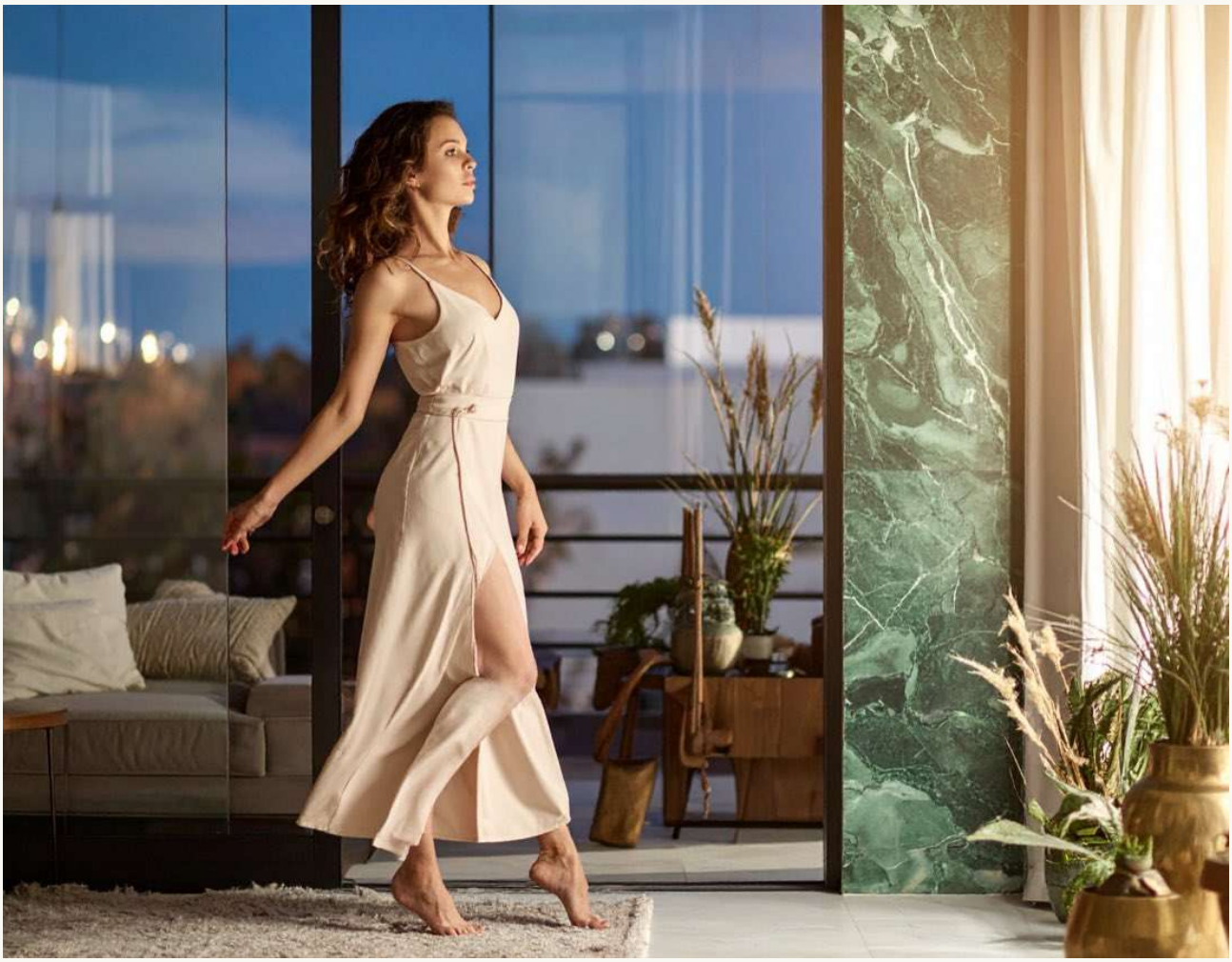
They argued the opposite: "we argue that pricing is a capability." Setting the right price, in their account, takes resources, routines and skills, built over time and spread across people, and a firm that lacks them cannot price well however good its products are. They show the capability at work in one company, in the detail of who gathers what information, who decides, and how a decision travels to the customer. It is one firm, studied closely, and its strength is depth rather than reach. Its central point does not depend on the firm. Price is not a number someone types into a system. It is the output of an organisation.

The study also makes a point that is easy to miss, and it matters for anyone who thinks of recovering price as a contest with the customer. Firms without good pricing processes, the authors wrote, "may be unable to set prices that reflect the wishes of its customers, so the customers may misuse their resources." A price that is wrong in either direction misleads the customer as well as the seller. A customer who is charged too little for same-day delivery uses it for orders that could have waited, and the firm's vans run half empty to serve a habit the price created. A customer charged too much for a product that costs little to serve buys less of it than it would have. Pricing well is not only how a firm keeps what it creates. It is how it tells its customers the truth about what things cost.

Read the analyst's two desks through that sentence. The invoice discount was set by the account manager, who is measured on volume. The rebate was written by the sales director three years ago, to win the account from a competitor, and is paid by finance, who pay what the contract says without asking whether the volume was met. The early-payment discount is applied by the system automatically; credit control sees the late payments, but its job is to collect the money, not to reclaim a discount. Free delivery was agreed when the customer's yard was two miles from the depot, before the customer moved. The returns policy belongs to the warehouse, which is measured on accuracy, and an unopened box is the easiest return there is.

Each of these people is competent. Each of them owns one bar of the waterfall. None of them owns the pocket price. The leak lives in the space between their jobs, and nobody is measured on a space.

The house's Luminous 100, its reading of the frameworks every consultancy sells, says of Porter's value chain that "The competitive advantage lives in specific activities, not the whole company." The pocket price is the same truth seen from the bottom of the account. The loss does not live in "the customer" or "the market". It lives in specific lines, kept by specific desks, and it can only be found there.



Every bar had a reason

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Every bar had a reason

It is worth being fair to the waterfall, because a leader who sees it for the first time is tempted to treat every bar as a mistake. Almost none of them began as one.

The rebate won an account the firm wanted, against a competitor who was offering more. The early-payment discount was agreed when the customer paid in ten days, and it bought the firm cash it needed that year. The free delivery made sense when the van passed the customer's door on its way to somewhere else. The full credit for unopened returns kept a customer who had over-ordered for a project that was cancelled. A marketing contribution is how distributors in this trade show their suppliers they are serious. If the analyst had been in each room when each concession was made, she would probably have agreed to it.

The trouble is not the concession. It is that the reason expires and the concession does not. The customer starts paying at fifty-eight days and keeps the discount meant for ten. The volume falls and the rebate is

paid anyway, because the clause that ties it to volume is in a contract nobody in finance has read since it was signed. The customer moves its yard and the van makes a special trip. Each bar outlives the reason it was granted for, and nobody is asked to notice, because each bar is somebody else's.

Santa Anna's *Ecstatic Economics* puts the principle underneath in a sentence that was written about currencies and holds just as well for a rebate: "money is a design choice, not a law of nature." Every bar below the invoice is a design choice. The firm made it once, on purpose, for a reason. What it has not done is make it again, on purpose, now that the reason has changed. A concession that is chosen every year is a decision. A concession that is simply renewed is a leak with a history.

The view from the account

It would be easy to tell this story as if the account manager were the cause, and it would be wrong. His view of the same year is worth hearing, because it is the view from which most of the waterfall is built.

He has looked after the account for four years. He knows the buyer's children's names and the date of the customer's busy season. He knows, because the buyer has told him more than once, that a competitor has offered a better price, though he has never seen the competitor's quotation in writing. Every concession he has agreed was agreed in a conversation in which the alternative seemed to be losing the account, and the account is a large part of the volume on which he is paid. When the customer asked to keep the early-payment discount while paying later, it was in the week a rival's representative had been seen in the customer's yard. When the customer asked for the same-day vans, it was after a delivery had gone wrong, and the vans felt like an apology.

None of these conversations was recorded anywhere a finance director would read. The firm's systems record what was invoiced. They do not record what was asked, by whom, under what pressure, or what the alternative was believed to be. So when the margin falls, finance sees a number and the account manager sees four years of reasonable decisions, and the two views never meet. Each side, privately, thinks the other does not understand the business.

The account manager also carries something the analyst does not, and it is in his body rather than in the ledgers. He is the one who will have to make the phone call. He is the one the buyer will be disappointed in. He has spent four years being the person at the firm who says yes to this customer, and he has, without ever deciding to, come to feel that saying yes is his job. Any change to the waterfall will be experienced by him, first, as a change to who he is to the buyer.

That is why the waterfall cannot be fixed by finance alone, and why it should never be presented to the account manager as a list of his mistakes. Every bar on it was a reasonable answer to a real question. What the firm lacked was not judgement in the moment. It was a place where the moment was written down,

and a time when it was read again, which is the same lack that leaves a professional firm's extra work unbilled (Chapter 2).

There is a human reason the bars are rarely revisited, and it is the one the analyst feels in her stomach. To ask about the rebate is to ask about the sales director's best deal. To ask about the early-payment discount is to ask the account manager to ring a friend and say something unwelcome. The *High Frequency Workbook*, writing about why people avoid their own accounts, says that money "is a mirror. Not of your worth — never of your worth — but of your patterns." The waterfall is that mirror for an organisation. It does not show whether the firm is good. It shows what the firm has been unwilling to ask.

What the band shows

The analyst does not stop at one customer. On Wednesday morning she takes the thermostatic valve, the firm's most common line, and works out the pocket price for every customer who bought more than a handful in the year. There are a little over two hundred. She sorts them, and draws the band.

It is wide, and it is not shaped the way anyone would have designed it. Some of the largest customers are near the bottom, as expected, because they buy in volume and cost little to serve per unit. But some large customers are near the top, and some small ones are near the bottom, and the order has more to do with which account manager each customer has had, and how long ago its terms were last negotiated, than with anything the firm would defend in public. The installer in the next town is in the top tenth. He pays on the day, takes no rebate, collects his own stock, and returns nothing. He is, by any measure of cost to serve, one of the cheapest customers the firm has. He pays among the highest prices.

The analyst sits with the band for a while before she shows it to anyone. It is an uncomfortable picture, and it is tempting to read it as a verdict on the firm or on the people who built it. The *High Frequency Workbook* has a short sentence for the moment of first looking at numbers that have been avoided, written for a person facing her own accounts: "Whatever it is, it is just a number." The band is just a number, two hundred times over. It describes what has happened. It does not yet say what anyone should do, and the first thing it asks for is not blame but a second look.

That is the part of the band leaders tend to miss, and it changes what the exercise is for. The band is not only a map of revenue the firm has failed to collect. It is also a map of fairness. Somewhere on it are customers paying more than their business costs the firm, subsidising customers who pay less, and neither group has been told. A firm that reads the band only as a list of accounts to squeeze has read half of it. The other half is a list of customers it may be overcharging, and those customers are often the small, loyal, uncomplaining ones whose business would be the easiest to lose to a competitor who noticed first.

This matters for anyone who wants to share in what the band reveals. A gain that comes from charging a captive customer more than it agreed is not a gain anyone should want to measure. A gain that comes from

honouring what was agreed, from tying each concession back to the reason it was given and from pricing the cheapest-to-serve customers as fairly as the most demanding ones, is a gain that the customer can see and survive. The difference between the two is the difference between a firm that recovers its revenue and one that merely moves cost onto the people least able to argue.



Drawing it by hand

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Drawing it by hand

What the analyst does next is the practice this chapter is about, and it is more a way of looking than a technique.

On Thursday afternoon she asks the account manager to sit with her for an hour. She has a sheet of A3 paper and a pencil, and she draws the waterfall for the one customer by hand, bar by bar, from the list price down. Each bar comes from its own ledger, and she writes the source beside it: the invoice system for the invoice discount, the rebate file for the rebate, the carrier's statements for the freight, the warehouse log

for the returns. Drawing it by hand is slower than a spreadsheet, and that is the point. The account manager watches the bars appear one at a time, each one familiar, and sees for the first time how far down the page the last one ends.

Then they go back up the page, bar by bar, and ask three questions of each. Who approved this, and when? What was the reason at the time? Does the reason still hold? They write the answers on the sheet. The invoice discount holds; the customer's volume still earns it. The rebate's reason does not hold, because the volume it was written for has not been reached for two years. The early-payment discount's reason does not hold either. The free delivery is mixed: it holds for full pallets on the regular route and not for the same-day vans. The returns credit holds for a project cancellation and not for routine over-ordering.

The account manager is quiet for most of this. Then he says something the analyst did not expect. He has known about the late payments for a year. He did not raise them, because credit control had not raised them, and he assumed that if it mattered someone in finance would say so. Credit control, it turns out, assumed the discount was the account manager's business. Readers of *Where the Flow Stops* will know the pattern. It is the meeting after the meeting, held between two departments that never met.

The decisions they take are small, and they are taken in order. First, every bar gets one of three answers, written beside it: keep, because the reason holds; renegotiate, openly, with the customer; or stop. Second, nothing is stopped by surprise. The account manager rings the customer's buyer the following week, before any invoice changes, and says plainly what the firm has found and what it proposes: the early-payment discount for payments within its terms, the rebate tied to the volume it was written for, free delivery on full pallets and a charge for same-day vans. The house has a book line on stating money plainly, from its own guide to selling, and the advice transfers exactly: "Present the investment as a clear, confident statement — not an apology". Third, the analyst puts the installer's price on the list too, and the firm brings it down to where his business belongs.

The phone call goes better than the account manager feared, and worse than he hoped. The buyer agrees to the delivery change at once, argues for a month about the rebate, and accepts the payment terms only after a meeting. What makes it possible to have the conversation at all is that the firm can show, on one sheet, exactly what it is asking and why, and that some of what it has found is in the customer's favour. The harder part, renegotiating a term that has been ignored for years without treating the customer as the one at fault, is the conversation about the clause in the drawer (Chapter 3), and it has its own discipline.

There are predictable ways for this to go wrong. A firm that draws the waterfall and then announces new terms by letter has turned a discovery into an ambush. A firm that draws it for its largest customers only, and not for the band, will recover from the accounts strong enough to push back and miss the ones it is overcharging. And a firm that leaves the incentives unchanged will find the bars growing back, because the account manager is still measured on volume and the cheapest way to volume is a concession nobody sees. Why that is so, and what the last week of a quarter does to the price (Chapter 5), is a matter the research

on sales incentives has been precise about. Chapter 7 carries the run sheet for the waterfall and the band, the sources for each bar, the three questions and the order of the conversations, and Chapter 6 places it in the order of a first ninety days.

The gain in all of this is real and it is worth naming exactly without inventing its size. It is the difference between the pocket price the firm receives today and the pocket price it would receive if every concession still matched its reason. It is measured against the firm's own ledgers, which already hold every bar. And before anyone shares in it, it has to be measured in a way that both the firm and its customers could look at without flinching, which means counting what was returned to the installer as carefully as what was recovered from the account.

Drawing your own waterfall

The article this chapter began as ended at the analyst's folder. The book can go further, into the finer points a leader meets when she draws the waterfall in her own firm, and the first of them is which customers to draw.

Not the worst. A waterfall drawn for the customer everyone already complains about produces a story everyone already knew, and a remedy aimed at one account. Draw three: one of the largest accounts, one ordinary account in the middle of the book, and one small, loyal customer who never asks for anything. The three together show the shape of the firm's pricing habits rather than the history of one relationship, and the small customer is the one most likely to show something the firm would not want to defend.

The second point is where each bar lives. The invoice discount is in the billing system. Rebates are usually in a separate file or spreadsheet kept by finance or by the sales director, sometimes in the contract alone. Payment terms are in the customer master, but the days actually taken are in credit control's ageing reports, and the discount for early payment is often applied automatically whether or not the payment was early. Freight is in the carrier's statements, rarely allocated to customers at all. Returns are in the warehouse's log and the credit notes. Promotional and marketing contributions are wherever the person who agreed them keeps them. Before drawing anything, list the ledgers and their owners. The list is itself a finding: it shows how many desks hold a piece of one customer's price.

The third is how to put a cost against a unit. Some bars attach naturally to a product, and some, like freight and the cost of returns, attach to orders or to the year. Spread them in the way the customer actually causes them: freight by the orders that incurred it, not by an average across all customers; returns by the lines returned. A waterfall built on averages hides exactly the differences it exists to show.

The fourth point is a caution about what the waterfall is not. The pocket price is what stays in the firm's pocket from the sale. It is not the profit on the account, because customers differ in what they cost to serve in ways the waterfall does not capture: the time of the account manager, the technical support, the com-

plexity of their orders. A low pocket price can be fair for a customer that is cheap to serve, and a high one unfair for a customer that is cheap to serve and pays it anyway. Read the waterfall beside whatever the firm knows about cost to serve, and say plainly where it knows little.

The fifth is the band, and what to look for in it. Once the pocket prices for one product are sorted, ask what explains the order. Volume should explain some of it. Cost to serve should explain some. Whatever remains, the spread that no reason the firm would defend can account for, is the finding. It usually sorts by account manager, by the year the terms were last negotiated, or by whether the customer has ever threatened to leave.

The sixth is who is in the room. The waterfall is drawn with the account manager, never about him. He supplies what the ledgers cannot: what was asked, what the alternative seemed to be, what the customer values. If he first sees the waterfall in a finance report, the exercise has become an audit of his judgement, and he will defend every bar on it.

And the decision that most changes the result is timing. Draw the waterfall before the customer's annual negotiation, not after it. Every bar is easier to change when the conversation is already due, and almost impossible to change in the middle of a year without seeming to go back on a deal. Chapter 6 places the first waterfalls in the opening weeks of a ninety-day plan, before anything is said to any customer, and Chapter 7 gives the waterfall sheet, the list of ledgers, the three questions for each bar and the band worksheet on single pages.

Ten to six, the next February

It is ten to six on a Tuesday, a year later, and the analyst has the same customer's year on her desk. It fits on one desk this time. The rebate was paid in January against volume the customer reached in November. The early-payment discount appears on most invoices and not on the ones paid late. The same-day vans are on the invoices, at a charge the buyer agreed in April, and there are fewer of them, because the customer's stores manager has started ordering a day ahead.

The thermostatic valve's pocket price for this account is a little higher than last year. The installer's is a little lower. The band, when she draws it again, is narrower, and its order makes more sense.

The A3 sheet from last February is in a folder with the customer's name on the spine. She adds this year's beside it, in pencil, and puts the folder back where the next person to look after the account will find it.

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