



Contents lists available at ScienceDirect

## Industrial Marketing Management



## Performance-based and functional contracting in value-based solution selling

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## ARTICLE INFO

## Article history:

Received 26 May 2016

Accepted 27 May 2016

Available online xxxx

## Keywords:

Value-based sales

Performance-based contracting

Functional contracting

Integration

Action research

## ABSTRACT

Solution sellers increasingly use value-based selling and pricing strategies to market and monetize their offerings. Performance-based contracts constitute a key component of value-based pricing strategies. The present study explores solutions to the challenges solution sellers may encounter while developing value-based selling processes and implementing value-based pricing. The research design builds on the explorative action research methodology. While our study confirms earlier research on barriers to value-based selling and pricing, we also identify legal-technical contract design issues as an important but previously unknown barrier. We further identify integration as the appropriate theoretical framework for conceptualizing the barriers. Finally, we identify functional contracting as a solution for value-based sellers to overcome the barriers arising from deficient precontractual integration. The study highlights the role of contracts as barriers to be overcome by legal sales efforts when implementing value-based selling and pricing strategies. Further, the study stresses the utility of functional contracting in pre-contractual integration.

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## 1. Introduction

Industrial solutions combine technology components, maintenance, training, business consultancy, and financial services to produce customer value propositions that product-based technology offerings fail to match (Davies et al., 2001; Frambach, Wels-Lips, & Gündlach, 1997; Hobday, 2000; Storbacka, 2011). Sizeable literatures exist on the design, commercialization, and marketing of industrial solutions (Davies & Hobday, 2005; Nordin & Kowalkowski, 2010; Storbacka, 2011; Terho, Haas, Eggert, & Ulaga, 2012). In particular, value-based solution selling has attracted attention among scholars and practitioners. In value-based selling, sellers seek to understand and influence their customers' desire for value, quantify and communicate the value of their offerings to the customer, and devise a value-based pricing method to capture some of the value offered to the customer (Hinterhuber & Liozu, 2012; Storbacka, 2011; Terho et al., 2012; Töytäri, Rajala, & Alejandro, 2015).

Value-based pricing can be achieved by using performance-based contracting (PBC). In PBC, at least a portion of a contractor's compensation is tied to the achievement of specific and measurable performance standards and requirements. In recent years, PBC has been studied in, for example, supply chain management and performance-based logistics (Devries, 2004; Kim, Cohen, & Netessine, 2007; Mirzahosseini &

Piplani, 2013), business model research (Ng, Xin, & Yip, 2013), service science (Hypko, Tilebein, & Gleich, 2010a,b; Ng, Maull, & Yip, 2009), and legal scholarship (Epstein, 2014; Mandaglio, 2010).

In the study reported in this paper, we followed and contributed to the efforts of Gamma, a division of a global logistics equipment manufacturer, as the company was attempting to introduce value-based selling and pricing to market its new solution offering. The project was fraught with difficulties from the outset. Gamma was struggling to design and market its new offering and pricing model. The company, for example, faced considerable difficulties in developing the performance-based contracts, encountered customers with seemingly perverse value perceptions and had trouble understanding and affecting those value perceptions, as well as struggled to gain access to influence within the customers.

Gamma soon understood that to overcome the difficulties the company would be forced to identify and forge appropriate organizational interfaces, influence customer value quantification tools and processes, manipulate customer decision-making sequences, and align and fine-tune the performance-based contracts to match the customer's value capture model and incentives. A review of the nature of the challenges led us to view and treat them as arising from Gamma's failure to achieve sufficient intra- and inter-organizational integration. With the relational integration tools Gamma first deployed, the company was not able to bring about a sales phase (Cacciatori & Jacobides, 2005, p. 1852) intra- and inter-organizational "unity of effort" (Lawrence & Lorsch, 1967,

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p. 4) that would have allowed Gamma and its customer to reach agreement.

This prompted us to instigate the development and testing of a negotiation process based on the functional contracting approach (Schepker, Oh, Martynov, & Poppo, 2014). The idea was to support and facilitate the complicated precontractual integration processes between Gamma and its customers by using contractual techniques to coordinate the negotiation process. In practice, Gamma designed a series of Memoranda of Understanding to help in orchestrating and sequencing the organizational and operational transformations necessary for achieving the desired integration level.

The problems Gamma encountered and the solutions developed constitute the setting for the article's research questions. The high level research question is *How can an industrial solution seller commercialize its solution with value-based selling techniques when using a highly advanced performance-based contract as the pricing device?* The existing literature was unhelpful. Even if theory suggested (Storbacka, 2011) that solution providers should widely use value-based pricing in their offerings, we found no account explaining *how* an industrial solution provider had successfully introduced such offerings and pricing models. The majority of existing PBC literature focuses on the procurement (i.e. buying) of complex performance and, thus, on "buy-side" problems (e.g. Caldwell & Howard, 2011; Hartmann, Roehrich, Frederiksen, & Davies, 2014; Roehrich & Lewis, 2014) and pays less attention to the problems sellers face as they attempt to introduce performance-based contracts (Datta and Roy (2011); Selviaridis and Norrman (2014) are notable exceptions).

The challenges we encountered during the process led us to ask two sub-questions that lacked answers in the literature at the time we initiated the research project.

*Sub-question 1* was framed by our observation that migrating to value-based selling and pricing was hard for the company. This prompted us to inquire: *What are the factors that hamper solution sellers' value-based sales efforts?* The answers to the question, we later discovered, in many respects matched those identified by Töytäri et al. (2015) and Töytäri and Rajala (2015). We, however, diverge from the findings of the articles on two issues. First, upon reviewing the obstacles, we concluded that the earlier literature had failed to address the question (a) *What is a suitable theory framework for explaining and addressing the barriers to value-based selling and pricing?* Without adequate theory, solution development is handicapped. Second, our empirical material implied that legal-technical contract issues may be much more persistent obstacles than suggested earlier. In addition, no accounts of how such complexities may be addressed exist. Business scholars have seldom acknowledged the importance of contracts, even in passing (cf. Mouzas & Blois, 2013; Töytäri et al., 2015). Legal scholars have diverted their attention to a number of PBC aspects, such as the constitutional implications of PBC use, but there are few research articles with a contract design orientation (cf. Epstein, 2014; Mandaglio, 2010). Thus, we also set out to outline (b) *What techniques could be developed to overcome the legal-technical contract issues?*

*Sub-question 2* was triggered by our observation that the company, along with other industry actors, seemed to be missing the potential that functional contracting techniques could have in facilitating the precontractual integration required for successful value-based selling. This prompted us to inquire into the question of *What kinds of functional contracting techniques could facilitate the achievement of the inter-organizational integration necessary for value-based selling with performance-based contracts?*

The empirical observations we made while observing and participating in the transformation process have a number of important theoretical and practical implications. The study, first, contributes to the literature by deepening the understanding of the challenges that relate to PBC use in industrial solutions sales. Chief among these are two observations. First, PBC use may be inhibited by the value-sharing pattern entrenchment effect that Töytäri et al. (2015) identified. Second,

companies have to consciously work to overcome this reluctance towards value-based pricing through *legal sales* efforts. Concerted legal sales efforts, where the seller attempts to demonstrate the feasibility of its contracts, are needed as entrenching the contracts is likely a key success factor in PBC-based industrial solutions sales.

Second, the findings highlight the importance of proper integration design in facilitating the value-based and legal selling of industrial solutions. Our contention is that the complex multi-layer intra- and inter-organizational transformations necessary for successful solution sales when using advanced performance-based contracts as value capture devices require the deployment of the functional contracting approach. In addition, our evidence provides insights into how functional contracting techniques may be used to create the necessary level of integration. One crucial limitation of our research is that we lack quantitative data on the effects of the functional contracting process as most of the sales cases that we observed are still ongoing, while others have failed due to reasons unrelated to this study.

The paper is structured as follows. In Section 2, we conduct a literature review on industrial solutions, value-based selling, integration, performance-based contracting, and functional contracting theory. In Section 3, we discuss the methodology employed in the study and the data we collected. The section further describes the value-based sales process development project we initiated and participated in during the study. In Section 4, we discuss the empirical findings of our study. In Section 5, we present and discuss key conclusions and their relation to extant research streams. In addition, we propose future research directions.

## 2. Literature review

As our findings suggest, the factors that hampered the case company's sales efforts were best theorized as precontractual, sales phase integration difficulties. Further, we discovered that functional contracting techniques could facilitate the required precontractual integration for successful value-based selling. Consequently, we will briefly review the literature on industrial solutions, value-based selling, integration in industrial solutions, performance-based contracting, and functional contracting.

This entails that we forgo, for example, explicit customer relationship management, co-creation, sales management, and market orientation perspectives as the theoretical backdrops for our study, although these are implicitly present as tacit approaches in the integration mechanisms designed at the case company.

### 2.1. Industrial solutions

Integrated industrial solutions are "longitudinal relational processes, during which a solution provider integrates goods, service and knowledge components into unique combinations that solve strategically important customer specific problems, and [is] compensated on the basis of the customer's value-in-use" (Storbacka, 2011, p. 699). This results in the solution provider often identifying and diagnosing problems in the customer's organization (the business model and processes of which the customer might have been unaware) and offering proactive solutions that aid the customer in overcoming these problems. Moreover, compared to a traditional goods- or product-dominant business logic (Grönroos, 2000; Vargo & Lusch, 2004), migrating towards an industrial solution business model that "is characterized by longitudinal processes and collaboration that involve several functions of both the buying and selling organization" (Storbacka, 2011, p. 699) entails several shifts and repositionings. These shifts affect the industry value chains and required organizational capabilities (Galbraith, 2002) and add to the complexity of performance and contractual arrangements used when selling and procuring the solutions (Caldwell & Howard, 2011).

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