

# Pricing and Profitability Management

A Practical Guide for Business Leaders

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# Contents

*Cover*

*Title Page*

*Copyright*

*Dedication*

*Foreword*

*Acknowledgments*

*Chapter 1: Introduction to Pricing and Profitability Management*

*Pricing: The Critical Lever for Raising Performance*

*Common Obstacles to Pricing and Profitability Management*

*Understanding—and Leveraging—the Human Side of Pricing*

*An Integrated Approach to Pricing: The Six Core Competencies*

*Beginning the Journey: Key Questions to Ask*

*Chapter 2: Conducting a Pricing and Profitability Diagnostic*

*The Case for a Diagnostic*  
*How to Execute a Diagnostic*  
*Consolidating Findings and Identifying*  
*Opportunities to Improve Capabilities*  
*Challenges and Considerations*

## *Chapter 3: Developing an Effective Pricing Strategy*

*What Comprises a Successful Pricing Strategy?*  
*How to Make Value Your Focus—and Why*  
*Formulating a Value-Based Pricing Strategy*  
*Designing and Integrating an Effective Pricing Structure*  
*Identifying and Using the Principal Pricing Archetypes*  
*Critical Challenges Faced by Pricing Strategists*  
*Tips for Moving Forward*

## *Chapter 4: Price Execution*

*What Is Price Execution?*  
*Using the Best-Practice Pricing Process Framework*  
*Setting Policies to Reinforce Pricing Processes*  
*Tips for Moving Forward*

## **Chapter 5: Advanced Analytics and Price Setting**

**Building a Transaction-Level Data Set**

**Conducting Transactional Profitability Assessments**

**Integrating Cluster Analyses to Segment Customers, Products, and Services**

**Assessing the Competition: Value Equivalency Analytics**

**Demand-Based Optimization Modeling to Improve Price Setting**

**Tips for Moving Forward**

## **Chapter 6: Achieving Effective Organizational Alignment and Governance**

**Five Key Components for Aligning a Pricing Organization**

**Aligning Sales to Support Pricing and Profitability Goals**

**Identifying and Empowering Pricing Leaders**

**Designing Robust Organizational and Governance Structures**

**Implementing Change Management and Adoption Processes**

**Evaluating and Managing Pricing Talent**

**Making the Organizational Commitment to Change**

## **Chapter 7: Pricing Technology and Data Management**

**What Is Pricing Software?**

**The History of the Pricing Software Market**

**Building a Business Case for Pricing Technology**

**Selecting Pricing Management Software**

**The Pricing Software Development Lifecycle**

**Future Trends in Pricing Technology**

**Pricing Technology Selection and Implementation Recommendations**

## **Chapter 8: Integrating Tax and Regulatory Policies with the Pricing Strategy**

**The Convergence of Tax and Pricing Strategy**

**How to Integrate Pricing and Tax Functions –and Why**

**Managing Pricing and Compliance Costs to Maximize Returns**

**Navigating Regulatory Environments When Making Pricing Decisions**

**Where to Go from Here?**

## **Chapter 9: Pricing as a Sustainable Competitive Advantage**

**Why Taking a Holistic Approach to Pricing Matters**

**Bringing it All Together: A Case Study**  
**Emerging Trends in Pricing and Profitability**  
**Management**

**Lessons Learned: Getting Pricing on the**  
**Executive Agenda**

**Appendix: What Is Value and Why Is**  
**It So Difficult to Measure?**

**Index**

# Pricing and Profitability Management

A PRACTICAL GUIDE FOR BUSINESS LEADERS

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*To Don, Jack, Charlie, and Theresa*

# ***Foreword***

Several years ago, I was asked to lead the transformation of an organization with a record of success that spanned a century. In an effort to continue and to grow that success, we embarked on a comprehensive program to transform some areas within the company. One of the most important was pricing. The leadership team knew we could improve our pricing, and that the value this would create was larger than any other improvement initiative we could undertake. As a result, I had the opportunity to work closely with several of the authors. I have personally applied what you are about to read, and can attest to the value it will create.

I have more than a passing familiarity with pricing, from both my academic background and my career in business management. There are literally dozens of books on pricing theory, and I have read a fair number of them. Most address specific aspects of pricing; while helpful in addressing specific challenges, they do not provide an integrated, holistic approach to setting and managing price. If we were truly going to transform our organization, we needed an approach that incorporated theory, but also gave us a pragmatic and realistic roadmap for applying advanced pricing capabilities as quickly and efficiently as possible. This approach also had to take into account that the business would not stop while we determined the future. We needed a roadmap that told us where to start, gave us the right tools and techniques needed to improve our performance, provided a sequencing that both built capabilities and delivered early results, and most importantly, told us how to do this in a way that the organization would accept and adopt as quickly as possible. We also needed to know the

challenges we would face and how best to address those challenges, as well as how to manage expectations both internally and externally, with internal stakeholders as well as with our customers and competitors.

We knew when we started this program that we would be changing, in some cases radically, how pricing is executed, and who would set and execute price. Traditionally, pricing has been managed in pieces across various parts of the business, and this cross-functional integration is an ongoing challenge within any organization. With pricing, sales often sets base price and provides insights into customer behavior and competitive intelligence, marketing determines promotions, segmentation, channel, and brand positioning, operations determines cost, and supply chain drives cost-to-serve. Finally, finance sets hurdle rates, expected ROI and ROA, and holds the organization accountable for results. There are endless variations on the model I just described, depending on your specific circumstances. A key concept explored in this book is “how do these pieces all fit together? How should they fit together, and how do we align the organization to achieve and retain a high level of integration across pricing activities?” You will find the answers to these questions, and more, within this book.

When we started this journey, we were a relatively unsophisticated organization in terms of setting and managing price, especially in our field organization. Giving it tools that allowed them to understand and learn about the behavior/characteristics of its particular clients (willingness to pay), to understand the drivers of profitability (cost to serve), and to rank each different client (relative value) was especially valuable to us. I believe it attracts and identifies the “naturals” in the sales force that are at ease making analytically-based decisions, and also fosters the development of true

business acumen in these same individuals. That by itself will be of significant benefit to the organization, and as the results become apparent, those talents become a core component of the organizational culture.

Another significant benefit comes with creating a framework and an environment where the organization can create experiments and learn. As an example, having an explicit methodology for testing various promotional and discount activities, and then using that information for developing better future pricing policies is a great way to get your people to think about what they are doing when they pull the various levers in sales and marketing, and how those actions can affect segmentation, willingness to pay, and so on. This is particularly valuable in exposing how apparently dissimilar, unrelated activities can and will affect other parts of the organization, and again, the customer in terms of driving behavior, both intended, and almost more importantly, the unintended consequences that often occur when potential pricing actions are not fully evaluated in terms of “what if” scenarios. The cultural impact of creating a “test and learn” environment should not be underestimated; removing the fear of failure will create a level of engagement and thinking that is not common in most organizations today.

Truly effective pricing requires a level of integration and analysis that has been and continues to be rare in most organizations. Driven by deep analytics, both from a price-setting and a price-execution perspective, companies now have access to information in a form and at a level of granularity that not only enables this integration, but demands it. This book is a practical guide, outlining why the integrated, holistic approach is essential, how to align disparate functions so that integration happens as planned, and most importantly,

how to make that integration sustainable within your organization.

The benefits that will be achieved by the application of these concepts are significant. When we started our program, our expectations were high, but not unreasonable. In reality, we have achieved many, many times the benefits we initially expected, totaling literally hundreds of millions of dollars. In addition, these benefits are recurring, and there is a first-mover advantage from adopting the integrated approach outlined in these pages. Integrated price management capabilities are iterative; the more you do it, the better you become at it. Companies who adopt these capabilities before others in their industry will create a sustainable competitive advantage through their ability to manage price, even in the midst of continuing economic uncertainty, and the growing complexity of the global economy.

There are several things this book is not. This book is not a comprehensive guide to cost management. Cost management has been an established discipline for decades, and this book would need to be an order of magnitude longer to include even an overview of leading cost management techniques. While the authors go into great detail in understanding costs associated with specific transactions, the techniques required to manage cost effectively are not covered in detail. What is covered is the ability to determine what value a customer creates for you and how your costs in attracting, serving, and retaining that customer align with the value they create for you as a customer. This is not only the value of higher margins; business leaders today need timely information for making strategic tradeoffs. As an example, when should I place brand or marketplace considerations on par with economic value? What if market share is how the analysts evaluate us? What will that cost us, and what

can we expect in terms of a payoff, again, not just in margin, but across strategic considerations?

This book is also not intended to explain the theory of economic value. Theory, while required as a base for charting your course, does not give you practical advice for dealing with hundreds of salespeople, thousands of customers, and hundreds of thousands of transactions. The challenge addressed by this book is not the development or further evolution of pricing theory, but the pragmatic translation of theory into tactics, in a way that drives results for both you and your customers. A consistent theme within this book is how to identify and quantify the value you create for the customer, the value specific customers create for you, and how to align your organization and capabilities so that every interaction you have with the customer creates value for both of you. At its best, the holistic, integrated approach to pricing will enable you to identify and implement pricing programs that drive value for everyone in your value chain, from you, through distributors and retailers, and on to end customers.

As I stated earlier, I have seen firsthand the value created through this approach. It is challenging, and will require your organization to change long-standing beliefs, roles, and operating models. While challenging, the value that will be created more than justifies the risks and effort required to make this real. Simply put, this works, works quickly, and creates tangible, measureable and significant improvements in both revenue and margin. Done well, it will also improve customer relations, and drive you and your customers into a much closer and mutually beneficial relationship.

Decades of research has shown that investing in improved pricing capabilities has a higher rate of return than any other improvement initiative you might launch

within your organization. This book is a comprehensive guide to making that investment pay the highest possible rate of return as quickly as possible, while also giving you information you never previously had for making strategic decisions, and in time to make those decisions matter. You, your people, your customers, and your shareholders will all benefit. If you are responsible for the financial performance of your organization, it is imperative that you read this book.

**Juan José Suárez Coppel**  
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# ***Chapter 1***

## ***Introduction to Pricing and Profitability Management***

*The moment you make a mistake in pricing, you're eating into your reputation or your profits.*

*—Katie Paine, founder and CEO of KDPaine & Partners*

There is an old joke about a businessman who loses margin every time he sells his products. A customer asks, “How do you make money?” The businessman answers, “I make it up in volume.”

A company that routinely sells products below its margins would hardly seem likely to remain in business for long. Nonetheless, many firms follow this approach today. In some cases, this approach is an unintentional move, which results in the company losing money on every transaction. In other cases, it reflects a carefully considered decision to maximize profitability across a portfolio of product offerings. However, in other instances, this approach is adopted by business leaders who simply misunderstand which of their products and customers are actually generating margin and the factors that truly determine their company's profitability.

The field of pricing management has been growing steadily in recent years. If you mention the subject in a group, many people will assume the ensuing discussion will be limited to price setting. But the discipline involves much more than just prices themselves. Pricing management is a strategic competency that involves people, processes, technology, and information. Its reach

extends into virtually every corner of an organization (i.e., marketing, sales, IT, operations, finance, accounting, and executive leadership). Effective pricing management is capable of changing the way a company views and operates its entire business; it helps ensure the overall profitability of an enterprise and it can affect the bottom line profoundly. This book is intended to serve as a comprehensive introduction to the discipline and a reference work for business leaders, managers, and students who want to deepen their understanding of and sharpen their capabilities in this critical function.

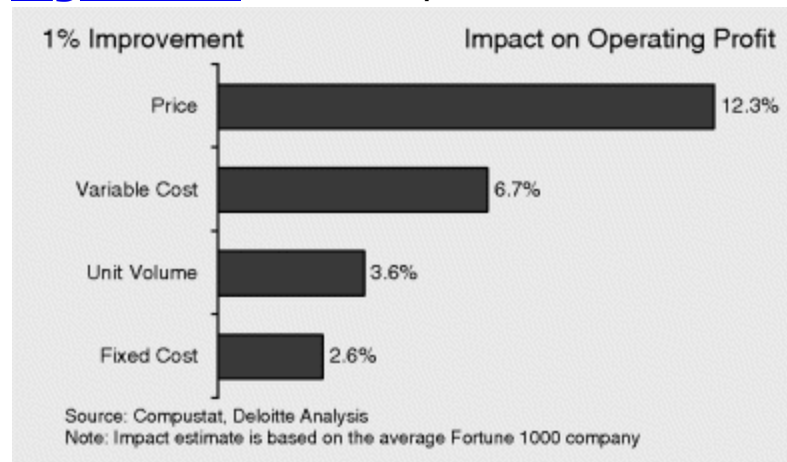
## **Pricing: The Critical Lever for Raising Performance**

Why make pricing improvement a focus for an organization? The answer is simple: the benefits are enormous. A study has shown that 90 percent of pricing investment meets or exceeds return on investment (ROI) expectations.<sup>1</sup> Put another way, *for any dollar invested in performance improvement, the greatest return comes when it is invested in pricing.*

[Figure 1.1](#) reflects one version of an often-replicated analysis.<sup>2</sup> All versions lead to the same conclusion: pricing is the most powerful lever available to raise performance. Despite this, the evolution of pricing management has, until recently, been slow. Although it has long been recognized as one of the traditional *four Ps* of marketing, systemic and structural challenges prevented pricing management from achieving the same level of sophistication or having the same capacity to improve performance as it has now. In its early days, practitioners focused on revenue/yield management and operated almost exclusively in the airline and hospitality

industries. But recent developments have led companies to appreciate the breadth and critical importance of the discipline. We discuss three of these developments briefly in the following.

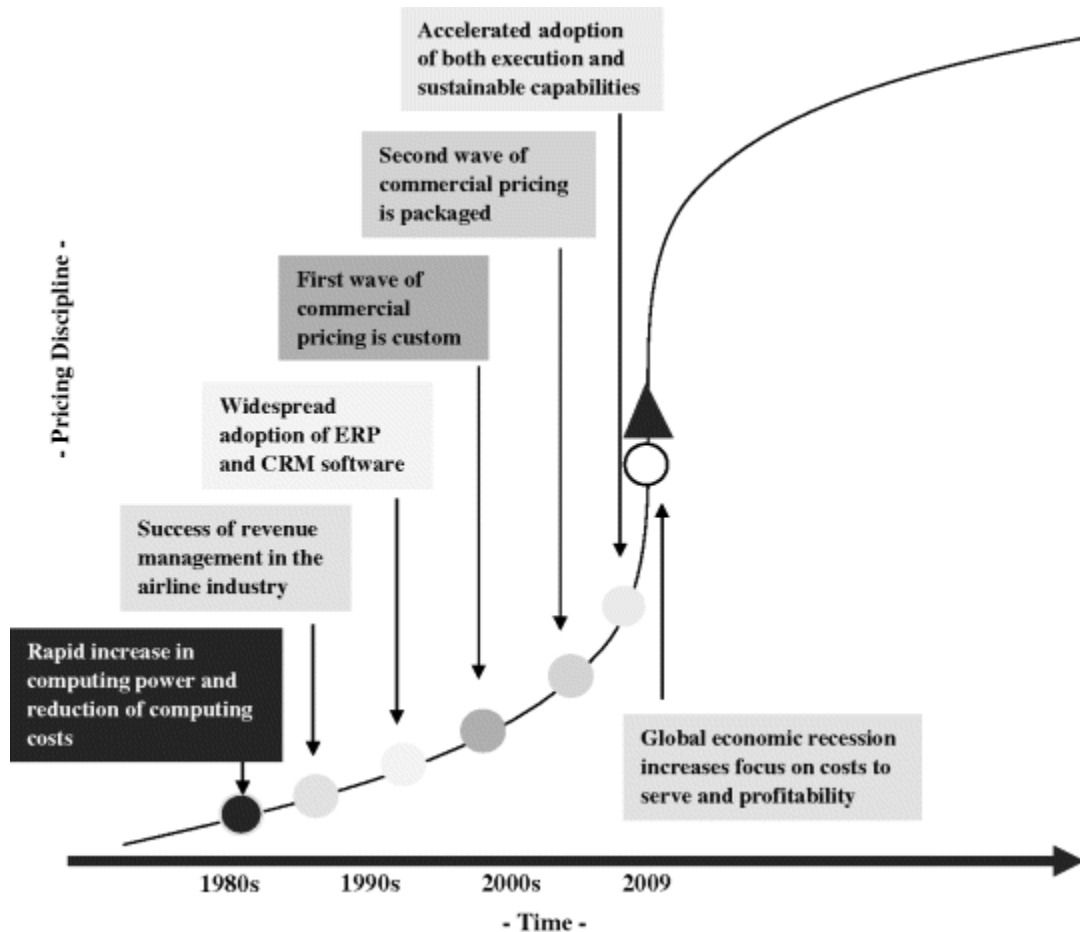
**Figure 1.1** Profit Improvement Initiatives and ROI



## The Search for Improved Data Management Solutions

The widespread adoption of enterprise resource planning (ERP), particularly over the past 10 years, has enabled firms to collect, process, and store more transaction-level data than ever before—a prerequisite for effective pricing management. However, management of this information has lagged behind. Data mining, transaction-level price analyses, demand-elasticity curves, price waterfalls, price-band analysis, customer segmentation, and transaction-level profitability measurement are all tools that require large amounts of clean, available data. Companies have aggressively sought new ways to manage this data, which, in turn, has led to an explosion in price optimization software (see [Figure 1.2](#)).

**Figure 1.2** Causes of Historical Growth of the Pricing Discipline



Traditionally, pricing software addressed demand curves, price optimization, and, at the highest level of sophistication, revenue/yield management. In the past five-to-seven years, however, the need for software to address price execution has been recognized and addressed. The software continues to evolve in response to market needs, as various packages leapfrog each other with improved capabilities. Overall, vendors have moved from offering purely custom solutions to providing true “off-the-shelf” functionality that can be implemented in months, not years. In addition, these vendors aggressively pursue the integration of stand-alone pricing software and core ERP systems.

The response to these software developments has been striking. Every single competitor in the ERP space has bought or built software, or partnered with other vendors

that have software, to bring advanced pricing capabilities to the market. This is true for both the business-to-business and the business-to-consumer markets.

As this book was going to press in 2011, the pricing software industry was well into a consolidation phase. Some of the small niche players had gone out of business or been absorbed by larger firms that coveted the specific capabilities they could add to their existing application portfolio. A few key players had emerged, but the true winners had not yet achieved dominance.

However, despite its obvious importance, software alone will not provide a competitive price advantage; good data can only serve as a basis for developing an effective strategy. In fact, if software is positioned as the “silver bullet,” it can actually decrease a company's ability to set and manage prices because sales personnel will likely resist using the tool without careful preparation. For example, an advanced software application can help calculate customer-specific pricing, but if sales incentives are not aligned with the new prices, then discounting practices may arise that undermine them and make the new price list suboptimal. For this reason and many others, software must be part of a comprehensive strategy that can meet the demands of an increasingly complex world.

## **The Growing Challenges of Global Markets**

Globalization (and the expansion of cross-border arbitrage and gray market activity) has increased the need for multinational companies to create worldwide pricing strategies. If not addressed effectively, gray markets will cannibalize sales for manufacturers and jeopardize relationships with distributors who own

contractual rights within a region. The need to address these issues strategically in international markets will continue to grow as companies realize that other profitability initiatives have ceased to work.

## **Reaching the Limits of Cost-Cutting**

An organization can only undertake so many cost-reduction initiatives without diminishing its ability to serve its customers effectively. For example, a manufacturing company can consolidate plants to slash expenses only so long as its production capacity is still able to meet demand. Similarly, a retailer cannot continue eliminating sales personnel if this strategy interferes with the running of the store, causing revenue to drop. Companies can never “cut” their way to prosperity. Pricing, in contrast, is a constant means to profitable growth.

The emergence of these three trends—improved data management solutions, the challenges of global markets, and the limits of cost-cutting—has helped companies see the tremendous opportunities that pricing management can produce. The benefits are both sizeable and quickly realized. (There is also a first-mover advantage: the earlier a firm addresses pricing, the further along its learning curve and ahead of the competition it will be.) Yet while companies have more and more tools available to help them develop an improved pricing capability, many still have failed to act. Why?

## **Common Obstacles to Pricing and Profitability Management**

In a 2004 study, AMR Research found that fewer than 3 percent of companies effectively managed,

communicated, and enforced prices.<sup>3</sup> Why? Because pricing, done correctly, is an extremely complex undertaking that requires a group of trained practitioners to view the business through a unique lens.

While executives may understand the benefits of improving their organizations' capabilities, the obstacles they face may seem insurmountable and can create institutional inertia. Many apparent barriers simply reflect the demands of pricing management itself. Other barriers reflect the natural confusion of an organization that lacks the structure and the personnel to handle the new strategic approach. A few of the common impediments follow.

## **Daunting Complexity**

Pricing is an intricate and interdependent competency that affects all levels of an organization and the market it serves (including customers and competitors). At any given time, an organization must ask itself and address a multitude of questions:

- How can price be used as a competitive advantage, and how can we achieve results as quickly as possible?
- How do we position a price with our customers, and how do we differentiate our offering?
- What should our value propositions be for each customer segment?
- How does our product portfolio match the needs of our customers?
- What do we have to do to meet the promises made by our executives and our sales force, while still delivering the required margin?
- Can we use price to influence demand (and can we build that into our production and supply chain

thinking)?

- What should our price be?
- Once we have the right price in place, how do we execute it effectively, and what will be the likely customer and competitor responses?

## **Internal Resistance**

Pricing data collection and cleansing can be a challenging and time-consuming task that requires specialized technical skills and a cross-functional and multisystem understanding of the data. Winning cooperation between the different functional groups involved may prove difficult. Initial improvement efforts are often viewed skeptically by organizations simply because they reflect a new approach. In addition, individual units may rely on different data sets to form their assessments of the organization's needs and market position, which can lead to strategic disagreements. Thus, many pricing initiatives fail before they truly begin because managers find various reasons to resist changing the status quo and are unwilling to adopt a fresh, objective view of the business at a transaction level.

## **Fear of High Stakes**

Besides being costly, pricing errors can produce long-term (if not permanent) consequences for an organization. Any organization that has engaged in a price war with a competitor can attest that the brand (and/or the price levels) never fully recovers. Many firms fear the negative consequences of poor decisions, and conclude that maintaining the status quo with acceptable margins is a safer path than trying to achieve better margins and risking a catastrophic mistake.

## Unavailable, Inaccessible, or Unclean Data

If data are missing or otherwise unusable, then companies lack the basic information they need to formulate a plan. For example, a company will have trouble performing a profitability analysis by customer segment if it lacks organized transaction-level data and customer-level, cost-to-serve information. This problem will remain if effective modeling or sampling techniques cannot be developed to address the issues.

## Human Resource Constraints

Engaging the right people for pricing improvement (i.e., those with the appropriate authority, political connections, and skills) can be challenging as many managers are already too busy executing their day-to-day activities to take on additional responsibilities. Many organizations struggle to dedicate the necessary personnel required to mount an initiative as ambitious as pricing improvement.

## Hidden Problems

Many weaknesses in a company's existing pricing strategy can be masked or obscured by the complexities of overlapping functions. Uncovering the trouble spots can be a challenging exercise. [Table 1.1](#) identifies some of the major pricing issues and their common indicators.

**[Table 1.1](#)** Common Indicators of Major Pricing Issues

Symptom	Description of the Problem	Impact
<b>Maverick Selling</b>	<ul style="list-style-type: none"><li>• More than 30% of all deals are closed below the established discount guidelines or policies.</li></ul>	<ul style="list-style-type: none"><li>• Unwarranted discounts are issued.</li></ul>
<b>Price Erosion</b>	<ul style="list-style-type: none"><li>• Lack of visibility into historical pricing of comparable deals (or into historical trends) causes deeper than necessary discounting.</li></ul>	<ul style="list-style-type: none"><li>• Unwarranted discounts are issued.</li></ul>

<b>Symptom</b>	<b>Description of the Problem</b>	<b>Impact</b>
<b>Margin Erosion</b>	<ul style="list-style-type: none"> <li>• Below-the-line transactional expenses and incentives are not considered during deal negotiations or not recovered after deals close.</li> </ul>	<ul style="list-style-type: none"> <li>• Revenue leakage and lost profits.</li> </ul>
<b>Slow Response Time</b>	<ul style="list-style-type: none"> <li>• The time to respond to a customer's pricing request is relatively long.</li> </ul>	<ul style="list-style-type: none"> <li>• Deals are lost.</li> </ul>
<b>Unsegmented Pricing or Discounts</b>	<ul style="list-style-type: none"> <li>• Prices are not set at a level granular enough to capture the maximum profit from a transaction.</li> </ul>	<ul style="list-style-type: none"> <li>• Unwarranted discounts are issued to unprofitable customers.</li> <li>• There are revenue leakage and lost profits for price-insensitive customers.</li> </ul>
<b>Price Agreement Compliance</b>	<ul style="list-style-type: none"> <li>• A single customer has multiple agreements for the same product, but consistently makes purchases at the lowest price.</li> </ul>	<ul style="list-style-type: none"> <li>• Unwarranted discounts are issued.</li> </ul>
<b>Customer Volume Compliance</b>	<ul style="list-style-type: none"> <li>• Customers have an established agreement with volume commitments, but do not buy to their full potential.</li> </ul>	<ul style="list-style-type: none"> <li>• Unwarranted discounts are issued.</li> <li>• Revenue is not realized.</li> </ul>
<b>Less Productive Pricing Team</b>	<ul style="list-style-type: none"> <li>• The team does not have the ability to prioritize and analyze special pricing requests properly to have the maximum impact.</li> </ul>	<ul style="list-style-type: none"> <li>• Unwarranted discounts are issued.</li> </ul>

## **Cross-Functional Chaos**

“Pricing touches everything, and everything touches pricing.” This simple truism is recognized by pricing professionals, but it is not often recognized across an organization. In a typical organization, Marketing sets list (or market) prices and gathers customer and competitive pricing information; Sales negotiates prices with customers; IT provides data and maintains the systems that support pricing decisions; Finance shares costs and “profitability” data; Operations offers input regarding capacity; Order Fulfillment determines how best to process purchase requests (and generates the costs that flow from these decisions); and Executive Leadership monitors pricing and profitability, while reporting key metrics to external stakeholders. Lack of coordination and

conflict between these functions (which have different agendas) can make it nearly impossible to set up a dynamic, informed, and integrated pricing competency.

Organizations that lived through the wave of reengineering in the 1990s still bore the scars, more than a decade later, of attempting to manage processes across functional boundaries. The results were impossible to quantify and simply set various functional groups against each other. The good news is that pricing, unlike other options, drives immediate and recurring results and produces measurable improvements to the bottom line. Effective pricing gives a place at the table to all the internal groups affecting, or affected by, its policies. Unlike many cross-functional initiatives, pricing does not require one function to win and others to lose. In fact, the balancing of each group's objectives creates a natural tension that, when used effectively, actually improves pricing performance by ensuring that the various functions' needs and goals are addressed.

## **Differing Organizational Pricing Perspectives**

The internal debates on pricing are endless. The level of real insight into customer buying behavior is limited; value propositions are nonexistent (or worse, come from an internal perspective); and the real margins by customer, product, or salesperson are poorly understood and difficult, if not impossible, to calculate. Thus, there are several distinct perspectives, which generally follow functional lines:

- *It's all about the numbers.* According to this school of thought, deep analysis of the numbers (derived either algorithmically or by regression) will produce profound insights into customer

behavior; the product or service value proposition; and, ultimately, what the optimal price offering should be.

- *The sales force should be given complete freedom.* Advocates of the sales team believe that the sales team, because of its daily interaction with buyers and direct insight into customer behavior, should be the sole determiner of price. One senior vice president once summed up this perspective nicely: “My sales force needs total flexibility at the point of contact with the customer.” Is this ever really true? And, if it is, at what cost? Getting pricing right inherently requires the ability to make fully informed tradeoffs.
- *Get your costs right, and price will take care of itself.* Seasoned managers who have built successful careers on cost management believe too much effort is spent on the “soft side” (i.e., attempting to understand customer behavior). The real answer to any pricing issue, they believe, is to move further down the cost-experience curve, using production efficiencies and statistical process controls to produce goods more cheaply than the competition. This group tends to favor a cost-plus pricing approach, which determines margin (and ultimately selling price) by taking the cost to produce and adding a “fair” or “reasonable” markup.
- *Customers will pay us a premium if we create a better product.* Little emphasis is placed on pricing during the new product development process; innovation for the sake of innovation is valued. Yet while many products are high function and top quality, manufacturers are generally

unable to recoup a margin that warrants their investments in development.

- *Better information systems are the silver bullet.* The failure to meet pricing challenges is often framed as the result of a lack of relevant information. If the IT systems delivered the right information, advocates believe, then setting and negotiating price would be easy, and deals would almost close themselves. (Of course, good data can serve as only the basis for developing a strategy—this should not be confused with actually having a plan.)
- *The customer rules.* For some in the organization, the voice of the customer represents the final word on what prices should be. Little or no effort is made to evaluate the value a product creates for buyers, let alone to determine if the offered price takes into account the value the customers create for the organization. Focus groups, surveys, and, above all, anecdotal insights from the sales force are used as the basis for determining what to charge and what a customer is willing to pay.

Each of the perspectives listed above is a key indicator of a corporate culture dominated by a certain function: the first by finance; the second, sales; the third, manufacturing; the fourth, innovation or engineering; the fifth, IT; and the final, marketing. Each perspective can produce important insights but offers only a fragmentary view of pricing. In this case partial answers will yield only partial results. The more one view predominates, the less effective pricing will be.

Why is it that a book on pricing begins with a discussion of corporate culture? Because the human factors are so