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The six pricing myths that kill profits

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Abstract Pricing is the most important driver of profits. Pricing is also, surprisingly, the area most executives overlook when implementing initiatives to increase profits. There is a reason: Research presented in this article suggests that most executives implicitly hold on to a series of weakly held assumptions about pricing that ultimately are self-defeating. These pricing myths are that (1) costs are the basis for price setting, (2) small price changes have little impact on profits, (3) customers are highly price sensitive, (4) products are difficult to differentiate, (5) high market share leads to high profits, and (6) managing price means changing prices. This research shows how executives can overcome these misconceptions and thus implement sustainable profit improvements via pricing.
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1. Pricing: Guided by principles or driven by myths?

Pricing is, for better or worse, the most important driver of profitability (Schindler, 2011). However, pricing is not yet on most executives' agendas as a primary concern. Less than 5% of companies have a chief pricing officer (Hinterhuber & Liozu, 2014). For every company that has a chief pricing officer, such as General Electric (GE), there are dozens of Fortune 500 companies—such as BASF, Volkswagen, Nestlé, Sony, Toshiba, Daimler, British American Tobacco, and others—that do not. At the vast majority of companies, pricing falls between the cracks. Everybody, from sales (in negotiating prices with customers) to marketing (in setting list prices) to finance (in defining payment terms) to controlling (in setting discount levels) to supply chain (in determining which customers are eligible for free shipping) to key-account management (in price negotiations with large accounts), is responsible for pricing—so in the end, of course, nobody is.

How does this self-defeating behavior persist? The extensive research I conducted over the past 5 years (see Appendix) suggests that senior and middle managers unconsciously cling to six pricing myths that kill profits. In this article I explore these myths in detail. And, conversely, I show that an increasing number of highly profitable companies that incorporate well-crafted pricing strategies in their executive agendas have found ways to overcome these myths and increase profits.

So the key question is: Is pricing guided by sound principles or driven by myths? There are abundant examples of companies that fail or merely limp along because they fall victim to the pricing myths.

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One such dramatic case occurred at General Motors (GM).

1.1. A tale of two companies in the automotive industry

At GM, market share was the number one goal of the company's executive suite. Legend has it that Rick Wagoner, the former CEO, wore cufflinks engraved with the number 29: the magical market share objective. Bob Lutz, then vice chairman, justified aggressive discounting thus: "We had to keep the plant going and pump out vehicles to meet the market plan" (Simon, 2007, p. 22). Contrast this obsession with volume with the approach of another mass-market producer, Fiat. Sergio Marchionne, the CEO of Fiat Chrysler Automobiles, stated: "Unprofitable volume is not volume I want. We have a very good track record for how to destroy an industry—run the [plants] just for the hell of volume, and you're finished" (Linebaugh & Bennett, 2010, p. B1). Historically dominated by engineers and finance wizards, pricing at GM was heavily cost based. Bribing customers to drive its vehicles off dealers' lots—in other words, discounting—became an integral part of the company's culture. In a press release following reports that some customers obtained more than US$10,000 in discounts despite companywide attempts to cut back on the practice, a GM spokesperson commented: "It's to be competitive. You have to do something out there" (Simon & Reed, 2008, p. 17). GM in the past simply assumed that the first purchase factor of customers was price, followed possibly again by price. Similarly, the company fatally—and fatalistically—assumed that cars were seen by customers as a commodity. As a result, GM stopped creating breakthrough customer value via innovation and made discounts from list prices the main selling point, inviting a series of profit meltdowns. Only recently did GM finally come to grips with the importance of pricing, and executives enthusiastically started by changing list prices and discount structures.

Contrast this approach with the principle-guided approach to pricing of another company in the automotive industry, Continental AG, the second-largest automotive supplier globally, headquartered in Germany. Executives at the company understand that changing prices is the last part of any pricing initiative; Continental AG first improves information systems, pricing processes and tools, incentive systems, and pricing capabilities. Most important, it invests significantly in improving the abilities of its salesforce to practice value-based selling. Armed with relevant and resonating messages, the salesforce is thus superbly able to demonstrate to customers why high prices are more than justified by higher value. The difference in profitability between these two companies is staggering. Both GM and Continental AG are in the automotive industry. The former went bankrupt, largely as a result of ineffective pricing; the latter is among the most profitable and valuable automotive suppliers globally, largely as a result of its disciplined approach to price setting and price getting.

2. The six pricing myths

I contend, as a result of this research, that a significant reason for GM's profitability problems—and, by extension, those of other companies lacking adequate pricing leadership—was a reliance on outmoded pricing myths that damage profitability; and, conversely, that an important reason for Continental AG's success is its rigorous attention to pricing: guided by principles, not driven by myths. In the next sections, I look at these myths, state the reasons for discarding each myth ('truth'), and provide insight on how to build a more viable pricing strategy after each myth is eliminated from practice ('key learning'). Figure 1 provides an overview.

2.1. The origins of these myths: About the academic research and the managerial practices underpinning these misconceptions

Myths are widely held and unquestioned beliefs that lack scientific basis. The following, counterintuitive observation is important: The actions resulting from an erroneous reliance on myths appear to produce desired outcomes. A scientific analysis, as opposed to a myth-driven analysis, will conclude that these outcomes are not optimal. Consider the following example (adapted from Denrell, 2008): An anthropologist visiting a remote tribe observes that each morning members of the tribe sacrifice a goat. This, so the tribe elders say, makes the sun rise. Because food is scarce in this poverty-stricken community, the anthropologist has a simple idea to alleviate the suffering: She proposes that the community refrain from sacrificing the goat for just one day to see if the sun will still rise. In response, tribe elders tell her, terrified: "In matters of life and death we cannot afford to experiment."

This story illustrates the fundamental problem of misconceptions: Decision makers associate actions with a desired outcome and infer a causal relationship without attempting to understand whether alternative actions produce a superior outcome.

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