

What every manager should know about pricing

Andreas Hinterhuber

The neglected driver of profitable growth

Profits are the result of revenue growth, cost reductions and pricing. Ask any smart, high-performing manager about priorities to drive profits along these three dimensions and you will find a simple but surprising truth: managers allocate three-to-five times more effort toward revenue growth and cost reduction than they do toward pricing. Standard marketing textbooks may be partly to blame in their emphasis that pricing is critically important in the context of innovation. The thinking goes: as a manager, I must find the next blue ocean or breakthrough innovation and then get pricing right; in the absence of a blue ocean innovation, there is not much pricing can do, so it is all about productivity and cost reductions. This statement has intuitive appeal, but it is fatally wrong. This thinking leads to actions that severely limit a company's profitability. In some instances, this thinking leads to outright bankruptcy. The full story is in the textbox.

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Pricing: A tale of two companies

The contrasting fortunes of General Motors (GM) and Peugeot (PSA) illustrate both the positive and damaging effects of pricing. To be clear, none is considered the innovator, the thought leader, in the industry. Both are, in many respects, average companies with average products that are neither highly differentiated nor low cost. Both companies make use of pricing, but it is here that similarities end. In GM, pricing was the instrument of last resort to drive sales: the company offered ever-increasing amounts of discounts – up to \$10,000 per vehicle – to drive sales. Contrary to intention, this policy of “desperation pricing,” as financial analysts called it (Ceraso and Durham, 2006, p. 4), did not lead to volume growth; instead, volumes eroded, and, in the face of mounting losses, GM was forced to declare bankruptcy in 2009. Poor pricing was a decisive factor in GM's demise. Now to PSA: when Carlos Tavares was appointed CEO of the company in 2014, strategic, intelligent pricing became his personal obsession. In April, in his first presentation to financial analysts, he laid out his first priority for the company: “improve net pricing” (Tavares, 2014, p. 4). He sets targets and regularly reports on target achievements on key pricing metrics, such as on pricing gaps versus German competitors and on pricing power. He understands that intelligent pricing can achieve extraordinary results for companies with a merely average product portfolio. Pricing in PSA is driven by the recognition that small changes in price have an outsized effect, by managing the price–volume trade-off intelligently, by pricing based on customer value, not costs, and by the recognition that a personal interest by the CEO in pricing can transform organizations. Profitability surged: operating profitability was 0% in 2014 and increased to industry-leading levels of 8% in 2018 largely due to improved

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pricing (Tavares, 2019): financial analysts admirably noted that “improved price discipline” led to “higher profitability” (Kreitmair and Stegemann, 2019, p. 19). We can observe his most impressive achievement as CEO with respect to pricing at Opel, the European car maker that PSA purchased from none other than GM. Opel had cumulative losses of over \$19bn in 17 years under ownership by GM. In 2018, its first full year of ownership under PSA and Tavares, Opel produced an operating profit of 5% of sales. This is the power of pricing. This is what pricing can do in the absence of a blue ocean of a breakthrough innovation.

The weakly held assumption that pricing is relevant only in the context of innovations is similar to the idea that physical exercise is relevant only for professional athletes. We know that everyone, from couch potatoes to aspiring Olympians, benefits from physical exercise. For the latter, exercise is a necessity; for all of us, it increases life expectancy. By analogy: Pricing is necessary for innovations, but pricing based on solid academic research benefits every company. So what is it that every manager needs to know about pricing in order for pricing to become, as for PSA, an enabler of superior profitability and not, as for GM and others, a death knell?

Below are the eight principles that every manager needs to understand to get pricing right. These principles are built both on rigorous academic research, on studies undertaken by this writer and on the best available evidence published in leading journals, as well as on experience gathered during research and consultancy collaborations with companies (see “About the research”).

Number 1: understand and manage the price–volume trade-off

Over the past 20 or so years, this writer has conducted pricing workshops with thousands of managers from countries across the world, who worked for some of the most widely known companies as well as for small companies known only inside narrow niches. Regardless of their seniority, regardless of their companies’ reputation, regardless of their role – CEO; managing director; sales, marketing, innovation or pricing manager – more than 80% of managers failed a simple quiz about the effect of price changes on volume. If you like a challenge, then please take the following test.

The price–volume trade-off – a simple test

Suppose that you are working as marketing VP for a company producing a widely known energy drink. Your boss, the CEO, storms into your office and asks you if you would agree to drop the price from currently \$2 per can to \$1.70 (–15%). You have the following data:

- total sales volume: 1,000,000 units/year;
- variable costs: \$1 per can (i.e. 50% of current unit price); and
- fixed costs: \$0.5m (administration, marketing, depreciation, etc.).

You want to know: under which circumstances is the proposed price cut profitable? What you need to find out, in other words, is the answer to the following question: What is the minimum required volume increase so that the proposed price change increases profits? These are the options:

- (a) 15%
- (b) 22%

- (c) 30%
- (d) 33%
- (e) 43%
- (f) 50%
- (g) 100%
- (h) between 100% and 200%

Most managers do not understand the volume implications of price changes. Relatively small price changes frequently require very substantial changes in volume to maintain total profitability. The table provides an overview of the minimum required volume increases associated with any given price reductions as a function of the current product contribution margin (upper half). The table also provides an overview of maximum affordable volume losses associated with price increases as a function of the current product contribution margin (lower half).

This table is based on the not yet widely known formula for break-even sales analysis (Smith and Nagle, 1994):

$$\Delta \text{BES}(\%) = - \Delta P(\%) / [\text{CM}(\%) + \Delta P(\%)]$$

where:

$\Delta \text{BES}(\%)$ = break-even sales change (i.e. minimum required volume increase for price reductions or maximum affordable volume loss for price increases);

$\Delta P(\%)$ = percent change in price; and

$\text{CM}(\%)$ = percent contribution margin (i.e. price minus variable costs divided by price).

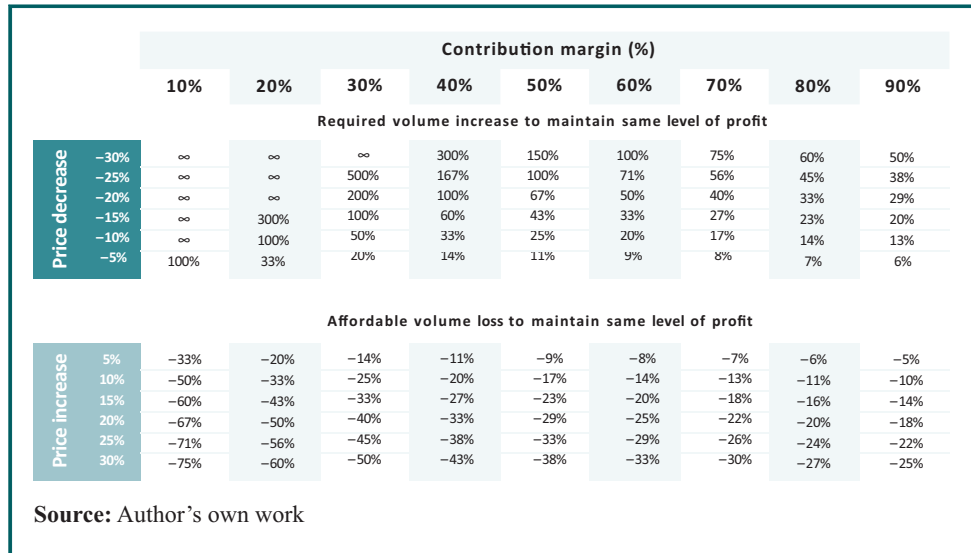
Thus, the answer to the quiz is +43% (correct answer: e; note that answer b is the required turnover increase). The price change is minus 15% (ΔP : -15%), the current contribution margin is 50% (CM %; +50%); inserting these values in the formula yields the result. This result can be read from Figure 1 by crossing the current contribution margin with the planned price change.

Seasoned managers may now ask: who would ever need a break-even sales analysis? Hannes Wieland, SVP of Würth Group, a company with €19,95bn in sales and over 85,000 employees, comments: “Our entire sales force had in the past this table as a laminated plastic card in their pockets. This allows sales reps to make intelligent on-the-spot decisions when customers ask for price concessions. Our sales force immediately knows for how much more volume to ask when customers demand a lower price. Today, our sales reps have the possibility to consult this on their digital sales information system (on tablets and mobile devices).”

The Würth Group is the global market leader in the development, production and sale of assembly and fastening materials and has currently over 43,000 sales representatives, making the company’s sales force one of the largest sales forces of all companies globally. The insight is that simple tools – such as the break-even sales analysis and a table printed on a plastic card – can help sales managers make better pricing decisions.

It is also clear that convincing customers to buy more when they ask for discounts will not always be successful. However, then again, because most sales managers do not understand the volume implications of price changes and have no immediate answer for

Figure 1 Break-even sales analysis – a powerful pricing tool to understand the volume implications of price changes



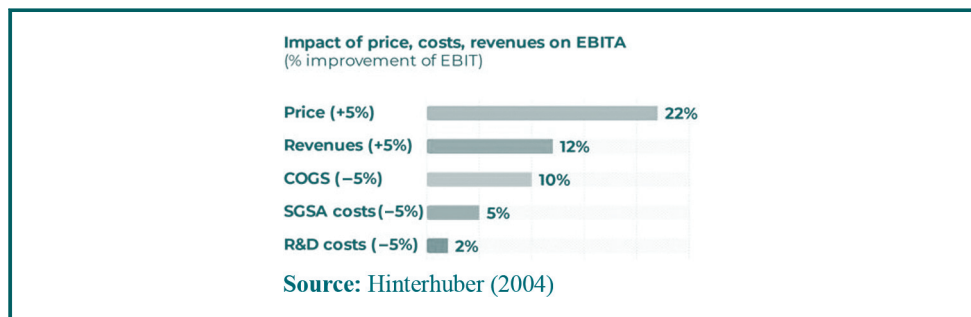
how much volume to ask when confronted with a request for a price concession, even a less than 100% success rate in convincing customers to buy more or pay list price will produce a dramatic improvement in profitability – more on this point below.

The key is managers need to understand and manage the price–volume trade-off. Tim Cook, CEO of Apple, is widely known for not chasing volume for its own sake, preferring instead to hold prices firm. Similarly, Carlos Tavares, in his role as CEO of Peugeot (PSA), does not cut prices, preferring instead to lose some market share (Stohard and Campbell, 2016). This reflects a solid understanding of the effects of price changes on volume: for these and other companies, the expected volume growth is lower than the minimum required volume increase (Figure 1), making it more profitable not to lower prices.

Number 2: pay attention to details – small changes in price lead to big differences in profits

Small changes in net selling prices lead to far bigger improvements in profitability than similar changes in revenues or cost reductions. Pricing is a very powerful tool and can increase or destroy profitability far more than any other operational lever (see Figure 2) (Hinterhuber, 2004).

Figure 2 Impact of small changes in price on profits



For a company with a 10% operating profit margin, a two percent improvement in net selling prices improves earnings before interest and taxes by a whopping 20%. Executives thus have to learn how to handle pricing so that it becomes a creator, not a destroyer, of value. Managers at all levels, from CEOs to frontline managers, are well-advised to take pricing and small variations in net selling prices seriously.

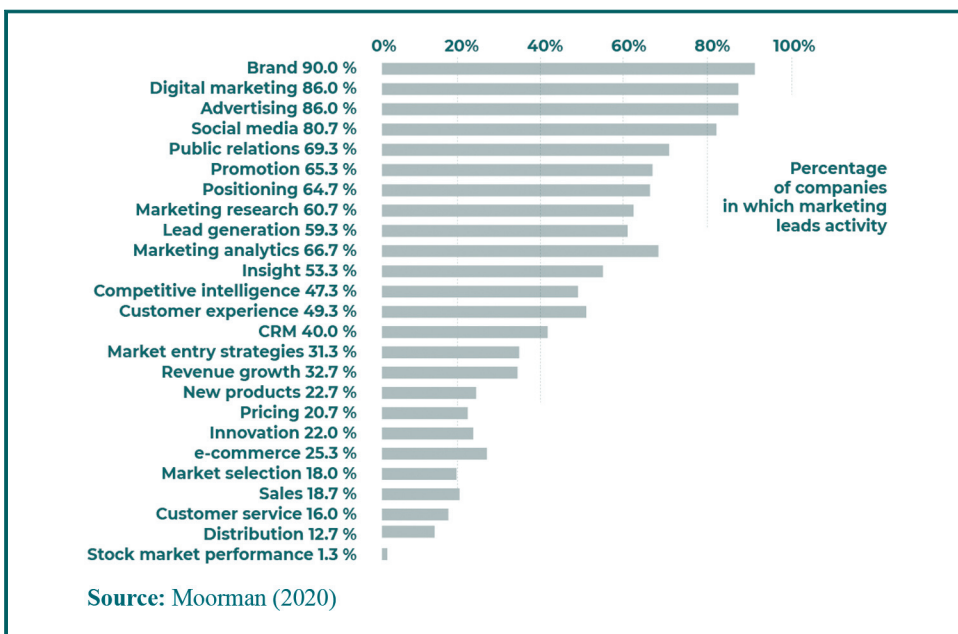
The insight is: granting a \$200 price reduction on an order with an invoice value of \$10,200 may not seem like much, but it is. If all sales managers grant a price reduction of two percent on all customer orders, profitability nosedives. Senior executives and managers must learn to fight for pennies. In pricing, details matter. An obsession with details is a distinct advantage.

Number 3: create a pricing function in charge of improving performance and capabilities

In its biannual survey of chief marketing officers, the American Marketing Association, the preeminent marketing association on this planet, polls marketers on their spheres of influence. The most striking result of the most recent survey: marketing typically does not lead to pricing (see Figure 3). In most companies, marketing is responsible for branding, digital activities and advertising, but not pricing (Moorman, 2020). It is high time to wake up pricing.

If marketing is not responsible for pricing, then who is? The answer is simple. Everybody is responsible for pricing: marketing (list price definition), sales (discounting), finance (margin guidance), supply chain (decisions on free express shipment), customer service (provision of free supplementary services) or even the CEO (price concessions due to personal connections with customers). This means, of course, that nobody is. In most companies, there is no one, not a function, not a dedicated organizational unit, responsible for defining list prices, developing company-wide pricing capabilities, defining pricing and discounting policies, enforcing discounting discipline or quantifying and documenting value to customers. Pricing typically falls between the cracks. Pricing is not managed. If pricing is

Figure 3 Domains of influence of the marketing function in large US companies



not managed as a strategic activity, profitability erodes as a consequence of weak price setting and price getting.

The insight: to drive profitability via pricing, companies need to appoint a functional unit with responsibility for pricing, a centralized, formalized and specialized pricing team led by a VP of pricing. Typical responsibilities include definition of list prices, definition of pricing guidelines (i.e. target prices by customer, region, channel), development of discounting guidelines, price approval management, price monitoring, development of negotiation capabilities in sales managers, information collection and diffusion (e.g. competitor price levels, customer needs), implementation of annual price adjustments, new product pricing and development of price lists for supplementary services. This is quite a handful and requires resources. Recent research among global Fortune 500 companies finds that only about 20% of companies have a pricing organization with 20 or more dedicated pricing professionals, a low number given that the average global Fortune 500 company has 140,000 employees and \$66bn in sales (Liozu, 2019). Companies with centralized, formalized and specialized pricing teams experience tangible performance improvements, both in pricing process efficiency and overall profit performance (Liozu, 2021). The key insight is: a dedicated pricing organization is a competitive differentiator that improves performance.

Number 4: improve price setting and price getting

Pricing excellence has two aspects: price setting and price getting (see Figure 4) (Hinterhuber and Liozu, 2012).

Price setting refers to the different approaches companies use to determine selling prices: cost-based, competition-based and customer value-based. Most companies are not very good at price setting. In fact, today, pricing is still largely cost- or competition-based. Figure 5 summarizes the prevalence of different price setting approaches across industries (Hinterhuber, 2008).

Excellence in price setting means, quite simply, value-based: A series of separate studies conducted by multiple scholars involving sales managers, marketing managers, CEOs, entrepreneurs and pricing managers finds that value-based pricing is positive, while competition-based pricing is negatively related to company performance (Liozu and Hinterhuber, 2013b).

Figure 4 Price setting and price getting as critical aspects of pricing

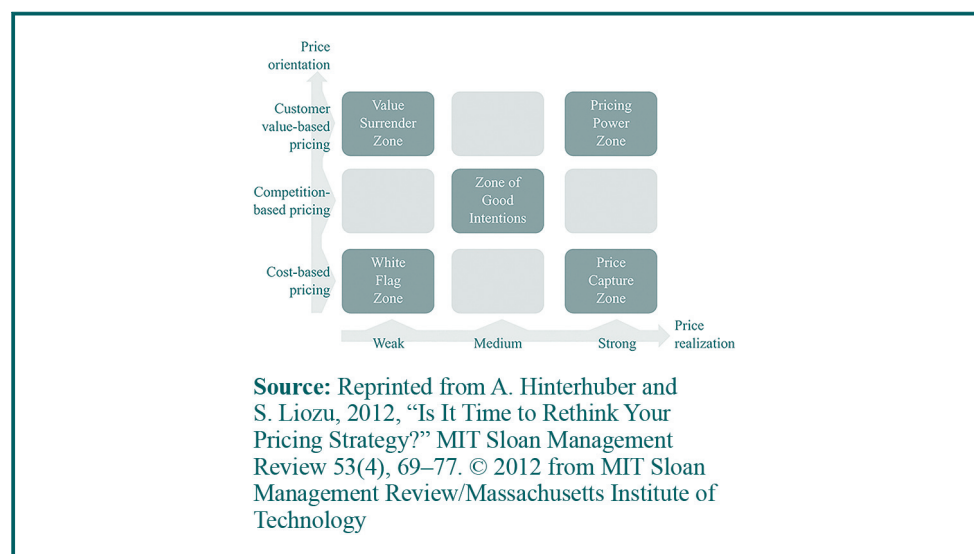
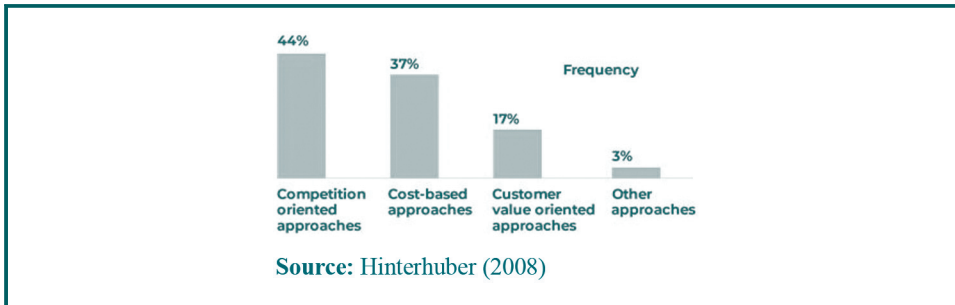


Figure 5 Pricing approaches in practice



Price getting refers to different abilities to actually get the price set out in the first place: some companies are very good at realizing their list prices, via value communication, customer value quantification, price controlling, enforcement of discounting discipline and pricing policies for supplementary services. Other companies are less effective, and prices erode as a result of poor negotiation, poor value communication or weak price-realization capabilities.

Pricing power results from excellence in price setting, which is value-based, and excellence in price getting, enforcing pricing discipline and value quantification. The pricing capability grid is a tool that allows firms to measure and improve capabilities on these two dimensions over time. Improvements in price setting and in price getting capabilities directly improve company performance. The insight: managers who aim at improving profits via developing organizational pricing capabilities should improve both price setting and price getting capabilities (Figure 4). This means, typically, moving from cost- to value-based pricing and improving value communication, value quantification and price realization, i.e. reducing discounting.

Number 5: the CEO as pricing champion

In many companies, pricing is a clerical task, buried in the lower levels of the organization. Managers with a technical background, sales administrators or controllers set and manage prices. Executives mistakenly assume to be responsible only for the big picture, letting the small things take care of themselves. Executives thus assume that pricing is part of these small things. This is bad practice. The case of Peugeot may serve as a vivid example, where Tavares, as CEO, took a passionate, near-obsessive interest in pricing (see the opening textbox). A study polling more than 300 CEOs and business owners from companies globally finds that CEO championing of pricing leads to both increased pricing capabilities and improved company performance (Liozu and Hinterhuber, 2013a).

In the best-managed companies, CEOs are interested to the point of being obsessed with pricing (Liozu and Hinterhuber, 2022). CEOs can play a very important role by acting as champions of pricing and the pricing function. CEOs can and should champion pricing by developing company-wide pricing capabilities, establishing and promoting the pricing function, defining pricing and discounting targets, showing a personal and passionate interest in customer value creation and pricing and ensuring that executives across functions and levels live and breathe pricing. It is really quite simple: The higher the CEO championing of pricing, the higher the company's performance. The old adage is still true: "the new idea either finds a champion or dies" (Schon, 1963, p. 84). A champion overcomes obstacles and energizes others. Obsession with pricing is a good thing. Even better: Obsession with value.

Number 6: value first, then price

The most important rule in pricing is this: "Value first, then price" (Hinterhuber and Snelgrove, 2017). First quantify value, then set price. First, ensure that customers

comprehend value, then discuss price. Managers in B2B and B2C must ensure that the price difference vis-à-vis the competition is lower than the value difference. In other words, managers need to convince customers, both in B2B and B2C, that the differential value versus the best available alternative is more than the difference in price. [Figure 6](#) provides an illustration of this fundamental principle.

To do this, managers must know how to quantify value. Value quantification is what the best-managed companies do – before discussing price. Value quantification is what enables SKF, the €7bn industrial bearings manufacturer, to achieve industry-leading profitability and growth. Value quantification capabilities enable SKF sales and marketing managers to achieve a price premium of 50% over the best available alternative and document that the customer is better off by purchasing from SKF than from a competitor. SKF documents that the price premium is substantially less than – about 15% of – customer quantified value. [Figure 7](#), taken from a document that SKF actually shares with customers ([Snelgrove, 2013](#)), illustrates this idea. “Value quantification is essential for existing products,” comments Todd Snelgrove, the former VP of Value at SKF, “in the end, our ability to quantify value allows us to demonstrate to customers that it would be against their own self-interest to purchase from

Figure 6 Value quantification – justifying higher prices with quantified value

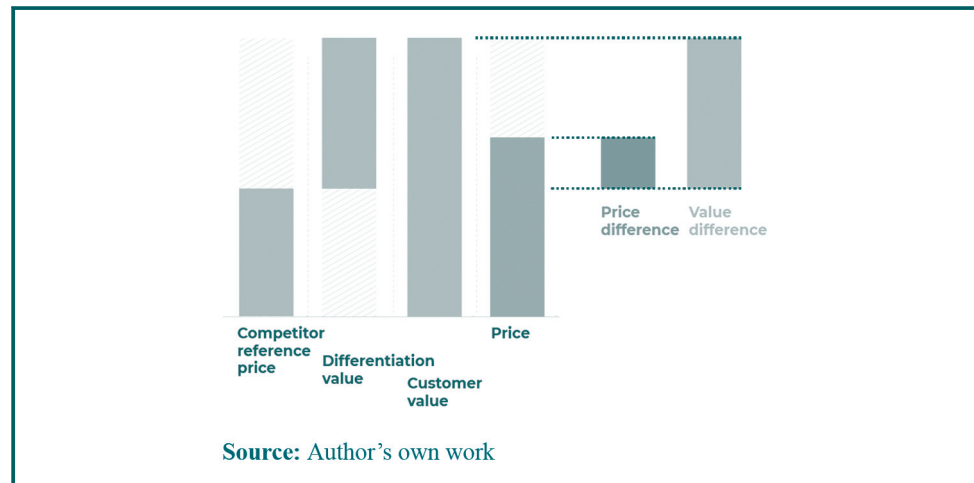
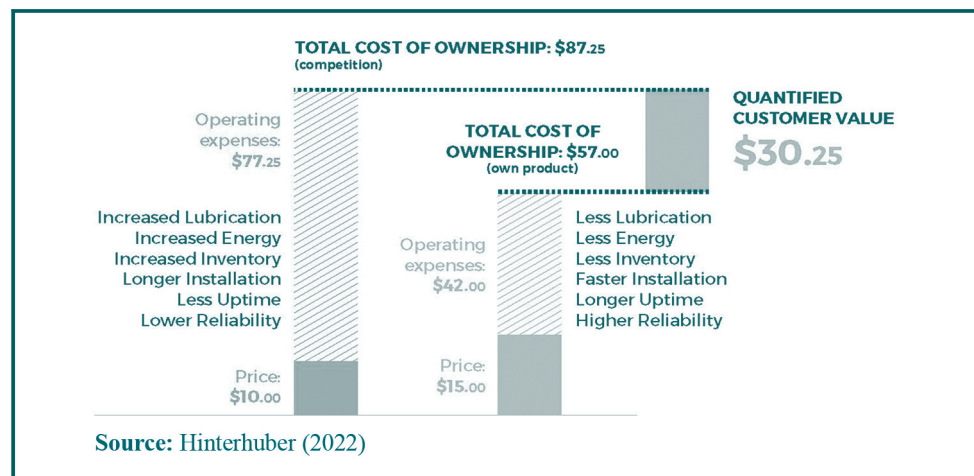


Figure 7 Value quantification in industrial markets – an example



an apparently lower-priced competitor. Value quantification allows us to demonstrate, via verifiable data collected in prior projects, that customers end up spending less money by purchasing an apparently higher priced product from us.”

Substantial research across industries, both for existing products and new products, has shown that value quantification capabilities are positively associated with company performance (Hinterhuber, 2017). “The value quantification capability refers to the ability to translate a firm’s competitive advantages into quantified, monetary customer benefits. The value quantification capability requires that the sales manager translates both quantitative customer benefits – revenue/gross margin increases, cost reductions, risk reductions, and capital expense savings – and qualitative customer benefits – such as ease of doing business, customer relationships, industry experience, brand value, emotional benefits or other process benefits – into one monetary value equating total customer benefits received” (Hinterhuber, 2017, p. 164).

The higher the sales and account manager capabilities to quantify and document value, the higher the company performance. Key is the ability to translate both quantitative benefits (total cost of ownership advantages) as well as qualitative benefits (reputation, ease of doing business, brand equity) into one monetary economic value representing total customer benefits. Value quantification resonates with procurement. In fact, B2B procurement managers increasingly expect that sales managers quantify the benefits of their solutions beyond simple statements such as “lower failure rates” or “better quality,” translating the quantitative (tangible) and qualitative (i.e. intangible or strategic) benefits delivered to customers into quantified economic value. The insight: sales, account and marketing managers should learn the language of finance to be able to express competitive advantages – better, faster, shinier – in terms that all customers understand: money.

Number 7: practice innovation in pricing

Innovation is frequently seen as product or business model innovation. Innovation in pricing brings new approaches to pricing strategies, pricing tactics and the organization of pricing to increase customer satisfaction and company profits conjointly (Hinterhuber and Liozu, 2014). Pricing is not a win/lose proposition between companies and customers. Innovation in pricing breaks the deadlock and allows to increase profits and customer satisfaction conjointly.

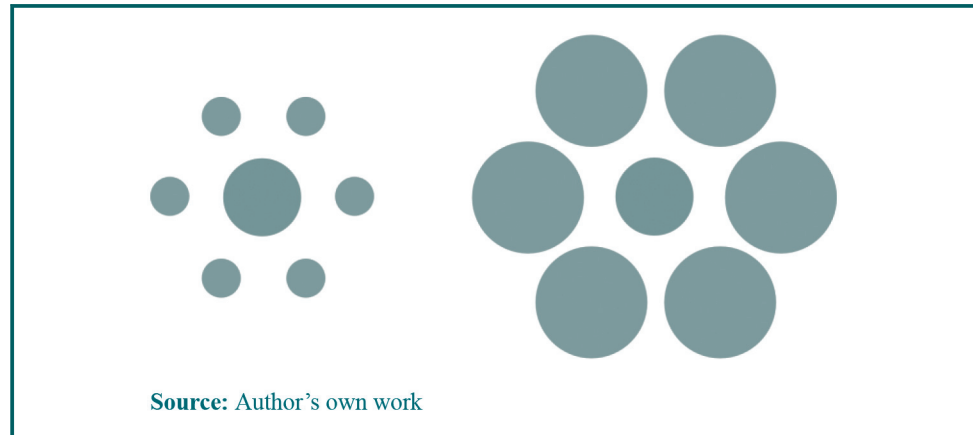
Netflix, for example, replaced per-day pricing with a flat fee. “Power-by-the-hour,” pioneered by Rolls-Royce in 1962, radically changed the way airlines purchased jet engines, allowing them to replace a capital expenditure with an operational expenditure, thus closely aligning customer and supplier interests. In both cases, managers practiced innovation in pricing for existing products that had been on the market for decades. Innovation in pricing is a powerful driver for disruption. New pricing models shape new markets and give pioneer companies a lasting competitive advantage.

Number 8: use psychology to favorably influence perceptions of value and price

Our perceptions of value and price are subject to bias. Take [Figure 8](#) below. We all know, after deliberative reasoning, that the two green circles are of equal size. Yet, instinctively, it seems that one circle is larger.

Understanding consumer psychology in B2B and B2C allows managers to favorably influence perceptions of value and price without lowering price (Hinterhuber, 2015). [Figure 9](#) provides an overview of some prevalent psychological effects in pricing that illustrate that perceptions of value and price are not given: managers can influence how customers perceive value and price and thus influence customer choice without actually

Figure 8 Objective versus perceived reality



lowering the price (Hinterhuber, 2015). An understanding of these psychological effects allows managers to shape customer choices.

An example: when Apple launched the iPad in 2010, the prices for comparable tablets were \$250, a fraction of Apple's price. Without an understanding of consumer psychology, the risk of unfavorable customer reactions was real. Enter Steve Jobs. He first presents the new marvel of technology, then reports that pundits had indicated a launch price of around \$1,000. With rising excitement, he announces that the launch price for the new iPad is not \$999, but only \$499 (Jobs, 2010). The audience screams and sales roar. In the language of Figures 8 and 9, Steve Jobs masterfully uses anchoring, i.e. an arbitrary number, to favorably influence customer perceptions of value and price. Amazon, Xerox, Starbucks, Louis Vuitton and many others skillfully present prices by making use of the effects outlined in the figure.

The insight: selling is human (Pink, 2012), but buying is human, too. The more managers understand the inherent psychological biases affecting buyers' purchase decisions, both as individual consumers and as purchasing managers in organizations, the better they can frame their offers to favorably influence perceptions of value and price. An interest in psychology and a supreme understanding of human nature allowed Steve Jobs to frame prices creatively, making the product appear less expensive than it really was.

Using these principles to drive performance – simple but not easy

These are the eight pricing principles that every savvy manager should know (Figure 10).

These principles allow merely average companies to achieve above average results – as the example of Peugeot (PSA) suggests. In the context of workshops and executive MBA programs, this writer presents these principles to audiences of senior managers, frequently with budget responsibility of hundreds of millions of dollars, working for some of the most admired and well-known companies globally. At the end of an intense day, inevitably, the question comes: "Is this all? Is pricing this *simple*?"

After a long and deliberate silence, the answer is, confidently: "Yes." "So why are companies not doing this?" is the predictable follow-up question. The principles are simple; putting them into practice is not easy. Why?

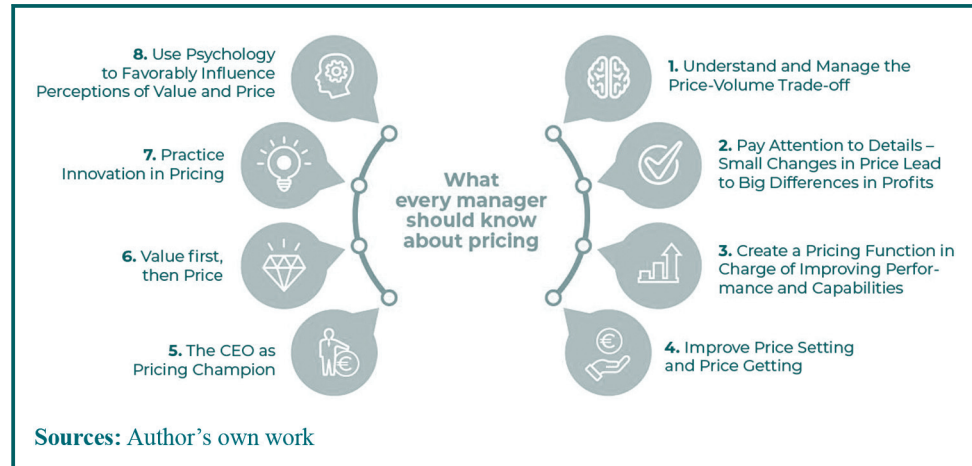
A digression, again: Our species, *homo sapiens*, has been roaming prairies and forests for close to 300,000 years. Mankind has been practicing medicine for at least 5,000 years – before inventing writing. When did humans discover that physical exercise benefits health? The intuitive answer must be: "since thousands of years." Wrong. Another guess:

Figure 9 Psychological effects in pricing – on overview of current research



“since several hundred years: after all, the world’s first faculty of medicine was established eight hundred years ago at the University of Padua in 1222.” Wrong again. The correct answer is: “in 1952.” That was the year of the landmark study on London’s iconic double-decker bus workers, which, at that time, had conductors as well as drivers. The drivers sat, conductors jumped off and on and frequently walked up and down stairs. Jerry Morris, a pioneering epidemiologist, and his colleagues found that coronary heart disease mortality was 30% lower for conductors than for drivers (Morris *et al.*, 1953). A subsequent study on a much larger population concluded that physically active persons had a 50% lower mortality from heart disease than physically inactive persons (Morris and Crawford, 1958). Science – randomized tests with a population that differed only in their extent of physical exercise – led to a simple answer to a vexing problem. Thanks to these studies, we now know that physical exercise reduces the risk of heart attacks, depression, anxiety, diabetes and other ailments. Physical exercise is beneficial for everyone. Simple, yes – but easy?

Figure 10 What every manager should know about pricing



On to pricing: Although entrepreneurs and managers have been pricing products and services since the dawn of commerce, pricing is a surprisingly young discipline: Thomas Nagle and Kent Monroe published their seminal textbooks in the 1970s and 1980s (Monroe, 1979; Nagle, 1987). As of today, only about 9% of business schools offer pricing courses (McCaskey and Brady, 2007). Pricing is a routine activity – like physical movement – but we have started to examine the effectiveness of this routine activity only recently. Only now do we have the insights that allow us to define a set of principles that improve firm profitability via pricing. These are:

- understand and manage the price–volume trade-off; tools, like the break-even sales analysis can help;
- pay attention to details – small changes in price lead to big differences in profits. It pays to fight for pennies;
- create a pricing function in charge of improving performance and capabilities;
- improve price setting and price getting;
- the CEO as pricing champion. Pricing needs attention and a passionate interest from senior leaders;
- value first, then price. Quantify customer value first, then set the price;
- practice innovation in pricing; and
- use psychology to favorably influence perceptions of value and price.

These are the principles of pricing that every manager should know. The best available academic evidence suggests that pricing strategies based on these principles increase profits.

Back to the question: What stops people from physical exercise, what stops managers from implementing pricing – although the principles are simple and although we understand the benefits?

We need, in other words, a theory that allows us to predict and influence human behavior. The most widely cited and influential theory for the prediction of human behavior is Ajzen's theory of planned behavior (Ajzen, 1991). At its core, the theory argues, and hundreds of studies show, that we act when we have strong intentions and when we are confident in our

abilities. These are the two key factors – intent and confidence – that allow us to predict why we engage in substantial behavioral change, why we quit smoking, drink less, donate blood, learn new skills, exercise, use new teaching methods, benchmark against competitors or cheat (Armitage and Conner, 2001). Managers should formulate a clear, passionate intent regarding pricing and convince themselves that they will succeed. They will: science, after all, is on their side.

About the research

Over the past 20 years, this writer has conducted dozens of academic surveys with managers exploring the antecedents, moderators and consequences of pricing practices for existing and new products. The writer has analyzed all pricing research published in leading academic journals over the past decades. Finally, as equity partner of Hinterhuber & Partners, a pricing consultancy (www.hinterhuber.com), this writer – through collaborations with companies and workshops conducted with practicing managers – has collected data and insights on best practices in managing pricing as a strategic activity.

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Pricing,
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