Firms pressure sales people to invest in costly internal negotiations

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In many firms sales people spend as much time negotiating internally for lower prices as they do interacting with customers. A new study appearing in the November issue of *Marketing Science*, a publication of the Institute for Operations Research and the Management Sciences (INFORMS) finds that firms should allow their sales people to "waste" energy on internal negotiations. In fact, it says, firms should make the process wasteful on purpose.

The study, "Why do sales people spend so much time lobbying for low prices?" was conducted by Duncan Simester, the Nanyang Technological University Professor of Management Science, and Juanjuan Zhang, Associate Professor of Marketing, both at the MIT Sloan School of Management.

Management often expresses mistrust when the sales force asks for lower prices. The sales force, which generally knows more about customers' needs, often makes the case that lower prices encourage sales.

"The sales force thinks that the product managers are just unrealistic in terms of the prices they are trying to charge," Simester says. "The product managers think the sales force is just trying to make their own jobs easier."

The authors asked, why not simply change the compensation so that the sales force is paid more if the price is higher? Using a game-theory model, the study finds that while this tactic helps mitigate the problem, it can only be a partial solution. Since lower prices make it easier to sell, firms must make the compensation attractive enough for sales to be willing to try selling at high prices. This compensation can be expensive.

The authors find that sales force lobbying, wasteful as it sounds, can be a good solution. Generally described as a "special pricing" process or a "price exception" process, this solution has been widely adopted in practice. In special pricing, firms shift the power to make pricing decisions away from the sales force and pass it to a committee or manager who must approve any discount. Most firms allow exceptions, and this is where the sales force can lobby for lower prices.

Firms require evidence before agreeing to an exception. The key to the profitability of this mechanism is the design of the evidence requirement. Firms can decide whether to require evidence, what amounts to acceptable evidence, and how much evidence to require. Surprisingly, many firms introduce requirements that make decision-making less nimble and more unwieldy.

"It looks like a totally unproductive activity, adding a layer of bureaucracy to price flexibility," says Simester. "Yet it is still profitable for firms to do so. The reason is that it can increase the level of trust you have in your sales force, as long as you make the process difficult enough so they only want to go through with it when they really need to."

In surveys, about 72 percent of executives agreed with the statement: "Salespeople want to charge prices that are too low." The authors also cite examples from the literature in which up to 90% of transactions were entering a company's exception process.

Supporting this process typically requires a substantial organizational system. Software companies, including Microsoft, SAP and Oracle, offer software modules specifically designed to support the price exception process. Consulting firms have also identified this as a market opportunity, and have developed consulting practices to advise companies how to manage their price exception processes.

The authors don't argue that firms should discontinue their price exception policies. Instead, the focus should be on managing the process so that it is not used too often.

"Designed correctly, the exception process is only used when discounts are truly needed to close the sale," says Zhang. "If sales people want to claim every transaction is an exception then the process will not be profitable and will instead merely represent a waste of the organization's resources."

Underlying the problem is recognition that the sales force often knows more about the firm's customers than the firm. By imposing a lobbying requirement, the firm can overcome the information advantage enjoyed by the sales force. Even though this introduces an administrative hurdle, which makes pricing less responsive and less flexible, this additional bureaucracy is justified if it enables the firm to better match its prices with what customers are willing to pay.

Provided by Institute for Operations Research and the Management Sciences

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