****Part 1: Learning Objectives****

1. Discuss the relationships among pricing, image, competition, and value.
2. Describe effective pricing techniques for introducing new products or services and for existing ones.
3. Explain the pricing methods and strategies for retailers, manufacturers, and service firms.
4. Describe the impact of credit on pricing.

****Part 2: Class Instruction****

****Introduction****

Setting prices is a business decision that is both an art and a science. Unfortunately many small business owners set prices without enough information about their cost of operation s and their customers.  Research shows that proper pricing strategies have far greater impact on a company’s profits than corresponding increase in unit volume and reductions in fixed or variable costs.  Refer to Figure 10.1, The Impact of Pricing and Cost Improvements on Profitability.

Due to the Great Recession customers have become more price sensitive.  In addition, modern shoppers use technology such as smart phones and tablets to shop for the best deals.

Setting prices too high drives customers away, but prices that are too low (a common tendency for entrepreneurs) robs a business of its ability to generate a profit, creates the impression that the products and services are of inferior quality, and threatens long-term success.

Price is the monetary value of a product or service; it is a measure of what the customer must give up to obtain what they want or need.  Price is also a signal of the value of a product or service, so price must be compatible with customers’ perceptions of value.

****Three Potent Forces: Image, Competition, and Value         LO 1****

      Companies that take a strategic approach to pricing and monitor its results can raise their sales revenue between 1 and 8 percent.

****Price Conveys Image.****

Pricing sends an important signal to customers about a company, its brand, its position in the market, the quality of its products and services, the image it wants to create, and other important concepts.  Too often, entrepreneurs underprice believing that low prices are the only way they can achieve a competitive advantage.  They fail to recognize the extra value, convenience, service and quality they give their customers.

The relationship between value and price are demonstrated with an equation that includes the following variables: standards of doing business, product or service quality and performance, doubt in customers’ minds that detract from the value of the company’s standards and products or services, product or service price, and customers’ expectations of a company and its products and services.  Rather than ask, “How much should I charge?” entrepreneurs should ask, “How much are my target customers willing to pay?”

****Competition and Prices.****

Today small companies face competition from local businesses as well as from online businesses.  Unless a small business can differentiate itself by creating a distinctive image in customers’ minds or by offering superior service, quality, design, convenience, or speed, then it must match its competitors’ prices or risk losing sales.  Blindly matching competitors’ prices can lead a company to financial ruin.  Refer to Figure 10.2, The Reality of Setting Prices.

Generally entrepreneurs should avoid head-to-head price competition with other firms that can more easily achieve lower prices through lower cost structures. Nonprice competition can be an effective strategy.  However, if a business chooses to offer lowers prices it must first create a low cost advantage by: choosing a low-cost location, minimizing operating costs by maximizing efficiency; exercise tight control over inventory and restricting product lines to those items that turn over quickly; providing customers with no or limited service; using low-cost, bootstrap marketing techniques; offering basic products but offer the option of purchasing addition product features that generate higher profit margins; achieving high sales volume.

Entrepreneurs usually overestimate the power of price cuts.  In reality, sales volume rarely increases enough to offset the lower profit margins of a lower price.  Customers lured by the lowest price usually exhibit little loyalty to a business.  Rather than join in a price war by cutting prices, entrepreneurs can adjust their product and service offering to appeal to different market segments; offering lower priced items that use less expensive materials and offer fewer extras for price-sensitive customers and higher-quality premium products for those who care less about price and more about quality and service.  The lesson is to stay out of a price war by differentiating your company, emphasizing the unique features, benefits and value it offers its customer.

****Focus on Value****

The “right” price depends on the *objective* value and *perceived* value.  The objective value is the price customers would be willing to pay if they understood perfectly the benefits that a product or service delivers for them.  Unfortunately, customers only see its perceived value, which determines the price they are willing to pay.  Value does not equate to a low price.  Setting prices too low is more dangerous than setting them too high.  Raising prices that are too low is much more difficult and can create the wrong image for a business.

Techniques that companies can use to increase customers’ perception of value include offering coupons and rebates, offering limited-time-only discounts, or launch a ***fighter brand***, which is a less expensive, no-frills version of a company’s flagship product that is designed to confront lower-priced competitors head-on, satisfy the appetites of value-conscious customers, and preserve the image of the company’s premium product.

Through marketing and other efforts, companies can influence customers’ perception of value.  For most shoppers, three reference points define a fair price; the price they have paid in the past, prices competitors charge, and the costs a company incurs to produce the product or service.  This means it is important for business owners to remind customers periodically that they must raise prices to offset the increased cost of doing business.  In addition, customers are less likely to notice small, regular price increases that result from rising costs than a single, steep price increase.

One of the biggest mistakes an entrepreneur can make is underestimating the company’s actual total cost of a product or service.  When setting prices, some entrepreneurs think strictly in terms of product or service costs and fail to consider the total cost of providing the product or service, such as rent, insurance, labor costs, etc.  Businesses facing rapidly rising costs should consider the following strategies:

* Communicate with customers.
* Rather than raise the price of the good or service, include a surcharge.
* Eliminate customer discounts, coupons, and promotions.
* Offer products in smaller sizes or quantities.
* Focus on improving efficiency everywhere in the company.
* Emphasize the value your company provides to customers.
* Raise prices incrementally and consistently rather than rely on large periodic increases.
* Shift to less expensive raw materials if possible.
* Anticipate rising materials costs and try to lock in prices early.
* Consider absorbing cost increases.
* Modify the product or service to lower its cost.
* Differentiate your company and its products and services from the competition.

Costs impact pricing. It is important that price takes cost into consideration. These costs should be passed along to customers and communicated through the value you offer.

      When all is taken into consideration, the factors that small business owners must consider when determining price for goods and services includes:

* Product/service costs
* Market factors - supply and demand
* Sales volume
* Competitors' prices
* The company's competitive advantage
* Economic conditions
* Business location
* Seasonal fluctuations
* Psychological factors
* Credit terms and purchase discounts
* Customers' price sensitivity
* Desired image

      For most products there is an acceptable price range, not a single price for a product.  This price range is the area between the price ceiling defined by customers in the market and the price floor established by the company’s cost structure.  The goal is to position prices within this acceptable price range.  Refer to Figure 10.3, What Determines Price?

****Pricing Strategies and Tactics                             LO 2****

      Pricing strategies must be compatible with the firm’s overall strategy.

****Introducing a New Product.****

When introducing a new product, the owner should try to satisfy three objectives:

1. Get the product accepted. The acceptable price range depends on the product’s position:

* ***Revolutionary products*** are so new and unique they transform existing markets.
* ***Evolutionary products*** offer up-grades and enhancements to existing products.
* ***Me-too products***offer the same basic features as existing products on the market.

1. Maintain market share as competition grows
2. Earn a profit

      There are three basic strategies when establishing a new product’s price: penetration, skimming, and life cycle pricing.

1. Penetration: Set prices below competitors to gain market entry. This pricing strategy grows market share and makes it less attractive for new competitors to enter the market.
2. Skimming: Set higher prices for new products and for markets with little or no competition. This pricing strategy offers the optimal margin with higher price points.
3. Life Cycle Pricing: Set higher prices initially and, as technological advances or additional experience enables the firm to lower costs, it can reduce the product’s price one step ahead of competitors.

****Pricing Established Goods and Services.****Each of the following pricing tactics can become part of the toolbox entrepreneurs can use:

* ***Odd pricing*** – a pricing technique to set prices in odd numbers to create the psychological impression of lower prices.
* ***Price lining*** – a technique that greatly simplifies the pricing function by pricing different products in a product line at different price points depending on their quality, features, and cost.
* ***Freemium pricing*** – a pricing strategy that involves providing a basic product or service to customers for free but charging a premium for expanded or upgraded versions of the product or service.
* ***Dynamic (customized) pricing*** – a technique in which a company sets different prices for the same products and services for different customers using the information they have collected about their customers.
* ***Leader pricing*** – a technique that involves marking down the normal price of a popular item in an attempt to attract more customers who make incidental purchases of their items at regular prices.
* ****Geographical pricing**** – prices vary according to the costs of shipping merchandise to customers across a wide range of geographic regions. One type of geographic pricing is ***zone pricing***, which is a technique that involves setting different prices for customers located in different territories because of different transportation costs.  Another option is ***delivered pricing***, a technique in which a company charges all customers the same price regardless of their locations and different transportation costs.  The final option is ***O.B. factory***, in which a small company sells merchandise to customers on the condition that they (the customers) pay all shipping costs.
* ****Discounts**** – There are five variations of discounts:
  + ***discount markdowns*** are reductions from normal list prices.
  + ***earned discounts*** which customers earn by making repeat purchases at a business.
  + ***Limited time offers*** provided by retailers for a limited amount of time with the goal of creating a sense of urgency and excitement among customers.
  + ***Steadily decreasing discount*** is a limited duration discount that declines over time.
  + ***Multiple unit pricing***is a technique offering customers discounts if they purchase in quantity.
* ***Bundling*** is grouping together several products or services or both into a package that offers customers extra value at a special price.
* ***Optional-product pricing*** is a technique that involves selling the base product for one price but selling the options or accessories for it at a much higher markup.
* ***Captive product pricing*** is a technique that involves selling a product for a low price and charging a higher price for the accessories that accompany it.
* ***By-product pricing*** is a technique in which a company uses the revenues from the sale of by-products to be more competitive in pricing the main product.
* ****Suggested retail prices.**** This practice eliminates the need for small businesses to make a pricing decision.  However, it can create problems such as prices being inconsistent with the company’s image, cost structure, or competitive situation.
* ****Follow-the-leader pricing****

****Consider using You Be the Consultant: “What’s the Right Price?” or Ethics and Entrepreneurship “The Ethics of Dynamic Pricing” at this point.****

****Pricing Strategies and Methods for Retailers      LO 3A****

      As customers have become more price conscious, retailers have changed their pricing strategies to emphasize value, which allows for a wide variety of practices used to increase customer loyalty.

****Markup****.  ***Markup (or markon)*** pricing is the difference between the cost of a product or service and its selling price.  It is a calculation of the addition amount charged in addition to the cost to procure. It must be large enough to produce a profit.

      Markup is based on this equation:

            Dollar markup + Retail price – Cost of the merchandise

      For example, if a shirt costs $14 and the sales price is $30, the markup is $16. Percentages can easily be calculated.  Additional calculations are included in this chapter.  Refer to Table 10.1, Costs and Markup Calculations for Apple’s iPad and Microsoft’s Surface Tablets.

      Once entrepreneurs create a financial plan, including sales estimates and anticipated expenses, they can compute their companies’ initial markup.  The initial markup is the average markup required on all merchandise to cover the cost of the items, all incidental expenses, and a reasonable profit.  Operating costs, such as rent, utilities, depreciation and reductions must also be taken into consideration.  Entrepreneurs must be aware of the impact that discounts have on their markup percentages.  Refer to Figure 10.4, The Mathematics of Markups and Markdowns.

Finally, retailers must verify that the retail price they have calculated is consistent with their companies’ image.  Perhaps most important, customers must be willing and able to pay this price.

****Pricing Concepts for Manufacturers                    LO 3B****

*****Cost-plus pricing***** is a pricing technique in which a manufacturer establishes a price that covers the cost of direct materials, direct labor, factory overhead, selling and administrative costs, and a desired profit margin, which is the most commonly used pricing technique for manufactures. While it is a simple way to determine prices, it does not encourage the manufacturer to use resources efficiently.  In addition, it fails to consider the competition and market forces.  Refer to Figure 10.5, Cost-Plus Pricing Components.

****Direct Costing and Pricing.****Successful pricing for manufacturers requires a reliable cost accounting system that can generate timely reports.

* ***Absorption costing*** is the traditional method of product costing in which all manufacturing and overhead costs are absorbed into the product’s total cost.
* ***Variable (direct) costing***is a more useful method of product costing that includes in the product’s cost only those costs that vary directly with the quantity produced. Variable costing encompasses direct materials, direct labor, and factory overhead costs that vary with the level of the company’s output of finished goods.  Overhead costs that are fixed (rent, depreciation, and insurance) are not included.

Refer to Table 10.2, Full-Absorption versus Direct-Cost Income Statement.

* ***Contribution margin*** is the amount left over out of a dollar of sales after variable expenses are paid that contributes to covering fixed expenses and earning a profit. A calculation is included in the chapter.

****Computing the Break-Even Selling Price.****Calculations are included in the chapter.

The break-even selling price allows a manufacturer to determine at what point revenues equal expenses. This is the break-even point and the next unit sold represents the first dollar of profit.

****Pricing Strategies and Methods for Service           LO 3C****

      Service firms must establish prices on the basis of the materials used to provide the service, the labor employed, an allowance for overhead, and profit.  Most service firms base their prices on an hourly rate, usually the actual number of hours required to perform the service.  Others base their feeds on a standard number of hours, determined by the average number of hours needed to perform the service.  Calculations are provided in the chapter.  Refer to Table 10.3, Direct-Cost Income Statement, Ned’s Computer Repair shop.

***Pocket price*** is the price a company receives for a product or service after deducting all discounts and purchase incentives.

****The Impact of Credit on Pricing                                 LO 4****

Consumer credit has a dramatic impact on pricing and on the attractiveness of the business.  Refer to Figure 10.6, Percentage of Customers Who Shop Only at Businesses That Accept Multiple Forms of Payment.   This includes credit cards, installment credit, and trade credit. It is important to recognize the value that credit offers a company, and equally important to take steps to protect it.

****Credit Cards.****Accepting credit cards broadens a small company’s customer base and closes sales that would normally be lost if customers had to pay in cash.  However, companies incur additional expenses for offering this convenience.  Businesses must pay to use the system, typically 1 to 6 percent of the total credit card charge, which they must factor into the prices of their products or services.  They also pay a transaction fee of 5 to 25 centers per charge.  Refer to Figure 10.7, How a Typical Credit Transaction Works.  An ***interchange fee*** is the fee banks collect from retailers whenever customers use a credit or debit card to pay for a purchase.  Some entrepreneurs offer customers incentives to pay with cash in order to avoid the fees.

* E-Commerce and Credit Cards.Online merchants must ensure their customers’ privacy and the security of their credit card transactions by using encryption software.  There are steps online merchants can take to avoid credit card fraud, including:
  + Verification of customers’ billing address information.
  + Require customers to provide the CVV2 number on the back of a credit card.
  + Check customers’ Internet protocol (IP) address.
  + Monitor activity on the Web site using a Web analytics software package.
  + Verify large orders.
  + Post notices on the Web site that your company uses antifraud technology.
  + Contact the credit card company or the bank if you suspect an order may be fraudulent before processing an order.
* Debit Cards. In 2003, for the first time shoppers used credit and debit cards more often than cash or checks.  Compared to credit cards, the equipment to accept debit cards is easy to install and the cost to the company is negligible.  Interchange fees are lower.
* Mobile Wallets. ***Mobile wallet*** applications link a smart phone or tablet to a credit or debit card, transforming the device into a digital wallet.  Shoppers download software, and then swipe the devices over a near field communication (NFC) or Quick Response (QR) reader to complete a purchase.  The technology not only speeds up the checkout process but also allows merchants to recognize customers when they walk in the store; send personalized coupons, incentives, and rewards to them; and generate useful reports.

****Installment Credit.****Small companies that sell big-ticket consumer durables (major appliances, cars, boats, etc.) rely on installment credit.  Customers are typically required to make an initial down payment and then finance the balance for the life of the loan.  Because installment credit absorbs a small company’s cash, many rely on financial institutions to provide installment credit.

****Trade Credit.****Trade credit is essentially customer charge accounts offered by the business; customers are billed each month.  To speed collections, some offer cash discounts if customers pay their balances early; others impose penalties on late payers.

* Although technically not a form of credit, layaway plans enable customers to purchase goods over time.  The customer selects an item, pays a deposit on it, and makes regular payments until it is paid in full.  The retailer keeps the item until the customer has finished paying.

****Conclusion****

      Pricing has a significant impact on many aspects of business. Price communicates an image of the business with a direct impact on customer behavior. Price then sets the stage for cash flow and ultimately business profits. Pricing decisions are some of the most important decisions an entrepreneur will make. Setting the price structure needs to be strategic and intentional.

****Part 3: Chapter Exercises****

****You Be the Consultant: “What’s the Right Price?”****

1. ****Why do many entrepreneurs underprice their goods and services, especially when they first get into business? Discuss the connection between the prices a company establishes for its goods and services and the image it creates for the company.  (LO 2)  (AACSB: Reflective thinking)****

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1. ****What advantages does J. Hilburn’s pricing strategy create for the company? What risks are associated with the company’s low-price strategy? (LO 2)  (AACSB: Reflective thinking)****

Students should review the company’s business model and to focus on how J. Hiburn creates value for the target customer, as this case is not just about selling shirts at a lower price.  The use of a direct sales model offers the value of improved customer service, as well as customization of the shirts to the customer’s measurements and preferences.   Students should be reminded that prices must be set based on customers’ wants and needs.

The main risk is creating a price war.

1. ****Visit the Web site for J. Hilburn. What advice on pricing can you offer Hil Davis?  Work with a group of your classmates to brainstorm various pricing strategies and the impact they might have on the company.  How should Davis implement your pricing suggestions?  (LO 2)  (AACSB: Analytical thinking)****

Visit their Web site at [http://www.jhilburn.com/ (Links to an external site.)](http://www.jhilburn.com/" \t "https://fisk.instructure.com/courses/1910/pages/_blank).  The FAQ page offers sufficient information to begin a group discussion.

      There are three basic strategies when establishing a new product’s price: penetration, skimming, and life cycle pricing:

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2. Skimming: Set higher prices for new products and for markets with little or no competition. This pricing strategy offers the optimal margin with higher price points.
3. Life Cycle Pricing: Set higher prices initially and, as technological advances or additional experience enables the firm to lower costs, it can reduce the product’s price one step ahead of competitors.

Depending on the number of students in your course, consider assigning one of these strategies to each team.