

Pricing

Chapter 17

Unit 4

Performance Objectives:

You will research the selling price of products or services similar to yours. You will read about and discuss various pricing strategies. You will choose a pricing strategy and set goals. You will discuss the factors involved in determining a price. You will analyze these factors for your own business using a pricing worksheet and will determine appropriate prices for your products or services.

Evaluation Criteria:

Successful completion of this chapter requires you to:

- ❖ Read information on the “myths” of pricing.
- ❖ Go online and visit the Web sites of competitors.
- ❖ Read about four different pricing methods.
- ❖ Choose a pricing method for your business.

Task 1: Is Pricing Important?

Read the following material.

The second of the 5 Ps of Marketing, pricing strategy is one of the most underestimated tools in the marketing strategies of many new small businesses. In fact, wrong pricing is one of the biggest mistakes small business owners make and is a leading contributor in small business failure.

So how do you go about deciding on what pricing strategy is right for your business? First of all there are some important “myths” about pricing that many small business owners hold that need to be laid to rest:

Myth #1: Price drives all purchasing.

No! Price is important but it is usually **NOT** the most important thing people have in mind when buying services or products. Quality, reliability, good service, robustness, brand reputation, warranties and guarantees, even “brand loyalty” are all factors people weigh when making a purchasing decision.

Myth #2: Price and quality are not linked.

No! High quality products or services sold for rock bottom prices sell equally well as low quality products sold at high prices. They don't! Don't make the mistake of trying to gain market share using low pricing. It won't work because most people will think there is “something wrong” with your product. If you don't value your product, why should a potential customer?

Myth #3: You must match or beat your competitors' prices.

No! You don't need to “follow the leader.” Don't make the mistake that your prices must be the same, or, even worse, lower than your competitors. If you have a product that is better quality than your competitors, you should charge **more** for it, right from the outset.

How much should I charge for my products or services?

Getting your prices right is complex balance of your costs, quality, image, target market, positioning, location, service, demand and perceived value. In addition, it's very important that you select the right pricing strategy at the start-up of your new business because how you set prices will play a considerable role in the way people perceive your new company. The wrong perception can be very harmful – if you start out “cheap,” people will perceive your company as “cheap.” You may never be able to recover from that perception. Getting prices right, therefore, needs some research and careful thought.

Although it is not a good idea to set your prices equal to or lower than your competitors, a good starting point for your research is to find out just what other businesses producing the same products or providing the same services as you are charging.

Task 2: Checking out your Competitors' Prices

In Chapter 7 you searched the Internet and the Yellow Pages for online and local competitors. Select **one** online business and **one** local business that you consider to be your **closest** competitors from those you identified in Chapter 7. Complete the following worksheets for the two competitors.

Go online and visit the Web site of your online competitor. Fill in the information you found about your competitor in Chapter 7 in questions 1 through 6. Then make a list of every product or service that they make or provide that **you** intend to make or provide. Locate their pricelist and write their price beside each item on the list. (*Hint: sometimes online businesses don't have their prices on their Web sites. If so, email or call them for a price list.*)

1. What is the name of the business?
2. What is the location of the business? (city, state)
3. Who is its target market?
4. What special features or services does it provide?
5. What features or services does it NOT provide that it should?
6. How can you do things better than this business?

<u>Product / Service</u>	<u>Price</u>
1.	
2.	
3.	
4.	
5.	
6.	
7.	
8.	
9.	
10.	

For your local competition, fill in the information you found about your competitor in Chapter 7 in questions 1 through 6. Then go to their place of business or to businesses where their products or services are sold. Look around and make a list of every product or service that they make or provide that **you** intend to make or provide and write their price beside each item on the list.

1. What is the name of the business?
2. What is the location of the business? (city, state)
3. Who is its target market?
4. What special features or services does it provide?
5. What features or services does it NOT provide that it should?
6. How can you do things better than this business?

Product / Service

Price

- 1.
- 2.
- 3.
- 4.
- 5.
- 6.
- 7.
- 8.
- 9.
- 10.

Task 3: Understanding Pricing Methods

Below are explanations, with examples, of several pricing methods. Please read the examples carefully. You will be asked to determine which method will be best for you to use in pricing the products or services of your new business.

1. **Going Rate or Suggested Rate Pricing:**

This method is simply meeting the prices of your competitors and is the worst pricing strategy that you could use. In this method, price controls your company instead of your controlling prices. It ignores the costs involved in producing your product or service and can quickly lead to business failure. This method of pricing is what “price wars” are all about. In a price war scenario, the company with the deepest pocket wins. Don’t even think of using this strategy in your business!

2. **Full Cost Pricing:**

With this method you identify all of the costs involved in producing your product or service and then add a certain percentage profit that you want to make on each item or service. There are two very important factors that must be taken into account for full cost pricing to work:

- You need to sell enough to meet your break-even point.
- When calculating the price you must make sure that you include every single cost before you add your percentage markup. Any cost that you miss comes directly out of your profit.

3. **Gross Margin Pricing:**

In the gross margin pricing method, the percentage mark up on a product is calculated, strangely enough, using **all** the costs (total expenses) **not** used to calculate the gross margin! To calculate a price using this method, the percentage profit required is added to total expenses expressed as a percentage of total sales. This percentage is subtracted from 100% to yield a difference. The cost of manufacturing the item (COGS: costs included in the calculation of gross margin) is then divided by that difference to yield the selling price. That is:

$$\text{Price} = \text{Cost of Goods Sold} \div [100\% - (\% \text{profit} + \% \text{expenses})]$$

Example:

In Chapter 10 we met the RVC Fine Furniture company. For the month of June 2010, they had a great total sales figure of \$5,395, but yet a pretax profit of a mere \$163! They didn’t really have a pricing strategy – they just charged what they thought was a reasonable price that customers would pay for their furniture.

Realizing that they were selling themselves short, their accountant suggested that they try using his method of gross margin pricing for the new product they were planning, a solid maple butcher block table. They went through the following steps:

- a. First, decide on a reasonable profit. The accountant thought they should go for **20%** profit.
- b. Next, calculate the total expenses as a percentage of total sales (refer to Chapter 10).

Total Expenses = \$1,387
 Total Sales = \$5,395

$$\% = \frac{1,387}{5,395} \times 100 = .257 \times 100 = 25.7\% = \mathbf{28\%} \text{ rounded up.}$$

- c. RVC calculated that the total cost of making one butcher block table (COGS) would be **\$235**.
- d. Finally, fit all the numbers into the formula:

$$\mathbf{\text{Price} = \text{Cost of Goods Sold} \div [100\% - (\% \text{profit} + \% \text{expenses})]}$$

$$\mathbf{\text{Price} = \$235 \div [100\% - (20\% + 28\%)]}$$

$$\mathbf{\text{Price} = \$235 \div (100\% - 48\%)}$$

$$\mathbf{\text{Price} = \$235 \div (52\%)}$$

$$\mathbf{\text{Price} = \$235 \div (0.52)}$$

$$\mathbf{\text{Price} = \$451.92 \text{ rounded up } \$452}$$

RVC should therefore charge \$452 dollars each for their butcher block tables. With their new pricing structure, RVC's June pretax profit could be beaten with the sale of just one butcher block table!

4. **Cost Plus or Formula Pricing:**

In this method, the pricing of a product or service, in addition to the basic cost of the product or service, also includes certain intangible image factors such as service, location, brand, etc. To use this type of pricing, it's best to know how you are perceived by your customers and what value they place on your products so that you can accurately gauge the "add-ons" used in this pricing strategy. To price your goods by this method, use a formula like:

$$\mathbf{\text{Price} = \text{COGS} + \text{expenses} + \text{acceptable profit} + \text{image factors}}$$

Example:

JR's U\$ed CDs store you met in Chapter 10 is doing quite well for a new start-up. His total sales for June were \$2,975, not bad for his third month in business. However, his pretax profit was only \$395 for the month – and since JR's draw has to come from the profit, he doesn't have much to live on.

JR's only pricing strategy was that he "bought high and sold low." JR's accountant suggested that JR might want to adopt a proper pricing strategy and that cost plus or formula pricing would be a good way to go.

The accountant pointed out to JR that his downtown store in the entertainment district (location) was very convenient for his customers, as was his hiring two employees (service) who were able to help in keeping the store open long hours in the evening and during the weekend. He also pointed out that JR's intense interest in and knowledge of music and musical artists, as well as his ability to search out and find rare and unusual albums, were very valuable to his customers (perceived value). So instead of just buying for \$3-4 and selling for \$5-10, JR should adopt a pricing policy using the formula:

Price = cost + expenses + profit + location + service + perceived value

Analyzing the formula:

Cost	JR will continue to buy used CDs for \$3-4 .
Expenses	JR expects to be turning over about 1000 CDs a month when he is fully established. He will distribute his \$1,499 monthly expenses over the thousand CDs = \$1.50 each.
Profit	JR will add \$2.00 / \$2.50 profit to each \$3 / \$4 CD.
Location	It costs JR about \$250 a month extra for his downtown location. He will distribute that over the thousand CDs = \$0.25 .
Service	To keep the store running at hours suitable to many music collectors costs JR \$560 a month. He will distribute that over 1000 CDs = \$0.56 rounded up to \$0.60 .
Perceived Value	JR's expertise is immeasurable and it takes a lot of work to maintain. JR will add a rareness / collectability premium to each CD of \$0.50 to \$5.00 in \$0.50 increments. Therefore the premium on a moderately collectable CD would be \$2.50 .

Previously JR would have sold a moderately rare CD that he bought for \$4 for between \$8-10, with the obvious bad effect on his bottom line. Using the formula, JR would now price the CD at:

$$\text{Price} = \$4 + \$1.50 + \$2.50 + \$0.25 + \$0.60 + \$2.50 = \mathbf{\$11.35}$$

Using his old strategy, JR's cheapest product, a common CD with little collectable value bought for \$3.00 and sold for \$5.00, was too little profit to be viable. Using his new formula, his cheapest product would be:

$$\text{Price} = \$3 + \$1.50 + \$2 + \$0.25 + \$0.60 + \$0.50 = \mathbf{\$7.85}$$

Task 4: Choose Your Pricing Method

Think about the four methods discussed and choose the method that you think is most appropriate for your business.

My business is using the _____ method of pricing because: