Chapter 10

Pricing

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Objectives

10-1 Explain the functions of price.

10-2 Explain how to determine the breakeven point for pricing.

10-3 Define and calculate markups and markdowns.

10-4 Describe different pricing strategies and how they are applied.

10-5 Describe the various external and internal factors that can affect prices.

THE ROLE OF PRICE

Price is included among the 4 P's of the marketing mix because setting prices directly affects the perceived needs, attitudes, perceptions, and motivations of the consumer. If a product or service is properly priced, price becomes a customer relations tool. If the price is not perceived as a fair exchange, it becomes a buying inhibitor.

Proper pricing of a product or service serves as a positive marketing incentive and ensures enough profit to the seller to allow the business to continue serving the market.

The price of a product or service must accomplish the following objectives. By satisfying these requirements, the entrepreneur is operating under the **total pricing concept**.

1. The total cost of the item to be sold must be covered. This includes the direct expenses of manufacturing or buying the product and the operating and overhead expenses incurred in operating the business.
2. Pricing must contribute to the long-term stability of the business. There must be enough profit to generate retained earnings, which can be put back into the business for future growth and development.
3. The entrepreneur must be rewarded for the effort expended and the risk assumed in owning and running the business.
4. Customers must perceive the price as giving a fair value.

Supply and Demand

It is important for entrepreneurs to understand the relationship between **supply and demand**. Proper allocation of goods and services to the market at an affordable cost helps maintain a healthy economy. Consumers can buy only what they can afford, so the higher the price of the product or service, the smaller the market. If the market perceives the price of a product as too high, then the demand for the product will be low. This will cause a surplus

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of the product in the marketplace, and production will have to be slowed or stopped. Conversely, if a product is priced below the perceived value, the demand will be great. This will cause a shortage in the marketplace, and production will need to be increased to bring supply in line with demand.

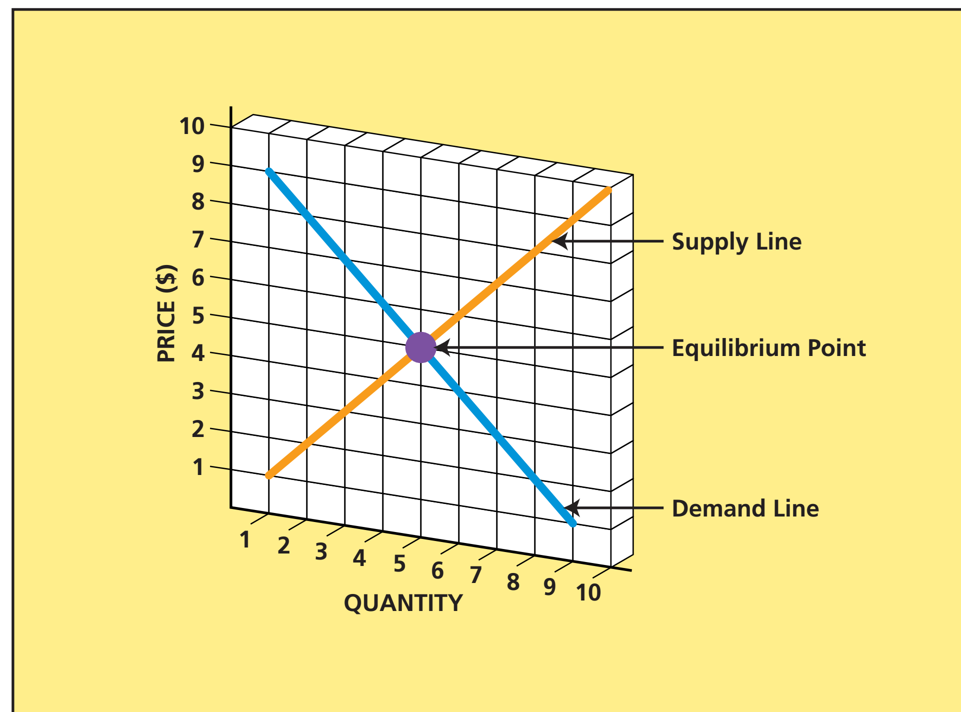
The entrepreneur's goal is to find the price point that allows a balance between supply and demand. When a price is set high enough to ensure a profit for the seller, certain portions of the market will switch their demand to other products. This guarantees that the supply of the higher-priced product will be adequate for demand. On a supply and demand graph, such as that in Figure 10-1, the equilibrium or balance point is reached when the demand line intersects with the supply line. To read the graph, use the vertical (price) scale in conjunction with the supply line. Use the horizontal (quantity) scale in conjunction with demand line. For example, if an item costs $2, read across the graph until you reach the point where the demand line intersects the horizontal "2" line. The demand for a $2 item would be eight units.

FUN FACTS

The consumer price index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. It is one of the factors affecting such economic indicators as the rate of inflation. In 2003 the CPI rose 1.9 percent.

FIGURE 10-1

Supply and Demand



It is not difficult to sell a product at below-market prices. The challenge is to sell products and services at a high enough price to ensure profit and still pass on customer value. Too often small businesses get caught up in playing the sales game and not paying enough attention to profit, the bottom line. Anyone can sell ice cream at a low price, but to sell ice cream at a profitable price requires entrepreneurial skills.

The prices that entrepreneurs set need to be low enough to encourage a high demand for their products or services but high enough to ensure a profit. Low prices will certainly increase demand, but they may yield little or no profit. High prices could mean more profit, but only if demand does not drop. Therefore, it is important to find a price point that is acceptable to the buyer and yields a satisfactory profit to the seller. In a relatively free marketplace, the determination of the acceptable price point ultimately comes from the buyers. They will not buy what they cannot afford. Using the various strategies employed in the marketing plan, the entrepreneur attempts to determine what that price is.

BREAKEVEN POINT

Price setting begins with determining the breakeven point. The **breakeven point** is reached when the cost of producing and/or selling a product or service is covered. You can determine that point by first analyzing your **fixed costs**, which are the costs that do not vary even when there are changes in production and/or sales volume. Examples of fixed costs are rent, utilities, and insurance. You will also need to analyze your **variable costs**, which are costs that fluctuate with changes in production and/or sales volume. Examples of variable costs are the cost of goods or materials, payroll, and advertising. Fixed and variable costs should then be broken down to determine the cost of each unit sold.

Once the breakeven point is reached, additional sales produce profit for the entrepreneur. The more units are sold, the greater the profit per unit. Total profits can be projected by multiplying the amount of money that will be made per unit by the number of units that will be sold, then subtracting the total cost (fixed plus variable) of selling the units.

Figure 10-2 is a graphic illustration of the breakeven point for a small manufacturer of a product—call it a Gizmo. The price of $10 will cover all fixed and variable costs of making Gizmos when 1,000 units have been sold. If fewer than 1,000 units are sold at this price, there will be a loss. Each sale in excess of 1,000 will mean a profit.

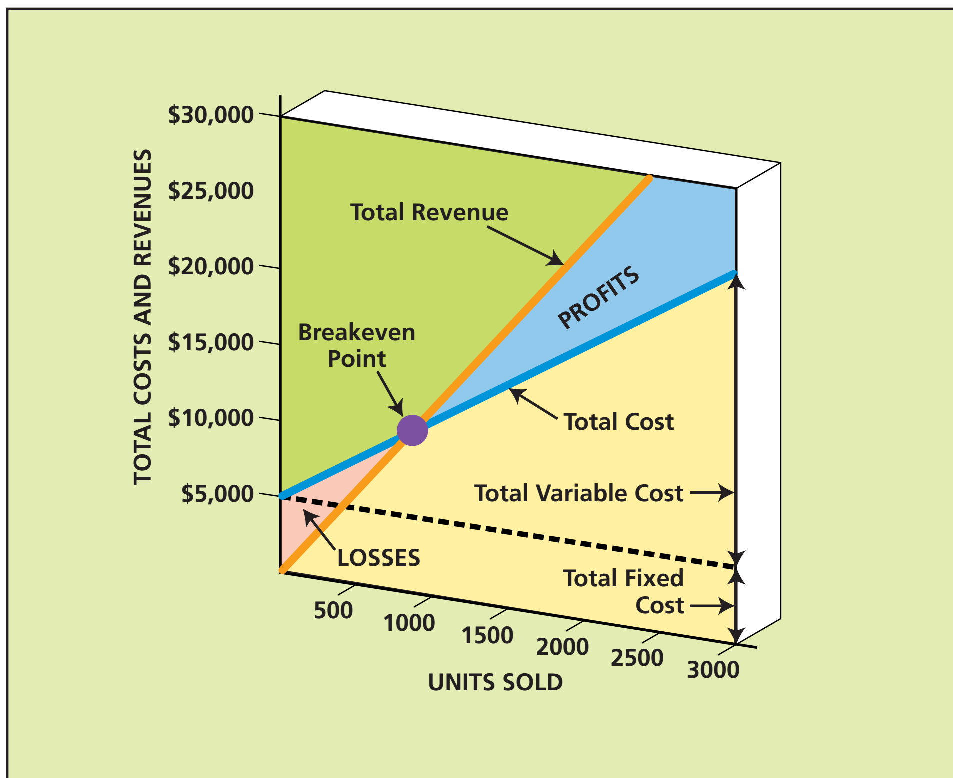


FIGURE 10-2

Breakeven Point

Businesses become exciting and profitable as they go further past the breakeven point. The first Gizmo sold after the breakeven point, unit 1,001, will return just a small fraction of its price as profit. However, as you can see from Figure 10-2, the margin grows as more units are sold. At unit 2,000 the revenue is approximately $20,000, the total cost is $15,000, and therefore the profit is $5,000, which is $2.50 for each $10 unit sold above the breakeven point. That profit on each unit sold will continue to increase as more units are sold.

The **contributing margin** is the gross profit derived from the sale of the product, that is, the selling price less the cost of the goods or materials. The contributing margin for the Gizmo is $4.

Selling price	–	Cost of goods	=	Contributing margin
$10	–	$6	=	$4

Breakeven Formula

To find the breakeven point when you know the total fixed cost and the contributing margin of the units sold, divide the fixed costs by the contributing margin. If the fixed cost is $100,000 per year and the average contributing margin is $4, the breakeven point is reached when you sell 25,000 units.

Fixed costs	÷	Contributing margin	=	Breakeven point
$100,000	÷	$4	=	25,000 units

At the breakeven point, the revenue and the total cost are equal.

25,000 units × $10 = $250,000 revenue

$100,000 fixed cost + $150,000 variable cost = $250,000 total cost

MARKUPS AND MARKDOWNS

A **markup** is the amount added to the cost of an item to arrive at a selling price. A **markdown** is the difference between the original selling price and the price at which an item is actually sold. You can express markup in dollars or as a percentage of the selling price or the cost of the product. An item that costs $5 and sells for $10 has a markup of $5 or 50 percent of the selling price or 100 percent of the product cost. Most retailers express markup or markdown as a percentage of the selling price.

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The amount of markup added or the amount discounted as a markdown will vary widely depending on the industry and market conditions. Entrepreneurs must learn how to calculate markups and markdowns to make sure they are following the total pricing concept.

Find the Selling Price

To calculate the selling price at a percent markup when the cost is known, simply divide the cost by 100 percent minus the desired markup percent.

Cost	÷ (100% –	Markup percent)	=	Selling price	
$5	÷ (100% –	50%)	=	$10	Cost: $5; Markup: 50%
$6	÷ (100% –	40%)	=	$10	Cost: $6; Markup: 60%

Find the Cost To calculate the cost when the selling price and the markup percent are known, multiply the selling price by the markup percent and subtract the answer from the selling price.

$10 selling price × 40% = $4 markup
$10 selling price – $4 markup = $6 cost

Find the Markup Percent To determine the markup percent when the cost and the selling price are known, subtract the cost from the selling price. Divide the difference by the selling price.

$10 selling price – $6 cost = $4 markup
$4 ÷ $10 = 0.4 or 40% markup

Manufacturers and wholesalers use the same formulas to determine the markup on their selling price to retailers. However, they are often operating in a more volatile environment because materials, transportation, and labor costs are more variable and time sensitive than in retail purchasing. Once a desired markup percentage is achieved, the cost of materials, goods, and transportation must be closely monitored to prevent an unexpected decrease in the contributing margin of the company's product sales.

Protecting Your Profit Margin

Many small businesses do not adequately protect their profit margins—their markup is too low. For example, a retail store sells its products at a 50 percent markup: for every $1 of product sold, the average cost is 50 cents. The profit and expense for each dollar sold is calculated as follows:

Sale price	$1.00
Cost of product	– 0.50
Freight cost	– 0.02
Gross profit	0.48
Operating expenses	– 0.34
Net operating profit before taxes	0.14

Averaging a 50 percent markup allows the owner to receive a profit of 14 cents for each dollar of product sold. The 14 cents must cover the owner's salary, taxes, and loan principal payments and contribute to retained earnings. If the selling price of the $1 example was cut to 90 cents (a 44 percent markup rather than 50 percent) and if all operating and freight expenses remained the same, the profit would be only 4 cents on each dollar sold. The owner would have to sell considerably more products to make the same amount of money. Too often entrepreneurs engage in price wars with larger competitors, which results in severely decreased profits.

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Taking Markdowns

Markdowns are taken when a product does not sell at the desired price. When a product is "on sale," its original selling price has been reduced. To calculate a markdown, decide on the percent of markdown. Multiply the original selling price by the percent of markdown, and then subtract the result from the original selling price to get the sale price.

$10 selling price × 40% markdown = $4 markdown
$10 original price – $4 markdown = $6 sale price

There are a number of reasons for taking markdowns.

- **Damaged Merchandise** A defective item usually cannot be sold at its original selling price.
- **Old Merchandise** Some products remain on the shelves too long and go out of style or become obsolete. The entrepreneur needs to divest old products in order to raise capital to buy new products.
- **Broken Assortments** Items that were intended to be sold in sets or groups lose their salability when part of the grouping is missing or damaged.
- **Special Promotions** Low prices are offered to increase demand and, therefore, customer traffic.
- **Limited Space** Markdowns are needed to clear shelves in order to make room for new inventory.

When setting markups for new items, be sure you consider future markdowns. The initial markup must be high enough to accommodate periodic markdowns.

PRICING STRATEGIES

In the initial stage of selling a product or service, the entrepreneur must set prices to determine what is acceptable to customers. Ultimately the customers determine what is an acceptable price, as they will not buy if the value is not perceived as fair.

To arrive at a pricing strategy, the seller must take into consideration the total pricing concept and the marketing objective of the business. The strategy will depend on the maturity of the business, the particular cycle of the economy, the newness of the product, and the reaction of the competition. Common pricing strategies include skimming, market penetration, loss leader pricing, price lining, price bundling, status quo pricing, and price points.

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Skimming

Skimming is a short-term profit strategy often used for products that are not expected to remain on the market for an extended period of time. These products are fads that take advantage of current—but temporary—demands in the marketplace. The products are sometimes tied into a current market happening, such as a popular movie or a music or fashion trend. Manufacturers produce these items with the expectation of selling a lot quickly, then getting out of the market. These products carry a high risk, since sales are dependent on whether or not the fad catches on and how long it lasts. Prices are set very high in the anticipation that the short selling period will encourage customers to pay a high price for the "in" product. The higher markup also gives manufacturers and retailers a cushion in the event they are caught with a high inventory and must take large markdowns when the fad subsides.

A good example of this is the Pet Rock, a novelty product that became popular during the Christmas holiday season a number of years ago. It was an ordinary garden rock, 2 to 3 inches in size, packaged in a small carton that looked like a doghouse. The Pet Rock came with instructions on how to train it to do tricks such as "sit," "stay," or "roll over." It caught the country's attention on late-night television programs and became the rage as a novelty Christmas present. At a price of $6.95, it sold millions within a six-week selling period and just as quickly disappeared from store shelves immediately after the holidays. A price of $6.95 for a common rock was truly a price set as part of a skimming or short-term profit strategy. More recently Pokemon, Power Rangers, and ET dolls were products with intended short-term life cycles, priced to get in and get out of the marketplace quickly. Some did well, while others (ET dolls) failed miserably.

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Market Penetration Pricing

Sometimes entrepreneurs use the opposite of the short-term profit strategy—selling at the lowest possible price for a short-term period. This strategy, known as **market penetration pricing**, is often used to introduce a new product or business with an expected long-term life cycle. The idea is to gain market share. By setting a low price to entice people to try a new product, the business is hoping to gain customers at their competitors' expense. Taking customers from the competition dilutes the competition's portion of the market while increasing the market penetrator's portion. By gaining market

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share, the entrepreneur increases demand for the product or service. Once a desired share of the market is attained, prices gradually rise to the level of the competition.

Grocery stores and new restaurants often rely on the market penetration strategy. Small businesses need to be careful not to permanently violate the tenets of the total pricing concept by not protecting their proper profit margin. Market penetration pricing can be effective as an introductory tool to acquaint the marketplace with a new business or product but should not be used on a continuous basis.

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Loss Leader Pricing

A **loss leader pricing** strategy consists of purposely pricing some products at a level that eliminates profit and incurs losses on those particular products. This is done to increase customer traffic and thereby the likelihood that other, related products will be purchased at a normal or higher markup. By enticing customers to come in and buy certain products at bargain prices, business owners hope that those customers will also buy other products at full price to offset the losses incurred on the bargain prices. The bargain prices are advertised on television and radio and in newspapers, and there is usually a time limitation on the price. Department stores, variety stores, toy stores, grocery stores, and drugstores utilize this marketing/pricing strategy on a regular basis. Manufacturers and wholesalers also offer loss leader bargains to their customers to entice them to buy more related products in large volumes. But small business owners are advised not to use it, as it requires additional expenditures on advertising and can be detrimental to achieving the overall desired markup percentage of the business.

Price Lining

When businesses group products at certain price points—such as all items for $9.99—they are **price lining**. By grouping items, they make shopping easy for the consumer and average out their desired markup. Some items are priced under the desired markup and others over it, but the average reaches the desired results as long as the products sell evenly. It can be risky, but rewarding, if customers respond to a simple one-price-for-all strategy.

Price Bundling

Selling a product in multiple units—such as "Two for the price of one" or "Buy three and receive one free"—is a type of pricing strategy called **price bundling**. Many retail outlets use it. Price bundling is similar to penetration pricing in that it can in-crease market share. It can also be used to reduce surplus inventory. The latter use can be effective for small businesses, but price bundling is not recommended as a permanent tool because it does not normally sustain a proper profit margin.

Status Quo Pricing

Most businesses settle into a **status quo pricing** strategy in which price levels are firmly established and remain relatively fixed until something happens in the marketplace that requires a change or adjustment. Such events include new competition, changes in the established competition's pricing strategies, changes in demand due to market shortages or overflows, or changes in the economy. New competition causes disruption in the market. Established business owners must react by increasing advertising, matching prices, or holding their position until the disruption settles down. When an established competitor makes a dramatic shift in prices, other business owners must react either with similar action or by adding value to their offerings. If a product is undersupplied (such as Cabbage Patch Dolls or Pokemon) or oversupplied (gasoline availability), supply and demand will affect prices. Prices will also change if the economy enters a prolonged period of inflation or recession, as either condition will change consumer buying behavior. It is wise to keep a close eye on these conditions in order to react quickly.

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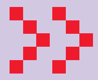
You can reach your profit goals only if you use the right pricing strategy for your particular type of business. Strategies appropriate for certain target markets may not work for others. You must be realistic in your expectations and knowledgeable about the supply and demand conditions of the market you wish to serve in order to determine the best pricing strategy. This requires constant evaluation of market conditions and your pricing policies.

Price Points

It is very important to understand the psychology of violating **price points**, which are the price levels with which consumers feel psychologically comfortable. Normally they fall at even dollar levels in increments of fives, tens, or hundreds. Price points vary from industry to industry, but the general guidelines are consistent. In the minds of many consumers there is a big difference between $9.95 and $10.50. $10 is a recognized price point in many consumer goods categories. Going above $10 is a violation of that particular price point. A car selling for $19,900—below the $20,000 price point—appeals to a larger market than one that sells for $20,750.

Sellers need to be sensitive to making decisions that may violate consumers' psychological perception of value exchange. Staying below a price point is possible when the entire price point ranges are considered. For instance, there is not much difference between perceptions of $18.95 and $19.95—they are both below the price-sensitive point of $20. Taking this into account, you can increase an $18.95 price tag to $19.95, which allows you at the same time to lower the suggested markup of a $20.95 item and price it at $19.95. The goal is to receive the desired markup on the entire product line as an average.



Small Business Technology

The complications of determining values in foreign currencies are behind you. Small businesses can now convert a foreign currency to a U.S. dollar value with a click of the computer mouse. A search of "currency exchange" brings up a number of conversion web sites. Say you wish to explore the wholesale purchase of weather instruments from South Africa and the seller quotes a price of 300 rand per piece. A quick visit to a conversion site will tell you that 300 rand equals $47.39. Also, banks can send bank drafts overseas in a matter of minutes and automatically convert the receipt into the seller's account. The huge growth of international trade has prompted new technology to solve a problem that once deterred many businesses from considering foreign commerce.

Discounts

Small business owners must be careful not to fall prey to larger businesses by competing strictly on price. This is not the entrepreneur's strong point. Big businesses compete for a cost leadership position and are able to offer larger discounts because they have greater capital resources. You make your profits through differentiation, with a unique product or personalized customer service.

The drawbacks of discounting can be illustrated by the following example. A small business sells 5,000 units at $100 each, an average 45 percent markup, resulting in revenues of $500,000.

Revenues	$500,000	5,000 units @ $100
Cost of goods	– 275,000	5,000 units @ $55
Gross profit	225,000	
Operating expenses	– 200,000	
Net operating profit	$25,000	

The entrepreneur decides to reduce prices 20 percent, or $20 per unit, to compete with a large discount operation. He first assumes a minimum sales increase of 20 percent more units, or 6,000 units, at $80, the new selling price.

Revenues	$480,000	6,000 units @ $80
Cost of goods	– 330,000	6,000 units @ $55
Gross profit	150,000	
Operating expenses	– 200,000	
Net operating loss	<$50,000>	

He changes his calculation to show a 100 percent increase in the number of units sold, 10,000, at the $80 selling price.

Revenues	$800,000	10,000 units @ $80
Cost of goods	– 550,000	10,000 units @ $55
Gross profit	250,000	
Operating expenses*	– 225,000	
Net operating profit	$25,000	

**includes additional advertising, payroll, and supplies to sell extra units*

It isn't until he increases projected unit sales to 300 percent, 15,000, that it makes any sense to lower prices 20 percent.

Revenues	$1,200,000	15,000 units @ $80
Cost of goods	– 825,000	15,000 units @ $55
Gross profit	375,000	
Operating expenses	– 300,000	
Net operating profit	$75,000	

Taking the risk of discounting requires ample capital, space, and advertising. Certainly a 300 percent increase in unit sales would require additional payroll, an aggressive advertising campaign, more supplies, and moving to a larger space in order to house and display or assemble inventory.

Strategic planning requires that you identify your objective in terms of sales and profits and how they can be obtained. The choice is normally to achieve goals by cost and price leadership or by differentiation and service leadership. Small businesses should build their strategies around the latter course. Although it may take longer to reach and surpass the breakeven point, it will result in a more stable business.

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FACTORS THAT AFFECT PRICES

There are a number of factors that can affect the price of a product, both externally and internally. Legal considerations and the customer's perception of fair value also affect prices.

External Factors

Elements surrounding a business that indirectly affect its operations are called **external factors**. They may be economic cycles, societal changes, technological developments, the market entry of substitute products, new competition, or other disruptions in the marketplace.

Economic Cycles Changes in the economic environment can encourage or discourage consumer buying. You may read many economic stories from Washington and sometimes think they will not affect you. However, just the mention of inflation, recession, stagnant economy, rising interest rates, or increasing and decreasing taxes has a psychological impact on consumers.

Inflation says prices will be going up, and consumers may wish to purchase before they do. Recession says the economy is faltering, jobs are being lost, and production is down, in which case consumers become conservative and watch prices more closely. If interest rates are rising, consumers put off making major purchases. When interest rates drop, consumers charge and buy more freely. If there are tax rebates and decreases, consumers feel free to spend extra money and are not as cautious. If taxes go up, consumers have less spending money. Entrepreneurs must keep an eye on the economic environment and be prepared to change prices as necessary to accommodate the impact of any changes.

FUN FACTS

The market basket of consumer goods used to measure CPI consists of a selection of goods from eight major categories: food and beverages, medical care, housing, recreation, apparel, education and communication, transportation, and other goods and services, from haircuts to funeral expenses.

Societal Changes Whether they are short-term fads or long-term lifestyle changes, societal attitudes affect the marketplace and price acceptability. Certainly this is evident in the fashion industry. What opinion leaders decide to wear often determines demand, which of course determines prices. Examples of longer-term changes are the growing ethnic populations, dual-career families, and the sexual revolution. In a changing social environment, some entrepreneurs can increase their prices while others have to decrease them as demand changes. Successful entrepreneurs stay abreast of the changes that surround them.

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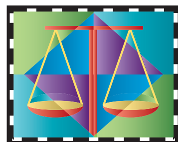
Technological Developments When new technology is introduced, older technology suffers. A business may be stuck with obsolete products and little demand unless it stays up to date with new technology. New technology also offers great opportunity for entrepreneurs. Being among the first to sell or manufacture a new technology is often a road to riches as demand outweighs supply and allows the seller to receive maximum prices. It was not long ago that a simple handheld electronic calculator sold for over $100. Now they are giveaways for businesses like banks and insurance companies.

Substitute Products One characteristic of the free market system is that if a product is selling at a greater profit than expected, other entrepreneurs will at some point introduce similar or substitute products to gain a share of the market and its profits. Established business owners need to be on the lookout for new products that serve the same target market and change their prices accordingly to counter the threat of these new product entries.



Ethics for ENTREPRENEURS

During emergencies some businesses raise the prices of essential products, such as candles and batteries during power outages. Even during the 9/11 disaster some gas station owners raised gasoline prices as rumors of pending oil shortages spread. Those who engage in this type of price gouging refer to the principles of the free market and assert that under high-demand conditions it is acceptable to raise prices to what the market will bear.

Think Critically

1. Do you believe these businesses are following acceptable business practices?
2. Who is hurt by price gouging? Should it be illegal?
3. Give examples of other price gouging situations that you are familiar with.

New Competition New entrants into the market have an immediate impact and should always be taken into account when determining prices. If a new sandwich shop opens and sells 20 sandwiches a day, that means 20 sandwiches have been taken from other businesses. Those businesses will respond, often by lowering prices. The new business will set prices according to how it believes the market will respond but at the same time must be prepared for a reaction from the competition.

Internal Factors

Internal factors are elements within a business that directly affect prices. They may be an increase in fixed costs, supplier shortages, increases or decreases in the cost of materials or goods, or more efficient technology that allows increased production.

Increase in Fixed and Variable Costs If a business is faced with an increase in fixed costs, it has to adjust in some manner, often by raising prices. An increase in rent, freight charges, or other fixed costs changes the bottom-line profit figure. If a business is holding on to a slim profit margin of 7 percent and its fixed costs rise 2 to 3 percent, an adjustment must be made or the business will cease to exist. One alternative is to increase prices. During inflationary times the competition will have to respond, and the winner may be the one who can hold out the longest. This scenario also occurs when the cost of materials or goods to the final seller is increased, and prices rise accordingly.

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Supplier Shortage If a supplier shortage slows the supply of a product in great demand, the entrepreneur with excess inventory or better access to the product may decide to increase prices. Because of the supplier shortage there will be little competition. If it is a short-term shortage, the entrepreneur may choose not to raise prices in order to avoid appearing to be a "price gouger."

New Technology Businesses that can improve efficiency with better technology and thereby benefit from economies of scale may be able to increase production and decrease their costs. This, in turn, may allow them to lower their prices and gain a larger market share. Economies of scale work to the advantage of consumer and entrepreneur alike.

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Legal Considerations

There are many types of legal considerations that affect prices, including price discrimination and tie-in sales.

Price Discrimination As you have learned, the practice of charging different prices to different customers for the same goods is called price discrimination. It is in violation of the Robinson-Patman Act of 1936 if it interferes with competition and injures the discriminated buyer. The Robinson-Patman Act *does* allow sellers to allow quantity discounts to larger buyers, citing that this can save in manufacturing costs. In other words, an entrepreneur can sell a product at a different price to Wal-Mart than to Smith Brothers Hardware, but only if it is truly a quantity discount.

Tie-in Sales A related legal consideration is **tie-in sales**. For promotional purposes it is legal to offer an additional item for the same price as for the original item alone. However, you cannot tie in the purchase of one product line to the purchase of another without violating the Clayton Act. In other words, it is legal to sell two for the price of one, as long as the offer is made to all customers, but it is not legal if the customer must also buy another product that is not related directly to the original offer.

Types of Prices Often it can be very confusing for the consumer to determine the final price, particularly in such instances as buying an automobile. Some common types of prices are the following.

- **List Price** The **list price** is the standard price charged to customers.
- **Net Price** After all discounts are subtracted, the balance is the **net price**.
- **Zone Price** The price set for a particular geographic area is the **zone price**.
- **FOB** With free on board or **FOB** pricing, the buyer must pay transportation charges to deliver the products, and the title or ownership of the products is passed to the customer when the items are loaded on the shipping vehicle.

Entrepreneurs who manufacture products must make sure that all their salespeople are knowledgeable about discounts and price components and that their products are sold legally and ethically.

Fair Value

In Chapter 9 utility satisfaction is defined as the search for value—that is, the consumer's search for those products or services that give the greatest satisfaction in exchange for his or her money. It is imperative for a business that

its customers believe they have received fair value. In the mind of the seller it is the price charged, but in the mind of the customer it is the cost incurred for a purchase. To a buyer, true cost consists of what has been received in comparison to what has been given up. It can be expressed as a ratio.

true cost to customer = price:value

The seller has determined the price, but the value will differ depending on the customer's needs. Value is the total package of benefits, which may not always be immediately identifiable but is anticipated. Life insurance or an IRA are examples of products that you buy with the anticipation that in the long term they have a greater value than in the immediate transaction.

Customers' View of Quality Customers have undergone quite a transformation in the way they view price in regard to quality. Shifting from the product concept of marketing to the customer concept has changed marketing strategies to emphasize value and quality more than in the past. When there were only three major automobile manufacturers or three television networks, customers were limited in what they could purchase or view and often settled for second-rate products of questionable value. Since the invasion of Japanese goods in the 1960s—initially cars and electronics, then a steady stream of other quality products—American manufacturers have awakened to the idea that to compete effectively they must offer value through quality products.

Japanese automobiles coming into America offered superior quality at lower prices than American automobile manufacturers were offering. The impact was so great that the U.S. government placed high tariffs and quotas on imported automobiles to protect domestic manufacturers and the huge number of jobs related to the automobile industry. The tariffs and quotas were not intended to last forever but were installed to give American companies time to retool and rethink their manufacturing processes. The result was a better-quality American automobile and at the same time a message to all manufacturers that quality *does* count and that contemporary consumers have many more choices about how to spend their money. Prices and perceived values were affected in many industries.

THINKSTOCK

The Global ENTREPRENEUR

Hurray for the euro! Since 2002, 12 European nations have used a standard currency, the euro, for international business purposes. The value of the euro at the time was determined by the value of the U.S. dollar. In its initial implementation, the dollar and euro were equal in value. Since then the euro has risen in value past the value of the dollar, and over time its value will continue to fluctuate. The transition went more smoothly than many experts had predicted and has made monetary exchange between countries and businesses much easier. This development has been a boon for further globalization.

Think Critically

1. If one euro is of greater value than one dollar, what effect does that have on American and European imports and exports?
2. There were, and still are, some European countries reluctant to accept the euro as their currency. Why do you believe they hesitate?

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Managing Quality A new management style, **total quality management** or TQM, became a buzzword in many organizations. TQM theory was essentially taken from the Japanese method of manufacturing. Its basic premise is one of continuous improvement in quality and customer service. The idea of setting up various methods of ensuring quality and improving customer service has caught on with many American companies. It has also carried over into the international business community and is the cornerstone of ISO9000 regulations. These regulations are international standards of quality control management that set uniform guidelines for manufacturing processes to ensure that products conform to customer expectations. In order for a company to receive endorsements for its products in many foreign markets, it must follow ISO9000 recommendations for product manufacture and guarantees.

The result of all this is a market that offers more choices to more informed customers who have a much clearer understanding of value. Entrepreneurs who attempt to price-gouge with inferior products will not be successful in the long term.

Price Objections

Price is considered the hidden objection when it comes to selling. Many times interested buyers are persuaded not to buy because of the price of a product, but they are reluctant to admit it. They might say, "No, I don't like the color," when what they really don't like is the price. Professional salespeople learn how to handle price objections by being knowledgeable about the value of the product and about ways to assist the buyer in overcoming the objection. They become experts at finding this hidden objection, bringing it out, and handling it with carefully chosen questions and constructive suggestions. A price objection to an expensive item might be countered with, "If we can spread the payments out over a period of time, would that help you make the purchase?" Price objections should always be handled from a positive standpoint, using positive words.

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You must be able to defend your pricing strategy and counter the consumer's quite normal reaction. For customers the difficult part of the purchase decision is giving up what they have for something they do not have, no matter how good the product or the sales presentation.

Pricing Criteria

Before determining your final prices you should do the following.

1. Compute what will be required to cover the four points of the total pricing concept.
2. Determine the breakeven point.
3. Gather information on competitors' prices and how long they have maintained those prices.
4. Ask selected representatives of the target market or a focus group for input.
5. Ask members of the industry what has worked for them.
6. If necessary, experiment with introductory pricing strategies, keeping in mind that it will be easier to lower prices at a later date than to raise them.
7. Examine closely the image of the product and the price consumers would be willing to pay for that image.
8. Scan the business environment for external and internal factors that might influence customer buying attitudes.
9. Give careful consideration to the chosen strategy and its long-term goal.
10. Determine the best way to defend your prices when questions and objections are raised.

0538439211_10 1/18/05 7:10 PM Page 224

Chapter Review

Ship in a BOTTLE

Setting Prices

Determining the prices was a two-part process: wholesale and retail. Fred had a starting price based on his cost and on Johann's prices at his Hamburg store and web site. By calculating the cost to an American of ordering a model from Johann, including the cost of shipping from Germany, Fred could calculate a fair value to the customer. His research and conversations with Johann had convinced him that Johann's retail prices were perceived as a fair value. Therefore he could calculate his initial retail prices by adding the cost of an individual shipment to a U.S. address from Germany to the advertised prices on Johann's web site. He also believed he could justify adding a small premium for the convenience of buying in the U.S., which saved customers considerable time and allowed personal communication with the seller.

Arriving at a wholesale price would not be difficult once the retail price was set. Fred knew that independent retail operations expected a 50 percent markup. His objective was to determine a retail selling price on the web site that could be discounted 40 to 50 percent to his retail store clients so their prices would be in line with his. The difficulty was making sure these prices would cover the four requirements of the total pricing concept: cost of product, cost of operations, a reasonable profit, and a return of earnings for business expansion and/or debt reduction. Fred tried a few approaches.

1. First he calculated his fixed costs. Four trade shows per year, including travel and accommodations, would cost $10,000. Road travel to visit retail stores would cost $6,000 for 20,000 miles per year and 16 nights on the road, plus $4,000 for lease payments on a van. Total fixed costs would be at least $20,000 per year.
2. Variable costs were more difficult to estimate. Fred had not yet decided how much to order or how much to spend on advertising, wages for office and trade show assistants, and office supplies.

Fred knew there would be some guesswork involved and that it was possible prices would have to be revised after final financial projections and plans were in place. His best course of action was to be aggressive initially and, if the prices were too high, back off later.

Using a ship-in-a-bottle model that Johann offered for $100 on his web site, Fred added $22 as the savings in shipping and a $3 premium for ease of acquisition to arrive at a retail price of $125. Could he sell it wholesale for $65 to $70 to retailers, who could then sell it for $130 to $150? Johann was willing to sell to Fred at 40 percent of his retail prices, assuming at least $3,000 per order. The $100 model would cost Fred $40 plus shipping costs and customs fee. The shipping cost would average $4 per unit. So the cost of goods was $44 on Johann's $100 model. His final calculation showed:

Web site retail price: $125 – $44 = $81 64.8% contributing margin

Wholesale price: $70 – $44 = $26 37% contributing margin

Assuming a 50 percent ratio of retail to wholesale sales, Fred added the $81 margin to the $26 margin and divided by 2 to estimate an average contributing margin of $53.50 on each unit. This gave an average markup of 50.9 percent, since (64.8% + 37%) ÷ 2 = 50.9%.

Would these margins hold up after factoring in the cost of operations? Fred thought they would. Using the breakeven formula, he estimated that with fixed costs of $20,000 per year and an average contributing margin of $53.50, he would be all right

continued

as long as he sold at least 374 units per year, well under his expectations. Fred decided the 50.9 percent average unit markup would be his initial objective.

Think Critically

1. How would you classify Fred's initial pricing strategy? As a new entrepreneur, what other pricing strategies should he consider?
2. Is it possible that Fred is setting his wholesale margin (37 percent) too low, considering that it represents 50 percent of his total projected sales volume?

Summary

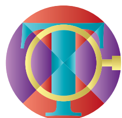
If products or services are not properly priced, customers will not buy. The entrepreneur's goal is to set prices low enough to ensure a demand for the product and high enough to ensure a sufficient profit to successfully operate the business. Consumers will buy what they perceive will bring them the greatest need satisfaction for their money.

Successful entrepreneurs follow the total pricing concept by pricing their products to ensure good customer relations and long-term profits. To accomplish these objectives, they must find the breakeven point for a product, service, or business operation. They then apply markup formula calculations and determine the best pricing strategies for the business.

Numerous external and internal environmental factors must be taken into account when determining prices. Shifts in economic cycles, lifestyles, and marketplace competition are a few considerations analyzed by successful entrepreneurs. Pricing should be considered a marketing tool with many legal and financial considerations.

A Case in POINT

A Shortsighted Pricing Decision



Charlie's Tobacco Patch Store used a discount pricing strategy on cigarette cartons to entice customers into the store. Charlie felt that once they were inside, they would buy enough related smoking items to offset the lost profit margin on the cigarettes. The strategy was working to his advantage until a national chain drugstore in the same mall undercut Charlie's prices by 10 percent. Charlie countered with a similar discount. A few weeks later the drugstore cut prices again, and Charlie followed suit. At this point Charlie was selling his cigarette cartons for less than he actually paid for them—a true loss leader. However, his customer count continued to rise, and his sales revenue was growing as well.

But now Charlie has received a rent bill that includes a percentage rent charge, and he realizes the mistake he has made by competing with a discounter on price. His loss leader cigarette sales have risen to 60 percent of his total revenue. Therefore 60 percent of sales are not even covering the cost of goods. To make matters worse, he is now paying additional rent as a result of his increasing sales volume. For every dollar of revenue he receives from the sale of cigarette cartons, Charlie is paying 6 cents in rent plus the cost of the product itself.

Charlie had better do something fast, or he could be out of business.

Think Critically

1. Can you help Charlie with some suggestions on how to raise prices on his cigarettes?
2. Should Charlie visit the landlord and request that the percentage rent clause be eliminated because he has to compete with a tenant in the same mall?

0538439211_10 1/18/05 7:10 PM Page 226

Chapter Review

Vocabulary Builder

1. breakeven point
2. contributing margin
3. external factors
4. fixed costs
5. FOB
6. internal factors
7. list price
8. loss leader pricing
9. markdown
10. market penetration pricing
11. markup
12. net price
13. price bundling
14. price lining
15. price points
16. skimming
17. status quo pricing
18. supply and demand
19. tie-in sales
20. total pricing concept
21. total quality management
22. variable costs
23. zone price

Review the Concepts

24. Describe the role of price in the marketing mix.
25. What objectives are addressed by the total pricing concept?
26. Explain the relationship between supply and demand.
27. What is the difference between fixed and variable costs?
28. How is the breakeven point calculated?
29. Distinguish markups from markdowns.
30. If the cost of an item is $50 and it is sold for $100, what is the markup percent? If an item retails for $50 and has a 40 percent markup, what was its cost to the seller?
31. List and describe the six pricing strategies.
32. Name three external factors and three internal factors that can affect the pricing decisions of a business owner.

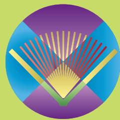
0538439211_10 1/18/05 7:10 PM Page 227

Critical Thinking

33. In a free market economy, how do supply and demand correct prices and protect against monopolies?
34. If the fixed costs of a business operation are $50,000 and the average contributing margin of its products is $11, how many units must be produced to reach the breakeven point?
35. What are the factors that must be considered in arriving at the variable cost of a product?
36. What pricing strategy would you suggest for a new technology product? A brand-name set of tires? A new addition to a restaurant's menu? A grand opening for a new wholesale business?
37. What products have you purchased recently that were loss leaders?
38. What dangers and risks does discounting present to the small business?
39. Why is it necessary for an entrepreneur to scan the environment for external factors if they do not have a direct, immediate impact on the business?

Project

Build Your Business Plan



At this point in the business planning process, it is time to set the initial prices of the products or services you will be selling. Apply the breakeven analysis and total pricing concept to this process.

1. Defend your reasons for the prices you have set.
2. Describe or show your products to classmates and friends and ask their opinions as to their perceived value.
3. Choose a pricing strategy. Do you plan to change this strategy once it has been established?
4. Which of your competitors do you consider price leaders?