Wentworths & Associates
Accountants & Business Advisors

Pricing strategies

The purpose of this guide is to highlight some of the more important considerations for small and medium-sized businesses planning to develop or revise their pricing strategies.

Introduction

A business might set or adjust prices when they start up, when introducing a new product or service, to achieve a new business objective, or in response to changes in the marketplace or the general economic climate.

Whatever the occasion, setting prices for your products or services is possibly one of the most important business decisions you make. It does have a considerable impact on your profitability and thus can be a decisive factor in the financial success or failure of your business.

Setting objectives

Determining a pricing strategy should not be carried out in isolation but in relation to your evolving business strategy. You need to be clear about what your pricing objectives are, how they relate to your general business objectives, and how they tie in with your marketing and sales plans. Common pricing objectives include:

- Maximising short or long term profit
- Increasing sales volume or sales revenue
- Increasing market share
- Achieving a specific rate of return on sales or investment
- Maintaining or improving growth
- Achieving or maintaining price leadership
- Matching competitors' prices or gaining a competitive advantage
- Enhancing the image of the business, product, or service
- Preparing the business for disposal
- Survival in a challenging market place.

Once you are clear about your pricing objectives the next step is to decide on the best strategy to achieve them.

Pricing strategies

There are many different approaches to pricing but the two most common are:

1. Cost-plus pricing
2. Value-based pricing

Cost-plus pricing

With this approach you set a price that covers the variable cost of producing the product or providing the service and an appropriate portion of your fixed costs plus an amount added towards profit, which is usually expressed as a percentage of cost.

It is important to be aware of the effect any price change will have on variable costs and factor this into your calculations. Care must also be taken not to overlook hidden costs and inadvertently overestimate potential profit per sale.

One drawback with cost-plus pricing is that it does not take adequate account of demand and it can often be difficult to assess how changes in price might affect demand.

This approach also disregards potentially important factors such as business or brand reputation, market positioning, and the value of the product or service to the customer or client. Indeed, setting prices based just on costs can result in selling a product or service at less than the customer or client is willing to pay, thereby failing to maximise potential revenue.

Pricing strategies

Value-based pricing

With value-based pricing you focus principally on assessing what the product or service is worth to the customer or client and set the price accordingly. The aim is to avoid charging too little and so missing out on potential revenue while not setting the price higher than the customer or client is willing to pay. The key is to identify the benefits you offer the customer and ensure they understand and appreciate them.

In a competitive environment it is especially important to differentiate your product or service by demonstrating unique features and benefits wherever possible. The more you can enhance the exclusivity of your product or service or demonstrate genuine added value that your competitors do not offer, the more you will stand out in the marketplace and the easier it will be for you to command higher prices.

The main drawback with value-based pricing is the need to have the right information and the difficulty this can present to smaller businesses. At its most basic, information on what people are willing to pay can be gleaned from customer surveys, monitoring competitors' pricing strategies, or simply through trial and error. More sophisticated options include data mining technologies and professional market research. For businesses that operate online there is generally a wider and more flexible range of options for capturing and evaluating data.

Other approaches

There are many other approaches to setting prices that might be adopted depending upon circumstances. Some of the more common are:

- **Skimming or creaming** - setting an initially high price then gradually lowering it to 'skim' profits from the market layer by layer
- **Penetration pricing** - setting a low price to increase sales or market share
- **Competition-based pricing** - setting prices primarily in relation to those set by your competitors
- **Loss leader** - selling one product or service at a low price (at cost or even below cost) to stimulate sales in other areas
- **Discriminatory pricing** - setting different prices for different segments of the market
- **Premium pricing** - setting an intentionally high price to reflect or encourage the perception of the exclusiveness of the product or service
- **Psychological pricing** - adjusting prices to make them psychologically more attractive, e.g. £4.99 instead of £5.00
- **Bundle pricing** - selling products or services in bundles at a reduced price
- **Option pricing** - selling a core product or service at a relatively low price and offering a range of optional extras to increase sales revenue
- **Marginal cost pricing** - setting the price close to or at the marginal cost of producing a product during a time of weak sales, or to sell off excess stock

Different pricing strategies can be adopted at different times depending on circumstances.

Price elasticity of demand

One of the most important factors to be considered when setting prices is price elasticity of demand (PED). Basically, PED is a measurement of how the quantity of a product or service demanded responds to a change in price. It is calculated by dividing the percentage change in the quantity demanded by the percentage change in price. If the resultant value is greater than or equal to one the demand curve is said to be elastic. If it is less than one it is said to be inelastic.

Among the factors that affect PED are:

- The availability of a suitable substitute
- Whether or not the product or service is regarded as a necessity
- The percentage of income or budget the price represents
- The strength of brand loyalty
- The duration of the price change
- Whether or not the purchaser is paying personally.

The effect of a price change on revenue

To calculate the effect of a change in price on total revenue you can use the following formula:

percentage change in total revenue = percentage change in quantity demanded + percentage change in price

For example, if the PED of a product or service is relatively inelastic (the percentage change in the quantity demanded is less than the percentage change in price), a price increase will result in an increase in total revenue and a price decrease will result in a decrease in total revenue.

On the other hand, if the PED is relatively elastic (the percentage change in the quantity demanded is greater than the percentage change in price), a price increase will result in a decrease in total revenue and a price decrease will result in an increase in total revenue.

There are many other factors that need to be taken into consideration when setting prices, such as the product or service life cycle, your marketing mix, and competitor activity. If you would like to find out more, please contact us to arrange a meeting.

How we can help

As can be seen, developing a pricing strategy is a complex process with a great deal riding on it as far as the success of your business is concerned. But help is at hand. We are ideally positioned to help you with much of the background work including:

- Planning - assisting with your general business plan, marketing plan, and sales plan
- Cost analysis - analysing fixed and variable costs and the impact any change in price might have on costs
- Financial forecasting and budgeting - mapping the financial consequences of different courses of action and preparing appropriate budgets
- Profitability analysis - analysing various scenarios to determine their potential impact on your profitability.

These are just some of the ways we can help. If you would like meet with us to review your pricing strategies please do not hesitate to contact us.