Pricing Concepts

What is the price?

The price is what is given on an exchange to purchase a product or service. Price plays two roles in the evaluation of product alternatives: both a measure of sacrifice and an indication of information. To some degree, these two effects are opposites.

The sacrificial effect of price

The price is "what is renounced", which means that it is sacrificed to obtain a good or a service. In America, sacrifice is usually money, but it can also be other things. It can also be time lost while waiting to purchase the product or service. Waiting in long lines at the airport, first to register and then to go through security checkpoint procedures represents a cost. In fact, these delays are one more reason why people choose alternate modes of transport for relatively short trips.

The price could also include the "loss of dignity" for those who lose their jobs and must turn to charity for food and clothing.

The price information effect

Consumers do not always choose the lowest priced product in a category, such as footwear, cars or wines, even when those products are similar in other respects. An explanation of this, based on research, is that we infer quality information from price. That is, a higher quality is equal to a higher price. The effect of price information can also extend to the perception of others of a favorable price, because higher prices can convey the prominence and social status of the buyer.

Therefore, a Swatch watch and a Rolex can both indicate the time accurately, but convey different meanings. Therefore, a Buick Enclave and Lexus 450LX are both SUVs and can reach point A to point B. However, the two vehicles convey different meanings.

Courage is based on perceived satisfaction

Consumers show interest in obtaining a "reasonable price." This actually means a "reasonable perceived value" at the time of the transaction.

Example: a man bought an elegant European-designed toaster for about $45. The large entrance of the appliance allowed to toast a bagel or heat a pancake and, with a special accessory for $15, a grilled sandwich could be prepared. The author considered that a toaster with all these characteristics was sure to be worth the total price of $60. But after three months of using the appliance, the bread was burning on the crust and remaining raw in the center, so it lost its appeal. The disappointed buyer put the toaster in the attic. Why didn't they return it to the retailer? Because the store had closed and no other retailer carried that brand; in addition, there was no service center in the United States. Remember, the price paid is based on the satisfaction that customers expect to receive from a product and not necessarily on the satisfaction they actually get.

Price can relate to anything with a perceived value, not just money. When goods and services are exchanged, trade is called *barter*. For example, if you exchange an English book for a Chemistry book at the end of the school year, you have participated in a barter. The price you paid for the chemistry text was this book.

Pricing Objectives

To survive in today's highly competitive market, companies require pricing targets that are specific, achievable and measurable. The realistic pricing targets that have already been established require regular monitoring to determine the effectiveness of the company's strategy. For convenience, pricing objectives can be classified into three categories: profit-oriented, sales-oriented and status-quo.

1. Profit-oriented pricing objectives

Profit-oriented objectives include maximizing profits, which are satisfactory and the target return on investment.

Below is a brief analysis of each of these objectives.

- **Profit Maximizing:** this means setting prices, so that total income is as large as possible relative to total costs. However, maximizing profits does not always mean unreasonably high prices. Both price and profits depend on the type of competitive environment a company faces, i.e. whether it is in a monopoly position (being the sole seller) or in a much more competitive situation. Also, remember that a company cannot set a higher price than the perceived value of the product. Large numbers of companies do not have the accounting data they need to maximize profits. It is easy to say that a company must continue to produce and sell goods or services as long as its revenue exceeds the costs. But it is often difficult to establish an accounting system that can accurately determine the point of maximization of profits.

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Sometimes managers say that your company is trying to maximize profits, in other words, that you try to get as much money as possible. While this goal may seem impressive to shareholders, it is not good enough for planning.

The statement of "We want to make as much money as we can" is vague and lacks focus. Authorize management to do anything they want.

By trying to maximize profits, managers can try to expand revenue by increasing customer satisfaction or they can try to reduce costs by operating more effectively. Another possibility is to try to do both. Recent research has shown that striving to improve customer satisfaction leads to greater profitability (and customer satisfaction) than following a cost-cutting strategy or trying to do both. This means that companies should consider allocating more resources to customer service initiatives, loyalty programs and customer relationship management programs and allocate fewer resources to programs designed to improve efficiency and reduce costs. Of course, both types of programs are critical to the company's success.

- **Satisfactory Profits:** are a reasonable level of utilities. Rather than maximizing profits, many organizations strive for profits that are satisfactory to shareholders and management, in other words, a level of profit consistent with the level of risk an organization faces. In a risky industry, a satisfactory utility can be 35%. In a low-risk industry, it could be 7%.

To maximize profits, a small business owner may need to keep their store open seven days a week. However, the owner may not want to work so hard and could be satisfied with fewer utilities.

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- **Target return on investment:** the most common profit target is a target return on investment (ROI), sometimes called a return on total company assets. ROI measures overall management effectiveness in generating profits from available assets. The higher the company's ROI, the better it is. Many companies, such as DuPont, General Motors, Navistar, ExxonMobil and Union Carbide use a target ROI as their primary pricing target. In short, ROI is a percentage that puts a company's profits into perspective by showing profits relative to the investment.

The return on investment is calculated as follows:

Return on investment

Net after-tax income

Total assets

Suppose that in 2009 Johnson Controls had assets with a value of $4.5 million, a net profit of $550,000 and a target ROI of 10%. This was the actual ROI:

ROI

$550,000

$4,500,000

12.2 %

As you can see, Johnson Controls ROI exceeded its goal, indicating that the company prospered in 2010.

However, comparing 12.2% of ROI with the industry average provides a much more meaningful outlook. Any ROI must be assessed in terms of competitive environment, industry risks and economic conditions. In general, companies try to get a ROI in a range of 0 to 30%. For example, General Electric seeks a ROI of 25% while Alcoa, Rubbermaid and most major pharmaceutical companies strive for a ROI of 20%. However, in some industries such as grocery, a yield of less than 5% is common and acceptable.

A company with a target ROI can predetermine its desired level of profitability.

The marketing manager can use the standard, such as a 10% ROI, to determine whether a particular price and marketing mix are feasible. However, in addition to this, the manager must assess the risk of a given strategy, even if the yield is in the permissible range.

2. Sales-Oriented Pricing Objectives

Sales-oriented pricing objectives are based either on market share or on dollar or unit sales. The effective marketing manager should be familiar with these pricing objectives.

3. Status Quo Pricing Objectives

Status quo pricing seeks to maintain existing prices or to meet the competition's prices.

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This third category of pricing objectives has the major advantage of requiring little planning. It is essentially a passive policy.

Often firms competing in an industry with an established price leader simply meet the competition's prices. These industries typically have fewer price wars than those with direct price competition. In other cases, managers regularly shop competitors' stores to ensure that their prices are comparable. Target's middle managers may visit competing Wal-Mart stores to compare prices and then make adjustments.

REFERENCE:

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