LAP

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Pricing LAP 3 Performance Indicator: PI:002 **Student Guide**

Make Cents

Factors Affecting Selling Price

Objectives:

A Explain the importance of selling price.

B Discuss pricing objectives.

C Discuss factors affecting selling price.

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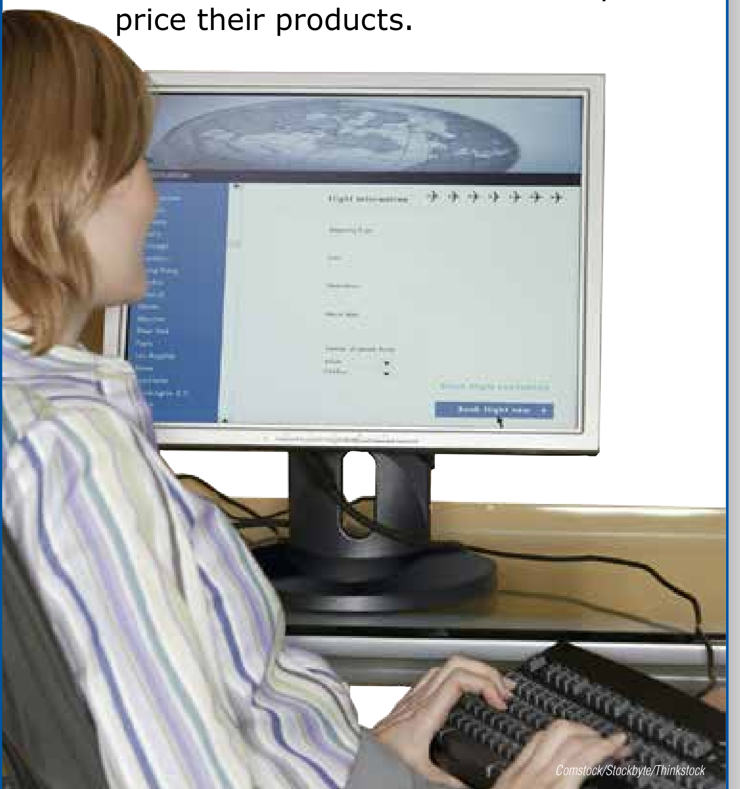
When you want to buy lunch at a local restaurant, purchase a computer, or book a plane ticket, what is one of the first questions you ask? If you're like most people, you ask "how much?" Before making a buying decision, we need to know the selling price of the good or service we're interested in purchasing. We may spend some time deciding whether or not we can pay the price and whether we want to do so. However, we probably don't spend much time thinking about how the selling price was determined. Let's examine selling price and what businesses consider when they price their products.



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The Power of Price

The amount a seller charges for a good or a service is the **selling price**. People often think of selling price as the dollar figure shown on a price tag. However, there are many other kinds of selling prices, such as:

- Membership dues
- Insurance premiums
- College tuition
- Bus fare
- Legal fees

Zedcor Wholly Owned/PhotoObjects.net/Thinkstock

When you think of how different these kinds of prices are, you can easily see that sellers can't pull prices out of thin air. Each business must go through its own process for pricing its product(s). And, as you've probably observed, the selling price of almost everything fluctuates.

Components of selling price

Some people think businesses keep all the money that customers pay for a product. This isn't true. From the selling price, the business must:

- **Pay all product costs.** Businesses incur costs when they make or buy products to sell. They must get back the money they have spent.
- **Pay all operating expenses.** All businesses must use part of their income to pay expenses such as rent, utilities, and payroll.
- **Obtain a profit.** A business must make a profit to invest in its future.

Importance of selling price

Selling price helps customers compare products when making buying decisions. Most customers feel that price indicates quality and use selling price as a guide to select the products they buy. This is especially important when the customer must choose from a variety of similar products. Selling price also helps customers allocate their money. Since very few people can buy everything they want, selling price helps them decide which items they can afford and which ones are beyond their means.

For businesses, selling price is important because it determines the amount of income from sales each business receives. The business's success or failure may be determined by the amount of income it earns. Businesses should include enough markup in their selling prices to pay current expenses and provide for future growth. **Markup** is the difference between the cost of a product and its selling price.

BananaStock/BananaStock/Thinkstock

▲ *Businesses determine how much markup is necessary to pay expenses and make a profit for future growth. Movie theaters, for example, are notorious for high markups on concessions such as popcorn and soft drinks.*

iStock/Thinkstock

How would you price a product? Play with this profit margin calculator to see a few different scenarios: [https://www.dinkytown.net/java/ProfitMargin.html.](https://www.dinkytown.net/java/ProfitMargin.html)

Summary

Selling price is the amount a seller charges for a good or a service. It must allow a business to pay all the costs of the product, pay operating expenses, and obtain a profit. Customers rely on selling price to compare products and to decide how to allocate their money. Businesses rely on selling price to determine income from sales and to achieve company goals.

TOTAL RECALL

1. What is selling price?
2. What are the three components of selling price (the three things it must do)?
3. Why is selling price important to customers?
4. Why is selling price important to sellers?

Price It Right

A firm’s pricing objectives should be compatible with its marketing objectives. In other words, the business must know where it wants to go before it chooses selling prices to get it there. Sometimes, a business must use a combination of pricing objectives to reach its goals. In all cases, the business should set its marketing objectives first, and then select pricing objectives to help it meet its marketing objectives.

Choosing pricing objectives isn’t a one-time job. As circumstances inside and outside the business change, or the business changes its goals, pricing objectives may also need to change.

Discount Image

Exclusive Image

Sales-oriented pricing

The purpose of **sales-oriented pricing objectives** is to increase the total amount of income from sales. There are two ways a business can do this. One way is to charge low prices in an effort to increase sales volume, increasing total income. The alternative is for the business to charge high prices in an effort to increase the dollar value of its sales. This means the business will have more total income even if it doesn’t sell more products because it will make more money on the products it does sell.

Some specific objectives a business might achieve by using sales-oriented pricing include:

Creating an image for the business. The selling prices a business chooses create its image. Prices might be used to give the business a discount (Walmart) or an exclusive (BMW) image.

Being more competitive. There are different ways selling price can be used as a competitive tool. One way is to match competitors' prices. This often happens in industries with similar products and customers who are familiar with the market price (e.g., Pepsi vs. Coke).

Some marketers choose to price above the competition. This works when customers see the product as more valuable than other similar products. An experienced attorney with a reputation for winning cases can charge higher fees than a recent law school graduate, for instance. To make the higher prices acceptable to customers, marketers may have to offer extra benefits, such as convenient locations or longer hours.

The third alternative is to price below the competition. To do this and still make a profit, the business has to keep tight control over its costs. This can be very hard to do. Companies that undercut competitors' prices also run the risk that customers will perceive their product(s) as being of lower value.

The Gray Zone

Jamie has four tickets to next weekend's concert. She is taking her friend, Isaac, and planning to sell the other two tickets. The concert is sold out, and lots of students at Jamie's school are dying to attend. Jamie paid $50 each for the tickets, but she thinks she can sell them for $100 each, or maybe even more. When one classmate offers her $75 for each ticket, she tells him that another classmate has promised $85 each. The price continues to climb.

Some people might think that Jamie is treating her peers unfairly by asking for more money than she originally paid for the tickets. Others would say that she is just getting market price—and if someone is willing to pay that much for the tickets, then it's a fair deal. What do you think? Are Jamie's actions ethical or unethical?

Obtaining, maintaining, or increasing market share. Many businesses consider the size of their market share as a measure of success. Marketers may use selling price to obtain a share of the market, to enlarge the share they already have, or to maintain that share. Some new companies set low prices to get as much of the market as possible right from the start. Established companies may also lower prices to enlarge their market share. Other companies just want to maintain the market share they have and keep their selling prices stable. All of these companies feel that they will benefit over time because the customers who are attracted by their prices will become regular customers.

Profit-oriented pricing

Profit-oriented pricing objectives focus on creating profits for the business. Some businesses choose prices that will result in the greatest possible amount of profit, while others just want to recover costs and earn a reasonable amount of profit. Since market conditions are always changing, it is difficult to predict just what prices will be the most profitable over time.

Some of the objectives a business might achieve through profit-oriented pricing include:

Surviving. A business that is in financial trouble may use pricing for profit simply to survive. It needs the profit from its selling prices to stay afloat until the situation improves.

Maximizing profits. The objective of some firms is to make the most possible immediate profit. This is called **profit maximization**. Most firms using this kind of pricing are more interested in their short-term profits than in increasing profits over time. Some businesses that try to make maximum profits are not in financial trouble, but want to improve their **cash flow**, or the amount of money coming in and out of the business. In other cases, the company may need to make maximum profits because of the nature of its products.

lucadp/iStock/Thinkstock

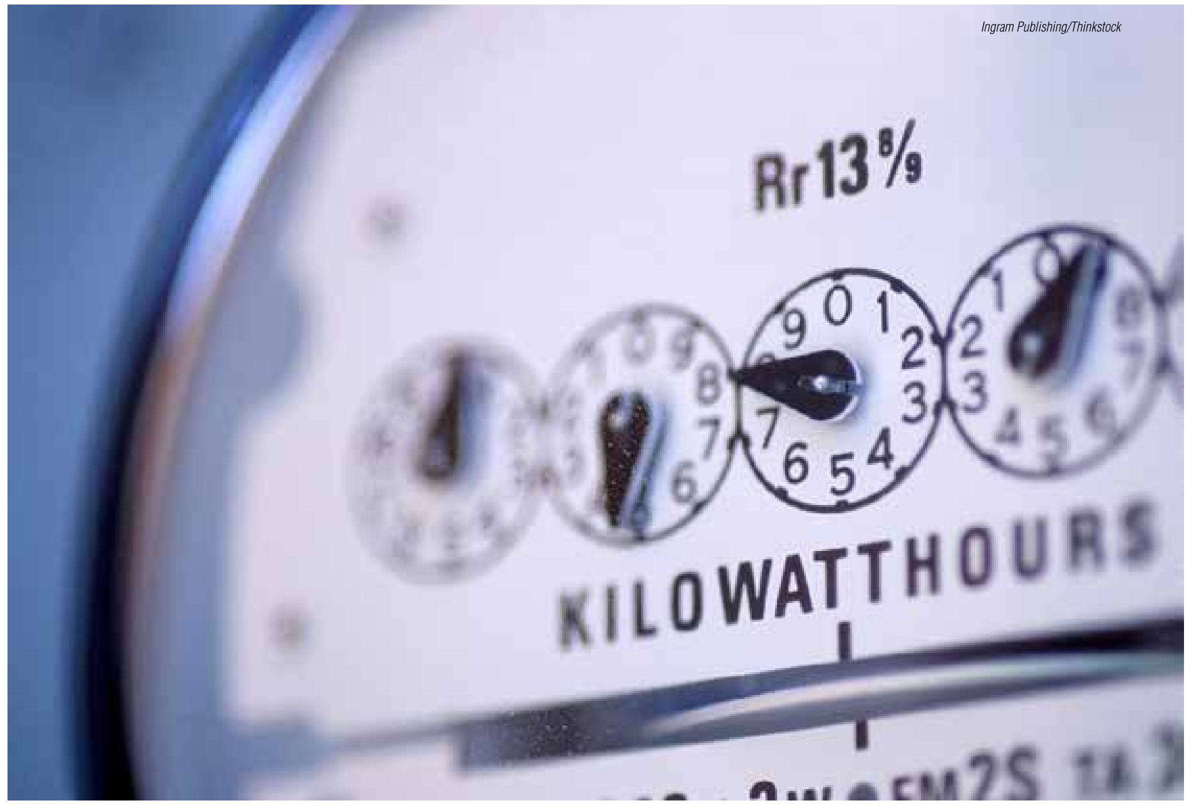
▲ *Producers and sellers of children's toys know they must make as much profit as possible on each new product before it loses its popularity.*

Earning a return on investment (ROI). An initial investment is necessary to start and operate a business, and all businesses need to earn income, or return, from that investment. Some companies base the amount of profit they want to earn on the amount of their capital investment. This profit goal is often expressed as a specific percentage. The business sets prices that it hopes will provide enough profit to give the firm that percentage of return. For example, a business with a $500,000 capital investment would need to make a profit of $100,000 on its sales to have a 20 percent return on investment.

Earning a return on sales. Some firms base their profit goals on their sales. This is called **target return** because the company uses a percentage of profit on its sales as the goal. Target return, or return on sales, is often used by companies that don't want to be accused of unfair trade practices or of earning too much profit.

iStock/Thinkstock

Sales-oriented and profit-oriented pricing are the two basic pricing objectives, but much more goes into selecting a pricing strategy. Check out this quick video by Victor Antonio that summarizes eight basic pricing strategies: [https://www.youtube.com/watch?v=qKft8EC4ejQ.](https://www.youtube.com/watch?v=qKft8EC4ejQ)



Ingram Publishing/Thinkstock

▲ *The government allows utility companies to earn enough profit to pay dividends to their stockholders and have some capital left to invest back into the business. Most utility companies try to set prices that will allow them to serve the public at the best rates and still earn an acceptable return on sales.*

Summary

Choosing pricing objectives is an important job. These objectives should be compatible with a firm's overall marketing objectives. Sales-oriented pricing objectives might help a business create an image; be more competitive; or obtain, maintain, or increase market share. Profit-oriented pricing objectives might help a business survive, maximize profits, earn a return on investment, or earn a return on sales.

TOTAL RECALL

1. What are sales-oriented pricing objectives?
2. What goals might a business achieve by using sales-oriented pricing objectives?
3. What are profit-oriented pricing objectives?
4. What goals might a business achieve by using profit-oriented pricing objectives?

Pick a Price

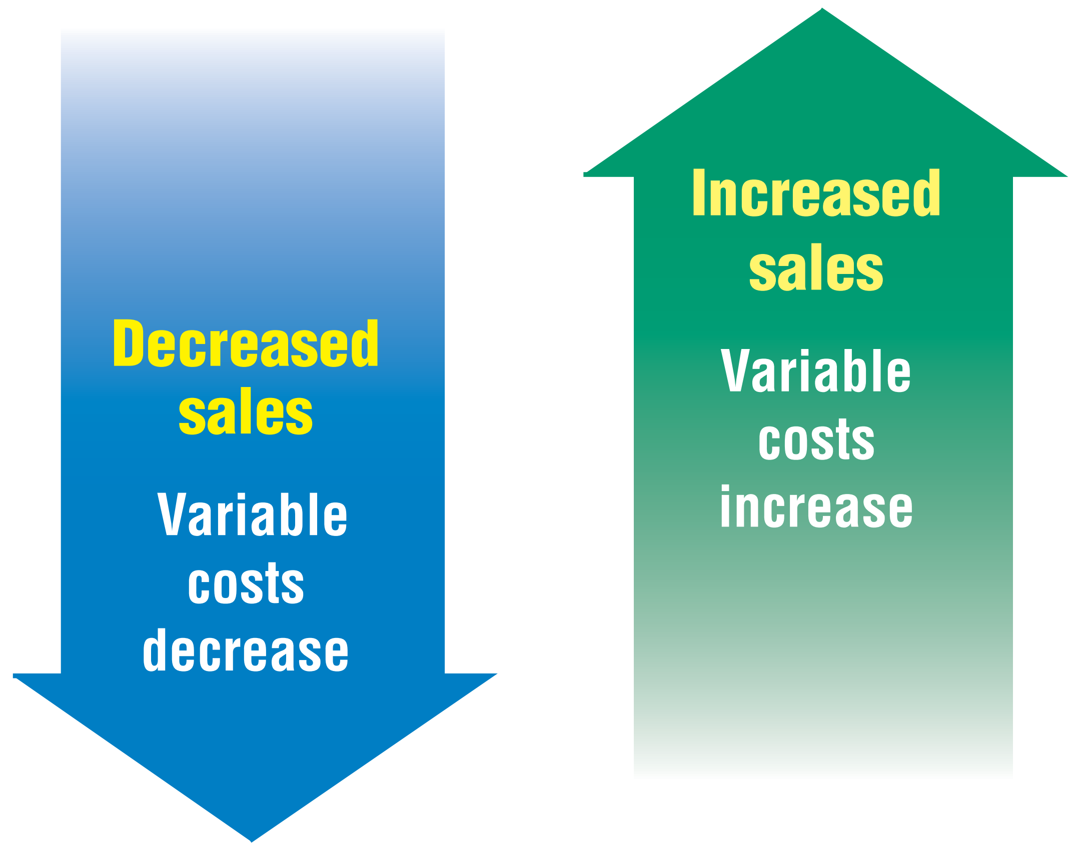
Factors affecting selling price vary from business to business. Common factors include:

Costs

Knowing the total costs of a product is very important in setting selling prices because the business needs to recover those costs. If it doesn't, the business will eventually go broke. **Total costs** are made up of fixed and variable costs.

Fixed costs. **Fixed costs** are not affected by changes in sales volume. They remain the same no matter how many products you sell. Fixed costs include such expenses as machinery, mortgage, and insurance.

Variable costs. **Variable costs** change according to changes in sales volume. When sales increase, variable costs increase, and when sales decrease, variable costs decrease. Variable costs include expenses like utilities, wages, and transportation.



Supply and demand

Marketers must have adequate information about the demand for their products when they are engaged in pricing. Some of this information can be obtained by monitoring current business and economic conditions, trying to predict how those conditions will change, and estimating the way those changes will affect the demand for their products.

Supply and demand are determined by what people want and can afford. When consumer demand for a product increases, producers make more of it, the supply increases, and the selling price goes down. If a company makes a new video game that becomes popular, demand increases, and the company makes more of it. As the supply increases, the number of buyers may decrease, and sellers will have to reduce the price to get it off the shelves. On the other hand, if the producer is not able to increase production, and the supply does not increase, the price may go up. Customers may be willing to pay the higher price to obtain the game. However, if the selling price goes too high, customers may stop buying, and demand will drop.

Economic conditions

The national economy is always changing. Ups and downs in economic activity are known as **business cycles**. Marketers monitor business cycles and try to predict whether business conditions will get better or worse. This helps them to adjust their pricing according to the changes in the economy.

In times of economic growth, both individuals and businesses increase spending, which increases demand. When demand is higher than producers can meet, prices go up. As economic growth slows, demand begins to fall because consumers cut back on spending. Businesses reduce their prices to survive until demand increases, and the cycles begin to repeat themselves.

Jack Hollingsworth/Photodisc/Thinkstock

◄ *Businesses lower prices to encourage spending during periods of economic decline.*

Competition

Most marketers watch their competition carefully, especially when it comes to pricing. They know that customers compare prices to get the best buys. Businesses must be ready to adjust their prices to remain competitive or to become more competitive.

The kind of market in which the business operates determines what kind of pricing will help the business be more competitive. Each one affects pricing in a different way:

Pure competition. In a **pure competitive market**, there are many buyers and sellers of nearly identical products, and marketers have little control over pricing. More competition exists in this kind of market than in any other. Most products are sold at **market price**—the actual price that prevails in a market at any particular moment. Market price is controlled by supply and demand. Sellers can't sell above the market price because buyers can obtain the product at the lower market price. Sellers can't lower the price to increase demand because buyers are already buying as much as they want of the product.

Popartic/iStock Editorial/Thinkstock

◄ *What would happen if Pepsi raised prices significantly? Most people would probably switch to Coke!*

What is pure competition? In one word—impossible. Watch this video by Investopedia.com and learn more about this hypothetical world at http://www.investopedia.com/video/play/perfect-competition-0/.

Monopolistic competition. In a **monopolistic competitive market**, there are many buyers and sellers, but there is a range of prices rather than one market price. Companies make their products different from each other in terms of quality, service, features, styles, and prices, so that competition is not based on price alone. Customers decide which product to buy based on its difference from other products. Both big firms and small businesses compete in this kind of market.

Oligopoly. In an **oligopolistic market**, there are relatively few sellers, and the industry leader usually determines prices. Prices are fairly stable because not too many new firms can afford to enter the market. If the industry leader raises or lowers prices, the other firms usually follow. Sellers watch each other's pricing because they know they will lose customers if the competition lowers prices. Competition is more likely to be based on style or brand than on price.

Monopoly. In a **pure monopoly**, there is only one seller or provider of a product, and no substitutes are readily available. Pure monopolies have been almost eliminated by the federal government because monopolies control the pricing of their products. This is unfair to customers who would have to pay whatever price was charged because they could not get the product elsewhere. The monopolies, such as utility companies, that exist today are either owned or controlled by the government.

◄ *Pure monopolies have complete control over what prices to charge. Because of this, they have been almost completely eliminated by the federal government.*

Smokhov/iStock/Thinkstock

Government regulation

There are both state and federal laws that affect pricing. The major purposes of government regulation of pricing are to promote competition and to prevent monopolies. Some of the pricing areas regulated by law are:

Price fixing. The government prohibits **price fixing**, agreeing on a price or price range for a product. Even though businesses might choose a fair price, the practice is forbidden because it limits competition.

Price discrimination. Businesses are not allowed to charge different prices to similar customers if doing so would damage competition. These laws were passed to protect small businesses in competition with larger businesses. Without these laws, a drug wholesaler might charge a large drugstore much lower prices than it would charge a smaller drugstore because the large drugstore buys in larger quantities. This would put the smaller store at a competitive disadvantage.

iStock/Thinkstock

Take a closer look at the ins and outs of price discrimination in this video by Investopedia.com: http://www.investopedia.com/video/play/price-discrimination/


Jupiterimages/Stockbyte/Thinkstock

▲ *Laws against price discrimination help to keep small businesses open.*

▲ *Car companies may promote low prices and interest rates, but may not actually offer those prices and rates to every customer.*

Price advertising. The chief purpose of price advertising laws is to prevent any kind of customer deception. Businesses may not advertise a product at a reduced price unless the product was sold for a reasonable length of time at a higher price. Businesses may not claim their prices are lower than competitors' prices unless they can prove these things are true. They may not use **bait-and-switch advertising**—promoting a low-priced item to attract customers to whom they then try to sell a higher priced item.

Unit pricing. Some states have laws requiring businesses to use **unit pricing**. Unit pricing shows the price per unit (ounce, pound, etc.) along with the total price of the item. Unit pricing is an added expense for the business because of the time required to calculate unit prices, to print labels, and to post prices. However, unit pricing makes it much easier for consumers to compare the value of products.

Channel members

Each member of the distribution channel, from producer to retailer, affects pricing because they are all trying to make a profit. Certain channel members expect producers to provide them with support such as sales and service training, sales promotions, or cooperative advertising. Producers must consider the cost of the support they are expected to provide when they price their products. If they price the products too low to provide adequate support, channel members may buy from another producer. If they add too much to their prices to cover support activities, the price may be too high to encourage sales.

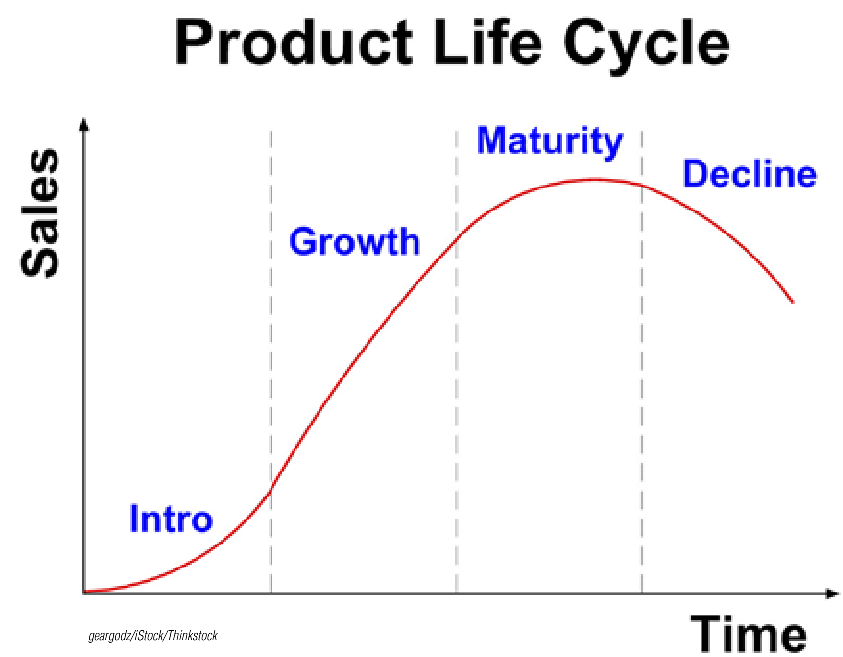
When manufacturers and producers raise their prices, these increases are usually passed through the channel to customers. In some cases, channel members absorb part of the increase rather than pass all of it on to customers because they fear the higher price will reduce their sales.

Company objectives and strategies

No two companies have the same set of objectives and strategies, but there are several common factors that affect pricing, including:

Product mix. The number of products that a company chooses to sell is an important factor. A company with a large product mix does not have to rely on any one unit for its income. Such a company can even price its products to be competitive with each other. However, in a company with a small product mix, the price of each product has more effect on the firm's total income.

Product life cycle. In the **introductory stage**, products are usually priced higher to enable the business to recover its investment in the new product. During the **growth stage**, prices are usually reduced to promote sales and to compete with copycat products that have entered the market. At this point, production costs have been recovered and the producer can afford to reduce prices. During the **maturity stage**, the effort is on stabilizing prices to maintain a share of the market. As the product enters the **decline stage**, sellers reduce prices to get rid of it.



geargodz/iStock/Thinkstock

Target market. Customers in different markets view prices differently. Most marketers feel it is a good strategy to price according to the way their customers view the product. Customers judge the perceived value vs. the price to determine whether or not to buy the product. However, even within the same market, not all customers see price from the same point of view. Some customers see low price as an indicator of low quality, while others see low price as a bargain. Or, some customers see high price as an indicator of high quality, while others see it as a poor value for the price. Marketers need to determine what price range will be accepted in their markets.

Summary

Factors affecting selling price vary from business to business, but the basics are costs, supply and demand, economic conditions, competition, government regulation, channel members, and company objectives and strategies.

TOTAL RECALL

1. How do costs affect selling price?
2. How does supply and demand affect selling price?
3. How do economic conditions affect selling price?
4. How does competition affect selling price?
5. How does government regulation affect selling price?
6. How do channel members affect selling price?
7. How do company objectives and strategies affect selling price?

Make It Pay!

Think of a purchase you've made within the past week. How much did you pay? How do you think the selling price was influenced by costs? By supply and demand? By economic conditions? By competition? By government regulation? Do you think you paid a fair price for the product? Why or why not?

