Think Ahead ACCA

Guide from
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Pricing your product or service

Your prices can have a dramatic effect on sales and profits. The right prices need to be low enough to be competitive while still being high enough to protect your profit margins.

While your costs will be a factor, it's more important to focus on the value of what you offer and how it compares to the competition.

1. The market

Assess the competition

- Find out how much your competitors charge. Try phoning and asking for a quote or checking prices online.
- Find out whether your competitors offer price-sweeteners (eg 'buy now, pay later' deals). If so, consider whether you can compete.
- Try to understand their strategy: for example, see if they offer seasonal discounts or whether their prices are deliberately kept low to attract sales on other products.

Find out which products (or services) are seen by customers to offer the best value

- Which products are the most successful? Do different market segments buy different products?
- What are the key criteria customers base their decisions on? Which criteria justify higher prices for different products? How do prices vary?
- To what extent are customers attracted by low prices? Or do they value higher-priced, higher-quality products?
- To what extent is customers' perception of value affected by total lifetime costs as well as initial purchase costs? Providing lifetime value for money will be more important if you hope to get repeat business.

Compare your own product offering

- Break down what you offer into all its components: for example, the core product, extras, customisable features and additional services.
- Assess the benefits that customers see each component as offering, and how much these benefits are worth to them.
- Be alert to differences between different market segments. Different customer perceptions of value may mean that you should offer different packages to different market segments, or use special pricing tactics.
- Keep a comprehensive record of customer feedback and remain objective when analysing it. Don't take negative comments personally – derive value from them.
- Consider carrying out field research with a representative sample of potential customers. Have a sample of your product to show (or a well-considered explanation of your service and its benefits).

Use competitors' prices as a benchmark

- If you set your price too high above theirs you risk gifting them an important competitive advantage.
- Set your price too far below theirs and you will be throwing away profit, while consumers might wrongly consider your product to be inferior.

Consider whether you can justify a higher price

- Sales strategy, economies of scale or access to cheaper supplies might be responsible for a competitor's lower price.
- You will be able to justify a higher price tag if your product offers better quality or additional benefits.
- If their product is similar to yours and you cannot match their price, consider your product's commercial viability.
- You could trim your costs to undercut them. However, cutting your margin to win custom can be dangerous.

2. Pricing strategy

Take account of the constraints on your business

For example:

- investor requirements (eg high short-term returns or long-term growth) and other external influences
- your financial resources and your production capacity
- your costs.

The most appropriate strategy will depend on how you want to position the product

- In many markets, a high price contributes to the perception of a product as being of premium value.
- You may want to establish consistent pricing across your product range, or to position individual products ‘up’ or ‘down’ market.
- Different strategies may be appropriate at different stages in the product’s life cycle.

You can charge higher prices if high barriers to entry prevent new competition

- For example, if you have a patent, special skills or strong customer loyalty.

- Customers will be more loyal if purchasing an unsatisfactory alternative carries significant risk to them.

You may want to limit your prices

- If barriers to entry are low, low prices avoid encouraging new entrants.
- You may need low prices to introduce a new product to a new market, or if you face intense competition.
- You may want to use low prices as a tactic – for example, when demand is seasonally low or to offer bulk or trade discounts.
- You should always aim to keep your prices high enough above your costs to at least break even.

You may want to charge different prices for different customers

- Customers who purchase repeatedly, or buy add-on or related products, are the most valuable.
- Customers who are expensive to satisfy (eg demanding special features or services) will be less profitable, unless you can charge them higher prices.
- One-off sales generally carry far higher costs than repeat business.

3. Your costs

Work out your cost structure

- Variable or direct costs are linked to volume – the more you manufacture, the higher the cost. These include raw materials, electricity, packaging and distribution charges.
- Fixed or overhead costs remain constant regardless of volume. Fixed costs typically include premises costs, administrative overheads and salaries (though wages will increase if you have to pay overtime for rush orders).
- Make sure you take into account all your costs – for example, research and development costs for new products.

Analysing your costs tells you what prices are viable

- If you charge less than your direct variable costs, you will make a loss.
- If you charge more than your direct costs, each sale will make a contribution towards covering your fixed costs and ultimately making a profit.
- The contribution each sale makes towards covering your fixed costs tells you what volume you need to sell to reach breakeven.

Your cost structure may influence your strategy

- If you have high costs relative to your competitors, you will need to position your product with a premium price.
- The higher the proportion of fixed costs, the more important it will be to generate high sales volumes.
- Some costs are unrecoverable if sales are not made soon enough. For example, if products are perishable or become obsolete.

Basing your prices on your costs has major disadvantages

- Cost-plus pricing is common but does not take into account the level of demand and competition.
- Cost-plus pricing ignores brand image and market position. When you want to create the perception of a high-quality brand, the price needs to reflect this.
- The price you need to charge depends on the volume you sell, which in turn will depend on the price you charge.
- If you fail to include all your costs in your analysis, you will end up undercharging. It is easy to overlook hidden costs such as wastage, holiday pay and depreciation.

Analysing costs and margins can be a useful benchmarking exercise

- In the absence of other reasons, margins below industry norms suggest your costs are too high or your prices too low.
- Industry margins provide a rough guide to the prices that may be achievable when considering new products.
- Differences in costs can be a useful way of creating consistent pricing across a range of products or markets.
- Low-margin, low-volume products should not occupy large chunks of your time or storage space at the expense of higher-margin products.
- Analysing the additional costs can help to prevent you from undercharging for special orders or demanding customers.

4. Boosting profits

Look for ways to provide something customers are willing to pay for

For example:

- Convenience. A late-night convenience store can charge much more than a supermarket for a pint of milk.
- Brand. There may be little to choose in technical terms between a branded and an unbranded product, but big spenders will go straight for the expensive product if the brand is well marketed.
- Fashion. Some people will pay a premium for hot items (eg the latest trainers or cars).
- Uniqueness. If you are the exclusive supplier of a product or service, you can set your own prices.
- Scarcity. Tickets for top-level sports events can be highly priced as there will be more committed potential customers than available seats. Higher prices can give you fat profits, but may also alienate customers and draw in new competitors.

Look at other ways to increase profits

- Would more marketing muscle help? Would sales rise if you increased prices by 5% and spent the extra revenue on promotional activity and improved customer care?
- Can you reduce variable costs? Are there cheaper supplies elsewhere or would existing suppliers be prepared to drop their prices?
- Can fixed costs be pared down? What could you negotiate?
- Should you alter your product mix? If you cannot make enough profit on a product, consider dropping it.

5. Tactics

Varying your prices with differential pricing can increase your profitability

For example:

- charging lower prices for high-profile products to capture customers who will also buy higher margin products
- charging different prices at different times of the day, week or year to reflect changing demand or the changing value to customers of your product
- charging different prices for different levels of service or product specification.

Discounting can be worthwhile, but only if it achieves your aims

- If you offer discounts make it clear that they are one-offs or short term. Discounting too often can lead customers to question your usual prices.
- A cash payment discount can encourage early payment, though some customers may claim the discount but delay payment anyway.
- Bulk discounts can encourage larger orders. The costs of dealing with large orders may be not much higher than for much smaller, less profitable orders.
- Clearance discounts can help you to sell off old stock and release working capital.
- Retrospective discounts or rebates may encourage customers to concentrate their purchases with you.
- Introductory discounts may encourage customers to try a new product. However, they may create the wrong image or generate sales that are not repeated when the discount is removed. They can also cause resentment among current customers.

Special tactics may work in particular situations

For example:

- Bundling additional products together and charging a package price. This works well if the perceived increase in value is greater than the additional costs.

- Charging a psychologically attractive price. For example, £7.99 can be perceived as being more than a penny less than £8. Make sure that you have a plan to increase from this price point or you may be stuck with it forever.

6. Checking your prices

Review your prices regularly to ensure that they are optimal.

Keep up to date with the market

- What is the competition doing?
- How are customers' perceptions of the value of your product and competing products changing?
- What effect is any change in your costs having on your margins?

Changes in turnover may indicate a pricing problem or opportunity

- Products with high or growing market share may present an opportunity to increase prices.
- If you pitch or tender for business, too high a success rate suggests that you are underpricing.
- If both margins and market share are low, you need to change something – or discontinue the product.

Limited trials of price changes can provide valuable information at reduced risk

For example:

- changing the price for a sub-sector of your market
- introducing a new product at the new price while continuing to offer the old product.

Analyse the effectiveness of any pricing tactics you use

- Are you achieving your aims – for example, increasing sales to target market segments?
- Are there signs of unwanted side-effects?
- What is the overall effect on profits?

7. Aim high

Underpricing your product can be even more dangerous than overcharging.

It is far easier to reduce prices than to increase them

If in doubt, try higher prices first.

- Be prepared to lower prices if the required sales volume is not achieved and your cashflow is under pressure.
- Customers may not respond to low prices.
- A low price may create an image of a low-quality product and service.
- Your target market may not be particularly price sensitive.

Low prices may attract unprofitable customers

- While prices are low, so are margins.
- Price-sensitive customers tend to be disloyal when prices increase.
- Cheap products may cannibalise sales of more expensive ones.

Competing on price is often a mistake

- Low pricing is more often a strategy of big companies that cannot compete on service. Smaller companies can offer a string of benefits such as convenience, speedy delivery and specialist skills.
- Many small firms underprice in order to build up sales. Aim to build up profits instead; the buying decision is rarely made purely on price.

8. Increasing prices

Consider the likely impact on profits before making any price change

- What will the effect on sales volumes be? What will the effect on margins be? Increasing prices (and hence margins) can sharply increase your profits, even if your turnover drops.
- Sudden or excessive increases can have a disastrous effect on sales. If necessary, conduct market research to gauge reaction to your proposed price increase.

Explain to your customers why you are increasing prices

- Give customers advance warning if they need to budget for the price increase.
- Use the price change as an opportunity to re-emphasise the benefits you offer. Attribute part of your price to the cost of providing high-quality service.
- Work with them to explore all the options if they cannot meet the increased price.

You can try to hide price increases

- You can introduce new, improved products and make old products obsolete. The increase in price should more than cover any increase in product costs.
- You can lower the specification (and your costs) while maintaining the same price.
- Hiding price increases runs the risk of adverse reactions when customers realise what you are doing.

Think about timing

- It is easiest to increase prices when demand is high.
- Unreasonably price increases can destroy goodwill, especially if the customer has no immediate alternative supplier.

This should not be used as a definitive guide, since individual circumstances may vary. Specific advice should be obtained, where necessary.