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The price is right? Guidelines for pricing to enhance profitability

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Abstract Pricing is a key element of the marketing strategy. It does not require significant investments or resources, and is perhaps the most accessible lever to manage profitability. Even minor fluctuations in pricing can have a significant impact on both revenues and profitability. As such, lack of careful planning in pricing is a wasted opportunity. With this as a backdrop, we make a case for precision in pricing to enhance profitability. Since consumers vary in their preferences, motivations, and propensity to spend, they assign varying degrees of emphasis regarding price upon their purchase decisions. We argue that pricing is a creative exercise in math and behavioral economics, and companies should stay focused on profits. We also provide a series of guidelines for creating effective base prices, and then modifying them to enhance profitability. Finally, monitoring prices at the transaction level will reduce leakage in profits and further add to the bottom line.
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If you've got the power to raise prices without losing your business to a competitor, you've got a very good business. If you have a prayer session before raising the price by 10 percent, you've got a terrible business. ~Warren Buffet, Berkshire Hathaway CEO, on the importance of pricing power (Bloomberg Businessweek, February 28 — March 5, 2011, p. 22)

1. The power of pricing

The power of pricing cannot be overstated. Next, we explore the issue of pricing and discuss the many ways in which pricing impacts business.

1.1. Pricing has a significant impact

Of all the tools available to marketing managers, pricing has the most immediate impact on both the top and bottom lines. The advantages offered by pricing are extremely powerful. When pursued carefully, businesses can make significant gains via pricing, and the impacts are easily seen. According to a McKinsey & Company study based on Global 1200

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Table 1. The high impact of pricing

	Impact on Profitability for 1% Change	% Change Needed to Double Profits
Increase in Price	11.0%	9.1%
Increase in Unit Sales	3.7%	27.1%
Decrease in Variable Costs	7.2%	13.7%
Decrease in Fixed Costs	2.7%	37.1%

companies, average operating profit accounts for 9.1%, with 66.4% accounted by variable costs and 24.5% accounted by fixed costs. Therefore, on average, a 1% increase in price would lead to an 11% increase in operating profit; a 1% increase in sales volume would increase profits by 3.7%; a 1% decrease in variable cost would increase the operating profit by 7.2%; and for a 1% drop in fixed cost, profits would increase by 2.7% (Baker, Marn, & Zawada, 2010).

Looking at it another way, to double the profits, price just needs to be increased by about 9%; so a 10% increase in price can more than double the profits. In short, modifying price has the highest leverage (see Table 1). Arguably, it's also the most accessible lever to pull. Companies work consistently to cut costs, but since price is relatively difficult to assess, approximations come into play. Fine tuning (i.e., increasing) the price—even by 1%—can have a significant and immediate impact on profitability.

This is, of course, based on the assumption that an increase in price will not lower the sales volume. While a drop in sales is certainly possible, it's worthwhile to note that a 1% increase in price rarely reduces sales by 2%—still resulting in a net increase in operating profit of 3.08%, even at a 2% loss in sales volume. Of course, the reverse is true, too. As a result, for most products, minor fluctuations in price can have a significant impact on profitability. This need for precision makes pricing a fascinating and critical decision.

And, what resources does it entail? Pricing does not require any significant investments; neither new products need be introduced, nor large financial commitments made (as opposed to advertising, for example). In fact, managers must approach pricing as a creative exercise in math and behavioral psychology. If done correctly, profitability can be greatly enhanced via pricing.

1.2. It's all about the relative price

One of our colleagues is a loyal purchaser of Colgate Total Whitening toothpaste. He has been buying it for years, in the 5.8 ounce tube size, and mainly from the same retailer: Target. When we asked him what it costs, he didn't know the exact price; he guessed $3.49. We then checked at Target and found out that 5.8 ounce tubes of Colgate Total Whitening retail for $3.00. The difference between the actual and estimated costs may not seem all that significant, but our colleague was 'off' by more than 15%—for a product he buys on a regular basis! Given this example, it can easily be argued that the inaccuracy in price recall is likely even higher for products that are not bought regularly. If we were to put this in the context of the impact of 1% change in price, it's easy to see the significance of pricing.

However, assuming that consumers do not know prices, and therefore that product prices can be increased without being noticed, would be very simplistic on the part of manufacturers. Even though consumers don't always remember an exact price, they may very well know that—for example—Colgate Total Whitening is somewhat mid-to-high priced, and it's comparable to other leading brands such as Crest and Aquafresh. Also, they may not know the exact product size/weight, but rather that it comes in small, medium, or large. That's how consumers judge the fairness of the offer: in comparison to other brands. So, in essence, it's the relative price that matters, not the absolute price.

Let's examine the evidence for this assertion. Monroe and Lee (1999) make a case that if consumers cannot memorize the price, it does not imply they don't know the price. Prior studies had shown that only a small proportion of buyers could accurately recall prices of products they had purchased, leading to the assumption that price considerations may not be important in purchase decisions (Inman & Wakefield, 1993). But that can be misleading. Price recall, measured as a percentage of the correct price, generally has errors ranging from 6% to 20%. Conover (1986) explained this by demonstrating that buyers may not even attempt to memorize exact prices, and instead compare prices with other brands. They may, in fact, rank the brands on prices. High correlations between recalled and actual ranks of brand prices supported this proposition. In another study (Mazumdar & Monroe, 1990),

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