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The price is right? Guidelines for pricing to enhance profitability

Chiranjeev Kohli [a,*], **Rajneesh Suri** [b]

[a] *Mihaylo College of Business & Economics, California State University Fullerton, Fullerton, CA 92834, U.S.A.*
[b] *LeBow College of Business, Drexel University, Philadelphia, PA 19104, U.S.A.*

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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.

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

* Corresponding author.
E-mail addresses: ckohli@fullerton.edu (C. Kohli), surir@drexel.edu (R. Suri).

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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),

respondents were more accurate in rankings than in their recall scores.

If this logic is to be pursued—going back to our example of toothpaste—a marketer may be able to raise the price to $3.50 or more, as long as it stays in a reasonable range and does not exceed the price of the next brand up; more on that later, under the topic of zones of price indifference (Section 2.5.3.). Thus, the asymmetry between sellers' and buyers' knowledge of price, and their abilities to control price, can be exploited by sellers to their advantage.

1.3. Price may not have much to do with costs

If we were to just look at prices objectively, they often would not make sense. A state-of-the-art MP3 player—Apple Nano 6th generation—costs as little as $134.95, but a quick search of amazon.com shows that prices for a waterproof plastic case with simple ear buds for Nano range as high as $99.95, more than two-thirds the cost of the iPod itself. How can that be justified at a rational cost-plus level? Because buyers, over time, create anchors for prices that then stand as benchmarks of what's fair. For example, travelers staying at luxury hotels may consider a $14.99-per-day Internet access fee to be fair, even though the same service is often provided for free by lower-end motels. Response to pricing, then, is almost like an acquired behavior based on what buyers are repeatedly exposed to; it may have very little to do with actual costs.

Too many firms, however, are still focusing on costs. Considering how much discussion there is regarding value pricing, it is surprising that a significant proportion of companies use cost-plus pricing. In a study of three nations—the United States, India, and Singapore—Rao and Kartono (2009) found that of the 19 pricing strategies presented, cost-plus was the most widely employed, followed by price signaling (using price to signal the quality of products) and perceived value pricing (basing price on customers' perception of quality). While companies used multiple pricing strategies, they placed highest importance on the cost-plus approach.

1.4. All consumers are different . . .and willing to pay different prices

Consumers have differing needs, preferences, buying power, and desire for instant gratification. This impacts their purchasing behavior, and they are willing to pay widely varying prices. It is important to appreciate this reality.

The automobile industry has capitalized on these differences in a very effective manner. Each manufacturer offers a wide variety of models to cater to the preferences of different buyers: from subcompacts to compacts, full-size sedans, SUVs, and sporty cars. Within each category, they also provide numerous options to make the offerings more suited to multiple buyers, who may then pick and choose the options they desire.

Similarly, many consumers pay higher prices for electronics items, knowing very well that they will come down significantly over time. And, stores like Gap and Old Navy routinely mark down merchandise after a relatively short time following the introduction of a new item; once again, however, many consumers do not hesitate to pay full price.

1.5. There is a lack of appreciation of the impact of pricing, particularly at the transaction level

Price is often set at a strategic level. Once price moves out of the corporate offices, though, strict adherence to it becomes more problematic. Many other entities get involved, each with differing objectives. Examples include the company sales force, channel members, and—as we discuss later—customers who can be adept at manipulating price. This results in 'leakage' that significantly impacts profitability. To a large extent, the blame lies with the corporate offices. Pricing leverage is often not explained to employees, nor is it adequately and objectively built into the compensation system. Frontline employees are not given the means or appreciation for realizing the effect pricing can have on operating profits, and their compensation is often based on revenue rather than margins.

2. Setting the base price

Base price is important: it serves as an anchor and a benchmark. As such, it is crucial that decision makers think strategically, be creative, and focus on profits to create a precise base price. In this vein, we now consider (1) getting pricing under your control, (2) aligning pricing with the marketing strategy, (3) considering the competition and the value being offered, (4) practicing pricing as a creative art, (5) practicing pricing as a science, and (6) focusing on profits.

2.1. Get pricing under your control

Either companies control their prices or the markets dictate it for them. Companies that want to control their prices have to differentiate their

products; otherwise, they will be stuck in a commodity world. Inability to differentiate curtails their ability to set their base price. If they can break out of this trap, cost has less bearing on price, margins can be increased substantially, and the game gets interesting.

'De-commoditization' of products is, therefore, very important. While it can be more difficult to create differentiation for some products as opposed to others, it is still achievable and worth striving for. Consider Starbucks, the company that de-commoditized coffee; Pinkberry, which de-commoditized frozen yogurt; and Zappos, which de-commoditized shoe retailing—a seemingly daunting challenge. Zappos took a commodity retail service and added unmatched customer service, to make buying shoes the absolutely best customer experience. So pleased are Zappos customers, indeed, that—in the words of company CEO Tony Hsieh—they have placed calls urging the firm to start an airline or run the IRS (Burrus & Mann, 2011).

There are many ways to de-commoditize: by enhancing quality, adding features, offering after-sales service, and so forth. This, however, requires a certain amount of creativity. Chevron has been able to de-commoditize its product—gasoline, a quintessential commodity item—by utilizing 'ingredient branding.' During seminars we've held, we have come across a substantial number of respondents who profess to buying Chevron because it contains Techron; interestingly, many of these same individuals, when queried, could not identify what Techron was. In fact, Techron is just a brand name for the detergent Chevron uses in its gas. All brands of gasoline contain detergents, though the respondents did not know this fact, either. Chevron simply decided to brand its detergent additive as Techron, and emphasize the element in company advertising. Such was its success that other competitors have tried to emulate this practice; 76 brand gasoline, for example, now trumpets its ProClean brand of detergent. If gasoline can be de-commoditized, so can—with sufficient thought—any other product.

De-commoditization is not the exclusive domain of large companies. With some creativity, establishments of all sizes can accomplish this. Consider Massachusetts-based real estate agent Lillian Montalto, who sells residential properties totaling approximately $500 million per year. That breaks down to an average $1.4 million home each day! How does she do it? By de-commoditizing the purchase process. Montalto was one of the first realtors to create personalized websites for her clients, featuring pictures and video clips of the homes and views from each room. She manages her communications to suit individual customers' preferences—via email, texts, face-to-face, phone, or anything else—to make their experience special for them. She also provides referrals to services in her customers' new neighborhoods. On a trip to England, Montalto so enjoyed riding in a classic London cab—whereby passengers sit facing each other—that she ordered one and had it shipped to Massachusetts, such that she can converse and make eye contact with her customers while squiring them to view potential homes (Burrus & Mann, 2011, pp. 192–203). Talk about a unique customer experience!

2.2. Align pricing with the marketing strategy

To get maximum leverage, pricing should be a key component of the marketing strategy rather than a tactic to be used after the marketing strategy is already in place; that is, it should be an integral element from the start. The two must offer synergy. Automobile companies have fairly consistently adopted this strategy. Use of the Acura brand by Honda, Infiniti by Nissan, and Lexus by Toyota—and the correspondingly higher prices—were intended to reflect the premium markets being pursued by these manufacturers. The higher prices by the parent brands would have been more difficult to justify, since each originally entered the American market on the low end of the price spectrum. More recently, cars friendly to young adults have been flooding the market: the Nissan Versa, Honda Element, and Toyota Scion, to name a few. These cars' features and styling appeal to the younger markets and seem friendlier to the corresponding budgets.

Swatch serves as another good example. With prices starting at $50, Swatch—a stylish and fun product line—is very reasonably priced and has consistently maintained this outlook. The product's relatively low price corresponds with the brand intention to make watches a fashion statement. Customers want to buy newer designs as they become available. As the head of Swatch design once said: "Price has become a mirror for the other attributes we try to communicate. . .A Swatch is not just affordable, it's approachable. Buying a Swatch is an easy decision to make, and an easy decision to live with" (Dolan, 1995, p. 175). This also explains why the average Swatch customer in Italy owns six (Normann & Ramírez, 1993).

2.3. Consider the competition and the value being offered

Price is evaluated relative to competing offerings. It is important to maintain this focus and move away

from cost-plus pricing, which does not respond to the market and the popularity of which is often based on a sense of risk aversion. While the logic of recovering costs and making profits may be appealing, it has little relevance to the demand side of the market.

It's vital to consider the competition, offer differentiation (Section 2.1.), and price products accordingly. To the extent that it is easy to compare prices and quality, price premiums charged can only be proportionate to the value being added. Interestingly, value may be added on the basis of attributes, benefits, or—arguably most effectively—brand image. This appears to be borne out by a leading advertising agency study, which found consumers throughout the world saw less differentiation between products that emphasized physical attributes than those that used image appeals (BBDO, 1988).

As an example, products are seen as highly differentiated in the image-heavy perfume market, although the cost of the product is typically 15% of retail. Further, perfumes can be duplicated as they enjoy limited patent protections. Contrast this to—for instance—the paper towel market, which focuses on physical product attributes such as number of plies and thickness. Consumers feel most paper towel brands offer little differentiation. While product differentiation is worth pursuing, it must be noted that strong brand image requires a long time to build.

Similarly, many car companies are able to add value by offering superior performance, trims, or a strong brand image. For years, car company Hyundai suffered from a poor quality image; however, by offering a 100,000 mile bumper-to-bumper warranty, the firm achieved a market-perceived significant addition in value. To address the recession, Hyundai even started offering a 'Job-Loss Protection' plan in 2008, guaranteeing a repo-free experience in case customers lost their jobs (Niedermeyer, 2011).

Finally, prestige pricing to signal superior quality may be used to enhance price and profits. Amaldoss and Jain (2005) argue that prestige can positively influence purchase decisions and, in some cases, the price curve may be upward sloping. It's worth pointing out, though, that this may be easier at product launch; once prices are established, it takes a significant change in the value being offered (vis-à-vis the competition) to increase price.

2.4. Practice pricing as a creative art

Creativity, when applied correctly to pricing, can significantly enhance the very basic pricing model, and heighten revenue and profits. Consider Visionary Apps, which sought a piece of the rapidly growing smart phone application market (Burrus & Mann, 2011). The company faced a crowded and often unprofitable field. Visionary Apps identified an opportunity in the real estate market: homes foreclosed upon due to the tanking economy. Since a majority of consumers didn't even know of these foreclosure opportunities—approximately 120 million per year—Visionary Apps saw potential in this arena.

What would have been a good price point for the application the company developed? $0.99, $1.99, $2.99, $3.99, or $4.99? Those were the typical price points for smart phone apps, but research suggested that demand would be low at any price point, and only likely pick up if the app were offered for free. So, instead of charging consumers, Visionary Apps decided to change its business model and charge realtors $24.99 per month for exclusive rights to each zip code. With 42,000 zip codes in the United States, the company now potentially could earn more than $1 million dollars per month on a recurring basis. The product was launched in February 2010, and in its first week was covered by *The Wall Street Journal*, *Forbes*, *Businessweek*, and *USA Today*. Visionary Apps was able to sign up real estate agents all over the country and because the price came with exclusive rights, agents typically bought not just for one or two zip codes, but rather four to twelve. The complete change in the basic pricing paradigm resulted in a successful company that seemed to have no future otherwise.

2.5. Practice pricing as a science

Pricing should be practiced as a science: with precision. For most companies, however—with the exception of leading consumer goods companies—it is anything but precise. Mostly, it's a world of approximations, and many companies are losing opportunities to derive more profits. A quick look at a sample page from target.com shows that a disproportionate number of items have been rounded up to the nearest $5 or $10, including—of course—$19.99, $34.98, and so forth. Anecdotal evidence suggests that many marketers utilize prices that are rounded up. Such approximation is particularly disconcerting considering how even minor fluctuations in price can impact profits. So, in the context of pricing, good enough is neither good nor is it enough, because with precise calculations companies can enhance their profitability considerably. To effectively practice pricing as a science, the company should (1) use research to assess the ideal price point, (2) create a precise base price for maximum long-run profitability, and (3) analyze the zone of price indifference.

2.5.1. Use research to assess the ideal price point

If a price change of just 1% can impact a 10% change in profit, it is well worthwhile to use quality research to test price points. Depending on the size and nature of the project, the cost of price elasticity studies may range from $50,000 to $200,000. Smaller enterprises can bring that down to the $20,000 range if appropriate respondent databases, survey tools, and some relevant expertise are available in-house.

Quick expected value calculations can help assess the merits of doing this research. For the sake of illustration, we offer a straightforward example using simple numbers. If two price points are being considered, and the lower price point (say) results in $1 million in profits with a 25% probability of a pessimistic outcome, and $2 million with a 75% probability of an optimistic outcome, the expected monetary value (EMV) of the profits is $1.75 million. If the higher price point results in $0.5 million in profits with a 25% probability of a pessimistic outcome, and $3 million with a 75% probability of an optimistic outcome, the EMV of the profits is $2.375 million. EMV, under certainty, will then be $2.5 million (= 0.25*$1m + 0.75*$3m). And, EMV for perfect information will then be $0.125 million, or $125,000 (= $2.5m − $2.375), which gives an upper limit to the amount that should be spent on this research. Of course, these calculations can be modified for each specific situation.

2.5.2. Create a precise base price for maximum long-run profitability

Price elasticity studies are effective for assessing exact price at any given point in time. However, this should be used as an input to calculate profits over the life of the customer. For frequently-purchased products, it may be good to err on the low side if necessary, because the hope is to build a customer base that will buy repeatedly—provided the first experience with the product is satisfactory. So, it is important to induce trial with a large customer base. For durables, on the other hand—especially with low repeat loyalty—more emphasis can be placed on immediate profits.

2.5.3. The zone of price indifference

For most existing products, there is a zone of price indifference: the range on either side of the current price over which demand is unlikely to change. It is lower for commodity-type items and higher for differentiated products. The zone of price indifference averages about 10% for industrial goods (Ross, 1984), 17% for branded consumer goods, and only 2% for financial products (Baker et al., 2010). Considering the significant impact of pricing, though, even a 2% difference can imply a considerable difference in operating profits as the product moves from one end of the price indifference zone to the other. For example, a user of Brut deodorant that retails for $4.50 may very well be willing to pay $4.95—a 10% increase—but will likely balk if the price is increased to $5.49.

Some products have lower search costs (e.g., life insurance services), whereas others have higher search costs (e.g., IT consulting). This can impact the zone of indifference, as can other factors including the channel of distribution; for example, consumers are markedly indifferent to prices of soda when buying from a vending machine as compared to purchasing the same from supermarkets. Similarly, the zone of price indifference can be affected by manufacturers who skew it toward the high end. Exposing consumers to extreme prices can shift their price anchor (Adaval & Wyer, 2011). One way of doing this entails offering higher-end priced products to increase the acceptable price range. Zones of price indifference vary, and should be managed carefully.

2.6. Focus on profits

In sum, when setting the base price, it is important to keep the focus on profits. Companies often focus on revenue or market share maximization, but profit maximization is ultimately a more relevant metric in the long term. Revenue or market share maximization does help in two ways: the bragging rights that come with a higher market share, and the economies of scale that drive down costs. Nonetheless, the exact value of both should be evaluated. In the absence of such deliberate assessment, following revenue maximization blindly can often be misleading. Revenues can be increased by lowering prices, but it can have a devastating effect on profitability.

3. Modifying price

There are different means of modifying price. Next, we examine (1) versioning, (2) discounting, (3) bundling, and (4) unbundling.

3.1. Versioning

The various segments comprising a market will value different options, or versions, and will pay prices accordingly. Indeed, most markets have an upscale segment, which will pay disproportionately higher prices for better versions of products. This manifests itself in most lines, creating unique opportunities

for 'versioning': offering modifications to existing products.

Versioning allows companies to adopt pricing that is less reflective of costs. It also allows companies to charge much steeper prices for the higher-end versions, to signal the extra attributes, benefits, or quality they may offer. This, in turn, can also provide a disproportionate contribution to the operating profit. Consider Audi, Volkswagen group's luxury brand. Audi contributed €1.12 billion at the end of first quarter 2011, as compared to €1.06 billion for the Volkswagen brand (Reiter, 2011)—this despite the fact that the unit sales mix is dominated by the Volkswagen brand, and many of the components are shared between the two brands.

Similarly, automobiles made on the same chassis can often command widely varying prices that do not necessarily reflect the comparatively lower variations in costs. For example, the Ford Expedition has an MSRP of over $36,000 while its counterpart, the Lincoln Navigator, has an MSRP of over $57,570—even though some critics claim that apart from the badge, grille, and other slight cosmetic changes, these are functionally identical vehicles.

Apple practiced versioning in a very effective manner. Using hard disk space and access to cellular networks as differentiators, the newly released iPad2 features prices ranging from $499 for the 16GB base model to $829 for a 64GB machine with 3G wireless access. On top of that, optional accessories such as covers, connector cables, and charging docks can easily add another $300 to the price. While Apple does not reveal cost figures, it is safe to assume that the difference in prices cannot be attributed to the difference in costs.

Versioning has another advantage: when properly executed, it can help move the customers toward a more profitable sales mix. AT&T and Verizon, providers of wireless access to smart phones and iPad devices, do their own versioning with interesting differences. While AT&T charges $15 a month for 250 megabytes of data, or $25 for two gigabytes, Verizon offers 1 gigabyte for $20, 3 for $35, 5 for $50, or 10 for $80. While it's too early to judge the winner of this rivalry, depending on how consumers may anchor the price, the versions created by the two competitors are likely to yield very different revenue and profit streams.

3.2. Discounting

Discounting is equally appealing to both the buyer and the seller. Sellers may want to discount prices to sell to as many customers as possible for the maximum price each is willing to pay, and to make better utilization of their supply capacity. Buyers also vary in their buying power, propensity for instant gratification, and search costs. This suggests that different consumers will be willing to pay different prices, and profits would be suboptimal if they are treated as one homogeneous group and charged the same price. Discounting, therefore, is a very viable and desirable strategy.

Price skimming for new products, with gradual price reduction, is a good example of discounting over time; this tactic is used extensively for high ticket, less frequently purchased items, which are constantly evolving. Many consumer electronics items—plasma televisions, digital video recorders, mobile phones, and such—fall into this category. iPad pricing provides a perfect illustration of this practice. Lots of people would argue that buying an iPad2 is an emotional purchase, because at a rational level, iPad2 doesn't offer much more than its first-generation counterpart (Pogue, 2011). Although iPad is not as flashy as the iPad2—no camera, slower processor, no magnetic Smart Covers—with the release of iPad2, the original iPad is available at an appealing discount of $150 (Grobart, 2011).

Movie ticket pricing for off-peak hours, on the other hand, is also a good discounting practice, but is driven more by the sellers' need for incremental revenues gained from unused capacity that would otherwise likely go to waste. This is the core idea behind Groupon Now. In April 2011, Groupon took its service local and real-time with a new mobile app employing two buttons: "I'm Hungry" and "I'm Bored." The hope is to help people find deals that are nearby and valid immediately, for a short window of time; further, it's a chance for merchants to fill empty tables or bring in customers during slow times (Frommer, 2011).

While discounting is appealing, there are some caveats that need attention. Incessant discounting, in the long term, can actually harm a brand's image. Even in the short term, discounting runs the risk of making all groups gravitate toward the lowest possible prices. If so, the challenge is to create barriers so that consumers willing to pay a higher price are unable to cross those barriers easily. These barriers may take the form of added wait time needed to buy the product at the discounted price. So, Gap and American Eagle consumers keen on instant gratification will pay a higher price, while those willing to pay less must wait it out. Alternatively, discounts may be offered at unexpected times, making it impossible to predict sale dates and thereby allowing only dedicated bargain hunters to capitalize on that.

3.3. Price bundling

Price bundling has historically been used to offer a deal whereby customers buy two items instead of

one; for instance, a Colgate toothbrush with Colgate toothpaste. This is a very useful practice: customers get a price break and companies increase their profitability if the probability of the customers buying the second item from them is rather low. [It is also helpful in inducing trial for the second item.] This takes the form of 'mixed bundling' if the components of the bundle are also available individually, or 'pure bundling' if they are not. In either case, it is important to consider the behavioral implications. Consumers often separate the total savings into two parts: savings from individual items if bought separately, and the additional savings from purchasing the bundle. To facilitate this and make it more appealing, it is helpful to list prices on the individual items even as a decoy (Yadav & Monroe, 1993). This can be weighed against the added costs of packaging, delivering, and carrying inventory of the individual items.

3.4. Price unbundling

While profitability can be improved with price bundling, it can also be improved with 'price unbundling.' This is a practice of breaking down the product or the service and charging separately for each component. Recent moves by the airline industry in this direction are worth studying. While customers may complain, many airlines have got it right: they unbundled their basic service and offered many elements of the same as options. To understand the efficacy of this, let's take a quick look at buyer behavior for air travel. Most customers make their decision based on price for the round-trip ticket, aided by price comparison sites such as kayak.com. They may even be extremely price sensitive at this point, because most airlines are considered commodity services. However, once the ticket is bought, customers often willingly spend extra for add-on services; consider in-flight meals, audio headsets, Internet access, seating with extra leg room (economy plus and exit rows), paper tickets, checked baggage, and so forth. With buyer behavior like that, it makes sense for airlines to capitalize on this by unbundling the services. Customers have most visible and easy access to the base airfare, while researching prices of add-on services is more cumbersome. Not surprisingly, this change in pricing has been a major factor in returning airlines to profitability.

4. Monitoring pricing

It is helpful to evaluate pricing policies at the strategic level, but this should be complemented by a review at the transaction level, as well. It's at the latter point that the impact of the market, competition, the company's strategy, and also the implementation of its pricing policies can be seen. It is also where a lot of profit leakage occurs. We now look at monitoring pricing policies at a strategic level and transactional level, and make several suggestions to keep final pricing in line with overall pricing objectives.

4.1. Higher awareness: Pricing at the strategic level

A regional fast-food chain in the Southwestern United States, by the pseudonym Fast Grill, wanted to increase its profitability. In a top management meeting during an audit process, everyone was quick to agree that profitability is the top metric that should be pursued. But when asked what the current margin was, the responses ranged from 3.5% to 5.5% to 7.5%. When the CEO was asked for clarification, he replied: "It's somewhere between 3.5% and 7.5%. Let me explain, 3.5% is the number we [said] we could hit, 5.5% is the number we will hit, and 7.5% is our stretch goal" (Connors & Smith, 2011, pp. 30—33). Anecdotal evidence, in our experience, seems to suggest that Fast Grill has ample company.

Lack of clear knowledge regarding the pricing policy and exact numbers is a dangerous indicator of a deficiency of understanding about the importance of pricing and, as a strategic element, has significance for operational issues. In the case of Fast Grill, profit goals had immediate implications on how many people needed to be seated, how many times the seatings had to be turned over, and how quickly the tables had to be tidied between customers. The impact of all this on revenue and—subsequently—on pricing and profitability can be assessed, and the problem should be addressed.

4.2. A closer look at transaction price bands

A company may set exact prices at a strategic level; however, rarely does an item sell at the same transaction price. This results in a range that is often referred to as a 'price band.' Marn and Rosiello (1992) found that the price band—that is, the difference between the highest and lowest transaction price—was 35% for a flooring manufacturer, 60% for a lighting fixtures manufacturer, 70% for a computer peripherals supplier, 200% for a specialty chemicals company, and 500% for a fastener supplier. Recognition of the width of the price band is a

necessary and important first step for companies, which must then find out the causes and fix the problems that exist.

For example, Castle Battery Company (CBC)—a manufacturer of replacement batteries for automobiles—had operating profits of about 7%. As such, its overall profitability was very sensitive to slight variations in price. The industry had become commoditized and there was always a downward pressure on price. CBC's base price of $28.40 was reduced by as much as a $2.98 off-invoice discount, and an invoice discount of $10.22 (=36%), the result of a combination of a variety of discounts. The transaction price ranged from $14 to $25—clearly a very large variation, which warranted investigation (Marn & Rosiello, 1992).

The reasoning for volume discounts seemed logical, because it cost CBC less to serve its larger accounts. But, a closer look showed that there was no relationship between the size of the accounts and the prices paid by them; in other words, many smaller accounts were enjoying substantial discounts. CBC found that experienced customers who had dealt with the company for 20 years or more were clever in extracting discounts. These customers knew who to call to get the right discounts, and were easily able to exploit a well-intentioned discount system.

CBC addressed this by identifying these outlying accounts and gave the responsible salespeople 9 months to bring these accounts in line. If they couldn't do that, they were asked to invest their time in replacing these accounts with new customers willing to pay slightly higher prices. As a result, Castle was able to fix 90% of the problem cases and find replacements for most of the remaining 10%. Moreover, it also targeted the accounts paying a higher-than-average transaction price and decided to reward these clients—not by reducing prices, but rather by offering extra attention, higher service levels, and shorter order lead times. Finally, Castle decided to take a more strategic and careful approach to discounting. All elements were evaluated and the reporting was to be done at the individual account level, as opposed to the companywide level. CBC also incorporated transaction price into the incentive compensation for its salespeople. Within a year, average transaction price increased by 3% even though volume remained flat. And, operating profit shot up by 42%.

Another company, home appliance manufacturer Tech-Craft, undertook a similar exercise. In this case, the firm just moved off-invoice discounts to on-invoice. This had a significant impact, because its customers—the retailers—did not pay as much attention to the off-invoice discounts and took it for granted psychologically. Also, not all retailers were equally sensitive to the reduced discounts or to the different types of discounts. As a result, a targeted surgical discounting approach was used. Tech-Craft's volume actually grew by 11%, its average transaction price increased by 3.5%, and operating profit increased by 60% (Marn & Rosiello, 1992).

4.3. Closing the loop

Pricing operates at three levels: market forces, marketing strategy, and transaction. We argued earlier that marketing managers should do what they can to reduce the effect of the market structure, and gain more control of this key variable. That's pricing at the marketing strategy level. We now turn our attention to transaction level prices, which are often not controlled by the marketing managers. We discuss reasons for this and suggest guidelines for addressing the same.

Marketers can suggest a price (MSRP), but they cannot often dictate that price to intermediaries. This problem worsens as more intermediaries become involved in the chain, as they all may have profit maximization curves whose optimization does not coincide with the manufacturer's. This problem does not have an easy solution, except being cognizant of the prices and sales volume that result from this and incorporating this into planning.

Another major problem is interference from other internal groups in the organization. While marketing may determine prices at the marketing strategy level, the sales department often controls prices at the transaction level. More often than not, compensation for the sales force is based on volume as opposed to profits. As such, salespeople have little incentive to charge a higher price; in fact, they are typically more than willing to offer maximum discounts to their clients in order to close deals. Not surprisingly, there is tremendous pressure on sales support/contracts managers to constantly resist demand for additional discounts from the sales force. Incentives should be devised and implemented in accordance with the company's profitability goals. While a 5% decrease in price for a revenue-based salesperson may only reflect a 5% decrease in their individual compensation, it will ultimately impact company profitability by more than 50% based on average company economics. It is imperative that the sales force be well informed regarding the importance of pursuing proper pricing practices.

The existence of multiple discounts also needs to be addressed. When designed, multiple discounts often have meaningful objectives, but tend to lose their focus over time and often result in overlaps that are not productive. The plethora of discounts available—including volume discounts, trade discounts, early payment disclosures, slotting fees paid to retailers, cooperative discounts, and the like—makes it difficult to coordinate these discounts, and assessing the impact of each becomes very difficult because they interact with each other. As such, the objective and efficacy of various discounts should be studied and changes implemented in a focused manner to get maximum leverage (as suggested in the Tech-Craft case).

It is also critical to understand each customer's needs and their importance to the company's profitability such that only discounts valued by them are offered, and no discounts are wasted. A company should conduct an audit of its customers and identify the final price paid by them, and also list every discount received by them. For customers at the high end of this spectrum, additional support may be desirable. It would be productive to assess what they need, why they are willing to pay a high price, and facilitate operations that add value for them. For customers at the low end, it would be meaningful to establish the reasons they've been receiving high discounts, and eliminate the unproductive discounts. Many times, the latter occurs simply because the salesperson just handed it to them. If this is the case, a company can extend an adjustment period for its sales force to bring accounts back in line with pricing objectives. In fact, guidelines should be created to determine when a certain discount can be provided, and strict adherence to it should be required.

Finally, mistakes do happen. Undercharging is difficult to assess with precision, but this can still be accomplished. Customers are more likely to complain when they are overcharged, as compared to when they are undercharged; therefore, if several complaints are lodged regarding overcharging errors, it may be worthwhile to undertake a thorough audit. How much do companies lose from undercharging? Without completing an extensive analysis, if over- and undercharging are genuine errors, it can be argued that over- and underestimation are somewhat equally likely; statistically speaking, a crude estimate of undercharging is the amount that has been overcharged (Baker et al., 2010). If that is a large number, investment should be made to tweak the systems aimed at ensuring error-free pricing operations.

5. A final word on pricing

In conclusion, all levels of the organization should be involved in pricing—from marketing and finance, to the CEO. Similarly, everyone should be involved—from frontline employees to operations and the sales force. It is important to educate all concerned about pricing, and integrating it in the company culture. Pricing has too much of an impact to be ignored, and promises high returns to warrant this.

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