

1. Introduction to Pricing

1.1 Introduction

The SBA Learning Center presents: *Introduction to Pricing*.

Produced by the SBA's Office of Entrepreneurship Education, this self-paced course offers an introduction to pricing and how it impacts your business. The subject matter is indexed for quick reference and easy access. It will take about 30 minutes to complete the course. Additional time may be needed to review included resource materials and to complete the "Next Steps" suggested at the end of the course.

Audio is used throughout the training, so please adjust your speaker volume accordingly. A transcript and keyboard shortcuts are available to assist further with user accessibility.

When you complete the course, you will have the option of receiving a course completion confirmation from the SBA.

1.2 Course Objectives

The course has eight key objectives:

1. Define pricing.
2. Explain how costs affect pricing.
3. Describe pricing as a component of the marketing mix.
4. Identify pricing objectives.
5. Describe pricing strategies in relation to sales promotion.
6. Explain the three general pricing models for small business.
7. Identify common pricing mistakes.
8. Recall the legal issues involved in antitrust actions, loss leader pricing, and price discrimination.

1.3 Course Topics

This course provides an introduction to pricing and how pricing affects sales of a product. Some of the questions answered in this course are:

- What is pricing?
- How do costs affect pricing?
- What are the components of the marketing mix?
- What are the objectives for pricing a product?
- How do pricing strategies affect sales promotion?
- What are the three general pricing models for small businesses?
- What are some common pricing mistakes?
- What are the legal issues involved in antitrust actions, loss leader pricing, and price discrimination?

Many additional resources are identified to help you. Visit the resource icon in the course player or locate additional tools, templates, and mentors on SBA.gov once you finish the course.

Let's get started!

1.4 What is Pricing?

Let's begin with the definition of Pricing.

Pricing is the method followed by a business to determine the selling price for its products or services.

Price is one of the four Ps of marketing. The other three are product, promotion, and placement. These are all costs incurred by a business during operation. Note that pricing is influenced by the cost of production, promotion, and placement of the product being sold.

Other pricing factors include competition, market conditions, brand, and quality of product.

The price of a product, and of services like tuition, insurance premium, interest, rent, fare, toll, and salary, are some examples of price.

1.5 Steps for Pricing a Product

Now, let's learn about pricing in detail.

Pricing a product usually involves:

- Developing a marketing strategy,
- Creating the "marketing mix," a technique used to develop plans for marketing a product,
- Studying and estimating the demand for a product,
- Calculating the fixed and variable costs related to a product,
- Generating a price based on the market needs by predicting competitor strategies and understanding legal constraints, and
- Setting the price of the product using the information collected through the previous steps.

1.6 Pricing vs. Costing

Do you know how pricing differs from costing? Let's first learn about cost to find out.

To determine the price for a product or service, business owners should understand the costs of running their business.

If prices do not exceed costs in the long run, the business will fail.

Costs include:

- Property and equipment leases,
- Loan repayments,
- Inventory,
- Utilities,
- Financing costs, such as interest on loans,
- Salaries/wages/commissions,
- Markdowns,
- Shortages, such as not having an item in stock,
- Damaged product,
- Employee discounts, and
- Desired profit.

Profit should be included on the list of costs and treated as a fixed cost. Nobody runs a business just to break even.

1.7 Pricing as a Component of the Marketing Mix

Now that you know about the first Ps of marketing, here's an overview of the four Ps of marketing.

The "Marketing Mix" is composed of the four Ps of marketing:

- Product
- Price
- Place
- Promotion

As a product is developed, a business needs to create a marketing strategy by identifying the target market and product placement. Ideally, the price of a product should match its quality.

Pricing is determined by these tradeoffs among the elements of the marketing mix.

1.8 Pricing Objectives

Do you know why it's important to conduct a pricing exercise?

A part of a pricing strategy depends on the objectives of the organization. Some common pricing objectives are:

- Increasing sales: Here, the objective is to sell the maximum number of product units or serve the maximum number of customers to decrease long-term costs and increase market share.

- Increasing profit: Here, the objective is to increase current profit by increasing revenue and decreasing costs.
- Increasing revenue: Here, the objective is to increase current revenue irrespective of profit margins. Here, the company is trying to maximize long-term profits by increasing the market share and reducing costs.
- Considering competitors' price: Price of a product should be fixed considering the competitors' prices.
- Maintaining quality leadership: The objective is to use price to create a perception that the product is a quality leader.
- Recovering partial cost: Sometimes a business may use other revenue sources to subsidize the price of a product or service. It may do this to increase market share, especially when selling a complementary product or while improving the business's public image.
- Surviving unmanageable situations: There could be situations, such as an economic recession, in which the organization's sole objective would be to cover costs to remain in the market. Until the situation improves, profits may be ignored.
- Maintaining stability: Here, the objective is to avoid price wars and achieve price stabilization to maintain profit at a steady level.

1.9 Sales Promotion

Pricing strategies can also be used as sales promotion tactics. Some common ideas are:

- Skim Pricing,
- Penetration Pricing,
- Leader Pricing,
- Premium Pricing,
- Differentiated Pricing,
- Psychological Pricing, and
- Discounts and Sales.

You will learn about these pricing strategies in the next few pages.

1.10 Skim Pricing

Let's start with skim pricing. Using this strategy, the organization attempts to sell a product at a high price. This is mainly aimed at customers who are not concerned about the price when the product is new to the market and there are fewer competitors. The price decreases when more competitors enter the segment.

This strategy can be used when:

- The product is new to the market and there is little competition,
- Demand is fixed and the customers are not too price-sensitive,
- High volumes do not assure cost savings, and

- Companies are identifying investors to finance high-volume production with low profit margins during the initial phase.

1.11 Penetration Pricing

In the Penetration Pricing strategy, the business tries to maximize the quantity sold and increase the market share, by lowering the prices. This strategy can be used when:

- The customers are price-sensitive and the sales will increase as the price declines,
- Higher volumes guarantee cost savings,
- The product or service is of a type that can gain mass appeal rapidly, and
- The competition is intense.

1.12 Leader Pricing

In the Leader Pricing strategy, a product or a group of products is offered at a lower price to attract customers with the expectation that they will also buy premium products.

The products that are sold at a lower price are called loss leaders because they are sold at a loss. Usually, retailers use this strategy.

An example is that of “freemium games.” These are free games (usually downloaded as cell phone apps) that later encourage the player to buy premium features such as higher levels of the game.

1.13 Premium Pricing

In the Premium Pricing strategy, a product or service is priced at the high end of a possible price range to create a sense of perceived quality, which will attract status-conscious consumers.

This strategy may work if target consumers believe that:

- High price guarantees good quality, and
- Buying a premium product or using a premium service signals their high worth to others and indicates that they are the members of an exclusive group.

1.14 Differentiated Pricing

Differentiated Pricing is also known as Price Discrimination.

In this strategy, the same product or service is priced differently for different customers and different markets. This strategy has three variations:

Select each tab to learn more.

- **First-degree price differentiation:** This is also called personalized pricing or one-to-one marketing. Here, the goal is to maximize the price that each customer is willing to pay. In this, the product or service is sold to each customer at a different price. A business that uses this strategy is a car dealership.
- **Second-degree price differentiation:** In this case, price differs depending on the quantity. An example is selling large quantities at a lower unit price. This applies when selling to industrial customers, who are bulk buyers and enjoy higher discounts. This method allows businesses to set different prices for different market segments and capture a larger portion of the total market surplus.
- **Third-degree price differentiation:** Also called group pricing; in this variation, the market is divided into different segments and the same price is charged to every consumer in the segment. An example is the discounts given to students.

1.15 Psychological Pricing

Psychological pricing is the practice of displaying prices which are a few cents less than a price expressed in full dollars. This is based on the assumption that the customers will not round the dollars-and-cents prices up, and that, therefore, they will consider the dollars-and-cents price to be significantly lower, when it is only marginally lower. Thus, this strategy is based on prices that appear as a bargain, to the consumer at first glance—for example, \$2.99 per pound instead of \$3.00 per pound. Nowadays, many companies use psychological pricing to increase their sales.

1.16 Discounts and Sales

Consumers today are used to discounts and sales. Most people buy in large quantities only if the product is available on sale. Most supermarkets have sales on all the time, or have very small interval between sales.

Here are some types of discounts offered to customers:

- **Quantity discount:** This type of discount is offered to bulk buyers.
- **Cumulative quantity discount:** This is offered to buyers who purchase large quantities over a period of time, but do not place a large stand-alone order.
- **Seasonal discount:** This is usually offered based on the time when the purchase is made or the service is used. For example, the travel industry offers discounts based on the time or day of travel, or the season.
- **Cash discount:** This is offered to customers who pay the bill before a specified date.
- **Trade discount:** This is a discount offered to the members of the distribution channel for performing their roles. An example is a discount offered to a small retailer who may not be a bulk buyer.

1.17 Pricing Model Categories

Now, let's learn about the categories of pricing models. The three general categories of pricing models are:

- Cost-based pricing,
- Customer-based pricing, and
- Competition-based pricing.

These three categories cover the majority of pricing models used by small businesses; however, there are others. The application of these models, including how to use them to calculate price, can be found in SBA's online course, *Pricing Models for a Successful Business*.

1.18 Cost-based Pricing

Let's look at cost-based pricing.

In this strategy, a business first determines the cost of developing a product and adds a markup for each unit based on factors such as expected profit, sales objectives, and customer expectations. For example, if the cost of the product is one dollar, and the organization needs a 10-percent profit margin, the final selling price is set at \$1.10.

Cost-based pricing is commonly used for pricing large development contracts with the Government, services provided to the Federal Government, and credit card transactions.

Some advantages of cost-based pricing are that:

- It helps to find fair prices easily
- It involves calculating the full cost of the product. Pricing based on full cost looks factual and precise and may be more ethical
- It reduces the cost of decision making and lets a business set prices in an uncertain market where knowledge is incomplete as it does not involve much market research
- It is less risky than other methods
- It helps achieve competitive stability because Cost-based pricing helps set a price likely to yield returns acceptable to other members of the industry
- It is simple and readily available, and
- It helps justify price increase by relating to cost increase

Some disadvantages of cost-based pricing include the following:

- It ignores the role of consumers in determining price - there is no guarantee that your consumers are willing to pay this price
- It ignores the role of competitors - the price may be much more or much less than what a competitor charges
- It creates little incentive for cutting costs, and
- It ignores opportunity cost

1.19 Customer-based Pricing

The customer-based pricing model is also sometimes called value-based pricing. In this model, the business first evaluates the customer to understand what he or she is willing to pay for the product or service, and then charges the price each customer is willing to pay. It gives little or no consideration to the cost of the product or service. This strategy is often used by car salesmen.

Customer-based pricing has the following advantages:

- It gives the business the flexibility to charge different prices to different customers
- It can serve as a way to maximize profit margins
- It provides an incentive to offer a quality product and customer service and to keep costs down

Customer-based pricing has the following disadvantages:

- It can alienate customers who end up paying more than the successful bargainers
- Over time, customers can become aggressive bargainers
- It is harder to scale if the number of customers increases
- It may be difficult to implement in a market where buyers have a lot of options
- Businesses must still ensure that their costs are being covered by the revenue generated in the long run

1.20 Competition-based Pricing

In the competition-based pricing strategy, prices are fixed using the price of the competitors' products. This strategy is applied in industries with one or two prominent companies. Thus, it's also referred to as "follow the leader."

The main advantage of competition-based pricing is that it's easy to use, as extensive marketing research and statistical analysis are not required.

Some disadvantages of competition-based pricing are that:

- It is difficult to know how the competitor is pricing the product; it may or may not be the best way
- The price can no longer be used as a variable in the marketing mix because the business no longer has control over it
- If the competitor's product is not similar to your own, the price may not reflect the true value of the product. Additionally, it may not cover all of the costs to produce the product

1.21 Common Pricing Mistakes

Now, let's talk about some common pricing mistakes small businesses make:

- Not having a strategy or not sticking to your strategy,
- Underestimating costs,
- Assuming that the only way to compete is via low price,
- Setting your pricing strategy and forgetting to check if it works well or needs a modification, and
- Ignoring legal issues.

1.22 Antitrust Actions

Antitrust actions deal with activities that businesses should be aware of, in order to protect consumers against violations such as:

- Scheming to fix market prices,
- Scheming to allocate markets or customers,
- Colluding to reduce competition, and
- Monopolizing a particular market.

1.23 Loss Leader Pricing

When using a loss leader pricing strategy, make sure that:

- The advertised product is in stock
- The product price mentioned in advertisements matches the actual price at the store

If the price mentioned in the advertisement differs from the actual price of the product, it is considered illegal.

1.24 Price Discrimination

Charging different prices to customers for the same product is price discrimination. Generally, it is illegal to discriminate on the basis of race, religion, gender, age, or nationality, or to violate antitrust laws. However, there are no hard and fast rules, and certain localities may have stricter laws than federal law. If you are uncertain that your pricing structure (or that of your competitors) is legal, you should consult with a licensed attorney.

Mostly, price discrimination causes injury to the competition among various sellers in the market. Injury can occur in one of the two ways: Primary injury occurs when a seller offers a product for low prices to weaken his/her direct competitors. Secondary injury occurs when a seller offers a product for low prices to his/her favored customer, thereby allowing that customer to destroy his/her own direct competitors.

1.25 SUMMARY

- You have learned some complex marketing concepts in this course. It's time to sum it all up.
- Pricing is the method followed by a business to determine the selling price for its products or services.
- Pricing is influenced by cost of production, promotion, and placement of the product being sold.
- Common pricing objectives are:
 1. Increasing sales
 2. Increasing profit
 3. Increasing revenue
 4. Considering competitors' price
 5. Maintaining quality leadership
 6. Recovering partial cost
 7. Surviving unmanageable situations
 8. Maintaining stability
- The strategies related to sales promotion include:
 1. Skim pricing
 2. Penetration pricing
 3. Leader pricing
 4. Premium pricing
 5. Differentiated pricing
 6. Psychological pricing
 7. Discounts and sales
- The three general categories for pricing in small business are cost-based pricing, customer-based pricing, and competition-based pricing.
- Common pricing mistakes are not having a strategy, underestimating costs, thinking the only way to compete is via low price, setting your pricing strategy and forgetting to check, and ignoring legal issues.
- Small business owners need to be aware of antitrust laws and the legal difficulties involved in loss leader pricing and price discrimination.

1.26 Next Steps

Now what should you do? Follow these steps to begin applying your knowledge of pricing in your business.

- Step 1) Evaluate your current pricing strategies.
- Step 2) Evaluate strategies that may have to be revised.
- Step 3) Create a game plan for revising strategies or coming up with new ones.
- Step 4) Identify whether the current strategies can lead to any legal problems.

1.27 Resources

SBA has a broad network of skilled counselors and business development specialists. Below is a short description of our resource partners:

- Over 900 Small Business Development Centers (SBDCs) provide a vast array of technical assistance to small businesses and aspiring entrepreneurs. By supporting business growth, sustainability and enhancing the creation of new businesses entities, SBDCs foster local and regional economic development through job creation and retention. As a result of the no-cost, extensive, one-on-one, long-term professional business advising, low-cost training and other specialized services SBDC clients receive, the program remains one of the nation's largest small business assistance programs in the federal government. The SBDCs are made up of a unique collaboration of SBA Federal funds, state, and local governments, and private-sector resources.
- SCORE is a powerful, nationwide source of free and confidential small business advice to help build your business. More than 12,000 SCORE volunteers are available to share their expertise and experience in lessons learned in small business.
- Women's Business Centers (WBCs) are education centers designed to assist women in starting and growing small businesses by providing management and technical assistance. Over 100 WBCs are located throughout the U.S. and Puerto Rico.
- The SBA has 84 District and Branch offices in all 50 states, as well as Puerto Rico, the U.S. Virgin Islands, and Guam. These offices support the growth of small business by connecting customers to resources, products and services provided by our resource and Agency partners at the Federal, State and local levels.
- The Veterans Business Outreach Program is designed to provide entrepreneurial development services such as business training, counseling and mentoring, and referrals for eligible veterans owning or considering starting a small business. The SBA has 15 organizations participating in this cooperative agreement and serving as Veterans Business Outreach Centers (VBOC).
- The SBA Learning Center is an online portal that hosts a variety of self-paced online training courses, quick videos, web chats and more to help small business owners explore and learn about the many aspects of business ownership. Content is filtered by topic, so no matter the stage of your business, or the kind of insight you need, you can quickly get answers.

Find your local resource using our handy [zip-code tool](#).

1.28 Have a Question?

- Call SBA at 1-800 U ASK SBA (1-800-827-5722)
- E-mail SBA at answerdesk@sba.gov
- Locate a SCORE counselor, SBA district office near you, or an SBDC office near you at www.sba.gov/local-assistance.
- To provide feedback, comments or suggestions for other SBA online content, please email learning@sba.gov.

1.29 Certificate

Congratulations on completing this course. We hope it was helpful and provided a useful introduction to pricing. Click the certificate to receive a course completion confirmation from the U.S. Small Business Administration.

2.0 Recommendations

A.C.T. NOW!

The Article, Course and Tool below are related to the course you just completed. They are provided to help you take action on your path to entrepreneurial success. You can also get in-person assistance for all of your business needs through a local resource center. And if you liked the course, please help spread the word by sharing it with your friends!

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Read an SBA Article.

The article, [How Minimum Advertised Pricing Impacts Your Retail or Online Store's Marketing Efforts](#), explores the topic of Minimum Advertised Pricing.

Take Another Course.

SBA's course, [Pricing Models for a Successful Business](#), is an intermediate-level course that delves into ways business owners can set prices, calculate costs, assess competitors, provide value to customers, and adapt pricing to changing market conditions.

Try a Tool.

Check out SBA's [SizeUp tool](#) to help you assess how your business stacks up against the competition.

Find local assistance!

[SBA has a broad network of skilled counselors and business development specialists.](#)