The entrepreneurs guide to transforming profits through price

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Foreword

Working too hard for too little money

Have you ever felt…

- There is downward pressure on price… your customers keep complaining over price,
- Your competitors keep lowering their prices,
- Your margins are being constantly squeezed,
- Customers aren't paying you on time and you're often short of cash,
- You're working too hard and too many hours, and ultimately
- You're not making enough money?

If so, you're not alone.

The most common underlying reason for these problems is **the wrong way of pricing**.

Unfortunately, most businesses use *emotional pricing*, which comes from a lack of understanding of pricing strategy; reacting to gut feel and emotion rather than the facts. Rather than from **a proper understanding of the numbers**.

Without understanding the numbers, pricing strategy and price psychology, most small businesses end up competing on price with no real differentiation in the market.

In this eBook, I will show you how to choose the right pricing strategy, how to put your prices up without losing customers and, ultimately, build a more profitable and successful business.

I hope you enjoy reading this eBook, and most importantly I hope you take some action.

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Why do businesses fail?

There are many reasons why businesses struggle, and in some cases, ultimately fail. It happens for both Start Up businesses and established businesses. Here are some of the common causes.

Starting out in business

According to research more than half of new businesses don't survive beyond 5 years. Here are some of the reasons for such high failure rates:

- An inability to build a profitable business model with proven revenue streams,
- Failure to create and communicate value propositions in a clear, concise and compelling way,
- No real differentiation in the market, which means competing on price,
- Emotional pricing – a lack of understanding of pricing strategy; reacting to gut feel and emotion rather than the facts,
- Not really in touch with customers and a lack of understanding of the market,
- Lack of business and strategic planning,
- Rapid expansion leading to 'over-trading' and running out of cash,
- A lack of systems, and
- Poor sales and marketing processes.

It doesn't get any easier after 5 years… just a new set of problems.

The established business

Businesses that have been established for 5 or more years have typically gone through an initial high growth phase, but then they start to stagnate. Some of the common problems we find include:

- Constant cash flow issues due to the demands of high overheads and working capital needs,
- Slow growth – or even declining sales,
- Downward pressure on price and margins,
- The business owner working too hard, and
- Consistently falling short of profit targets.

Very often the biggest reason and the root cause of business problems is they don't understand the numbers and the business model. They don't understand the impact and importance price has. And it's not their fault... there is simply not enough opportunity to learn the necessary skills.

Let me introduce you to Eddie

Eddie runs a small business. He's a videographer and creates professional videos for corporate customers. His business has annual sales of £850,000. It grew fast in the early days, but growth is slowing down. He hires in additional help as required on large projects, such as video editors, script writers, make-up artists and actors. His annual financial statements show that these costs – accountants call them variable or direct costs because they vary with sales – amount to 42% of sales. In addition, Eddie has fixed costs, such as the rent and rates on his studio and office, telephone bills and what he pays to his bookkeeper and other professionals. These total £460,000 which leaves him with a profit of £33,000.

Not much for all the crazy hours Eddie works! But then again, that's not uncommon for business owners.

If you want to increase the profit of your business you must understand the numbers. For that reason, I am going to come back to Eddie in this book to show you the impact price can have on profit.

Let's summarise Eddie's business:

	£
Annual sales	850,000
Variable costs (*or direct costs*)	357,000
Gross profit percentage	*58%*
Gross profit	493,000
Fixed costs	460,000
Net profit	**33,000**

In the next chapter, we're going to explore how Eddie can improve his profits and make more money.

The most powerful lever in the profit equation

You can't manage profit. Profit is simply an end result. It's the end result of a series of processes.

It's the business model.

Numbers drive that business model. When you fully understand your business model and how the numbers work you will be able manage and improve the drivers of profit.

Every business is different and will have its own unique business model and profit drivers. Nevertheless, for most businesses there is a generic model. This model has 9 drivers, so let's explore that.

A model of your business

Profit is the end result of deducting *costs* from *sales*. It looks like this:

PROFIT = SALES – COSTS

But that's far too simplistic. We have to understand both sales and costs in more detail.

What drives costs?

Costs are made up of *fixed costs* and *variable costs*. It's important to differentiate between the two because they have a very different impact on your business model.

Variable costs – sometimes referred to as *direct costs* – change in proportion to changes in sales. Typical examples are direct labour and the cost of raw materials.

Fixed costs, as the name suggests, don't change (at least, not in the short term). Typical examples are premises costs, sales force salaries and administrative staff salaries. Fixed costs are usually fixed in the short term, but over the longer term can vary. Whilst a 10% increase in sales is unlikely to have any impact, a doubling of the business may lead to the need to hire more administrative staff or larger premises.

Other forms of cost exist, such as *stepped costs,* which are a form of fixed costs that jump in steps as business activity and sales increase. For example, if you manufacture widgets and you increase your sales by 10% your variable costs also increase by 10%. Your fixed costs probably won't change with a small change in sales.

If your sales of widgets increase by a larger amount, say 50%, your direct costs would increase by 50%. Some of your fixed costs such as premises costs may continue to be unchanged. But to generate that increase in sales of 50% the cost of your sales force is likely to rise (possibly by as much as 50%, or even more). Those costs will not vary directly with sales, but they will increase in steps.

Whilst you should be aware of different costs and how they react to changes in sales and business activities, splitting costs between variable and fixed will usually suffice. So, we'll keep things simple.

So, our formula now becomes:

PROFIT = SALES – VARIABLE COSTS – FIXED COSTS

Have you spotted something about this formula?

This is how accountants set out your end of year financial statements. Go and check them out. Here again is Eddie's financial statement (I've just added the terms used in the above formula for clarity).

You'll see that accountants simply add in a line for *gross profit* which simply means sales less variable costs (and often this is expressed as a ratio too, often referred to as *gross margin*):

		£
Annual sales	SALES	850,000
Variable costs (*or direct costs*)	VARIABLE COSTS	357,000
Gross profit percentage		*58%*
Gross profit		493,000
Fixed costs	FIXED COSTS	460,000
Net profit	**PROFIT**	**33,000**

Whilst this analysis of a business provides some useful insights – measuring trends in these numbers over time and analysing changes in gross margins – it doesn't go anywhere near far enough.

Let me explain why…

You could improve profit by focusing on fixed costs. The trouble is there is only so much fixed cost you can remove from a business before it has a seriously detrimental impact. You almost certainly can't halve your fixed costs without radically redesigning the whole business model. It's quite hard to reduce fixed costs by 10% without harming the business in some way.

Whilst you should be mindful of costs at all times, improving this profit driver will only result in a relatively small improvement in profit.

It's the same with variable costs.

Realistically, if you focus on reducing your fixed and variable costs you would probably achieve a 5% improvement in both, and for Eddie that would increase his profits from £33,000 to £73,850. Certainly worthwhile, but not *game-changing*.

Unfortunately, this is where the advice from many accounting professionals stops. When asking for advice on how to improve profits, most focus on the cost drivers. The real power lies tucked away in the drivers of sales.

What drives sales?

The famous marketer, Jay Abraham, championed the idea of "*Three ways to grow a business*" which describes a powerful way of looking at how sales are made up. He describes it like this:

SALES = NUMBER OF CUSTOMERS x AVERAGE AMOUNT OF EACH TRANSACTION
x AVERAGE NUMBER OF TRANSACTIONS IN A YEAR

Let's simplify the terminology into this:

SALES = CUSTOMERS x SPEND x TRANSACTIONS

From a marketing perspective, this is very powerful. Most business owners wanting to grow their business focus solely on the first component; winning more customers. And whilst there is nothing wrong with that, it limits what is possible.

For example, let's imagine Eddie wants to grow his business by 10%. He could carry out some marketing activities to win 10% more customers. If he does that, his sales and profits would look like this.

Winning 10% more customers	**Before £**	**After £**
Annual sales	850,000	935,000
Variable costs (*or direct costs*)	357,000	392,700
Gross profit percentage	*58%*	*58%*
Gross profit	493,000	542,300
Fixed costs	460,000	460,000
Net profit	**33,000**	**82,300**

I'm assuming here that fixed costs will not change. However, there are likely to be some additional costs in respect of the marketing, such as advertising or hiring a marketing consultant. Consequently, the impact on bottom-line profit is likely to be a little less.

He could of course achieve exactly the same result if instead he puts some systems in place to increase the amount of money his existing customers spend with him each time they do business by 10%. Increasing the average amount of each transaction has the same impact on sales.

Alternatively, Eddie could implement some strategies for getting his existing customers to buy more often each year by 10%, i.e. increase the average number of transactions in a year.

A 10% improvement in any one of these three drivers will increase sales by 10%.

However, marketers teach us that working on the second of those sales drivers is much easier because you already have an existing relationship with your customers. It's much easier to sell more to an existing customer who knows you, than to acquire a new customer.

The power of synergy

What would happen if Eddie put in place some strategies and systems to increase *each* of those three sales drivers? What if he acquired 10% more customers, and got his customers to spend more each time by 10% and by 10% more frequently?

What would be the overall impact on sales?

Not 10%. Much better than that.

And not 30% either.

It's actually 33.1%.

What happens is each of the drivers interacts with each other and we get synergy. For this reason, you grow your business faster if you make small improvements in all the drivers, rather than focussing on just one thing, like winning new customers.

Putting this together

We now have 5 drivers of profit in our business model:

PROFIT = (CUSTOMERS x SPEND x TRANSACTIONS) – VARIABLE COSTS – FIXED COSTS

This is a much more useful model of a business. But we can take this a step further.

What determines the number of customers you have?

If you want to increase the profits of your business you could focus your attention on the first sales driver, *number of customers*. But what determines the number of customers?

We can break this driver into 3 separate components:

CUSTOMERS =
CUSTOMERS LAST YEAR + (NUMBER OF SALES LEADS x SALES CONVERSION RATE)
– CUSTOMER DEFECTION RATE

In other words, there are 3 things that drive the change in the number of customers:

1. Getting more sales leads (*which is MARKETING*)
2. Converting more of those sales leads into customers (*which is SALES*)
3. Reducing the number of customers that leave (*which is CUSTOMER SERVICE*)

Once again, we can model this mathematically and identify how a change in each of these drivers impacts on profit. A good accounting professional will be able to do this for you.

Why is the price driver different?

The second of Jay Abraham's 3 ways to grow a business is the average amount of each transaction. In other words, what can you do to get customers to spend more money with you every time they do business with you?

This is very powerful.

But to build our mathematical business model we need to break this down into two separate components. Essentially there are two ways of getting customers to spend more:

1. Buy more from you each time (for example, by creating some *up-selling* systems), and
2. Changing the price.

It's important to consider these two separately because they each have a different impact on costs. Buying more of your products or services means variable, *or direct*, costs also go up. Changing price has *no impact on costs*.

This is one of the reasons why, mathematically, price is the most powerful lever in the profit equation. To illustrate, let's go back to Eddie.

Remember, if Eddie wants to grow his business by 10% he could get his existing customers to buy more from him every time they do business. For example, when he agrees the price for doing a film shoot he might then offer some enhancements such as creating a blooper reel, doing a multi camera shoot or something else that enhances the service and increases the order by 10%. This is the impact doing this would have on Eddie's profit:

Customers buying 10% more	**Before £**	**After £**
Annual sales	850,000	935,000
Variable costs (*or direct costs*)	357,000	392,700
Gross profit percentage	*58%*	*58%*
Gross profit	493,000	542,300
Fixed costs	460,000	460,000
Net profit	**33,000**	**82,300**

Notice that these additional sales will increase the variable costs by 10% too.

However, he could instead increase the amount his customers spend by increasing the price. If he does this by increasing average prices by 10%, and assuming no resulting loss of customers, his profit will now look like this:

Increasing price by 10% without losing customers	**Before £**	**After £**
Annual sales	850,000	935,000
Variable costs (*or direct costs*)	357,000	357,000
Gross profit percentage	*58%*	*61.2%*
Gross profit	493,000	578,000
Fixed costs	460,000	460,000
Net profit	**33,000**	**118,000**

Changing price does not impact on the cost structure. The impact on profit is much greater than increasing sales in other ways. The latter increases Eddie's profit by 249.4% to £82,300 which is a great result. But even more impressive is the 357.6% increase to £118,000 by changing average prices.

Not only is the potential impact on profit much greater, it is also faster. In other words, to grow sales using any of the 3 sales drivers takes time. To grow a business by 10% with a focus on winning new customers can easily take a year or more (unless you are a new business Start Up). In contrast, you can change your pricing structure tomorrow.

But there is a big problem

If you put your average prices up by 10% you will lose business. Possibly as much as 10% of customers. And possibly much more.

At least, that's the common reaction.

However, the reality is likely to be very different. In most cases, the number of customers you lose from a price rise is much less than expected. Sometimes it's even no loss of customers. And sometimes it results in an *increase* in new customers.

Of course, you may well be sceptical. And there is nothing wrong with healthy scepticism.

Very often, the number of customers you can afford to lose and maintain profits is higher than you might think. For example, if Eddie increases his prices by 10% and loses 10% of his customers, his bottom-line profit will still increase by £27,200.

Why is that?

With a 10% increase in price and a 10% loss of customers, sales don't change much (they would actually reduce by just 1%). Much more importantly, with 10% less customers to serve, those variable costs also reduce by 10%.

In fact, Eddie can afford to lose 14.71% of his customers and his profit won't change. And that would still be a great result. Making the same profit but with 14.71% less customers, Eddie can work less hard for the same money.

Not only that. Think about which customers leave when you put your prices up. Is it those loyal customers who love what you do, are a joy to work with, give you the most – and most interesting – work and always pay you on time?

No. Those are the customers who will stay with you. The ones you lose are the ones who always moan and complain about your price. They are the ones who pay you late. In short, the customers you hate dealing with.

In contrast, when you cut prices you attract price shoppers. And the problem with price shoppers is, they have no loyalty. They are the first to leave you when someone else cheaper comes along. Here's a simple rule:

Reducing your prices attracts the worst customers

Putting your prices up improves the quality of your customer base

I've shared with you some numbers for Eddie's business. Every business is different. Your business is different. The results you would get depend upon your cost structure. Nevertheless, you can build a mathematical model to describe your business. When you do this, you can see the impact on your profit from making changes to any of these 8 profit drivers.

If you don't know how to build that mathematical model, we will be able to do this for you.

That just leaves one more driver.

The 9th driver

The final driver is a little different, but no less important.

The first 8 drivers can be built into a complex mathematical model; a model that predicts what happens to profit when you manage and change any of the drivers.

The final driver is to systemise everything. To create systems for improving each of the drivers of profits, e.g. customer service systems, selling systems, referral systems, pricing systems.

Quick summary of the 9 drivers of profit

Here are the 9 profit drivers (and the function of a business they fall within):

1. Getting more sales leads (*Marketing*)
2. Converting sales leads into customers (*Sales*)
3. Getting customers to spend more (*Marketing*)
4. Getting customers to spend more often (*Marketing*)
5. Getting customers to remain customers for longer (*Customer Service*)
6. Pricing for maximum profit (*Pricing/Marketing*)
7. Variable costs (*Operational*)
8. Fixed costs (*Operational*)
9. Systemise everything (*Operational*)

Which profit driver should you focus on?

You should work on all of them simultaneously. But if you were to pick one you should always start with price. Firstly, it is the most powerful lever in the profit equation, i.e. it has the biggest mathematical impact on profit. Secondly, it can have an *immediate* impact on profit.

You must also understand how each of the drivers impacts on other elements of the profit equation. Most businesses focus on getting more sales leads and winning more customers. However, if the price is wrong (or by giving discounts to attract new customers) very often this can have a negative impact on profit.

I often come across business owners who are working way too hard, getting very stressed and not making enough money. They think the solution is to win new business. However, the real problem is usually the wrong pricing. If your prices are too low, winning new customers simply compounds the problem… you just find yourself working harder and harder.

This is why pricing is so important. Get your pricing right and you'll see your profits rising significantly. Get it wrong and it's a fast way to go out of business.

You must understand the numbers.

This is why you always start with the numbers before creating your pricing strategy.

What is the right pricing strategy

There are really only two pricing strategies:

- Low-cost leadership
- High-price differentiation

Everything else just falls somewhere in the middle.

In fact, most small businesses don't have a pricing strategy. They often use what I call, *emotional pricing*; reacting to gut feel and emotion rather than the facts. Reacting to what the competition is doing. Pricing based on guesswork, or simply pricing the way it's always been done in the past.

Low-cost leadership

This is a strategy where you make a conscious choice to focus on low prices and undercut the competition. Your goal is to dominate your market with a low price. This can be an effective strategy and we see it executed in businesses such as Richer Sounds, Dell, Ryanair, IKEA, Aldi and Lidl.

The trouble is, you need the right set of circumstances for it to work.

It is very, very rare for this to be a sensible choice. To do this you must have something unique in your cost structure that means that you have lower costs preventing your competition copying your strategy.

So, let's consider the alternative.

High value differentiation

If you don't have scale or capital to dominate your market, you are much more likely to be successful by focussing on a high-margin product or service offering the customer *added value*. The key is to focus on *differentiation* and offering more value. Very often it makes sense to operate in an appropriate niche.

Think about Eddie's business.

Perhaps his current pricing structure has been arrived at by copying his competitors. If instead he realises he has a particular area of expertise which is particularly valuable to some of his customers and he decides to pursue this as a niche, he adds some extra value by repackaging his services and puts his prices up by 25%. He wants to be positioned as the best videographer and now wants to be much more expensive than his competitors.

Eddie analyses his current customer base. He crunches the numbers. He realises from talking to his customers that one category who make up 75% of his sales will value the direction he is going in and the extra value he will add. And 25% are likely to leave.

Yes, that's extreme, and the thought of losing 25% of customers is usually enough to cause a small business owner to have a breakdown. But let's at least see what this might mean for Eddie's profit:

25% price increase and expecting to lose 25% of customers	**Before £**	**After £**
Annual sales	850,000	796,875
Variable costs (*or direct costs*)	357,000	267,750
Gross profit percentage	58%	66.4%
Gross profit	493,000	529,125
Fixed costs	460,000	460,000
Net profit	**33,000**	**69,125**

That could double his profit and some! Surely worth exploring further.

But again, there's a problem I hear. "*I sell a commodity product and it can't be differentiated*" or "*My service is a commodity and it's the same as everyone else*".

You can differentiate anything

Here's an important definition:

A commodity is a basic good used in commerce that is interchangeable with other commodities of the same type; commodities are most often used as inputs in the production of other goods or services. The quality of a given commodity may differ slightly, but it is essentially uniform across producers.

Very often business owners think that definition describes their product or service and they fall into the *commodity trap*. In other words, they believe what they sell is a commodity and therefore must compete on price. However, a product (or service) is only a commodity if you think it's a commodity and you treat it like that.

Ultimately, with creative thinking, anything can be differentiated, and therefore sold at a higher price.

Take lettuce for example.

You can buy a whole lettuce for a certain price. How do you differentiate it? It's just a lettuce.

We know customers want convenience. And many years ago, someone came up with the idea to cut up the lettuce, wash it and put it in a bag. It's still the same lettuce. But people willingly pay significantly higher prices (over 100% higher) per kg of lettuce.

What about water?

Much of the earth is made up of water. It comes out of the kitchen tap and costs almost nothing. Surely, it's a commodity.

Not if you differentiate it by putting it in a bottle, then you can sell it for much, much higher prices.

What about air?

Oxygen is the most abundant element on earth, so surely you can't differentiate it and charge a price for it, let alone a higher price.

And yet companies like oxygenbars.com sell Personal Oxygen Dispensers for $29.99 each. It's a thriving market.

The ultimate commodity

Arguably the ultimate commodity is stocks and shares. After all, a share in Disney is traded on stock exchanges around the world at the same price. How can you differentiate the ultimate commodity, when at any point in time it's the same price around the world?

The website GiveAShare.com does exactly that. You can buy a share in companies such as Disney, McDonalds and Harley Davidson for typically DOUBLE the price listed on a stock exchange. How?

Very simple. They differentiate it by putting it in a frame. You can choose the type of frame. Then you can add an engraved plaque. They've turned the product into something different; a gift. That opens up a new market for people who want to buy shares in iconic companies as a gift for a loved one.

If you can differentiate lettuce, water, air and shares, you can differentiate what you do. So how can you make your product or service different? How can you make it better? How can you make it more convenient? How can you change the way you package your product to make it different? Later in this book we'll look at how you can do this in more detail.

When you differentiate your product from the competition, *customers will pay you higher prices*.

Are you convinced?

If not, we'll look at one of the biggest pricing myths in the next chapter.

It’s all a big lie

When I tell business owners they need to put their prices up they usually say, “*You just don’t understand. My customers are price sensitive!*”

There is a perception that most people are price sensitive. It’s one of the big pricing myths.

There certainly are price sensitive people in society, but it’s much less than you probably think. Estimates by behavioural economists and price psychologists put it at between 14 – 20%. These are people for whom price is the sole determinant of whether to buy or not. For example, the retired gentleman who eagerly awaits his free Sunday paper so he can cut out and collect the vouchers for a few pence off groceries at the local supermarket. Those people who shop in discount stores like Poundland where everything is £1. They are price sensitive.

And if they are your customer segment, then I agree; it is much harder to put your prices up.

However, the reality is most people are not price sensitive. They are value sensitive.

When we buy anything, we compare the benefit we get from that product or service and the cost to acquire it (the price). If the benefit is greater than the price we make a *profit* on the deal. For most people, the size of the gap is more important than the price.

Let’s look at a couple of examples.

Where do you buy your coffee from?

An increasing number of people buy their coffee from chains such as Starbucks, Costa Coffee and Peets. They happily pay £2 - £4 for a coffee. Are they crazy? You can get coffee at a fraction of the price from cheaper independent coffee shops, and even less if you buy instant coffee in a jar from the supermarket.

Of course, they’re not crazy.

I’m not crazy when I buy a Venti Latte from Starbucks. Yes, I pay a premium price. I pay that because there are things about Starbucks I value. I like the taste. I like the consistency. I like the predictability. I like the fact I can sit in Starbucks to work and get access to Wi-Fi. I can get access (at certain tables) to a power supply. I can have a business meeting there. All this adds up to a great deal of value. The benefit to me of getting my coffee from Starbucks far outweighs the price I pay.

I’m value sensitive. Anyone who buys their coffee from Starbucks, or an equivalent coffee chain, by definition, cannot be price sensitive. A price sensitive person would not buy from Starbucks because there are cheaper ways of getting their coffee fix.

Starbucks don’t care because they are not looking to serve that segment of society who are price sensitive.

Do you own an Apple product, such as an iPhone, iPad, iPod or MacBook?

If so, once again, by definition, you cannot be price sensitive. A price sensitive person would not buy an iPhone because you can get a free basic phone as part of a low-price mobile phone contract for a few pounds per month. There are cheaper tablet devices, cheaper MP3 players and cheaper computers.

If you have customers who buy Apple products, or get their coffee from chains like Starbucks, they are value sensitive and not price sensitive.

That doesn't mean price isn't important. Price is always important. But it's only one of the elements of the value equation. There are many other factors determining whether we buy or not.

The harsh reality most business owners are unaware of

The reality is, most businesses that compete on price fail because (a) they don't understand the maths, i.e. how many extra customers you need to win to compensate for lower prices, and (b) in the absence of appropriate pricing knowledge, price strategies and pricing systems they end up in a price war which few people win.

And once again, let's consider Eddie's business.

Imagine Eddie wants to grow his business. He wants more customers. He decides that by discounting his prices and using promotions so his average price is 10% lower, he will attract new customers and grow his market share. He thinks he'll grow his customer base by 10%.

When he crunches the numbers, he will find this:

10% price reduction to win 10% more customers	**Before £**	**After £**
Annual sales	850,000	841,500
Variable costs (*or direct costs*)	357,000	392,700
Gross profit percentage	58%	53.3%
Gross profit	493,000	448,800
Fixed costs	460,000	460,000
Net profit	**33,000**	**-11,200**

Oh dear! That's not good. He's just crashed his profit margins from 58% to 53.3%. And he's killed his profit. He's now making a loss.

In fact, for Eddie to be no worse off financially, he would actually have to win 20.83% more customers to compensate for the 10% price cut. That's a lot of extra business Eddie is hoping to win.

The dangers of discounting

What cost takes up the biggest share of the annual sales of almost every business (and it doesn't appear in your annual financial statements)?

Price discounts.

Annual financial statements for any company report sales *net* of discounts and promotions. That means the cost of those discounts and promotions is often not measured and forgotten.

We saw how reducing average prices by 10% for Eddie could be disastrous. Here's a more high-profile case…

A salutary lesson

1931 was the start of a 77-year period where General Motors dominated the auto industry. They led the world in car sales for 77 consecutive years until 2008 when they fell to second place.

A few years earlier, in the Spring of 2005, business didn't look good for General Motors.

Then the marketing teams at General Motors hit upon a revolutionary idea. They wouldn't just offer the usual discounts or cashback incentives seen in the auto industry. They would offer their vehicles at the deeper discount normally reserved for its employees.

This was launched with much publicity on 1 June 2005 and the promotion continued for 4 months. Rather than the usual quantification of the discount, it declared, "*GM's employee price is what a dealer actually pays for a vehicle*".

Sales rocketed in June 2005 to over 40% of the sales of June 2004. July 2005 was almost 20% up on the previous July. This was such a significant increase in sales the marketing team were applauding themselves for this stroke of genius.

Sales then fell sharply over the next few months and General Motors eventually posted a loss of $10.5 billion.

Just 4 years later, in June 2009, this giant of the auto industry that dominated for 77 straight years, filed for bankruptcy. The discounting didn't increase sales; it simply gave customers a reason to bring forward the purchase of their next car. Just like Eddie in the previous example, they destroyed their margins and killed off profitability.

Discounts are crazy!

You should never crash and burn on price by simply discounting. When you discount you undervalue yourself and you train your customers to haggle. Instead, maintain the integrity of your prices and be prepared to walk away. Discount regularly and customers become trained to wait for the next discount.

Reducing, or even eliminating, discounts can make a very significant difference to profits.

What if your customers only choose you on price?

Unless you really are only serving the price sensitive segment of the market, if your customers choose you on price it's because you haven't given them any other reason to choose you. You haven't made your products or services sufficiently different or better. Customers see you as the same as everyone else, with the only thing that differs being the price – so they'll choose the cheapest price. And that's your fault, because you haven't given them any reason to do anything other than choose the cheapest.

What's more, if customers choose you on price, then they'll probably also leave you on price. In other words, if they choose you solely because you are the cheapest, then as soon as another competitor offering an even cheaper price comes along you'll lose them as customers.

There's a double whammy from competing on price. You make lower margins. And you have less customer loyalty.

Of course, there may be occasions when you want to run promotions and offer discounts. So, let's look at the right way to do that next.

Discounting the right way

In many industries discounts off list prices are the largest single group of costs; a cost which is not shown on a traditional profit and loss account.

One of the biggest problems is discounts being given by employees and sales people indiscriminately. Very often they are given with little or no senior management involvement or authorisation. There needs to be better systems, training and communication.

If you have employees and sales people in your business, make sure you educate them about the profitability levels of different products. If employees and sales people are to have the ability to use discretion to give discounts there needs to be guidance. For example, you might decide that discretionary use of discounts is only appropriate when:

- they are used to up-sell or upgrade customers to a more profitable product,
- part of negotiations to get the customer to say "Yes" only after all other attempts have failed, and
- to win sales away from your competitors.

Discounts should not be given when they are not asked for or expected by the customer.

Significant improvements to profit can usually be achieved by tightening up your discount authorisation procedures.

A better way to profit from volume discounts

Discounts offered to incentivise customers to buy more are popular, and can be very effective. There are essentially two types of volume discounts:

- **Flat rate discounts** (sometimes referred to as *full volume discounts*) are where the discount is applied to the entire purchase, and
- **Stepped discounts** (sometimes referred to as *incremental discounts*) are where the discount only applies to the additional volume.

Consider this example for a product priced at £100:

		Flat rate discount		Stepped discount	
Discount	Applies…	Revenue	Average price	Revenue	Average price
0%	Up to 99 units				
10%	From 100 units	£9,000	£90	£9,000	£90
20%	From 200 units	£16,000	£80	£17,000	£85
30%	From 300 units	£21,000	£70	£24,000	£80

If a customer buys 100 units they get a 10% discount under both types, reducing the price from £100 to £90.

If they buy 200 units, under the flat rate discount they receive 20% off the entire purchase bringing the price down to £80. And if they buy 300 units, the discounted price becomes just £70.

However, with a stepped discount, if the customer buys 200 units they pay £90 for the first 100 units and £80 for the second 100 units, which is an average price of £85. And if they change their mind and increase their purchase to 300 units, the 3rd lot of 100 is priced at £70 bringing the average price they pay for the 300 units down to £80.

Let’s consider the impact on sales and profits if a customer buys 300 units.

Under the flat rate discount the 300 units are all sold at a discount of 30% bringing the price down to £70 and total sales are therefore £21,000. With a stepped discount the average price is £80 and so total sales is £24,000. The £3,000 difference in total sales may seem small.

However, you should consider the impact on profit. Let’s assume that the variable costs are £60 per unit. If someone purchases 300 units the variable costs are £18,000 resulting in a total profit of £3,000. But if we use the stepped discount *profit doubles to £6,000*.

What looks like a small difference in the discount structure, in this instance, actually *doubles* profits. You should choose stepped discounts whenever possible. They encourage people to buy more and often work out cheaper.

Quick summary

Many businesses struggle and ultimately fail because their pricing is wrong. Price is the most powerful lever in the profit equation.

Most times, pursuing a high-price discrimination strategy is preferable to low-cost leadership. This is, in part, because most people in society are value sensitive, and not price sensitive.

We’ve looked at the potentially calamitous impact on profit of indiscriminate discounting and that you should either stop discounting or discount strategically.

In short, you should consider raising prices, rather than reducing. In the next chapter, we’ll explore the issue of raising prices.

How to put your prices up the right way

When you look at the most successful businesses in any sector, whilst there may be one or two that are successful using a low-price strategy, the majority are premium high-priced businesses, such as Apple, Starbucks and Disney.

Despite that, and even if you acknowledge that most of your customers are really value sensitive as opposed to price sensitive, you might be thinking, *"If I put my prices up I'll lose customers!"*

Not necessarily.

Why the concept of incremental irrelevance will instantly increase profits

Think of one of your favourite products. Perhaps it's your iPhone, or your favourite bottle of wine. How much does it cost?

Before reading on, stop and think about this.

Write down one of your favourite products.

Next write down its current price (or at least your best guess).

Finally, write down what the price would be if it increased by 1%.

For example, if one of your favourite products is your iPhone and it currently costs £689.00, then a 1% increase in price would make the new price £695.89. Or perhaps you were thinking about your favourite bottle of wine. And if it is currently £7.49, a 1% increase in price would raise it to £7.57.

What are the numbers for your favourite product.

Don't continue reading until you've done that.

Here's the important question. Ask yourself, if tomorrow the price rises by 1% to the new price you've written down, would you still buy your favourite product? Or would you switch?

The answer for the vast majority of people is likely to be "No". It certainly is when I've done this in seminars and workshops.

Why is that?

When a product or service is valuable and of high quality you won't switch for a tiny 1% increase in price. 1% is such a tiny change in price. It's likely to be less than inflation. It's *irrelevant*.

Think about your product or service. Is it good quality? Do your customers like it? If so, chances are they wouldn't switch either if you put your prices up by 1%.

So, if that's the case, why not put your prices up by 1% immediately.

Putting your prices up by 1% is likely to have no impact on your customers buying choices. And yet the impact can be significant.

Let's take Eddie for example. If Eddie decides to put his prices up by 1% on average, his net profit increases by 25.8% from £33,000 to £41,500:

1% incremental price rise	**Before** **£**	**After** **£**
Annual sales	850,000	858,500
Variable costs (*or direct costs*)	357,000	357,000
Gross profit percentage	58%	58.4%
Gross profit	493,000	501,500
Fixed costs	460,000	460,000
Net profit	**33,000**	**41,500**

What would be the impact on your business from a tiny 1% increase in average price? Probably a worthwhile amount.

What if you increase your price by just 2%?

If you could do that, and not lose any customers, the impact on your profit is much bigger still. Eddie could potentially increase his profit to £49,000.

What about 3%, or even 5%. How much can you increase your average price before you start to see a reduction in sales quantity or number of customers?

You will never know unless you test.

Of course, there's a limit isn't there? If you put your prices up by 20% you definitely will lose sales volume.

Or will you?

Raising prices doesn't always mean you lose market share

People often use price as a short cut in assessing quality. A high price is an indicator of quality. Sometimes, raising the price impacts on the customer's perception of quality. Since most people are value sensitive rather than price sensitive, an increase in the perception of quality, brought about by a price rise, can result in an increase in sales volume. That's why you see premium companies like Starbucks and Apple with high market share.

Customers use the price as an indicator of the product's quality. Sometimes this is referred to as the *prestige phenomenon*.

If you can achieve this, the impact on profit is considerable. Let's consider Eddie's videography business again. Eddie decides to re-design his logo, website, packaging and promotional material to suggest higher quality. He reinforces this with a 10% price rise. He is now an attractive option to those higher quality customers who previously dismissed him as *cheap and cheerful*. As a result, he grows his customers by 10%. This is what his profit would look like:

10% price rise: re-positioning attracts 10% more customers	**Before £**	**After £**
Annual sales	850,000	1,028,500
Variable costs (*or direct costs*)	357,000	392,700
Gross profit percentage	58%	61.8%
Gross profit	493,000	635,800
Fixed costs	460,000	460,000
Net profit	**33,000**	**175,800**

That’s a huge increase in Eddie’s profit.

When your competitors are cheaper

Pricing is always complicated with the presence of competitors. You have to consider the quantitative effect on your sales arising from any change your competitor might make to its pricing, and how a competitor will respond when you change your pricing.

If your competitors are cheaper than you there are two things you can do. One of the two is smart and the other is usually stupid.

The stupid thing is to try to compete with them on price – by cutting your prices and perhaps even starting a price war. Unless of course, this is your pricing strategy. But as discussed already, it is very rare that this is an appropriate strategy for an accountancy practice.

The smart thing to do is not to even try to compete on price and pursue a pricing strategy of having a highly differentiated service that adds value, so that you can charge a premium price.

If you choose the smart route – not to compete on price - then you will need to master one of two key skills… and preferably both of them:

- You will need to prevent your customers worrying about your higher prices
- And you need to become much better at justifying your higher prices – in other words, much better at handling price objections.

Strategies for beating the price crashers

The guiding principle is simple… if two competing products are the SAME then customers will choose the cheapest. But if one of the products is *different* and *better*, then customers will pay more for it.

Always remember, the right customers will gladly pay more when they understand that they are getting more. The general rule is:

- Most people don't really buy on price
- They *say* they do… but that is only a ploy to get you to reduce your prices
- Don't fall for it!

Of course, there are some people who are price sensitive. You may even have some amongst your customer base. Here are some of the characteristics of genuine price buyers; they:

- Do all the complaining,
- Take up lots of your time,
- Tell others how little they have paid,
- Leave when they get a cheaper offer, and
- Forget to pay you.

The key advice is: *avoid them wherever possible*.

A strategy for getting higher average prices

Let's start with one of the most profound principles in the field of pricing. And that principle is, *different customers value things differently.*

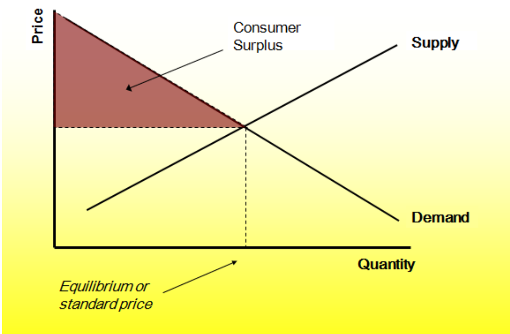
We all value things differently. We all have a different perception of the value of any product or service. So, we all have a different maximum amount we are willing to pay for a particular product or service. Economists call this the *buyer's reservation price*. And your goal is to set your price as close as possible to each buyer's reservation price.

"So what?" you might be thinking.

Well, this seemingly tiny observation has a profound implication. You see, it means that if you currently have a single price, that price is *wrong*!

Having only a single price causes you to lose out in two different ways. For some customers that price is too high – so they don't buy, and you lose them as a customer. And for other customers that price is too low – so you end up charging them less (and earning less profit) than they are willing to pay. Which means you lose again.

Economists call the amount by which you lose in this second scenario the "Consumer surplus" – and it is shown by the shaded area on the supply and demand diagram you can see below.



One of the keys to dramatically improving your profits is to claw back some of this 'consumer surplus' by charging different customers different prices. But how?

Well, the good news is that there are many ways of charging different customers different prices, and we'll look at some of them in this chapter.

But first let's look at some numbers to illustrate the power of this concept.

Example

Imagine that one of the services Eddie offers is to film a promotional video to be used in a Facebook Ad. Eddie normally charges £1,000 for this service and his variable costs are £420. There are three potential customers: A, B and C.

- Customer A is willing to pay £2,000,

- Customer B is willing to pay £1,500, and
- Customer C is willing to pay £1,000.

With Eddie's current single price at £1,000, then all three potential customers will gladly pay him that amount. So, he'll make total sales of £3,000 and total profits of £1,740:

Single price of £1000	Quantity sold	Revenue	Cost @ £420 each	Profit
Customer A	1	£1000	£420	£580
Customer B	1	£1000	£420	£580
Customer C	1	£1000	£420	£580
			Total Profit =	**£1740**

Of course, Eddie could set his single price at £1,500, so Customer C won't buy. But the other two will gladly pay you £1,500 each. Again, he'll make total sales of £3,000 again, but this time his total profits are £2,160:

Single price of £1500	Quantity sold	Revenue	Cost @ £420 each	Profit
Customer A	1	£1500	£420	£1080
Customer B	1	£1500	£420	£1080
Customer C	-	-	-	-
			Total Profit =	**£2160**

There is a third option for Eddie. He could set a single price at £2,000, which only Customer A will buy. Then his total sales will be £2000 and his total profits will be £1580:

Single price £2000	Quantity sold	Revenue	Cost @ £420 each	Profit
Customer A	1	£2000	£420	£1580
Customer B	-	-	-	-
Customer C	-	-	-	-
			Total Profit =	**£1580**

For Eddie, a single price of £1,500 is the best price. This price generates more profit than either £1,000 or £2,000 for his video shoot. I call this the *Magic Price;* the price at which you make the most profit. We'll come back to the concept of Magic Price later.

This will increase your profits substantially

Unfortunately, if Eddie sets his price for doing filming a Facebook Ad at £1,500, even though it's the *Magic Price*, he is leaving money on the table. We know that: Customer A is willing to pay £2,000, Customer B is willing to pay £1,500 and Customer C is willing to pay £1,000.

So, if instead of charging those three customers all the *same* prices, we charge them the full price they are willing to pay (their buyer's reservation price), then Eddie's total profits will increase significantly:

Different prices	Quantity sold	Revenue	Cost @ £420 each	Profit
Customer A pays £2000	1	£2000	£420	£1580
Customer B pays £1500	1	£1500	£420	£1080
Customer C pays £1000	1	£1000	£420	£580
			Total Profit =	**£3,240**

If Eddie simply sticks to his *old* price of £1,000 per customer his profit is £1,740. If he changes his price to the *Magic Price* of £1,500 his profit increases by 24.1% to £2,160. But if he can find a way to charge each customer the maximum price they are willing to pay, his profit increases by 86.2% to £3,240.

If these 3 potential customers are representative of Eddie's customer base, i.e. a third of them would willingly pay an extra 50% and another third were willing to pay double, so that he is able to increase his *average* prices by 50%, then his profit will change as follows:

Charging each customer their buyer's reservation price	**Before £**	**After £**
Annual sales	850,000	1,275,000
Variable costs (*or direct costs*)	357,000	357,000
Gross profit percentage	58%	72%
Gross profit	493,000	918,000
Fixed costs	460,000	460,000
Net profit	**33,000**	**458,000**

That's an extraordinary increase in profit. And yes, it's extreme (finding a way to charge every single customer their buyer's reservation price is not simple). I've also kept the numbers as simple as possible and yet, the real world is much more complicated.

But those complications do nothing to alter the fact that if you can find a way to charge different customers different prices – so that they each pay the maximum price they are willing to pay – then you will *always* make more profit than you do by using any single price, even if that single price is your Magic Price.

Charging different customers different prices *will* increase your profits… and probably by a lot!

Why you root everything back in numbers

We started off this eBook by looking at the 9 drivers of profit and the importance of understanding the business model. Hopefully you can now see why price is the most powerful driver of profit. You must understand the numbers behind your business and the business model. And with pricing, you should always *test* and *measure* to see what works, and what doesn't.

What next?

Price is just a number and an important part of the profit equation for your business.

The trouble is, the field of pricing is still relatively new. Much of what we know about pricing has only been discovered in the last few decades from the study of price psychology, and even more recently, behavioural economics.

Nobody understands the numbers behind a company's set of annual financial statements and management reports the way accountants and some bookkeepers do. And since price is just another number it makes sense that the accounting profession is the obvious place to look for help with pricing.

Unfortunately, most accountants and bookkeepers are very traditional. They still just add up the numbers and file the accounts, tax returns and other statutory reports. And that's OK for business owners who only want that stuff doing.

However, there are ambitious business owners wanting to grow their business. So, we specialise in helping those people build more profitable and successful businesses. Since price is the most powerful lever in the profit equation we have invested in training, knowledge, resources and tools to become one of the world's leading accounting firms helping businesses tackle the challenges of pricing.

How can we help you?

We are the numbers experts. We work with numbers every day. And one of the key numbers in any business that they specialise in is the price number.

Using our skills with numbers we will help you analyse your business model, understand different price points and identify a pricing strategy that will maximise your profits. Some of the things we do include:

- Identifying a price strategy that will enable your business to grow more profitably,
- Establishing price points that will yield greater profit,
- Presenting your price in a way that is more appealing so that more people say, "Yes" and buy from you,
- Building in payment structures that reduce cash issues, and
- Making your price seem smaller than it is using the power of price psychology.

The bottom line is, you will make more sales and at higher prices, your profit will grow and you will have more cash in the bank.

A great place to start

If you just want to dip your toe in the water and don't want to commit to a full consulting programme, or even just want pointing in the right direction, ask for a pricing strategy session. It's a great way to get started.

This session typically lasts a couple of hours, can be delivered online, and we will:

Carry out an initial assessment: To get a better understanding of your business and a clear picture of where you are now. This includes the most important numbers in your business and what those numbers are now. This process will give you greater clarity on where you and your business are.

Possibility analysis: Using our skills with numbers we use *'what-if analysis'* to identify possibilities and your potential. At the end of this stage you will have a clear picture of how much profit your business should be making.

Strategic pricing options: Once we understand what is possible we will identify some initial pricing strategies you can implement quickly and get a result, fast.

Prioritised pricing action plan: At the end of your session we will summarise the key actions identified. You will have a clear picture of what you need to do next, how to do it and when to do it so you can achieve the results you want.

Of course, this is just a starting point.

You can participate in our pricing training programme or ask us to help you create pricing systems within your business. Here is a quick overview of the sort of things we are likely to cover within our pricing training programme.

Pricing training programme

The programme takes you through a structured approach to your pricing giving you the knowledge and skills you need to price more effectively. This is how the sessions might unfold:

Your price discrimination strategy

Different customers are willing to pay different prices. For this reason, if you don't use price discrimination you are leaving money on the table. In this session, we'll take you through all the price discrimination strategies and identify the ones that will work best for your business. An effective price discrimination strategy often results in an *average price increase of 20% or more*.

Building your value

The two big reasons why people think price is too high are either there isn't enough value or they don't understand the value. In this session, we explore both of these. You will discover ways to first create more value (which means you need to explore the components of the value equation). Then we explore techniques for educating your customer so they understand the value and are much more willing to pay a higher price.

Presenting your value

The way you present your solution (product or service) is critical. This session picks up where the last one left off and you'll discover ways to reveal your offerings. You'll also discover how to construct better payment terms. Why? Payment terms are part of the pricing equation and there is some interesting price psychology that means you can use payment terms to get more sales, and put more cash in your bank account.

Formulating your price

The first three sessions are all about building your value in your customer's mind so they want to buy. The only thing stopping them saying, "Yes" is the price. So now you need to look at the numbers. How do you arrive at a price that will maximise your profit? And how do you present that price to the customer in a way that maximises the chance of them buying?

How to make your price seem smaller than it really is

Session 5 is where everything is taken to another level. This is where we explore in detail price psychology. We work together through dozens of techniques to identify ways of expressing your price so that it seems much less than it really is. Techniques such as:

- The power of 9,
- The power of 7,
- The contrast principle,
- Don't reveal the headline price,
- Left digit management,
- When to use verisimilitude,
- The price-order effect,
- And much, much more

Your power strategies

In this final session, everything will be pulled together and improved further with the *power strategies*; tools that will take your pricing to yet another level. When you implement what you have learned across these 6 sessions you will be able to increase your average price considerably (many businesses increase average prices by 20 – 50% using these ideas).