Substantiation of Price Decisions in a Crisis Context

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Abstract

In this article the authors aim to address key issues regarding pricing decision substantiation in a crisis context and to create an overview of the elements that should underlie such substantiation. We can say that making price decisions is both a science and an art, based on precise calculations and sound economic reasoning.

But, especially in a crisis context, such reasoning and calculations should not exclude intuition, flair, hunches, and experience and so on, all instruments belonging to the art of management. A solid reasoning assumes that those involved ask the right questions and understand all the factors that determine the success of some price decisions and failure of others.

Keywords: *relevant costs, irrelevant costs, perceived value, total sacrifice, price war.*

JEL classification: D23, D24, M21.

Introduction

Lately there is more and more talk, especially in our country, that the lack of economic performance has its justification in the absence of relevant strategies or their rightful application where they exist. The practical approach to strategy formulation, given the company's mission, should be based on the main strategic objective that has to be achieved through that particular strategy; this main strategic objective is different from one company to another, even competing companies, and different even for the same company from one period of time to another. Companies can have very different strategic objectives; we can have profit-oriented objectives (profit maximization, which is the ultimate goal of any economic company, obtaining a certain level of short-term profit), sales-oriented objectives (getting a certain amount of sales, reach a certain market share), objectives such as

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company survival (especially in a crisis or fierce competition context), market dominance through product quality, and others. But, whatever the targeted strategic objective, price plays a decisive role in achieving it and, in general, in the success of the company's strategy, not few being the cases where the wrong price decisions have undermined the overall company's strategy.

1. Price impact on the company's strategic objectives

If we take into consideration the primary objective of any economic company, which should be profit maximization, the factors influencing its size are: cost, price and sales volume. Of these three factors, price is par excellence the primary factor. Today, after the companies have minimized their costs and made their sales force a primary weapon, they started showing growing interest in the possibilities offered by prices.

In the competitive environment, price is always perceived as a source of problems: customers complain that it is too high, competitors use it as a competitive weapon to gain market share and distributors exert a high pressure on it, all inevitable courses of action given modern competition.

The question that arises is: what should be the price of a product for the company to be competitive on the market? There is no accurate method of pricing that ensures sustainable success in the market, but the fact is that the price must be set taking into account the following main factors: the company's marketing objectives (which derive from the fundamental objectives of the company), the demand and supply, production and sales costs.

The clearer a company defines its marketing objectives; the easier it is to make its price decisions as well. As previously stated companies can have very different strategic objectives, but a profitable price, taking into account any of these objectives cannot be determined from a simple mathematical calculation of costs, given that it is not known how customers will react to it; it cannot be determined according to customers either, as long as competitors' reaction cannot be predicted; and it cannot be determined taking into account both customers and competitors either if the company's objectives cannot be achieved. Therefor, none of these factors can be determined regardless of the others, making price decisions very complicated and subtle, given their multiple effects. We can say that pricing is both a science and an art, based on precise calculations and solid reasoning, which, especially in a crisis context, should not exclude elements based on intuition, flair, hunches, experience and so on, all instruments belonging to the art of management. A solid reasoning assumes that those involved ask the right questions and understand all the factors that determine the success of some price decisions and failure of others.

It is obvious that the price level directly determines the margin that the company can obtain, a higher price increasing the margin that each sold product gets us, but price increases will almost always cause a decrease in sales volume, which can adversely affect the level of profits. Also, price affects costs; for example, a price reduction may result in an increase in sales volume and, ultimately, total cost per unit reduction due to economies of scale and the effect of experience.

We have to note that a price cut, even an insignificant one, may substantially reduce the obtained margin, which in turn requires a considerable increase in sales to maintain the same level of profit; conversely, a slight increase in price can lead to a strong improvement in margins and profit, despite a significant reduction of sales volume. If in a context of economic growth such an opportunity can be seized by a company in order to increase its profit (as long as it accepts the risks arising from a course of action or another) in a crisis context making the decision on price adjustment becomes more complex, since we are facing a lot more uncertainty elements and aspects of cognitive dissonance are more emphasized. As we know, "the economical risks are determined both by the organisations' context evolutions and the quality of its economical activity" (Radu & Simion, 2009).

The reasoning that if I don't gain from volume, I have to gain from margin and vice versa is no longer valid in a crisis context, confirming this reality!

Also, the price impact is not only stronger, but also we can feel it much faster compared to other components of the marketing mix. For example, the performance of an advertising company or a new product policy must be evaluated over several months or even years (if a new product policy), however, the effects of price changes can be expected within days or even hours (Simon, et al., 2006).

Moreover, the price is the only element of the marketing mix that brings revenues; all other components of the said marketing mix require additional expenditures or prior investments. Given this fact, the marketing mix's optimization is always possible, especially in situations where we have limited financial reserves or situations of economic and financial crisis. Advertising, research and development for product enhancement require massive expenses and investments that often companies cannot afford to undertake, and even if they would undertake the, their results would materialize only after a while.

2. Cost information in making the price decision

According to experts in marketing, production and sales cost should never be a determining factor in pricing, but still it will play a critical role in making a decision on price, since this kind of decision is always related to sales volume decisions and sales volume affects production and sales costs. It is a known fact that the price buyers are willing to pay for a product or service is not related to the supplier's costs, but equally true is the fact that the supplier's decisions regarding what to produce and in what quantities depend heavily on production and sales costs. Any company wishing to establish a price that on the one hand covers all production and sales costs, and on the other hand, that makes a profit worth the assumed risks. We could say that the production and sales cost represents the price's lower limit.

No one can effectively determine prices without firstly understand costs; understanding costs are probably the most challenging aspect of pricing. Understanding costs means more than knowing what they amount to. It is very easy for the CEO of a company to know what the total cost is and what it's made of (raw materials, wages, overhead costs, and so on), All it takes is for him to request this information from the economic manager, but understanding the costs involves much more than knowing what they amount to, respectively knowing how they will change and the impact on profits arising from decisions establishing or amending prices (Deac, 2009).

In our opinion, for business management production and sales costs typology is very different from the theoretical perspective of political economy or from the rigid accounting perspective, in terms of establishing prices; here, costs gain a totally different meaning.

Within a company there are a variety of cost categories, but not all of these are relevant for each decision establishing or amending prices and therefore the first step to establish price is to identify the relevant costs, i.e. those which have an impact on profit. This is especially important given the wide range of costs within a company and the multitude of classification criteria (variable/fixed costs, direct/indirect costs, production/administration/sales costs, simple/complex costs, preliminary/operating/anticipated costs), and also the many costing methods (absorbant methods, partial methods, plot-effective methods, advanced costing methods).

To further "complicate" this array, based on the relevance of the various cost categories for price decisions, we should only consider one cost classification, above those already entrenched, that being relevant/irrelevant costs (Deac, 2009). Basically, identify all costs that may be included in these two categories of costs can be quite difficult, involving analysis and solid reasoning.

For example, if a decision to reduce the price in order to exploit an opportunity to increase sales volume implies an increase in production capacity, fixed costs driven by the new capacities will become relevant cost when deciding if the firm can lower the price in a profitable manner; typically, a company's fixed costs are considered irrelevant.

An often overlooked opportunity in using cost as an advantage over competition when it comes to pricing is the provided opportunity to better manage the cost structure of the company. In situations in which a company has more than one cooperation relation in order to manufacture its products, with other independent companies or divisions set up as profit centers of the same company, that set the price of products going from one to the other, it may be less competitive and profitable in terms of price than competing vertically integrated companies (Nagle & Hogan, 2008). Consequently, a price maneuver made by a company in the sector may be perfectly valid in terms of profitability to the concerned company and completely uninspired to other competing companies whose cost structure is different, due to varying degrees of cooperation in production. For companies with a high degree of cooperation in the manufacture of their products (such as car manufacturers, for example Dacia Mioveni, which cooperates with more than 70 suppliers of parts, assemblies and subassemblies), the price of all different parts inputs, assemblies and subassemblies are considered variable costs, and also relevant costs in substantiating price. But these costs, in fact, contain the fixed costs of companies from which the inputs come from and their profits, which are often relevant in terms of price substantiation.

Different degree of cooperation of companies from the same sector ultimately translates into a different cost structure, i.e. a high proportion of variable costs and low fixed costs for companies with a high degree of cooperation, unlike vertically integrated companies, where the situation is reversed.

This different structure determines completely different responses to a price change decision.

3. Price and purchasing behavior of customers

Typically, consumers can find a wide range of products that would satisfy a particular need. How do they choose between these products? Let's say you build a house and you have to choose its heating system. This need could be met by a variety of products, from classic wood burning stoves to boilers with different fuels (solid, liquid or methane gas) or even solar or wind powered systems. All these respond to the basic need (to produce heat), but in addition to this need, each responds to other needs too: desire for greater comfort, greater safety, lower operating costs, protection of the environment. Each chosen solution meets these needs differently: the classic wood stove will provide less comfort (must buy wood, fuel it, to remove ashes, and it pollutes the environment), but is much cheaper than a solar heating system (which provides comfort, protects the environment, but it is not functional in sunless periods and, in addition, is very expensive). The choice will vary from buyer to buyer depending on the value they each perceive, taking into account these needs and product price.

Analyzing price according to the purchasing behavior of customers, we can define it as the total sacrifice the customer agrees to make in order to purchase a product or service, taking into account that the customer systematically compares this sacrifice with the value he assigns to the product he wants to buy (Deac, 2009). Price and perceived value are the two major foundations of all economic transactions. This client consented total sacrifice has an objective side (we can talk about economic sacrifice), but also a subjective side (we can refer to a psychological sacrifice also). The economic sacrifice consented by the customer represents all the incurred costs for obtaining and using the product, meaning: the purchase price of the product, additional commissioning costs (transport, handling, installation) and its operating costs (maintenance, repair, failure or poor performance risk contingencies). The psychological sacrifice is unquantifiable, but has a huge impact on purchasing decisions in some instances, and it’s given by the state of discomfort (cognitive dissonance) that the buyer may have when deciding to purchase a product whose performance falls short of the initial expectations (i.e. since no brand is perfect, customers get to be unhappy with some shortcomings of their brand choice and become even unhappier that they lost other benefits of brands they did not purchase) or, for various reasons, has to give up other products or options that he could spend the money at its disposal on, a particularly important aspect in a crisis context.

Therefore, for the consumer price is rather an element of cost, and the said consumer is constantly searching for ways to minimize that cost. Consequently, faced with several options, the customer will prefer the product that gives the highest net value, the biggest difference between perceived value and actual purchase price. If production and sales costs mark the minimum price, customer perceived value marks the maximum price. The concept of "customer perceived value" refers routinely to all economies, gains in value, benefits or satisfaction that a buyer obtains as a result of purchasing a product. Practical understanding by the manufacturer of how buyers perceive product value while using it is a very complex and difficult issue, requiring detailed information about the product users. We note that the "benefits" of the product, underlying valuation are both quantifiable and measurable and quantifiable, less tangible, something that raises more problems in quantifying the value (in terms of buyer). Given this, a first step in establishing the value is the correct identification of all factors that influence it. The range of factors that influence perceived value is very large and they can be classified into two broad categories (Deac, et al., 2010).

a) Objective factors

Included in this category are those objective needs of clients on which the manufacturer's product could have a direct impact, such as: increased productivity, savings for different cost categories (energy, fuel, raw materials, labor, and maintenance), greater reliability, additional necessary attributes, time savings and so on. This applies in both cases where consumers are legal persons, with regard to individual consumption goods (e.g. consider refrigerator brand X has a higher perceived value and the customer is willing to pay a higher price because it has lower power consumption, higher reliability and a three year warranty) and in the cases of industrial goods (industrial equipment, raw materials) bought by companies (they buy the Y machine which has a higher price because it also has a higher yield and will reduce labor costs, or buy alumina from the Z supplier although the price is higher because they will also make larger electricity savings). In this category we also list cases in which the manufacturer's product will be incorporated into the buyer's product, which gives it a higher value, since it offers the latter the opportunity to raise prices and thus profits (e.g. Intel sought by all means to convince buyers that their microprocessors are really the best. In this respect, they subsidize advertisements for PC manufacturers bearing the label "Intel Inside", in order for every buyer to be convinced that his PC has an Intel microprocessor; PC manufacturers claim that through this advertisements their product value and advertising effectiveness increased) (Kotler & Armstrong, 2007).

These objective factors are especially encountered in the case of products that focus on their functional side. Generally manufacturers seek to quantify the value conferred by these factors to their products, given the belief that they only sell to the customers product attributes and that superiority offered by these attributes is critical and important to consumers, which recognize this fact and consequently are willing to pay for it.

b) Subjective factors

In this category we have factors that determine the spiritual, psychological value, factors we find in the case of products focusing on the emotional side (comfort, pleasure, safety, satisfaction, status, prestige and so on). In practice they are very difficult to measure and quantify, if not impossible; they represent natural extensions of client objectives (e.g. we can describe and even strictly measure the technical characteristics of a luxury car, but it is impossible to determine which of them are relevant to a particular customer).

The subjective factors differ from client to client, whatever is natural or normal for one client, can have no justification for others (if an individual considers that paying 20,000 euros for a mobile phone is normal, because he wants to impress his friends and business partners, projecting a successful man image, for other individuals this may seem like something extravagant).

Typically, the value created by these subjective factors, more present in the case of reputation (luxury) products is much higher, aspect that is very well exploited by the seller in order to raise prices and thus profits.

By exploiting these psychological factors, companies are really seeking to attract buyers through emotional involvement at the expense of functionality. A typical case is that of Starbucks, which in the late ‘80s began to turn coffee from a functional product used pursuant to a routine habit into an emotional experience or what consumers called “created coffee oasis”, selling the concept of “place of coffee consumption” or coffee shop. These coffee shops offered not only good coffee, but a pleasant meeting place, a certain status, relaxation and conversation. Starbucks has turned coffee into an emotional experience, and ordinary coffee consumers into “coffee connoisseurs”, for which a three-dollar cup price seemed reasonable. Thus, the Starbucks became national brand in the USA, earning five times the industry average margin (Cârstea, et al., 2002).

What Starbuks did for coffee, Swatch has done for ordinary watches. Long regarded as functional items, these watches were bought simply to keep track of time. Citizen and Seiko, industry leaders, were competing on the advance in terms of functionality, using quartz technology to improve the precision or electronic display (which is easier to read). Swatch exploited the emotional side and turned these watches into fashion accessories. This practice was then copied by other companies in the sector (think of the famous diamond watches worth tens of thousands of euros, considered true jewels), or in other sectors, most recently in the mobile industry, starting with the famous outfit assorted mobiles all the way to the diamond ornated ones, which are worn as accessories.

Very few industries are better oriented towards the emotional attraction, exploiting subjective factors, than the cosmetic industry. This industry sells brilliance and beauty, hopes and dreams, as much as it sells products. On average, packaging and advertising costs account for 85% of companies’ total costs in this industry.

In addition to these two main factor categories, we can name other factors influencing perceived customer value. The better the buyer is informed and better acquainted with the product the lower perceived value gets, and the said buyer is willing to pay a lower price (e.g. you can sell a tablet at a much higher price to an uninformed customer that knows he will make a good impression by showing his tablet, since it is fashionable to own one, than to an IT specialist).

If usually the price you pay on a bottle of water is 2 RON, for the same plain water you would be willing to pay even 10 RON or more if you would find yourself thirsty on a desert safari, or in an airport waiting for the plane, or in a club and so on. In such situations, although the seller knows that the perceived value can be very high, he is aware that he cannot ask for a price as high as that value, since few people would be willing to pay that price. Buyers know they are never required to pay the full value they perceive, always aware that competitors will come up with a better offer or, if we consider some of the presented situations, that if they wait a bit more, alternatives will appear, some of them much better.

But equally true is the fact that in situations where the acquisition involves spending other people's money (usually legal persons), buyers are not as motivated to search for the best deal as in situations where their own money is at stake.

Moreover, if we consider a crisis context, like the one we are going through now, the above-mentioned items related to value acquire new meaning. Customers seek better information, negotiate harder, show greater caution, establish their priorities better, and so on. If customers understand product value correctly and in a normal context would be willing to pay the price required by the buyer, in a context of economic crisis this sacrifice may be considered by some clients as too high and therefore they would stop buying the product, although the price is lower than the usual one. Thus, the notion of maximal price depends on the context, situation and on every client too, customer diversity resulting in market segmentation in order to suit customer groups, price differentiation on each segment and variable prices according to context. Also, the perceived value concept suggests that the price must be determined dynamically, it varies over time and depends on the maximal price each customer is willing to pay.

Given the above, it appears that the biggest challenge for a manufacturer, in a crisis context, during the price decision making process is finding and understanding that "something" which creates value for individual customers (that something can be economical/social/psychiological in nature) and setting price in accordance to this value, so that it will be best exploited.

4. Competitors' impact on price decision

In a strategic pricing initiative we should always identify competitors in view of their membership in the strategic sector of the company (Chetochine, 1997).

In the case of a price reduction from a company where successive similar reactions from competitors occur, we may be facing the risk of starting a **"price war"**. All industries and all markets can be the scene of a "price war", but studies have revealed that insufficient capacity of production and product simplicity are by far the most frequent causes of a “price war”. Besides these two main causes we can point out other objective (have economic justification) and subjective (purely psychological) causes, namely:

- high price elasticity: reducing the price, a competitor can hope to win a short-term competitive advantage;
- different production costs: competitors that have lower production costs and consequently higher unit margin (or a favorable cost structure) may be tempted to use this additional leeway (or favorable cost structure) to apply an aggressive price strategy;
- very ambitious targets: companies whose goal of increasing market share is very high, but have no real competitive advantage often resort to the “price weapon” to achieve these goals;
- aggressive personality (e.g., aggressiveness of the U.S. airlines managers played a key role in the “price war” in the early ‘90s).

The main task of management is to understand the requirements of starting a “price war”, but also to identify levers that can be used to achieve their desired objectives given the competition. For this purpose it is necessary to correctly anticipate the effects of different pricing strategies used by the company not only on their own sales volume, market share, costs and final results as well as their competitors’. Depending on how these factors are influenced competitors will react one way or another. The place that a company will occupy against its competitors is determined by the strategic competitive advantages that the company will be able to develop, or price can seldom be an element of strategic competitive advantage (Trout, 2006). A price lower than the one of the competition or a price reduction, either explicit or disguised in various forms (rebates, promotions, longer payment periods and so on) can provide an immediate increase in sales and profits, proving itself an effective tactical maneuver in the short term, but cannot be a successful long-term strategic approach inevitably leading to a deterioration in profitability of the sector. Pricing competition is usually a “negative sum game” and the more intense it is the further it undermines the value of the market on which this competition takes place.

And a request to raise prices in a crisis context is much less desirable, representing a suicidal act for a company, something highlighted in a study by Dan Orenstein, an expert in finance and taxation, study which analyzes the results of 304 companies (which made in 2011 a turnover of 109 billion euros, or almost 88% of Romania's GDP); the study shows that the biggest mistake committed by the managers of many companies at the beginning of the crisis has been the price and margins increase in order to offset the decrease in sales. With increased prices, without a restructuring of the business, many of these companies have been at a loss in 2011 and continued to make losses. The study shows that there were companies that, although prices increased, remained profitable in the long run, this being due to the high degree of market penetration and consumer dependency of their products and services.

Conclusions

Integrating aspects of competitive responses, pricing strategies and decisions become more complex and require a precise volume of information on competitors' reactions to price changes or to a certain practiced price level. There are many strategic sectors (such as steel production, fertilizers and chemicals, building materials, and so on) for which the differentiation possibilities are low, quality of service is similar and therefore attacks on other competitors' positions are significantly low; in such cases price becomes the main weapon of attack, taking into account the high clients' sensitivity to this variable.

But, whatever the particularities of the strategic sector, the competitors' reactions to price maneuvers of a company differ from a reduction or increase in price; these reactions depend on a number of objective economic factors related to the economic situation (normal, growth, recession), company size and economic power, but also a number of subjective factors related to the psychology of those who decide (rivalries between competing companies' managers can lead to irrational decisions, contrary to common).

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