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THE IMPACT OF PRODUCT PRICE CHANGES ON THE PROFITABILITY OF SMES IN NIGERIA

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ABSTRACT

This research work treats the impact of pricing on the profitability of organizations, a study of SMEs in Nigeria. The methodology adopted was the survey and empirical approach, with the administration of questionnaires to some SMEs in Nigeria, the financial report of a major sample company was also evaluated to measure the significant impact of pricing on profitability. The Pearson Correlation Coefficient statistical tool, the student t-test as well as the accounting financial ratios were used to measure the impact of change in price on the profitability of the sample company. The work found that there is a relationship between effective pricing and profitability and that any significant change in the price of a product will have its own effect on the turnover as well as the profit of the organization. Recommendations were made for the close monitoring of SMEs and that SMEs should employ the service of price experts when making pricing decisions.

KEYWORDS

Product, SME, Price, Financial, Profitability.

INTRODUCTION

For any organization that is involved in the production of goods and rendering of services, after answering the question what to produce, and who to produce for, there is need to answer the question how much will our potential customers be willing to pay for the good? This difficulty of price fixture and the effect changes in the price of products has on the profitability, has posed a sense of concern to most business enterprises in Nigeria. Pricing decision is a crucial decision every organization has to make, because this will eventually affect their corporate objectives, either directly or indirectly (Monroe, 2003). For every business entity, irrespective of their line of business and objective, cost minimization and profit maximization is a general factor to be considered and for non-profit making organizations, there will always be the need to reduce cost at all means and to maximize output. A business whether small or big, simple or complex, private or public, is created to provide competitive prices (Ayozie, 2008). According to Hilton (2005), setting the price for an organization's product or service is one of the most crucial decisions a manager faces, and one of the most difficult, due to the number of factors that must be considered. Horngren, et al (1996), buttresses this point by stating that managers are frequently faced with decisions on pricing and profitability of their products. Some of the objectives of business enterprises vary from maximization of profit, minimization of cost, maximization of shareholders fund, becoming a market leader, etc. From the various objectives of business organizations, the primary objective of any business enterprise is to maximize profit and minimize cost, except for charity organizations that are set up primarily not to make profit, but there will be need to minimize cost by all means, therefore the need to set prices, which therefore connotes that pricing decision arises in virtually all types of organizations, irrespective of their level of activities. According to Lovelock & Wirtz (2004), the principal approach to an effective pricing strategy is to manage revenues in ways that support the firms' profitability objectives, which leads to the question; how well can we complement the various factors that influence pricing decision, to achieve our overall objective, which is maximization of profit.

This study is aimed at evaluating the various factors that influence pricing decision and how well an organization can manage these factors effectively to maximize profit. The study focuses on how product price changes affect the profit of an organization with a close assessment of the profit of a sample company.

LITERATURE REVIEW

Pricing is a major subject matter in the management sciences and has been viewed from different perspectives and dimensions. For this study three major backgrounds to the pricing theory will be considered and this consists of the Economists' perspective, the Accountants' perspective as well as from the Marketers' perspective. The accountants have given a background look at the study at hand giving it a comparison to how well a relationship can be established between total cost, price and profit. The marketers are mainly concerned with how well price can be set to suit the value the customers will be willing to pay (customer satisfaction). The economists have provided much of the theoretical background to pricing. The theory states that firms should seek the price which maximizes profit and will thereby obtain the most efficient use of the economic resources held by the firm. From the Accountants' point of view, pricing theory is based on the concept that a relationship can be established between price, quantity demanded, quantity sold and total revenue. Demand sympathizes with price and therefore varies with it, and if an estimate can be made of demand at different price levels it should be possible to derive a profit maximizing price, and a revenue maximizing price. Except if realistic estimates of demand at different price levels can be made, pricing theory is difficult to apply in practice (Asaolu and Nassar, 2007).

From the Economists' point of view, firms should seek the price which maximizes profit and will thereby obtain the most efficient use of the economic resources held by the firm. This price is at that level of sales where the addition to total revenue from the sale of the last unit (the marginal revenue, MR) is equal to the addition to total costs resulting from the production of that last unit (the marginal cost, MC). The economic theory is more concerned with the behavior of aggregates or markets, particularly how persistent and widespread behavior leads to stable results called equilibrium. One important aspect of the economic perspective is to realize that it views the firm as a price-taker rather than a price-maker. This means that management only determines the quantity of a product to produce, and the market sets price through the forces of supply and demand. In contrast to the economists' point of view, the marketing perspective views price as a decision variable, instead of a given variable. In line with the marketers point of view, price is a decision variable influenced by various factors (Lucey, 1996; Monroe, 2003). Pricing is the only element in the marketing mix that creates sales revenue, the other elements are costs. Price is the amount of money we must sacrifice to acquire something we desire. (Monroe, 2003; Oyeniyi, 2004). Prices determine what products and services should be produced and in what amounts. Prices determine how these products and services should be produced, and for whom the products and services should be produced (Lawal et al, 2007).

For the purpose of this study, pricing will be looked at from the accountants' point of view, which looks at how a relationship can be established between price, quantity demanded, quantity sold and total revenue. Demand sympathizes with price and therefore varies with it, and if an estimate can be made of demand at different price levels, it should be possible to derive:-

1. A profit maximizing price
2. A revenue maximizing price

Except if realistic estimates of demand at different price levels can be made, pricing theory is difficult to apply in practice (Asaolu and Nassar, 2007). Price changes, is the process of either increasing or reducing the selling price of a product or service. It involves the process of responding to the various factors influencing the pricing decision. There are various ways of changing price, with respect to changes in cost of production and changes in other intervening variables, which may at the long run affect the long term objectives of the company, if not changed. Most organizations only pay attention to the amount of money to be received from the customer, without taking a close look at the quantity of goods delivered. One way to change price is to change the quantity of money or goods and services to be paid by the buyer. Another way is to change the quantity of goods or services provided by the seller. Hilton (2005) stated that most industries, both market forces and cost considerations heavily influence prices. No organization or industry can price its products below their production costs indefinitely. And no company's management can set prices blindly at cost plus a markup without keeping an eye on the market. Therefore, the need for price changes, which is carried out strategically, through the use of good market survey and strategic pricing. Companies are sometimes price takers, which mean their products' prices are determined totally by the market. In most cases, however, firms have some flexibility in setting prices. The demand law, which is what obtains in most cases is the fact that as the price of a commodity increases, there will be a decline in the quantity demanded of that product.

CAUSES OF PRODUCT PRICE CHANGES

At every point in time when an organization discovers that the price charged on the sales of its product or services is too high or low, there will be need to make a pricing decision on whether to increase or reduce the current price charged, so that it does not affect the company pricing objective. When pricing decision is to be made, some factors have to be put into consideration, so that the decision will not affect the overall objective of the company. Some of the factors which must be considered among other things include:

1. **Cost of Production:** For effective pricing, the total cost of production must be fully ascertained, leaving no stone unturned. The fixed cost as well as the variable cost must be determined and all the various costs that may be incurred in the marketing process must be inculcated e.g. advertising expense, transportation, etc. When cost is not fully ascertained, pricing decision becomes faulty and when the price is wrong, it will definitely affect the income of the company and eventually may affect the survival of the business, especially for the new business and also the small and medium enterprises. Alongside with the other factors that affect pricing decision, cost is a factor that must be looked into critically. When it is discovered that there is a significant increase or decrease in the cost of production, there will be need to either increase or reduce the product price as the case may be.
2. **Nature of market competition:** The nature of market competition must also be considered when pricing decision is made. For a business that is in a monopolistic market, competition may not really affect the pricing decision, but a business in the oligopolistic market or a free market, where competition is tense, this has to be considered before price is set.
3. **Customers and market segment:** When a producer knows his customers, he will be able to set his prices accurately. The market segment must be carefully identified and the amount they will be willing to pay for the product identified.
4. **Demand:** For a new product, there is need to price such product strategically in such a way that it penetrates the market, even if it will be at par with the total cost, while for a highly demanded product, an increase in price may not really have a high effect on the demand for such products, so is the need for management when making pricing decisions to consider the demand for the product.
5. **Consumer behavior and perception:** Consumers attitude and perception about the product must be considered, when making pricing decisions. The company should consider if an increase in price will lead to an increase or a decrease in demand, and vice versa. When the consumer behavior has been established, the producers, will then need to effect the necessary change as at when due.
6. **Channel of distribution:** The cost of distribution and the channel of distribution must also be considered when the price of a product is to be set. It must be considered if the product will be supplied directly to the final consumer or has to pass through the various channels of distribution.
7. **Macroeconomic trends:** The macroeconomic trends of the country must also be put into consideration when pricing decisions are made. In an unstable economy, where cost of living increases, without a change in the income of the people, an increase in the price of a product may affect demand for that product.
8. **Company Objective:** When pricing decisions are made, they must be in line with the overall company objectives, as this is what will inform what the pricing objective really is, so that the pricing decisions made will not be against the company objective, and when it is discovered along the line that the present price is against the company overall objective, there will be need to change the price is such a way that the company objective is achieved.

THE EFFECT OF PRODUCT PRICE CHANGES ON PROFIT

A change in the price of a product will affect the quantity demanded, which will in turn affect the sales turnover and eventually affect the profit of the company. In accounting, the equation for calculating the profit is: Turnover - Cost of Sales - Overheads

This also shows that when turnover reduces, it will eventually have an effect on the profit. When there is a 5% increase in the cost of sales, with overheads remaining constant, with an increase in the price of the product, which will result in a reduction in quantity demanded and finally on the sales turnover. A decrease in demand, resulting in a decrease in turnover less cost of sales and overheads will eventually affect the profit generated by the company.

From the economists point of view, if price is constant, the total revenue curve must go through the origin (if zero units are sold, total revenue will be zero); but because some costs are fixed in the short run, the total cost curve does not go through the origin. As long as revenue received from the sale of an additional unit of output (marginal revenue) is greater than the additional costs of producing and selling that unit (marginal cost), the firm will expand output (Hilton 2005:637). Because price is constant, marginal revenue equals price, and the firm will produce at the quantity level where marginal revenue (price) equals marginal cost. (In economic analysis marginal is defined as the change resulting from a unit increase in effort). Profits are at a maximum where total revenue minus total cost is the greatest or where the slope of the total revenue curve equals the slope of the total cost curve. (In quantitative analysis, slope measures the amount of change in the dependent variable (revenue or costs) produced by a unit increase in the independent variable (quantity).

DATA ANALYSIS

Below is a summary of the profit and loss account of a company that changed its price (increase in price) in February, thus two months before the change in price and two months after the change in price.

TABLE 1: DATA FROM THE SAMPLE COMPANY (SALES REACTION TO CHANGE IN PRICE)

Product	January		February		May		July	
	Price	Sales (N)	Price	Sales(N)	Price	Sales (N)	Price	Sales
Big Loaf	N120	1,880,550	N120	1,795,204	N140	2,336,730	N140	3,083,702.8
Medium Loaf	N30	166,785	N30	45,090	N40	70,125	N40	124,197.5
Small Loaf	N25	152,640	N25	205,535	N30	134,395	N30	195,310
Mini Loaf	N20	524,920	N20	87,160	N25	159,455	N25	164,900
Big Fruit Loaf	N140	102,890	N140	141,970	N150	402,580	N150	786,720
Small Fruit Loaf	N70	183,370	N70	128,770	N80	272,600	N80	377,630

Source: Data collected by Researcher (2008)

From the table above, it can be seen that there was an initial decrease in the sales revenue between the month of January and February, and in May, due to the increase in price there was an increase in sales revenue as well as the month of July, but this change can be said to be non-commensurate to the change in price. There was a change of 17%, 33.3%, 25% & 7.1% increase in the price of the products. The change in revenue from the month of January to July is 27.9%, but quantity demanded as disclosed by the management of the company declined for some weeks, before there was a gradual increase in quantity demanded. The change in sales turnover was not evident, as a result of the inability to determine the quantity demanded.

TABLE 2: CORRELATION OF PRICE CHANGES AND PROFITABILITY

		Changed Price	Pricing profit
Changed Price	Pearson Correlation	1	-.111
	Sig. (2-tailed)		.155
	N	166	166
Pricing profit	Pearson Correlation	-.111	1
	Sig. (2-tailed)	.155	
	N	166	166

Source: Data collected by Researcher (2008)

One-Sample Test

	Test Value = 0					
					95% Confidence Interval of the Difference	
	t	df	Sig. (2-tailed)	Mean Difference	Lower	Upper
pricingprofit	43.530	165	.000	1.12651	1.0754	1.1776
ChangedPrice	51.556	165	.000	1.07831	1.0370	1.1196

Source: Data collected by Researcher (2008)

From the tables above, there is a significant negative correlation between the two variables (Profit and Price Changes) at 0.05 level of significance. It can be decoded that there is a negative significant relationship between change in price and profit, thus, an increase in price will not necessarily result in an increase in profit.

TABLE 3: CHANGES IN GROSS PROFIT, NET PROFIT, OPERATING EXPENSES & SALES

Month	Gross Profit (N)	Net Profit (N)	Operating Expenses (N)	Sales (N)
January	3,061,050.91	2,824,408.91	356,343.96	5,738,160
February	2,455,971.20	2,068,965.20	506,707.96	4,771,884
May	2,191,552.20	1,800,630.85	510,623.31	6,141,000
July	3,154,538.32	2,987,176.82	287,063.46	7,336,429.30

Source: Data collected by Researcher (2008)

To measure the impact of change in price on the profit of organizations, three profitability ratios will be used.

TABLE 4: PROFITABILITY RATIOS

Month	Gross Profit Margin	Net Profit Margin	Operating Expenses Ratio
January	53.30%	49.20%	6.20%
February	51.50%	43.40%	10.60%
May	35.70%	29.30%	8.30%
July	43%	40.70%	3.90%

Source: Data collected by Researcher (2008)

From the above calculations, it can be seen that the company had a favourable Gross profit margin of 53.30% in January, which later dropped to 51.50% in February, but in May, due to the change in price of the products, and other concealed factors, there was a drastic reduction in the gross profit margin to 35.70% and in July, the company picked up and moved to 43%, but was unable to reach the 53.30%. The same trend occurred for the Net profit margin and a close look at the Operating expenses ratio, it can be said that the company had the highest operating expenses ratio in the month of February, which is the month preceding the change in price, thus in the month of May, this ratio reduced to 8.30% but was unable to get to 6.20% which is the figure for January, but in July, the Operating expenses ratio reduced drastically.

From the analysis above, it can be said that when there is a significant change in the price of a product, it will have an effect on the sales turnover generated, which will in turn affect the profit margin on the product, which may be either positive or negative, depending on the type of change and how this change is effectively executed and managed.

CONCLUSION AND IMPLICATIONS

From the various discussions above, it can be said conclusively that price changes is an inevitable factor in the operations of a business enterprise, and that any significant change in the price of a product will have an effect on the quantity demanded for the product which will in turn have an effect on the sales turnover and finally on the profit margin generated from that product, which will eventually have an effect on the corporate objective for a profit oriented company. To this end, it is expected that managers of business enterprises take cautious efforts in evaluating the market as well as the effect a one percent change will have on the profit of the business enterprise. Therefore if SME are a major tool for economic growth and development, there must be a close monitoring of the SMEs up to the point of maturity to reduce the rate of liquidation and collapse of SMEs in Nigeria and Africa at large. Also lack of adequate information about the various pricing techniques will affect the pricing decision of SMEs, which may in turn affect their survival and profitability.

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