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Lecture-13

Pricing Decisions

Pricing Decisions

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Objectives

After studying this Chapter, you will be able to:

- Identify the need of pricing decisions
- Describe the types of pricing decisions
- State the methods of pricing

Introduction

Pricing which is part of the overall marketing strategy plays a very critical role in the success of a company as it is able to increase the profitability and or increase the market share.

Normally, the higher the prices means higher profit being attained but might means lower market share. Pricing ties very closely with the various stages of a product life cycle. Under normal circumstances, selling price is based on total cost, i.e., production, administration and selling overheads – fixed as well as variable plus normal profit. In the long-term planning, selling price must cover all costs plus a desired profit. There are, however, a variety of business situations where fixation of selling price may vary from inclusion of desired profit to selling even below total cost. Marginal costing technique helps in determining the most profitable relationship between costs, prices and volume of business.

13.1 Need of Pricing Decisions

When there is considerable unfilled capacity it may be necessary to accept a lower contribution in order to provide work in the factory. Alternatively, if there is sufficient order, normal price may be quoted and the contribution obtainable may be high. The aim of the fixer of prices is to

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sell the present and future capacity for the greatest obtainable contribution. When the capacity remains unused, the potential contribution is being sacrificed and the acceptance of an order with a lower contribution will at least partially meet from fixed costs being incurred. This amount of contribution would otherwise be lost if the order is refused. In fixing the lower price than normal, the price fixed must take into consideration the following:

1. The amount of contributions at the proposed price;
2. The possibility of other more remuneration job;
3. Comparison with normal selling price in order to determine the concession being offered; and
4. The possible adverse effect upon the future sales and customer's confidence in the company's pricing or trading policy.

Example: X Ltd. is found to be working below the normal capacity due to recession. The directors have been approached by another company with an enquiry for a special purpose job. The costing department estimated the following in respect of that job:

Direct materials ` 1,00,000

Direct labour 5000 hours @ ` 3 = 15,000

Overhead costs: Normal recovery rates:

Variable = Re 1 per hour.

Fixed = ` 1.50 per hour.

You are required to advise the company on the minimum prices to be charged.

Solution:

Marginal costs will have to be determined as follows:

		(`)
1.	Direct materials	1,00,000
2.	Add: Direct Labour	15,000
3.	Add: Variable overhead @ Re 1 per hour for 5000 hours	5,000
4.	Total marginal costs	1,20,000

The floor price, the absolute minimum price should be ` 1,20,000. That is, a total of marginal costs. At this level, it will not make any contribution. Hence, a certain portion of fixed costs must be added to the marginal costs to accept the job with profit. In this case, the fixed overhead is found to be ` 7,500 (5,000 hours × ` 1.5 per hour).

Thus, this technique assists in pricing a product.

Notes **Objectives of Pricing Decisions**

The following are the key objectives of pricing decisions:

5. The important pricing objective is to exploit the firm's competitive position in the market place.
6. The products are priced in such a way that sufficient resources are made available for the firm's expansion, developmental investment, etc.

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3. Some companies adopt the main pricing objectives so as to maintain or to improve the market share towards the product. A good market share is a better indication of progress.
4. The pricing objectives may be to meet or prevent competition.
5. It also prevents price war amongst the competitors.
6. Product Line pricing to maximise long-term profits is another price objective.

Task Make a strategy for taking pricing decision for a organisation providing financing services.

Self Assessment

Fill in the blanks:

7. Pricing ties very closely with the various stages of a …………………
8. The aim of the fixer of prices is to sell the present and future capacity for the greatest …………………
9. Marginal costing technique helps in determining the most profitable relationship between costs, prices and ………………… of business.
10. Normally, the higher the ………………… means higher profit being attained but might means lower market share.

13.2 Types of Pricing Decisions

The following are the key types of pricing decisions:

11. ***Perceived Value Pricing Method:*** In this method, prices are decided on the basis of customer's perceived value. They see the buyer's perceptions of value, not the seller's cost as the key indicator of pricing. They use various promotional methods like advertising and brand building for creating this perception.
12. ***Value Pricing Method:*** In this method, the marketer charges fairly low price for a high quality offering. This method proposes that price represents a high value offer to consumers.
13. ***Going Rate Pricing:*** In this method, the firm bases its price on the average price of the product in the industry or prices charged by competitors.
14. ***Sealed Bid Pricing:*** In this method, the firms submit bids in sealed covers for the price of the job or the service. This is based on firm's expectation about the level at which the competitor is likely to set up prices rather than on the cost structure of the firm.
15. ***Psychological Pricing:*** In this method, the marketer bases prices on the psychology of consumers. Many consumers perceive price as an indicator of quality. While evaluating products, buyers carry a reference price in their mind and evaluate the alternatives on the basis of this reference price. Sellers often manipulate these reference points and decide their pricing strategy.
16. ***Odd Pricing:*** In this method, the buyer charges an odd price to get noticed by the consumer. A typical example of odd pricing is the pricing strategy followed by Bata. Bata prices are always an odd number like ` 899.99 etc.

7. ***Geographical Pricing:*** This is a method in which the marketer decides pricing strategy depending on location of the customer like domestic pricing, international pricing, third world pricing, etc. Multinational firms follow such a pricing strategy as they operate in different geographic locations.

17. ***Discriminatory Pricing:*** This is a method is which the marketer discriminates his pricing on certain basis like type of customer, location and so on. It occurs when a company sells product or service at two or more prices that do not reflect a proportional difference in the costs. One can sell at different prices in different segments. Different prices for different forms of the same product can sell the same product at two different levels depending on the image differences.

Caution **Factors Affecting Pricing Decisions**

Before a decision on the pricing is made, certain factors need to be consider:

18. What are the objectives of the company—to maximize profit/to gain market share/ to penetrate the new market, etc.?
19. What are the existing economic conditions?
20. Any government regulations;
21. Cost structure of the organization;
22. Demand for the product which should includes a study of the price elasticity of demand;
23. Inflation;
24. Surplus production capacity;
25. Level of competition; and
26. Political scenario.

Self Assessment

Fill in the blanks:

27. Under ………………… method the marketer charges fairly low price for a high quality offering.
28. Prices like ` 899.99 etc. are the example of ………………… strategies.
29. While evaluating products, buyers carry a reference price in their mind and evaluate the ………………… on the basis of this reference price.
30. Under going rate pricing the firm bases its price on the ………………… of the product in the industry or prices charged by competitors.

13.3 Methods of Pricing

The various methods of pricing include the following:

31. Full cost pricing;
32. Variable/Marginal cost plus pricing;
33. Rate of return pricing;

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4. Break-even pricing;
34. Minimum pricing

13.3.1 Full Cost Pricing

Full Cost Pricing is a traditional method of pricing a product. It has following features:

35. Most commonly used method;
36. Prices are set by adding a percentage of profit (either a mark up or a margin) to the total cost of the product;
37. Consistent with the absorption costing technique;
38. Commonly used by wholesalers, retailers, construction contractors, services, government contractors.

Full Cost Pricing is useful in situation where:

39. Products are made based on specification by the customers;
40. Main objective is to make profit after considering fixed costs of the business;
41. The costs are difficult to estimate in advance;
42. Expected demand at different price levels is difficult to estimate.

Example: Let's look at Product A:

Production cost as follows:

Variable cost-material $1.50

Variable cost-labor $1.50

Total variable cost $3.00

Fixed cost $3.00

(excludes administrative and selling overheads)

Required 50% mark up on total production cost.

For Full-Cost Plus Pricing:company wants Product A to at least cover its total production cost.

Full Cost Pricing has many advantages. A few of them are as under:

43. Easy and simple to understand;
44. Pricing decisions become standardized;
45. Adopts a conservative approach that in the long run to at least ensure the recovery of fixed cost of a business;

    Total cost = $ 3.00 + $ 3.00 = $ 6.00

    50% on total/full cost = 50% × $ 6.00 = $ 3.00

    Hence, Selling price = $ 6.00 + $ 3.00 = $ 9.00 per

    Chapter. By pricing at $ 9.00, the
46. Difficult of estimating demands can be avoided.

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Like everything else, full cost pricing also has certain disadvantages which are as under:

47. Tendency to set prices on inaccurate estimates;
48. Challenges of apportioning the fixed overheads properly into different products;
49. Unsuitable for short term decisions making particularly in situation like surplus production capacity, tendering for contracts price and others;
50. Ignores competition and price elasticity of demand; and
51. Ignores opportChaptery costs and relevant costs.

13.3.2 Variable/Marginal Cost Pricing

Under marginal Cost pricing, selling price is determined by adding a mark up or margin on the total variable costs (marginal cost). Its salient features are as under:

52. Based on the assumption that any price above variable cost would generate a certain level of contribution towards meeting fixed costs;
53. Consistent with the marginal costing technique;
54. When using this pricing method, need to be careful to ensure that it is sufficient to cover all fixed cost and to generate sufficient margin for profit otherwise the long term survival of the business might be at stake.

Example: Let's look at Product A:

Production cost as follows:

Variable/direct material $1.50

Variable/direct labor $1.50

Variable Production overheads $1.00

Variable Administrative overheads $0.50

Variable Selling overheads $0.10

Total variable costs $4.60

Say required mark up of 65% $3.00

Variable Cost Plus Pricing $7.60

The selling price is determined at $7.60 where the company wants Product A to at least cover its total variable cost and contribute towards recovery fixed costs and profit.

Advantages of Variable/Marginal Cost Pricing are as under:

55. As it adopts the margin cost approach, it provides better information as it segregate the variable and fixed costs;
56. Highlights the importance of contribution;
57. Useful for contract bidding where competition could be quite intense;
58. Eliminates the difficulty of computing fixed costs into the products.

Disadvantages of Variable/Marginal Cost Pricing:

59. For short-term pricing decision, it's alright otherwise needs to be very careful the pricing in the long-term can recover fixed costs and generate sufficient profit for the business;
60. Might be unsuitable for production costs consist a lot of fixed costs.

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13.3.3 Rate of Return Pricing

For this type of pricing, the company needs to specify the rate of return on its capital invested. Similar to Cost pricing, the difference is that the marked up will be based on the target rate of return. The salient features include:

61. The target rate of return varies with market norm or what management considers a fair return.
62. Useful method to use when a business has invested too much on the project or products.
63. However, difficult to use where a company has too many product lines or competes in many markets.

Example: Capital invested/employed $2,000,000

Target return 10%

Estimated costs $500,000

$$\text{Mark up} = \frac{10\% \times \$2,000,000}{\$500,000}$$

= 40%

13.3.4 Break-even Pricing

For this type of pricing, the price at which the products will break-even is used. This break-even price will then be added a profit mark up.

Example: If Fixed Cost $25,000, Variable cost $2.00 per Chapter, Number of Chapters produced 4,000 and Mark-up is 15% on the break-even price, what will be selling price to the customers?

Solution:

Break-even price = Fixed Cost + Variable Cost/Marginal Cost

Total Number of Chapters produced = $25,000 + $8,000

4,000 = $8.25 + mark up of 15% ($1.24)

= $9.50 which is the selling price to the customer.

13.3.5 Minimum Pricing

For this type of pricing, the selling price is the lowest price that a company may sell its product. Normally, the price will be the Total Relevant Costs of Manufacturing. Its salient features include:

64. Useful method in situations where there is a lot of intense competition, surplus production capacity, clearance of old stocks, getting special orders and or improving market share of the product.
65. Minimum Price is Incremental costs of manufacturing + OpportChaptery Costs (if any),

Example: Assuming the following details of product X:

Material	$2.50
Labor (2 hrs. @ $3.00)	$6.00
Variable production overhead	$2.50
Fixed production overhead	$1.20

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Total	$9.70

Say that the labor is in short supply and is used for other product Y which generates a contribution of $6 per Chapter and requires 2 hours of the same labor.

Material	$2.50
Labor	$6.00
Variable production overhead	$2.50

Add:

OpportChaptery cost from labor scarcity:

$6/2 hours = $3.00 per hr × 2 hr = $6.00

Minimum price = $17.00

Caselet

Product Pricing

One of the tougher decisions that a marketing manager faces is how to price a product in the market. In an existing market (i.e. where a new brand is being introduced in a category that already sees competition) the decision is a little easier than in a new market since the marketer can take some cues from the competition's price ranges.

In this situation, the marketer has to be clear about the segment being addressed by the new product. Once that is clear, he can choose from the following options:

66. Price the product on par with the competing product(s)
67. Price the product very close to the competing product(s)
68. Consciously price it quite a bit lower as an incentive to induce trial.

The third decision could prove counter-productive; a lower price could adversely affect the brand value perception unless the communication strategy establishes a value-for-money platform. The other danger is that it could prevent the brand from increasing the price even later, i.e. consumers who came in at the lower price may migrate away when the price is raised.

When launching a new product that is likely to create a new category altogether - as ready-to-eat chapatti did a few years back - the pricing decision in even tougher. Here, there is often no comparison point at all - the traditional method of making chapattis gives no pointers whatsoever to what consumers may pay for the new product.

Therefore, the marketer has to debate various scenarios. Pricing it low might encourage trials and good volumes, but the price may not prove viable in the long run. If priced too high, it could inhibit trials, so the product could be a non-starter.

Nonetheless, given that there are a large number of affluent consumers who are ready to spend, many marketers are in favour of pricing the product higher. It seems to be a given that a high price does more to create a perception of brand value than almost any other strategy.

As long as the boom in consumption sustains, this method would probably work well; if the economic conditions were to see a downtrend, then, probably, such a strategy would not work.

Unfortunately, market research does not help much in the area of pricing. Various pricing research models have been generated and being from the MR industry I have done my

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share of testing these models. But in a research situation, consumers become artificially conscious of the price point and, hence, become artificially price sensitive too. Thus, it is not unusual to see research respondents saying that a price increase of ` 2 in a pack priced at ` 10 would make them switch brands; in actual fact, the consumers probably didn't know whether the price was ` 10 or ` 11.

Till research methods evolve in this area, pricing decisions will continue to need a lot of gut feel and sagacity from the marketer.

Source: http://www.thehindubusinessline.in

Self Assessment

Fill in the blanks:

69. ……………… Cost Pricing is a traditional method of pricing a product.
70. For minimum pricing, the selling price is the ……………… price that a company may sell its product.
71. ……………… is a useful method in situations where there is a lot of intense competition.
72. The target rate of return varies with ………… or what management considers a fair return.
73. ……………… eliminates the difficulty of computing fixed costs into the products.
74. Multinational companies use ……… to minimize their worldwide taxes, duties, and tariffs.
75. Full Cost Pricing is a ……………… of pricing a product.

13.4 Summary

Pricing which is part of the overall marketing strategy plays a very critical role in the success of a company as it is able to increase the profitability and or increase the market share.

When there is considerable unfilled capacity it may be necessary to accept a lower contribution in order to provide work in the factory.

The important pricing objective is to exploit the firm's competitive position in the market place.

Before determining prices certain important factors should be taken care of.

The various methods of pricing include the following: Full cost pricing; Variable/Marginal Cost Plus pricing; Rate of Return Pricing; Break-even Pricing; Minimum Pricing, etc.

13.5 Keywords

Marginal Cost Pricing: Under marginal Cost pricing, selling price is determined by adding a mark up or margin on the total variable costs (marginal cost).

Marginal Costing Technique: Marginal costing technique helps in determining the most profitable relationship between costs, prices and volume of business.

Transfer Prices: Transfer prices are the amounts charged by one segment of an organization for a product or service that it supplies to another segment of the same organization.

13.6 Review Questions

76. "Pricing plays a very important role in the marketing strategy of a firm and a significant one in the overall success." Evaluate the statement.

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2. Before a decision on the pricing is made, certain factors need to be considered. What are those factors?
77. The aim of the fixer of prices is to sell the present and future capacity for the greatest obtainable contribution. Discuss.
78. Illustrate full cost pricing with a suitable example.
79. If Fixed Cost $25,000, Variable cost $2.00 per Chapter, Number of Chapters produced 4,000 and Mark-up is 15% on the break-even price, what will be selling price to the customers?
80. Critically evaluate the key methods of pricing.
81. Discuss the concept of Goal congruence.
82. From the details given below calculate minimum price of product X:

Material	$3.50
Labor (2 hrs. @ $3.00)	$5.00
Variable production overhead	$2.50
Fixed production overhead	$1.20
Total	$9.70

83. What is the significance of using odd pricing strategies? Give some suitable examples.
84. Why companies go for discriminatory pricing strategy?

Answers: Self Assessment

1. Product Life Cycle
2. obtainable contribution
3. volume
4. prices
5. value pricing
6. odd pricing
7. alternatives
8. average price
9. Full
10. lowest
11. Minimum pricing
12. market norm
13. Marginal cost pricing
14. transfer pricing
85. traditional method

13.7 Further Readings

Books

B.M. Lall Nigam and I.C. Jain, *Cost Accounting*, Prentice-Hall of India (P) Ltd.

Hilton, Maher and Selto, *Cost Management*, 2nd Edition, Tata McGraw-Hill Publishing Company Ltd.

M.N. Arora, *Cost and Management Accounting*, 8th Edition, Vikas Publishing House (P) Ltd.

M.P. Pandikumar, *Management Accounting*, Excel Books.

Online links

www.allbusiness.com

www.internalaccounting.com