PRICING STRATEGIES

Introduction

- Pricing is the function determining the product or service or idea value in monetary terms by the marketing manager before it is offered to the target consumers for sale.
- Pricing is a profit-planning exercise in which management searches out the alternatives in an effort to choose one alternative which promises to be the advantageous.
- In the process of pricing, Cost Accountant plays a very significant role by assisting the management in the evaluation of profit arising out of various alternatives

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- Pricing decisions are so vital which have vital impact on the profitability of the organization and any wrong and incorrect pricing may be fatal to the organization.
- Pricing should serve the basic goals of the firm and it is appropriate to examine them and the ways in ways in which they influence business behavior in general and pricing in particular.

Factors Influencing Pricing Decisions

Pricing of a product or service refers to the fixation of a selling price to a product or service provided by the firm. Pricing decisions are influenced by both internal and external factors. Such factors are

1. Cost data of the product which may be actual, replacement, standard or any other cost base.
2. Firm's profit and other objectives.
3. Demand for the product or service and its elasticity.
4. Nature of product and its life expectancy.

5. Pricing decision as a long-run decision or short-term decision.

6. Type of competition for the product or service and availability of close substitutes.

7.Number of suppliers in the market.

8. Economic and political climate and trends and likely change in them in future.

9. Type of industry to which the product belongs and future outlook of the industry.10. Governmental guidelines, if any.

Among the many factors influencing the pricing decisions, the three major factors influences are customers, competitors and costs.

Economic Theory of Pricing

The traditional economic theory of pricing is based on the following assumptions:

A. From Businessman point of view

- Maximisation of total profit both in long-run and in short-run
- Firm produces only one product or if it has several products, they are produced and sold in the same proportions.
- Knows exactly what each level of output would cost him, an
- Also knows how much he could sell at each possible price

B. From Consumer point of view

- Consumers are fully aware of the quality and price of each of the goods and services offered for sale in the market.
- They take in to account of the present situation.
- They will distribute their expenditure so that their purchases should give them the maximum possible satisfaction.

Elasticity of Demand

1.Price elasticity of demand

An individual's reactions to price changes depend on the relative magnitude of the difference concerned rather than on their absolute value.

$$\text{Price elasticity of demand} = \frac{\%\text{change in the rate of purchases}}{\%\text{change in the price}}$$

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The price elasticity of demand depends upon several factors as mentioned below:

- The law of diminishing marginal utility.
- Essential and non-essential commodities.
- Availability of complementary products.
- Availability of substitutes.
- Income group of the consumers.
- Habits and preferences of consumers.

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2.Cross elasticity of demand

This shows the effect of a change in the price of one good on the demand for another good.

$$\text{Cross elasticity of demand} = \frac{\%\text{change in quantity of 'x' demanded}}{\%\text{change in price of 'y'}}$$

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3. Income elasticity of demand.

This shows the effect on demand of change in income.

$$\text{Income elasticity of demand} = \frac{\%\text{change in quantity demanded}}{\%\text{ change in income}}$$

Pricing Policy

Pricing policy refers to framework of rules and constraints within which pricing are taken. The factors governing prices may be divided into internal and external factors.

Internal Factors:

- Corporate objectives and business goals.
- Cost structures-direct and indirect.
- Existing prices.
- Historical practice and precedent in price setting within the firm.
- Degree of market knowledge of key executives.
- Pressures from feedback of other individuals within the firm eg. Salesmen.
- Levels of R&D and pace of new product development.

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External Factors:

- The nature, strength, and pricing behavior of competition.
- The role and importance of distributors.
- Pressures from suppliers of raw materials, components etc.
- The size, structure and perceived price sensitivity of demand.
- The purchasing procedures and motivations of customers.
- Existing and anticipated Government policies.
- General conditions prevailing in different markets.

Objectives of Pricing Policies

- Maximization of the profits for the entire product line.
- Promotion of the long range welfare of the firm.
- Adaptation of prices to fit the diverse strategies and competitive situations.
- Flexibility to vary prices to meet changes in economic conditions affecting various consumer industries.
- Stabilization of prices and margin.
- Pricing the goods based on average costs.

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- Increase in market share or its growth rate at the expense of immediate profits.
- Avoid adverse public reaction consequent on charging high price.
- Early cash recovery of investment.
- Achieving a satisfactory rate of return.
- Product line promotion rather than yield a profit on the product by itself.
- Market penetration through low price to stimulate market growth and capture large share thereof.

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- To safeguard the emergence of new producers in the same line.
- Growth oriented rather than profit maximization.
- To provide incentive to the producers for adopting efficient and improved technology.
- Encourage optimum utilization of plant and machinery.
- Work towards a better balance between demand and supply.
- Avoid adverse effects on the rest of the economy.

Pricing Decision Process

Pricing is the process involving a series of sequential decisions which can be taken over a period of time rather than as a single all-embracing solution. The steps involved in pricing process are as follows:

- Identification of target markets.
- Choosing an appropriate image.
- Constructing the marketing mix.
- Selecting a pricing policy.
- Determining price strategy and facts.
- Definition of a specific price.

Role of Costs in Pricing

- Cost data constitute the fundamental element in the price setting process.
- Higher costs including promotional expenses involved in connection with advertising or personal selling as well as taxation may necessitate an upward adjustment of price.
- If costs go up, price rise can be quite justified. However, their relevance to the pricing decision must neither be under-estimated nor exaggerated.
- Costs are just one of the several factors to be considered in a pricing decision.

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- The question may arise what are the relevant costs for pricing?.
- Though in the long-run, all costs have to be covered for managerial decisions.
- In the short-run direct costs are more relevant. In a single product firm, all costs are direct costs with respect to the product.
- In multi product firm, for pricing decisions relevant costs are those costs that are directly traceable to an individual product.
- In addition, it must contribute to the common costs and to the realization of profit.

Methods of Pricing

The major methods of price fixation are discussed below:

1.Cost based or Cost plus pricing

Under this method of pricing, a fixed percentage of profit is added to the historical cost (materials, labour and overhead). It takes the full cost into consideration including an allowance for all the overheads and adds the profit margin to the total. Full cost, cost plus, cost based and absorption costing are the terms by which this is called.

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Arguments in favour of Cost plus Pricing:

- This method leads to prompt cost calculation which is very much needed for billing purposes.
- It is to understand and thus it is commonly used in Government supplies.
- It offers a means by which fair and acceptable prices can be found with ease and speed, and it does not matter how many products the firm handles.
- It provides convenient base in risky ventures.
- Prices based on full cost look factual and precise and may be more defensible on moral grounds than prices established by other means.

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- Assures the contractor of a reasonable profit margin
- Firms preferring stability use full cost as guide to pricing in an uncertain market, and in market where knowledge is incomplete.
- Where firms are uncertain about the shape of their demand curve and about the probable response to any price change makes it too risky move away from full cost pricing.
- It is difficult, except ex-post, to identify and compute direct costs.
- Fixed costs must be covered in the long-run and firms feel that if they are not covered in the short-run they will not be covered in the long-run either.

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- A major uncertainty in setting a price is the unknown reaction of rivals to that price. Hence, cost plus pricing is best suited.
- Management tends to know more about the product costs than other factors which are relevant to pricing.
- Cost plus pricing is specially useful in:
- Public utility pricing.
- Product tailoring i.e. product designing.

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- Pricing products that are designed to the specification of a single buyer.
- It is useful for multi-product firms where price elasticity for individual products may be hard to determine, as it provides a common work up which can be used to field target level of profit.
- If the planned level of sales is attained at the price calculated, total cost will be recovered, and a satisfactory profit earned.

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Arguments against Cost plus Pricing:

- It ignores demand – there is no relationship between cost and what people pay for a product.
- It fails to reflect the forces of competition adequately.
- It exaggerates the precision of allocated costs.
- There is no incentive to the manufacturers for bringing down cost, as profit is determined as a percentage of total cost.
- Full cost pricing ignores marginal or incremental costs and uses average costs instead.
- This method does not differentiate between high technology and low technology.

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- It is unreasonable to expect that different products and products at different stages of their life-cycle all earn the same profit or return on investment.
- Over concentration on full costs of production may lead to incorrect allocation of overheads and the foregoing of worthwhile profit opportunities.
- This method is not based on any scientific base.
- This method tends to ignore the demand or market side of the pricing problem and concentrates instead on production or selling side of the problem.
- It does not facilitate advance budgeting, as the price to be paid is not known before hand.

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2. Marginal Cost Pricing

Under this method fixed costs are ignored and prices are determined on the basis of marginal cost. A firm seeks to fix its prices so as to maximize its total contribution. Marginal cost is the change in total costs that results from production of additional unit of a product or service.

Marginal costing is more effective than full cost pricing for the following reasons:

- Prevalence of multi-product, multi-process and multi-market concerns makes the absorption of fixed costs into product costs is difficult.

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- Constant development in science and technology makes the long-run situation more uncertain and highly unpredictable. Long-run consists of a series of short-runs and we must aim at maximizing contribution in each short-run which will lead profit maximization in the long-run.
- Marginal cost method of pricing is generally adopted under the following situations:
- Where supply is in excess to the existing demand.
- Pricing of new products.
- Make or buy decisions.

- Where the installed capacity is more than operating level of production.
- Public utility services.
- When cut-throat competition is prevailing in the market.
- Pricing of export products.
- Pricing decisions relating to special orders.

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Arguments in favour of Marginal cost pricing

- Marginal cost pricing permits to develop an aggressive pricing policy which lead to higher sales.
- It is more useful for pricing over the life-cycle of product which requires short-run marginal cost and separate fixed cost data.
- Marginal costs most accurately reflect future as distinct from present cost levels and cost relationships.
- It avoids the need to artificially allocate among products a share of fixed indirect cost.
- It helps a business firm to enter into new markets easily, to increase its competitive position in the existing markets, to survive during trade depressions, to utilize spare available capacity, to dispose off surplus or obsolete stock, and to make profitable special order decisions.

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Arguments against Marginal cost pricing

- Marginal cost pricing method requires thorough knowledge over cost analysis and cost behavior.
- It may tempt to take business which only makes a small contribution.
- In recession, firms using marginal cost pricing may lower prices in order to maintain business and this may lead to other firms to reduce prices leading to cut-throat competition.
- In oligopolistic markets, cutting price close to variable cost may lead to similar action by competitors with the result that no one benefits except customers.
- In this pricing, recovery of fixed costs may be doubted.

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3. Pricing for Target Rate of Return

Under this method, in determining the product price, a certain percentage of capital employed as profit margin is added to the total cost.

Profit oriented pricing is generally exercised by setting a target rate for the next accounting period (usually a year) on the investment.

This method is commonly employed because it recognizes full cost of product plus reasonable return on investment. For this purpose the following popular policies are followed:

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- Maintain a mark-up rate of profit over costs.
- Maintain a mark-up rate of profit over total sales.
- Maintain a constant return on capital employed.

Total costs+ (Desired %on Capital x Capital employed

Selling price= --

Volume of output

- Capital employed consists of net fixed assets employed for production and net working capital.
- Arguments for and against cost plus pricing will also be applicable to this method.

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4. Added Value method of pricing

Unlike full cost pricing, added value method of pricing (conversion cost pricing) takes into account only the costs incurred by the firm in converting raw materials and semi-finished goods into finished goods.

One of the limitations of the full cost pricing is that where the firm is selling two products which require different degrees of effort to convert to a marketable state, no distinction is drawn between them.

In some industries it may be preferable to take only the conversion cost by excluding the material cost for the following reasons:

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- It is simpler to find a relation between the conversion cost and the margin of profit.
- Material prices may be fluctuating and so any profit margin cannot be expected to be stable and the actual revenue may widely differ from that expected.
- When profit is the remuneration of the entrepreneur, who is responsible for converting the raw material into finished product.
- When costs vary only due to different qualities of material, comparatively higher selling prices for products using costly material will not be justified.

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5. Differential Cost Pricing

- The differential cost is the additional cost incurred with the additional output or additional activity of the firm.
- Differential cost pricing method involves adding a mark up on differential cost which is the increase in total cost resulting from the production of additional units.
- When the firm is taking decision as to accept or reject a special order in addition to the normal activity then the price for the additional units will be the additional cost incurred for that order plus the desired profit from that special order.
- This differential cost pricing involves the comparison of the expected changes in costs and revenues relating to such special order.

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6. Going –rate Pricing

- The main emphasis under this method is pricing based on the prevailing market price of similar products.
- This method completely ignores the costs incurred on it.
- The firm adjusts its price policy to the general pricing structure in the industry.
- This occurs when a firm tries to keep its price at the average level charged by the industry.
- The approach is typically found in conditions where there are many sellers of an undifferentiated product i.e., in a perfectly competitive environment.
- It will be recalled that under oligopoly, too, there is a tendency for a going rate to become established.

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7. Standard Cost Pricing

Standard costs represent the costs that should be attained under efficient operating conditions at a normal capacity.

Standard cost pricing is based on the cost standards developed in management accounting systems.

The standards variable cost per unit is calculated by adding the total variable costs of production, namely cost of materials and direct labour, and the cost of bought in components, and dividing this sun by the number of units produced.

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The steps taken to establish a standard cost price are as follows:

- Calculate the standard variable cost per unit.
- Calculate the fixed cost per unit.
- Determine the profit required per unit during the same period.
- Add (a),(b) and (c) together to give the provisional price.
- Analyse market prices for competitive products.
- Adjust provisional prices as necessary to take account of market price levels.

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8. Opportunity Cost Pricing

- Opportunity cost is the revenue foregone by not making the best alternative use.
- Opportunity cost of good or service is measured in terms of revenue which could have been earned by employing that good or service in some other alternative uses.
- In managerial pricing decisions, quite often it becomes necessary to consider not the actual cost of a product but its opportunity cost.

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9. Administered Pricing

- Sometimes Government enforces price control or fixing prices or certain essential or basic products like iron and steel, rubber tyres and tubes, sugar, drugs, etc.
- The prices are administered by Government to achieve one or more of the following objectives:

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- Regulating the activity of national economy.
- To safeguard the consumers against profiteering or monopolistic conditions in the market.
- Aiding the secondary and tertiary producers to receive raw materials at fair price.
- Aiding a producer to receive a profitable price for his products.
- Introducing proper cost accounting system preferably on an uniform basis for collecting information.
- To bring about reasonable stability in prices.
- To ensure optimum production.

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10. Customary Pricing

- Prices of certain goods become more or less fixed not by deliberate action on the seller's part but as a result of their having prevailed for a considerable period of time.
- For such products changes in costs are usually reflected in changes in quality or quantity.
- Only when costs change significantly the customary prices of these goods are changed.

Export Pricing

- Price is one of the most important considerations in international marketing.
- The international market is highly competitive and extremely sensitive to the price factor.
- Export pricing decisions must be based on complete understanding of the varied marketing situations which differ from country to country, product to product and also from time to time.
- Export pricing will be determined differently from price for domestic sales.
- Certain cost elements like advertising, administrative costs are not fully applicable on export sales and as such do not form part of export pricing.

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The additional costs generally considered in export pricing are:

- Obtaining any necessary approval for selling the product in another country.
- Modification of the product to any prevailing foreign standards.
- The cost of packaging, insurance and transport.
- Any import duty to entry to the other country, and
- The channel or distribution costs at the other end.

Methods of Export Pricing

The following methods are in practice in export pricing strategy:

1. Cost plus pricing

- Under this method full costs taken into consideration including an allowance for all overheads and adds profit margin to the total cost for export pricing.
- Price based on this method is cost oriented rather than market oriented and not suitable when the international market is highly competitive except in case of traditional products.

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2. Marginal cost pricing

- Under this method only those costs which are directly relevant to manufacture of export products are taken into account.
- If an exporter is able to realize his marginal costs, including the additional costs incidental to export, he will not suffer a loss so for his export transactions are concerned.

Marginal cost pricing of export is suggested in the following cases:

- As sales in the domestic markets cover the entire fixed costs and the export goods may be required only to cover direct costs.
- Surplus capacity is available in the plant.
- When all the production is not meant for export.
- There is scope for price maneuverability in domestic market.
- Low prices can be effectively used as a technique in securing market acceptance for products newly introduced in the market.

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Selling at or even below the marginal cost in export markets may be resorted to in the following cases:

- To eliminate competition from weak rivals.
- To introduce or popularize a new product.
- To stay in the market and keep in touch with the customers.
- To keep employees and the plant in use in readiness to go to full stream when required.
- Tax credits on export profits and sales may justify lower export sales price.
- Political motivation.
- To clear excessive stocks.

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3. Incremental or differential cost pricing

- Incremental cost is the additional cost due to change in the level or nature of business activity.
- The change in cost is due to execution of export order will only be considered for calculating the profitability of export decisions and for export pricing.
- Incremental analysis involves a comparison of the expected changes in costs and revenues relating to the export of goods.

Strategies in Product Pricing

- Selling prices should be set with reference to overall marketing strategy, product design and quality, advertising and promotion, distribution methods, etc. are likely to influence the sales pricing decision.
- During the life of an individual product, several stages are apparent – introduction, growth, maturity, saturation and decline.
- The duration of each stage of the life cycle varies according to the type of product, but the concept is nevertheless important as each stage is likely to influence the firm's pricing policy.

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- In the long-run all operating costs must be fully covered by sales revenue.
- However, over-emphasis on cost in the short-run may result in sub-optimal decisions.
- An organisation's competitors will usually react in some way to changes made to the selling price structure.
- In practice, price adjustments may be heavily influenced by expectations of customers.
- If the organization produces a range of different products, it is faced with the problem of setting selling prices for each individual product in such a manner as to obtain the optimum product mix.
- Arrival of new and more attractive substitute products also affects pricing decision of the firm.

Pricing Strategies for New Products

- The introduction of a new product creates a monopoly, whose duration depends on a list of strategic variables inside and outside the firm's control.
- The basic problem for the firm is to find a price and promotional mix that will maximize the long-run profit from the new product.
- One important variable is the 'newness' of the product.
- The expected costs and the ratio of fixed to variable costs must also be estimated.
- Having achieved the necessary demand and cost estimates, the firm introducing the new product is faced with a choice of pricing strategies, which will depend upon the objectives of the firm the market opportunities revealed by demand and cost estimation.

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The two extremes of policy available are:

1) Skimming price policy and

2) Penetration price policy.

1. Skimming pricing policy

- The skimming price policy involves charging a high initial price, recovering development costs quickly and making large profits that attract entry.
- The skimming policy is useful for new product when:
- Demand is more elastic in the short-run than the long-run because of novelty.
- Each consumer purchases the good only once.
- The firm has cash flow problems, and thus needs a high return quickly.
- The firm is a ‘snatcher’ and intends to leave the industry after a short period of high profits.

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2. Penetration pricing policy

- The penetration policy implies charging a low price to deter entry, so that a smaller profit is made over a longer period.

The penetration price policy is likely to be successful if:

- The short run price elasticity of demand is high.
- Economies of scale are significant.
- The firm is a 'sticker' and intends to remain in the industry long term.

Pricing Established Products

- Pricing for established products generally implies pricing in an oligopolistic market, where actions of each firm have an effect on the performance and behaviour of competitors.