CA BUSINESS SCHOOL
EXECUTIVE DIPLOMA IN BUSINESS AND ACCOUNTING

SEMESTER 3: Cost Control in Business

Pricing Strategies

Determining the Price of the Product & Service

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Introduction

Assume that you are running a business in which you manufacture a particular product and sell in the local market. You should have many crucial elements/activities/steps. What shall be the most crucial?

In order to survive in a highly competitive market, total cash inflows of the business must exceed total cash outflows in the long run. Revenue of an entity is the main source of bringing cash inflows which basically determines with the combination of sales volume and selling price of the product/service.

It is a responsibility of the key management to make most suitable right decision about setting and/or accepting suitable selling price for their products and/or services.

Determining a Suitable Price

Among many factors affect the pricing decisions of an entity, following will be crucial and pivotal.

- Organizational goals/objectives (Vision & Mission)
- Nature of the product/service
- Business life cycle
- Product life cycle
- Product mix
- Price/demand relationship
- Behavior of the competitors and markets
- Behavior and style of the key management
- Cost recoverability
- Marketing strategy

Methods of Pricing

Following are the most common mechanisms/methods used in setting price for the product/service.

- The economist's pricing model
- Cost based pricing formulae
- Target mark-up percentages
- Activity based cost-plus pricing method

Methods of Pricing/1

The economist's pricing model

The theoretical solution to pricing decision is presented in the economist's pricing model which explains how the optimum selling price is determined. This model provides a suitable framework for discussing the cost information that is appropriate for pricing decisions.

- Determined several possible selling prices
- Determined possible demand at each level *(when price go down, demand goes up)*
- Determined total costs at each level
- Calculate MR & MC at each level
- Select the level (price) at which MR>MC and maximize the profit

Methods of Pricing/2

Cost based pricing formulae

This is another most popular mechanism of setting price of the particular product/service. It is necessary to determine the unit cost of a product/service and add a percentage mark-up on such cost to provide a reasonable level of profit. This approach also termed as cost-plus pricing.

This technique encompass a variety of different methods that are used to established the cost.

Some entities used total cost and some used total manufacturing cost. Some entities even used total variable cost/prime cost. The value (percentage) of mark-up will vary accordingly and many of both monetary and non-monetary factors to be considered in this event.

Methods of Pricing/3

Target mark-up percentages

Instead of using past data, an entity attempt to determine its selling price of product/service based on target mark-up. Depend on the product/market or/and behaviour of the customers, target mark-up will vary. Consider the sales of a jeweller and the sales of a super market. Jeweller tends to keep high profit margin due to low degree of sales turnover while super market keep low profit margin due to high degree of sales turnover.

If absorption approach used, mark-up = $\frac{\text{ROI (desired)} + \text{SELL\&ADMN}}{\text{Volume of units X CPU}}$

If marginal approach used, mark-up = $\frac{\text{ROI (desired)} + \text{TFC}}{\text{Volume of units X VCPU}}$

Methods of Pricing/4

Activity-based cost-plus pricing methods

The activity-based approach attempts to measure the total organizational resources required to produce a product and thus report long-run average product costs.

It was shown that activity-based systems report more accurate long-run product costs than traditional product costing systems.

Pricing Strategies

The final price determined for the product/service will depend upon the pricing policy of the company and as such key management can select a pricing strategy which best suits in accomplishing company's goals and objectives.

- Price skimming : is an attempt to exploit those sections in the market that are relatively insensitive to price changes. High price at initial stage and gradually decline in later.
- Penetration pricing : is based on the concept of charging low prices initially with the intention of gaining rapid acceptance of the product.

Product life cycle : What? How relate? Why important? What types of actions need?

Exercise;

1. Calculate selling price of product “X” using following information.

DM	10.00
DL	15.00
FOHs – variable	5.00
fixed	10.00
Non MNOHs – fixed	10.00

a) If total cost-plus used at a margin of 20%
b) If manufacturing cost-plus used at a margin of 50%

2. ABC company determines investment of LKR 2,000,000 to manufacture 50,000 units of product “Y”. Company estimate LKR 30.00 of CPU while selling and administration cost of LKR 700,000 per annum. Company expects 25% return on its investment.

Calculate the target selling price of one unit of “Y”.