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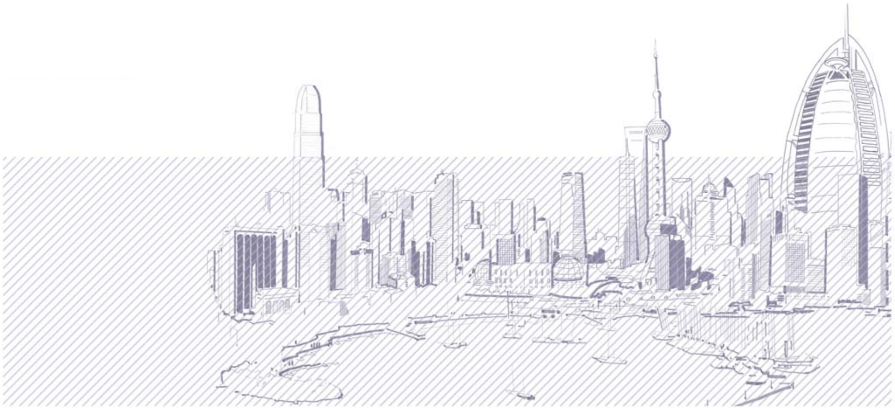

Pricing strategy

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2. Selection of a pricing policy
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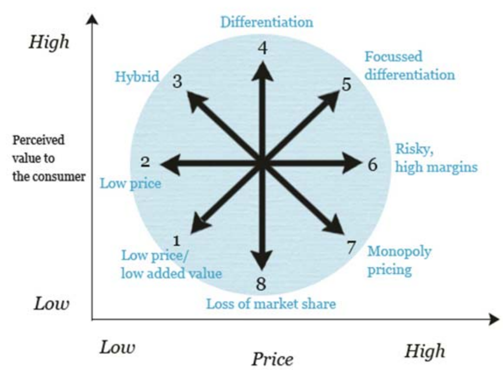
Pricing strategy and competitive strategy

Bowman's Strategy Clock



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Selection of a pricing policy

First of its Kind

Penetration Pricing

- Initial low price
- High volumes

Market Skimming

- Initial high price
- High profits

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Selection of a pricing policy

Premium Pricing

Premium pricing is pricing above competition on a permanent basis. This can only be done if the product appears “different” and superior to competition, which normally means establishing a brand name based on:

- Quality
- Image
- Reliability
- Durability
- After-sales service

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Selection of a pricing policy

Price differentiation

If the market can be split into different segments, each separate from the others and with its own individual demand function, it is possible to sell the same product to different customers at different prices.

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Selection of a pricing policy

Loss leader pricing

When a product range consists of one or more main products and a series of related optional “extra”, which the customer can “add on” to the main product, the supplier can set a relatively low price for the main product and a high one for the “extras”.

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Selection of a pricing policy

Psychological pricing

Odd-even pricing

- $99.95 vs. $100

Prestige pricing

- Artificially high level
- Higher price with higher quality

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Development of pricing method

Three types of pricing methods:

- Cost-plus pricing
- Market-based pricing
- Competition-orientated pricing

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Cost-plus pricing

- Cost-plus pricing formulas
  - Price = cost base + (mark-up percentage × cost base)
- Mark-up percentage is dependent on the definition of product cost used
- Two issues
  - What is the best definition of cost base to be used in the cost-plus pricing formula?
  - How will the desired mark-up be determined?

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Determining the mark-up

Return on investment (ROI) pricing

- Selling price is determined by using the required rate of return to determine the mark-up on cost base
- The profit margin is based on the firm's target return on investment
- Average investment × target ROI = target profit

$$\text{Markup percentage} = \frac{\text{profit required to achieve target ROI} + \text{total annual costs not included in cost base}}{\text{annual volume} \times \text{cost base per unit used in cost-plus pricing formula}}$$

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Product cost distortion and pricing

- Conventional volume-based product costing fails to capture the cost implications of product diversity
- When cost-plus pricing is used
  - High-volume and relatively simple products may be over priced
  - Low-volume and complex products may be under priced

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Absorption Costing – Variable Costing

	Per Unit
Direct materials	$ 6
Direct labor	4
Variable manufacturing overhead	3
Fixed manufacturing overhead	7
Unit product cost	$ 20
50% markup	10
Target selling price	$ 30

	Per Unit
Direct materials	$ 6
Direct labor	4
Variable manufacturing overhead	3
Unit varible cost	$ 13
130.76% markup	17
Target selling price	$ 30

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Purple manufactures rustic furniture. The cost accounting system estimates manufacturing costs to be $240 per table, consisting of 60% variable costs and 40% fixed costs. The company has surplus capacity available. It is Purple's policy to add a 75% markup to full costs.

A large hotel chain is currently expanding and has decided to decorate all new hotels using the rustic style. Purple is invited to submit a bid to the hotel chain. What per unit price will Purple most likely bid on this long-term order?

A) $168 per unit
B) $180 per unit
C) $252 per unit
D) $420 per unit

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Purple is invited to bid on a one-time-only special order to supply 100 rustic tables. What is the lowest price Purple Trees should bid on this special order ?

A) $7,200
B) $12,000
C) $14,400
D) $42,000

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Market-based pricing

Target costing is the process of determining the *maximum allowable cost* for a new product and then developing a prototype that can be made for that maximum target cost figure. The equation for determining the target price is shown below:

Target cost = Anticipated selling price – Desired profit

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Market-based pricing

1. Develop a product that satisfies the needs of potential customers.
2. Choose a target price.
3. Derive a target cost per unit by subtracting target operating income per unit from the target price.
4. Perform cost analysis.
5. Perform value engineering to achieve target cost.

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Competition-orientated pricing

- Two or more companies submit sealed bids (or prices) for a product or project to a potential buyer for the product/project
- The supplier has spare capacity
  - If the bid price exceeds the incremental costs of producing the product, this will contribute towards covering the supplier's fixed cost and generating a profit
- The supplier has no spare capacity
  - Incremental costs are relevant
  - Opportunity costs must be assessed
  - A bid price should cover the opportunity cost
  - The bid price may be higher than when spare capacity exists

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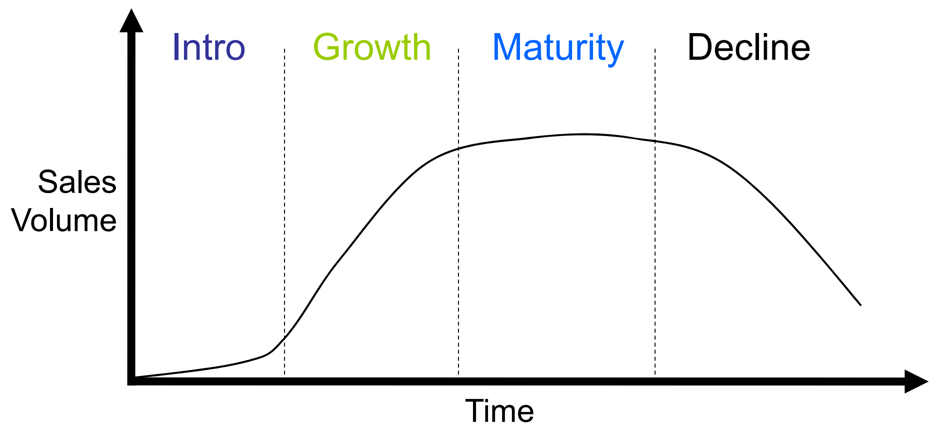
Product life cycle and Pricing strategy



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Product life cycle and Pricing strategy

Life cycle stages	Introduction	Growth	Maturity	Decline
Strategic objectives	Sales growth	Sales growth	Profits	Cash flow
Costs	High R&D, Advertising Low Plant and Equipment	Moderate R&D High Advertising, Plant and Equipment	Moderate R&D High Advertising, Plant and Equipment	Low R&D Low Advertising, Plant and Equipment
Profits	Negative, but increasing	Positive and increasing depending on the company's position in industry	Peak then decrease	Decrease
Strategic Pricing	Market skimming/ Price penetration	Lower the initial market skimming launch price	Premium price	Lowest price/ product bundling

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Practice

Baker Ltd. is preparing to submit a bid for an order. An, controller of Baker, has asked Hanh, the cost analyst, to prepare a bid. To determine the amount of the bid, Baker's policy is to mark-up the full costs of the order by 10%. Hanh prepares the following costs for the bid:

Direct material		**$40,000**
Direct manufacturing labor		10,000
Overhead costs		30,000
Design and administration	4,000	
Production order	5,000	
Setup	5,500	
Materials handling	6,500	
General and administration	9,000	
Full production costs		80,000

All direct costs and 30% of overhead costs are incremental costs of this order.

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Practice

An reviews the numbers and says: "Your costs are way too high. You have allocated too many overhead costs to this order. You know our fixed overhead is not going to change if we win this order. Rework your numbers. You have got to make the costs lower."

Hanh verifies that her numbers are correct. She knows that An wants this order because the additional revenues from the order would lead a big bonus for An and the senior division managers. Hanh knows that if she does not come up with a lower bid, An will be very upset.

Discussion:

Evaluate whether An's suggestion to Hanh to use lower costs numbers is unethical. Would it be unethical for Hanh to change her analysis so that a lower cost can be calculated?

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Practice

GG is a magazine renowned for their reporting of unverifiable entertainment news. Dee is the marketing director of GG. Recently, Dee decided to lower the price of GG to $2 in order to drive out some of the smaller competitors. Dee's behaviour is best described as an example of:

A. Skimming pricing

B. Penetration pricing

C. Predatory pricing

D. Discriminatory pricing

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Q&A

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Thank you for your participation !

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