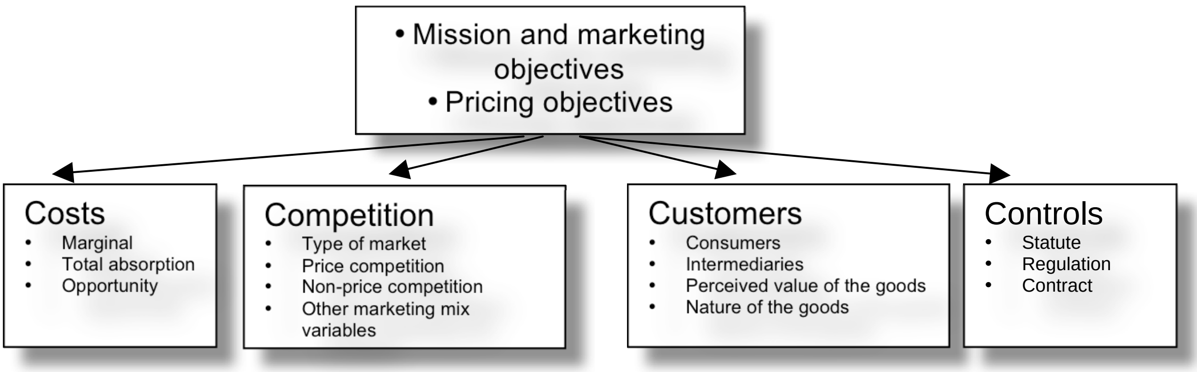
Studying Paper P3?
Performance objectives 7, 8 and 9 are relevant to this exam

BUSINESS STRATEGY AND PRICING

The revised Paper P3 *Study Guide* now includes an additional learning objective, E3e: 'Describe a process for establishing a pricing strategy that recognises both economic and non-economic factors'. This is an extension to the learning objective E3d which refers to the effect of e-marketing on the traditional marketing mix of product, promotion, price, place, people, processes and physical evidence. It is, of course, appropriate for accountants to specialise in the determination of price as this can relate closely to other accounting measures such as costs, revenues and profits. Additionally, altering the price of a product will usually allow much faster changes to organisational performance than developing products or designing and running promotional campaigns. This article looks first at the influences on prices and then at specific approaches.

The influences on prices

The influences on prices can be summarised by the following diagram:



Although there might appear to be a natural or normal order in which to deal with these influences, if must be emphasised that, as in all of strategic planning, the process is likely to be iterative. One might have a marketing objective in mind but then find that it will be impossible to achieve it because of cost or competition issues, so the objective has to be revisited. Pricing is certainly a dynamic process as nothing will remain constant: the economy, taste, innovation and above all, perhaps, competitor actions and reactions will change continually, often forcing prices to be re-appraised.

Mission and marketing objectives

Pricing is ultimately part of an organisation's strategy and we should, therefore, go back to where strategic planning should begin: the organisation's mission. There we will find the organisation's purpose, its self-perception, its feeling about its position in the market, and material relating to the organisation's culture and ethics. Pricing cannot be separated from mission.

For example:

- An organisation might have a charitable or not-for-profit purpose, in which case prices for its products and services might be zero or heavily subsidised.
- An organisation might perceive itself to be 'up-market', in which case it might have to charge high prices to project quality and exclusivity.
- Pharmaceutical companies face ethical issues when pricing their life-saving products for both rich markets where they hope to make profits, and for poor markets where there are ethical and social responsibility dimensions.

Pricing objectives
Whereas missions and marketing objectives tend to be long term, in the shorter term there can be a variety of pricing objectives. For example, profit-seeking organisations have to at least break even eventually and, if possible, prices have to be set to allow this. There is, for example, no point in having a mission which is to be upmarket, and then trying to enforce that impression by having prices so high that sales volumes are negligible. Sometimes, the need to survive and bolster cash flows quickly will dictate massive price cuts. Sometimes an organisation might reduce its prices, sustaining losses for a while, in the hope of forcing competitors to withdraw from the market.

Costs
In profit-seeking organisations, revenues have to exceed costs; in not-for profit organisations revenue has to match income. By this stage of your studies you should be well aware that any positive contribution (that is when marginal revenues exceed marginal costs) helps to cover fixed costs. To make a profit, revenue has to exceed all costs. What might become more relevant in strategic management is the importance of opportunity costs and of exit costs.

An opportunity cost is the revenue foregone as a result of a decision. If you build on a piece of land you cannot then sell the land for cultivation, for example, and the sale price foregone is an opportunity cost of the decision to build. Exit costs can arise when trying to abandon a strategy. For example, in some countries large liabilities can be incurred if employees are made redundant. Sometimes clean-up or reparation costs can be triggered if undertakings are closed down. In such circumstances, it might be cheaper to carry on provided marginal revenues just exceed marginal costs. If competitors are in this position then we are likely to suffer great price pressure from them.

Competition
There are four main types of market, each giving rise to a particular type of competition:

- Perfect competition. This form of market consists of many small suppliers and customers none of which can influence the market. There is free entry and exit from the market and all supply identical products. Here, suppliers must charge the market price. They cannot charge more because, as the products are identical, every customer would move to cheaper suppliers; there is no point in reducing their prices because all output can be sold at the market price. It is worth noting that the internet has tended to make price and competition much more transparent and that there are sites which specialise in comparing suppliers' prices.
- Oligopoly. This special type of market consists of a small number of suppliers supplying identical products. An example is found in petrol companies. If a supplier increases prices, the others simply have to maintain theirs to gain market share. If a supplier reduces prices, the others must follow suit to maintain their market share. There is therefore little incentive to reduce prices as competitors will follow.
- Monopoly. In a monopoly market there is only one supplier of a product. The supplier can charge whatever is wished, though demand is likely to vary as a result. This is the great freedom a monopolist has: choose the price to charge so that profits can be maximised. Note that despite that statement, being a monopolist does not guarantee that a profit is made. You might be the sole supplier of something no one wants.
- Monopolistic competition. This is a very unhelpful, almost self-contradictory term for the type of market this represents. This form of competition means that there are a number of suppliers supplying similar but not identical goods. Essentially, the products are being differentiated in some way and, therefore, can command different prices. Suppliers are competing, but with different offerings.

Price competition means that consumers are motivated primarily by price and usually suppliers will have to offer low prices to succeed. Very often organisations which use a cost leadership strategy adopt price competition. Their products are ordinary, but because their costs are very low (if not actually the lowest) prices can also be kept down.

Many laptop producers use price competition because, for most, their products have been commoditised: they all do the same things, with the same operating systems, run the same application software and have similar reliabilities.

Non-price competition means that consumers pay attention not only to the price of the goods but are also influenced by other marketing mix variables such as the:

- quality, brand and features of the goods
- promotion activities
- place (where the goods or services are obtained).

Essentially, organisations which follow a differentiation or focus strategy will be making use of non-price competition. They seek to make their products different so that they are particularly attractive to consumers, who in turn are willing to pay premium prices. Considering again the laptop producers mentioned above, we could probably argue that Apple uses non-price competition. Its laptops look different and unique, they have a different operating systems and run different (but often compatible) software. This can make it difficult to directly compare prices, but many people have the impression that, insofar as it is possible to compare like with like, Apple machines are more expensive than others. Nevertheless, they sell well and profitably.

Consumers
Suppliers have to keep in mind both what the end consumers are willing to pay and also the profits that will be expected by intermediaries in the supply chain. Many industries have 'rules of thumb' about the mark-ups they expect to be able to apply. It is common to segment markets according to wealth so that a company will have a 'value' range of goods for poorer or thriftier customers who might respond to price competition, and a more exclusive range for better-off customers, who might respond to non-price competition.

Even if there are not different lines of goods for different customer groups, it can still be possible to charge different prices for the same product to different groups. This is known as price discrimination. For example, it is often cheaper to buy electronic goods in the US than in Europe. Leakage of goods from the cheaper to the more expensive market must be prevented in some way, so the groups have to be sufficiently separate (or un-informed). The pharmaceutical company example given above is another instance of price discrimination where drugs are sold at high prices within rich economies and often at much lower prices elsewhere. Leakage from one market to the other is reduced by giving the products different names (even though they are pharmacologically identical) and by controlling distribution carefully through hospitals and government agencies.

The perceived value of goods is a concept which is also related to non-price competition and, indeed, to price. We have all, no doubt, been influenced by the thought that a higher price implies goods of a higher value even though we are often essentially ignorant about the merit of those goods. For example, when buying a T-shirt there is a very wide range of prices for a range of garments which are very similar looking. We assume that the expensive T-shirt with the fashionable label is ‘better’ than the cheaper, more basic lines. However, often we really do not know, and might even be paying for the kudos we feel an exclusive label gives us.

Whether goods are necessities or luxuries also influences consumers’ reactions to prices and price changes. This affects the elasticity of demand of the product, which is a measure of how a change in sales volume is caused by a change in price. Goods that have a high elasticity of demand are very price sensitive and are likely to be luxury products that consumers are prepared to do without if the price rises too much. Goods with a low elasticity of demand are relatively unaffected by price changes and are likely to be necessities. As prices rise, demand will stay high because customers need the goods. Note that not all goods are regarded the same way by customers. Some consumers might regard a foreign holiday as the highlight of their year and sacrifice other consumption so that they can afford higher air fares. Other consumers have little interest in going abroad so would immediately react to price increases.

Controls
Some industries are closely regulated by statute and regulation, and they have little power to choose their own prices. Other industries are able to, or try to, dictate final prices charged to consumers. For example, exclusive perfume and cosmetic producers resist price competition by insisting in their supply contracts that their retailers do not discount their products. Note that not all contractual arrangements are legal. Pricing cartels (competitors fixing prices) are frowned upon by most governments.

Setting prices
Now that we have looked at what can influence prices, we can consider how to set prices. Once again we must refer back to the organisation’s mission and objectives as it cannot set prices without reference to its longer term ambitions. In an ideal world, organisations would have full information about:

- Customers – what would they pay and what is the likely demand?
- Competitors – what are their products, what are their prices and how do they compete?
- The resultant costs, revenues and profits arising from a specific price.

In practice, determining much of this information can be difficult, and again it is worth emphasising that markets are often very volatile and prices might need to be reviewed and changed frequently. Note that ‘price’ includes not just the price level itself, but also the use of discounts (particularly important in business to business sales), and payment terms.

The methods of setting prices include the following.

Setting prices to maximise profits
In theory, and as you might recall from earlier studies, profits are maximised when:

Marginal cost = Marginal revenue

In practice, this is almost useless advice to most organisations. Although we might expect a well-controlled organisation to have reasonable information about how its costs move, very few will have sufficiently detailed or stable information about how revenues move, as they are affected by fickle consumers, competitor action and economic confidence.

Setting prices to break even
The break-even volume is given by:

Fixed costs/(Selling price per unit – Variable cost per unit)
or
Fixed costs/Contribution per unit

Setting a high selling price per unit will generate a high contribution per unit and this would require a smaller volume to be sold before breakeven point is reached. The company could, therefore, evaluate various options of prices and volume and compare these to what it feels customers might find attractive and what competitors might be charging.

Cost-based pricing
Here the cost per unit is determined (either total absorption cost, marginal cost or relevant costs) and a set amount, or a set percentage, is added to that to give the selling price. If the forecast volume is sold at the price set, then the forecast profit would be made. However, although useful as a guideline, the method is not sufficient because it is entirely inward looking and pays no heed to competitors or customers. The resulting prices must always be looked at with some scepticism, and the organisation must assess how those fit in with the market. An inability to make a reasonable margin on sales must indicate that either costs are too high or demand for the product is too weak. Strategically speaking the organisation would be ‘stuck in the middle’.

Competition-based pricing
By contrast, this approach is entirely outward-looking. It strives to match what competitors are charging and is the only option when in perfect competition. Goods should sell at that price, but there is no guarantee that sufficient profit will be made. This approach, therefore, places high importance on being able to achieve low costs, ideally cost leadership.

Marketing-orientated pricing
In this approach, the organisation attempts to escape from the constraints of perfect competition and sells a product differentiated by features, quality, design, promotion, place and so on. Generally, higher prices are sought and are justified by products better matching a market segment's needs. For example, consider a company which makes agricultural chemicals. In general, farmers will need to buy these in spring, but will get no income from their crops until harvest in the autumn, so farmers have a very adverse cash flow for around six months. Think how attractive it might be if the manufacturer gave farmers payment terms of six months to match their cash flow needs. The prices of the chemicals might be higher than those of competitors, but the convenience to farmers plus the apparent empathy shown with their problems could well outweigh the price differences.

Strategic approaches
It is important to note several ways in which price can be used with more strategic intent, here using the term 'strategy' to mean a 'ploy'.

- Price skimming. This approach is often seen when new technology is introduced. There are some consumers who will pay a very high price for new products, perhaps because they need them or perhaps because they have more money than sense. After the most desperate, the richest or the most profligate consumers have been satisfied, the price is reduced to skim off another layer. At some stage a longer-term stable price is reached.
- Penetration pricing. Here, the ambition it to use a very low price to capture a very high market share. Note that this very high market share could well give economies of scale that will allow low costs and hence low prices to be maintained in the long term. In fact, a large market share can be a barrier to entry as smaller new suppliers will have to match, what are to them, uneconomic low prices.
- Product-line pricing. Car manufacturers, for example, offer ranges of the same model of car. This enables them to attract customers by advertising 'Prices from $10,000…', and then often to persuade the customer to move up the range. You can be sure that the additional price on upmarket models will be much greater than the additional costs incurred making them.

- Related product pricing. We have probably all experienced this with inkjet printers. Many of these sell for about $100, and when you come to renew the ink cartridges you have to pay about $80. Here the organisation makes most of its profits on after sales services that consumers feel committed to after the initial purchase.
- Demand manipulation. This is frequently seen in train ticket and airline prices. Not only are the companies using price discrimination (charging business travellers more for peak-time travel) but they are also encouraging others to make use of the services at other, less crowded times. Another example can be seen in heating engineering businesses which can have a problem meeting demand in winter but have idle staff over summer. They could even-out demand (and lower their costs) by offering routine servicing over summer at a discount, or for which payment did not have to be made until much later.

Summary

- Pricing is part of the marketing mix of both products and services and it can be changed very quickly.
- After the marketing and pricing objectives have been decided, pricing has to then consider costs, competition, customers and controls.
- In the long-run, prices must at least match all costs if profits are to be made, but sometimes exceeding marginal costs and relevant costs will be sufficient.
- Competition can be based on price or can be non-price competition. In non-price competition the company is in some way differentiating its products or services so that price is not the only factor influencing purchasing decisions.
- Consumers will react to prices and price changes. For example, luxury goods are likely to be more sensitive to price changes than necessities. Price discrimination can allow different prices to be charged for the same product in different markets.
- Controls over prices can be set by governments and regulators.
- The calculation of the selling price can be based on various approaches (such as cost plus). However, unless a company is very lucky, it is unlikely to have full information about the demand that will be generated by any price and a ‘reality check’ is needed.
- There are a number of strategic approaches to pricing such as price-skimming, related product pricing and demand manipulation.

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