The Limitations in Making Pricing Decisions

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Abstract

In deciding the right price, a company should consider many factors such as customers, competitors, government, and what methods or strategies would be chosen. Therefore, the company could understand the price elasticity of demand of its products. In this case, management accountants play an important role by providing sufficient information for the company. To do so, management accountants should aware what factors can influence price and how market condition is.

This report would try to describe pricing methods and strategies and analyse factors that influence price elasticity. It also would describe the role of management accountants in pricing decision.

Introduction

Pricing decisions of a company could be a dilemma. If the company sells too low price for its product, it may be insufficient to generate profit, however, if the company sells too high price, its customers will try to find other alternatives, therefore the company will lose its customers. The pricing decisions will also depend on the types of market into which products are sold and are influenced by the price elasticity of demand. Therefore, understanding the price elasticity of demand is essential to determine appropriate price methods and pricing strategy to meet company's objective.

Price Sensitivity and Accounting Cost Information

Price Elasticity of Demand as Price Sensitivity Measurement

Pricing is a very important management function for a company to achieve its objective such as maximizing profits and dominating the market. Therefore, pricing management is important as it also can influence the customer demand.

Over the last decades, researchers have published numerous studies on price sensitivity of demand. These studies were usually motivated by academic curiosity about consumers' price sensitivity or by managerial concern about appropriate price levels. Tellis (1988) finds that changing in price will lead to the changing of sales. It describes how complex pricing is (Dutta et al., 2002).

A major issue in pricing is the impact of price on demand and sales volume (*See also* ***Appendix I***). Traditionally, the typical demand function is negatively sloped, indicating that the increase in price will lead to the decrease in volume sells. The relationship between demanded volume and price, which is the buyers' price sensitivity, is usually measured by the price elasticity of demand (Blois et al., 2000). Price elasticity of demand is not always constant. If demand is price-elastic, then a decrease in the selling price will lead to the increasing in revenue (Flath and Nariu, 2000). In contrast, for products with price-inelastic demand, an increase in the selling price will bring about a similar outcome.

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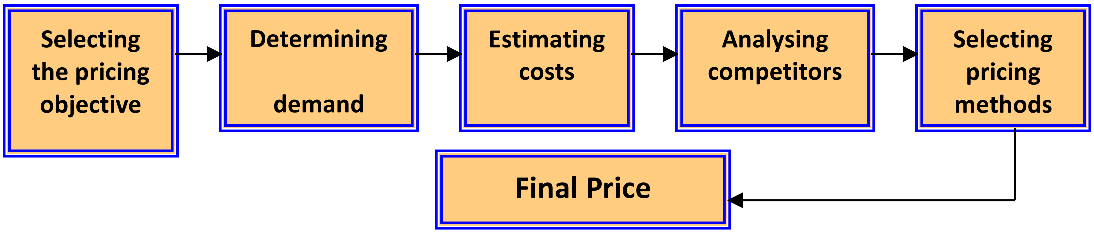
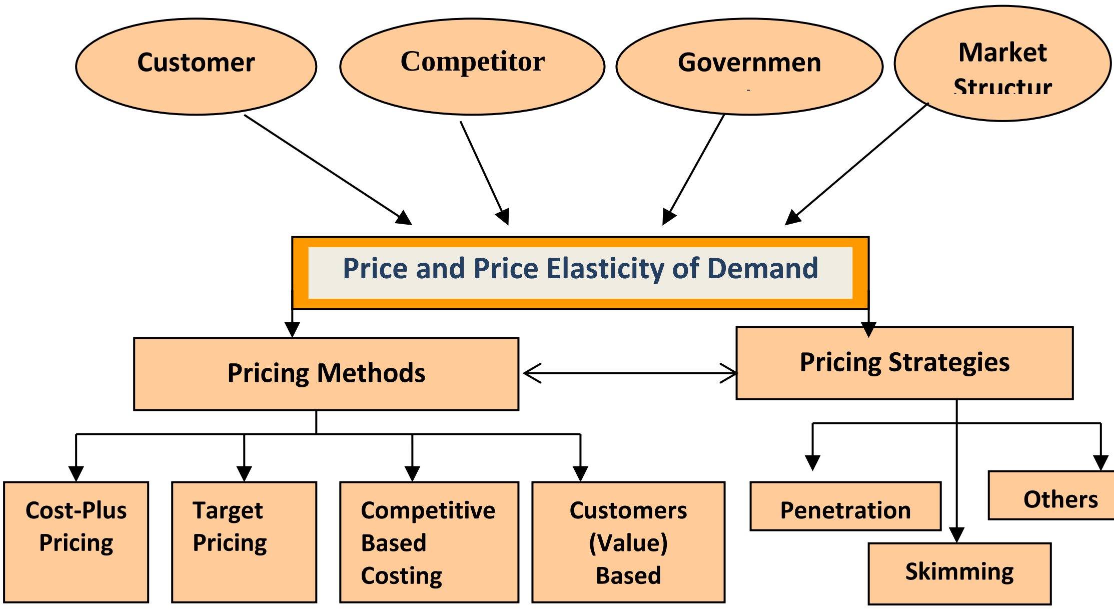
Price elasticity of demand has impact on company's pricing strategy. Selecting price method in determining the final price is shown in Figure2. As shown in the figure below, the firms need to determine and understand demand in the market that will impact on their price and how responsive or elastic, demand would impact to the price. Noreen and Burgstahler (1997) explain that pricing strategy is essentially dictated by the market if demand is extremely elastic. On the other hand, if demand is inelastic, the demand theory in the economy will not really influence the company's decision in pricing as the pricing decision can also be affected by the other factors e.g. government regulation.

Figure 1 Final Price Flow



It is important for managers to pay attention to the nature and duration of a price change and to how extensively the price change will be communicated or promoted to the market (Monroe and Cox, 2001). Price elasticity of demand has influence in determining pricing methods and strategies for the company to achieve its objectives as shown in the chart below.

Figure 2 Factors that influence Price and Price Elasticity of Demand in Determining Pricing Methods and Strategies



Pricing Methods and Strategies

Pricing Methods

It is important for management accountant to understand the price elasticity of demand and the type of market for every product that are sold to apply appropriate pricing methods. Price elasticity of demand has impact on the level of sales and hence revenue, therefore, influences pricing decision of

[2] http://myphliputil.pearsoncmg.com, "Designing Pricing Strategies and Program"

the company. Shim and Sudit (1995) cited by Noreen and Burgstahler (1997) reveal that 69.5 percent of 141 respondents used cost-plus pricing in determining their final price and only 17.7 percent of the respondents set their prices based on other pricing methods.

Cost-plus pricing strategy involves determining a price by adding to the total cost per unit produced a certain fixed percentage for profit margin (McNamee, 1992; Lipe, 2004). Cost-plus pricing can be optimal approaches that need to use concept of price elasticity of demand that provides a measure of the elasticity of demand to changes in price. However, sellers (domestic and international) may face problems when applying this method as it could result higher price in weak markets and lower price in strong markets. Therefore, this method could not demonstrate the real market condition. As a result deciding the right variables for a product price is important in any markets (Raymond et al., 2001).

In the era of global competition, some firms have used target costing as their pricing method. This pricing method targets a certain Return on Investment (ROI).[3] With target costing, the firms try to examine of the existing market, for example, as part of benchmarking exercise, and set prices that make break even or set the desired target profit that they want. Target costing is suitable for company that has high volume, standardised products, and may be used by price-taking firms, since price is not available to them as a strategic competitive variable.[4] In contrast to cost-plus pricing strategy above mentioned, this pricing method does not take into account the price elasticity of demand relationship; however, this method helps the firms in determining target profits and minimum prices to cover its predicted costs.[5]

Bhattacharya and Friedman (2001) say that price can be used as a tool to increase both profits and customer satisfactions. They suggest firms to use value-based pricing i.e. ‘smart pricing’ rather than determine prices by considering only what the product costs to produce. If using this method, a company should know the products that are needed by the customers. Therefore, understanding customer demand and profit margins are important if this method would be applied. Moreover, in this method, the price of a product will change as the demand from the customer change.

Bhattacharya and Friedman (2001) also emphasize that a company may have difficulty in applying this method because it is impossible to make a generalisation on customer demand as they may have different point of view on the company’s product.

Pricing Strategies

Understanding customer, competitors and government intervention that affect to price elasticity of demand is important in conducting pricing strategy for the firm to achieve its objectives. One of pricing strategy is skimming. This strategy applies higher price in short period when a new product is introduced in to the market, therefore, a company could make high return on investment in that short period. The high return is resulted through inelastic demand happens in the marketplace or in product segmentation (Moses, 1992).

The other strategy is penetration. Sellers in this strategy offer lower price to get high market share even to control it (Moses, 1992). This could be achieved if there is elastic demand in the market. By using this strategy, sellers expect current customer will buy more products and target customer will be interested in buying the product. If this strategy successfully applied, sellers will acquire more revenue because more unit products are sold. On the other hand, as the seller sold more unit products, the cost would decrease which will lead to the lower cost per unit product.

[3] www.bized.ac.uk
[4] http://www.ex.ac.uk
[5] http://myphliputil.pearsoncmg.com, “Designing Pricing Strategies and Program”

The company could choose an appropriate strategy for marketing their products. The company may apply market penetration if it wants control the market otherwise it could apply skimming when introducing a new product to get more revenue in the short period.

Factors that Influence Price Elasticity of Demand

Customers

When planning, price strategies for products which have a high price elasticity of demand (such as international air travel) particular attention must be paid to the consequences of price changes. In this case, customers will tend to find other alternatives with the same product that has cheaper price. Therefore, price elasticity of demand will depend on the way of company to serve its customers (Bolton and Myers, 2003).

Competitors

The actions of competitor firms also affect price elasticity of demand (*See also* ***Appendix II***). When competitors react by changing their price on a similar product, demand will be less elastic. This happens because demand on a company product may change as product price of other companies change (McNamee, 1992; Blois et al., 2000).

Government

Government could control price to alter customer demand from one product to another (Brown and Saving, 2002). Governments also can limit the freedom of companies to change prices (Blois et al., 2000) and changing customer preferences by using government regulation (McNamee, 1992).

Market Structure

Market structure is defined by the number of players (buyers and sellers) and the degree of product differentiation (Davis and Lam, 2001). When there are more buyers than sellers and there is less product differentiation, the price will be higher compared if there are more sellers, less buyers and more product differentiation.

A company should understand that price also could be affected by market structure. In a perfectly competitive market, firms are unable to use marketing policies to affect the price at which they sell because in perfectly competitive market is characterized by many producers supplying to the market, each with similar cost structures and each producing an identical product, many buyers in the market, both buyers and sellers are free to enter or leave the market, and there is a ready supply of information for buyers and sellers (Salvatore, 2001).

On the other hand, in imperfect market competition, to some extent demand will increase if companies offer lower prices because there is significant relationship between price and demand of the companies' products. Therefore, understanding price elasticity of demand is very important for companies to forecast how much units would be sold if price is changed. Regarding this matter, inelastic demand happens if demand does not change when price is changed otherwise elastic demand occurs if demand changes when price is changed (Salvatore, 2001).

Management Accountant's Role in the Pricing Decision

The role of management accountants is also important in pricing decisions of the organisation such as in deciding pricing method (Lucas, 1999). They should understand many factors. For example, management accountants should know the right price level that influences customer decision in buying companies' products. They also should recognize how customers, competitors, and government affect the price elasticity of demand. Prior to providing advices to the company, management accountants should know what factors that can influence product price in the marketplace and understand market conditions. Consequently, the advices regarding on the product price absorb many considerations and at the end of the day the objective of the companies is more likely could be achieved.

Conclusion

Organisations can achieve its objective and maximise its profit by getting the price right. To do this, the strategic in price is important for organisational success. Price is influenced by price elasticity of demand. Customers, competitors, government intervention and type of market have an impact on this level of elasticity. Therefore, to support pricing strategy and methods in the organisation, management accountant plays important role. The role of management accountants in this case are; providing advices regarding product price and customer behaviours that can influence price elasticity.

Appendices

Appendix I: Pricing in The Home-Video Market

Enamoto et al., (1996) observes and researches on issues that are important in the pricing aspect of the home videocassette. Buyer's, including of consumers and film distributor, sensitivity to price is being looked at in order to derive at the overall profit obtained by the videocassette.

Home video used to be common in the nineties. It was a very popular form of modern entertainment as almost every single household, that has a television set owns a videocassette recorder (VCR) (Enamoto et al., 1996). However, this has changed greatly nowadays in the twenty-first centuries, due to rapid advance in technology. VCD and DVD player has replaced the role of VCR in most households.

According to Enomoto et al. (1996), "it was found that the rating of the film, box office receipts, and video release date influence the pricing decision." It is also found that the price elasticity of demand from a particular target market differs from other target market. Taylor (2000) states that there are a number of factors that affects elasticity. These factors are the availability of substitutes, the importance of purchase and the urgency of need.

Due to the high increase of revenues collected from the home video industry, it is vital that the some of the firm marketing mix which are promotions, through advertising, and pricing of the pre-recorded cassettes should not be ignored. Thus, it will lead to the issue of pricing decision. Czinkota et al. (2000) maintains that multiple objectives should be satisfied by the pricing decisions. In other words, a firm's pricing strategy should at least provide the foundation for the products' marketing strategy, assist in achieving the financial goals of the organization and fit the realities of the marketplace environment.

Hence, pricing decisions are of supreme importance in order to obtain good profits. It can be said that a poorly made decision can lead to loss or perhaps lower profits achieved.

Appendix II: Why Small Firms Rely on Cost-Based Pricing

Hankinson, A., (1995) explains and illustrates the reason why small firms use cost-based pricing and why they are unwilling to seek help from experts outside the firm. However, in general, this problem does not arise, and hence, not limited, to small firms, bigger companies are also facing this type of problems.

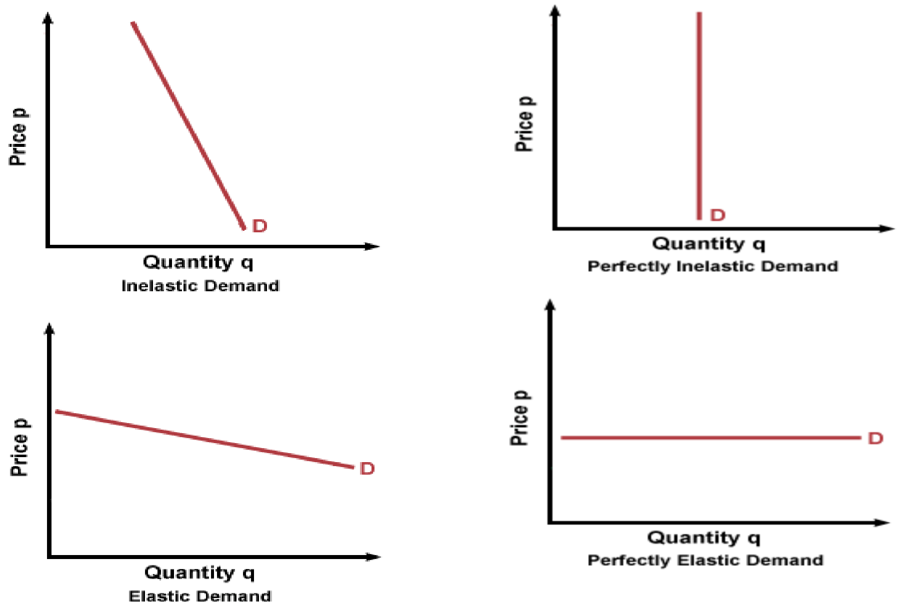
Basically, Monroe (1995, cited in Warshawsky, 1996:23) claims that the ground of why these firms lack interest in seeking outside help is due to the fact that "they feel that they are victims of a hostile economic and competitive environment, about which they can do little."

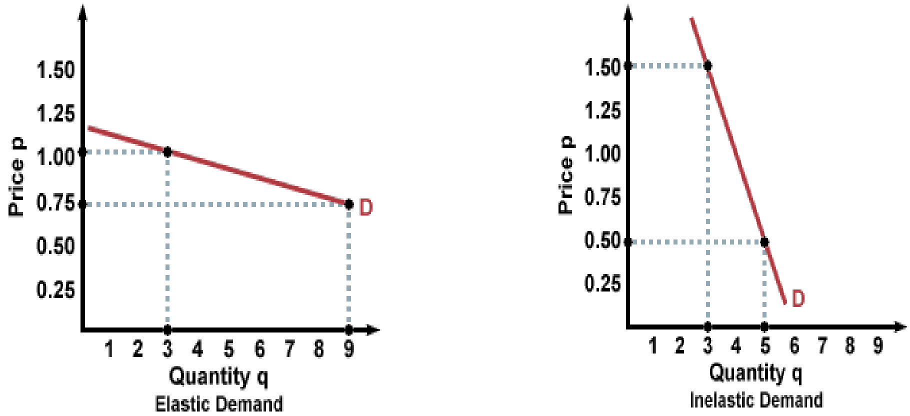
These small firms felt that bigger companies simply have too many advantages as compared to them. One aspect of these is in terms of their size, due to the structure of the large companies, they are able to buy goods in bigger bulk amounts, and thus they are able to get more discounts from suppliers. This ultimately led to lower cost of production and bigger profits. In terms of rental, they have high negotiating power as compared with smaller firms; hence, they are able to obtain more favourable rental agreements. Another aspect in which they have more benefit is in terms of obtaining funds. Large companies have more shareholders and they can also raise capital by issuing shares to the public. Therefore, they can afford high cost advertising to increase products' awareness and heighten consumers' perception of the product.

Hankinson (Hankinson, 1995:14-20) also emphasizes that problems arise due to small businesses lack of sophistication in pricing and this lack of expertise is worse in the area of accounting and finance in which small firms use accounting system that is only adequate to prepare and gather data together for their tax returns.

Besides lack of sophistication in pricing, smaller firms' management has insufficient knowledge of the marketing concept; this causes them to make poor decision on the firm's pricing strategy. Instead of acknowledging that pricing is one of the most essential management functions and that it has huge impacts on the performance of the company, the only issues that they are concerned about is to avoid price wars. Even though some small firms hire outside consultant to rectify these problems, Hankinson (1995) argues that the difficulties caused by the imbalance in management experience and sophistication at many firms may make use of outsiders problematical.

Appendix III: Graphs of Elasticity of Demand[6]





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[6] http://www.sparknotes.com/economics/micro/elasticity/section1.html

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