Management accounting – setting prices

Business, Management

cco Management Accounting Tutorial 5 15-3. List and briefly describe 4 major influences on pricing decisions Customer Demand: the demands of customers are of paramount importance in all phases of business operations, from the design of a product to the setting of its price. Product-design issues and pricing considerations are interrelated, so they must be examined simultaneously. For example, for a higher quality product; you need higher quality materials which will affect a higher cost and needs more time and this will lead to a higher pricing on a product.

Also, a manager must not price its product out of the market price range. Actions of Competitors: companies must keep an eye on its competitors. If its competitor reduces its pricing on a product, they might have to follow suit to avoid losing its market share. However, one must not follow the actions of its competitors' blindly as a company has to predict competitive reactions to its product-design and pricing strategy. The company must also be careful to properly define its product, such that if they increase the price of the product; will the consumers continue purchasing the product?

Costs: some prices are determined almost entirely by market forces. Industries such as agriculture; where most products are market-driven. To make a profit, farmers must produce at a cost below the market price. This is very risky as it is not always possible to produce at a price lower than the market price and this will inevitably lead to losses for the farmers. In other industries, prices are set by adding a markup to production costs so managers do have some latitude in determining the markup. Therefore, both market forces and cost considerations heavily influence prices.

No organization or industry can price its products below their production costs indefinitely. And no company's management can set prices blindly at a cost plus a markup without keeping an eye on the market. Political, Legal and image-related issues: managers must adhere to certain laws. The law generally prohibits companies from discriminating among their customers in setting prices. It is also forbidden in collusion in price setting between major firms. Political considerations also can be relevant.

For example, if the firms in an industry are perceived by the public as reaping unfairly large profits, there may be political pressure on legislators to tax those profits differentially or to intervene in some way to regulate prices Companies also consider their public image in the price-setting process. A firm with a reputation for very high quality products may set the price of a new product high to be consistent with its image. 15-11. Write the general formula for cost-plus pricing, and briefly explain its use. Price = Cost + (Markup % * Cost) 15-12. List the 4 common cost bases used in cost-plus pricing.

How can they all result in the same price? - Variable manufacturing cost + (Markup % * Variable manufacturing cost) - Absorption manufacturing cost + (Markup % * Absorption manufacturing cost) - Total cost + (Markup % * Total cost) - Total variable cost + (Markup % * Total variable cost) Several different definitions of cost, each combined with a different markup percentage can result in the same price for a product or service. 15-13. List 4 reasons often cited for the widespread use of absorption cost as the cost base in cost-plus pricing formulas. - In the long run, the price must over all costs and a normal profit margin.

Basing the cost-plus formula on only variable costs could encourage managers to set too low a price in order to boost sales. This will not happen if managers understand that a variable cost-plus pricing formula requires a higher markup to cover fixed costs and profit. Nevertheless, many managers argue that people tend to view the costs base in a cost-plus pricing formula as the floor for setting prices. If prices are set too close to variable manufacturing cost, the firm will fail to cover its fixed costs. Ultimately, such a practice could result in thefailureof the business. Absorption-cost or total-cost pricing formulas provide a justifiable price that tends to be perceived as equitable by all parties. Consumers generally understand that a company must make a profit on its product or service in order to remain in business. Justifying a price as the total cost of production, sales, and administrative activities, plus a reasonable profit margin, seems reasonable to buyers. -When a company’s competitors have similar operations and cost structure, cost-plus pricing based on full costs gives management an idea of how competitors may set prices Absorption-cost information is provided by a firm’s cost accounting system, because it is required for external financial reporting under generally accepted accounting principles. Since absorption-cost information already exists, it is cost-effective to use it for pricing. The alternative would involve preparing special product-cost data specifically for the pricing decision. In a firm with hundreds of products, such data could be expensive to product. 15-14. What is the primary disadvantage of basing the cost-plus pricing formula on absorption cost? The primary disadvantage of absorption-cost or total-cost pricing formulas is hat they obscure the cost behavior pattern of the firm. Since absorption-cost and total-cost data

include allocated fixed costs, it is not clear from these data how the firm's total costs will change as volume changes. Another way of stating this criticism is that absorption-cost data are not consistent with cost-volume-profit analysis. CVP analysis emphasizes the distinction between fixed and variable costs. This approach enables managers to predict the effects of changes in prices and sales volume on profit. Absorption-cost and total-cost information obscures the distinction between variable and fixed costs. 5-15. List 3 advantages of pricing based on variable cost - Variable-cost data do obscure the cost behavior pattern by unitizing fixed costs and making them appear variable. Thus, variable-cost information is more consistent with cost-volume profit analysis often used by managers to see the profit implications of changes in price and volume - Variable-cost data do not require allocation of common fixed costs to individual product lines. - Variable-cost data are exactly the type of information managers need when facing certain decisions, such as whether to accept a special order.

This decision often requires an analysis that separates fixed and variable costs 15-16. Explain the behavioral problem that can result when cost-plus prices are based on variable cost. If the managers perceive the variable cost of a product or service as the floor for the price, they may tend to set the price too low for the firm to cover its fixed costs. Therefore, if variable-cost data are used as the basis for cost-plus pricing, managers must understand the need for higher markups to ensure that all costs are covered. 15-17. Briefly explain the concept of return-on-investment pricing

A common approach to determine the profit margin in cost-plus pricing is to base profit on the firm's target return on investment 15-18. Explain the

phrase price-led costing. Target costing sets the target cost by first determining the price at which a product can be sold in the marketplace. Subtracting the target profit margin from this target price yields the target cost, that is, the cost at which the product must be manufactured. This simple, but strategically important, relationship can expressed in the following equation:

Target cost = Target price – Target profit 15-19. Why is a focus on the customer such a key principle of target costing? To be successful at target costing, management must listen to the company's customers. Management needs to aggressively seek customer feedback and then the products must be designed to satisfy customer demand and be sold at a price they are willing to pay. In short, the target costing approach is market driven. 15-25. Describe the following approaches to pricing new products: skimming pricing, penetration pricing and target costing.

Skimming pricing; which the initial product price is set high, and short-term profits are reaped on the new product. The initial market will be small, due in part to the high initial price. This pricing approach often is used for unique products, where there are people who ' must have it' whatever the price. As the product gains acceptance and its appeal broadens, the price is lowered gradually. Eventually, the product is priced in range that appeals to several kinds of buyers. Penetration pricing; which the initial price is set relatively low. By setting a low price for a new product, the management hopes to penetrate a ew market deeply, quickly gaining a large market share. This pricing approach often is used for products that are of good quality, but do not stand out as vastly better than competing products. Target cost; where

the company first uses market research to determine the price at which a new product can be sold. Given the likely sales price, management computes the cost for which the product must be manufactured in order to provide the firm with the cost for which the product must be manufactured in order to provide the firm with an acceptable profit margin.

Finally, the engineers and cost analysts work together to design a product that can be manufactured for the allowable costs. This method is used widely by companies in the development stages of new products. It is projected long-run cost that will enable a firm to enter and remain in the market for the product and compete successfully with the firm's competitors. 15-27. Briefly explain the potential negative consequences in pricing decisions from using a traditional, volume-based product-costing system. Use of a traditional, volume-based product-costing system may result in significant cost distortion among product lines.

In many cases, high-volume and relatively simple products are overcosted while low-volume and complex products are undercosted. This results from the fact that high0volume and relatively simple products require proportionately less activity per unit for various manufacturing support activities than do low-volume and complex products, yet a traditional product-costing system, in which all overhead is assigned on the basis of a single unit-level activity like DL hours, it fails to capture the cost implications of product diversity.