Pricing decisions as a management strategy

ASSIGN BUSTER

\n[toc title="Table of Contents"]\n

\n \t

1. Price taking and price making \n \t
2. Time horizons – Short run and Long run \n \t
3. Pricing decisions in short run \n \t
4. Pricing decisions in long run \n

\n[/toc]\n \n

Supply and demand is an economic model of price determination in a market. It concludes that in a competitive market, price functions to equalise the quantity demanded to the quantity supplied. This results in an economic equilibrium. The Pricing decisions, deciding what to charge the customers may be based on the Marketing or Cost and management accounting. Pricing is one of the most difficult decisions faced by organisations. " It is possible for management to foresee a profit squeeze" (Horngren, Datar & Foster, 2003). Pricing decisions are based on what to charge for the products and services organisations offer. These decisions have major impacts on the revenue an entity earns.

This study is focused on pricing decisions as a management strategy. It will then discuss about costing (subset of management accounting) and its influence in pricing. " Major changes have occurred in the business world in recent years, including deregulation, privatisation, the growing expectations of share holders and the impact of new technology" (Atrill & McLaney, 2009). These changes have led towards a fast changing and competitive environment, and this has radically changed the way that entities need to be

managed. " Managers must approach pricing decisions with care because of the significant impact they can have on the profitability of business" (Drury, 2008).

Management must approach pricing decisions with care because of the significant impact they can have on the profitability of an entity. Managers consider three main influences on pricing decisions: customers, competitors and costs. Managers tend to see the pricing issues through the customers' eyes. Any increase in price may cause customers to reject an entity's product and switch to its competitors. In the current business environment, understanding customers' prices and product preferences are a competitive advantage to any entity. Management can price dynamically to respond to demand, to create demand, to reduce waste and to turn over stock immediately. The reactions of competitors influence pricing too. " Many companies globally, have established departments to search out information on its competitors' financial performance, patents, technology and operating policies" (Bhimani, 2008). " Most companies price products to exceed the production costs" (Alan, 2002). The surveys and case studies reveal that executives weigh customers, competitors and costs differently.

Price taking and price making

Most entities need to make decisions about setting or accepting selling prices for their products or services. An entity will have to accept the market price under few circumstances. If there are entities in an industry and there is little to distinguish their product or service from each other then the management needs to consider price taking. Entities in commodity markets can be quoted as examples. Any small entity operating in an industry where

there are dominant entities that influence prices then small entities will have to accept those prices. In contrast, if the entity is selling highly customized or differentiated products then they can influence the prices and be a price setter.

Time horizons – Short run and Long run

Pricing decisions have both short run and long run implications.

Pricing decisions in short run

Short run pricing decisions include pricing for a onetime special offer. This can be an opportunity where an entity will have to bid against its competitors. In such a situation incremental costs of undertaking the order should be taken into account. Product mix could be adjusted where the incremental sales revenue exceeds incremental short run costs and will provide a contribution towards fixed costs.

Pricing decisions in long run

Long run decisions could include pricing a product in a major market where price setting has considerable leeway. Long run time horizon is mostly of a year or longer.

Organisations are supposed to consider the long run implications since they commit their resources for a lengthy period of time. “ Long run decisions have a profound effect on the firm’s future position” (Drury, 2008). Pricing decisions are more prominent since that is how organisations earn their revenues. Target costing and Life cycle costing are two of the strategies used by organisations in pricing.

Target costing is the estimated price for a product or service that potential customers will pay. In other words, firms determine the allowable cost for the product or service, given a competitive market price, so the firm can earn a desired profit (Target cost = Competitive price – Desired profit).

Firms have two options to cut down costs to the level of target cost. It could be either by redesigning the product or service and or by integrating new manufacturing technology. While once managers focused only on manufacturing costs, they now look at cost upstream (before manufacturing: Research and development and design) and downstream (after manufacturing: marketing, distribution and customer service) in the product life cycle to get a complete analysis of product cost and profitability.

Another long term pricing strategy is Life cycle costing. Typically, product or service costs are calculated and reported for shorter periods, such as a month or a year. Unlike the typical strategies Life cycle costing provides a long term perspective.