Chapter 5 Questions

1. The directors of **Parsons Perry** are currently examining pricing strategies in relation to their line of hair care products. One of the company's products is an economy hair conditioner with the following cost structure per 150 ml bottle:

	€
Variable materials costs	0.15
Direct labour costs	0.20
Prime cost	0.35

Fixed overheads are recovered on the basis of a percentage of direct labour. The percentage currently used by the company is 275%.

The directors are planning to start their discussions on pricing this product by calculating a) a cost-plus price based on a profit mark up of 82% on full cost, and b) a variable cost-plus price based on a profit mark up of 235% on variable cost.

Required:

a) calculate possible selling prices based on the profit marks up percentages noted above

b) identify and discuss issues that are relevant to the pricing of this product. You should include references to the possible selling prices identified in i).

2. Quaint Inns is an unlisted company which runs a chain of 25 high quality hotels in the UK and France. The company's tariff is published on the internet, but discounts from the published tariff are available for corporate clients, tour operators and travel agents. The published cost of a double room with breakfast in Stratford-upon-Avon is £190. Corporate clients can usually obtain the room for £140 and the company lowers its price to as little as £98 for the larger tour operators. Needless to say, these reductions are not widely publicised. The variable costs associated with the provision of the room and breakfast are £31.

The company has been approached by an Internet-based service business which offers substantial discounts on late-booked rooms. In exchange for a fixed fee per year Quaint Inns would be able to advertise rooms at heavily discounted prices: the later the booking the greater the discount. The directors are about to meet to discuss whether or not to use this service.

Advise the directors on the principal issues that they should consider in their discussion.

Chapter 5 Answers

1. Parsons Perry

a) possible selling prices

i. based on a cost-plus price

	€
Prime cost of one bottle of conditioner	0.35
Fixed overheads: 275% x direct labour charge	
= 0.20 x 275%	0.55
Total costs	0.90
Profit mark up: €0.90 x 82%	0.74
Selling price	1.64

ii. based on a variable cost-plus price

Prime cost (as above)	0.35
Profit mark up: €0.35 x 235%	0.82
Selling price	1.17

b) discussion of relevant issues

Demand for a product like hair conditioner may range from relatively elastic to relatively inelastic. If a particular product is widely and effectively advertised, customers may be motivated to acquire that conditioner in preference to any other. This means that they place a relatively high value on the product. They are less likely, however, to express such a preference for an economy product. Because there will no doubt be many other such products competing in the market, demand for this type of conditioner is relatively elastic. The product competes, principally, on price, although other issues such as quality of packaging design may also have a part to play.

The cost-plus calculations in part i) are of some assistance in establishing pricing parameters. However, they are likely to be fairly unimportant in fixing a price for this conditioner. The company is unlikely to be able to charge significantly more than its competitors, and so, market-based pricing is more important in this particular instance than cost-based pricing. The cost-based prices established in part i) are subject to a great deal of estimation in any case. The prime cost of the product is so low and the percentage add-ons are so large that there is a great deal of scope for inaccuracy.

2. In theory, any price above £31 per room would be acceptable because it would make some contribution to fixed costs. However, the directors may be reluctant to set such a low price for a room. Some degree of discounting, such as that described in the question for corporate customers and tour operators, is acceptable and normal in the hospitality industry. However, very heavy discounting could potentially damage the reputation of the hotel group and its image as a high quality service provider. If the individual customers who normally pay £190 per room were prepared to leave their booking until the last minute they could benefit from substantial savings; these savings to the customer would represent lost revenue to the hotel.

The directors may wish to consider piloting a partial use of the service in one or two locations. They could establish the level of price discount that would be acceptable to them so as to avoid loss of reputation and potential loss of revenue.