

Chapter 11 Pricing

Questions

1. The directors of Parsons Perry plc 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 150ml bottle:

Variable materials costs	0.15
Direct labour costs	<u>0.20</u>
Prime cost	<u>0.35</u>

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 (i) a cost-plus price based on a profit mark up of 82% on full cost, and (ii) 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 mark 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 (a).

2. Quaint Inns plc 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.

3. Discuss the key factors that would arise in determining selling prices for:
 - (a) a silversmith whose principal activity is making small items of jewellery
 - (b) an employment agency.

Answers

1. Parsons Perry plc

i)

(a) possible selling prices

(i) based on a cost-plus price	£
Prime cost of one bottle of conditioner	0.35
Fixed overheads: $275\% \times \text{direct labour charge}$	
$= 0.20 \times 275\%$	<u>0.55</u>
Total costs	0.90
Profit mark up: $\text{£}0.90 \times 82\%$	<u>0.74</u>
Selling price	<u>1.64</u>
(ii) based on a variable cost-plus price	
Prime cost (as above)	0.35
Profit mark up: $\text{£}0.35 \times 235\%$	<u>0.82</u>
Selling price	<u>1.17</u>

(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 (a) 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, therefore, market-based pricing is more important in this particular instance than cost-based pricing. The cost-based prices established in part (a) 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.

3. (a) Silversmith

A silversmith making jewellery is likely to be principally engaged in producing unique designs of rings, earrings and so on. Pricing the products is, therefore, somewhat akin to the pricing of unique art works, and prices depend very much on what the customer is prepared to pay. Customers will, however, pay only so much for work in silver which is a relatively inexpensive metal. Gold and platinum fetch higher prices because they are scarcer commodities and therefore intrinsically more valuable.

As in any other commercial enterprise costs cannot be ignored. The silversmith needs to make at least enough to live on, and to cover costs such as raw materials, workshop rental and security costs.

(b) Employment agency

Employment agencies charge fees for services rendered to employers of staff. A common arrangement is for the client (the employer) to pay the equivalent of a number of months salary to the agency as a fee for finding an appropriately qualified and suitable permanent member of staff. So, for example, if the employment agency finds a secretary on behalf of X Limited, the fee payable will be, say, one half of the secretary's annual salary.

Fees may not be related very closely at all to the time and effort spent on the search for employees. If the work involved is simply matching a potential employee already registered with the agency with the employer's request, the work involved may be

minimal and the reward to the agency is relatively high. However, the search for an appropriate member of staff could take a long time. The potential employer may interview and reject several applicants, or there may be a general shortage of suitably qualified staff which will make it difficult for the agency to match client and employee.

The fees charged are, therefore, not closely linked at all to costs incurred, except in the very general sense that any business must be able to cover all its costs in order to survive. The basis for charging fees is, principally, market-based; if the going rate for recruitment agencies in the local area is a fee of four months of the employee's starting salary, no agency is likely to be able to charge much more than this.