International Journal of Research Publication and Reviews

Journal homepage: www.ijrpr.com ISSN 2582-7421

Product Pricing for Businesses Set Prices and Enterprises Accept Prices

Hoang Khanh Van

University of Labour and Social Affairs, Hanoi, Vietnam

* vanhk2121984@gmail.com

ABSTRACT:

Setting product prices in a business is often a long-term strategic decision, sometimes involving short-term adjustments by managers. Therefore, pricing decisions usually align with the company's overall strategy and reflect the market's dynamic nature. Cost information is crucial for managers to price products and make decisions about product structures. How managers use cost information in these decisions depends on whether the business is large or small within the manufacturing sector. After determining the company's pricing capabilities, managers must set short-term and long-term prices that correspond to their ability to influence prices.

Keywords: product pricing, businesses set prices, businesses accept prices

1. Introduction

Companies set their prices in many ways; in small businesses, it's often the owner who calls the shots. A department head and product line manager are responsible for ensuring pricing in larger companies. Even in big firms, upper management sets overall pricing goals and policies and usually approves prices suggested by lower-level managers. In industries where price is key, companies might have dedicated pricing departments to establish and support other departments in determining the right price points. This department reports to marketing, accounting, or upper management. Others who can influence pricing include sales directors, production managers, finance officers, and accountants. Product pricing decisions in a business are typically long-term strategic choices, sometimes with short-term adjustments by managers. Therefore, these decisions align with the company's overall strategy and reflect market flexibility and changes. The price a company sets will fall somewhere between being too low to make a profit and too high to generate demand. The cost per unit sets the floor price, while customer perception of value sets the ceiling. Additionally, businesses must consider competitors' prices, substitute products' prices, and other relevant factors to find the most suitable price between these extremes.

Anthony A. Atkinson et al (2007) believe that managers use cost information to assist in pricing decisions. Cost information is vital for administrators to set prices and make product structure decisions. How managers utilize cost information in these decisions depends on whether the businesses are large or small within the manufacturing sector. If the business has a significant market share and plays a leadership role in the industry, it can decide what prices to set for its products. These businesses are price-setters. A smaller business must adhere to the prices set by these major industry players if one or more large companies are driving an industry's price structure. In such cases, small businesses are price takers because they have chosen their product structure based on pre-determined market prices for their products. After identifying the company's pricing capability, managers must determine short-term and long-term selling prices corresponding to their ability to influence prices. In the short term, mandatory fixed costs such as depreciation, management salaries, etc. are incurred to create basic operational capabilities and are closely linked to the company's long-term objectives, being less affected by short-term decisions. Therefore, mandatory fixed costs are not suitable for short-term decision-making. When pricing products based on cost, managers typically use variable costs without considering mandatory fixed costs. Conversely, in the long term, pricing must account for all production costs, sales support, and management expenses; thus, full costing becomes an essential basis for determining selling prices. Therefore, businesses that accept market-driven prices will price according to market perspectives, while those that set prices will do so based on cost perspectives. Depending on the timeframe of decision-making, cost-based pricing will include all costs or only focus on incremental costs (variable costs).

2. Product pricing for price-accepting businesses.

In a competitive market, the products made by one company are similar to those produced by others (the products are standardized, and there's little chance to differentiate one company's products from another's). As a result, companies that are price-taker businesses must accept the market's price. Numerous cost-accounting studies have emphasized that the market determines prices in many industries. Even though the market sets the price, cost data can help companies decide on the production level that maximizes profits and the actual pricing based on market rates. Cost information is crucial for companies to determine their actual selling prices (using the market price as a benchmark) through sales policies like discounts and commissions. Small companies, or those with an insignificant market share, are considered price-takers because they face similar conditions to monopolistic competition. This price aligns with the market rate and then decides how many units of each product need to be produced and sold. If a company consistently demands a higher price for its products, customers may turn to other competitors in the industry unless it can successfully differentiate its products by offering unique features or services. Moreover, significant discounting can lead to severe damage across the industry, possibly triggering retaliatory price cuts from competitors. Such discounting could lead to a price war that would erode profits for companies and the industry as a whole. Market-driven pricing combined with a price-taker company's cost information is used to: (1) find the product mix that maximizes profits and identify loss-making products; and (2) decide on sales policies that enhance profits when influenced by market prices.

Drury (2004), the timing factor is crucial in determining the relevant cost information for product pricing. Therefore, they advocate distinguishing between companies that accept pricing decisions for products in the short term and those facing such decisions in the long term.

- *Businesses that accept pricing face product pricing decisions in the short term.*

Companies willing to accept the price may face short-term business opportunities in a market with established selling prices. Embracing short-term ventures, where increased sales revenue exceeds incremental costs, can contribute to offsetting fixed expenses and thereby boost overall profits (or reduce total losses) in the short term. However, such business is only advisable if the following conditions are met:

1. There's available excess capacity that isn't replacing or supplementing current production.
2. The company doesn't engage in repeat, long-term business when prices only cover short-term incremental costs.
3. The company must commit to fulfilling the order in a short time frame because a long-term capacity commitment for a profitable order compels companies to add new capabilities to handle increased future sales volumes.

Drury (2004) points out that, besides considering new short-term opportunities, in certain situations, it's necessary to contemplate the integration of products in the short term. If committed resources are maintained, product profitability analysis should be based on comparing incremental revenue with incremental short-term costs. The general principle accepted is to pursue short-term business when excess capacity exists if the incremental revenue exceeds the incremental short-term costs. Therefore, for small businesses—price takers—deciding how much production and sales of a product to undertake for maximum efficiency requires managers to pay attention to costs related to short-term pricing decisions. In the short term, managers have limited flexibility to change the capacity of some resources. When deciding on a product mix, managers will choose products with the highest contribution margin per unit. However, due to limited operational capacity that can't change in the short term, managers must consider how to allocate resources most beneficially to optimize profits. Not every item with a high contribution margin should be focused on for production while neglecting or producing less of those with lower margins. A product with a high per-unit contribution margin but consuming too many resources might not yield optimal results when considering the contribution margin per resource unit (like machine hours, direct labor hours, etc.). Deciding on a product mix under limited resource conditions must be based on the contribution margin generated by a unit of limited resource. Depending on the actual conditions of the business, factors limiting operational capacity could include machinery, plant space, etc.

Besides using cost information to determine the product consumption structure, the company also employs cost data to set the actual short-term selling price of the product. The market price is the benchmark, and it's tough for businesses to sell at prices significantly lower or higher than this standard. By leveraging variable cost information, businesses can establish their real short-term prices to achieve the desired profit margins through sales policies.

- *In the long-term, businesses committed to price acceptance face decisions regarding product pricing.*

When market forces determine prices, a company decides which products to sell based on those market prices. Costs indicate which products can be produced and sold at what price levels, aiding managers in selecting a profitable product mix. Over the long term, a company can adjust the allocation of resources used for a product. Comparing product costs with market prices reveals unprofitable products in the long run, allowing businesses to realign operational resources to meet production demands. The role of managerial cost accounting is to conduct regular profitability analyses to distinguish between profitable and unprofitable products, ensuring only profitable ones are produced and sold.

Decisions to add new products or phase out existing ones from the product lineup can significantly impact a business's product structure in the long run. To curate an appropriate product portfolio, managers must consider the product life cycle in the market, removing items from the lineup as they decline and replacing them with new ones that promise higher profit growth. Introducing new products and discontinuing old ones will alter the company's cost structure, especially maintenance costs like design and manufacturing, sales, and upkeep. Costs related to batches, such as machine operation and product inspection, will change if there's a shift in the product mix. However, managers can't easily adjust resource allocation for many product maintenance activities and batch-related operations. The cost implications of introducing new products or eliminating current ones require careful execution and must go through several stages. Therefore, when making long-term pricing decisions, managers need to use comprehensive cost information.

Comparing the cost of products with their market prices reveals which ones are unprofitable in the long run, as companies can adjust their operational resource capacities to match production demands. If some products have full costs that exceed market prices, managers should consider dropping them.

Before considering product elimination, managers like Anthony A. Atkinson and his colleagues (2007) typically explore other options, such as redesigning or reengineering unprofitable products or improving processes to cut out wasteful activities and align costs with market prices. If, after improvements, the production cost calculated by the full costing method still exceeds the market price, then the product must be dropped. Ditching products can enhance profitability, provided that managers eliminate any operational resources no longer necessary to support the discontinued product and redeploy resources from the dropped products to increase production of profitable ones. These activities don't just vanish with the reduction of unprofitable products. It's only when businesses remove or redeploy these resources that actual costs will go down.

Therefore, capacity constraints have little impact on long-term product structure decisions, as companies can adjust resources for long-term operations. The result is a comparison of product prices to costs based on its operational basis, providing a critical assessment of the product's long-term profitability.

When deciding to add a new product to the company's portfolio, it's crucial to consider its price. If the company is in a position to accept the market price and the new product is not different from those already available, then its price is determined by the market. Business managers use cost information to compare with market prices and make appropriate decisions, including pricing. However, if the new product has unique features, then cost information serves as a fundamental factor in setting its price.

3. Product pricing for price-setting businesses

In markets with little competition, companies selling products that stand out due to unique features or market leadership have some pricing power and are classified as price-setting firms. According to Kaplan and Atkinson (1998), a price-setting firm is one that sets the prices for its products and holds a significant market share. Cost information is vital for pricing decisions. Management accounting methods are designed to provide managers with information for decisions related to pricing.

- *Businesses setting prices face the challenge of making product pricing decisions in the short term.*

In the short term, price-setting businesses, which hold market power, often use cost-based methods to price their products. If a short-term perspective is applied to price-setting products, prices should be established using a method that takes into account variable costs, thereby assuming that fixed costs are not affected by pricing decisions.

When there's spare capacity, the manager will opt for the product mix with the lowest cost to maximize profits. They'll also set a minimum price that covers the additional costs incurred in production and distribution.

If surplus capacity isn't available, the company will have to shoulder additional costs to secure the necessary capacity. Management should consider options like overtime or renting extra equipment. In this case, the minimum price must cover all the incremental costs (including the full expense of increasing capacity). Therefore, the acceptable minimum price should compensate for all additional expenses incurred. However, when determining the extra capacity needed to fulfill an order, one must consider the costs associated with deciding whether to accept or reject that order.

Garrison (1991) points out that of the two product pricing methods, full costing and variable costing, variable costing is more flexible and preferred in the short term. Kaplan (1988) argues that when there is idle capacity, short-term incremental costs provide sensible information as a cost basis for short-term pricing. However, he notes that if orders are maintained repeatedly, the demand for resources is likely to increase, leading to higher long-term fixed costs and consequently higher prices. Therefore, Kaplan contends that companies deciding on short-term pricing should always consider the long-term implications, and a short-term perspective should only be adopted based on specific conditions. Typically, incremental costs may include additional materials required to complete an order, extra labor costs, and additional energy and maintenance costs for machinery and equipment needed to fulfill the order.

Short-term pricing decisions hinge on a cost basis and depend on the availability of operational resource capacity. Short-term product mix decisions also require information about costs incurred in the short term. If capacity is limited in the short term, managers can use the contribution margin per unit of limited capacity as a criterion to prioritize products in the production plan. Thus, the nature of cost information necessary for pricing and product mix decisions varies with the time frame considered. In the short term, variable costs provide relevant information for making pricing decisions for companies setting prices.

- *Businesses setting prices are grappling with long-term product pricing decisions.*

Drury (2004), in the long-term, companies can adjust the supply of most operational resources. Therefore, a product should be priced to cover all the resources used. If a company can't generate enough revenue to cover long-term costs, it will operate at a loss and may not survive. Accurate cost information (a costing method that precisely measures the resources used by each product) is essential for setting prices. However, allocating costs is not a simple task. Allocating indirect costs based on outdated criteria like direct labor can lead to distorted information. Cost distortion can result in either too little or too much cost being allocated. In the first scenario, the price may not include the long-term resources used for a product. Conversely, in the second scenario, business profits might be lost because inflated product costs have led to prices being set too high, adversely affecting sales volume. According to Drury (2004), the preferred method of pricing for companies is to allocate costs to activities using an activity-based costing approach.

In the long-term, businesses continue to set prices based on cost-plus pricing, with full costs as the baseline. Thanks to market-based pricing capabilities, managers often adjust selling prices through discount policies to clear inventory and optimize equipment capacity rather than rigidly sticking to a fixed price based on full costs. Moreover, demand for certain products fluctuates seasonally, so in the short term, it's necessary to tweak prices accordingly. When demand for a company's products dips, they become more aware of potential short-term excess capacity. Then they lower product prices to boost sales volumes. Conversely, when demand rises, businesses realize that their current resources might not meet all needs. Therefore, they'll hike prices based on the higher incremental costs they incur when operating at full capacity. While short-term prices fluctuate based on costs, in the long run, selling prices tend to average out these short-term fluctuations. Most companies rely on full costing to determine their target or standard selling price in the long term, so they can adjust prices up or down depending on demand situations. A company's business strategy also has an impact on setting long-term target pricing. Many businesses often lower the markup added to the price. A company might choose a low markup for a new product to penetrate the market and snatch market share from an existing product. Contrary to penetration pricing strategies, sometimes businesses deploy skimming price strategies to set high prices and quickly maximize profits.

New products are those not yet available in the market or those that are similar to existing ones but differ in design, style, or some quality parameters. Pricing these new products is particularly tricky and challenging for business managers setting prices, because if the price is off, it can hurt both profits and the company's reputation. Garrison (1991) argued that pricing new products is often complex due to the doubts associated with it. If a product is unlike anything on the market, its position is uncertain. If the new product is similar to what's already being sold, its place will be as a substitute to the extent that it can replace existing market offerings.

4. Conclusion

For businesses that are price-takers, in the short term, variable costs are a crucial basis for pricing decisions and for determining the product mix and sales volume under conditions of price acceptance and limited resources. When making long-term pricing decisions, price-taking companies rely on comprehensive cost information to identify profitable and unprofitable products, ensuring only the profitable ones are produced and sold. As for price-setting enterprises, variable costs provide relevant information for short-term pricing decisions. In the long run, these companies continue to set prices based on a cost-plus method, with full costs as the base. Pricing decisions for new products depend on the company's goals, which dictate the cost information used. If the initial goal is profit, prices will be based on full costs; if it's market share, prices will lean on variable costs. Contrary to short-term strategies, in the long run, price-setting companies opt for full costs as their pricing foundation.

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