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Pricing Decisions

6.1 Introduction and objectives

Pricing decisions are among the most important decisions management has to make. Formulating an effective pricing policy is a complex and delicate matter which needs to consider the economic environment, competitor, financial and psychological factors. Setting the 'right' price is a constant challenge in a changing marketplace and is essential to long-term business success. This is made even more complex when pricing services and packaged products.

After studying this chapter you should be able to:

- Understand the importance of the pricing decision and its impact on the business
- Develop a working knowledge of pricing methods
- Consider pricing from a financial, economic and market perspective; and
- Reflect on the specific issues within hospitality, tourism and events sectors.

6.2 Pricing approaches

The three key approaches relate to pricing from a financial, economic, or market perspectives. Each of these has different merits and within these three broad approaches there are different techniques that can be used.

6.2.1 Financial approach to pricing

This is often referred to as the traditional approach to pricing. Although there are a number of variations the basic traditional approach is simply:

$$\text{Costs} + \text{Mark-up} = \text{Selling price}$$

Mark-up is a predetermined amount added to the costs to calculate the selling price. Given the calculation, this approach is known as Cost-plus pricing. There are variations to the cost base in this formula that lead to variations to this approach – these are summarised in Figure 6.1 and then discussed in more detail.

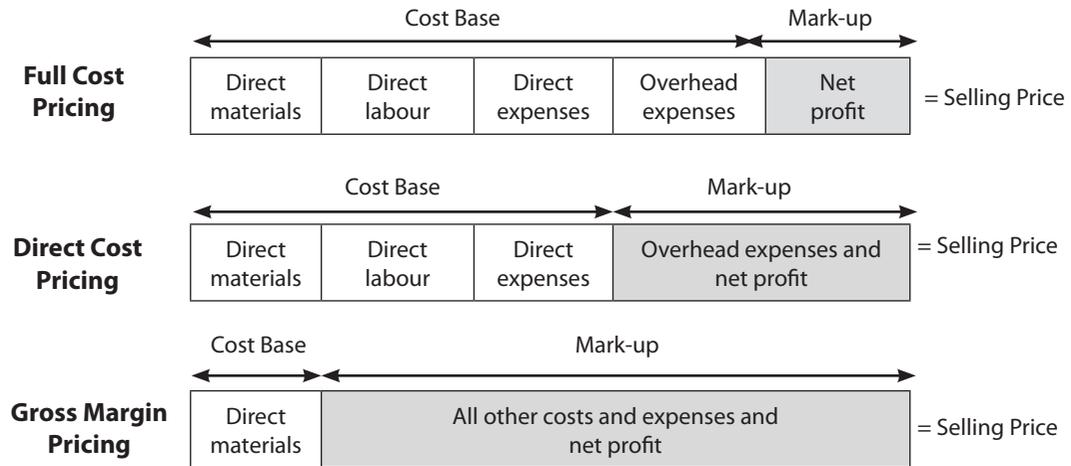


Figure 6.1: Cost-plus pricing variations

6.2.1.1 Full cost pricing

This basic 'cost-plus' approach, known as full or total cost pricing, entails establishing the total cost of individual products or services and then adding a mark-up to that to cover the required profit.

As an example, a company has estimated the following data:

Direct materials = £60,000

Direct labour = £30,000

Direct expenses = £15,000

Overhead expenses = £25,000

Desired profit = £30,000

The above data can be displayed as follows to show the total cost and the desired profit (Table 6.1). On this basis the desired sales revenue becomes £160,000. From this data the percentage mark-up can then be calculated.

Table 6.1: Total costs and desired profit

	£
Direct materials	60,000
Direct labour	30,000
Direct expenses	15,000
Overhead expenses	<u>25,000</u>
Total costs	<u>130,000</u>
Desired profit	<u>30,000</u>
Sales revenue	<u><u>160,000</u></u>

The following formula is used to calculate the mark-up needed on costs to reach the desired profit.

Formula using full cost pricing

$$\frac{\text{Profit}}{\text{Total costs}} * 100 = \text{Mark-up \%} \quad \frac{30,000}{130,000} * 100 = 23\% \text{ Mark-up}$$

How does this help in setting a price for individual products? If for an individual item (unit) we have calculated the total costs to be £10 the price would then be:

$$£10 + 23\% = £10 + £2.30 = £12.30 \text{ Selling price}$$

If another item (unit) had a total cost of £15 the price would be:

$$£15 + 23\% = £15 + £3.45 = £18.75 \text{ Selling price}$$

If you can easily establish all the costs then this total cost (absorption costing) base for pricing can work. Based on space/time usage for a conference, however, across events, hospitality and tourism sectors given the service element this is not always as easy to do, so an alternative cost base may be more desirable.

6.2.1.2 Direct cost pricing

In this approach only the direct costs are calculated and then a mark-up is added to cover the desired profit and the overhead expenses. Within events and banqueting, or even tourist packages it may be possible to identify all direct costs. If a conference has been requested for 150 people with a set menu these direct costs can be readily calculated, i.e. food and drink costs, direct labour for the event and specific expenses. Taking the previous data, this is how direct cost pricing is calculated.

Formula using direct cost pricing

$$\frac{\text{Overheads and profit}}{\text{Direct costs}} * 100 = \text{Mark-up \%} \quad \frac{25,000 + 30,000}{105,000} * 100 = 52\% \text{ Mark-up}$$

If the direct costs for an individual unit were calculated at £8 the selling price would be:

$$£8 + 52\% = £8 + £4.16 = £12.16 \text{ Selling price}$$

Or if the direct costs were £12:

$$£12 + 52\% = £12 + £6.24 = £18.24 \text{ Selling price.}$$

There are many situations where calculating all direct costs can be difficult, in this case gross margin pricing could be a better option.

6.2.1.3 Gross margin pricing

In a factory situation it is reasonably easy to establish for an individual product being made how much direct labour is involved, i.e. how many minutes a specific task takes. This isn't always so easy with a service encounter. Imagine two individual customers come in to a restaurant, they order the same food and drink.