

PRICING DECISIONS

Question 1

What are the disadvantages of Cost Plus Pricing ?

(5 Marks)(May, 2011)

Answer

Disadvantages of cost plus pricing:

- (i) It ignores demand, fails to take into account buyers' needs and willingness to pay.
- (ii) Fails to reflect competition adequately.
- (iii) Assumes correct cost estimation, whereas in multiproduct firm, costs may be arbitrarily allocated.
- (iv) In many decision, incremental costs are more relevant than full cost. This is ignored.
- (v) Fixed Overheads depends on volume if volume is more cost is less, and vice-versa. Increase decrease in sales volume depends on price. Thus it is a vicious circle – cost plus markup is a price based on sales volume & sales volume is based on price.

Question 2

Explain briefly the concept of skimming pricing policy.

(2 Marks)(Nov., 2009)

Answer

Skimming Pricing Policy:

When the product enters the market, a high price is charged so that price covers the initial cost of production and the demand is unknown e.g. Mobile Phones, Flat LCD TVs, etc. Price are gradually reduced.

Question 3

Briefly explain skimming pricing and penetration pricing policies.

(4 Marks) (Nov., 2008)

Answer

Skimming prices: Policy of highly pricing a product at the entry level into the market and reducing it later.

For example: Electronic goods, mobile phone, Flat, TVs, etc.

It is used when market is price insensitive, demand inelastic or to recover high promotional costs.

Penetration Pricing: Policy of entering the market with a low price, then establishing the product and then increasing the price.

This is also used by companies with established markets, when products are in any stage of their life cycle, to avoid competition. This is also known as “stay-out pricing”.

For example, entry of a new model small segment car into the market.

Question 4

What is Price Discrimination? Under what circumstances it is possible? (4 Marks)

Answer

Price discrimination is charging different prices with respect to customers, products, places and time

It is possible when

- the market being capable of being segmented
- the customers is not able to resell the product at a higher price
- The competitors' underselling is not possible

Question 5

In a company, factory, overheads are applied on the basis of direct labour hours.

The following information is given:

	Department	
	A	B
Fixed factory overheads(₹)	3,36,000	1,26,000
Variable labour hours (₹ per hour) required as per direct labour hour budget	0.50	1.50
For product X	1,40,000	70,000
For product Y	28,000	56,000

(4 Marks) (May, 2011)

Answer

	Products	
	X	Y
Variable Overheads	175000	98000
Fixed Overheads	<u>350000</u>	<u>112000</u>
Total	<u>525000</u>	<u>210000</u>

	Department A	Department B
Variable Overheads		
Product X	70,000	1,05,000
Product Y	14,000	84,000
Fixed Overheads		
Product X	2,80,000	70,000
Product Y	56,000	56,000

Question 6

Hind Metals Manufactures an alloy product 'Incop' by using iron and Copper. The metals pass through two plants, X and Y. The company gives you the following details for the manufacture of one unit of Incop :

Materials	Iron: 10 kgs @ ₹5 per kg. Cooper: 5 kg @ ₹8 per kg.
Wages	3 hours @ ₹15 per hour in Plant X 5 hours @ ₹12 per hour in Plant Y
Overhead recovery	On the basis of direct labour hours
Fixed overhead	₹8 per hour in Plant X ₹5 per hour in Plant Y
Variable overhead	₹8 per hour in Plant X ₹5 per hour in Plant Y
Selling overhead :	(fully variable) – ₹20 per unit

- Find out the minimum price to be fixed for the alloy, when the alloy is new to the market. Briefly explain this pricing strategy.
- After the alloy is well established in the market. What should be the minimum selling price? Why?

(6 Marks)(Nov.,2009)

Answer

		₹ /u of alloy
<i>Materials:</i>		
Iron 10kg @ ₹ 5/-	50	
Copper 5 kg @ ₹ 8/-	<u>40</u>	90
<i>Wages</i>		
X : 3 hrs @ 15 ₹ /Hr.	45	
Y : 5 hrs @ 12 ₹ /Hr	<u>60</u>	105
<i>Variable OH (Production)</i>		
X : 8 hrs × 3 hrs	24	
Y : 5 hrs × 5 hrs	<u>25</u>	49
<i>Variable OH – Selling</i>		<u>20</u>
<i>Total Variable Cost</i>		264
<i>Fixed Off:</i>		
X : 8/hrs × 3 hrs.	24	
Y : 5/hrs × 5 hrs	<u>25</u>	<u>49</u>
<i>Total Cost</i>		<u>313</u>

- (i) If pricing strategy is to penetrate the market, the minimum price for a new product should be the variable cost i.e. ₹ 264/-. In some circumstances, it can also be sold below the variable cost, if it is expected to quickly penetrate the market and later absorb a price increase. Total Variable Cost is the penetration price.
- (ii) When the alloy is well established, the minimum selling price will be the total cost – including the fixed cost i.e. ₹ 313 per unit. Long run costs should cover at least the total cost.