

## THE POLICY OF PRICES AN IMPORTANT ELEMENT IN SUBSTANTIATION OF PENETRATION STRATEGY IN NEW MARKET SEGMENTS

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*Pricing policy aims to determine the price of goods and services sold by the organization. These figures have an impact over the turnover that must be higher to the total expenses for the enterprise to make profits. Therefore, it is important to know the cost when are decided the selling prices. However, there is only one way to calculate the costs to be adapted to all decisions relating to prices. Why? Because these decisions are different among themselves as regards the consequences more or less distant, and their context. For example, McDonald's restaurants may decide on a price of € 0.99 for a hamburger. It is a fixed price. An estate agent may ask for a € 495,000 property, knowing that potential buyers will negotiate the price decrease. It is important to know the laws of variation and training costs to decide, wittingly, the price to be asked (and agreed to be paid).*

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### **Introduction**

Economic theory demonstrates that the optimal behaviour of an enterprise is to sell quality for which the marginal charging (the price received for the last unit sold) is equal to marginal cost (the cost that it is the last unit sold). The market price is the price for which it is a solvent request for this optimal quantity. This chapter explains the way the managers make profit by assessing the request according to the price level and using costs to act on the offer. Analysis of customer profitability pursues the profits generated by the different categories of customers in place to analyze the profits according to the category of products.

The three main parameters of the prices policy are<sup>411</sup>:

- customers,
- competitors and
- costs.

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411 Călin O. &al., Managerial accounting, Editura Didactică și Pedagogică, București, 2008.

**Customers.** The issue of prices must always be approached from the viewpoint of the client. An increase of prices may push the customers to deny the products of the enterprise and to choose the products of competitors or other replacement products.

**Competitors.** Reactions of the competitors affect the price policy. Prices and products of a competitor may constrain an enterprise to decrease prices in order to remain competitive. A well-informed enterprise about the competition (technology, production capacity, management policy) is able to estimate costs, which is valuable information to determine its own prices. Competition analysis is made in several respects. Many companies worldwide have created services responsible with gathering information about the competition (financial results, deposits of patents, techniques used, turnover and cost structure, and strategic alliances). Even competitors, their customers, their suppliers and former employees make important sources of information. Another means of informing is the study of competition products with the purpose to integrate what they have best in creating our own products. Competition has no limits. When its production capacity cannot be absorbed on the national market, the policy of prices of an enterprise often becomes aggressive on the export markets. Today, business' leadership pursues these issues globally and takes account, in determining process of the pricing policy, of both their competitors from foreign countries, and competition in the country.

**Costs.** Typically, the companies set higher prices than the cost of production. Analysis of expenses variation law allows an evaluation of the results that arise from different combinations of price and volume of sales of a certain product.

Economic theory and case studies regarding decision making in terms of prices shows that enterprises assigns a different weigh of the three parameters: customers, competitors and costs. Take the case of the insurance group *Royal and Sun Alliance* in which "prices are set according to profitability and not the maintenance of market share"<sup>412</sup>. In effect, the *Diversia.com*, a Spanish sales online enterprise provides a ticket for shopping of € 18 to each person who registers on the site. In five weeks, registered 60 000 people<sup>413</sup>. The strategy of the two companies is clearly different. Enterprises that sell basic products (wheat, rice, soya, etc.) on very competitive markets must accept the price dictated by the market forces. However, ultimately, they are the ones who decide on the quantities they sell out to, depending on costs.

On the less competitive markets, the price of a product results from the combination of *request* and *offer*. Customers exercise some action on the price through the request effect. The costs exercise an action on prices because they have influence over the offer. Competitors offer similar products or replacement products, which affects the request and pricing. To satisfy the customer, is important for prices to fall, but to improve quality, which involves also a reduction of costs. The continuous progress from the enterprise is the key of keeping prices under control.

## 1. Prices Policies And Time Factor

When he wants to reduce the cost, an enterprise studies the expenses in all aspects of its scale of values, starting by conducting studies and researches and ending with the provided service. When are calculated the significant expenses for pricing establishment, it is essential to establish also the period in which the decision will take effect. Decisions regarding prices are taken on long or short term. Among short-term decisions, we remind:

- pricing for an exceptional command which will not have an impact on long term, and
- adaptation of components and the volume of sales in a reactive market.

For expenses that depend on the options considered through the decisions made are made predictions on six months or even a year. Decisions on long-term aim in particular establishment

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412 Royal and Sun Alliance, Raport anual, 1999.

413 The Industry Standard Europe, 11 ianuarie 2001.

of the price for a product in a market where there is a large freedom of prices. In this case, is required significant expenditure for a year or even more.

Let us imagine that an enterprise receives an exceptional order to provide certain products for four months. Acceptance or refusal of such orders should not affect the turnover (quantity and price) from the usual sales.

Enterprise TESANO has a factory with a monthly production capacity of 1 million boxes of solutions for windows cleaning (each box contains 200 doses). Currently, it produces and sells 600,000 boxes per month. The price of a box is € 90. Expenditure with research and development are negligible. Very low cost of service is included in trade taxes. All variable expenses depend on the quantity and the quantity produced is equal to the sold quality. Unit variable cost and unit fixed cost (based on 600,000 boxes per month) are detailed as follows<sup>414</sup>:

	<b>Variable cost of a box</b>	<b>Fixed cost of a box</b>	<b>Total cost of a box</b>
Production expenses			
Raw material	€ 7	-	€ 7
Conditioning	€ 18	-	€ 18
Direct labour	€ 4	-	€ 4
Indirect expenses	<u>€ 6</u>	<u>€ 13</u>	<u>€ 19</u>
<b>Total production expenses</b>	<b>€ 35</b>	<b>€ 13</b>	<b>€ 48</b>
Trade taxes	€ 5	€ 16	€ 21
Sales logistic	<u>€ 9</u>	<u>€ 8</u>	<u>€ 17</u>
<b>Total cost</b>	<b><u>€ 49</u></b>	<b><u>€ 37</u></b>	<b><u>€ 86</u></b>

Indirect variable production expenses of € 6per box include heating, cooling and lighting. The detailing of fixed production expenses and their reduction to a unit (based on 600,000 boxes per month) is presented below:

	<b>Total fixed expenses</b>	<b>Unit fixed expenses</b>
Depreciation and support	€ 3,000,000	€ 5
Expenses with goods supply	€ 600,000	€ 1
Salary expenses of operation modification	€ 1,800,000	€ 3
Mentioning of products and processes	€ 2,400,000	€ 4
Total of fixed production expenses	€ 7,800,000	€ 13

Company INTER BRAND is building a new factory in Ukraine. This factory will start to produce just over four months. However, the leadership of INTER BRAND wants to start selling in Ukraine of 250,000 boxes per month in the following four months. INTER BRAND launched a tender for this exceptional command to which have responded both TESANO, and other companies. Characteristics of the windows cleaning solution required for the one from INTER BRAND are identical to those produced now by TESANO.

If TESANO would produce 250,000 boxes in addition, current fixed production costs (€ 7,800,000 per month) would not change. In addition, TESANO would support the new fixed costs, amounting to € 300,000 (supply of materials, € 100,000, operations modification, € 200,000). Expenditure with research and development, trade costs, logistics of sales and service do not change. The 250,000 boxes would be marketed in Ukraine through INTER BRAND. Currently, TESANO not sells in this country.

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414 Horngren Charles &al., Comptabilité de gestion, Education Pearson, Paris, 2006.

INTER BRAND notifies the intermediaries that, probably, a higher offer of € 45 per box will not be taken into account. TESANO knows that one of the competitors, with a very performing factory, has an unused production capacity and that, certainly, will agree. What price should mention TESANO in the tender? To determine the significant expenditure in the supply response, TESANO analyzes the spending in all departments of the enterprise making the value chain. In her case, only the costs of production are significant, the other ones not presenting any variation. The following table shows the analysis of significant expenditures. Within appear all the costs of production that would be altered if TESANO would sign the contract with the *new* fixed costs under the contract. On the other hand, the existing fixed costs are excluded from the analysis, since it would remain unchanged.

**Table no 1. Significant monthly expenses as TESANO response to the offer**

Raw materials (€ 7 x 250,000 boxes)		€ 1,750,000
Conditioning (€ 18 x 250,000 boxes)		€ 4,500,000
Direct labour (€ 4 x 250,000 boxes)		€ 1,000,000
Variable indirect production expenses (€ 6 x 250,000 boxes)		€ 1,500,000
New fixed expenses	€ 100,000	
Supply with goods	€ 200,000	
Modification of operations		€ 300,000
Total of new fixed expenses		€ 9,050,000
Total of significant expenses		
Unit significant cost: € 9,050,000/ 250,000 boxes = € 36.20		

This table shows that any higher price of € 36.20 would lead to an increase of profits for TESANO. It would be wrong to determine the offer price depending on the production cost of € 48 which was calculated before. In fact, the cost of € 48 includes expenditures that are not significant in this case.

Although the significant cost putted in evidence is essential information, TESANO must take into account also the possible offers of its competitors. If they knew that competition would propose a price of € 39, TESANO would agree to accept a price of € 38.

Decisions regarding pricing are often long-term effects. Buyers, regardless of who they would be, prefer a long term stability of prices. Prices being fixed, there is no need to constantly monitor the prices of suppliers. Stability supplies the forecasts and allows establishment of long-term relationships between buyers and sellers.

## **2. Discriminatory fixation of price**

*Discriminatory price fixing* consists in making certain customers to pay a higher price than the required one by other customers. In the case of an airline company there are two categories of customers: business people and tourists. Business people travel for business purposes: go to the established place of meeting and then return home immediately, after they have finished the job. These features make relatively insignificant the price paid for the flight of business people. Their demand is *not flexible*. Therefore, the airlines companies may apply higher rates for business trips without reducing in any way the demand also.

Tourists are not so hurry to return home during the week. In fact, they often prefer to spend the weekend on holiday. Because they pay their own travel, are more sensitive to price than business people (their demand is elastic to price). For airline companies is profitable to stimulate demand for tourist travel by practicing moderate rates. Request from the Saturday night allows a distinction between the two segments of customers. Discriminatory fixing of price for air travel

brings profit to companies from the difference of sensitivity to price of the two segments, although it is not any difference between them as regards costs.

### 3. Differential fixation of prices in time

In addition to discriminatory fixing, pricing policy takes account also of other factors, such as the capacity constraints. Differential fixing of the price in time consists in practicing a higher price for the same product during periods in which demand is approaching the capacity limits. Prices are higher during peak periods than in more quiet periods. This policy is seen on the railways, in telecommunications, in hotel industry, in parking of cars and supply of electricity.

### Conclusions

Activities management of an organization of any kind involves a decision-making process whose complexity is determined by the hierarchical level which is the human factor responsible also for the need of documentation and substantiation of that decision. Prices are a key element in economic systems management. Determination and analysis in order to improve the decision performances constituted continue concerns also in scientific research domain, and in economic practice<sup>415</sup>.

Information is a product of human mind, is the fundamental capital, the central cost and essential resource of the economy<sup>416</sup>. That is why for the development of management control is necessary to study the relationship between information and decision. The relationship between these two elements can take two forms, depending on the decision-making universe in which is situated:

*We express the view according to which **the ability of managers, located on different hierarchical levels of the entity, to assert as active "actors" of economic process, depends on the insurance of a fund and an appropriate and evaluated information infrastructure, because the quality information creates, for manager, conditions of use at any time performance mechanisms. In this context, information, particularly accounting one, converted in managerial skills is manifested as major source of authority and legitimacy decision-making. Furthermore, it is easy to see the fact that, increase of complexity of the economic environment involves continuous improvement of the information system and its organization in a unitary form, efficient and modern, information is trigger of decision making, they are not their replacement, but only their support, providing at disposal of decedents the necessary data for adoption of decisions that are required. In their quality of deciders, managers appreciate, more often, information as a true resource that can really give to the holder a real competitive advantage, and not only as a subordinate element of the decision adoption.***

*Although the management accounting produces information that has to be diversified for many categories of managers, they are used in different ways. Therefore, they are considered in their diversity, more complement than competing.*

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