Chapter 4
Financial Analysis in Pricing

ABSTRACT

Firms in a competitive marketplace are successful by improving their strategies on pricing and profitability. Consistency of strategy in the product, pricing, communication, and marketing channels yields a synchronized effort, which improves the profitability of the firm. The author argues in this chapter that the most competitive and profiteering firms that emerged as an outgrowth of the globalization in many developing countries are successful not because they have the lowest costs but because they outmaneuver their competitors on price. Deriving the financial analysis on pricing, it is further argued that getting pricing right is always a challenge in a competitive market as growth substitutes, increasing switching behavior of consumers, inconsistency in demand, excess production and supplies, and greater price sensitivity. Besides the core pricing strategies, various financial issues on pricing including mark-up strategies and profitability, pricing models, international pricing fundamentals, and value-chain pricing are also discussed in the chapter.

INTRODUCTION

Companies tend to assume that little can be done to reduce product costs once a design is set. This belief has shaped many cost management programs across diverse products' life cycles. Because of it, firms often focus on cost reduction during the design phase and cost containment during manufacturing. The companies competing aggressively on cost might consider adopting some form of an integrated cost management program that spans the entire product life cycle (Cooper and Slagmulder, 2004).

There are three major elements comprising 3Cs—Customers, Competitors, and Costs—that influence the pricing decisions. Competitive-cost analysis represents a strategic application of cost modeling. At the highest level, it allows for a direct comparison of a company and one of its products or services with a direct competitor or competitive offering. In a competitive marketplace firms need to focus on market-driven costing and develop profitability strategies in reference to gross margins by measuring costs incurred on serving the customers including opportunity costs. It has been observed that relationship between

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true gross margins and managers' perceptions demonstrate the ability of the firms to compete in the marketplace. There are two general classes of gross profit strategies exist among the firms in the competitive market that include volume-driven, and price/bundling gross profit strategies. The latter is particularly applicable to the firms in low-margin markets (Smith, 2006).

Firms in a competitive marketplace are successful by improving their strategies on pricing and profitability. Consistency of strategy in the product, pricing, communication, and marketing channels yields a synchronized effort that improves the profitability of the firm. Leading manufacturing and marketing firms now analyze their suppliers' cost drivers to help shape sourcing strategies as well as supplier-improvement efforts. Competitive-cost analysis starts with an understanding of such basic cost-accounting elements as direct labor, raw materials, and facility overhead. Although these elements explain where the costs accrue, they provide limited insight into why. Cost drivers are the levers that managers can influence to affect a change in operational performance and reduce costs. A recent study has discussed the cost assessment methodology, which is based on the integration of three techniques including simulation modeling, Association Rule Mining (ARM) and Activity-Based Costing (ABC). Simulation modeling is used to model process variability and produce a range of cost values, instead of a point estimate of the cost, by generating a range of values for the simulated cost drivers. The advantage of the proposed methodology lies on the effective utilization of ARM in the ABC model; it extracts dependencies between cost drivers, whose estimation is time-consuming, with another cost driver, which can easily be calculated. These associations can assist the estimation of the empirical distributions of those cost drivers, which are difficult to calculate (Kostakis et al, 2011).

Small firms that are grown in niche often do not give enough thought to an accounting system during the planning or implementation phases of their business. Working on an effective business plan forces them to use pro forma financial statements, and soon they need certified accounting methods for meeting the needs of investors, lenders and taxing authorities. But systems designed solely for those needs often fail to provide the managerial accounting information necessary to operate the venture to make sound operating, strategic, and tactical decisions. The traditional accounting system largely relies on to do this as absorption costing, which does not include costs of marketing and distribution. Activity-based costing provides a better framework for gauging the profitability of product lines and avoids some of the distortions caused by absorption costing. ABC is particularly useful in service firms by identifying activities, specifying cost drivers for each activity, calculating charging rates for each activity, and allocating costs to each product/service. In particular, ABC enables the firm to isolate the costs of unused capacity. Simple examples are provided and worked through one step at a time to illustrate the differences in logic and conclusions yielded by ABC as opposed to absorption costing (Baxendale, 2001).

The value of a company is determined by the interrelationship of various variables. Costs in firms significantly contribute to its revenue streams as well as business growth. Success in managing costs has a phenomenal effect on value because of the relationships between costs, business risk, financial risk, and valuation. These relationships are non-linear. Consequently, success in cost management yields amplified benefits in terms of value creation. The quality of cost management focuses on benefits of cost management in terms of the reduction of business risk, asymmetric effect on the creation of value, and the increased tax benefits. It offers additional considerations relevant in emerging cost control technologies such as activity-based costing and cost driver analysis (Groth and Kinney, 1994). Activity-Based Management (ABM) is a system that incorporates many of the concepts of

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