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Special Pricing Decisions as Instrument for Improving Companies' Performance in Nigeria

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Abstract: One of the poor performances of manufacturing firms in Nigeria is attributed to insufficient market demand. This study examines, how special order pricing can be successfully introduced to improve contribution margin. The findings reveal that special pricing decisions are better means of reducing idle capacity and that this technique can be successfully introduced if the country achieve economy stability and favourable operating environment are introduced by the government.

Key words: Companies, performance, advantage, manufacturing firms, insufficient market demand, Nigeria

INTRODUCTION

Many companies in the developing nations have weak competitive advantage when compared with companies in the developed nations. Production capacity is not only low but also they are aged. The problem of low production capacity is a function of insufficient demand. Thus, this adverse factor leads to:

- Reduction in revenues which sometimes leads to incurring losses where the contribution earned is not sufficient to write off the fixed costs
- Unable to properly maintain the existing facilities
- Insufficient fund for procuring new technology
- Closing down some business segments or closing the entire business operations whenever situation becomes critical

The problem of insufficient demand started after the Second World War as a result of global recession that followed. The keen competition and the rapid technological innovations that were introduced to the business circle later worsen the situation any time recession persists in any environment. Now a days, the problem is not peculiar to few countries alone but it is more or less a global phenomena. However, 3rd world nations are more concerned while many companies in the developed countries have been able to reduce cost, improve product quality and increase both demand and profits because of the introduction of automated defects control machines and JIT system to their manufacturing operations.

The effect of low production capacity differs from country to country since, it is observed that some countries perform better than others. This study examines how special pricing decisions technique can be used as instrument for improving company's performance in Nigeria. It also examines the extent to which this technique has been successfully applied by few reputable manufacturing organisations.

Theoretical framework: The environment of insufficient demand is always a critical issue that affects the operational performance of any concerned organisation. In most cases, the idle machines would be rusted because of inadequate financial resources created by this adverse operational environment. This is the reason why Hilton (2005) observed that the demand of customers are of paramount importance in all phases of business operations, from the design of a product to the setting of its price.

In the past and of recent, different developmental techniques have been used to improve normal production capacity such that idle capacity created can either be drastically reduced or completely eliminated where there are other favourable factors of production. Such techniques include application of marginal costing through special pricing decisions technique as instrument for improving company's performance in Nigeria, target costing which tries to determine the price that potential customers are willing to pay where an alternate product is designed, just in time manufacturing that tries to produce according to demand and procure materials input according to production requirements, throughput accounting that tries to maximise the use of bottleneck machines and drastically reduce stock piling and some other techniques.

The subventions given to companies in the past by the government have not proved positive. The various governments themselves could not provide needed basic facilities and transportation systems in the country are grossly inefficient. The level of wage differential system also in the country is also a major factor affecting demand. Special pricing decisions

technique is guided by the concept of relevant costing which involves decisions that affect output level. Relevant costs is defined as the anticipated future costs and future revenues that differ among alternatives (Iwarere, 2009). Thus, from the foregoing, it can be stated that relevant cost is one of the major pillars of short term decision management. For instance, if a firm is operating in a low market environment, resulting in an idle capacity, the costing of a special order requires that certain costs must be excluded and treated as sunk costs or irrelevant costs.

The logic behind the latter statement is that in order to ascertain the minimum price, cost that must be incurred whether the product is manufactured or not should be treated as an irrelevant cost. From the definition of relevant cost, three important features are noticeable. These comprise:

- They are future costs i.e., cost yet to be incurred.
- They are differential costs i.e., they differ between current alternative decisions
- They involve cash flows

Horngren *et al.* (2002) assert that special pricing decisions belong to the category of one-time decision making process where there is idle production capacity and where the order has no long-run implications. In another related dimension. Drury (2006) identifies special pricing decisions to relate to decisions outside the main market which typically involved one time only orders or orders at a price below the prevailing market price.

The obligation facing the management in connection with special pricing decisions is how to determine the minimum price and thereafter ascertain the acceptable price range that lies between the minimum price and the determined unit price. In determining the minimum price, cost account for major input. Companies should ensure they incur costs lower than costs incurred by their major competitors (Iwarere, 2009; Rue and Byars, 1995). Because of the problems arising from limiting factors, management often applies marginal costing to determine the product price of special order. The intention is to ascertain increase capacity utilisation in order to improve performance. The summary of marginal costing can be expressed in an equation form through the total cost and total sales equations. Thus:

- Total cost (TC) = TVC+TFC
- Total Sales Revenue (TSR) = Total Cost + Profit/(loss) i.e., TSR = TVC + TFC + Profit/(loss)
- Marginal cost = Total variable cost
- TSR - TVC = Contribution

Or contribution is the difference between the sales revenue and the variable cost.

Ascertainment of profit: Under marginal costing, profit is the difference between the contribution and the fixed cost i.e., Profit = Contribution-Fixed Cost.

Where contribution is less than fixed cost, the equation becomes:

$$L = F\text{-}C$$

Where:

$$L = \text{loss}$$

Iwarere (2009) observes that management is often faced with problems of low production capacity due to insufficient market demand in a weak economy. The critical area therefore centres on how to improve contribution margin by utilising the idle facilities to improve production volume. Thus, where demand is serving as the key factor, an idle capacity is created. This idle capacity generally lowers the firm's target profit. From the basic principles of cost, when applied to domestic sales:

$$\text{Average total} = \text{AFC+AVC}$$

Average total cost is the same as Marginal Cost (MC), per unit change in output which is defined as:

$$MC = \frac{(\text{Percentage change in TC})}{\text{Percentage change in Q}} \text{ ie., } \frac{TC_2 - TR_1}{Q_2 - Q_1}$$

However, Perreault and McCarthy (1996) expresses that average cost approach is that it does not consider cost variations at different levels of output. Another obtain expression for marginal revenue can be obtained, MR, per unit change in output which is the same as average revenue i.e., AR = TR ÷ Q or:

$$MR = \frac{(\text{Change in total revenue})}{\text{Change in Q}} \text{ i.e., } \frac{TR_2 - TR1}{Q_2 - Q1}$$

But profit is maximised when MC = MR. From the above, profit is maximised at a point where MC equates MR. However, profit maximisation objective as applicable for domestic requirement is not the basic principle adopted for special pricing decisions. But improving contribution margin is important because of the idle capacity created. The idle capacity is created because of different reasons. This includes changes in government policies or increase in competition. But whatever may be the case, competition either enables a firm to be more efficient in its operational performance or exit from the

present business carried out because of inability to possess a favourable cost advantage for its products Before deciding on the issue of special pricing decision, management must ascertain the acceptable price for the domestic market that covers the entire normal production volume. In fixing the price for the latter production volume, the following parameters should be assessed:

- Size of the market
- Cost of production
- Expected profit for the period
- Seasonal fluctuation in demand
- Volume of competitors sales and substitute products available in the market
- Prevailing economic trends

Once the domestic price has been finalised and there is an assurance that the firm will achieve the target sales of normal production volume, then, the next step is to determine ways of improving the performance through special order. This is likely possible through the effort of:

- Embarking on sales promotion through the use of price cut. In this case to avoid conflict, regular customers must be notified to find out those interested
- Searching for buyers from other locality or from foreign countries that are interested in buying above the differential cost of producing the quantities specified for the special order

When considering problems of price fixation on special order, the firm should distinguish between an elastic and inelastic market. According to economic theory, in an elastic market, there is an inverse relationship between the price and the quantity demanded.

Thus, an increase in the unit price automatically leads to a decrease in the quantity demanded and vice versa. The extent of the price cut is determined by the degree of elasticity of demand. In order to optimise profit, the firm will produce at the level of output where differential cost equates incremental revenue.

Conversely, in an inelastic market, the increase or decrease in the unit price has no significant effect on the quantity demanded. The decision, therefore is that the firm fixes a high unit price for an inelastic market where an idle capacity is created.

The high price fixed for the inelastic market generally includes the total fixed cost. Thus, the sales revenue is determined by adding profit to the total cost. This is the same as (VC+FC)+Profit. Based on the market categorisation, the home market falls into an inelastic market whenever idle facilities are created. The summary of the last two paragraphs is that whenever a firm witnesses a low production capacity, price discrimination strategy is generally introduced by selling at different prices to different markets (Iwarere , 2009; Perreault and McCarthy, 2006). The elastic market is favoured for a reduced price while the inelastic market is charged with the variable and fixed costs. The manner in which a firm discriminates in its pricing policy by selling at a lower price in an elastic market where positive elasticity of demand operates and at a higher price in an inelastic market is known as dumping process. Dumping process can be described as a situation whereby an imported item is sold at a unit price below the market price of an identical or similar product that is manufactured by the local producer. This process assists a firm to:

- Reduce its idle capacity and improve its overall profit
- Continue engaging its labour force, avoid retrenchment exercise, enable labour to improve productivity and be more competent
- Improve its product quality and reduce unit cost
- Improve its competitive power over the other competing firms
- Build adequate reserves for the purpose of expansion programmes, modification of the existing facilities where necessary and be able to change along with the trend of technological innovation

Whatever may be the situation, the firm can improve the performance of demand in the domestic market by introducing sales promotion, such as price cut during the slack period. Based on the preceding presentations, fixed costs are generally not included in the determination of minimum price for special order. However, incremental fixed costs incurred deliberately because of accepting to execute the special order should be included in the determination of minimum price. The incremental fixed costs include additional plant required, additional supervision and additional administrative costs.

Such fixed costs are categorised as relevant costs simply because of the decision to accept to manufacture the special order received. To accept the special order, the following situation should arise: the incremental revenue exceeds the incremental cost of executing the special order. The production facilities are idle and have lower profitability if used to execute other decisions. The customer is ready to at least offer a price that is not below the minimum price computed. The execution of special order has no effect on the firm's normal output directed to the market.

The concept of minimum price: One major obligation of special order in a low machine capacity relates to the ascertainment of minimum price through the use of differential costing. The minimum unit price for the special order is ascertained below; Total differential cost+expected profit on the special order/Number of quantities for special order.

Reasons for the computation of minimum price for a special order:

- When demand is low, the computation of minimum price considers that some costs that were incurred before accepting the order should be treated as been sunk. When a product is first introduced in the foreign market, the firm first fixes a low price in order to improve sales and popularise the product
- The minimum price must cover the marginal cost or differential cost that relates to the cost incurred as a result of accepting the special order. This is because the fixed cost had been incurred before accepting the order. The rejection of the order, simply because the price offered fails to cover the total cost implies that contribution will be lost

Factors to be considered before fixing minimum price: These include:

- Seasonal fluctuation in demand
- Exchange rate when dealing with export order
- Effect on regular customers
- Effect on special order customers when they become regular

Generally, when dealing with special order from abroad, it is important to understand that the keen competition in the industry accounts for pricing the product below the official price and above the marginal cost. The major reason for the keen competition is as a result of many producers from different countries operating in the same foreign market. Because of the inelastic nature of the domestic market, fixed cost is included in the determination of product price as mentioned earlier. The reason for selling below the official price of the domestic market but above the marginal cost which is the differential cost of producing the special order is that the company earns additional contribution. The larger the special order, the larger will be the size of the contribution to earn. The contribution earns in this case will be used to improve profit as against using it to write off the fixed cost. This is because the fixed cost incurred is charged to the domestic market. The reality is that the company should ensure the price fixed for special order is at least equal to marginal cost or more. The higher the unit selling price above the marginal cost, the higher is the contribution that the firm will realise from every unit sold. Conversely, the firm incurred a loss where the marginal cost is above the unit-selling price.

Precautions to be taken when special order is from abroad: Before a firm could embark on committing financial resources to the implementation of a special order, certain precautions are to be taken. These are:

- The company must ensure that the foreign buyer is reputable and possesses sufficient financial backing for settling the international transaction
- There is no restriction placed by the foreign government on goods requested by the buyer
- There must be a permit from the government of the exporting country. An example is the low price edition textbook produced from the United Kingdom which sometimes states that the book must not be sold outside, Africa, the Caribbean, Bangladesh, India, Nepal, Pakistan and Sri Lanka
- Where the buyer is not well known, it is necessary for the company to ask the buyer to open a confirmed irrevocable letter of credit with a bank in its own country in order to secure an international settlement

MATERIALS AND METHODS

Data were gathered through questionnaire and interview for the domestic soap manufacturing firms and multinational foreign companies also manufacturing soaps and detergents locally in Nigeria, while questionnaire and interview were directed to local agents of foreign firms manufacturing outside Nigeria but importing soaps and detergents to the country. The interview and questionnaire were also extended to the wholesalers and retailers for the purpose of obtaining their views. Descriptive method was adopted to analyse data collected from the respondent firms and agents. In all, four manufacturing local firms, two multinational companies manufacturing soaps and detergents locally in Nigeria and four foreign firms operating outside Nigeria were selected.

RESULTS AND DISCUSSION

Even though, low capacity utilisation has been one of the major global problems affecting many manufacturing firms yet, the basic fact is that some countries performed better than others while it is also true that some firms equally performs better than others even

within the same nation. Those firms that possess better managerial and technical skills and execute special order pricing to foreign countries apart from the domestic sales realised were able to perform better than those firms that distribute their products only to satisfy the local market.

The observation from the data gathered gives a clear evident that many customers are willing to offer high prices for the purchase of foreign products. For this reason, companies that execute special order pricing in the international market have the opportunity to improve product quality. The view of management accountants is that customer value is determined by two factors such as:

- Price that customers are willing to offer
- Satisfaction derived by consuming the products or services rendered

The outcome of this research, clearly identifies the foreign firms to perform better because of the ability to improve their capacity utilisation through special pricing decisions which also enable them to obtain high customer value. The improvement in capacity utilisation generally results in:

- Retaining employees rather than constantly embarking on staff retrenchment exercise
- Introducing efficient production facilities that lower costs, improve demand and generating sufficient profit

The situation for the local producers that are not multinational firms seems pathetic as they fail to capture the opportunities that could be obtained from special order pricing to reduce idle capacity. The outcome of the interview conducted from all the categories of respondents confirmed that neighbouring Africa countries are good markets for reducing machine idle capacity and for improving demand. The observation is that multinational companies operating in Nigeria get their products sold to the neighbouring countries. The outcome of this research work for the domestic manufacturers operating only in Nigeria revealed that:

- They produce low quality products
- The demand for their products in the local market is drastically low
- They often adopt staff retrenchment exercise
- Productivity of their staff is not encouraging
- The low profit earned on an annual basis is not sufficient to introduce efficient production facilities that reduce costs and improve product quality
- Customers attach low value for their products
- Customers satisfaction is not encouraging in terms of benefits derived from the product consumed

The comparison of the local firms' operational performances during 1970s and early 1980s with the present operational performances and from the outcome of the interview conducted clearly shows that some of the factors responsible for low demand are:

- Instability in the national economy
- Deplorable road condition
- Power failure and low current that led to acquiring standby generating plants. These require high maintenance cost
- Low purchasing power of the consumers
- High foreign exchange rate against the naira value affects the acquisition of new production facilities
- High inflationary trends
- Corrupt practices of top management team
- High wage rate and constant general salary increase in the country which favour few percentage of the customers and for which local based producers could not afford to execute the general wage increase
- High input costs
- Negative attitudes of workers in performing their tasks
- Insufficient training facilities

Even though, the outcome of the research revealed that foreign companies perform better than the local firms, instability in the national economy that affected their level of profitability resulted in reducing their operations to the extent that few of the reputable foreign firms operating in Nigeria have moved their major production plants to the neighbouring country, Ghana. This is considered as a major catastrophe to the nation. The interview conducted clearly identified that, the instability in the national economy has the following impacts on the multinational firms operating in Nigeria:

- High input costs
- High level of business risk
- Reduction in the customers' patronage
- High cost of operating Standby generating plants simply because of constant power failure and low power supply

The fact of the matter is that the innovations introduced to the production facilities of some multinational manufacturing firms operating in Nigeria could not prevent decision to shift their major plants to another African country.

CONCLUSION

The adverse working conditions identified for the local producers is an evident that important recognition should be given to special pricing decisions in view of the global implications on the manufacturing operations. There is no doubt that customer will continuously favour product with high quality that their incomes could afford. Thus, without generating adequate sales and profits, firms will posses inadequate financial resources to acquire production facilities that are more efficient. Whether a firm executes or fails to execute any special order, fixed cost charged in form of depreciation per annum remains the same except where new facilities are to be acquired for the purpose of executing special orders.

This clearly shows that fixed cost is not part of the costs incurred for producing special orders from the use of idle facilities. The observation is that implementing special order will improve the morale attitude of staff, because of the security of job attached to the firms operating at low production facilities. To ensure that the objective of special order pricing is achieved government should try as much as possible to encourage companies operating in the country through the assurance of economic stability and make available favourable operating environment that will reduce input costs.

The fact to remember which was identified in the theoretical framework is that for a firm to successfully export to foreign market, the price charged should be low and product quality should be high. This is because many producers from different countries transact in the same foreign market.

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