Small Firms Pricing:
A Survey

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INTRODUCTION

This investigation, (the 2004 Dorset-Hampshire survey) a follow-up to Hankinson (1987), (the 1987 Dorset-Hampshire survey) is an examination of price determination in a sample of 56 small engineering firms in the Dorset-Hampshire region of England during the period 2000-2004. The work is a critical survey of pricing decision making in the sample firms under review, and an assessment of small firms' pricing improvement, if any, over the 17-year period 1987 to 2004.

SOME EARLIER PRICING RESEARCH

The literature on pricing behaviour is inconsistent. A contribution to this field, especially in relation to the smaller firm is a major aim of the study.

Hall and Hitch (1939) found that firms were vague about the mechanics of marginalism and relied instead upon full cost pricing. These early findings were largely supported by Sweezy (1939).

Earley (1956), however, suggested that marginalism was strongly implanted in pricing behaviour.

Hague (1959) reported that firms were less interested in profit maximisation than in secure incomes. Firms based price upon total cost not unlike the Hall and Hitch suggestion.

Skinner (1970) concluded that cost plus percentage pricing was very much influenced by competition and demand. And firms making the distinction between fixed and variable costs were, in essence employing marginalism. But Sizer (1971) rejected Skinner's interpretation of the latter.

Silbertson (1970) felt that full cost pricing was well established but there were many marginalist and behavioural qualifications.

Sowter, Gabor and Granger (1971) conducted tests to show that price was a crucial element in explaining consumer behaviour. There was a strong relationship between sales and price.

Udell (1966) had earlier concluded that corporate management did not agree with the economic views of the importance of pricing, as 50% of his respondents did not select pricing as one of the five most important policy areas in the firm's marketing success. But it must be noted that Udell was investigating "successful firms".

Sowter (1973), using buyer-response curves, found that price acted as an indicator of quality.

Harcourt and Kenyon (1976), in examining larger firms, held that the size of the mark-up and the level of planned investment were related, given expectations about future demand. The relevance of the theory to the smaller firm is open to question as far as the Dorset-Hampshire study is concerned.

Gabor (1977) reported that pricing tended to be ruled by hit or miss instinct, but there was evidence of a change to a more objective approach.

On the other hand, Stone (1980) stated that the main problems in pricing were not problems of principle but empirical ones, in that pricing was based upon information, and information collection was invariably of doubtful quality.

Not surprisingly, other contributors over more recent years up to 2004, for example Hankinson (1991), Murphy (1996), Siropolis (1997), Wickham (1998), Burns (2001), Hatten (2003), Kaplan (2003) and Timmons (2003), have all felt varying degrees of uncertainty about the pricing studies available. But the 1987 survey did provide some definitive findings of pricing deficiency in the typical smaller firm at that time.

The extent to which pricing deficiencies have been corrected or eased over a 15 year period is the objective of the 2000-2004 research project.

RESEARCH METHOD

A sample of 56 small engineering companies in the 2000-2004 survey (60 in 1987) with up to 200 employees was selected subject to eight tests of acceptability, i.e.

- **population size of at least 50**

- **a range of sizes of rim up to 200 staff**
- **different ages of company**
- **mechanical and electrical engineering firms**
- **cluster locations in the Dorset-Hampshire region**
- **degrees of production run and speciality work**
- **independence**
- **incorporation**

All data were collected by personal, open, unstructured, face to face interviews with key personnel, i.e. owner managing director, finance officer, deputy managing director, etc. Selected follow-up discussions with these key personnel during the three-year period also took place.

The choice of sample additionally provided a cross-section of environments in which small firms operated and which had a variety of mixes of business approaches, e.g. specialist and non-specialist production units.

The summarised findings in this paper must only be regarded, even 17 years on, as an introduction to a subject of considerable scope and complexity and a paving of the way towards further in-depth research into this somewhat neglected topic.

For the purposes of this piece of work, "optimal pricing behaviour and performance" may be defined as that behaviour and performance laid down by the firms themselves as reasonably attainable.

PRICE DETERMINANTS AND INFLUENCES

On the available evidence, all firms in the Dorset-Hampshire sample made cost the essence of price calculation, but a minority claimed that non-cost pricing was practised on certain occasions. Costs had to be covered in the first instance but the ultimate selling price would be determined by "what the market would bear at the relevant output level", or "the price set by competitors". Where this ultimate price exceeded cost it would be applied over the longer term; where it fell below cost it would be regarded as a short run venture only. This was, of course, indicative of flexible mark-ups. The impact of rival prices was surprisingly not strong, unless forced upon the firm by crisis.

Most firms adopted the Hall and Hitch, Sweezy and Hague approaches to pricing. The Silbertson view of cost plus percentage as also confirmed, but there was little evidence of price being determined by "marginalist and behavioural qualifications", or by the "strong marginalism" forwarded by Earley. And the "rivalry and demand" determinants suggested by Skinner were somewhat weak.

An estimated 79% of the firms (82% in 1987) employed a cost-based price. It would seem remarkable that the majority should opt for this method when its limitations are severe.

At this point, the distinction between price determinants and price influences must be stressed. Cost was the major determinant, but "market conditions" were regarded as influences only by the respondents. But even if firms practised more flexible pricing from time to time, this policy appeared to be more imposed by the nature of the market rather than by conscious strategy. It is possible that this distinction between determinants and influences might go some way towards explaining the occasional conflict in the literature.

ONE-OFF PRICING

The survey data gave the clear impression that batch pricing tended to be rigid, but the pricing of one-off jobs was considerably more flexible. What the market would pay figured far more prominently in the calculation of one-off pricing that for routine production.

Flexible pricing was possible, was practised, was profitable and was successful, but almost exclusively on one-off contracts only.

Two arguments among others have been put forward as the main reasons for the widespread use of cost plus pricing. One is that firms are "satisficers" in the Simon (1955) tradition of firms pursuing a satisfactory and sufficient profit, as opposed to their being "maximisers".

According to the Simon satisficing hypothesis, firms will strive hard to achieve certain target levels of profits, but having achieved them they will not strive to improve their profit position further.

Associated with this approach is the belief that some firms genuinely want only a fair or just rate of profit, a point already made above. But the bulk of the evidence from the Dorset-Hampshire survey suggested that the size of the mark-up hardly varied at all over the longer term. And the work of Hall and Hitch (1939), Fogg (1960) and Kaplan (1958) found similarly.

The second argument is that in an uncertain world, firms just cannot estimate all the permutations of all the variables that should be taken into account in order to derive the optimum price. The possible permutations are numerous and even simple problems can turn out to be complex. Baumol (1965), (1972) and Clarkson (1963), (1968) have both demonstrated this point. The Dorset-Hampshire survey firms saw cost plus percentage pricing as the best solution in a complicated and unpredictable business world. The achievement of long run optimum profit was very much dependent on the ability of owner-manager-directors to overcome volatile conditions in the market.

But cost plus percentage pricing need not be totally employed as a policy. There is not shortage of advice in the pricing field. Lanzillotti and Parrish (1964), The Small Business Association (1978), Williams (1970), Cox and Meador (1973) and Abdelsamad and Sperry (1980) have all been active in this area of assistance.

MARK-UPS

Closely allied to full cost pricing is pricing in order to achieve a target rate of return on investment. In effect, firms pursuing this target return do so by calculating a mark-up on full costs according to the formula:

$$\text{Mark-up} = \text{Target} \times \frac{\text{Net Assets}}{\text{Sales}}$$

The sample firms, in the main, adopted a targeting approach. Unfortunately, there was little, or no, evidence of mathematical harmony between the mark-up and the target rate of return. Even if the mark-ups were initially correct, firms tended not to adjust prices on a continual basis. The mark-up soon became obsolete to achieve the target. Firms failing to reach their targets could hardly have done otherwise with the mark-ups employed. Price rigidity might have maintained customer relations, but it had also hindered financial performance.

Was the target set too high, or the mark-up too low? It can only be stated that the firms set their targets largely by convention and no doubt based upon what they considered to be reasonably attainable. The most frequently mentioned rationalisation included "fair and reasonable return"; "the traditional industry concept of a fair return" and "the desire to equal of better the firm's average return over a recent period of time". One might reasonably conclude from this, and also because of the preference for price stability among the 2004 Dorset-Hampshire firms, that the problem of failing to reach expected targets lay more within the pricing rather than the targeting, a finding, incidentally, very much in line with the 1987 results.

The analysis of the mark-ups of the firms is difficult both because of the nature of financial records and because of conceptual difficulties of definition and actual measurement. As a result of varying accounting practices the size of one firm's recorded mark-up may differ from others in the same line of business and situation. There maybe arbitrary differences in mark-up definition for ranges of products, differences in identifying priority cost areas and in the allocation of expenses incurred during a particular year which relate to activities of other years. In a small firm owned by a family or closely knit group of people, additional problems may exist which add to the difficulty of inter-firm comparisons. More often than not, the mark-up figure is the information which firms are most reluctant to give. It may well be for tax reasons or because of fear of competition or it may be inaccurate because of a lack of correct information on the part of the firm's management. Thus, the figures obtained must be viewed in this light. Nevertheless, the overall impression of sub-optimum returns emerges strongly, as indeed, was the impression in 1987.

Pricing mark-up attitudes revolve around the price level flexibility of firms, and has implication for sales promotion, among a range of possible outcomes. Edmonds (1977), Herrick (1976) and Temperley (1980) explored these areas and their views are mentioned in the 1987 survey.

PRICING AND INFLATION

In adopting the cost plus method pricing, one drawback of this method rests on the assumption that firms actually know what their costs of production are at given levels of output. It was by no means certain that the sample firms did have such information to hand. And even where costs had been monitored and analysed the problem of adjusting prices for inflation was an interesting one. Customers were generally reluctant to pay current prices under recessionary conditions, and respondents preferred to hold prices rather than adjust for inflation on a continual basis. Prices should be adjusted by small amounts and often, and not held constant for twelve months as a policy. The sample firms were clearly unaware of the rapid erosion of profits by delayed price adjustments for increased costs of production, and for inflation in particular. Some interviewees quoted 2004 inflation at around 2% and considered this to be manageable, but many engineering firms used materials which had risen in price by far greater amounts than 2%, yet still believed that current inflation was "self-correcting".

Some of the problems which inflation posed for the 1987 and the 2004 firms are to be found in the work of Winkler (1975), De Thomas (1977), Abdelsamad and Sperry (1980), Lackman (1979), Miller and Serdahely (1980) and Vickman (1981).

COSTS OF PRODUCTION

There was a low level of cost awareness. No firms in the 2004 survey (and also none in 1987) derived and employed cost curves to assist with their pricing, despite the majority's use of the cost plus percentage method. Some 71% of the sample firms (78% in 1987) were without any policy at all for cost curves, cost monitoring or cost saving. Some companies simply assumed that their costs were already at a reasonable minimum. Most firms, in both surveys, believed that external economic conditions were responsible for any disappointing results.

Govindarajan and Anthony (1983) confirmed the two surveys' finding that the majority of small firms employ the full cost pricing method. Only 14% (17% in 1987) seemed to understand variable costs sufficiently to use for pricing purposes. Hague (1959) reported that the businessmen interviewed were unaware of the concept of marginal revenue and that whilst a few of them had heard of marginal cost, they were sceptical of its importance.

Some firms were not only weak in cost awareness, but also in terms of basic cost accounting. There is much help at hand, Abdelsamad and Sperry (1980) being but one example, not to mention the various expanding consultancy services available since 1987.

Finally, it must be stressed that contribution analysis by the firms in 1987 and in 2004 was conspicuous by its relative absence. The importance of this technique cannot be over-emphasised, yet respondents seemed committed to absorption, rather than contribution, costing. Since it was not the intention of the two

surveys to concentrate specifically on this subject, the above comments in their brevity might serve to promote further research into this vital area.

PRICING AND THE DEMAND CURVE

Despite the controversy regarding the importance of price, it has usually been accepted that price and customer demand are inversely related. But the survey data revealed that whilst a significant raising of price by the firms would certainly contract demand, a marginal increase would not. Similarly, a marked lowering of price would extend demand, but a nominal decrease would not. Thus, the "demand curve" clearly possessed a perfectly inelastic section at the relevant output level. In other words, the demand curve was roughly "Z-shaped".

Firms themselves admitted that price could be raised marginally and no sales would be lost. Why did firms not take advantage of this? Obviously, all firms would have to resort to price adjustments in order to counter inflation from time to time, but it appeared that very few owner-manager-directors, in both surveys, were prepared to raise price to the point which they themselves knew to be more profitable than any other price. Firms simply fixed price by conventional cost plus percentage below the upper limit of the vertical section of the demand curve.

The "Z-shaped" demand curve is probably more relevant in the real world than the traditional demand curve employed in basic economic theory. It is doubtful if the "Z" demand curve has ever been used extensively before, for even in the Harrod (1952) entry-forestalling model, for example, demand is assumed to adjust when price is changed to produce normal profits only, and discouragement for new entrants.

The problem for entry-forestalling models is, in part at least, to decide whether it pays to forestall entry (and make fairly low profits for a long time, but with a large market share). Or instead to go for short run optimisation (making high early profits but accepting a reduced market share and excess capacity in the long run owing to pressure from new entrants). It is sufficient to say that there was no evidence in 1987 or in 2004 of entry-forestalling among the survey firms despite the "Z-shaped" demand curve. Among the most important of the pioneering attempts to incorporate entry-forestalling into firms' behaviour were those of Andrews (1949), developed by Edwards (1965), (1962) and Bain (1949). However, the work of Andrews (1949) in the field of full cost pricing and the reaction to it by Khan (1952) and Robinson (1950) is perhaps more significant albeit somewhat outside the scope of the two Dorset-Hampshire surveys.

PRICE FLEXIBILITY

Only 18% of the 2004 firms (15% in 1987) were pursuing short run markets via price flexibility. It could be the case that small firms in persisting with the goal of sheer survival do not have the will or the vision to apply pricing and market

flexibility. The literature, however, does show that managerial aims and strategies, not least in the pricing field, can be for flexibility.

Edmonds (1977) has shown that managerial aims and strategies can incorporate flexibility. Mason (1973) demonstrated product diversification opportunities for small firms, and Ross (1978) and Webster (1977) both have expanded on this diversification theme. Collins (1956) showed the gains in profits from flexibility as compared with the inflexible use of resources. Davies (1977) looked at flexible marketing decision making processes in small businesses, MacMillan (1965) dealt with strategy and flexibility and Brownstone (1978) successful selling skills for small firms. All suggested that that flexibility could be practised at most levels, not least in the pricing arena.

But let Nagle (1983) have the last word. Nagle claims that pricing is often treated as a technical problem to be solved by applying rules or procedures, and not as a creative marketing challenge to be met with a new insight into buyers' motivations. Pricing, no less that any other aspect of the marketing mix, can be made more effective by the design of creative strategies that reflect differences among buyers. In fact, all the pricing tactics discussed by Nagle call for creative insights based on differences in buyers, not differences in technology or production costs. In short, efforts to apply pricing rules suffer without exception from the requirement that the product is already designed, the markets already identified and segmented and the method of distribution is already in place.

PRICING AND INVESTMENT

Very few of the 1987 and 2004 firms had a related price-investment strategy. Harcourt and Kenyon (1976) attempted to establish a link (in larger firms) between mark-ups and planned investment, but it was obvious that no such relationship appeared to exist in the small firms under review. Firms invested when the need arose rather than for strategic purposes. If prices were affected by an investment decision, then this would tend to be coincidental. On the other hand, capital expenditure presented a quite separate problem. Investment strategies were negative or defensive even if apparent. Firms preferred to use their own funds for investment purposes and external finance was generally avoided despite profit potential. Some firms had adopted a specific non-borrowing policy, and especially so in 2004 when the reputations of certain financial institutions was under scrutiny. Was this absence of linkage between pricing and investment a missed opportunity? Separate research into this area might be a worthwhile exercise.

PRICING IMPROVEMENT

Could the respondents themselves suggest what might be done to make pricing more effective? Only a small minority (in 1987 and in 2004) had considered the issues sufficiently to reach the conclusion that a more positive pricing approach was essential. An even more remarkable, and disappointing, feature was the significant number that believed no action could or need be taken since activities

were severely constrained, once again, by external market forces beyond the firms' control. Another statistic of interest was the several that agreed that certain actions were possible to improve pricing, but then stated that the likelihood of these measures actually being implemented was remote. The suggestion that the advisory services might help in such circumstances raised the whole question of the value of consultancy, and why many small firms were simply opposed to the employment of consultants.

It is worth noting that, for example, Blake (1983), Holtz (1982), Snyder, Manz and Laforge (1983), Day (1978) and Saunders (1980) have all examined to varying degrees how firms might promote their businesses and monitor performances by self-improvement style management via the consultancy services.

PRICING AND THE ECONOMIC CLIMATE

During recessionary conditions it was perhaps understandable for the 1987 and 2004 sample firms to claim that business activity was at a low level as a result of future uncertainty. In fact, some 75% in both samples claimed that occasional recessions were responsible for their pricing problems. Whilst there was little doubt that a recessionary economic situation affected pricing decisions, it was also clear that other, and perhaps more basic factors were relevant. The impression was that the pricing expertise of many of the firms would have been sub-standard irrespective of the economic climate. Firms complained that because of the recession customers would only pay last year's prices. On the other hand, firms in both samples apparently had no choice other than to pay current prices for supplies. This situation was regarded as an external problem beyond the control of the owner-manager-directors. Although it could be argued that certain market difficulties were indeed outside the firms' sphere of influence, this particular pricing problem did seem to be self-imposed. For example, there was very little related diversification, expertise and service were insufficiently optimised and full cost pricing was the norm. In some instances under-pricing problems could have been more successfully tackled by resolute management rather than by arbitrary economic upturns.

Must small firms be severely constrained by recessionary economic conditions? Researchers have considered this problem. Bradway (1981) explored the protection of profits during inflation and recession, Brasch (1979) assessed market potential for exports, Pritchard, Bradway and Frenzel (1981) strategic marketing for small businesses, Brannen (1983) advertising and sales promotion cost effective techniques and Gordon and Carr (1983) low cost marketing research. All this research with some emphasis on pricing, was conducted with the intention to project small firms beyond the problems, perceived or otherwise, of recessionary conditions. The practitioner consultant would then apply the models and techniques to the firms in question. Let us now look specifically at this whole issue of pricing and consultancy with reference to the 1987 and 2004 surveys.

PRICING AND CONSULTANCY

It emerged that some firms had, indeed, resorted to outside expertise such as accountants, bank managers, the advisory services, etc., but not specifically for pricing purposes. Others felt that external assistance might be useful and would consider it, but only if the need arose. A large majority had neither employed nor had considered employing consultants for pricing advice.

Generally, the interviewees believed that management consultants were simply not required by small firms. A notable feature was that although most companies had not experience of consultants they nevertheless considered them to be overrated, too expensive, investors of problems, disruptive and representative of external interference. It is perhaps reasonable to state that the Dorset-Hampshire firms' reservations about consultancy were very much over-emphasised and they might well have benefited from the outside expertise they chose to reject. In short, pricing could have been employed rather more purposefully with the help of consultancy than without it.

Were the Dorset-Hampshire firms' reservations about consultancy justified? Commentators have suggested that consultancy need not be expensive, complex, disruptive, unhelpful or interfering. Richardson (1957) consultancy assistance for small firms, Chaplin (1982) choosing and using professional advisers, Institute of Chartered Accountants (1983) the need for chartered accountants, Harrison (1982) selecting professional advisers and the Small Firms' Division of the UK Department of Trade and Industry (1983) joint management of advisory services of the Small Firms' Service and the Council for Small Industries in Rural Areas, are some examples of this reassurance.

It is tempting to reach a conclusion that both sample firms' suspicions about consultancy were very much over-stated. The survival mentality could almost certainly have been promoted to a higher plane had the owner-manager-directors recruited the very expertise they chose to reject.

PRICING AND GOVERNMENT

The 56 respondents were asked to identify the most important area of assistance that the government could implement to make pricing decisions easier for small firms.

An ambivalent attitude could be discerned in that on the one hand firms had repeatedly valued their independent decision making capacity, whilst on the other they clearly expected some assistance from the authorities. But this required assistance did not include indirect aid. Direct help was expected such as immediate contracts from government sources.

Unfortunately, very few firms had any specific recommendations to make regarding pricing. Indeed, the sample firms were very largely unaware of the assistance offered by governments in recent years comprising incentives, grants, subsidies, training, export advice, research and development, inventions, etc.

Moreover most did not readily acknowledge or appreciate the lowering of taxation over the 1987-2004 period.

For an analysis of how governments might involved themselves directly in the affairs of small companies, Hulf and Odeen (1978) have examined government policies and small-scale industry and the role of government policies and institutional mechanisms in shaping small-scale industry. A pricing initiative would seem not to be impossible.

Other contributors have summarised the incentives available for small firms such as Morse (1979), White (1980), Hayes and Howell (1980), Mitchell, Hennessy and Watson (1979), Minns and Thornley (1978), Cheesmond et al (1980), Chadwick and Tonkin (1984) and Watson (1984). All the evidence in this field suggests that there is no real reason why small firms should not be aware of government incentives that might enable such firms to move away from their survival philosophy.

SUMMARY

The literature on pricing behaviour is somewhat inconsistent and lacking.

In the Dorset-Hampshire Survey some 79% (82% in 1987) of the firms set price by the cost plus percentage method, an approach unlikely to optimise profits.

One-off pricing occasionally adopted appeared to be far more flexible.

Few of the sample firms in the two surveys were aware of the required harmony between target and mark-up despite using cost plus percentage pricing.

They were also largely very tolerant of inflation, only adjusting prices one year in arrear, in the main.

No firm (1987 and 2004) was really impressive with its cost attitudes, approaches, systems or general monitoring.

Contribution pricing or analysis was minimal.

A "Z-shaped" demand curve emerged with a perfectly inelastic section at the output level from the under-pricing adopted.

Only a minority (1987 and 2004) pursued short run market by price flexibility, e.g. charging what the market would bear.

No link was discernible between pricing and investment despite the literature's affirmation of this in larger organisations.

No firm in both samples had considered how pricing might be improved, or had actually implemented any recommendations that had been made by various sources.

Some three quarters of both samples felt that recessions were responsible for pricing problems.

No firm in both samples had employed consultants proactively for pricing purposes.

Even though all firms surveyed expected government aid, they could not readily identify the pricing assistance they required.

The survival mentality prevailed throughout.

FINALITIES

Overall, the findings from both the 1987 and 2004 surveys suggested strongly that the firms' pricing behaviour was inconsistent with any goal of optimisation. The small firms under review appeared to ignore, and even avoid, opportunities for improved performances, financial or otherwise through more efficient pricing. The two surveys revealed endemic problems of pricing. Almost inevitably as a consequence of these non-rigorous approaches, financial returns would tend to remain below optimum for the small firm. Despite any limitations of the samples, data collection, analysis and interpretation, the overall picture cannot be easily disregarded.

Irrespective of the efforts of consultants, academics, governments and accountants over the 17-year period under review, the disturbing message is that very little progress seems to have been made.

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