Costing and Pricing

How costing and pricing help you make better business decisions

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Costing and pricing

TEL: 08000 75 8000

Edition Number **2008/01**

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Introduction

Three factors affect business profitability; these are price, volumes and cost. Unfortunately, each affects the other; price affects volume, volume affects cost, and cost affects price. Getting all three right is a delicate balancing act. In this book, we will look at various methods of setting prices, calculating costs, and estimating sales volumes.

Price is hard to determine because finding the 'ideal' price is so difficult. Customers don't just buy on price. They are influenced by all sorts of intangibles like advertising, promotion, image, fashion, 'hype', perceived quality etc. This is why it is almost impossible to determine the 'ideal' price. How high can you go? Cynics say that there are only three areas where there is no price ceiling - fast horses, fast cars and fast women!

Costing is fascinating - this workbook introduces four methods. We need to understand costs in order to control them. Effective cost control can mean the difference between profit and loss for many businesses.

Many businessmen have difficulty pricing their product or service so they, effectively, allow their competitors to dictate price. In doing this, they may be missing out on a great opportunity to generate additional profits from an understanding of what makes the business really tick.

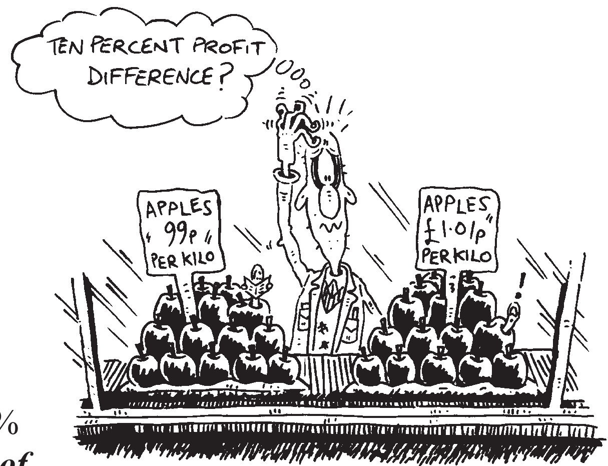
Section 1

Pricing a Product

It is important to set the right price. Here's an example of how a small change in price can produce a big change in profitability.

Example 1

Suppose a greengrocer normally sells £10,000 of apples. What would happen to the profit if:



- He raised apple prices by 1% (ie 1p in the £) ***and still sold the same weight of apples,*** or
- He lowered apple prices by 1% ***and still sold the same weight of apples***.

Let's work out the effect on profits resulting from these price changes.

	Before	After 1% price rise	After 1% price cut
Value of Sales (£)	10000	10100	9900
Total Costs (£)	8000	8000	8000
Profit (£)	2000	2100	1900
% Change in Profit	-	+5%	-5%

These figures show that a 2% change in price can produce a 10% change in profits.

Note: To keep the arithmetic simple, we have priced the apples in the cartoon at 99p per kilo and £1.01 per kilo. In practice, of course, some people will buy apples at 99p per kilo whereas they may not buy at £1.01 per kilo. This is because the price crosses the psychological barrier of £1 per kilo. However, don't let the desire to keep the arithmetic simple confuse the message which is 'small changes in price can produce big changes in profit'.

Exercise 1

Using the same figures as the example above, work out what would be the effect of a 5% change in price assuming that there was no change in the weight of apples sold.

Compare your answer with the model on page 51.

Setting prices can be more of an art than a science. The 'right' price has to satisfy both buyer and seller. On the one hand, the price can't be be so low that the seller makes no profit. On the other hand, the price can't be so high that it frightens customers away. Between these two extremes, there is a whole range of possible prices.

In theory, the higher the price, the less the customer buys. This is because, at higher prices, increasing numbers of customers decide that the product fails to satisfy their sense of value.

In practice, pricing a product can be complicated. Many factors affect the customer's decision to buy. Some customers buy on impulse without even giving price a thought! Ideally, we would like to experiment with different prices so that we can check customers' reactions at different price levels. However, it is hard to experiment with price because you upset customers who hear of others paying a lower price.

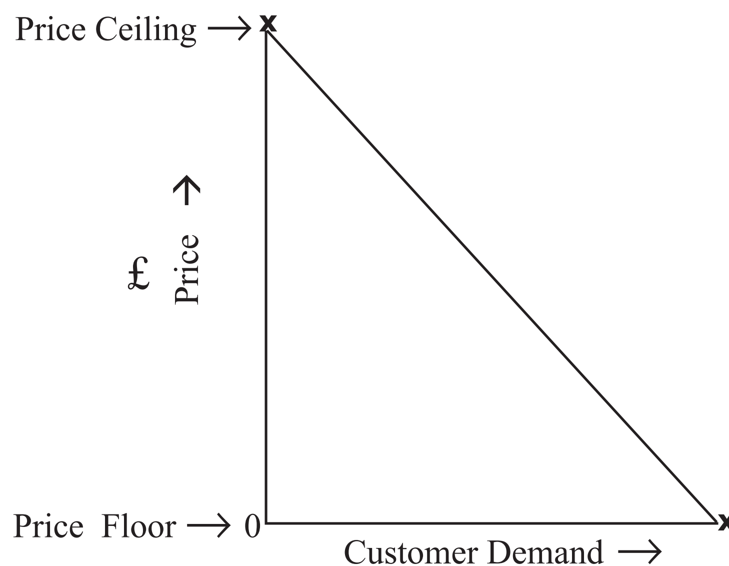
We show below a classic price/demand curve. Demand is the amount that customers want to buy at any particular price. If the product were only sensitive to price, and no other factors were involved, you would see the relationship between price and customer demand shown in the graph below.

The graph is marked with:

- The price ceiling - this price is so high that nobody in their right mind will buy.

- The price floor - this is the lowest price that the seller can make a profit. Below this price, it is uneconomic for the seller to supply the market.

'Classic' Price/Demand Curve



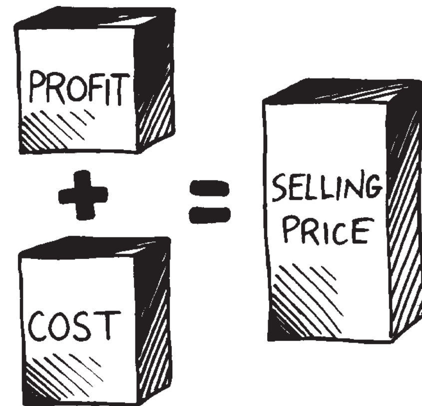
In the real world, of course, higher price doesn't always mean lower sales. For example, the purchase of an engagement ring may celebrate a joyous occasion when people spend as much as they can afford. In this case, the higher priced item could be more attractive.

Essential items, like basic foodstuffs, have to be bought, irrespective of price. If there are shortages of food (as in wartime), people still have to buy food even if the price is higher than they would normally pay.

Too low a price can also be a problem. Too low a price could give the impression that the article lacks quality. Perversely, this could mean that a drop in price leads to a drop in sales!

Pricing

Many businesses set their price by adding a profit margin to cost. Despite the widespread use of this method, 'cost plus profit pricing' is unlikely to give the best price for the seller (or for the buyer), except by chance. For a start, most customers don't know how much the product cost to make, nor do they know how much profit margin has been added, so they are in no position to judge whether the price is 'fair' or 'reasonable'.



Customers make their decisions on more varied grounds such as:

- Is this product cheaper or dearer than competitive products?
- Is the product better or worse than competitors' products?
- Is the product better value than competitors' products?
- Does this product meet their needs?
- Does it offer value for money?
- How good is it - the perceived quality?
- Will it 'do the job'?
- How much they can afford (either now when the bill has to be paid, or on monthly credit)
- Advertising, branding, image
- Convenience
- How much do they trust the supplier
- Availability
- How much they *need* it
- How much they *want* it.

An acceptable price will depend more on the customer's perception of worth rather than product cost.

We have said that the price must be right for the customer but it is also important that the price is right for the seller. Businesses have different targets at different times. For example, the business may be looking to:

- Maximise short term profit
- Maximise long term profit
- Increase market penetration
- Have a high rate of growth.