

The Cost Determinant of Price

Companies sometimes minimize or ignore the importance of demand and decide to price their products largely or only based on costs. Prices strictly determined based on costs may be too high for the target market, reducing or eliminating sales. On the other hand, cost-based pricing may be too low, resulting in the company earning less return than it should. However, costs should generally be part of any pricing, even if it only serves as a cap below which the price of a product or service should not be set in the long term.

The idea of cost may seem simple, but it is actually a multifaceted concept, especially for manufacturers of products and services. A variable cost is one that varies with changes in the production level; an example is the cost of materials. In contrast, a fixed cost does not change when production increases or decreases. Examples include executive income and salaries.

To compare the cost of production with the selling price of a product, it is useful to calculate unit costs or average costs. The variable average cost (CPV) is equal to the total variable costs divided by the production quantity. The total average cost (CPT) is equal to the total costs divided by production.

Marginal cost (CM) is the change in the total costs associated with a one-unit change in production.

Costs can be used to set prices in a variety of ways. For example, Markup Pricing is relatively simple. Profit Maximization and Break-Even Pricing use the more complicated cost concepts

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Markup Pricing

Markup pricing, the most popular method used by wholesalers and retailers to set a sales price, does not directly analyze production costs. Instead, commercial margin pricing uses the cost of purchasing the product from the manufacturer, plus the amounts of profit and expenses that have not been considered. The total determines the sales price.

For example, a retailer adds a certain percentage to the cost of the goods received to reach a retail price. An item that costs the retailer \$1.80 and sells for \$2.20, carries a 40 cent trade margin, which is a 22% margin on the cost ($\$0.40 \times \1.80). Retailers tend to analyze the price increase in terms of their retail price percentage, in this example, 18% ($\$0.40 \times \2.20). The difference between the retail cost and the selling price (40 cents) is the gross margin.

The reason retailers, among others, talk about increases in the sales price is because many important figures in financial reports, such as gross sales and revenue, are sales figures, not cost figures.

To use the trade margin based on cost or sales price effectively, the marketing manager must calculate an appropriate gross margin—the amount added to the cost to determine the price. The margin must eventually provide funds to cover sales expenses and profit. Once an appropriate margin has been determined, the trading margin technique has the main advantage of being easy to use. For example, Wal-Mart strives to achieve a gross margin of about 16%. Because supermarket chains such as Safeway and Kroger have generally had gross margins of 24%, they now find it extremely difficult to compete with Wal-Mart supermarkets. Today Wal-Mart is the largest retail chain nationwide.

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Commercial margins are often based on experience. For example, many small retailers increase the price of merchandise 100% above cost (in other words, they double the cost). This tactic is called duplication (keystoning). Some other factors influencing price increases include the attractiveness of the merchandise to customers, pre-reactions to price increases (consideration of implied demand), the promotional value of the item, the temporality of the products, its fashion appeal, the traditional selling price of the product and the competition. Most retailers avoid establishing a commercial margin of considerations such as promotional value and temporality.

Profit Maximization Pricing

Producers tend to employ more complicated methods of setting prices than those used by distributors. One is the maximization of profit, which occurs when marginal income equals marginal cost. You learned before that the marginal cost is the change in the total costs associated with a one-unit change in production. Similarly, marginal income (IM) is the additional income associated with the sale of an additional unit of production. As long as the revenue of the last unit produced and sold is greater than the cost of the last unit produced and sold, the company must continue manufacturing and selling the product.

Break-Even Pricing

Now let's take a closer look at the relationship between sales and cost. Balance analysis determines which sales volume must be achieved before the company reaches balance (its total costs are equal to total revenue) and no profits are made.

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The typical equilibrium model assumes a given fixed cost and a constant variable average cost. Suppose Universal Sportswear, a hypothetical company, has fixed costs of \$2,000 and that the cost of labor and materials for each unit produced is 50 cents. Suppose you can sell up to 6,000 units of your product to \$1 without having to cut its price, Universal's total variable costs.

Sportswear is up to 50 cents each time a new unit is produced and total fixed costs remain constant at \$2,000, regardless of the level of production. Therefore, for 4,000 units of production, Universal Sportswear has \$2,000 of fixed costs and \$2,000 of total variable costs (4,000 units \times 0.50) or \$4,000 in total costs. Income is also \$4,000 (4,000 units \times \$1), which gives a net profit of zero at the equilibrium point of 4,000 units. We should note that once the company exceeds the equilibrium point, the gap between total revenue and total costs becomes wider, because both functions are supposed to be linear.

The advantage of balance analysis is that it provides a quick estimate of how much the company must sell to reach the breakeven point and how much utility can be generated if you get a higher sales volume. If a company operates close to balance, you can consider what is possible to do to reduce costs or increase sales. Moreover, in a simple balance analysis, it is not necessary to calculate marginal costs and marginal income because it is assumed that the price and the average cost per unit are constant. Also, because marginal cost and revenue accounting data are often not available, it is desirable not to have to rely on that information.

A balance analysis does not lack several important constraints. Sometimes it is difficult to know if a cost is fixed or variable. If workers win a difficult guaranteed employment contract, are the resulting expenses a fixed cost? Are

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mid-level managers' salaries cost fixed? More important than cost determination is the fact that a simple balance point analysis ignores demand. How does Universal Sportsware know that it can sell 4,000 units for \$1? Could you sell the same 4,000 units at \$2, or even \$5? It is clear that this information would profoundly affect the company's pricing decisions.

REFERENCE:

Lamb, C., Hair, J. and McDaniel, C. (2011). Marketing. Ohio: Cengage Learning.