

## Cost Based Pricing

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## Goal

- Set a Selling Price that covers our Costs and Target Profit

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- Cost Based Pricing
- Competitive Based Pricing
- Customer Based Pricing

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## Cost Based Pricing Is Most Important



## Why Cost Based Pricing

### Four Reasons

- 1 Fair
- 2 Easy to Calculate
- 3 Industry Stability
- 4 “guarantee a profit”

## Some Costing Is Crude

- Direct Materials **plus**
- Direct Labor **plus**
- 300% of Direct Labor (to cover Fixed Costs) **plus**
- A 50% Markup **plus**
- Competitive adjustment **plus**
- What the customer will bear

Price Formula Comes From  
The Basic Profit Formula

$$Z = (P - V)Q - F$$

The Basic Cost Based  
Pricing Formula is

$$P = V + \frac{F}{Q} + \frac{Z}{Q}$$

Basic Cost Based  
Pricing Formula is

$$P = V + \frac{F}{Q} + \frac{Z}{Q}$$

Most of the time we just plug in  
the values for V, F, Q, and Z and  
solve for the Price

Target Returns (Profits)  
Where Do They Come  
From?

Sources of Targets

- ✦ 1 Deciding What Seems Fair
- ✦ 2 Wanting A Better Return Than Last Year
- ✦ 3 Establishing What They Believe They Can Get
- ✦ 4 Estimated Cost Of Capital
- ✦ 5 Wanting To Stabilize Prices

Discounts & Allowances

- ✦ Cash Discounts
- ✦ Trade Discounts
- ✦ Quantity Discount
- ✦ Rebates (Cumulative)

Discounts & Allowances

Everything Is A Percentage Off  
Catalog List Prices

Importance Of Catalog And  
Pricing Sheet Updates

## Cash Discount

3% /10 net 30

- ✦ Encourage prompt payment
- ✦ Reduce cost of credit
- ✦ Industry standard

## Trade Or Functional Discount

### Straight Percentage Off List

- ✦ Pay For The Functions A Middleman Performs
  - ✦ Class A or B Distributor
  - ✦ OEM
  - ✦ Educational
  - ✦ Government

## Quantity Discount

- ✦ Must Be Offered To All Customers
- ✦ Must Demonstrate Cost Saving Being Passed On

## Rebates & Allowances

- ✦ Cumulative
- ✦ Competitive Rebates (software)
- ✦ Seasonal
- ✦ Advertising Allowances
- ✦ Case Allowances

## Shipping Costs

- ✦ FOB origin
- ✦ FOB Destination
  - ✦ Phantom Freight
  - ✦ Postage Stamp Pricing

## Cost Based Pricing Does

- ✦ **Not** Guarantee Demand
- ✦ **Not** Guarantee A Net Profit
- ✦ **Not** Simplify e.g. Managers Confused About Costs
  - ✦ Unit cost versus variable cost
  - ✦ Sunk costs vs fixed cost
  - ✦ Discretionary