LEARNING UNIT 2

COSTING AND PRICING

Apply the principles of costing and pricing to a business venture -263455

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LEARNING

OUTCOMES

By the end of this unit, you will be able to:

- Identify and apply the criteria of a price setting policy for a new venture
- Identify and analyse internal and external factors that impact upon pricing decisions
- Demonstrate an understanding of the relationship between costs, revenue and profits

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CRITERIA OF A **PRICE SETTING POLICY FOR A NEW VENTURE**

Pricing is an important function in any business.

A price is an amount that is expected in return for a product or service.

This price can change at any stage and is affected by several factors.

These need to be considered, as well as costing methods, in order to arrive at a price that is fair to the consumer and to the seller.

WHAT IS PRICING?

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Pricing is **the process whereby a business sets the price at which it will sell its products and services and** may be part of the business's marketing plan. While setting the price of a product or service the following points have to be kept in mind:

Nature of the product/service.

The price of similar product/service in the market.

Target audience i.e. for whom the product is manufactured (high, medium or lower class)

The cost of production viz. Labor cost, raw material cost, machinery cost, inventory cost, transit cost, etc.

External factors such as Economy, Government policies, Legal issues, etc.

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WHAT IS **COSTING?**

Costing is the process of analysing the costs involved in providing the product or service and can differ in method from business to business.

Cost in a business is an expense that the business takes on to sell a product or service.

These costs include things like rent for a retail space, investments in replenishing inventory, and wages paid to employees.

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DIFFERENCE BETWEEN
COST &PRICE

COST	PRICE
Amount of an investment into a good or service	Amount charged to customer for a good or service
Paid to a vendor or service provider by company in return for raw materials used in production of goods or services	Paid by customer in return for goods or services

TYPES OF COSTS

FIXED COSTS

Fixed costs are those costs that do not change according to the production or sales levels. These costs will be incurred each month, regardless of whether you produce any products or sell any services.

However, it is important to remember that even though fixed costs are said to remain constant, this does not mean that the amount you have planned for cannot change from year to year.

Fixed costs simply will not be affected by the amount of production. These are costs such as salaries, rent and property taxes and depreciation.

VARIABLE COSTS

Variable costs are the costs incurred to create or deliver each unit of output.

Variable costs are functions of a company's production volume.

They change according to the number of goods or services a business produces.

If the company produces more, the cost increases proportionally.

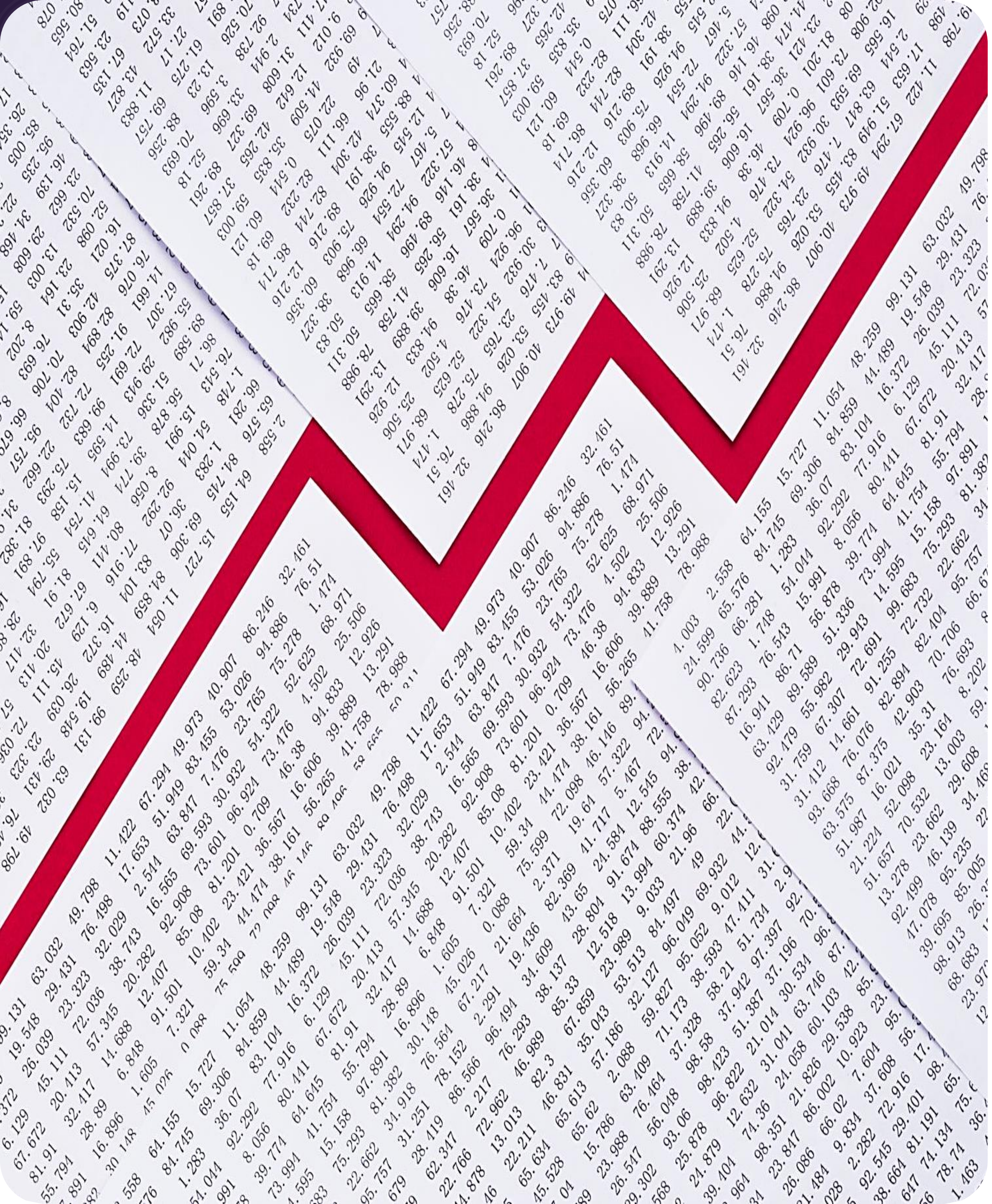
Examples include water, raw materials, electricity, wages, telephone

TOTAL COSTS

Total costs are composed of both total fixed costs and total variable costs.

Total costs are the sum of fixed and variable costs.

TOTAL COSTS = TOTAL VARIABLE COSTS + TOTAL FIXED COSTS



PROFIT

- The difference between price, the amount charged to the customer, and cost, the expense to produce the item, is called the profit, net income, or margin.
- **PROFIT= SELLING PRICE - TOTAL COSTS OF PRODUCTION**

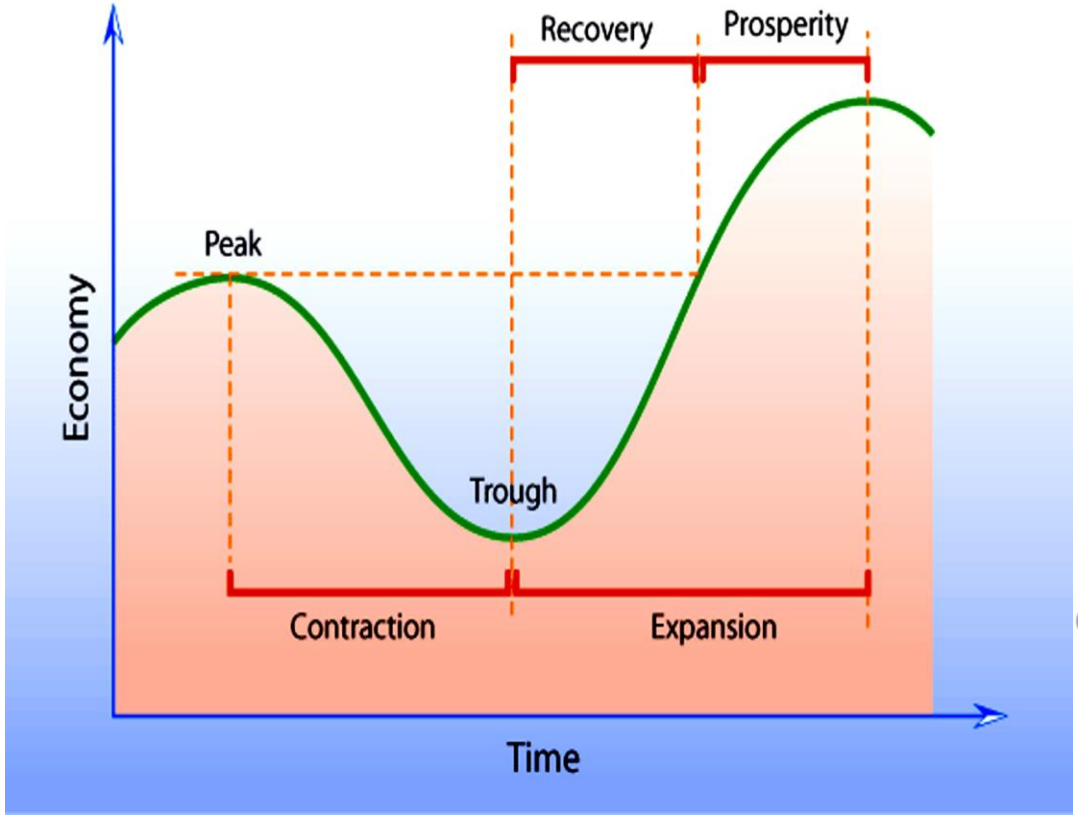
TRADING CYCLE

A **peak** is a temporary maximum in economic activity.

A **recession** is otherwise known as a contraction and is a period of decline in factors of economic activity, such as employment, income and trade.

A **trough** is a period when the economy reaches a temporary minimum in economic activity.

A **recovery** is otherwise known as an expansion and is a period where economic activity, such as output and employment, are rising.



WHY ITS IMPORTANT TO **KNOW BUSINESS CYCLE STAGE**

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A business owner should always take note of the phase through which the economy is moving.

Each phase of the trading cycle has certain influences on the growth and continued existence of the business.

It is good to predict the movements in the trading cycle in order to predict how the spending habits of consumers will be affected.

During the prosperity or peak phase, the business can produce and market new products and services.

This allows the business to explore new markets and expand its market share.

BUSINESS OR TRADING CYCLES

ARE CAUSED BY A FEW FACTORS

Innovations, which usually cause an expansion. An example of this is the microchip, which shocked the economy into an expansion.

Increasing productivity, which expands the economy. If productivity declines, the economy and trading cycle will begin to decline.

An increase in money, which causes an expansion. Too little money in the economy can cause a recession.

Changes in market spending. As spending increases, the economy expands and as spending decreases, the economy will enter a period of recession.

PRICING **OBJECTIVES**

Pricing objectives are the goals that guide your business in setting the cost of a product or service to your existing or potential consumers.

SURVIVAL

In this situation, the business decides to set its prices below those prices of its competitors in order to increase sales while covering costs, even if this means that the profits may decrease in the short term.

Survival is often the main objective of any business. If the business is in a market with intense competitors, survival may be the chosen pricing objective.

However, this is a short-run objective, and the business will need to move on to a more profit-focused objective in order for it to survive in the long run.

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PROFIT

Many firms try to maximize their current profits by estimating **the Demand and Supply** of goods and services in the market.

Pricing is done in line with the product's demand in the customers and the substitutes available to fulfil that demand.

Higher the demand higher will be the price charged. **Seasonal supply and demand** of goods and services are the best examples that can be quoted here.

RETURN ON INVESTMENT

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This objective needs to take certain aspects into account, such as the cost of producing a certain product or service as opposed to using the amount of money for an alternative use, such as investing in shares or on the stock exchange or starting another type of business.

The return from these options helps the business owner to decide which option is the most viable.

MARKET SHARE

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Many firms charge **low prices** for their offerings to capture greater market share. The reason for keeping the price low is to have an increased sales resulting from the **Economies of Scale**.

Higher sales volume lead to lower production cost and increased profits in the long run. This strategy of keeping the price low is also known as **Market Penetration Pricing**.

This pricing method is generally used when competition is intense and customers are price sensitive. **FMCG industry** is the best example to supplement this.

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PRODUCT
QUALITY

- Many firms keep the price of their goods and services in accordance with the **Quality Perceived** by the customers.
- Generally, the **luxury goods** create their high quality, taste, and status image in the minds of customers for which they are willing to pay high prices. Luxury cars such as **BMW, Mercedes, Jaguar**, etc. create the high quality with high-status image among the customers.

MAXIMUM
MARKET SKIMMING

- Market skimming means charging a **high price** for the product and services offered by the firms which are innovative and uses modern technology.
- The prices are comparatively kept high due to the high cost of production incurred because of modern technology. **Mobile phones, Electronic Gadgets** are the best examples of skimming pricing that are launched at a very high cost and gets cheaper with the span of time.

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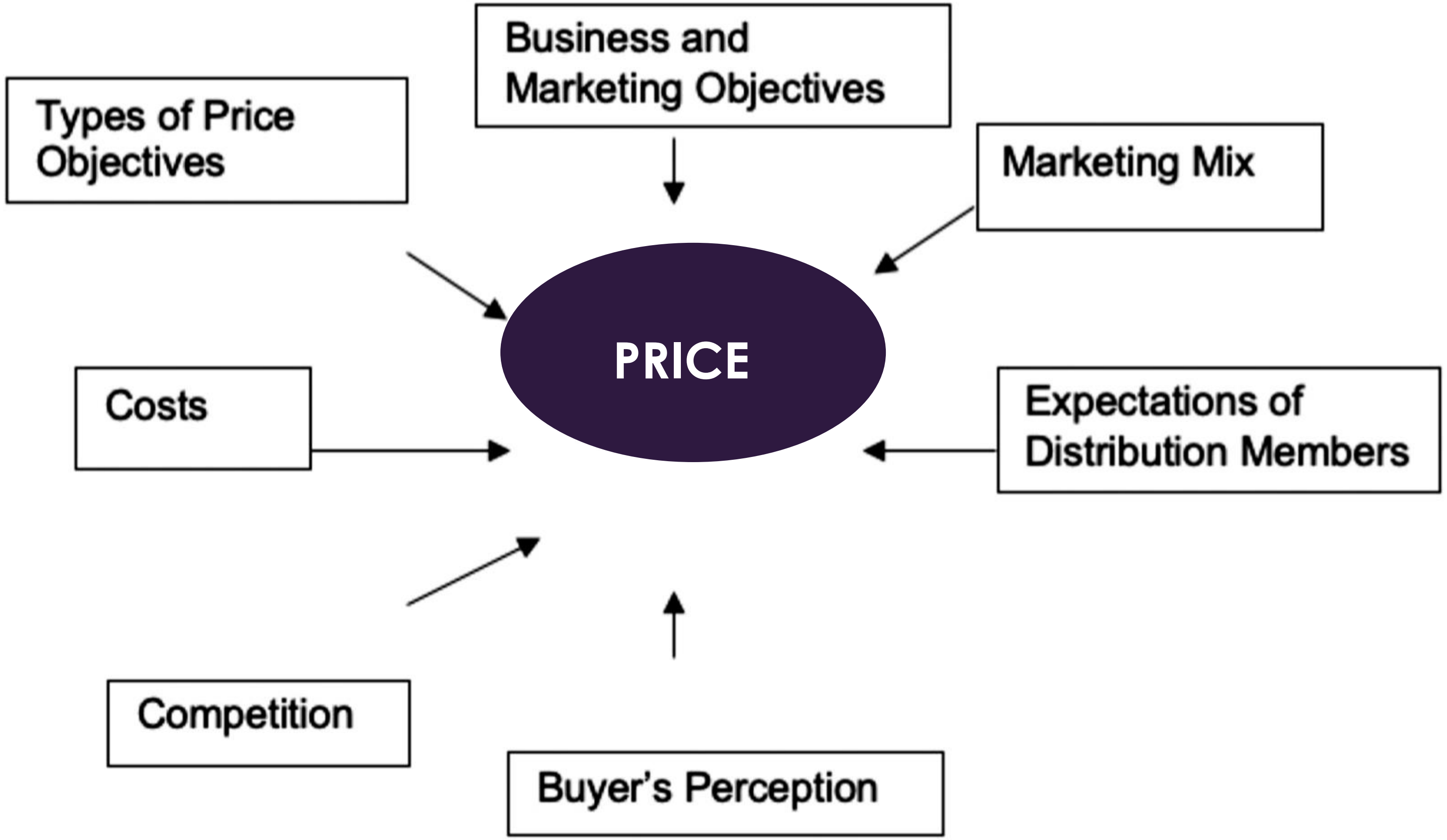
FACTORS
INFLUENCING PRICING DECISIONS



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BUSINESS AND MARKETING
OBJECTIVES

Business and marketing objectives, as well as other department objectives, need to be taken into account when determining a pricing objective.

MARKETING MIX- 4 P

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EXPECTATIONS
OF DISTRIBUTION MEMBERS

- You will need to understand the expectations of members distributing your products. These members may provide certain services in exchange for a certain profit.

- This amount of profit expected by the distribution members will influence your pricing. Other expectations could be large discounts on bulk orders and training for promoters.

BUYERS PERCEPTION

- Price can be more important for certain consumers than for others.
- This differs in the market segments, and this should be considered when setting a price strategy.

COMPETITION

- Competitor’s prices should always be taken into consideration. Prices should be adjusted according to competing products and services; however, they do not need to be the same.
- For example, in the airline business, it is important to set prices according to competitor’s prices in order to survive.

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FORMATIVE

ACTIVITY **B1-5**

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BASIC
PRICING METHODS

- Cost as a basis for pricing
- Demand as a basis for pricing
- Competition as basis for pricing
- A combination of the above

COST AS A BASIS
FOR PRICING

- Cost-based pricing is **a pricing method that is based on the cost of production, manufacturing, and distribution of a product**.
- Essentially, the price of a product is determined by adding a percentage of the manufacturing costs to the selling price to make a profit.
- **PRICE =** $\mathbf{\dfrac{\text{Final cost + Total Variable Cost + Estimated Profit}}{\text{Units Supplied}}}$
- Break-even point is the quantity at which the sales revenue equals the total cost at a certain selling price.
- If larger quantities are sold above the break-even point, a profit will result. Sales below this point will be a loss.

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EXAMPLE

VIDEO

https://youtu.be/6PPq9h7bcUU

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DEMAND

AS A BASIS FOR PRICING

Demand Based Pricing is a pricing method based on the customer’s demand and the perceived value of the product. In this method the customer’s responsiveness to purchase the product at different prices is compared and then an acceptable price is set.

Demand is rarely consistent across products and markets. Consumer behaviour and demand keeps changing based on various parameters, so the pricing methods based on demand are are used.

A disadvantage of this pricing method is that attitudes and personalities of consumers cannot always be determined, and their personal income can affect demand.

Also, the consumer could choose a competitor’s product or service as a replacement for your product. This influence is not always considered.

EXAMPLE

VIDEO

https://youtu.be/MJyTYv8KDzk

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COMPETITION
AS A BASIS FOR PRICING

- Competition-based pricing is a strategy by which price varies according to variations in the price of competitors
- The product price is detached from a customer's willingness to pay or product value and is attached solely to competitor prices
- A competition-based strategy is more focused on driving volume and might not necessarily be the most profitable one
- Competitive dynamic pricing is a popular strategy in ecommerce, where algorithms will analyse other brands selling similar products and then adjust product prices in real-time eg Takealot

STEPS FOR PRICING

Step 1: Determine Pricing Objectives.	**Step 2:** Analyse the Target Market	Here you will need to obtain vital information on your target market. Information on their purchasing power and buying attitudes or perceptions will help you to determine the correct price to set.	**Step 3:** Determine the Demand.	Market research will help to give you an indication of the demand for your product or service and the quantity that can be purchased within a specified period. This will help you to determine the ratio between the price and quantities required.
Step 4: Analyse Costs.	In order for the product or service to be sold at a profit, costs need to be taken into consideration. Here the break-even point is often used as an indicator.	**Step 5:** Evaluate Competitors Prices.	If you are aware of a competitor's prices, you will be in a more suitable position to set your own prices. Market research is often used to keep up-to-date with competitors' pricing strategies.	**Step 6:** Develop a Pricing Method
All the above information will help you to complete this step.	**Step 7:** Determine a Price Strategy and Adjustments.	Determine whether you will focus on a specific strategy or a combination of various strategies. Also consider how you will make pricing adjustments.	**Step 8:** Finalise the Price.	That's It! Be aware that once you have finalized a price, it is not set in stone.

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FORMATIVE

ACTIVITY **B6-11**

RELATIONSHIP

BETWEEN COSTS, REVENUE AND PROFITS

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Economic profit is the result of subtracting both explicit and opportunity costs from revenue.

Economic profit = revenues - explicit costs - opportunity costs

Normal profit is a situation where a firm makes sufficient revenue to cover its total costs and remain competitive in an industry.

Revenue is the total amount of money brought in by a company's operations, measured over a set amount of time. A business's revenue is its gross income before subtracting any expenses.