

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