

## Is Cost Based Pricing Fair?

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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"

## It seems Fair?

- Firms using it claim they are passing along costs they have no control over.
- Profit Margins are consistent with others in the industry facing the same risk.

## A Normal pricing policy.

Revenue \$10 per unit x 20,000	\$200,000	
CoGS (total variable cost) \$4 per unit x 20,000	\$80,000	
Gross Profit Markup = 60%	\$120,000	
Fixed Costs \$50,000/20,000 = \$2.5 per unit	\$50,000	
Profit ROS= 35% \$70,000/20,000 = \$3.5 per unit	\$70,000	

## Changes Occur in cost?

Revenue \$10 per unit x 20,000	\$200,000	
CoGS (total variable cost) \$4 per unit x 20,000 new cost \$6.50 per unit	\$80,000	
Gross Profit	\$120,000	Same 120,000
Fixed Costs	\$50,000	Same \$50,000
Profit	\$70,000	Same \$70,000

Fair Price Increase pass along cost increase?

Revenue \$10 per unit x 20,000	\$200,000	\$???? per unit
CoGS (total variable cost) \$4 per unit x 20,000 new cost \$6.50 per unit	\$80,000	\$80,000 + \$50,000 = \$130,000
Gross Profit	\$120,000	Same 120,000
Fixed Costs	\$50,000	Same \$50,000
Profit	\$70,000	Same \$70,000

What is the New Price to charge?

Fair Price pass along the \$2.50

Revenue \$10 per unit x 20,000	\$200,000	\$250,000 \$12.5 per unit
CoGS (total variable cost) \$4 per unit x 20,000 new cost \$6.50 per unit	\$80,000	\$130,000
Gross Profit	\$120,000	Same 120,000
Fixed Costs	\$50,000	Same \$50,000
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Fair Price Increase?

Revenue \$10 per unit x 20,000	\$200,000	\$250,000 \$12.5 per unit
CoGS (total variable cost) \$4 per unit x 20,000 new cost \$6.50 per unit	\$80,000	\$130,000
Gross Profit Markup = 60%	\$120,000	Same 120,000
Fixed Costs	\$50,000	Same \$50,000
Profit ROS = 35% \$70,000/20,000 = \$3.5 per unit	\$70,000	Same \$70,000

Add the new costs to the old price

Looks fair

- But !!!
- NOT the way it happens
- The calculate the new price using a “fair cost-plus” formula

What Price to Charge?

- $P = V/(1-Mp)$
- New Current Cost per Unit is  
 $V = \$6.50$
- Target “Fair” Markup is
- $Mp = 60\%$
- Cost Based Price is
- $P = \$6.50/(1-0.6) = \$16.25$

Fair Price Increase?

Revenue \$10 per unit x 20,000	\$200,000	\$250,000 \$12.5 per unit	\$325,000 \$16.25 per unit
CoGS (total variable cost) \$4 per unit x 20,000 new cost \$6.50 per unit	\$80,000	\$130,000 62.5% increase	\$130,000
Gross Profit Markup = 60%	\$120,000		
Fixed Costs \$50,000/20,000 = \$2.5 per unit	\$50,000	Same \$50,000	Same \$50,000
Profit ROS = 35% \$70,000/20,000 = \$3.5 per unit	\$70,000		Same ROS = 35%

**Fair Price Increase?**

Revenue \$10 per unit x 20,000	\$200,000	\$250,000 \$12.5 per unit	\$325,000 16.25 per unit
CoGS (total variable cost) \$4 per unit x 20,000 new cost \$6.50 per unit	\$80,000	\$130,000 62.5% increase	\$130,000
Gross Profit Markup = 60%	\$120,000	Same 120,000	\$195,000
Fixed Costs \$50,000/20,000 = \$2.5 per unit	\$50,000	Same \$50,000	Same \$50,000
Profit ROS= 35% \$70,000/20,000 = \$3.5 per unit	\$70,000	Same \$70,000	145,000 107% increase

**Price Increase?**

Is Cost Plus Pricing Really Fair?

Revenue \$10 per unit x 20,000	\$200,000	\$250,000 \$12.5 per unit	\$325,000 16.25 per unit
CoGS (total variable cost) \$4 per unit x 20,000 new cost \$6.50 per unit	\$80,000	\$130,000 62.5% increase	\$130,000
Gross Profit Markup = 60%	\$120,000	Same 120,000	\$195,000
Fixed Costs \$50,000/20,000 = \$2.5 per unit	\$50,000	Same \$50,000	Same \$50,000
Profit ROS= 35% \$70,000/20,000 = \$3.5 per unit	\$70,000	Same \$70,000	145,000 107% increase

As Long as the Whole Industry Uses  
the **“Fair”** Cost Plus Pricing Formula  
There is No Escape!

Questions

	Firm A	Firm B	Firm C
Price, P	\$9.75	\$11.75	\$12.75
Quantity, Q	155	115	95
Revenue, R	\$1,511	\$1,351	\$1,211
Variable cost, V	\$4	\$4	\$4
CoGS, C	\$620	\$460	\$380
Gross profit, G	\$891	\$891	\$831
Markup, Mp	0.59	0.66	0.69
Advertising, A	\$100	\$100	\$100
Net profit, Z	\$791	\$791	\$731
ROS	0.52	0.58	0.60

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Increase the  
cost from \$4  
to \$6

	Firm A	Firm B	Firm C
Price, P	\$14.63	\$17.64	\$19.35
Quantity, Q	155	115	95
Revenue, R	\$2,268	\$2,029	\$1,838
Variable cost, V	\$6	\$6	\$6
CoGS, C	\$930	\$690	\$570
Gross profit, G	\$1,338	\$1,339	\$1,268
Advertising, A	\$100	\$100	\$100
Net profit, Z	\$1,238	\$1,239	\$1,168
ROS	0.52	0.58	0.60