5 Pricing to achieve profit

- Different types of pricing
- Marketer’s methd of pricing
- Fitting the methods together
- Breaking even

Introduction

One of the most important techniques for managers to understand is how to price a product to attract customers – and also to achieve a profit (or at least cover all the costs). If you can be aware of all the different factors that influence a price (and not just what the customer is prepared to pay) then you will be able to generate both revenue and profit from your products and services.

Another helpful technique is to know how many you need to sell of a product or service at a given price to cover all the costs – this is called the 'break-even point'.

By the end of this chapter you will be able to:

- Describe the factors that influence pricing decisions
- Identify the most appropriate pricing method for a product or service
- Calculate a price to achieve a profit
- Calculate how many products or services you need to sell to reach the break-even point.

Different types of pricing

There are two different approaches used in pricing – which can be generally described as the 'accountant's method' and the 'marketer's method'. Traditionally the two are seen as totally different, but we will try and make them fit together in order to satisfy the needs of both. We'll also look briefly at putting package prices together. We will look at the 'accountant's method' first, which uses costs as the basis for calculating a selling price. This is known as 'cost-plus'.

One item to note: the selling price is the price the business receives and does not include any VAT (Value Added Tax), which needs to be added on afterwards to give a 'price charged to the customer' which you would display on a menu or tariff board.

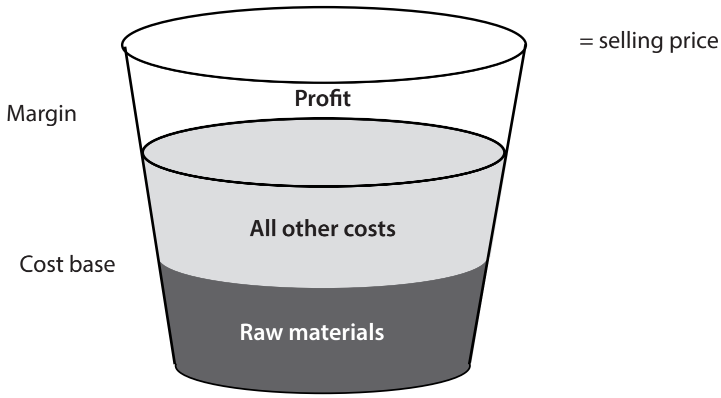
Cost-plus pricing

For this method the most important factor is the costs identified with producing (or buying-in) the product and then a margin, or 'mark-up' is added on to cover all other costs and the profit to arrive at the selling price. There are three main types of cost-plus pricing – gross profit, contribution margin and bottom-up methods.

Gross profit method

This is the most common method used in pricing food and beverage products, and is very simplistic in its approach. It uses only the cost of the raw materials, with the margin that is added covering all other costs (variable and fixed) and the profit required. Look at Figure 5.1.

Figure 5.1: Gross profit pricing



In this type of pricing the margin is the same as the GP achieved – hence the name – and this margin is normally quoted as a percentage of the selling price, e.g. a pint of beer:

	(£)	(%)
Cost of beer	0.85	35.0
Margin (GP)	1.58	65.0
Selling price	2.43	100.0

(If you then added VAT at 20% you'd have a price to the customer of £2.92 – more than three times the actual cost of the beer. For wines in restaurants it's quite common to pay four or five times the amount you would pay in a supermarket for the same bottle of wine.)

Tip

To add VAT at 20% on to a selling price to reach the 'menu price' or 'price charged to the customer', take the selling price and multiply it by 1.2 – that gives you the final number you need. The amount of VAT is the difference between the first and the second figures.

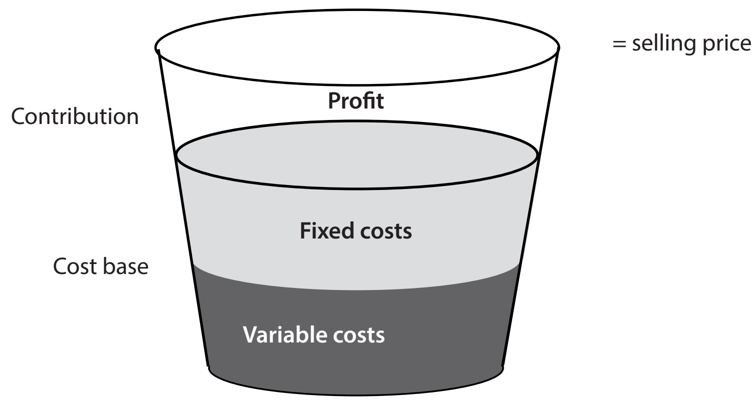
There are no 'standard' cost percentages for products – it will vary according to the type of operation, location and so on. You'll see this more when we look at market-based pricing.

Activity Look at your operation (or one you know) – do they use this type of pricing?

Contribution margin method

GP pricing only uses the raw materials – and ignores all other variable costs such as wages, paper goods, give-aways, linen, transport and so on (these are covered by the margin, mentioned above). A better approach would be to take all of the variable costs into the calculation – this is called contribution pricing. Here the 'cost base' is all the variable costs, which we discussed earlier. Using this method the margin then covers the fixed costs and the profit required (see Figure 5.2).

Figure 5.2: Contribution pricing



You can use this method where you have a lot of variable costs – such as a fast-food operation, a day trip or a package holiday. For example, for a burger bar:

	(£)	(%)
Variable costs – burger, bun, sauce, garnish, chips, drink, packaging, labour and so on	2.04	60.0
Contribution	1.36	40.0
Selling price	3.40	100.0
Plus VAT at 20% = Menu price	4.08	

Where the business has a wide range of products this method is still feasible. A theme park, for example, may have lots of rides, retail shops, food outlets and vending machines but should still be able to identify all the different variable costs associated with each type. The only minor drawback of both these methods is that they assume that the cost of the individual items will