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Introduction to Module 5
Costing and Pricing a Product/Service

This module is divided into two topics, and these are: Topic 1; Costing the Product/Service and Topic 2; Pricing the Product/Service.

In Topic 1 you learn about how to cost your product/service. We will look at the different categories of costs incurred by the business as well as how to calculate the break-even point. The Break-even point helps the businesses to know how much sales they should make before they realise some profit. Examples given in this topic will help you get a clear understanding of how to cost a product/service.

Topic 2 investigates how to go about the issue of pricing. To do that skillfully, you should be familiar with ideas that are commonly used in pricing. Some of these are: cost, loss and profit. These are closely linked with factors that influence pricing.

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Topic 1
Costing Your Product or Service

Introduction

The questions we may ask ourselves are; why do we cost the product or service? How do we cost our product or service? Every business aims to make profit and for the business to make profit, the cost of a product or service must be considered. It is of no use for a business to make a product, for example, and sell it at a price lower than the cost of production. The business will be running at an eternal loss.

In this topic you will learn how to calculate the fixed cost, the variable cost as well as the break-even point. These components of costing will help you as you set the price for your product or service in Topic 2.

Learning Objectives

- By the end of this topic, you should be able to:
- Define costing
- Explain the importance of costing
- Calculate the fixed and variable costs of a product or service
- Calculate the break even point.

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1.1 Costing

Every product/service comes with a cost. The cost may be of labour for producing the product, raw materials, machinery e.t.c. It is therefore very important for businesses to calculate their cost of production. What do we mean by production? Production is a process of turning raw materials into finished goods and services. During the process of production businesses incur some costs. They have to identify these costs in order to be able to set the right price for their goods and services. The selling price should always be set above the total cost of production in order for the business to realise some profit. Now let us define costing. Costing is finding out how much a business spends during the process of producing and selling a product or offering a service.

1.2 Categories of Cost

We will now look at the two main categories of cost that a business incurs during the process of production, which are fixed and variable costs;

(a) Fixed costs

Fixed costs are costs that do not change with the level of production. That is whether the level of production is high or low one has to incur the same amount of costs. For example if you rent out a mini bus that has a seating capacity of 25 and only 10 people manage to go on a trip, you will still have to pay the same amount of rental for the bus. Examples of fixed costs are salaries, rent and equipment's depreciation.

The following illustration shows the fixed cost of Ikageng Poultry Farm. The illustration shows that when Ikageng Poultry Farm produces 5000 chickens the fixed production costs are the same as when Ikageng Poultry Farm is producing 15000 chickens.

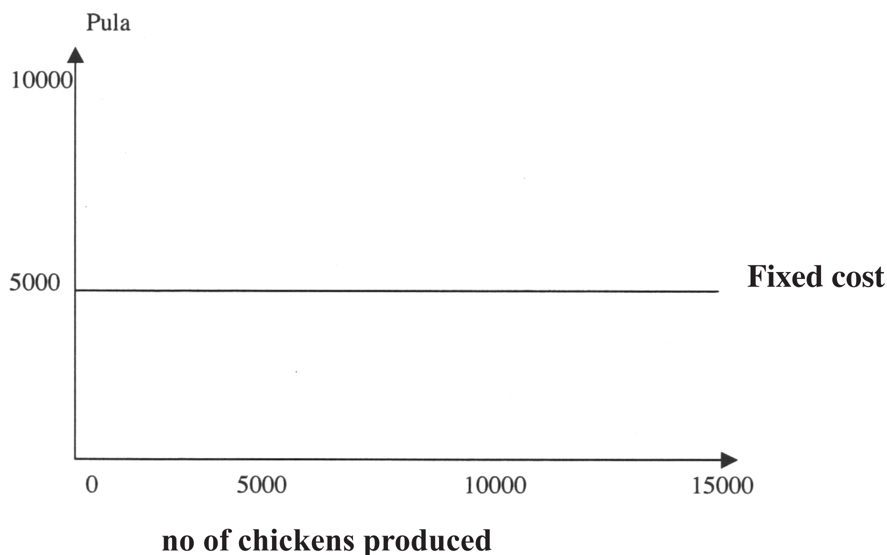

Figure 1 : **Fixed costs of Ikageng Poultry Farm**

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(b) Variable Costs

Variable costs are costs that change with the level of production. This means the more the products and services are offered the more the costs and vice verse. For example if you make school uniforms and you produce 100 of them the first month and 500 of them in the second month, it will mean that the variable costs of making the uniforms will be higher in the second month than in the first month. Variable costs helps the business calculate how much it costs to produce one product or offer a service. Examples of some of the variable costs for making school uniform are; cloth, buttons and thread. More raw materials will be used on 500 school uniforms than on 100 of them.

Activity 1A

Mr Borobe owns Borobe Bakery in Molepolole. He supplies fresh bread to the hospital and secondary schools. He operates from a rented bakery that belongs to the Village Development Committee (VDC). List rawmaterials that Borobe Bakery is most likely to use to produce bread.

Turn to the end of the topic for feedback on this activity.

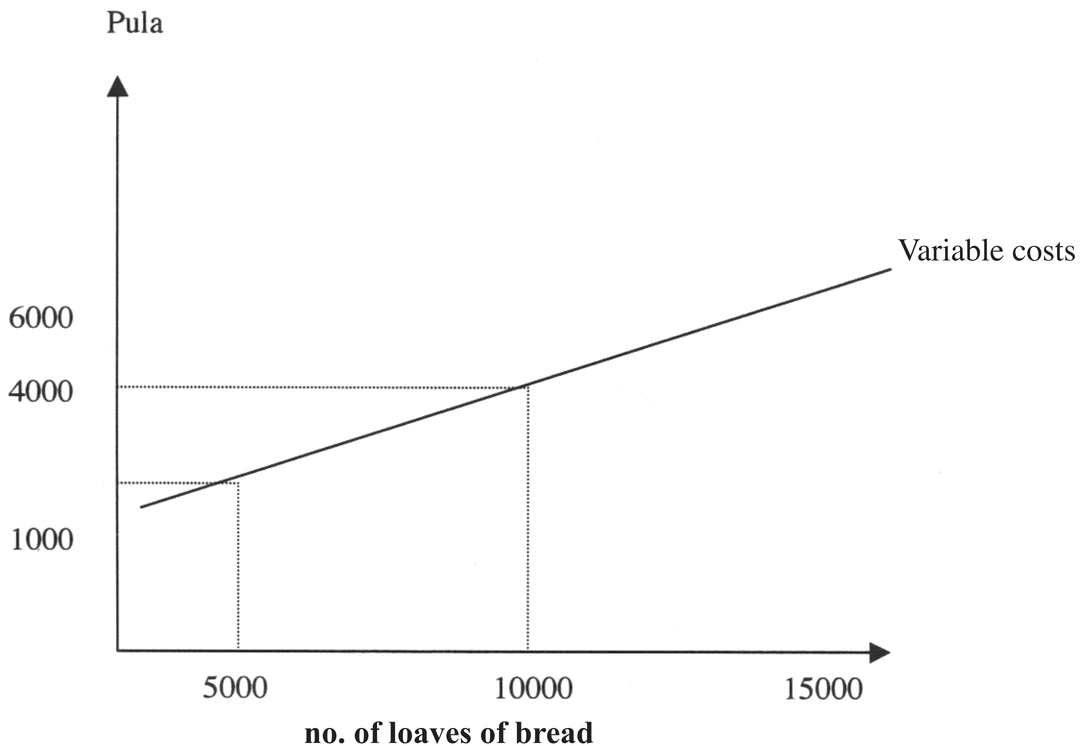

Figure 2: shows the variable costs for Borobe Bakery

Figure 2 shows the how the variable costs of Borobe bakery rise with the number of loaves produced. For example when 5000 loaves of bread are produced, the bakery incurs P2000 in variable costs. When the number of loaves rises to 10 000, the variable costs rise to P4000.

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Activity 1B

Classify the following according to fixed and variable costs for a tailor shop;

Water

Rent

Salary

Sewing machine depreciation

Thread

Cloth

Turn to the end of the topic for feedback on this activity

1.3 The Break-Even Point

It is very important for a business to calculate the breakeven point. Let us first define the breakeven point. The break-even point is the point at which total revenue equals total costs. Revenue is the total money that is received by a business from sales. At breakeven point the business has neither made profit nor loss. It is calculated by using fixed costs: these are costs that do not change with the level of production, variable costs: these are costs that change with the level of production and the *contribution.*

Before we calculate the breakeven point, let us first discuss the meaning and relevance of *contribution*. When we set the selling price for an item, it should cover both fixed costs and variable costs. It should also give us some profit. Put in another way;

Selling price = Fixed costs + variable costs + profit

If you remember some simple mathematics, the above relationship can be written as;

Selling price – variable costs = fixed costs + profit

The right hand-side of the above equation = contribution

This means that,

Contribution = Fixed costs + profit

Using this we can define *contribution as the part of the selling price that covers fixed costs and gives us profit*.

Contribution is very important because we know that if we cannot cover fixed costs, our business can close down. For example if we cannot pay rent, we can be chased from the

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premises by the owners. So we must know whether our selling price will allow us to cover fixed costs, then we remain with something for the profit.

Selling price – variable costs = contribution.

Let us consider the following example

If our selling price is P25.00 and our variable costs of production is P5.00 then our contribution will be as follows;

Contibution = Selling price – variable costs

= P25 – P5

= P20

The break-even point helps you to know at what unit of sales you should expect to start making profit. Figure 3 below shows the breakeven point of Mahube Petrol Station. Total Fixed cost = P40 000, Total variable costs = P60 000 and the breakeven point is P14 800. Total sales = P62 700

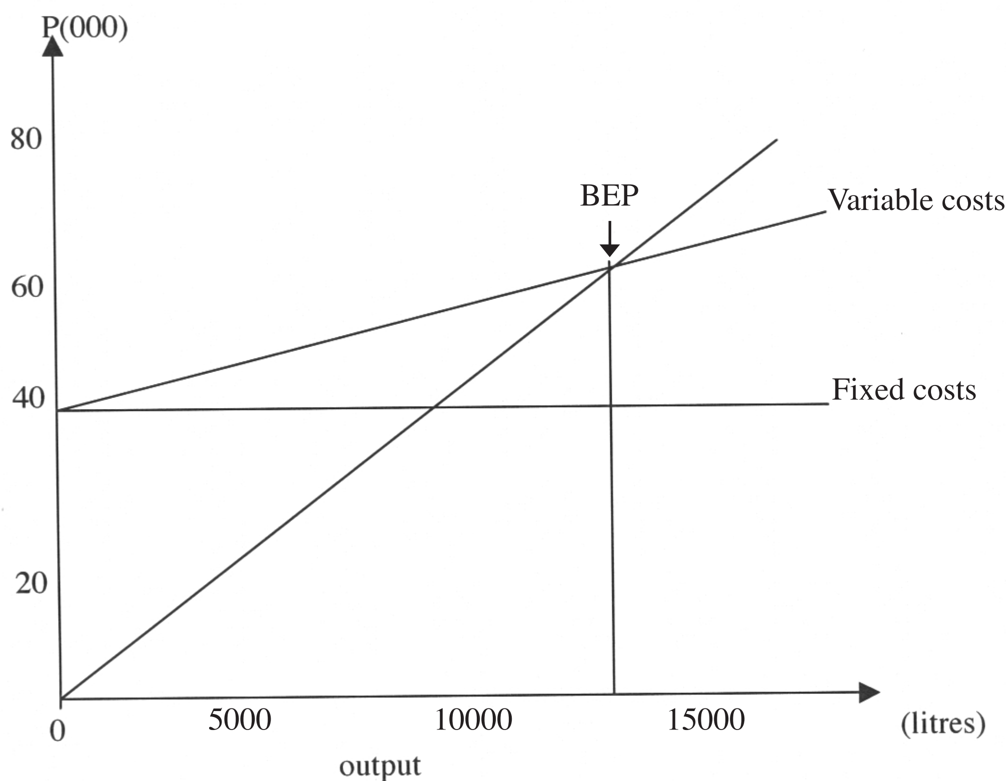

Figure 3: The breakeven point of Mahube Petrol Station

In order for us to understand more about how to calculate the break-even point, let us work through the following activity.

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Activity 1C

Dineo makes wedding cakes. Her Total fixed costs are P6000 and her variable costs are P400 and her selling price is P450 per cake

(a) Calculate the contribution

(b) Calculate her break-even point

Turn to the end of the topic for feedback on this activity.

1.4 How to cost a Product/Service

We are now going to look at how we cost our products and services. Remember that it is important to cost your product/service in order for you to set the right price for your product/service. We will start with an example of a product.

Example 1 – Costing a product

Mokgomane Brick Layers manufactures bricks for Mokgomane village. The first question we would ask ourselves is what are the fixed costs and variable costs of the business? Let us list these costs.

Fixed Costs		Variable costs per brick	
Rental	P15000	Cement	P1.00
Salaries	P7000	Sand	P0.50
Depreciation	P2000	Concrete	P0.75
Loan repayment	P8000	Water	P1.50
Total Fixed Costs	P18 500	Total variable Costs	P3.75
NB: The selling price per brick is P5.00			

The question may be, is P5.00 the right price for the bricks? Yes because P5.00 is higher than the variable cost of producing a brick which is P3.75. Let us now look at how many brick Mokgomane brick layers have to make in order for them to breakeven.

Break-even point = fixed costs/selling price – variable costs
= fixed costs/contribution
= P18 500 / P5.00 – P3.75
= P18500 / 1.25
= 14 800 bricks

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Mokgomane Brick Layers will have to make 14800 bricks to break even. This means they will start to make profit when they have made and sold14801 bricks and they would have made P1.25 as profit.

Example 2 – Costing a service

We will use the information below to calculate the break-even point for Douglas Fuel Delivery Services. Let us assume that the costs are based on a trip of a radius of 400 km.

Fixed Costs		Variable costs per trip	
Rental	P13 00 000	Fuel	P25000
Salaries	P1000 000	Oil	P2000
Insurance	P2500 000	Tyres	P2000
Loan repayment	P500 000	Maintenance	P4000
Total Fixed costs	**P5300 000**	**Total Variable costs**	**P36 500**
NB: The selling price per delivery is P45000.00			

Let us calculate the breakeven point for Douglas Fuel Delivery Service.

Break-even point = fixed costs/selling price – variable costs
= fixed costs/contributon
= P 5300 000 / P45 000 – P36 5000
= P5300 000 / P 8 500
= 623.529
= 624 trips

Activity 1D

Given the following costs calculate the break-even points.

Fixed costs; P4500

Variable costs P3.50

Selling price P 10.00

Fixed costs; P 60 000

Variable costs; P75.00

Selling price; P80.00

Turn to the end of the topic for feedback on this activity

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1.5 What Have We Learnt

- How to calculating the fixed and variable costs.
- The selling price must always be higher than the variable costs.
- How to calculate the contribution.
- How to calculate the breakeven point.
- It is important to calculate the breakeven point so that the business would know when it could expect to make profit.

1.6 Glossary

Costing: Costing is finding out how much a business spends during the process of producing a product or offering a service.

Cost of production: This is how much the business incurred during production or offering a service.

Level of production: How much the business has produced in a specified time period.

Wages: Income earned by day workers.

Commission: What a salesperson earns after selling a product or service.

Total revenue: Total income earned by the business in a specified Time.

Total costs: Total amount of money spent by the business during production or offering a service.

Fixed costs: Costs that do not change with the level of production.

Variable costs: Costs that change with the level of production

Contribution: The difference between the selling price and the variable cost.

Breakeven point: This is a point where the business has neither made profit nor loss.

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1.7 Self Assessment Exercises

True or false questions

1. If the cost of production is higher than the selling price the business will run at a loss__________
2. Fixed cost changes with the level of production _______
3. A business can be able to calculate how much it cost to produce a product or offer a service by using variable costs__________
4. Raw materials and wages are examples of fixed costs_________
5. The Break even point is the difference between the selling price and the variable costs_____________

1.8 Suggested Answers to activities

Activity 1A

Yeast

Flour

Water

Gas/electricity

Plastick bags

Activity 1B

Fixed Costs

Salary

Sewing machine

Rent

Variable costs

Water

Cloth

Thread

Activity 1C

(a) Contribuition = P450 – P400
= P50

(b) Break-even point = P6000/450 - 400
= 120 cakes

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This means that Dineo will start making profit on her 121st cake

Activity 1D

(a) Break-even point = P4500/P10-P3.50
= 692.3
= 692 units

(b) Break-even point = P60 000/P80-P75
= 12 000 units

1.9 Answers to Self assessment Exercise

1. True
2. False
3. True
4. False
5. False

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Pricing Your Product or Service

Introduction

In the previous topic we learnt about how we cost a product or service. We also learnt that it is important for us to set our selling price higher than our cost of production, otherwise we will be running at a loss. More often than not, some business owners set their selling price without taking into consideration the cost of producing or offering a product. The questions we may be asking ourselves are; how do we determine the selling price? How do I set a good price for my product/service?

Learning Objective

- Define pricing
- Explain the pricing strategies
- Discuss the factors influencing the price of a product/service

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2.1 Definition of pricing

In the previous topic we discussed about the cost of a product or service. In this topic we will discuss the pricing of a product or service. First let us look at the definition of price. Price is the amount that the buyer pays to the seller for acquiring a product or service. Price is one of the four P's of the marketing mix. The four P's of marketing mix have been discussed in module 4, the other three being product, place and promotion. Pricing means putting an amount to the product/service that the buyer must pay to the seller in exchange for the product/service. Normally the sellers put prices on the products or shelves and the prices are visible so that the buyer may not waste time enquiring about them.

2.2 Factors influencing the pricing of a product / service

Pricing can be influenced by the internal or external factors. Internal factors are those factors that are controlled by the business i.e. they come about as a result of decisions or actions taken by the business. On the other hand, external factors are those factors that are not influenced by the business, i.e. they do not come about as a result of decisions or actions taken by the business but they impact on the pricing of a product or service.

Let us look at these factors closely

1. Internal factors

We will look at two internal factors and these are cost and pricing objectives

(a) Cost Objectives

In the previous topic, we discussed how to cost a product or service. The cost of a product or service determines the selling price. For a business to realise profits, it should always set the selling price above the cost of production. The difference between the selling price and the cost of production is called the **margin**. Let us consider the following example. A motor vehicle company manufactures cars at a cost of P120 000 and sells them for P165 000. How much will be the margin in this case?

Margin = P165 000 – P120 000
 = P45 000

In a successful business, price must be high enough to cover total costs and give some profit. This profit is also called margin. A margin is the Pula amount added to the cost of sales to get the selling price.

There are two types of margins that are normally used in business. These are **gross margin** and **net margin**. Let us briefly look at these two terms because we shall be applying them in some parts of this topic.

Gross margin refers to the profit earned per 1 pula sale before expenses are deducted. This means that if we sell an item for 1 pula and the cost was 40 thebe, then our gross margin is 60 thebe. Assuming that after buying the item at 40 thebe, we spend another 30 thebe to cover

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other selling and administrative expenses, we can now calculate our net profit margin. This will become;

Selling price – total costs

= P1 – 70t = 30t.

A general term that is normally used to describe changes to the cost is mark-up or mark-down. A mark-down is a retail price reduction that is required because customers will not buy the product or services at the originally marked-up price.

Activity 2A

At the end of a particular season, retailers of clothes normally mark-down their prices of various goods they sell. Provide any five reasons why a retail price may be reduced.

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Turn to the end of the topic for feedback on this activity.

Total cost mentioned above includes three elements. The first is the cost of the product (or service) offered for sale. A dinner-ware dealer in China, for example, must consider the cost of the dinner ware and transport charges.

The second element is the selling cost. This includes the direct cost of the sales person's services as well as the cost of advertising and sales promotion. The third aspect is the general overhead costs applicable to the given product. Considered in this cost are such things as office supplies, utilities, taxes, officers' salaries and management salaries.

(b) Pricing Objectives

There are several pricing objectives a business could consider in order to make profit. A business has to determine what its objectives are before setting the price. These objectives could be meant to maximise sales volume, maximise profit or have the business remain in status quo. Let us look at these objectives closely.

Profit-oriented objectives

(i) Achieve a target return

A business may decide on a particular level of profit (expressed as a percentage of sales) that it wants to achieve. It then sets its pricing objective in order to achieve the target return on

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investment. For example, a butchery business may have a profit objective of earning a 10% on sales of beef products and it prices its beef products accordingly. The main advantage of a target return objective is that actual performance can be compared against the target and decisions made whether or not to eliminate those products that are not achieving the target return.

(ii) Maximise profits

The pricing objective of making as much money as possible is probably followed by a large number of businesses than any other goal. A profit-maximisation goal is likely to be desirable to both the company and the public in the long-run. The goal should be to maximise profits over all products rather than on a particular product.

Sales-oriented objectives

Sometimes businesses focus their attention on increasing market share and maximising sales volume rather than profits. In this situation, the pricing goal will be to increase sales and to maintain or increase market share.

(i) Maintain or increase market share

A market share objective forces a business to monitor its competitors in the market. An increase in market share may lead to lower costs. This is because the business can buy in bulk and get huge discounts. With a larger market share the business would be serving many customers, therefore if the firm sells at the same price as its competitors, it will get more profit. The business can also increase its market share by lowering costs of acquiring goods. This would make it lower selling prices to attract more customers.

(ii) Increase sales volume

A pricing objective aimed at increasing sales volume is usually expressed as the percentage increase in sales volume over a given time period. Maximising sales can only be achieved by a business with excess capacity that can make pricing decisions without being influenced by its competitor's actions.

Status quo objectives

Status quo means "don't change anything including prices". Status quo objectives are the least aggressive of all pricing objectives as they are designed to meet competition.

A status quo goal is often adopted by businesses in an industry where the product is standardised (e.g. copper, steel, salt etc) and where one of the large companies in that industry has always set a price for the product, small businesses simply follow-the-leader when setting their own pricing policies. A status quo pricing objective may form part of an aggressive market strategy focusing on price competition. Businesses who adopt this policy compete using those elements of the marketing mix other than price. For example, a business may differentiate its product, use different distribution channels or even promote different but relevant benefits of the product.

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2. External factors

(a) Demand for the product

You must have heard the statement; 'the higher the demand the higher the price' and vice versa. It is true that when everybody wants to buy the same item, business people would find it convenient to increase the price. But when the demand for a good is low, its price would also be low.

(b) Competitive reactions

The price of a product is influenced by both present and potential competition within the market. There can be no doubt that wherever the market is competitive, the customers will be more sensitive to price differentials than to the level of the actual prices. The threat of potential competition is high when the market is easy to enter and where profit prospects are encouraging. Comment on this in the following activity.

Activity 2B

Identify **three** main sources of competition in your business or any other business your are familiar with

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____
____
____

Refer to the end of the topic for feedback on this activity. Compare your answers with friends and discuss. Check your responses against those given at the end of the topic.

(c) Government reactions to price levels

In some cases, government may legislate maximum prices in which case the product cannot be sold at any price other than the one set by government. An example of this is price of petrol and similar products.

In certain situations government can intervene directly to force prices up or down. Examples of such situations is the imposition of sales tax which raises the prices and may lead to demand falling for such products, as alcohol and cigarettes and the imposition of subsidies which may lower prices and increase demand for such products as maize and sorghum meal.

(d) Other elements of the marketing mix

Pricing holds the central position in business. Pricing decisions are a major factor in determining a business's revenues and thus its profits, because of its effect on sales. Price is also an important influence on the volume of business being transacted. This we have already observed and it is repeated here for emphasis.

When setting the base price, marketing managers should consider the other major elements of the marketing mix product, distribution and promotion. Let us discuss these elements.

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(i) Product

Price of a product is affected substantially by whether it is new or older. The importance of the product in its end use must also be considered. A higher price relative to the cost of production and marketing permits the business to build quality features that will differentiate the product from its competition. A low price may mean that the business in a highly competitive industry would have to assess carefully every feature (size, colour, style, etc) of a product in terms of its importance to the buyer and its influence on cost.

The price of a product can also be influenced by (i) whether the product may be leased as well as bought outright (ii) whether or not the product may be returned to the seller, and (iii) whether a trade-in is involved.

(ii) Channels of distribution

The channels and types of middlemen selected will influence a producer's pricing. A business selling both through wholesalers and directly to retailers often sets a different factory price for each of those two classes of customers. The price to wholesalers is lower because they perform services that the producer otherwise would have to perform itself. Examples of such activities include storage, granting credit to retailers, and selling to small businesses.

(iii) Promotion methods

The promotional methods used and the extent at which the product is promoted by the producer, or middlemen, are factors to take into account in pricing. If a major promotion responsibility, is given to the retailers, by the producer, they must be charged a lower price for a product than if the producer advertises it heavily. Even when the producer promotes the product, it may still want its retailers to use local advertising to tie in with national advertising. Such decisions must be reflected in the producer's price to these retailers.

Activity 2C

Write down other factors that need to be considered before pricing a product/ service.

____

____

____

____

Turn to the end of the for feedback on this activity

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2.3 Pricing strategies

Having set the pricing objectives, the business should now look at how these objectives could be achieved hence engage the pricing strategies. There are a number of pricing strategies to consider when setting the price for a product/service. Several examples of these strategy considerations are discussed below.

(a) Penetration pricing

This strategy involves pricing goods or services lower than normal, longer-term market price in order to gain more rapid market acceptance or to increase existing market share. It is one of the methods used to price new products or services. This method of pricing tends to discourage new competitors from entering the market if they view the penetration price as a long-term price. This strategy sacrifices some profit margins to achieve other marketing goals. For example, if you started a laundry business you might want to charge very low prices to attract more customers and discourage competitors from entering the same business.

(b) Skimming pricing

A skimming-price strategy sets prices for products or services at very high levels for a limited period before considering a reduction to lower and more competitive levels later in the future. This is another method for pricing new products or services. This strategy makes an assumption that certain customers will pay the higher price because they perceive the product or service as a prestige or status item. This strategy makes practical sense when there is little threat of short-term competition or when the costs of starting a business are high and need to be recovered quickly before competition sets in. A furniture shop as an example, might charge a higher than normal price for a new and prestigious display cabinet.

(c) Follow-the-leader pricing

This is a strategy where a business sets the same price, even lower, than a bigger business that seems to be controlling the market.

The possible reaction of competitors is an important factor in determining whether to reduce prices below the existing level. A small business in competition with larger companies cannot be in a position to consider itself the price leader. If competitors see the small business' pricing as relatively unimportant, they may permit a price differential. This may well be the reaction if the price-cutting firm is sufficiently small. On the other hand, established businesses may view a small business price-cutter as a direct threat and counter with reductions of their own which could be much lower and could hurt the small business. In such a case, the smaller price-cutter stands to gain very little.

For example if you started a small business of brewing beer you would certainly have to charge the same price as Kgalagadi Breweries for your products or even lower to attract customers from the leader.

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(d) Variable pricing

This refers to setting different price levels to different customers depending on whether they buy in small or large quantities.

In some businesses, the business makes price concessions to selected customers even though it advertises a uniform price. Concessions may be made for various reasons, one of which is customer's knowledge and bargaining strength. In some businesses, therefore, pricing decisions involve two parts: a stipulated "list price" and a range of price concessions to specific buyers. A small stationery shop, for example, located in the village might give a lower concession price to schools in the area because they buy in bulk and charge a higher price to individual customers.

(e) Flexible pricing

Although many businesses use total cost as a point of resistance, most of them take into account special market conditions and practices of competitors in arriving at their prices. For example a blanket retailer can estimate the full cost, but modifies the price to meet market conditions. His or her time is less valuable in summer, when business is slow, than in winter and will therefore adjust the estimates of cost accordingly. Thus two different prices may apply for winter and summer due to different conditions in demand.

On certain occasions it may be wise to price at less than total cost. For example, if the facilities of a business are idle, some costs can be recovered by selling at less than total costs as long as this price covers variable costs (cost of raw material and other inputs).

(f) Price lining

A price line is a range of several specific prices at which a product is offered for sale. For example, ladies shoes might be sold at P150, P200 and P250. The general level of the different lines would depend on income levels and buying desires of a store's customers. Price lining has the advantage of simplifying choice for the consumer and reducing the necessary minimum inventory.

(g) What the traffic will bear

The policy of pricing on the basis of what customers will bear can be used only when the seller has little or no competition at all. Obviously, such a policy will work only for non standardised products. For example, a food store might offer sausage roll wrappers that competitors do not stock. Busy customers who want to fix the sausage rolls but who have neither the time nor knowledge to prepare the wrappers will buy them at any reasonable price.

Before you proceed with other sections, pause a while and answer questions in Activity 2D.

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Activity 2D

(a) What pricing strategy would you use if you are selling sorghum?

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____

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(b) If you were to set up a small brewery business in Botswana, which pricing strategy would you adopt and why?

____

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____

(c) If you have to market a new type of executive chair which pricing strategy would you follow?

____

____

____

____

Turn to the end of the topic for feedback on this activity

(h) Cost-plus pricing

Many business persons use a simple formula to arrive at their selling price. Firms that use cost-plus pricing set prices by totalling their costs and adding a reasonable margin of profits. This approach ensures that all costs will be covered and that a desired profit level will be obtained. For example, if 2Kg Omo costs P10 and is selling at P14, the mark up of P4 would be 40% of the selling price (P4 ÷ P10 x 100).

The main problem with this simple and quick approach is that it does not consider whether the customers will pay the price that is determined. In other words, the price might be either too high or too low for customers. If it is too low it leads to lost opportunities where money is lost unnecessarily. In general, this method ignores demand considerations.The formula used for arriving at retail price is: R = C + MU

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where R is the retail price, C is the cost and MU is the actual mark-up.

Activity 2E

If your restaurant business bought bread at P2 and adds a 25% mark-up. At what price will the restaurant sell the bread? ____________________________

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Work out the problem in Activity 2E and compare your answers with that of your friends. Answer is given at the end of the topic.

(i) Multiple pricing

This is whereby customers can buy products/services in large quantities and get a discount. This is a win - win situation for both buyers and sellers. Sellers are able to sell more products and services at ago and customers benefit through discounts. The prices of a single product/service is displayed together with the price of purchasing a large quantity of the products/service at a go. Buyers tend to pay more for purchasing a single item that purchasing more items at a go. Let us look at the following example. Thuso Dairy farm sells 2litres of milk to the retailers at P8.00 per bottle and P84 per dozen. How much does the customer save if they buy a dozen of fresh milk?

Consider the working out done below;

1 dozen has 12 bottles.

If 12 bottles cost P84, then

1 bottle costs P7.

This means if you buy 1 dozen, you will be saving P1 per bottle.

2.4 Setting a price

Now that we have looked at the factors to consider before we set the price as well as the strategies to be engaged when setting up the price, we will now set the price for our products/services. Remember that price is the only element of the marketing mix that brings profit in the business. It is important to set the right price in order to make profit. Setting the right price could be a difficult thing to do for small businesses. At times the price is set too low and the business is not able to make profit. At other times the price is set too high and this chases the customers away and the small business owners may find themselves out of business.

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In the previous topic we learnt about how to cost a product/service. Once the producer is able to put a cost to a product/service then the price could be set. It is very important to note that the cost of production should always be lower that the selling price for the business to realise profit. There are two ways of looking at price setting.

One way is when the business produces products. In topic one we discussed how the business uses variable cost of production to guide them as to how much the selling price could be. For example if the variable cost of producing a school uniform is P15, then the seller would set a price higher than P15.

The other way is when the business gets products/services from the supply for reselling and they put a mark up to the products/services i.e. a certain percentage on top of the initial price. For example if a retailing business buys products from a producer for P30 and sells them for P35. Their mark up can be determined in two ways:

(a) As a mark up on cost

Mark up = percentage mark up
Cost

P5 x 100%= 17%
P30

Price = initial price + (initial cost x percentage mark up)
= 30 + (30x 17%)
= P35

(b) As a mark up on price

Mark up = percentage mark up
Selling price

P5 x 100% = 14%
P35

Price = initial cost
(1.00 percentage mark up)
= 30
(1.00 – 14%)
= P35

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Activity 2F

A retailer buys a dozen of eggs from a farmer at P12. Calculate the percentage mark up price and percentage mark up on cost if he sells the eggs for P16

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Turn to the end of the topic for feedback on this activity

2.5 What have we learnt

We have learnt several things related to pricing that are of immediate benefit to any business. We learnt that:

- cost influences pricing
- there are also several other factors influencing pricing apart from cost
- any business can realise a loss or profit, but most businesses objective is to make a profit
- there are several methods used for setting a selling price

2.6 Glossary

Pricing: Putting a monetary value to the items or services to be sold.

Mark up: Amount of money added to the cost of an item to get the selling price.

Barter: Exchanging goods for goods e.g. a crate of tomatoes for 5kg sugar.

Channels of distribution: The people who handle the product before it reaches the customer.

Cost: The cost of an item is the amount paid when ordering it from the supplier.

Revenue: The income you get from sales.

Status quo pricing: Keeping prices the same without making any changes.

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2.7 Self assessment exercise

Choose the correct word from this list and complete each of these statements. Use each word once only. The words are: credit, gross margin, price, barter, calculations, cost, profit, sales-oriented, margin, revenue.

1. The ________________________ is the value placed on goods or services.

2. __________________ is the exchanging of goods for other goods.

3. __________________ is the money a business gets from sales.

4. When working out prices you should be able to do simple _______________.

5. A _____________ is the amount of money added to the cost of an item.

6. The __________________ includes other expenses.

7. Under the ________________________________ objective you are concerned with a larger market share.

8. The ____________________ of an item is its value before adding mark up.

9. A successful business makes enough _________________________ to bee viable.

10. In a _____________________________ sale the buyer promises to pay later.

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2.8 Suggested answers to activities

Activity 2A

- Merchandise may be soiled
- Style may change
- Fading
- Damage caused by handling
- Change of season
- Original price too high.

Activity 2B

- Directly similar products e.g. Nike shoes against Reebok shoes
- Substitute products e.g. rail transport against road transport or butter and margarine
- Unrelated products seeking the same consumer money e.g. video cassette recorder and refrigerator.

Activity 2C

Yes, there are many other factors that influence pricing and include the following:

- The objectives of the company based upon its short and long-term profit requirements
- The psychological (in the mind) effect that a price can have in implying "high price" equals "better quality"
- The effect of price upon the business image and brand name, for example the expectation that Pep Stores will sell cheap products
- The influence of government, trade association and consumer bodies in price setting
- Customer sensitivity to high prices

Activity 2D

(a) Flexible pricing

(b) Follow the leader pricing; Kgalagadi Breweries as leader in market would set pace in pricing for others to follow.

(c) Market skimming.

Activity 2E

R = C + MU

R = P2.00 + 25% (P2.00) = P2.50

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Actiivty 2F

(a) As a mark up on cost

$\frac{\text{Mark up}}{\text{Initial price}} \times 100\%$ = percentage mark up

$\frac{P4}{P12} \times 100\%$ **= 8%**

(b) As a mark up on price

$\frac{\text{Mark up}}{\text{selling price}} \times 100\%$ = percentage mark up

$\frac{P4}{P16} \times 100\%$ **= 25%**

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2.9 Answers to self assessment exercises

1. Price
2. Barter
3. Revenue
4. Calculations
5. Margin
6. Gross margin
7. Sales-oriented
8. Cost
9. Profit
10. Credit

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