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MARKETING MODULES SERIES



Marketing Module 6: Price

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Foreword

A marketing strategy is something that every single food and agriculture-related business (farms, wholesalers, retailers, etc.), no matter how big or small, needs to have in place in order to succeed in the marketplace. Many business owners in the food and agriculture sector in New York State and elsewhere are hesitant to set up an actual marketing strategy because they simply do not know how to go about developing it. How to better market their products and services remains a primary concern among New York State food businesses as a result.

In response to this need, we offer this Marketing Modules Series of eight modules which constitute a comprehensive training course in marketing management. The overall goal of this series is to improve the marketing skills of food business managers and owners in New York State so that they can develop successful marketing strategies to increase business profitability. More specifically, these Marketing Modules are intended to support the efforts of extension specialists and extension educators as they develop marketing training programs for their stakeholders.

Module 1 (Marketing) offers an overview of the series and discusses the basic pillars of a marketing strategy. Modules 2, 3 and 4 (Customer, Company and Competition, often referred to as ‘The 3 Cs’) focus on key concepts and techniques to conduct market analysis. Modules 5, 6, 7 and 8 (Product, Price, Placement/Distribution and Promotion, or ‘The 4 Ps’), hone in on the essential elements of marketing tactics.

To facilitate their use in extension-related educational activities, modules two to eight consists of three components: 1) a summary of the fundamental concepts, 2) a real-world example relevant to the New York State food and agriculture system to illustrate these concepts, and 3) a set of teaching slides to be used in training sessions and other educational activities in which these modules can be used individually or in combination. Because Module 1 (Marketing) is an overview of the whole series it only includes components 1 and 3. Examples for each of the sections in Module 1 can be drawn from the other seven Modules.

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The complete Marketing Modules series can also be accessed online at:
<http://hortmgt.gomez.dyson.cornell.edu/Marketing-Modules.html>.

1. What is Price?

Price is the dollar amount asked for a sales unit of your product or service. It should be a function of your input costs, operating expenses, desired profit, level of service provided, price of competing products and the overall product demand. Your firm's income is the result of your sales volume and your product(s)/service(s) price(s), hence the importance of setting competitive prices. Competitive prices will allow you to sustain business operations and make a profit, while at the same time attracting customers and building sales.

Setting a price begins with a definition of the pricing objective: is it to cover costs and make a profit? Is it to undercut the competition and gain market share? Is it to obtain a specific return on your investment?

Furthermore, setting a price is not a "one time" thing. Rather, it is an on-going process and for this reason you need to be alert to any changes that might affect the price for your product/service in a particular market (e.g. changing costs of supplies and materials and new technologies that may speed up processes or make them cheaper or more expensive.)

There is no "science" of pricing, nor does one have the benefit of a specific set of rules. Pricing is both an important financial matter for your business and a key marketing issue that not only affects revenue and profits but also your positioning in the market, your selling ability and your brand!

Three key aspects you need to keep in mind when considering pricing are:

1) The customer is the focal point for your business, so you need to know:

- Who the customers in your target market are
- What they want from your product/service
- Their willingness to pay for your product/service

2) You operate in a competitive market, therefore, it is very important to establish:

- Who your competitors are
- What they are offering and how much they are charging for their product/service
- If you have, or if you can develop, a competitive advantage over your competition
- If you will be able to charge a higher price than your competition (i.e. be a price setter) or if you will need to be a "price-taker" in this market

3) Your prices reflect your product/service position in the market so you must decide:

- How do you want your product/service to be perceived in the market
- Whether or not your price correctly positions your product/service in the minds of your current/prospective customers

Your product/service position in the market is the overall perception your customers have of your firm and your product/service versus their perception of competitors and their products/services, in the same category. As part of the marketing strategy marketers develop “positioning statements” to create the desired image of their company and product/service in the mind of their customers. *For more information on product/service positioning see Marketing Module 1: Marketing*

A word of caution: having the “lowest price in the market” image can’t get you higher prices for higher quality products while having a “value image” implies reaching an optimal combination of quality, service, and price!

2. How to Set (and Get) the Right Prices

It is your job to thoroughly understand what the price and attributes/benefits of your product/service are and to be knowledgeable about those attributes/benefits that are valued by your customers. This knowledge will allow you to determine how high you can set your prices and still attract customers in your target market. Always keep in mind that your ability to deliver value to your customers over and above your competitors has a direct impact on the pricing strategy.

2.1 Using the Market Price as a Benchmark

A good starting point in defining your prices is to identify the market price for your product/service, determine how this price compares with your costs and whether or not it fits your business plan. To determine what is selling, to whom and for what price, you need to do some market research. You can do it by talking to your vendors, by gathering information from your competitors, checking publications and competitor’s advertising, going to trade shows, etc.

Once you have a good idea of what the going or market price for your product/service is, you need to determine the “difference” between that price and your costs. Evaluating those differences needs to be nuanced enough to consider the quality, any added services and other features of your product/service. Ask yourself:

- Can I charge a higher price for my product/service (i.e. be a price setter) or will I have to go with the market price? (i.e. be a price-taker)
- Will I be able to make a profit at this price or will I most likely incur ongoing operating losses?

2.2 Prices and Your Marketing Mix

When considering prices for your product(s)/service(s), a very important aspect to keep in mind is that they need to be consistent with the other elements of your marketing mix (Product, Placement/Distribution, and Promotion.)

You need to constantly be asking yourself:

Product: is my price in line with my customer's perceptions of the quality and service of my product/service? If this is not the case, you need to consider either lowering or raising your prices accordingly or re-educating your customers about your product/service.

Placement/Distribution: is the price of my product/service consistent with the distribution channels that I am using? If not, you need to identify a better suited channel for your product/service.

Promotion: is my advertising message consistent with my product's price and the image/position I want to convey? If not, you need to adjust the message accordingly.

2.3 Common Pricing Strategies

Pricing strategies commonly used by firms can be classified as skimming, penetration, premium or economy pricing. Which of these would be appropriate for your firm's product/service?

Skimming Pricing is often used when there is no competitor in the market, allowing one to charge a fairly high price for a new or innovative product. Price can be reduced over time, as those customers who are early adopters have tried the product or as competition starts moving in.

Penetration Pricing is used when a firm wants to increase its presence in a given market. It consists in setting a low initial price to gain market share, stimulate sales and/or to defend market share of products that are in a later stage of their life cycle.

Premium Pricing consists in asking a high price for a product that is unique in some way. This is a strategy commonly used by those firms that have a substantial competitive advantage (e.g. organic fruits and vegetables, locally grown fruits and vegetables, Godiva chocolates.)

Economy Pricing consists of setting a low "no frills" price. It is a strategy in which production and marketing costs are kept as low as possible (e.g. CostCo, ALDI, etc.)

2.4 Common Pricing Mistakes

First worst pricing mistake: lowering prices to compete on price alone - it makes it difficult for businesses to cover costs and make a profit and conveys an image of lower quality. Having the lowest price IS NOT a strong position for small businesses as large competitors with lots of money (and the ability to reduce their direct/variable costs) can easily drive them out of business.

Second worst pricing mistake: lowering prices without reducing the benefits/services - it conveys the image of over-inflated prices

Smart pricing is good marketing and the key to avoiding mistakes from the beginning!

3. What You Need to Know to Calculate your Prices

Either a “forward” or a “backward” analytical process can be used to calculate your prices. The “forward” approach starts by considering your costs of production, distribution and promotion as well as the margins of those involved in the supply chain, to arrive at a retail price. The “backward” approach starts with the retail price and subtracts the margins typically taken by participants in the supply chain to arrive at the price you will need to be competitive. Your price should cover your costs and allow for a profit:

$$\text{Price} = \text{Costs} + \text{Profits}$$

To calculate your prices you need to know:

- **Your Total Costs**

To determine your costs, take into consideration everything that it takes you to get your product/service to the market. Include purchases of supplies and materials, packaging, production, labeling, marketing and sales expenses, overhead, administration, salaries, benefits, etc. Your production costs are the sum of your direct/variable costs (also called “costs of goods sold”) and your indirect/fixed costs.

- **What are Your Direct/Variable Costs?**

Direct/variable costs are the checkbook or “out of pocket” expenses incurred each time you sell a product/service. They are directly related to your sales volume and include costs of materials, labor costs, commissions, shipping, packaging, delivery charges, etc..

- **What are Your Indirect/Fixed Costs?**

These are the costs incurred regardless of sales volume. They include rent, administrative costs, real estate taxes, insurance, depreciation, etc.

- **What are Your Production Costs per Unit?**

$$\text{Unit Costs (\$)} = \frac{\text{Direct/ Variable Costs (\$)} + \text{Indirect/Fixed Costs(\$)}}{\text{Units produced (lbs, dozens, bags, etc.)}}$$

- **What is The Contribution Margin Per Unit?**

The Contribution Margin per Unit is the amount of money that you have left after covering your direct/variable costs/unit. It is based on the idea that each unit sold provides a return that goes toward covering fixed expenses. In a profitable business it should be enough to cover your indirect/fixed costs and your profit:

$$\text{Contribution Margin per Unit} = \text{Price/unit} - \text{Direct/Variable Costs/unit}$$

- **What is the Break Even Point?**

The Break Even Point represents the number of unit sales you need to cover costs. In other words, it is the price at which you just cover both direct/variable costs and indirect/fixed costs. Always ask yourself whether you will be able to sell the number of units required to break-even at the price you set. If you can't sell this number of units you will be operating at a loss!

$$\text{Break Even Point} = \frac{\text{Indirect/Fixed Costs}}{\text{Contribution Margin per Unit}}$$

- **What Would Your Profit Be?**

Profits are the income you generate after covering your costs (direct/variable and indirect/fixed/operating/administrative costs). You can calculate your profits as the difference between your price and total costs per unit multiplied by your sales volume:

$$\text{Profit} = \text{Sales Volume} * (\text{Price} - \text{Total Cost})/\text{unit}$$

Supplement No. 2, at the end of this module, provides an example and opportunities to calculate these parameters for your product(s)/service(s).

4. Calculating your Prices

To calculate your prices, you can use either a “Cost and Profit” approach or a “Planning for Profits” approach.

4.1 The Cost & Profit Pricing Methods

Three commonly used Cost & Profit pricing methods are “Gross Margin Pricing”, “Markup Pricing” and “Break-Even Point Pricing.” As illustrated below, your “Cost of Goods Sold” constitutes the basis for calculating your selling prices when using these methods. “Cost of Goods Sold” corresponds to the direct/variable costs per unit of product produced.

4.1.1 The Gross Margin Method

In this case, the Selling Price is calculated based on the Cost of Goods Sold and the desired Gross Margin (GM):

$$\text{Selling Price} = \frac{\text{Cost of Goods Sold}}{1 - \text{Desired GM}}$$

Example: Cost of Goods Sold = \$2.50

$$\text{Desired GM} = 40\%$$

$$\text{Selling Price} = \$2.50 / (1 - 0.40)$$

$$\text{Selling Price} = \$2.50 / 0.60$$

$$\text{Selling Price} = \mathbf{\$4.17}$$

Conversely, the Gross Margin (GM) for a particular selling price can be calculated as the difference between the direct/variable costs of your product/service and its' selling price, weighted by the selling price:

$$\text{Gross Margin (\%)} = \frac{\text{Selling Price} - \text{Cost of Goods Sold}}{\text{Selling Price}} \times 100$$

$$\text{GM} = \frac{\$4.17 - \$2.50}{\$4.17} \times 100 = 40\%$$

4.1.2 The Markup Method

A markup (typically expressed in percentage terms) is an increase applied to the direct/variable costs (or "cost of goods sold") of a product/service to determine a selling price. Markup pricing may be more appropriate when reselling a product. In fact, many retailers and middlemen prefer to use markups rather than gross margins in their price calculations.

$$\text{Selling Price} = \text{Cost of Goods Sold} + (\% \text{ Markup} \times \text{Cost of Goods Sold})$$

Example: Cost of Goods Sold = \$2.50
 Markup = 40%

$$\text{Selling Price} = \$2.50 + (0.4 \times \$2.50)$$

$$\text{Selling Price} = \mathbf{\$3.50}$$

4.1.3 The Break- Even Point Method

The Break-Even Price is the lowest price you can charge while still covering your product/service's costs/expenses. At this Selling Price, no profits are accrued.

$$\text{Break-even Price} = \frac{(\text{Direct/Variable costs} + \text{Indirect/Fixed Costs})}{\text{Number of units produced}}$$

Supplement No. 3, at the end of this module, provides an example and the opportunity for you to calculate the price of your product(s)/service(s) through the Gross Margin and Markup Methods.

4.2 Planning for Profits Pricing Methods

You can also calculate your prices on the basis of a specific profit goal or sales volume goal.

4.2.1 Setting a Profit Goal

This method is based on setting a specific profit goal (\$) and then determining the number of units you need to sell, at a certain price, in order to meet that goal. For that purpose, you calculate your sales volume at the “Profit Break Even Point.”

$$\text{Profit Break Even Point} = \frac{\text{Profit Goal}}{\text{Contribution Margin per Unit}}$$

Where Contribution Margin per Unit = Price/unit – Direct/Variable Costs/unit

4.2.2 Setting a Sales Volume Goal

Alternatively, you can set a sales volume goal and then calculate the expected profit at the price you have set.

$$\text{Profit} = (\text{Sales Volume} \times \text{Contribution Margin per Unit}) - \text{Total Costs (Direct+ Indirect Costs)}$$

A good practice is to try several different methods to calculate the prices for your product(s)/service(s). But, keep in mind that, regardless of the method you choose to determine your prices, as a smart marketer, you want to ensure that they match the other components of your marketing mix (product, placement/distribution and promotion).

5. Price Setters and Price Takers

Whenever a firm sets a price, it needs to strive for a “balance” between what it wants to charge and what the buyer (middlemen/consumers) will accept.

5.1 Price Setters

Price setters determine the prices they charge for their product(s)/service(s). Examples of price setters include retailers, direct marketers and firms selling products/services to niche markets. A farmer doing direct marketing is a price setter but, at the same time, needs to carefully observe prices at retail and wholesale markets before setting his/her own prices.

5.2 Price Takers

Price takers in the market have to settle for what the market dictates. Price takers are usually firms that produce an identical product/service in a market where there are few barriers to entry

or exit and where there are a large number of participating firms, each supplying only a small portion of the total market volume. As a result, these firms have no control over the prices they charge for their product(s)/service(s) in such markets. Price takers face a totally elastic demand for their product(s)/service(s) which means that they can sell into that market in any quantity at the market price.

Most farmers fall in this category as they produce relatively homogeneous commodities, have small individual market shares and usually are reluctant to organize in groups. This means that they cannot affect market prices by varying production at an individual level. Furthermore, due to the perishable nature and/or seasonality of their output, it is very difficult for farmers to command higher prices in the short run. The price a farmer gets depends largely on the distribution channel used to sell the product. Farmers producing bulk commodities are usually price-takers at terminal and wholesale markets.

Agricultural businesses cannot get higher prices for what is viewed as a generic commodity and wield little or no influence on the prices they receive. Under these circumstances, profits mostly come from producing at lower cost and/or delivering higher sale volumes.

5.2.1 How Can Price Takers Change their Fate?

Strategies that price takers can implement to change their fate include:

Developing alternative products/markets: moving out of commodity products and getting into more “niche” markets will provide an opportunity to become a price setter rather than a price taker. *Example: ethnic foods, baby vegetables, fresh herbs, edible flowers, etc.*

Differentiating products: differentiation can bring about higher prices and increased product demand. Strategies include branding, pre-packaging and new uses for a “commodity” product. *Example: Locally-grown produce*

Adding value: many customers are looking for a combination of quality, convenience and price. Incorporating value added features that customers recognize and appreciate will have a positive impact on the price they will be willing to pay. *Example: Pre-cut vegetables ready to cook/grill.*

6. Prices and Your Firm’s Income

At a certain point you might have to consider reducing the price on some of your product(s)/service(s) to meet your competition, to attract customers to a retail outlet (i.e., advertised specials) or to sell products that have been damaged, overstocked or seasonal. Or, conversely, you might want to consider increasing your prices for certain product(s)/service(s) to either reflect the value of a unique product, a special service, or to convey a prestige image.

When considering changing your prices, however, it is important to keep in mind that any action you take will likely have an impact on the total gross income of your business. For that reason, it

is in your best interest to anticipate what this impact will be before you make any decisions. See an example of how changes in prices impact a firm's income in Supplement No. 1, at the end of this module.

7. Beware of Price Wars

Engaging in price wars or competition-based pricing is extremely dangerous because it may drag you into cutting down prices to levels that will not allow you to make a profit and may even drive you out of business. In addition, price-cutting can also negatively affect the image of your product and/or your business!

Avoiding price wars starts with a full understanding of the demand for your product/service. Use the following three factors to guide you in this task:

- Carefully examine your competitors' offer

Examine your competitors' offer beyond price. Look at the whole package and identify their target market (are they targeting price-conscious or affluent consumers?). Determine whether there are any value-added services in your competitor's offer .

- Determine the ceiling price for your product/service

The ceiling price for your product/service is the highest price that the market will bear. If your product/service exhibits little or no response to price changes, i.e., has a low price elasticity of demand, you will have a higher price ceiling, other things being equal. Find out what the price limit is by surveying experts and customers.

- Estimate the price elasticity of demand for your product/service

Elasticity of demand (E) is a relative measure of the effect that a price change has on the level of demand of a product or service.

$$E = \frac{\text{Percentage change in quantity demanded}}{\text{Percentage change in price}}$$

Some products/services (necessities) have an “inelastic demand” or “low price elasticity of demand” meaning that their demand is not significantly affected by a price change. This is the case of products such as fine wines and flowers for special occasions. Low price elasticity of demand is a function of one or more of the following factors: limited competition in a market, buyer's perception of quality or buyers not used to looking for the lowest price in a particular product/service category. When demand is inelastic, total revenue increases with a price increase. Other product(s)/service(s) exhibit a marked decrease or increase in demand as a result of higher or lower prices, respectively. Products/services in this category are said to have an

“elastic demand”, such is the case of most agricultural products. When demand is elastic, total revenue decreases with a price increase.

Once you have mapped out the demand for your product/service you can review your costs and profit goals and see whether or not you need to make any price adjustments to be more competitive in your specific target market, stay in business and make a profit.

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Supplement No. 1 - Examples of Price Changes' Impact on the Firm's Income

Assume a direct marketer is selling just five major items from a farm stand. The direct marketer has calculated gross margin for each product using the “cost of goods sold” and has also estimated the approximate sales for each product as a percentage of total sales. The percentage of sales and gross margin for each product are shown below.

| Contribution to Total Sales and Gross Margin before Price Reduction | | | |
|--|------------------------------------|------------------------|------------------------------------|
| Item | A. % of Total Sales (estimated) | B. Gross Margin (%) | C. Total Gross Margin (C = AxB) |
| Peaches | 25 | 40 | 10.0 |
| Mums | 10 | 25 | 2.5 |
| Pumpkins | 15 | 30 | 4.5 |
| Sweet Corn | 20 | 20 | 4.0 |
| All Others | 30 | 30 | 9.0 |
| Total | 100% | | 30.0% |

Now the stage is set for some useful price analysis. Consider an example. If the direct marketer lowered the price on pumpkins as a Halloween promotion to meet a lower price offered by a competitor or to sell out the seasonal stock, the gross margin for this product most likely will fall. However, one might expect that the volume of pumpkins sales might materially increase at the new, lower price. Assume that the price reduction would result in a gross margin of 10% (a drop from 30%) and an increase in sales to 20% of the total (up from 15%). The impact of this price reduction on her/his total sales and profits would be as follows:

| Contribution to Total Sales and Gross Margin after Price Reduction | | | |
|---|------------------------------------|------------------------|------------------------------------|
| Item | A. % of Total Sales (estimated) | B. Gross Margin (%) | C. Total Gross Margin (C = AxB) |
| Peaches | 24 | 40 | 9.6 |
| Mums | 9 | 25 | 2.25 |
| Pumpkins | 20 | 10 | 2.00 |
| Sweet Corn | 19 | 20 | 3.8 |
| All Others | 28 | 30 | 8.4 |
| Total | 100% | | 26.05% |

As illustrated, the direct marketer will experience a drop in total gross margin from 30% to 26.05% or a loss of -3.95%. Assuming that sales for the business averaged \$5,000 per week, this would imply a weekly loss of:

$$\$5,000 \times (-3.95\%) = -\$197.50/\text{week}$$

However, if the lower price on pumpkins attracted more customers and/or stimulated more sales for the business as a whole, the result would be an overall increase in sales of more than \$197.50/week, implying an increase of the total gross revenue for the direct marketer, as follows:

Example:

Gross margin before the price reduction

$$\$5,000 \times 30\% = \$1,500$$

Gross margin after the price reduction (with
a \$900 sales increase)

$$\$5,900 \times 26.05\% = \$1,536.95$$

Supplement No. 2 - Calculating your Variable, Fixed and Total Costs and your Break-even Price

Example: Gourmet Salad Dressing

| <u>Costs</u> | Example | Your product |
|--|----------------------------|---------------------|
| <i>Variable/Direct Costs – Cost of Goods Sold</i> | \$/batch of 400 units | \$ |
| Raw materials (oil, vinegar, spices, salt, etc.) | 600 | |
| Labor (hours of labor required) | 800 | |
| Sales Commissions | 160 | |
| Shipping Charges | 100 | |
| Others | - | |
| | | |
| | | |
| Total Variable/Direct Costs – Cost of Goods Sold | 1,660 | |
| | | |
| <i>Fixed/Indirect Costs</i> | | |
| Rent, utilities, interest, taxes, insurance | 300 | |
| Others | - | |
| Total Fixed/Indirect/Operating Costs | 300 | |
| | | |
| Total Costs | 1,960 | |
| | | |
| Break-even Price = Total Costs/#of Units Produced | 1,960/400= 4.90 | |

Supplement No. 3 - Calculating Your Prices – Cost and Profit Pricing Methods

| Gross Margin Method | Example | Your Product |
|---|-----------------------------------|--------------|
| | \$ | |
| Cost of Goods Sold/Variable Costs/Unit | 4,19 | |
| Desired Gross Margin (GM) | 40% | |
| Selling Price = Cost of Goods Sold/(1-Desired GM) | $4,19/(1-0.40) = 6,92$ | |
| Desired Gross Margin (GM) | 30% | |
| Selling Price | $4,19/(1-0.3) = 5,93$ | |
| Desired Gross Margin (GM) | 50% | |
| Selling Price | $4,19/(1-0.5) = 8,30$ | |
| | | |
| CONVERSELY Calculating the Gross Margin for a specific Selling Price | | |
| Gross Margin = (Selling Price – Cost of Goods Sold)/Selling Price)*100 | | |
| <i>Selling Price</i> | 8,00 | |
| Gross Margin | $((8,00 - 4,19)/8,00)*100 = 48\%$ | |
| Selling Price | 6,00 | |
| Gross Margin | $((6,00 - 4,19)/6,00)*100 = 31\%$ | |

| The Markup Method | Example | Your Product |
|--|-----------------------------|--------------|
| | \$ | \$ |
| Cost of Goods Sold/Variable Costs/Unit | 4,19 | |
| <i>Markup</i> | 40% | |
| <i>Selling Price =</i> Cost of Goods Sold + (Cost of Goods Sold*Markup) | $4,19 + (4,19*0.40) = 5,81$ | |
| <i>Markup</i> | 30% | |
| Selling Price | 5,40 | |
| Markup | 50% | |
| Selling Price | 6,23 | |
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