Pricing

LESSON 1

What is Price?

Price is the amount of money a business charges for items it offers for sale. The selling price for merchandise must help the business make a profit and must be reasonable for customers to pay.

Determining Selling Price

When determining a selling price for merchandise, a business owner should consider cost and profit. Cost is the amount of money the store pays to purchase the merchandise from a supplier. There are some key factors that can influence the cost of the merchandise, such as discounts and terms for timely payment. These factors should be considered when determining the price to the customer.

Profit is the total revenue of a business less all expenses over a specific period of time. Each product a business sells should contribute to the business's profit. When a business owner determines the selling price for an item, he or she should consider all of the costs associated with having that item for sale in the store. Those costs include the overhead and operating expenses for the business, such as the cost of electricity, water, and employee salaries. Businesses must make a profit to remain in operation.

Main Idea

Pricing is a vital concern for business owners. It is crucial for merchandise to sell, so the price of an item must project value to the customer. Correct pricing of merchandise is essential for the business to generate a profit, and profit is necessary for every business to remain in operation. In this unit you will learn about the fundamentals of pricing, factors to consider when setting a selling price, some of the legalities of pricing, and mathematics involved in pricing.

After completing this lesson you will be able to:

- Calculate price based on unit cost and desired profit
- Compute margin based on price and unit cost
- Maximize profit by analyzing and adjusting price and margin
- Explain the relationship between price, demand, and profits
- Explain when and how to implement a markdown
- Change product pricing to remain competitive

Key Terms

- Price
- Cost
- Profit
- Margin
- Supply and Demand
- Market Share
- Markdown

Margin

A term that is often associated with price is margin. Margin is the difference between the retail price of an item and the cost of the item to the store. This may also be referred to as markup, which is often represented as a percentage figure. Frequently, stores will set a global percentage markup for the majority of its merchandise. The percentage markup most often used is based on the cost of the merchandise. See the Pricing Math section for how to compute markup based on cost.

Pricing and Competition

Most stores of the same type carry comparable types of merchandise. In most cases, these similar types of merchandise carry similar prices. A storeowner who prices merchandise in this way is said to be pricing to "meet the competition." In other words, this store's merchandise sells for about the same price as several other stores. Some storeowners may decide to sell similar merchandise at a price below that of the competition. This type of pricing is usually done with the hope of selling greater quantities of the merchandise and attracting more customers to the store. The storeowner is willing to accept a smaller margin on the item in hopes of selling larger quantities. Other storeowners will decide to sell similar merchandise at a price higher than that of the competition. Pricing in this manner will be successful if customers feel there is extra value or convenience in purchasing at the store with the higher price.

Supply and Demand

Pricing is affected by the principle of supply and demand. Supply and demand describes the amount of product available to sell and the willingness of customers to buy that product.

When a product is readily available the price will reflect that fact. Merchandise that is not readily available or that is in low supply can create higher customer demand and higher prices. The business owner must accurately judge customer demand and set the selling price accordingly.

What Happens When a Price is Too High or Too Low

Today's customers are well informed and price savvy. Merchandise that is priced significantly higher than what customers expect to pay is likely to remain unsold. Customers will not see enough value for their dollar in the merchandise. Merchandise that is priced significantly lower than what customers expect is also likely to remain unsold since customers may assume that there is something wrong with the product.

Market Share

Every store is located in a trading area, from which it attracts customers. This area usually contains similar stores that compete in the same market. Market share is the percentage that a store has of the total sales in its area. Market share is an important indication of how well the store is doing compared to its competitors. Lower prices can increase market share just as higher prices can decrease it.

Markdowns

Sometimes merchandise does not sell according to projections. When this happens, storeowners will reduce the price of the merchandise, employing what is known as a markdown. Markdowns will decrease the store's margin, but the decreased margin can be counteracted by the increase in sales of the item receiving the markdown. Well-promoted markdowns can also help attract more customers to the store. Markdowns are a normal part of doing business and should be considered when planning pricing for the store.

Pricing Laws

The federal government has passed many laws to combat pricing related fraud. Many state and local governments have also passed laws that deal with pricing. Storeowners should review pricing laws before determining a pricing plan.

Laws regarding pricing protect customers from unfair pricing. The Sherman Antitrust Act was passed in 1890. This law, which makes monopolies illegal, also covers price fixing, an illegal act committed by competitors who get together to set the price of certain merchandise.

The Clayton Antitrust Act of 1914 and the Robinson-Patman Act of 1936 outlawed the practice of price discrimination. Price discrimination is the act of charging different prices to different customers for the same merchandise.

The Consumer Goods Pricing Act of 1975 implemented the practice of manufacturer suggested retail prices. In some cases a manufacturer sets a recommended retail price for the items it produces. The manufacturer will suggest that retailers use this price in their stores. This legislation prevents manufacturers from requiring a set retail price and thus being able to punish storeowners who do not follow the manufacturer's pricing.

In 2007, the United States Supreme Court greatly eased the restrictions on manufacturers setting of minimum retail prices. The ruled, "vertical agreements establishing minimum resale prices can have either procompetitive or anticompetitive effects, depending upon the circumstances in which they are formed." Pricing practices are now to be judged by the "rule of reason." A jury can weigh all of the circumstances of a case in determining whether or not a particular pricing practice imposes a restraint on competition.

Summary

Pricing merchandise correctly in order for it to sell is of vital importance to retailers. In this unit we learned some of the factors to take into consideration when determining pricing: cost, profit, margin, competition, supply and demand, and pricing laws.

Key Math Concepts

PRICE

To compute the price of an item, use this formula:
Price = Cost + Desired Profit

For example, an item has a cost of $3.50 and a desired profit of $1.00.
$3.50 Cost + $1.00 Profit = $4.50 (Price)

MARGIN

To compute the margin for an item, use this formula:
Margin = Price - Cost

For example, an item has a price of $9.00 and a cost of $4.50.
$9.00 Price – $4.50 Cost = $4.50 (Margin)

MARKUP

To compute the markup of an item from a percentage of cost, use this formula:
Markup Amount = Cost x Markup Percentage

To compute the price of an item based on its markup, use this formula:
Price = Cost + Markup Amount

For example, an item that has a cost of $7.50 will get a markup of 40%.
$7.50 Cost x .40 Markup = $3.00 (Markup)
$7.50 Cost + $3.00 Markup = $10.50 (Price)

MARKDOWN

To compute the markdown of an item, use this formula:
Markdown Amount = Price X Markdown Percentage

To compute the price of an item based on its markdown, use this formula:
Markdown Price = Current Price – Markdown Amount

For example, an item currently sells for $12.00 and will get a markdown of 30%.
$12.00 Price x .30 Markdown Percentage = $3.60 (Markdown Amount)
$12.00 Current Price – $3.60 Markdown Amount = $8.40 (Markdown Price)

Key Terms

Price
The amount of money a business charges for items it offers for sale.

Cost
The amount of money the store pays to purchase the merchandise from a supplier.

Profit
The total revenue of a business less all expenses over a specific period of time.

Margin
The difference between the retail price of an item and the cost of the item to the store.

Supply and Demand
The principle that describes the amount of product available to sell and the willingness of customers to buy that product.

Market Share
The percentage that a store has of the total sales in its trading area.

Markdown
Reduction in price of merchandise to increase sales of a product not selling according to projections.

MATH EXERCISES

LESSON 1

Pricing

1. Compute the selling price of a sports drink that has a cost of $1.25 per item. The store needs to generate a profit of $0.50 per item.

2. Compute the new selling price for a group of sun visors that are currently selling for $6.00 each and that will receive a markdown of 25%.

3. Compute the selling price of a bottle of laundry detergent that has a cost of $8.75 and a markup percentage of 40%.

WRITTEN EXERCISES **LESSON 1**

Pricing

1 Your store has just received a shipment of a heavily advertised new brand of potato chips. You know that your store is not the only one in your area selling these chips. The cost and profit margin for the chips suggests a selling price of $2.75 per bag. Considering all factors, determine the selling price of the chips for your store and provide the reasons for your decision.

2. Your stock of ceramic coffee mugs is not selling as projected, so you would like to apply a markdown. The current selling price of the mugs is $5.00 each. Recommend a new selling price for the mugs and explain the reasons for your recommendation.

3. Your store has been losing market share in Freezies, a frozen beverage. Create a written outline that lists possible causes for the loss of market share and list some ways that can help your store regain its market share.

4. Make a list of five different products that have recently gone up in price. Record the former selling price and the new selling price next to each item. Then make a notation about whether you have continued to purchase each product, decided to purchase the product in smaller quantities, or stopped purchasing the product.

COMPUTER EXERCISE **LESSON 1**
Pricing

GOAL: Your goal is to adjust the prices in your store to improve profits. Specifically, you want to generate a weekly profit greater than $2500.

YOUR SITUATION: In this lesson, you control Pricing. All other actions are controlled for you.

Part A

1. Run the **Pricing, Run To**, **Products**, and **Financials** sections of the **Tutorial**.
2. Open the **Pricing** lesson, choose **Sim 1**.
3. Using **Pricing** under the **Actions** menu:
   a. Set **Margin Points** to 50 pts. This will test demand at a very high margin and price.
   b. Click **Options->Run To** and select **Run for Period of Time**. Set the sim to run for 2 weeks. Click the **Go** button and run the simulation until it stops.
   c. Click the **Financials** button and record your revenue and profit for the last week on line 1 of the worksheet below.

QUESTION 1A: Did you make a profit?

4. Repeat step 3, but set your margin to 5 points. This will test demand at a very low margin and price. Record your results on line 2 of the worksheet.

QUESTION 2A: At 5% margin, was your revenue higher or lower? Did you make a profit? Why or why not?

5. Repeat step 3, try several different margins that you think are better and record your results on lines 3-5 of the worksheet. Run the sim forward two weeks each time.

QUESTION 3A: What was the optimal margin you found? Did you make a profit?

WORKSHEET 1

Margin	Revenue (for week 2)	Profit (for week 2)
50 points		
5 points		

Continued

Part B

1. Open the **Pricing** Lesson, choose **Sim 2**.
2. Click **Products**. Uncheck the **Total** box, scroll down the product list and check the box next to coffee, and check **Table** under **Show As.**

QUESTION 1B: What were your sales for coffee for the last week?

3. Check the box next to **COGS: Actual Sales.**

QUESTION 2B: What was your Cost of Goods Sold (COGS) for coffee for the last week? What was your margin *(Sales – Cost of Goods)* for the last week? What was your margin percentage *(Margin÷Sales)* for the last week?

4. Close the **Products** report. Click **Financials**. Click the **More Detail** button.

QUESTION 3B: Looking under **Equipment->Fixtures,** what is your weekly cost to lease the coffee machine? Are you making money on coffee at your current margin?

5. Now adjust your pricing on coffee to try and maximize your margin. Click **Actions->Pricing**. Click the **More** button. Check the box next to coffee to set coffee-specific pricing. Try several different prices for coffee. Run the sim forward for two weeks after making each price change.

QUESTION 4B: What was the best dollar margin you could achieve on coffee? Was this margin enough to pay for the rental of the coffee machine? How did your best margin percentage on coffee compare to the storewide margin percentage set in **Sim 1**?

QUESTION 5B: Discuss why different products in a convenience store might require special pricing.