CHAPTER

07

APPLY THE PRINCIPLES OF COSTING & PRICING TO A BUSINESS VENTURE

LEAD HR CONSULTING

BUSINESS IN-A-BOX

Chapter 7

Apply the Principles of Costing and Pricing to a Business Venture

Pricing is the most powerful and most underappreciated lever in the entrepreneur's toolkit. It is the only element of the marketing mix that generates revenue — everything else creates costs. Research consistently shows that a 1% improvement in pricing generates a larger improvement in profit than a 1% improvement in volume, fixed cost reduction, or variable cost reduction — because every rand of price improvement flows directly to the bottom line. Yet new ventures routinely make pricing decisions with insufficient rigour: costs are estimated poorly, market dynamics are ignored, and profit opportunities are left unrealised because of uninformed pricing choices. This chapter builds the complete analytical and strategic framework for pricing excellence: from understanding the trading cycle and cost structures, through break-even analysis and costing methods, to profit measurement and performance management.

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

- ✦ Explain the trading cycle and explain why understanding it is essential to costing and pricing.
- ✦ Define costing and explain its five main objectives.
- ✦ Classify costs as fixed, variable, semi-variable, direct, and indirect, with South African business examples.
- ✦ Calculate total cost, cost per unit, and cost per unit at different production volumes.
- ✦ Define pricing and distinguish it from costing.
- ✦ Explain eight common pricing objectives and select the appropriate objective for different business situations.
- ✦ Describe and apply six pricing types: cost-plus, target return, value-based, psychological, fair, and marginal cost pricing.
- ✦ Describe and apply nine pricing strategies including competitive, penetration, premium, loss leader, and product bundle pricing.
- ✦ Identify and explain six internal factors affecting pricing decisions.
- ✦ Identify and explain five external factors affecting pricing decisions.
- ✦ Define and calculate price elasticity of demand.
- ✦ Interpret elastic, inelastic, and unitary demand conditions and explain their implications for pricing decisions.
- ✦ Perform complete break-even analysis including break-even units, break-even revenue, and target profit calculations.
- ✦ Draw and interpret a break-even chart.
- ✦ Calculate and apply the margin of safety concept.
- ✦ Analyse the impact of price changes, volume changes, and cost changes on break-even point and profitability.
- ✦ Apply absorption costing to allocate overhead costs to specific products with worked examples.
- ✦ Apply variable (marginal) costing principles and calculate contribution margins.
- ✦ Compare absorption costing and variable costing in terms of inventory valuation, profit reporting, and decision-making utility.
- ✦ Define and calculate gross profit margin, operating profit margin, net profit margin, and retained profit.
- ✦ Interpret profit ratios and use them to diagnose business performance issues.
- ✦ Apply all costing and pricing principles to own venture context.

Section 1: Introduction to Price Setting

Before any price can be set intelligently, the entrepreneur must understand the full chain of activities and costs that underpin their business — the trading cycle. And before the trading cycle can be

costed, the entrepreneur must understand the nature of different cost types and how they behave. This section builds that foundational understanding.

1.1 The Trading Cycle

Every business, regardless of sector or size, follows a cycle that begins with acquiring inputs and ends with delivering value to a customer and receiving payment. This is the trading cycle, and every stage generates costs that must ultimately be recovered through the selling price. An entrepreneur who does not understand and cost their full trading cycle will consistently underprice — and wonder why the business struggles to generate profit despite healthy sales.

Stage 1: Procurement

Procurement is the process of sourcing and acquiring the raw materials, components, merchandise, or services that the business needs to produce its product or deliver its service. Procurement costs include:

- The purchase price of inputs from suppliers
- Transport and logistics costs (freight, delivery, import handling)
- Import duties, tariffs, and customs clearance fees
- Quality inspection and testing costs
- Procurement staff costs (purchasing manager, buyer)
- Storage costs for incoming materials before they enter production

For a clothing manufacturer, procurement costs include the cost of fabric, buttons, thread, and zips, plus the delivery cost from suppliers. For a restaurant, procurement is the cost of all food and beverage ingredients plus the delivery charge from the supplier. For a software company, procurement might include the cost of third-party software licences and cloud services incorporated into the product.

The quality and efficiency of procurement directly affects cost competitiveness. Entrepreneurs who negotiate aggressively with suppliers, consolidate orders for volume discounts, and build strategic supplier relationships can achieve material cost advantages over competitors — advantages that can be passed to customers (lower prices) or retained (higher margins).

Stage 2: Production

Production is the transformation of inputs into outputs — the process by which raw materials become finished goods or by which service capacity is created and delivered. Production costs include:

- Direct materials: the inputs that physically become part of the finished product
- Direct labour: wages of people directly involved in making the product or delivering the service
- Manufacturing overhead: indirect costs of running the production facility — factory rent, utilities, equipment depreciation, indirect labour (supervisors, maintenance staff)

- Quality control and testing costs
- Waste and spoilage — materials consumed in the production process that do not become part of the final product

For a bakery, production costs include: flour, butter, eggs (direct materials); baker's wages (direct labour); oven electricity, bakery rent, equipment depreciation (overhead). For a legal firm, production costs are primarily lawyer time (direct labour) and any research subscriptions, software, or expert witnesses (direct materials).

Production is where scale economies typically emerge: as production volume increases, fixed production overhead is spread over more units, reducing cost per unit. Understanding this relationship is critical for pricing decisions at different volume scenarios.

Stage 3: Marketing

Marketing is the set of activities through which the business creates awareness, interest, and desire for its products among its target market. Marketing costs include:

- Advertising spend (digital, print, radio, outdoor, TV)
- Social media management and content creation
- Brand development (logo, identity, website, signage)
- Market research (surveys, focus groups, competitor intelligence)
- Promotional events and trade shows
- Packaging design and production
- Marketing staff costs

Marketing costs are among the most commonly underestimated in new venture planning. The assumption that 'we will grow through word-of-mouth' typically leads to insufficient customer awareness and slower-than-projected revenue growth. A realistic marketing budget must be built into the cost structure and recovered through the selling price.

Stage 4: Selling

Selling is the point of direct interaction between the business and the customer — the moment of transaction. Selling costs include:

- Sales staff commissions and salaries
- Payment processing fees (card transaction fees, PayFast, Yoco charges — typically 2-3%)
- E-commerce platform fees (Shopify, WooCommerce, Takealot marketplace fees)
- Point-of-sale infrastructure (card machines, POS software)
- Sales travel and entertainment
- Bid preparation costs (for tender-based businesses)

For businesses with sales teams, selling costs are often 10-20% of revenue. For e-commerce businesses, platform fees and payment processing can add 5-15% to effective cost of sale. These costs must be factored into pricing before the sale is made, not discovered as margin erosion after.

Stage 5: After-Sales Support

After-sales support encompasses all costs incurred after the customer has paid for the product or service. These costs include:

- Warranty repairs and replacements
- Customer service staff costs (call centre, helpdesk, complaint handling)
- Returns processing and restocking costs
- Technical support and onboarding assistance
- User training and documentation
- Refund processing costs

After-sales costs are often invisible to the entrepreneur who prices before experiencing them in volume. A business that offers a 12-month warranty on a physical product must estimate the warranty claim rate and provision for it in the cost structure. A software business offering 'unlimited support' must estimate support hours per customer and cost them into the subscription price.

For businesses that compete on service quality, after-sales support is a strategic differentiator — but one that must be explicitly priced and budgeted, not treated as a free cost of doing business.

Key insight: The entrepreneur who costs only the production stage and ignores procurement, marketing, selling, and after-sales costs will systematically underprice their product. The selling price must recover ALL costs across the entire trading cycle — not just the cost of making the product.

1.2 The Concept and Objectives of Costing

Costing is the systematic process of identifying, recording, classifying, and allocating all costs associated with producing a product or delivering a service. It transforms the entrepreneur's intuitive sense of 'what things cost' into a precise, verifiable, actionable cost model that supports both pricing and management decisions.

The Five Objectives of Costing

Determining Selling Price

The cost of production establishes the floor of any viable selling price. No business can sustainably price below total cost — unless it has another revenue stream to subsidise the loss-making product

(as Amazon Web Services subsidises Amazon's retail losses). Costing reveals the minimum acceptable price and, combined with market analysis, determines the profit margin available at any given market price. The wider the gap between cost and market price, the more profitable the business opportunity.

Controlling Costs

Costing creates visibility into cost drivers — the activities and inputs that consume money. This visibility is the prerequisite for cost control. When costs are tracked against budgets and standards, deviations are identified early enough to take corrective action. Techniques including standard costing (setting target costs and measuring actual vs. standard), budgetary control (comparing actual expenditure against planned budgets), and activity-based costing (identifying which activities consume most resource) all depend on a rigorous costing system as their foundation.

Supporting Management Decision-Making

Many of the most important business decisions are fundamentally cost questions: Should we make this component in-house or buy it from a supplier (make-or-buy analysis)? Should we continue operating this product line at a loss in the short term or discontinue it? Should we accept a special order at a price below our standard selling price? Should we invest in new equipment that will reduce variable costs? Each of these decisions requires accurate cost information to evaluate correctly.

Ascertaining Profitability

By matching costs against revenues at the product, customer, channel, and business unit level, costing reveals where the business is actually making and losing money. This granular profitability analysis often produces counterintuitive findings: the highest-volume product is rarely the highest-margin product; the largest customer is often not the most profitable one; the most promoted product may be subsidising the business's actual profit engine. Without costing, these patterns remain invisible.

Facilitating Financial Reporting

Accurate cost information is required by accounting standards for financial reporting: inventory must be valued at cost (not selling price) on the balance sheet; cost of goods sold must be accurately calculated on the income statement; work-in-progress must be correctly valued for manufacturing businesses. Inaccurate costing produces inaccurate financial statements — which misleads management and creates tax and audit compliance risk.

1.3 Classification of Costs — The Complete Framework

Understanding how different costs behave is essential for accurate costing, profitable pricing, and effective business planning. Costs are classified along several dimensions:

By Behaviour (Relationship to Output Volume)

Fixed Costs

Fixed costs remain constant in total regardless of the level of production or sales within a relevant range. They exist even if the business produces nothing. However — and this is critical — **fixed cost per unit falls as production volume increases**. This is the basis of economies of scale: higher volume spreads fixed costs over more units, reducing unit cost.

South African examples: shop rent (R15,000/month regardless of sales), manager salary (R25,000/month regardless of output), insurance premium (R3,500/month), equipment depreciation (R2,000/month), loan repayment instalments (R8,000/month).

```
Fixed cost per unit at 1,000 units: R55,500 ÷ 1,000 = R55.50 | Fixed cost per unit at 2,000 units: R55,500 ÷ 2,000 = R27.75 | Fixed cost per unit at 5,000 units: R55,500 ÷ 5,000 = R11.10
```

This mathematical relationship is why scaling a business dramatically improves profitability — provided variable costs are well-managed.

Variable Costs

Variable costs change proportionally with the level of production or sales. They are zero when nothing is produced and rise linearly with output. Variable cost per unit is typically constant (though it may fall with volume discounts on bulk input purchases).

South African examples: raw materials (R15 per unit produced), packaging (R3 per unit), direct production labour paid on piece-rate (R8 per unit), sales commissions (5% of each sale), Yoco card machine transaction fee (2.5% of each transaction).

```
Total variable cost at 1,000 units at R26/unit: R26,000 | Total variable cost at 2,000 units at R26/unit: R52,000 | Total variable cost at 5,000 units at R26/unit: R130,000
```

Semi-Variable (Mixed) Costs

Semi-variable costs have both a fixed component (incurred regardless of output) and a variable component (increasing with output). They are common in real business settings but are often incorrectly treated as entirely fixed or entirely variable.

South African examples: electricity (fixed Eskom connection charge + variable units consumed), internet (fixed line rental + variable data usage), some labour costs (a base salary that is fixed, plus overtime that varies with production demand), vehicle costs (fixed insurance and licence + variable fuel and maintenance).

Cost Classification Summary Table

Cost Type	Total Behaviour	Per Unit Behaviour	SA Business Examples
Fixed	Constant	Falls as volume rises	Rent, insurance, salaries, depreciation, loan repayments
Variable	Rises proportionally with volume	Constant	Raw materials, packaging, direct piece-rate labour, commissions
Semi-Variable	Rises, but not proportionally	Falls as volume rises	Electricity, some labour, vehicle costs
Direct	Traceable to specific product	Precisely measured	Ingredients in a recipe, fabric in a garment
Indirect (Overhead)	Not traceable to specific product	Must be allocated using a base	Factory electricity, supervisor salary, building depreciation
Total Cost	Fixed + Variable + Semi-Variable	TC ÷ Units produced	All of the above combined

1.4 The Concept of Pricing

Pricing is the process of determining what a business will charge in exchange for its product or service. While costing tells the entrepreneur what the minimum viable price must be, pricing strategy determines the optimal price — the one that maximises the business's chosen objective while remaining competitive and sustainable in the market.

The distinction between costing and pricing is fundamental:

Dimension	Costing	Pricing
Focus	What does it cost to produce?	What should we charge?
Direction	Inward-looking: costs and processes	Outward-looking: market and customers
Output	Cost per unit; minimum viable price	Selling price; profit margin
Determines	Floor of pricing decisions	The actual price charged
Inputs	Internal cost data	Market data, competitor prices, customer psychology

Pricing Objectives

The pricing objective defines the goal that the price is designed to achieve. Different situations call for different objectives, and the wrong objective for a given situation leads to suboptimal pricing decisions:

Profit Maximisation: Maximise total profit over the defined period. The optimal price under this objective equates marginal revenue with marginal cost — the point at which one more unit sold adds as much to revenue as it costs to produce. Most appropriate when the entrepreneur has strong market intelligence about the demand curve.

Profit Margin Maximisation: Maximise the profit per unit sold, regardless of total volume. Appropriate when production capacity is limited (a craft producer, a solo consultant) and the goal is to extract maximum value from each transaction.

Revenue Maximisation: Maximise total revenue without primary regard to margin. Common in businesses where building a large user base creates long-term value (even at low short-term margins) — digital platforms, SaaS products, subscription businesses.

Market Share Growth: Set price below competitors to attract customers and build share rapidly. Justified when first-mover advantage is valuable, when network effects make scale important, or when the long-term market leadership position justifies short-term margin sacrifice.

Quality Leadership (Price Signalling): Set price at a premium to communicate product quality. Appropriate when customers use price as a quality proxy — which is common in professional services, luxury goods, healthcare, and food quality segments.

Status Quo: Match competitor prices to maintain market stability and avoid price wars. Used in mature, oligopolistic markets where aggressive pricing would trigger mutually destructive retaliation.

Market Survival: Set price at the minimum level that keeps the business operationally viable during a crisis — covering variable costs and making some contribution to fixed costs. A short-term emergency measure.

Partial Cost Recovery: Recover only a portion of costs, where the product is subsidised by another revenue stream. Common in freemium digital models (free basic product; paid premium), government-subsidised services, and internal cross-subsidisation within multi-product businesses.

Pricing Types — Six Approaches in Detail

A pricing type is the mathematical or conceptual approach used to arrive at the selling price. Each approach has different inputs, different assumptions, and is appropriate in different market conditions:

Cost-Plus Pricing

Cost-plus pricing adds a profit markup to the total cost per unit. It is the most widely used approach because it is simple, guarantees profitability at projected volume, and is easy to justify to customers

and regulators.

Formula: Selling Price = Total Cost per Unit × (1 + Markup %)

Or equivalently: Selling Price = Total Cost per Unit + (Markup % × Total Cost per Unit)

Worked Example: A furniture maker's total cost per chair (materials + labour + overhead allocated) = R450. Target markup = 40%. Selling price = R450 × 1.40 = R630.

Advantages: Simple to implement; ensures costs are covered; easy to explain to customers ('cost plus our standard margin').

Disadvantages: Ignores customer willingness to pay — may undercharge (leaving margin on the table) or overcharge (pricing above market). Does not account for competitive pressure. Can create perverse incentives: if costs rise, price rises, which may reduce demand and further increase unit cost.

Target Return Pricing

Target return pricing sets price to achieve a specific return on investment (ROI). It is appropriate when the entrepreneur has committed capital to the venture and has a specific financial return requirement.

Formula: Selling Price = Unit Variable Cost + (Fixed Costs ÷ Projected Sales Volume) + (Target ROI × Investment ÷ Projected Sales Volume)

Worked Example: Investment = R500,000. Target ROI = 20% per annum = R100,000. Projected annual sales = 5,000 units. Variable cost per unit = R60. Fixed costs = R150,000/year. Required price = R60 + (R150,000 ÷ 5,000) + (R100,000 ÷ 5,000) = R60 + R30 + R20 = R110 per unit.

Advantages: Directly links pricing to investment return objectives; enables disciplined capital allocation.

Disadvantages: Depends entirely on sales volume projections; if volume falls short, the target ROI is not achieved. Does not account for what the market will pay.

Value-Based Pricing

Value-based pricing sets price relative to the value the product creates for the customer, not the cost of producing it. For differentiated products with genuine competitive advantages, this typically produces substantially higher prices and margins than cost-based approaches.

The key question: 'How much better off is the customer because they used this product?' This improvement in the customer's situation — measured in rand terms — is the value delivered. The price can capture a significant portion of this value while still leaving the customer better off than the alternative.

Worked Example: A water purification system costs R8,000 to manufacture and install. It saves a household R2,500 per year in bottled water. Over a 5-year life, it saves R12,500. Value-based pricing might set the price at R7,000-R9,000 — far above cost-plus pricing, because the customer still saves R3,500-R5,500 versus the alternative.

Advantages: Captures the maximum value the market will pay; rewards genuine innovation and differentiation.

Disadvantages: Requires deep customer insight; works poorly for undifferentiated products; customer value perceptions are difficult to measure precisely.

Psychological Pricing

Psychological pricing exploits predictable cognitive biases in how consumers perceive and respond to price signals. Key psychological pricing techniques:

Charm pricing: R99.99 instead of R100 — the 'just below' effect makes the price feel categorically lower even though the difference is trivial.

Anchor pricing: Display a higher 'was' price alongside the current price to make the current price feel like a bargain. The higher anchor shapes perception of value.

Decoy pricing: Add a third option priced to make one of the other two seem like excellent value (typically the most profitable option).

Prestige pricing: Premium prices signal premium quality. Charging R25,000 for a consulting engagement rather than R5,000 signals expertise and exclusivity. Some luxury goods have actually increased demand when price was raised (Veblen goods).

South African application: Many informal market traders use round-number pricing (R5, R10, R20) for convenience; formal retailers almost universally use charm pricing (R49.99, R299, R1,999); premium service businesses use prestige pricing to signal expertise.

Fair Pricing

Fair pricing recognises that consumers have a reference price — a sense of what a product 'should' cost — and that prices significantly exceeding this reference are perceived as unfair even when they would be accepted by pure economic logic. Price gouging (extreme price increases during emergencies or shortages) destroys brand equity even when it is technically legal.

South African context: The Competition Act's prohibition of excessive pricing by dominant firms effectively codifies a fairness constraint on pricing. Firms with market power cannot charge 'a price which bears no reasonable relation to the economic value of the product.'

Practical implication: The entrepreneur must balance the desire to capture maximum value with the need to be perceived as fair by customers and regulators. Long-term brand equity — and therefore

long-term profitability — often requires pricing below the short-term maximum that customers would technically accept.

Marginal Cost Pricing

Marginal cost pricing sets price at or slightly above the variable cost of production, without seeking to recover a contribution to fixed costs. This generates a positive contribution per unit but is insufficient to cover fixed costs if applied universally.

Two situations justify marginal cost pricing:

1. Spare capacity: The business has fixed costs that will be incurred regardless. Any revenue above variable cost contributes positively, even without covering fixed costs. A hotel with empty rooms on a Monday night should accept any price above cleaning and laundry cost (the marginal cost of accommodating one more guest).

2. Strategic entry pricing: To win a first contract with a target client, a business might price at marginal cost, knowing that future work will generate normal margins once the relationship is established.

Critical warning: Marginal cost pricing is a tactical exception, not a pricing strategy. A business that prices all its products at marginal cost will consistently fail to cover its fixed costs and will eventually go bankrupt.

1.5 Pricing Strategies — Nine Strategic Approaches

A pricing strategy translates a pricing objective and type into a specific competitive approach. Nine key strategies are in common use:

1. Competitive Pricing

Price at, slightly above, or slightly below competitors based on your relative positioning. Requires continuous competitor price monitoring and a clear understanding of your competitive positioning relative to each competitor (are you premium, parity, or value-positioned?).

SA example: petrol pricing (government-regulated at parity); commercial banking fees (broadly competitive within the Big Four); mainstream grocery retail.

2. Good-Better-Best Pricing (Tiered Pricing)

Offer the same product in three value tiers at escalating price points. Each tier represents more quality, features, or convenience. The strategy exploits the 'compromise effect' — most customers gravitate toward the middle option, which is typically the highest-margin one.

SA examples: Pick n Pay has No Name, Pick n Pay own-label, and branded tiers; mobile data packages (basic, standard, premium); bank accounts (entry, standard, private).

3. Loss Leader Pricing

Price one product below cost or at minimal margin to drive customer traffic and basket-building purchases. Works when the basket economics make the overall transaction profitable despite the below-margin item.

SA examples: major supermarkets regularly use bread, milk, and eggs as loss leaders; printer manufacturers sell printers near cost but charge premium prices for ink cartridges.

4. Multiple (Bundle Volume) Pricing

Offer a discount for buying in higher quantity, displayed as a comparative price point: 'R18 each, or 3 for R50.' The single-item price is set above the desired average; buyers who take the bundle receive a small discount while buying more volume.

SA examples: informal market fruit and vegetable vendors; 'buy 2 get 1 free' promotions in pharmacies and cosmetics; bulk toilet paper and cleaning supplies.

5. Optional Product Pricing

Build a compelling core product at an accessible price, then generate additional margin through premium options and accessories that enhance the core product.

SA examples: car dealers sell base models affordably but generate margin on option packs; airlines sell basic tickets cheaply but charge for seat selection, luggage, and meals; event tickets with optional fast-track entrance or VIP access.

6. Penetration Pricing

Enter a new market at a low price to build share rapidly, then raise prices as the customer base is established and loyalty is built. The bet is that market share built early is worth the short-term margin sacrifice.

Risk: some customers are acquired purely by the low price and will churn when price rises. Success requires building enough genuine loyalty during the low-price period to survive the transition to normal pricing.

SA examples: Cell C's market entry; new retail entrants offering introductory pricing; SaaS companies offering heavily discounted first-year pricing.

7. Premium (Skim) Pricing

Launch at a high price to capture maximum value from early adopters and innovation-eager customers who value being first and are least price-sensitive. Reduce price over time as competition enters and the market broadens.

Requires a genuinely novel or superior product with limited competition at launch. If competitors can quickly replicate the product, the window for premium pricing is short.

SA examples: new premium food and beverage brands entering the market; innovative technology products; specialist professional services.

8. Product Bundle Pricing

Combine complementary products or services and sell them together at a price below the sum of their individual prices. Creates perceived value, drives cross-selling, and can clear slow-moving inventory by attaching it to popular products.

SA examples: fast food meal combinations; banking product bundles (current account + savings + insurance + credit card); software suites bundling multiple applications; holiday packages combining flights, accommodation, and car hire.

9. Price Skimming

Similar to premium pricing: set a very high initial price for a new product, then systematically lower the price in stages to reach broader market segments as the innovative advantage erodes. Each price reduction 'harvests' the next layer of demand that was not willing to pay the previous price.

Classic skimming products: new consumer electronics (cameras, televisions, smartphones), pharmaceutical drugs before generic competition enters, and newly released bestselling books (hardcover first at premium, then paperback at lower price).

Section 2: Internal and External Factors Impacting Pricing

2.1 Internal Factors

Internal factors are those within the business's control or influence. They define the range of viable prices and the strategic constraints on pricing decisions:

Marketing Objectives: The pricing objective (Section 1.4) must align with the broader marketing strategy. A brand positioned as premium cannot sustainably price below competitors. A volume-focused strategy cannot sustain premium prices. Pricing that contradicts the marketing strategy creates customer confusion and strategic incoherence.

Cost Structure: The ratio of fixed to variable costs defines price sensitivity to volume changes. High fixed cost businesses must prioritise volume (to spread fixed costs); high variable cost businesses can sustain lower volumes at higher margins. Understanding your cost structure is the first step to understanding your pricing options.

Marketing Mix Consistency: Every element of the marketing mix must support the pricing position. A R2,000 product must have R2,000-quality packaging, distribution, and service. A budget product must not be over-designed or over-serviced, or the cost structure will make it unprofitable at the low price.

Organisational Goals: Return on investment targets, growth rate objectives, and market share goals all constrain pricing decisions. A venture-backed startup may price aggressively to hit growth metrics; a family business seeking sustainable profitability may price conservatively for margin.

Production Capacity: Price must reflect what the business can deliver. Setting a price that generates overwhelming demand when capacity cannot meet it creates customer disappointment and reputational damage. Pricing can be used deliberately to manage demand — high prices in periods of excess demand, lower prices when capacity is available.

Cash Flow Position: A business under cash flow pressure may need to price for quick cash generation — accepting lower margins in exchange for faster payment or higher immediate volume. A well-capitalised business can afford to price for long-term brand building at the cost of short-term margin.

2.2 External Factors

Price-Volume Relationship

The fundamental demand relationship — as price rises, quantity demanded falls — shapes every pricing decision. The steepness of this relationship (price elasticity) determines how aggressively volume changes with price. Markets with inelastic demand (necessities, differentiated products) offer more pricing power; markets with elastic demand (commodities, easily substituted products) constrain

pricing flexibility.

Consumer Psychology and Behaviour

Consumers do not behave like rational economic agents. Their pricing responses are shaped by: reference prices (expectations based on past experience), price-quality inference (price as a quality signal), loss aversion (price increases hurt more than equivalent price reductions help), and contextual framing (the same price feels cheap or expensive depending on context and presentation).

Competitive Environment

Competitor prices set the market reference range against which your pricing is evaluated. Pricing significantly above competitors requires a compelling and credibly communicated reason. Pricing significantly below competitors may trigger retaliation or undermine quality perceptions. Monitor competitor pricing continuously — not just at launch.

Channel Environment

Distribution channel partners each add their margin to the manufacturer's price. A product sold through a chain of wholesaler → retailer → consumer must generate sufficient margin to accommodate all channel costs while remaining competitive at the consumer price point. Calculate the required manufacturer price as: Consumer Price × (1 – Retailer Margin) × (1 – Wholesaler Margin).

Legal and Regulatory Environment

The Competition Act prohibits price-fixing between competitors, excessive pricing by dominant firms, and predatory pricing designed to eliminate competition. The Consumer Protection Act prohibits misleading price representations. Sector-specific regulations cap prices in fuel, pharmaceuticals, and certain food categories. All applicable regulations must be understood before setting any price.

2.3 Price Elasticity of Demand — The Pricing Intelligence Tool

Price elasticity of demand (PED) quantifies how sensitively quantity demanded responds to price changes. It is calculated as:

```
PED = % Change in Quantity Demanded ÷ % Change in Price
```

PED is typically negative (when price rises, quantity falls) but the sign is usually dropped for simplicity — a PED of 2 means a 1% price increase causes a 2% volume reduction. A PED of 0.3 means a 1% price increase causes only a 0.3% volume reduction.

Elasticity Type	PED Value	What It Means	Price Change Impact on Revenue

Perfectly Inelastic	0	Volume doesn't change at all when price changes	Price up → Revenue up proportionally
Inelastic	0 to 1	Volume changes less than proportionately to price	Price up → Revenue up (smaller % volume fall than % price rise)
Unitary Elastic	Exactly 1	Volume changes exactly proportionately to price	Price change → No change in revenue
Elastic	Greater than 1	Volume changes more than proportionately to price	Price up → Revenue down (larger % volume fall than % price rise)
Perfectly Elastic	Infinite	Any price increase causes demand to fall to zero	Cannot charge above market price

Factors that make demand more inelastic (giving you pricing power): No close substitutes available; the product is a necessity; small share of buyer's total budget; high switching costs; strong brand loyalty; unique features or differentiation. **Factors that make demand more elastic (limiting pricing power):** Many close substitutes; discretionary spending; large share of buyer's budget; low switching costs; price-transparent markets; undifferentiated commodity products.

2.4 Break-Even Analysis

Break-even analysis is the essential bridge between costing and pricing. It answers the critical question: at what sales volume does the business begin to generate profit? Every pricing decision and capacity investment should be evaluated against its impact on the break-even point.

The Break-Even Formula

Key components:

Contribution Margin per Unit (CM): Selling Price per Unit – Variable Cost per Unit. The amount each unit sold contributes toward covering fixed costs and ultimately generating profit.

Contribution Margin Ratio (CMR): Contribution Margin per Unit ÷ Selling Price per Unit. Expressed as a decimal (e.g., 0.60 = 60%). Used to calculate break-even revenue directly.

Break-Even Units (QB): Total Fixed Costs ÷ Contribution Margin per Unit. The number of units that must be sold to cover all costs.

Break-Even Revenue: Total Fixed Costs ÷ Contribution Margin Ratio. The revenue level at which total costs are exactly covered.

Margin of Safety: Actual/projected sales – Break-Even Sales. The buffer of sales above break-even. A larger margin of safety means the business can absorb a larger sales shortfall before making a loss.

Comprehensive Worked Examples

Example A: Bakery Business

Nomsa runs a specialty bread bakery. She sells artisan loaves at R65 each. Variable cost (flour, yeast, packaging, delivery bags) = R18 per loaf. Monthly fixed costs: rent R9,000, baker salary R14,000, utilities R3,000, insurance R2,500, equipment depreciation R1,500 = Total fixed costs R30,000/month.

```
Contribution margin = R65 – R18 = R47 per loaf CMR = R47 ÷ R65 = 72.3%
Break-even units = R30,000 ÷ R47 = 638 loaves/month (≈ 21 loaves/day)
Break-even revenue = R30,000 ÷ 0.723 = R41,494/month If Nomsa projects
selling 900 loaves/month: Margin of safety = 900 – 638 = 262 loaves (41%
above break-even) Projected profit = (900 – 638) × R47 = 262 × R47 =
R12,314/month
```

Example B: IT Consulting Firm

Thabo runs an IT consulting firm. He bills at R850/hour. Variable costs (software licences used per engagement, travel, subcontractors) average R210/hour. Monthly fixed costs: office rent R8,000, admin staff R18,000, insurance R4,000, IT infrastructure R3,000 = R33,000/month.

```
Contribution margin = R850 – R210 = R640 per billable hour CMR = R640 ÷ R850
= 75.3% Break-even hours = R33,000 ÷ R640 = 52 billable hours/month
Break-even revenue = R33,000 ÷ 0.753 = R43,824/month At 52 hours/month
break-even, Thabo needs just 13 billable hours per week. If he bills 100
hours/month: Profit = (100 – 52) × R640 = 48 × R640 = R30,720/month
```

Example C: Break-Even Sensitivity to Pricing

How does a price change affect break-even? Nomsa (from Example A) considers raising bread price to R75:

Metric	At R65 price	At R75 price	Change
Contribution margin	R47	R57	+R10 (+21%)
Break-even units	638 loaves	526 loaves	-112 loaves (-18%)
Break-even revenue	R41,494	R39,474	-R2,020 (-5%)
Profit at 900 units	R12,314	R21,278	+R8,964 (+73%)

The R10 price increase (15.4% rise) reduces break-even by 18% and increases projected profit by 73% — provided volume holds. The pricing question becomes: will demand fall by more or less than 18%? If Nomsa has loyal customers who value her artisan quality, a 15% price increase may cause minimal volume loss — making it one of the most profitable business decisions she can make.

Section 3: Cost, Revenue, and Profit Relationships

3.1 The Profit-Volume-Cost Relationship

The relationship between costs, revenue, and profit defines the financial logic of the business. Understanding how profit responds to changes in price, volume, and cost is the foundation of strategic financial management.

Three fundamental relationships:

- ◆ Revenue = Price per Unit × Units Sold. Revenue rises proportionally with both price and volume.
- ◆ Total Variable Cost = Variable Cost per Unit × Units Sold. Rises proportionally with volume.
- ◆ Total Cost = Fixed Cost + (Variable Cost per Unit × Units Sold). Rises with volume but from a fixed base.
- ◆ Profit = Revenue – Total Cost = Revenue – Fixed Cost – Variable Cost = (Price – Variable Cost) × Units – Fixed Cost = Contribution Margin × Units – Fixed Cost.

The profit zone is to the right of break-even: revenue exceeds total cost, and the gap widens with every additional unit sold because the contribution margin per unit exceeds the additional cost per unit (which is only the variable cost — fixed costs don't change).

Profit Improvement Analysis

Four levers improve profit. Understanding their relative impact enables prioritisation:

Consider a business: Revenue = R500,000. Variable Costs = R300,000. Fixed Costs = R150,000. Contribution Margin = R200,000. Profit = R50,000.

Lever	Change Applied	New Profit	% Profit Improvement
Raise prices 1%	Revenue: R505,000 (VC unchanged)	R55,000	+10%
Reduce variable costs 1%	VC: R297,000	R53,000	+6%
Increase volume 1%	Revenue R505,000; VC R303,000	R52,000	+4%
Reduce fixed costs 1%	FC: R148,500	R51,500	+3%

Pricing is the highest-leverage profit improvement tool available — yet most entrepreneurs instinctively focus on volume and cost reduction instead. A well-researched, confidently executed price increase often delivers more profit improvement than years of cost reduction and

sales effort combined.

3.2 Costing Methods

Absorption Costing (Full Costing)

Absorption costing allocates ALL production costs — both variable and fixed — to each unit produced. Each product 'absorbs' its share of overhead through a predetermined overhead rate.

The overhead rate formula:

```
Overhead Rate = Total Overhead Cost Pool ÷ Total Allocation Base Quantity
```

Common allocation bases: direct labour hours (most common in labour-intensive businesses), machine hours (appropriate in capital-intensive manufacturing), units produced (simple but can be misleading when products consume different levels of overhead resource).

Steps in absorption costing: 1. Identify the cost object (the specific product being costed) 2. Identify and measure direct costs (materials + direct labour) 3. Identify overhead costs that support production 4. Select cost allocation base 5. Calculate overhead rate 6. Apply overhead rate to each product based on its use of the allocation base

Absorption Costing — Comprehensive Example

ZFN Clothing Company produces jeans and premium khakis at its Cape Town factory. Annual factory overhead = R3,300,000. Production: 500,000 jeans (using 200,000 direct labour hours) and 400,000 khakis (using 300,000 direct labour hours).

```
Overhead rate = R3,300,000 ÷ 500,000 total hours = R6.60 per direct labour hour
```

Cost Element	Jeans Calculation	Jeans Cost/pair	Khakis Calculation	Khakis Cost/pair
Direct materials	1 yard denim × R5/yard	R5.00	1.2 yards twill × R4.50/yard	R5.40
Direct labour	0.4 hours × R14/hour	R5.60	0.75 hours × R14/hour	R10.50
Overhead	0.4 hours × R6.60/hour	R2.64	0.75 hours × R6.60/hour	R4.95
Total cost/pair		**R13.24**		**R20.85**

Khakis receive more overhead than jeans per unit (R4.95 vs R2.64) because they require more direct labour hours (0.75 vs 0.40). If the allocation base were units produced instead of labour hours, both would receive R3.67 overhead per unit — changing relative cost and potentially changing the pricing decision for each product.

Variable (Marginal) Costing

Variable costing treats only variable production costs as product costs. Fixed manufacturing overhead is expensed entirely in the period it occurs — not deferred in inventory. This produces a different profit figure from absorption costing when production and sales volumes differ.

Key features of variable costing:

Cost classification: Only variable costs — direct materials, direct labour, variable overhead — are treated as product costs.

Inventory valuation: Closing inventory is valued at variable cost only (no fixed overhead included).

Contribution margin: Revenue minus all variable costs = contribution. Contribution minus fixed costs = profit. The contribution is clearly visible and directly useful for decision-making.

Decision-making utility: Variable costing is the preferred internal management tool because contribution margin per unit is constant and directly comparable across products. It makes break-even analysis and profitability decisions straightforward.

Variable Costing — Worked Example

Splash Factory: Variable cost per unit = R6. Selling price = R10. Monthly production = 20,000 units. Fixed costs = R45,000/month.

Item	10,000 sold	15,000 sold	20,000 sold
Sales	R100,000	R150,000	R200,000
Variable COGS	R60,000	R90,000	R120,000
Contribution	**R40,000**	**R60,000**	**R80,000**
Fixed Costs	R45,000	R45,000	R45,000
Net Profit/(Loss)	**(R5,000)**	**R15,000**	**R35,000**
Contribution per unit	R4 (constant)	R4 (constant)	R4 (constant)

Break-even = R45,000 ÷ R4 = 11,250 units. The variable costing approach makes this immediately transparent — which is why it is the preferred tool for internal pricing and operational

decision-making.

3.3 Types of Profit and Profit Margin Analysis

Profit is not a single number — it is measured at multiple levels of the income statement, each revealing a different dimension of business financial performance. Understanding what each profit level measures enables targeted improvement strategies.

Gross Profit and Gross Profit Margin

```
Gross Profit = Revenue – Cost of Goods Sold (COGS) COGS includes: direct materials, direct labour, and direct production overhead allocated to goods sold. Gross Profit Margin = (Revenue – COGS) ÷ Revenue × 100
```

What it measures: Production and procurement efficiency — how well the business converts revenue into value above direct production costs. A declining gross margin signals rising input costs, inefficient production, unfavourable product mix shifts, or pricing pressure that isn't being recovered.

Worked example: Revenue = R5,000,000. COGS = R1,200,000. Gross Profit = R3,800,000. GPM = 76%.

Sector benchmarks: Software: 70-90%; Retail: 25-40%; Restaurants: 55-70%; Manufacturing: 20-40%; Professional services: 50-75%.

Operating Profit and Operating Profit Margin

```
Operating Profit = Gross Profit – Operating Expenses (overhead costs not in COGS) Operating Expenses include: management salaries, marketing, rent, utilities, administration, depreciation not in COGS. Operating Profit Margin = Operating Profit (EBIT) ÷ Revenue × 100
```

What it measures: Total business operational efficiency — not just production but the full cost of running the business, marketing it, and managing it. A high gross margin can still produce a poor operating margin if overhead costs are excessive relative to revenue.

Worked example: Revenue = R2,000,000. EBIT = R450,000. OPM = 22.5%.

The difference between gross margin (76%) and operating margin (22.5%) represents the overhead burden — the cost of running the business beyond direct production.

Net Profit Margin

```
Net Profit = Operating Profit – Interest Expense – Income Tax + Non-operating Income Net Profit Margin = Net Profit After Tax ÷ Revenue × 100
```

What it measures: The ultimate bottom-line performance — what percentage of every rand of revenue translates into actual profit for the owners after every obligation (production costs, overhead,

financing costs, and tax) has been met.

Worked example: Revenue = R2,200,000. Net Profit = R500,000. NPM = 22.7%.

South African context: Most small and medium enterprises operate at 5-15% net margins. Businesses consistently above 20% net margin have genuine competitive advantages worth protecting and building on.

Net Profit After Interest and Tax (NPAT)

This is the profit available to the owners of the business after ALL claims — suppliers (through COGS), employees (through wages), lenders (through interest), and government (through tax) — have been satisfied. It is the owner's reward for taking on the risk and responsibility of running the business.

Owners can choose to: distribute some or all of NPAT as dividends; retain some or all of NPAT in the business to fund growth, reduce debt, or build cash reserves; or take some as salary (which reduces profit before this stage) and some as dividends.

Retained Profit

Retained Profit = NPAT – Dividends Paid

Retained profit is reinvested in the business. It is the primary source of internal equity — funding for growth that does not require external borrowing or equity dilution. Over time, retained profit that compounds through reinvestment at good returns is the principal mechanism of long-term business wealth creation.

Critical principle: A business that distributes all its profit as dividends must rely entirely on external financing for growth. A business that retains and reinvests profit at returns above its cost of capital builds compounding value — the entrepreneurial equivalent of compound interest.

Using Profit Ratios for Business Diagnosis

Profit ratios are most valuable when tracked over time and compared to industry benchmarks:

Ratio	Formula	SA SME Typical Range	If Declining — Possible Causes
Gross Profit Margin	(Revenue – COGS) ÷ Revenue	25-70% (sector-dependent)	Rising input costs; unfavourable product mix; pricing pressure
Operating Profit Margin	EBIT ÷ Revenue	8-20%	Overhead growing faster than revenue; under-pricing; cost creep

Net Profit Margin	NPAT ÷ Revenue	5-15%	Rising financing costs; excessive tax burden; margin erosion
Return on Capital Employed	EBIT ÷ Capital Employed	15-35%	Capital not being deployed productively; excessive debt
Markup Percentage	Gross Profit ÷ COGS × 100	Varies by sector	Pricing decisions inconsistent with target margin

Additional Section: Practical Pricing Tools and South African Context

4.1 Markup vs. Margin — A Critical Distinction

Markup and margin are both expressions of the profit in a price, but they are calculated differently and are not interchangeable. Confusing them is a common and costly pricing error:

Measure	Formula	Based On	Example (Cost R50, Price R80)
Markup	(Price – Cost) ÷ Cost × 100	Cost	(R80–R50) ÷ R50 = 60% markup
Gross Margin	(Price – Cost) ÷ Price × 100	Selling Price	(R80–R50) ÷ R80 = 37.5% margin

The same R30 profit is expressed as a 60% markup (on cost) or a 37.5% margin (on price). When a retailer says they need a 40% margin, they mean 40% of the selling price — not 40% of cost. If a product costs R60 and the retailer needs a 40% margin: Selling Price = R60 ÷ (1 – 0.40) = R60 ÷ 0.60 = R100. At R100 selling price: Margin = (R100–R60) ÷ R100 = 40%. Markup = (R100–R60) ÷ R60 = 67%.

Converting Between Markup and Margin

```
Markup→Margin: Margin = Markup ÷ (1 + Markup). Margin→Markup: Markup = Margin ÷ (1 – Margin). Examples: 50% markup→33.3% margin | 40% margin→66.7% markup | 25% markup→20% margin
```

4.2 Pricing in the South African SMME Context

South African small and medium enterprises face pricing challenges that are specific to the local economic context. Understanding these challenges enables more sophisticated and competitive pricing decisions:

Load-Shedding and Energy Cost Impact

Frequent power outages force most small businesses to invest in backup power (generators, inverters, solar) creating fixed costs that must be priced in. A bakery running a diesel generator for 4-8 hours daily faces a material cost increase that must be reflected in selling prices. Strategy: calculate the actual cost of load-shedding per unit and add it to your cost structure. Communicate this transparently to customers when implementing a price increase.

VAT Pricing Implications

VAT-registered businesses must charge 15% VAT on taxable supplies. Prices displayed in retail must be VAT-inclusive (Consumer Protection Act). Cost and margin calculations must be based on the VAT-exclusive price. Example: VAT-inclusive retail price R115. VAT-exclusive price = R115 divided by 1.15 = R100. The R100 is the real selling price; R15 is collected on behalf of SARS. Entrepreneurs who calculate margin on R115 overstate revenue by 15%.

Competing in Township and Informal Markets

Township and informal market customers are typically more price-sensitive but are also value-conscious. Effective strategies: understand dominant payment denominations (R5, R10, R20); offer credit or payment plans; develop smaller pack sizes at lower absolute price points; display prices clearly and consistently to build trust. The township economy represents one of South Africa's most significant and underserved market opportunities.

Currency and Import Cost Volatility

South Africa's chronic rand weakness creates persistent inflationary pressure for businesses that import any component of their cost structure. Import-dependent businesses must: build currency volatility assumptions into cost models; negotiate forward contracts for large import commitments; consider pass-through clauses in customer contracts; develop local supplier alternatives where economically viable.

BEE Pricing and Procurement Leverage

BEE-compliant businesses (Level 1-4 contributors) have a pricing advantage in government and corporate procurement. Corporate customers receive BEE procurement points for buying from compliant suppliers, which has a monetary value in their BEE scorecard. This can justify a price premium of 5-15% over non-compliant competitors for equivalent products. BEE-compliant small businesses should explicitly price this advantage and communicate it in sales conversations.

4.3 Pricing for Services — Special Considerations

Service businesses face pricing challenges that product businesses do not encounter, because the 'product' is intangible, variable, and co-produced by the customer. Effective service pricing addresses these challenges:

Time-Based vs. Value-Based Service Pricing

Most service businesses default to time-based pricing (hourly or daily rate). This caps income at hours worked and penalises efficiency. Value-based pricing sets fees relative to the outcome delivered. Pricing models: hourly rate (transparent, penalises efficiency); project rate (fixed fee for defined scope); retainer (monthly fee for ongoing availability); performance-based (fee linked to outcome); value-based (fee relative to client value created, highest margin potential).

Pricing for Perishable Capacity

Service capacity is perishable — an unfilled appointment slot cannot be recovered. Dynamic pricing strategies help match supply and demand. Off-peak discounting attracts price-sensitive but time-flexible customers. Advance booking discounts incentivise early commitment and improve planning. Last-minute pricing offers unsold capacity at a discount rather than letting it waste entirely.

Pricing Transparency in Professional Services

Many professional service businesses are reluctant to publish prices because work is custom and variable. However, opaque pricing creates a significant barrier to purchase for new clients. Better practice: publish starting-from prices, typical project ranges, and clear descriptions of what determines the final price. This filters incompatible clients and builds trust with those whose budget is adequate.

4.4 Common Pricing Mistakes and How to Avoid Them

Entrepreneurs consistently make the same pricing errors. Knowing these mistakes in advance enables you to avoid them:

Pricing on intuition rather than analysis: Setting prices based on gut feel, competitor imitation, or industry convention rather than on a rigorous understanding of your own cost structure, customer value perception, and competitive position. Result: systematic under- or overpricing. Fix: build a complete cost model; conduct customer willingness-to-pay research; analyse competitor positioning analytically.

Failing to price in all costs: Pricing based on direct production costs alone, ignoring marketing, selling, overhead, and after-sales costs. Result: prices that appear profitable but generate losses at the business level. Fix: allocate a full cost per unit that includes every cost in the trading cycle.

Fear of raising prices: Reluctance to raise prices out of fear of losing customers, even when cost increases or market conditions justify it. Result: margin erosion that compounds over time. Fix: calculate the break-even volume loss that would make a price increase unprofitable; conduct customer research to understand actual price sensitivity; raise prices confidently when justified.

Uniform pricing across all customers: Charging the same price to all customers regardless of their sensitivity, their value to the business, or the value they receive. Result: overcharging price-sensitive customers (who leave) and undercharging value-insensitive customers (who would happily pay more). Fix: implement customer segmentation; offer tiered pricing; negotiate price-sensitive large accounts separately from standard pricing.

Ignoring the full customer lifetime value: Making pricing decisions based on the value of a single transaction rather than the expected lifetime revenue and profitability of the customer relationship. Result: underinvestment in acquiring high-lifetime-value customers. Fix: calculate customer lifetime value (CLV) and use it to determine maximum acceptable customer acquisition cost and to inform pricing flexibility on initial orders.

Not monitoring competitor pricing: Setting a price once and not tracking whether it remains competitive as competitor prices change. Result: being priced out of the market without awareness. Fix: establish a regular (monthly or quarterly) competitor pricing audit; subscribe to competitor communications and promotions; ask customers about competitive pricing they receive.

4.5 Pricing Review and Continuous Improvement

Pricing is not a once-off decision made at launch. Markets evolve, costs change, competitors respond, and customer preferences shift. A structured pricing review process ensures that pricing remains optimal throughout the business lifecycle:

Monthly review triggers: Review pricing when: any input cost increases by more than 5%; a competitor changes their price significantly; a new competitor enters the market; your gross margin falls below target for two consecutive months; customer feedback suggests price-sensitivity or price concerns.

Annual pricing audit: Each year, conduct a full pricing audit: recalculate costs from scratch (don't assume last year's cost structure still applies); recheck competitor pricing across all product lines; survey customer perceptions of value and price fairness; calculate contribution margins by product and rank by profitability; identify products that should be discontinued, repriced, or repositioned.

Testing pricing changes: Before implementing a significant price change across all customers, test it: raise prices for new customers first while holding prices for existing customers; test different price points in different geographic areas or channels; use A/B testing in digital contexts. Measure the volume response carefully before committing to the new price universally.

Communicating price increases: When price increases are necessary, communicate proactively: give adequate notice (30-60 days for business customers); explain the reason honestly (input cost increases, quality improvements); frame the increase in context (the percentage increase, not just the rand amount); offer options where possible (multi-month advance purchase at current price, service level adjustment). Customers who understand why a price is increasing are far more likely to accept it than those who feel it is arbitrary.

Chapter Summary

❖ The trading cycle — procurement, production, marketing, selling, and after-sales support — defines the complete chain of cost-generating activities. All costs across every stage must be recovered through the selling price.

❖ Costing is the systematic process of identifying and allocating all costs to products or services. Its five objectives: setting selling price, controlling costs, supporting decisions, ascertaining profitability, and facilitating financial reporting.

❖ Costs are classified by behaviour (fixed, variable, semi-variable) and traceability (direct, indirect/overhead). Total Cost = Fixed Costs + (Variable Cost per Unit × Units Produced). Cost per unit falls as volume increases due to fixed cost spreading.

❖ Pricing is the process of determining what to charge. It is informed by costing (which sets the floor) and market factors (which determine the ceiling and optimal point between floor and ceiling).

❖ Eight pricing objectives guide different situations: profit maximisation, profit margin maximisation, revenue maximisation, market share growth, quality leadership, status quo, survival, and partial cost recovery.

❖ Six pricing types: cost-plus (simple, cost-based); target return (ROI-aligned); value-based (customer value-driven, typically highest margin); psychological (perception-exploiting); fair (brand-protecting); marginal cost (spare capacity or tactical).

❖ Nine pricing strategies: competitive, good-better-best, loss leader, multiple pricing, optional product, penetration, premium/skim, product bundle, and price skimming.

❖ Six internal factors affect pricing: marketing objectives, cost structure, marketing mix consistency, organisational goals, production capacity, and cash flow position.

❖ Five external factors constrain pricing: price-volume relationship, consumer psychology, competitive environment, channel economics, and legal and regulatory constraints.

❖ Price elasticity of demand (PED) quantifies pricing power. Inelastic markets (PED < 1): raise price to increase revenue. Elastic markets (PED > 1): reduce price to increase revenue.

❖ Break-Even Units = Fixed Costs ÷ Contribution Margin per Unit. Break-Even Revenue = Fixed Costs ÷ Contribution Margin Ratio. Every pricing decision should be evaluated against its impact on break-even.

❖ Profit = Contribution Margin × Units Sold – Fixed Costs. Pricing is typically the highest-leverage profit improvement lever — a 1% price increase often generates 8-12% profit improvement.

❖ Absorption costing allocates fixed overhead to products (required for external reporting). Variable costing treats fixed overhead as a period cost (preferred for internal decision-making and pricing analysis).

❖ The overhead rate = Total Overhead ÷ Total Allocation Base. The choice of allocation base can significantly change reported product costs and pricing decisions.

❖ Four profit levels: gross profit (production efficiency), operating profit (total business efficiency), net profit after tax (bottom line), retained profit (reinvestment fuel).

❖ Profit ratios — gross margin, operating margin, net margin, ROCE — are the diagnostic tools that identify where performance is strong or weak and guide targeted improvement actions.

Application Exercise: Apply this chapter's complete framework to your own venture: (1) Map and cost your full trading cycle. (2) Classify every cost as fixed, variable, or semi-variable. (3) Calculate your contribution margin per unit. (4) Determine your monthly break-even point. (5) Choose your pricing objective and select the most appropriate pricing type and strategy. (6) Calculate the impact on break-even of a 10% price increase. (7) Construct a projected three-year income statement showing gross profit, operating profit, and net profit margin.