Chapter 10 – Pricing

They say that there are only three kinds of people: those who are good at math, and those who aren't!

If that doesn't make sense to you, don't worry … you don't have to be a math whiz to understand the basics of cost and pricing strategies for MWR/Services activities.

Is PROFIT a 4-Letter Word?

MWR/Services activities were not originally designed to make a profit. They existed solely as a support system for military members and their families, and were largely supported by appropriated funds (those monies actually appropriated by Congress from taxpayer revenues).

Category A Activities still generally follow this original intent, but MWR/Services *business* activities are expected to generate more money than they expend … the classic meaning of the word, "profit." Nevertheless, they do not exist primarily to generate revenue … the primary mission is still to support the military members and their families around the world. Profit generation is, however, essential to maintain the ability to offer that support. The goal is to be able to effectively set prices and manage costs so as to achieve financial goals.

Revenue (all money taken in) minus expenses (all money spent) equals Net Income (profit). That's the bottom line. You can improve the bottom line in two distinct ways:

1. Increase revenues.
2. Decrease expenses.

That's it…there is no third possibility!

In many ways, it is a simple equation. If you increase revenues by $1,000 while keeping expenses the same, you will improve Net Income (profit) by $1,000. If you maintain the same level of revenue but decrease expenses by $1,000, you will also improve Net Income by $1,000.

In real life, of course, it is not quite so simple. In order to increase revenue, you normally have to increase expenses. For example, you might spend more on marketing in order to try to increase sales.

To decrease expenses, you have to get rid of something. For example, you might cut back on labor. However, this might make it more difficult to serve customers effectively…resulting in lower revenue. As has been noted by many analysts, it's a delicate balance.

Let's study cost management first, and then consider pricing.

Cost Management

Generally speaking, you can show a short-term increase in Net Income by slashing expenses. But if the expenses were properly created as investments in the operation, the long-term outlook of this strategy may be bleak. Let's look at some examples.

One of the largest expenses on your Income Statement may be Cost of Goods Sold. You can decrease this cost by getting a lower quality product. But this could eventually decrease customer satisfaction and drastically decrease revenue.

Another huge expense is labor. You can decrease this by scheduling fewer people for fewer hours, but this could also decrease customer satisfaction…thereby decreasing revenue.

Look at each item on your Income Statement. What would happen if you decreased your Marketing Expenses? Maintenance? Administration? Yes, it is indeed a delicate balance.

Effective managers walk this tightrope of revenue versus expenses every day. We discussed how to breathe life into your financial statements, so that you can see more than just a matrix of numbers on a page. When you see, "Cost of Food," you should see steaks and lobsters being served to customers. When you see "Cost of Labor," you should see a group of individual employees and the work that they do.

In a perfect world, each "cost" is actually an *investment* in the overall success of your activity. $500 spent on marketing might yield an additional $5,000 in sales. $1,000 in labor costs should facilitate increased customer satisfaction, which should be directly related to increased revenues.

Standards

Standards are specific, measurable targets provided to management as a means of measuring success. For example, an activity might be given a Net Income target of 5% of revenue. That 5% is a *standard.*

These standards become *goals,* or benchmarks for success.

Each Service publishes standards for cost of goods sold, labor costs, and other measures.

Determining Standard Cost

In the case of products sold in a retail outlet, determining standard cost is normally as simple as looking at the invoice for the items when they were ordered. Just don't forget any "extra" costs, such as shipping/delivery charges.

In a food and beverage operation, the process is more complicated. For example, where do you find the cost for a Double Cheeseburger with French fries and condiments? The answer is to keep meticulous records of all ingredients, and to use *standard recipes* so that you know exactly how much of each ingredient is included.

You should be able to determine the precise cost of two all beef patties, a slice of pre-sliced cheese and one sesame seed bun, but you will have to make some intelligent estimates as to the average cost of mayonnaise, mustard, lettuce, pickles, onions and special sauce. There are also costs, such as ketchup, which will vary from one customer to the next. The process is to take the total ketchup used in a specific period (one day, one week, or one month) and divide by the total number of servings sold. We call that the "cost of goods sold" for that item, although it is actually the cost of goods sold, stolen and wasted!

Maintaining accurate records to back each standard is essential, as is conducting periodic inspections to ensure adherence to the standard (recipe, serving size, specific retail item, etc.).

The Price is Right!

Price is one of the most important aspects of any product or service offered for sale, but it is one of the most difficult problems for a manager. Charge too much, and the consumer won't buy—and you lose money. Charge too little, and the consumer may buy—in great quantities—but you won't cover all expenses, so you still lose money.

The solution, obviously, is to charge "just the right price." But how? Pricing strategies abound, but it is difficult to scientifically "prove" which pricing strategy will work best in a particular situation. There are too many variables. And trial-and-error can be a painfully expensive teacher.

Pricing Philosophy

Goods and services should be priced in a manner which tends to optimize the goals of the organization offering the goods and/or services for sale. In many cases, the assumed goal is to "maximize profits." A second look, however, demonstrates that this simplified goal is not easy to achieve…or even to explain. For one thing, maximizing short-range profits (such as by decreasing labor costs) often tends to depress long-range profits. Conversely, it is often necessary to forego immediate profits in order to build long-term profitability.

There are other problems with "maximizing profits" as an objective. Most managers operate from an ethical code which must not be violated in the search or profits. There must be concern for human welfare, the environment, or any of myriad other considerations.

In fact, some researchers have suggested that very few organizations actually operate in order to maximize profits. The observed behaviors seem to indicate an actual goal of "satisfactory" profits while maintaining preconceived notions about the type of business, location, ethics, or other constraints. This behavior has been called, "satisficing," a term coined by Herbert Simon in 1957.

In the government sector, including military MWR/Services, the term "profit" has even been considered a "dirty word" by those who envision PROFITS as proof that charges are excessive. In other words, if you are too successful in producing profits in certain MWR/Services operations, you may find yourself severely criticized!

On the other hand, if you *fail* to produce profits, your activity may flounder and be closed…or you may lose your job to someone who can produce better results.

It is *absolutely critical* to define the goals of your activity in a way that allows some measurement of the activity's success. In most cases, that includes some form of financial measurement…such as profit. The key is a well-defined *goal,* including specific financial objectives.

Pricing Strategies

What pricing structure do you use your first day on the job as the new manager of an established MWR/Services activity? You probably rely on the pricing already in effect. After you've been on the job for a while, however, blind reliance on historical pricing will probably be seen as a management weakness.

And there are times when it makes sense to retain—or return to—historically established prices. If you're having problems with product, service, delivery, etc., it may be advantageous to stick with a proven pricing structure. Established pricing may be more convenient. It is more convenient to pay $1.00 than $1.04; raising a price above a dollar may discourage some customers from making the purchase. Pre-set cash registers, expensive signage, recent advertising…these may all be reasons to NOT change existing prices. There's another time to use "status quo" pricing, and that's when the customers are happy and financial goals are being achieved. "If it ain't broke, don't fix it!"

But most managers will face a time when they have to adjust prices. Factors to consider when doing so include:

- Cost of goods: What did you pay?
- Competition: Military MWR/Services activities may have to follow various pricing regulations designed to provide value to the military community while maintaining fair competition with the civilian firms outside the gate.
- Policy Guidelines: Some pricing (such as child care services) is dictated within a certain range by higher headquarters.
- Financial Goals: Do you need to make a profit on this item or break even? What is the desired % cost of goods for this item?
- Market Conditions: What will the market bear?
- Marketing strategies: Would your activity benefit from a short-term sales promotion? Do you need to price older inventory to move quickly? Would your activity benefit from having a "loss leader", a product sold at a low price, at or below its market cost to stimulate other sales of more profitable goods or services.

You can see that a clear understanding of the financial basics we have discussed thus far (financial goals, financial statement analysis, inventory management, internal controls) will all factor into your understanding how to best price your specific product.

Summary of Chapter 10

Pricing is one of the most sensitive, difficult, and important aspects of successful management. And it takes constant effort and continuous adjustment as situations change.

Revenue (income) minus Expenses equals Net Income (profit).

There are only two ways to improve profit:

1. Increase revenues.
2. Decrease expenses.

Cost management is a delicate balance, as each expense is likely to have an impact on revenue. In order to control costs in a food operation, it is essential to employ *standardized recipes.* Goods and services should be priced in a manner which tends to optimize the goals of your operation … not necessarily maximizing profit. Refer to your individual Service regulations for guidance on specific pricing targets and policies.

Practice Problems

Need extra practice with math? Here are a few relatively simple problems that should reinforce the principles in this chapter.

1 If you have sales of $3,500 and expenses of $3,250, what is your Net Income?

2 Determine the Standard Cost of a Grilled Cheese sandwich, given the following cost information:

Your Standard Recipe calls for 2 slices of bread, 2 slices of cheese, and buttery spread. You garnish the sandwich with 2 pickles.

A package of sliced cheese (24 slices) costs $4.80.

A loaf of bread (30 slices) costs $3.60.
Buttery spread costs $5.00 per can. (You average 100 sandwiches per can.)

Pickles cost $1.98 per jar (18 count).

3. You are currently selling the Grilled Cheese sandwich for $1.50. What is your food cost percentage?

4. You want to achieve a 50% cost of goods sold for the Grilled Cheese sandwich. What is the new selling price?

(Don't be distracted by the prices in the examples…they have been designed to help keep the calculations simple for learning purposes, and may not represent current prices.)

Answers to Practice Problems

1. $250 $3500 sales

<u>-3250 expenses</u>

$ 250 Net Income

2. $ .91 2 slices of bread @ .12 = $ .24

2 slices of cheese @ .20 = .40

Buttery spread @ .05 = .05

<u>2 pickles @ .11 = .22</u>

Total Food Cost $ .91

3. 61% $ .91 food cost / $1.50 selling price = .6066 = .61 (round up)

4. $ 1.82 $ .91 food cost/ .50 (50% target) = $ 1.82 menu price