What Is Full-Cost Pricing?

Full-cost pricing is one of many ways for a company to determine the selling price of a product. To use this pricing method, you add together all costs of creating and selling the product (including material costs, labor costs, selling and administrative costs and overhead costs) and a markup percentage to allow for a profit margin. You then divide this number, which should include the price of all units produced, by the number of units you expect to sell.

The full-cost calculation is simple. It looks like: (total production costs + selling and administrative costs + markup) ÷ the number of units expected to sell.

An Example Calculation

Consider an example of how the full-cost system works. Tom's Treat Toys is trying to figure out a fair price to charge for their finest fun figures. They decide they want to make a profit margin of 50 percent and sell 50,000 units. The company spends $2 million making all of their products and $600,000 on their total company sales and administration costs. The finest fun figures take up 25 percent of their manufacturing floor and 25 percent of their overall sales and administration costs. That means the total production cost for the finest fun figures is $500,000, and the total sales and administration cost is $150,000.

The total cost of making and selling the product comes out to $650,000, which means that a 50 percent profit margin would be $325,000. When the profit margin is added to the total costs, the total comes out to $975,000. Divide that number by the number of units (50,000), and you'll get the total cost of the product per unit, which comes out to $19.50.

Benefits of Full-Cost Pricing

The greatest benefits to full-cost pricing are that it is fair, simple and will likely turn a profit. The pricing is easily justifiable because the prices are based on actual costs. When manufacturing costs go up, it is also easy to justify increasing prices without angering customers. If a product does have competitors and they take the same approach to pricing, this can also result in price stability as long as the competitors have similar costs.

Full-cost pricing is also fairly easy to calculate as long as the company doesn't sell too many products to make figuring out the costs per item impractical. In fact, full-cost pricing can actually allow junior employees to determine the cost of a product since it is based solely on formulas.

Finally, by taking all the expenses of a product into account and figuring in the profit margin a company would like to see, it can guarantee that the product will earn a profit as long as the calculations are correct.

Drawbacks of Full-Cost Pricing

There are some disadvantages to using full-cost pricing, though. As previously stated, for example, this pricing strategy is not good to use in a competitive market because it ignores the prices set by the competition. Similarly, it ignores what buyers are willing to pay, so the price could be too high or too low in comparison to what the company could be charging, resulting in either lost potential profits or lost potential sales.

By allowing for any possible product costs in the calculations, this pricing method also provides no incentive for designers and engineers to create a product in a less-costly manner. If costs increase, then selling prices will also increase accordingly, and employees may have little incentive to reduce costs internally rather than just passing them on to the consumer.

Another major problem with full-cost pricing is that it only takes into account expense estimates and sales volume estimates, both of which could be incorrect. This could result in a completely wrong pricing strategy. For example, if you account for 5,000 units being sold and only 2,000 units are sold, you may lose money on the item depending on the profit margin you set. It can also be difficult to figure out an accurate apportionment of costs if a company sells more than one product.

For many companies, full-cost pricing is too simplistic, failing to take into account the actual costs of all expenses and how they are allocated to one product over another. This is why absorption pricing is sometimes preferable because it further breaks down the cost of all expenses and divides them more accurately by all the products the company sells.

Variable cost pricing

What is a Variable Cost?

A variable cost is a corporate expense that changes in proportion to production output. Variable costs increase or decrease depending on a company's production volume; they rise as production increases and fall as production decreases. Examples of variable costs include the costs of [raw materials](https://www.investopedia.com/terms/r/rawmaterials.asp) and packaging. A variable cost can be contrasted with a [fixed cost](https://www.investopedia.com/terms/f/fixedcost.asp).

**Variable cost pricing** is an approach to pricing which defines a cost base as all variable costs and excludes fixed manufacturing costs and fixed selling and administrative costs.

Understanding a Variable Cost

The total expenses incurred by any business consist of fixed costs and variable costs. Variable costs are dependent on production output. The variable cost of production is a constant amount per unit produced. As the volume of production and output increases, variable costs will also increase. Conversely, when fewer products are produced, the variable costs associated with production will consequently decrease.

Examples of variable costs are sales [commissions](https://www.investopedia.com/terms/c/commission.asp), direct labor costs, cost of raw materials used in production, and utility costs. The total variable cost is simply the quantity of output multiplied by the variable cost per unit of output. Variable costs are usually viewed as short-term costs as they can be adjusted quickly.

Variable Costs vs. Fixed Costs

Fixed costs are expenses that remain the same regardless of production output. Whether a firm makes sales or not, it must pay its fixed costs, as these costs are independent of output.

Examples of fixed costs are rent, employee salaries, [**insurance**](https://www.investopedia.com/terms/i/insurance.asp), and office supplies. A company must still pay its rent for the space it occupies to run its business operations irrespective of the volume of products manufactured and sold. If a business increased production or decreased production, rent will stay exactly the same. Although fixed costs can change over a period of time, the change will not be related to production, and as such, fixed costs are viewed as long-term costs.

There is also a category of costs that falls between fixed and variable costs, known as [**semi-variable costs**](https://www.investopedia.com/terms/s/semivariablecost.asp)(also known as semi-fixed costs or mixed costs). These are costs composed of a mixture of both fixed and variable components. Costs are fixed for a set level of production or consumption and become variable after this production level is exceeded. If no production occurs, a fixed cost is often still incurred.

Example of a Variable Cost

Let’s assume that it costs a bakery $15 to make a cake—$5 for raw materials such as sugar, milk, and flour, and $10 for the direct labor involved in making one cake. The table below shows how the variable costs change as the number of cakes baked vary.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|    |  **1 cake** |  **2 cakes** |  **7 cakes** |  **10 cakes** |  **0 cakes** |
|  Cost of sugar, flour, butter, and milk |  $5 |  $10 |  $35 |  $50 |  $0 |
|  Direct labor |  $10 |  $20 |  $70 |  $100 |  $0 |
|  **Total variable cost** |  **$15** |  **$30** |  **$105** |  **$150** |  **$0** |

As the production output of cakes increases, the bakery’s variable costs also increase. When the bakery does not bake any cake, its variable costs drop to zero.

Fixed costs and variable costs comprise the total cost. Total cost is a determinant of a company’s profits, which is calculated as:

Profits=*Sales*−*Total* *Costs*​﻿

A company can increase its profits by decreasing its total costs. Since fixed costs are more challenging to bring down (for example, reducing rent may entail the company moving to a cheaper location), most businesses seek to reduce their variable costs. Thus, decreasing costs usually means decreasing variable costs.

If the bakery sells each cake for $35, its [gross profit](https://www.investopedia.com/terms/g/grossprofit.asp) per cake will be $35 - $15 = $20. To calculate the net profit, the fixed costs have to be subtracted from the gross profit. Assuming the bakery incurs monthly fixed costs of $900, which includes utilities, rent, and insurance, its monthly profit will be:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Number Sold** | **Total Variable Cost** | **Total Fixed Cost** | **Total Cost** | **Sales** | **Profit** |
| 20 Cakes | $300 | $900 | $1,200 | $700 | $(500) |
| 45 Cakes | $675 | $900 | $1,575 | $1,575 | $0 |
| 50 Cakes | $750 | $900 | $1,650 | $1,750 | $100 |
| 100 Cakes | $1,500 | $900 | $2,400 | $3,500 | $1,100 |

A business incurs a loss when fixed costs are higher than gross profits. In the bakery’s case, it has gross profits of $700 - $300 = $400 when it sells only 20 cakes a month. Since its fixed cost of $900 is higher than $400, it would lose $500 in sales. The break-even point occurs when fixed costs equal the [gross margin](https://www.investopedia.com/terms/g/grossmargin.asp), resulting in no profits or loss. In this case, when the bakery sells 45 cakes for total variable costs of $675, it breaks even.

A company that seeks to increase its profit by decreasing variable costs may need to cut down on fluctuating costs for raw materials, direct labor, and advertising. However, the cost cut should not affect product or service quality as this would have an adverse effect on sales. By reducing its variable costs, a business increases its gross profit margin or [contribution margin](https://www.investopedia.com/terms/c/contributionmargin.asp).

The contribution margin allows management to determine how much revenue and profit can be earned from each unit of product sold. The contribution margin is calculated as:

\begin{aligned} &\text{Contribution~Margin} = \dfrac{Gross~Profit}{Sales}=\dfrac{ (Sales-VC)}{Sales}\\&\textbf{where:}\\&VC = \text{Variable Costs}\\ \end{aligned}​Contribution Margin=*SalesGross* *Profit*​=*Sales*(*Sales*−*VC*)​**where:***VC*=Variable Costs​﻿

The contribution margin for the bakery is ($35 - $15) / $35 = 0.5714, or 57.14%. If the bakery reduces its variable costs to $10, its contribution margin will increase to ($35 - $10) / $35 = 71.43%. Profits increase when the contribution margin increases. If the bakery reduces its variable cost by $5, it would earn $0.71 for every one dollar in sales.

**Parallel Import:**

**Products those are brought in one country in an unofficial way and then sold more cheaply than other countries.**