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Pricing



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Pricing

This factsheet looks at the two different methods of setting a price for a product or service.

Setting a price for a new product or service can be one of the challenging tasks faced by small business owners. Working out the cost of a product or service can be relatively simple, but pricing is often dictated by the marketplace.

In very basic terms the price of a product or service needs to cover all the costs and generate a profit, but it must also take account of what competitors are charging and how much customers will be prepared to pay. Setting too high a price can lead to lost sales. Setting too low a price will reduce profits. Either of these scenarios can lead to a business failing.

Value-Based Pricing

Businesses that choose value-based pricing must determine how much a customer is willing to pay for a product or service based on the value it provides. Since this isn't an exact science, business owners must understand their target audience's needs to estimate the value they would place on a product or service. That value is typically determined by the benefits that a product or service offers.

Cost-Based Pricing

Businesses that choose cost-based pricing must determine how much it costs to make and sell a product or service and what price would generate a profit. In cost-based pricing, there is a "floor price," which is the minimum price that the product or service can sell for and still be profitable. There is also a "ceiling price," which is the maximum price that the market will bear for that product or service. Business owners position their selling price between the floor and ceiling prices to ensure profitability and to avoid overpricing that drives customers to competitors.

Key differences Between Value-Based and Cost-Based Pricing

The primary difference between value-based and cost-based pricing is that value-based pricing is almost exclusively focused on the benefits a product or service offers a customer, whereas cost-based pricing is focused on the features and characteristics of a product or service. Value-based pricing has a larger range of prices than cost-based pricing because value is an estimate of what people will pay to obtain desirable benefits, whereas cost is based on quantifiable numbers.





Cost-based pricing is typically less expensive than value-based pricing because cost-based businesses offer competitive prices to lure customers away from competitors. Value-based businesses are more expensive because they are based on the willingness of buyers to pay higher prices for benefits that are difficult to quantify. There is usually a higher profit margin with value-based pricing, but fewer of these products and services are sold than the more affordable products and services that use the cost-based pricing model.



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