PART 2

COST-PLUS AND BREAK-EVEN PRICING

The Financial Floor of Every Pricing Decision

Full cost-plus pricing mechanics with commission and overhead, markup vs. margin confusion and its financial consequences, target return pricing with ROIC sensitivity table, contribution margin pricing and the two-tier floor, break-even volume at given price, break-even volume change for price increases, multi-product break-even and mix, overhead allocation methods and ABC pricing with worked distortion example, legitimate uses of cost-plus in regulated industries, inflation pass-through framework, indexation clauses, and the complete cost-based pricing metrics framework.

SECTION 1
THE ROLE OF COST IN PRICING STRATEGY

Cost-Plus and Break-Even Pricing: The Financial Floor

Part 1 established that value-based pricing is the orientation that most consistently produces sustainable, profitable prices — that starting from customer value rather than internal costs is the path to maximum price realization. That principle is correct and important. But it does not mean cost is irrelevant to pricing. Cost is not the primary determinant of price, but it is the absolute floor beneath which no rational business can price indefinitely. A company that consistently prices below its fully-loaded cost of delivery is subsidizing its customers from its own capital, destroying shareholder value with every unit sold.

Cost-plus and break-even pricing are the financial disciplines that define and protect this floor. They answer the question: at this price, does the company make money? They quantify exactly how many units must be sold at a given price to cover costs and generate a target return. And in specific circumstances — regulated industries, government contracts, new product launches where market data is scarce, commodity markets where differentiation is minimal — cost-plus is not merely acceptable but is the operationally correct methodology.

This part covers the complete mechanics of cost-plus pricing in all its variations: full cost-plus, target return pricing, contribution margin pricing, and activity-based cost pricing. It covers break-even analysis at multiple levels — the break-even volume for a given price, the break-even price for a given volume, and the sensitivity of break-even to changes in costs and mix. It addresses the dangers of cost-plus when applied inappropriately, and it provides the framework for when cost-based pricing is the right starting point. Every concept is grounded in formulas, worked examples, and the financial realities that CFOs navigate in practice.

1.1 What Cost-Plus Pricing Actually Is

Cost-plus pricing is a family of methods, not a single approach. What they share is the logic of starting from costs and adding a defined return. What they differ on is which costs are included (full cost vs. variable cost vs. direct cost), how the return is defined (markup percentage vs. target gross margin vs. target return on investment), and how overhead is allocated to individual products or services. These differences — often treated as minor technical details — have enormous practical consequences for the prices they produce and

the financial signals they create.

Cost-Plus Variant	Cost Base	Return Mechanism	Best Application
Full Cost-Plus	All costs: direct + overhead + SG&A; + allocated corporate	Fixed markup % on full cost	Government contracting; regulated industries
Gross Margin Target	COGS only (direct + manufacturing overhead)	Target GM% applied to COGS	Manufacturing; physical goods businesses
Contribution Margin Pricing	Variable costs only (direct materials, direct labor, variable overhead)	CM% target; covers fixed costs over volume	Marginal pricing decisions; capacity utilization
Target Return on Investment	Full capital employed in the product line	Required return % x capital employed	Capital-intensive businesses; product line P&L;
Activity-Based Cost-Plus	Costs allocated based on activity drivers (orders, setups, shipments)	Markup on ABC-allocated costs	Complex product portfolios; service businesses

SECTION 2
FULL COST-PLUS PRICING MECHANICS

Full Cost-Plus: Building Price from the Complete Cost Stack

Full cost-plus pricing starts from the total cost of producing, delivering, and supporting a product or service — including every direct cost and every allocated overhead cost — and applies a target profit margin or markup to arrive at the selling price. It is the most comprehensive cost-based approach and the one most commonly required in regulated and government contract environments where costs must be transparent and auditable.

2.1 The Full Cost Stack

Building the full cost stack requires bringing together costs from multiple parts of the organization that are not always visible to the pricing team: direct materials and labor, manufacturing overhead (absorption rates applied to direct labor or machine hours), selling and distribution costs, administrative and corporate

overhead allocations, and the cost of capital for the assets employed. Each layer adds to the cost base against which the markup is applied.

FULL COST STACK — MANUFACTURED PRODUCT

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Direct Materials (per unit at standard cost):    $22.00
Direct Labor (0.75 hrs x $24/hr standard rate):  $18.00
Variable Manufacturing Overhead (0.75 hrs x $12): $9.00
Fixed Manufacturing Overhead (0.75 hrs x $18):   $13.50
= Manufacturing Cost (standard):                  $62.50

Outbound Freight and Distribution (per unit):      $4.50
Customer Service Allocation (per unit):            $2.00
Sales Commission (variable; applied to price):     [set last]
SG&A Allocation (15% of manufacturing cost):       $9.38
= Total Cost Before Commission and Profit:        $78.38

Target Net Operating Margin: 18%
Commission Rate: 5% of selling price

Solving for price (P):
  P - $78.38 - 0.05P = 0.18P
  P - 0.05P - 0.18P = $78.38
  0.77P = $78.38
  P = $101.79  (full cost-plus price at 18% NOM and 5% commission)
```

2.2 Markup vs. Margin: The Calculation That Confuses Everyone

One of the most persistent sources of pricing errors — and occasionally financial misstatement — is the confusion between markup (a percentage added to cost) and margin (a percentage of selling price). A 25% markup on a $100 cost produces a $125 price and a 20% margin. A 25% margin on a $100 cost produces a $133.33 price and a 25% margin. When sales teams say they need to 'make a 30% margin' but the pricing system calculates a 30% markup, the company consistently underprices every deal — and no one realizes it until someone builds the full P&L.;

MARKUP VS. MARGIN — THE CRITICAL DISTINCTION

```
MARKUP: Return expressed as % of COST
  Price = Cost x (1 + Markup%)
  Example: $80 cost x 1.25 = $100 price  (25% markup)
  The margin on this price: ($100 - $80) / $100 = 20%

MARGIN: Return expressed as % of PRICE (SELLING PRICE)
  Price = Cost / (1 - Margin%)
  Example: $80 cost / (1 - 0.25) = $106.67 price  (25% margin)
  The markup on this cost: ($106.67 - $80) / $80 = 33.3%

CONVERSION:
  Margin% = Markup% / (1 + Markup%)
  Markup% = Margin% / (1 - Margin%)

Common Error: Sales rep says 'we need 40% margin' and finance
  calculates 40% MARKUP. Resulting price is $112 vs. correct $133.33.
  Under-recovery: $21.33 per unit x annual volume = material profit leak.
```

CFO INSIGHT

Audit your pricing system and your sales team's pricing language for markup vs. margin confusion. This is not a theoretical risk — it is one of the most common sources of systematic underpricing in manufacturing, distribution, and professional services businesses. A $5M revenue business where the pricing system uses markup when the target is expressed as margin, with a 40% markup used instead of a 40% margin, is underpricing by approximately 18% on every deal. That is a $900,000 annual revenue leak that does not appear anywhere in the P&L; as a line item — it simply shows up as gross margin that is persistently below target with no obvious explanation.

SECTION 3
TARGET RETURN PRICING

Target Return Pricing: Pricing to Capital

Target return pricing is a variant of cost-plus that incorporates the cost of capital explicitly into the price calculation. Rather than targeting a fixed markup or margin percentage, it targets a specific return on the

capital invested in a product line, a business unit, or the entire enterprise. It is the pricing methodology most aligned with shareholder value creation because it explicitly links pricing to the return on invested capital (ROIC) that investors require.

3.1 Target Return Pricing Mechanics

Target return pricing requires knowing — or estimating — the total capital employed in the product or product line being priced. Capital employed includes net fixed assets (property, plant, equipment net of depreciation), net working capital (inventory plus receivables minus payables), and any other assets directly attributable to the product. The target return — expressed as a required ROIC — is then applied to this capital base to determine the required annual profit. That required profit is then expressed as a per-unit contribution that, divided over the expected volume, gives the required contribution per unit and therefore the required price.

TARGET RETURN PRICING CALCULATION

```
Capital Employed in Product Line:
  Net PP&E allocated to product line:     $12,000,000
  Net Working Capital (Inv + AR - AP):     $3,500,000
  Total Capital Employed:                 $15,500,000

Required Return on Capital: 15% (WACC + risk premium)
Required Annual Profit:     $15,500,000 x 15% = $2,325,000

Expected Annual Volume:     50,000 units
Required Profit per Unit:   $2,325,000 / 50,000 = $46.50/unit

Variable Cost per Unit:     $62.50
Fixed Cost per Unit (allocated): $22.00
Total Unit Cost:            $84.50

Target Return Price = Total Unit Cost + Required Profit/Unit
  = $84.50 + $46.50 = $131.00/unit

Sanity check: At 50,000 units: Revenue = $6,550,000
  Less Costs: $84.50 x 50,000 = $4,225,000
  Profit: $2,325,000  |  ROIC: $2,325,000 / $15,500,000 = 15% ✓
```

3.2 The Volume Assumption Problem

Target return pricing has a critical structural weakness: the required profit per unit depends on the assumed volume, and the assumed volume depends on the price. This circularity — known as the chicken-and-egg problem of cost-plus pricing — means the price calculated under target return pricing is only correct if the volume assumption is correct. If the market responds to a $131 price with only 35,000 units of demand rather than the assumed 50,000, the actual ROIC will be far below the 15% target.

The correct response to this problem is to build a sensitivity table that shows the ROIC at different combinations of price and volume, and to evaluate the probability distribution of outcomes rather than anchoring on a single target return price. This transforms target return pricing from a deterministic calculation into a probabilistic risk analysis — which is closer to how capital allocation decisions should actually be made.

Price	Volume (units)	Revenue	Total Cost	Profit	ROIC
$115	65,000	$7,475,000	$5,492,500	$1,982,500	12.8%
$125	55,000	$6,875,000	$4,647,500	$2,227,500	14.4%
$131	50,000	$6,550,000	$4,225,000	$2,325,000	15.0%
$140	42,000	$5,880,000	$3,549,000	$2,331,000	15.0%
$155	32,000	$4,960,000	$2,704,000	$2,256,000	14.6%
$170	22,000	$3,740,000	$1,859,000	$1,881,000	12.1%

The sensitivity table reveals that the 15% target ROIC can be achieved at either $131 (50,000 units) or $140 (42,000 units). The $140 price produces essentially the same profit with 16% fewer units — meaning less operational complexity, lower working capital, and potentially lower supply chain risk. This is the kind of pricing insight that a pure cost-plus approach would never reveal. Build the sensitivity table before committing to any cost-based price.

SECTION 4
CONTRIBUTION MARGIN PRICING

Contribution Margin Pricing: The Floor in Variable Cost Decisions

Contribution margin pricing sets the price floor at variable cost — the price below which each unit sold actually reduces total profit by consuming more in variable costs than it generates in revenue. It is not a complete pricing strategy on its own (a business that prices at variable cost with no contribution to fixed costs will fail), but it is the essential analytical framework for short-term pricing decisions involving marginal capacity, special orders, competitive bidding, and incremental volume opportunities.

4.1 The Contribution Margin Floor

Any price above variable cost makes a positive contribution to covering fixed costs and generating profit. A business with excess capacity that accepts an order at above variable cost is better off than one that leaves that capacity idle — even if the order price is below full cost. This is the fundamental logic of contribution margin pricing and the basis for many legitimate pricing strategies: the introductory price, the penetration price, the loss-leader, the capacity-filling special order.

CONTRIBUTION MARGIN PRICING DECISION

```
Variable Cost per Unit:          $42.00
Fixed Cost per Unit (allocated):  $28.00
Full Cost per Unit:              $70.00
Current selling price:           $85.00

Special Order: Customer offers $58 per unit for 2,000 units
  (Plant has 2,000 units of idle capacity; no additional fixed costs)

Full Cost Analysis: $58 < $70 full cost -> REJECT (wrong answer)

Contribution Margin Analysis:
  Contribution per unit: $58 - $42 = $16.00 per unit
  Total contribution from order: $16 x 2,000 = $32,000
  No additional fixed costs incurred
  -> ACCEPT: adds $32,000 to operating profit

Key condition: Fixed costs do NOT increase with this order.
  If accepting order requires additional fixed costs > $32,000, REJECT.
  If accepting harms regular customers' pricing, factor in that risk.
```

4.2 The Danger of Contribution Margin Pricing as a Permanent Strategy

Contribution margin pricing is a valid framework for marginal decisions with excess capacity. It becomes dangerous when it is applied as a permanent pricing strategy — when the company habitually prices at or near variable cost under the belief that 'at least we are making some contribution.' The danger is threefold. First, if the business consistently prices below full cost, fixed costs are never fully recovered and the business loses money in aggregate. Second, pricing below full cost sends a market signal that the product is worth less than it costs to make, which is difficult to reverse. Third, customers who learn they can obtain below-full-cost pricing will use every negotiating tactic to maintain that pricing indefinitely.

CFO INSIGHT

Establish a two-tier pricing floor for every product line: the contribution margin floor (variable cost) and the full cost floor (variable cost plus allocated fixed costs). Prices between the contribution margin floor and the full cost floor should be treated as exceptions — available only for specific circumstances (idle capacity, strategic customer, competitive win-back) and only with explicit CFO approval. Prices above the full cost floor and below the target margin should be treated as acceptable but tracked for trend. The CFO who allows pricing between the two floors to become habitual without monitoring and approval will wake up to a gross margin problem that is very difficult to reverse once customers have anchored to those prices.

SECTION 5

BREAK-EVEN ANALYSIS FOR PRICING DECISIONS

Break-Even Analysis: How Many Units, at What Price

Break-even analysis is one of the most versatile tools in the pricing toolkit. It answers several related questions: how many units must be sold at a given price to cover all costs and generate zero profit (the break-even volume)? What is the minimum price at which a given volume of sales covers all costs (the break-even price)? How does a price change affect the break-even volume? And how sensitive is the break-even to changes in costs or volume assumptions? These questions are relevant to every pricing decision — from setting the launch price of a new product to evaluating the financial impact of a price increase.

5.1 Break-Even Volume at a Given Price

BREAK-EVEN VOLUME CALCULATION

```
Break-Even Volume = Fixed Costs / (Price - Variable Cost per Unit)
                  = Fixed Costs / Contribution Margin per Unit

Example: New product launch
  Fixed Costs (annual):           $1,800,000
  Variable Cost per Unit:             $38.00
  Launch Price:                       $72.00
  Contribution Margin per Unit:   $72 - $38 = $34.00

  Break-Even Volume: $1,800,000 / $34.00 = 52,941 units

Break-Even at Different Prices:
  Price $60: CM = $22  |  BEV = $1.8M / $22 = 81,818 units
  Price $72: CM = $34  |  BEV = $1.8M / $34 = 52,941 units
  Price $85: CM = $47  |  BEV = $1.8M / $47 = 38,298 units
  Price $100: CM = $62 |  BEV = $1.8M / $62 = 29,032 units

Higher price = lower break-even volume; but must assess market demand
```

5.2 Break-Even Analysis for Price Changes

When a company is considering a price increase (or decrease) on an existing product, the relevant break-even question is: what volume can the company afford to lose (or must it gain) for the price change to be profit-neutral? This is the volume indifference point — the volume change that leaves total contribution margin unchanged. If the price increase generates less volume loss than the indifference point, the price increase improves profit. If it generates more volume loss, the price increase hurts profit.

BREAK-EVEN VOLUME CHANGE FOR PRICE INCREASE

```
Maximum Allowable Volume Loss = (Price Increase x Current Volume)
                                / (New Price - Variable Cost)

As a %: Maximum Volume Loss % = Price Increase % / (New CM% x 100)
  Where New CM% = (New Price - Variable Cost) / New Price

Example: Current price $80 (CM = $42); propose $88 (+10%); VC = $38
  New CM = $88 - $38 = $50
  Maximum Volume Loss = ($8 x 10,000 units) / $50 = 1,600 units (16%)

  If estimated volume loss from 10% price increase = 8% (inelastic market):
    Volume lost: 800 units  |  800 < 1,600 -> Price increase is PROFITABLE

  If estimated volume loss = 20% (elastic market):
    Volume lost: 2,000 units  |  2,000 > 1,600 -> Price increase DESTROYS profit
```

5.3 Multi-Product Break-Even and Product Mix

For businesses with multiple products, the break-even analysis must account for product mix — the relative proportion of high-margin and low-margin products in the sales mix. A company that breaks even on a blended basis may be very profitable on one product line and deeply unprofitable on another. Pricing changes that shift the mix toward higher-margin products improve the blended break-even; changes that shift toward lower-margin products worsen it.

WEIGHTED AVERAGE CONTRIBUTION MARGIN AND MIX

```
Product Portfolio:
  Product A: $45 CM; 60% of mix  -> Weighted CM: $27.00
  Product B: $28 CM; 30% of mix  -> Weighted CM:  $8.40
  Product C: $12 CM; 10% of mix  -> Weighted CM:  $1.20
  Weighted Average CM:                           $36.60

Fixed Costs: $2,196,000
Break-Even Volume (blended): $2,196,000 / $36.60 = 60,000 units

If mix shifts: Product A drops to 40%; Product B rises to 50%
  New Weighted CM: ($45 x 40%) + ($28 x 50%) + ($12 x 10%) = $33.20
  New Break-Even: $2,196,000 / $33.20 = 66,145 units (+10.2% more volume needed)

Mix shift toward lower-margin products raises break-even:
  The company must sell 6,145 more units to break even — at the same prices.
  Pricing strategy must actively protect high-CM product revenue.
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SECTION 6

OVERHEAD ALLOCATION AND ACTIVITY-BASED COST PRICING

Overhead Allocation: How Cost Allocation Choices Drive Pricing Errors

The way overhead costs are allocated to products and services has a profound and largely unrecognized impact on cost-plus pricing. Overhead allocation methods — whether direct labor hours, machine hours, revenue-based allocation, or activity-based costing — produce dramatically different costs per unit for the same product, and therefore dramatically different prices when cost-plus is applied. A company that allocates overhead on a revenue basis will systematically overprice its high-revenue products (which absorb too much overhead) and underprice its low-revenue, high-complexity products (which absorb too little). The result is a cross-subsidy that benefits some products at the expense of others — and the financial statements will show no obvious sign of the distortion.

6.1 Traditional vs. Activity-Based Cost Allocation

Traditional overhead allocation methods — direct labor hours, machine hours, units of output — were designed for manufacturing environments where overhead was a relatively small portion of total cost and was fairly uniform across products. In modern businesses, particularly service businesses and complex manufacturing, overhead often exceeds direct costs and varies dramatically by product complexity, order size, customer requirements, and service intensity. Applying a single overhead allocation rate across a diverse product portfolio produces costs that are systematically wrong for most products.

Allocation Method	Mechanism	When It Works	When It Fails	Pricing Risk
Labor Hour Rate	Overhead / Total DLH → applied per DLH consumed	Labor-intensive; similar products; uniform complexity	Automated products with minimal labor	High-labor products overpriced; automated underpriced
Machine Hour Rate	Overhead / Total Machine Hours → per machine hour	Capital-intensive; machine-driven processes	Labor-intensive services; variable machine efficiency	High-machine products overpriced vs. manual
Revenue-Based	Overhead / Total Revenue → % of selling price	Simple; widely understood	Never appropriate for pricing (circular logic)	Severely distorts relative product costs
Units of Output	Overhead / Total Units → per unit	Commodity; single product	Diverse products with different complexity	Complex products grossly undercosted
Activity-Based Costing	Overhead by activity (setups, orders, inspections) → activity rates	Complex portfolios; service businesses	Requires significant setup; costly to maintain	Most accurate; reveals true product economics

6.2 Activity-Based Costing for Pricing

Activity-Based Costing (ABC) allocates overhead costs to products based on the activities that drive those costs — the number of production setups required, the number of customer orders processed, the number of quality inspections, the number of engineering change notices. By connecting overhead costs to the activities that create them, ABC reveals the true cost of serving different products, customers, and channels — and therefore the true basis for pricing decisions.

ABC PRICING EXAMPLE

```
Two products: Simple Widget (SWG) and Complex Widget (CWG)
Traditional allocation (DLH-based, $45/DLH overhead rate):
  SWG: 0.5 DLH x $45 = $22.50 overhead/unit
  CWG: 0.8 DLH x $45 = $36.00 overhead/unit

Activity-Based Allocation:
  Machine Setups (SWG: 1/1,000 units; CWG: 1/50 units; $800/setup)
    SWG: $800/1,000 = $0.80/unit  |  CWG: $800/50 = $16.00/unit
  Quality Inspections (SWG: 1/500 units; CWG: 1/20 units; $120/inspection)
    SWG: $0.24/unit  |  CWG: $6.00/unit
  Order Processing ($35/order; SWG: 1/200 units; CWG: 1/10 units)
    SWG: $0.18/unit  |  CWG: $3.50/unit
  Total ABC Overhead: SWG: $1.22/unit  |  CWG: $25.50/unit

Pricing Impact (30% margin target):
  Traditional: SWG = $58.50/0.70 = $83.57  |  CWG = $92.00/0.70 = $131.43
  ABC-based:   SWG = $37.22/0.70 = $53.17  |  CWG = $81.50/0.70 = $116.43

Traditional method OVERPRICES simple products; UNDERPRICES complex ones.
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CFO INSIGHT

The ABC analysis almost always reveals the same uncomfortable truth: simple, high-volume, standard products are overpriced relative to their true cost, while complex, low-volume, custom products are underpriced. This cross-subsidy means the company is simultaneously losing price-competitive positions on its most standard products (because competitors who correctly cost those products can undercut them) while unknowingly subsidizing its most complex products (which consume disproportionate overhead). The CFO who commissions an ABC study and integrates the results into pricing is not just improving pricing accuracy — they are identifying which product lines are genuinely profitable and which are consuming more overhead than the price they command covers.

SECTION 7

WHEN COST-PLUS IS THE RIGHT APPROACH

The Legitimate Uses of Cost-Plus Pricing

Having established the limitations and dangers of cost-plus pricing, it is essential to identify the specific circumstances where cost-plus is not merely defensible but is actually the correct pricing methodology. The CFO who dismisses cost-plus entirely as an unsophisticated approach will find themselves unable to price in regulated industries, government contracting, utility services, and certain professional services contexts where cost-plus is mandated, expected, or structurally appropriate.

7.1 Regulated Industries and Government Contracting

In US federal government contracting, the Federal Acquisition Regulation (FAR) and Cost Accounting Standards (CAS) establish detailed requirements for how costs must be accumulated, allocated, and used in pricing. Cost-plus-fixed-fee (CPFF), cost-plus-incentive-fee (CPIF), and time-and-materials (T&M;) contract types are defined and regulated. The Defense Contract Audit Agency (DCAA) audits contractor cost accounting systems and pricing submissions. In this environment, cost-plus is not a choice — it is a requirement. The CFO of a defense contractor must build and maintain a DCAA-compliant cost accounting system or risk contract disqualification and potential debarment.

Context	Why Cost-Plus Is Appropriate	Regulatory Framework	CFO Priority
Federal Government Contracting	Mandated; transparency required; profit limited by statute	FAR; CAS; DCAA audits	Compliant cost accounting system; indirect rate management
Electric / Gas Utilities	Rate-of-return regulation; allowed profit set by PUC	State PUC; FERC (interstate)	Rate base management; cost of service testimony
Healthcare (Medicare/Medicaid)	Cost-based reimbursement for certain services; cost reports	CMS; state Medicaid agencies	Cost report accuracy; allowable cost compliance
Construction (cost-reimbursable)	Project scope uncertain; owner prefers cost transparency	AIA contract forms; GAAP project accounting	Cost controls; change order management; fee optimization
New/Unique Products	No market data; customer also uncertain of value	No regulatory framework; commercial context	Build EVC analysis alongside cost-plus as sanity checks
Cost-Recovery Pricing (NFPs)	Mission to provide service at cost; no profit objective	IRS 501(c)(3); grant compliance	Full cost recovery; avoid under-pricing that depletes reserves

7.2 New Product Pricing When Market Data Is Scarce

When a company launches a genuinely new product — one with no direct competitors and no existing market — the absence of market pricing data makes competition-based pricing impossible. The customer's WTP is unknown because the customer has no experience with the product and no basis for evaluating its value. In this situation, cost-plus pricing provides a reasonable starting point: it ensures the company is not pricing below cost while market data is accumulated. The critical discipline is to treat the initial cost-plus price as provisional and to update it aggressively as market feedback reveals actual WTP and competitive positioning.

The most common mistake in new product pricing is treating the initial cost-plus price as permanent once it is established. Customers anchored to the initial price resist subsequent price increases even when market data clearly supports a higher price. The CFO should establish a formal pricing review milestone 90 to 180 days after product launch, incorporating actual WTP research, competitive intelligence, and financial performance data to determine whether the initial price should be maintained, raised, or lowered.

SECTION 8
INFLATION AND COST PASS-THROUGH PRICING

Inflation Pass-Through: Maintaining Margin When Costs Rise

Inflation — sustained increases in input costs including raw materials, energy, labor, and logistics — creates an urgent pricing challenge that sits at the intersection of cost-plus and value-based pricing. The cost-plus imperative says: raise prices to recover increased costs. The value-based reality says: the market will only accept the price increase if customers perceive sufficient value. The CFO who manages inflation-driven price increases purely as a cost pass-through exercise — mechanically adding inflation to prices without considering customer perception and competitive dynamics — will find some increases stick and others generate catastrophic volume loss.

8.1 The Cost Pass-Through Decision Framework

INFLATION PASS-THROUGH ANALYSIS

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Input Cost Increase: Raw materials +18%; energy +12%; labor +6%

Current Unit Economics:
  Raw Materials:    $28.00 (35% of COGS)
  Energy:            $8.00 (10% of COGS)
  Labor:            $20.00 (25% of COGS)
  Other COGS:       $24.00 (30% of COGS)
  Total COGS:       $80.00
  Current Price:   $120.00  (33.3% gross margin)

New Costs After Inflation:
  Raw Materials: $28.00 x 1.18 = $33.04  (+$5.04)
  Energy:         $8.00 x 1.12 =  $8.96  (+$0.96)
  Labor:         $20.00 x 1.06 = $21.20  (+$1.20)
  New Total COGS: $87.20  (+$7.20; +9.0% cost increase)

To maintain 33.3% gross margin: New Price = $87.20 / 0.667 = $130.73
  Required price increase: +8.9% to maintain margin

Pricing Power Test: Can market bear 8.9% price increase?
  Price elasticity ε = -0.5: Volume loss = 8.9% x 0.5 = 4.5%
  Revenue at $130.73 x 95.5% volume: effectively maintained net revenue
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8.2 Indexation Clauses in Long-Term Contracts

For businesses with long-term supply contracts — particularly in manufacturing, energy, and professional services — building price indexation clauses into contracts is the most effective long-term tool for managing inflation exposure. An indexation clause ties the contract price to a defined external index (CPI, PPI, a specific commodity price index, wage indices) and provides for automatic price adjustments when the index moves beyond a defined threshold. Indexation clauses protect both parties: the seller from cost increases that erode margin, and the buyer from uncertainty about future pricing.

The CFO should evaluate every long-term contract above a materiality threshold for the absence of indexation provisions and should advocate for their inclusion in new contracts as a standard practice. A manufacturing business that signed three-year supply contracts without indexation in 2020 absorbed the full cost of the 2021–2022 inflation surge in their own margin. A comparable business with CPI-plus indexation clauses passed through a significant portion of that inflation automatically, without the negotiation friction

and customer relationship strain of reactive price increase requests.

SECTION 9
METRICS FRAMEWORK AND CFO CHECKLIST

Cost-Based Pricing Metrics and the CFO Checklist

9.1 Cost-Based Pricing Metrics

Metric	Formula	Benchmark / Target
Gross Margin % (realized)	(Revenue - COGS) / Revenue	Track vs. target margin; declining = pricing or cost failure
Contribution Margin % (by product)	(Price - Variable Cost) / Price	Track by SKU; below 30% warrants review
Break-Even Volume (per product)	Fixed Costs / Contribution Margin per Unit	Model at current price; sensitivity to ±10% price
Price/Cost Ratio	Selling Price / Total Unit Cost	Must exceed 1.0 always; target depends on model
Markup Realization Rate	Actual GM% / Target GM%	>95% healthy; <90% = systematic under-pricing
Cost Recovery Index	Actual Revenue / Break-Even Revenue	>1.20 comfortable; <1.05 = fragile margin cushion
Inflation Pass-Through Rate	% of cost increase recovered in price increase	Target: >80% pass-through within 2 quarters
Overhead Absorption Rate	Applied Overhead / Budgeted Overhead	>95% absorption; <85% = volume below budget
ABC Accuracy Index	Prices based on ABC vs. traditional allocation	Commission ABC study; track pricing changes post-adoption
Weighted Average CM (blended)	Sum(CM per product x Mix %)	Track vs. target; mix shift impact visible monthly

9.2 CFO Operating Checklist

- Markup vs. margin terminology standardized across all sales and finance systems: confirmed that 'margin' means percentage of selling price; no system calculates markup when margin is intended.
- Full cost stack documented for each major product or service: all cost components identified, including overhead allocations; updated at least annually and when input costs change materially.
- Contribution margin floor defined for each product line: approved by CFO; communicated to sales leadership; any deal below floor requires CFO approval and documentation.
- Break-even analysis maintained for each product line: break-even volume at current price; volume change required for price increase to be profit-neutral; sensitivity table prepared.
- Overhead allocation method documented and reviewed annually: ABC study commissioned for any product portfolio with significant complexity variation; results integrated into pricing.
- Cost pass-through model built for major input categories: inflation scenarios modeled at current and ±10% input cost levels; price response strategy defined before inflation event occurs.
- Long-term contracts reviewed for indexation provisions: contracts >12 months and >$500K without indexation flagged; renewal strategy includes indexation provision as standard clause.
- Government/regulated pricing (if applicable): DCAA-compliant cost accounting system operational; indirect rates calculated and filed on schedule; forward pricing rate agreements current.
- Target return pricing model maintained: capital employed by product line calculated; ROIC at current price vs. target ROIC tracked quarterly; below-target ROIC triggers pricing review.

Closing Perspective: Cost as Floor, Not Ceiling

The central discipline of cost-based pricing is understanding what it is and what it is not. It is the financial foundation that prevents a business from destroying value through systematically unprofitable pricing. It is the compliance framework that regulated industries require. It is the analytical tool for marginal capacity decisions and special orders. It is the inflation management mechanism that protects margin when input costs rise. What it is not is a substitute for market intelligence, customer insight, or value-based thinking.

The most sophisticated pricing organizations use cost-based analysis as a starting point and a constraint — not as the primary determinant of price. They start from costs to establish the floor, then look to value and competition to determine where above the floor the price should actually be set. The price waterfall analysis establishes what the company actually receives after all discounts; the break-even analysis shows what volume is required at different price points; and the activity-based cost analysis reveals which products are genuinely profitable and which are cross-subsidized.

Armed with this foundation, the CFO is ready to engage with the higher levels of pricing strategy — the value-based frameworks, the psychological pricing tools, and the dynamic pricing architectures — that determine how far above the cost floor the price can be set and sustained. The cost floor without the value ceiling produces pricing that is financially sound but commercially mediocre. The value ceiling without the cost floor produces pricing that is commercially ambitious but financially unsustainable. Mastering both is the discipline of pricing strategy.

Part 3 covers Value-Based Pricing in depth — the EVC framework applied systematically across customer segments, conjoint analysis and the Van Westendorp Price Sensitivity Meter, segmentation and WTP variation, the value case for enterprise sales, and how to document and communicate value in a way that commands premium prices.

End of Part 2: Cost-Plus and Break-Even Pricing | Pricing Strategy — A 14-Part Series

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