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Indirect Cost Factors In Menu Pricing

Abstract

In the discussion - Indirect Cost Factors in Menu Pricing – by David V. Pavesic, Associate Professor, Hotel, Restaurant and Travel Administration at Georgia State University, Associate Professor Pavesic initially states: “Rational pricing methodologies have traditionally employed quantitative factors to mark up food and beverage or food and labor because these costs can be isolated and allocated to specific menu items. There are, however, a number of indirect costs that can influence the price charged because they provide added value to the customer or are affected by supply/demand factors. The author discusses these costs and factors that must be taken into account in pricing decisions.

Professor Pavesic offers as a given that menu pricing should cover costs, return a profit, reflect a value for the customer, and in the long run, attract customers and market the establishment. “Prices that are too high will drive customers away, and prices that are too low will sacrifice profit,” Professor Pavesic puts it succinctly.

To dovetail with this premise the author provides that although food costs measure markedly into menu pricing, other factors such as equipment utilization, popularity/demand, and marketing are but a few of the parenthetic factors also to be considered.

“... there is no single method that can be used to mark up every item on any given restaurant menu. One must employ a combination of methodologies and theories,” says Professor Pavesic. “Therefore, when properly carried out, prices will reflect food cost percentages, individual and/or weighted contribution margins, price points, and desired check averages, as well as factors driven by intuition, competition, and demand.”

Additionally, Professor Pavesic wants you to know that value, as opposed to maximizing revenue, should be a primary motivating factor when designing menu pricing. This philosophy does come with certain caveats, and he explains them to you.

Generically speaking, Professor Pavesic says, “The market ultimately determines the price one can charge.” But, in fine-tuning that decree he further offers, “Lower prices do not automatically translate into value and bargain in the minds of the customers. Having the lowest prices in your market may not bring customers or profit.

“Too often operators engage in price wars through discount promotions and find that profits fall and their image in the marketplace is lowered,” Professor Pavesic warns.

In reference to intangibles that influence menu pricing, service is at the top of the list. Ambience, location, amenities, product [i.e. food] presentation, and price elasticity are discussed as well. Be aware of price-value perception; Professor Pavesic explains this concept to you.

Professor Pavesic closes with a brief overview of a la carte pricing; its pros and cons.

Keywords

David V. Pavesic, Indirect Cost Factors in Menu Pricing, Value, Food Cost, Price-value, A la carte, Beverage

Indirect Cost Factors In Menu Pricing

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Rational pricing methodologies have traditionally employed quantitative factors to mark up food and beverage or food and labor because these costs can be isolated and allocated to specific menu items. There are, however, a number of indirect costs that can influence the price charged because they provide "added value" to the customer or are affected by supply/demand factors. The author discusses these costs and factors that must be taken into account in pricing decisions.

Regardless of the methodology used to mark up food and beverages, prices charged by commercial food services must not only cover costs but return a profit as well. Pricing is an important function that directly influences customer counts and sales revenues. The optimum price must not only include some contribution to profit but it must also be deemed fair and reasonable by the public.

Of all the business decisions a restaurateur has to make, one that causes much anxiety is pricing the menu. Whenever pricing decisions require raising prices, the operator mentally prepares for some adverse customer response which usually comes in the form of spoken comments and the dreaded dropping customer counts. Consequently, the task of menu pricing is beset with misgivings and uncertainty. Prices that are too high will drive customers away, and prices that are too low will sacrifice profit. The main reason for this anxiety may well be the highly subjective methodology used to price menus in the first place. Anxiety results over whether the approach to pricing is the best or the right one for the respective menu items, existing market conditions, and the operational concept.

Prices partially influence which menu items will sell and therefore impact the overall profitability of the sales mix. The menu sales mix will, in turn, influence everything from equipment utilization to marketing efforts. Menu items will differ widely in cost, popularity, and profitability. In addition, the amount of labor required will differ from item to item. Thus pricing is not a simple matter of markup over cost, but an intricate combination of factors that involve both financial and competitive elements.

There are a number of other considerations that must be taken into account when it comes to pricing decisions. Prices can be market driven or demand driven, and depending upon the uniqueness or monopolistic aspects of the menu and operation, the approach to

pricing will differ. Costing out an entree and accompaniments is a relatively objective and logical process. Establishing a price for it is more of an art. Whatever the pricing methodology, there is no single method that can be used to mark up every item on any given restaurant menu. One must employ a combination of methodologies and theories. Therefore, when properly carried out, prices will reflect food cost percentages, individual and/or weighted contribution margins, price points, and desired check averages, as well as factors driven by intuition, competition, and demand.

Qualitative Factors Enter Into Pricing

If pricing were a purely quantitative exercise, a computer program that would incorporate operating costs, profit objectives, and raw food costs could be used to set menu prices. However, such an approach lacks important "qualitative" factors that enter into the pricing decision. It has been said of most retail products and services that the buyer determines the price, not the seller. Therefore the seller must be able to offer a product or service and make a profit selling it at the price the customer is willing to pay. Value judgments are hard to program into a cost-markup pricing program.

Menu pricing philosophies are as diverse as political and theological beliefs and sometimes just as controversial. Initially it was the popular belief that only raw food costs should be marked up to obtain a targeted food cost percentage. More often than not, the targeted food cost percentage was arbitrarily determined by simply copying a successful competitor or trying to match some industry average. The method of determining a targeted food cost percentage has been improved and one can analytically determine a realistic food cost standard based on each operation's financial and budgetary idiosyncrasies. However, a unit's financial limitations or profit demands may not be compatible or realistic with the existing economic or market conditions. If prices are too high relative to what competition is charging, if quality is too low, or if portions are so small as to negate the price-value relationship, sales and profit objectives may still not be realized.

A question often asked by restaurateurs is: "What price should I charge?" The response was, initially, "Charge the highest price you think the customer will pay." Finding that particular price point is not easy, and if one prices at that point, expect the customer to be more demanding and critical of the food and service.

A different perspective was offered by successful New York restaurateur Michael Weinstein during a recent Multiple Unit Food Service Operators Conference, sponsored annually by *Nation's Restaurant News*. Rather than charging the highest price the customer will pay, he charges the lowest price at which he can offer the item and still make a reasonable profit. In all fairness, Weinstein's restaurants are primarily on the upper west side of New York City, and this pricing philosophy shows dramatic contrast to comparable restaurants in Manhattan. His reasoning is that if you price at the high end, your operation must be on the "cutting edge" of excellence in food quality,

preparation, service, and atmosphere. He achieves satisfaction from customers who praise the price-value offered on his menus. People almost always comment on the reasonableness of the prices, the large portion sizes, and the high quality of the ingredients. Therefore, the two perspectives on how much to charge are charge as much as you can or charge as little as you can. Keep in mind that the success of any pricing methodology is influenced by many factors, including location, competition, clientele, and restaurant concept. What works on the upper west side of New York may flop in Atlanta, Georgia.

More often than not, prices are predominantly influenced by competition and/or customer demand. Whenever demand is greater than supply, pricing methodologies that favor higher gross profits and higher check averages can be effective in maximizing revenue. On the other hand, if customer counts are flat and strong competition exists for the products and services, such pricing would be disastrous.

Market Determines Prices

The market ultimately determines the price one can charge. If you charge too much, your customers will go somewhere else. However, it is important to interject a warning at this point. Lower prices do not automatically translate into "value" and "bargain" in the minds of the customers. Having the lowest prices in your market may not bring customers or profit. Too often operators engage in price wars through discount promotions and find that profits fall and their image in the marketplace is lowered.

Once initial prices are determined, adjustments up and down will be made after examining the price spread between the lowest and the highest priced items. Every restaurant will be categorized by customers according to the prices it charges. Customers will place a restaurant into one of three categories: low, moderate, and high priced. Specific numerical check averages are not given because customers, depending upon their incomes, will apply their own dollar ranges when rating restaurants in each category.

The restaurant's menu prices must be in line with the price category in which the majority of its customers place the operation. If prices of some items exceed that range, customers will not purchase many of those items. If prices are too low, there is a danger of lowering the overall image and the check average may drop.

In addition to placing the restaurant into a price category, customers will evaluate a restaurant as a place to "eat-out" or as a place to "dine-out." If a restaurant is considered an "eat-out" operation during the week (a substitute for cooking at home), customers will be more price-conscious. If a restaurant is considered a "dine-out" operation, the visit is regarded more as a social occasion and entertainment and price is not as much of a factor.

Knowing how patrons evaluate a restaurant is important to the pricing decision. Rarely will a restaurant be rated in two categories by the same patron. Frequency of visits to an "eat-out" operation will be greater than to the "dine-out" operation, but amounts spent will be considerably less than in the latter. Regular weekday customers

may go elsewhere for special celebrations like anniversaries or birthdays. Weekend clientele may differ greatly from week night customers. For example, local residents may be the bulk of the traffic during the week, while weekends may bring visitors, tourists, or people traveling from outside the restaurant's normal market area. Such patrons categorize the operation as a "dine-out" or special occasion restaurant, and will travel longer distances.

What is the proper price? From the customers' point of view, it is the one that makes them buy. From the seller's perspective, the successful price is one that moves the product and produces a profit. If a menu item is common or ordinary and offered by many competitors, the price will likely be at the low end. However, if the item is special or unique and not easily duplicated by the competition, it can be priced at the high end. It behooves management to have several "specialty" items on the menu to create some competitive distinctiveness which can be enhanced by other factors such as location, atmosphere, service, entertainment, and unique product presentation.

Rational pricing methodologies have traditionally employed quantitative factors to mark up food, beverage, or food and labor costs because they can be allocated to specific menu items. There are, however, a number of indirect costs that can influence the price charged because they provide "added value" to the customer or are affected by supply/demand factors. They include the following: market standing, service commitment, ambience, customer profile, location, amenities, product presentation, desired check average, and price elasticity.

- **Market standing.** This consideration relates to the operation's position in a particular market segment, i.e., whether it is a "leader" or a "follower." Is it considered the "number one" operation in its concept category or one that is just marginally competitive? Usually the first one into the marketplace has an advantage over others that follow. Eventually, "copycat" operations go head-to-head in the same market. The one that was there first can usually be more aggressive in its pricing strategy than the "clones." However, competition will usually moderate aggressive pricing strategy. This holds true for both fast food operations and the higher check average, table service restaurants. The number one operation in a particular food service segment usually finds that the competition tries to outdo it. To do so, "copy-cats" must go at least one step further than the leader in menu selection, service, ambience, and value in order to gain ground. The leader can never become complacent and let standards decline or market share may begin to erode.

- **Service commitment.** The service element can be just as important as the actual food being served in the customer's decision on which restaurant to patronize. This is especially true when the differences in product quality, quantity, and price are difficult for the customer to distinguish. In addition, the costs of providing table service versus self-service must be reflected in pricing structure. When the customer performs many of the duties of service personnel, prices

must be lowered to compensate for the inconveniences. But even self-service restaurants have opportunities to provide services that will distinguish them from their competition. The “invisible product”—the service component—is becoming an important measure of competitive distinctiveness.

Truly personalized service, service which is driven by the needs of the customer, becomes an intangible that is recognized as an added value by the customer and can be reflected in the prices charged. Increased competition leads to increased demand for services, and service can become the basis for improving one’s market position.

- **Ambience.** The atmosphere and decor of a restaurant can add much to the enjoyment of a meal. It can turn the experience of eating out into an enjoyable social occasion. People want quality food products regardless of whether they pay a little or a lot. However, the perception of value is certainly enhanced for the customer eating in a beautifully-decorated, carpeted, appointed, and lighted dining room. Some operators spare no expense in trying to create authenticity in their restaurants. The atmosphere can be informal or formal, casual or elegant. The more luxurious the atmosphere, the higher prices are likely to be. The customer does not usually object to paying a little more to dine in such surroundings.

- **Customer profile.** Although the type of clientele that regularly frequents a restaurant is influenced to a great degree by all of the factors listed, the pricing structure can dictate the status or economic class of clientele it will attract. The higher the average check or price range, the more selective and limited your customer base will be. Whether you are attempting to attract businessmen or professional women on their lunch hour, teenagers, baby boomer adults, or families with small children, the target customer will dictate to a great degree the prices you can charge.

- **Location.** Where the restaurant is located (place) has a significant influence on the prices the customer will be willing to pay and whether the operator should price at “what the market will bear” or at relatively competitive levels. Usually, restaurants with lower check averages and prices must be located in areas of dense population and high traffic. They require many transactions to achieve sales goals. On the other hand, white tablecloth restaurants serving French and Continental fare will need fewer covers per meal period and make up for it with high average checks (prices).

Location also refers to geographic area of the country, i.e., northeast, south, midwest, and even to certain parts of a city. These conditions may predispose a restaurant operator to a menu pricing structure, e.g., Lower Manhattan versus the Upper West Side of New York City, or Chicago’s south side versus the Rush Street area, a small rural town versus a large metropolitan city, and a residential neighborhood versus a commercial district.

If a location is accessible to tourists more than to local residents, higher prices are more likely than if only local customers are sought.

Place is also reflected in the example of what can be charged for an ordinary hot dog and Pepsi. At the football or baseball park, one does not complain about paying \$2.50 for what would sell for \$1.25 at a neighborhood sandwich shop. Obviously, lack of competition enters into the pricing decision, as the fans at a stadium have few choices on where to make their purchases.

• **Amenities.** Amenities cover a number of factors that can raise the value-added perceptions of the customer. Most definitely, with all other things being equal between two competing restaurants, one with live entertainment could have a competitive edge over one that doesn't in terms of customer perceptions of value. Other examples may be free valet parking, complimentary hors d'oeuvres in the lounge, reservations, fresh flowers on the table that are given to patrons free, and house charge accounts. Such extras must eventually be reflected in prices charged.

• **Product presentation.** This is the marketing concept that proclaims, "Sell the sizzle, not the steak." The product presentation is very important in the value perception of the patron. It is often said: "We eat with our eyes." If it looks good, the guests are likely to enjoy it. The same concept works for alcoholic beverages. Restaurants spend considerable time and money selecting appropriate china and glassware to "display" food and drink. They do many things to make the product stand out and be noticed by the customer ordering it. Some even turn the presentation into a production that causes other diners in the restaurant to take notice.

The presentation can be enhanced by visual or audio accents. The hot sizzle platter (audio) used by some steak houses can get the patrons' attention when the waiter places the steak in front of the guest. A seafood assortment served on a fish-shaped platter is not common and will elicit favorable comments from customers. One restaurant serving "London broil for two" created attention by serving from a cart that was rolled through the dining room. When it reached the table, the maitre d' would hone the carving knife before slicing the London broil. The slices were placed on a superheated steak liner that sizzled and steamed when a ladle of au jus was added. Since this was the most expensive dinner on the menu, its presentation was deserved.

This type of presentation costs very little in relation to the additional price that can be charged. Another example pertains to alcoholic beverage service. If you have ever been to Pat O'Brien's in the French Quarter of New Orleans or at a luau at the Polynesian Village at Disney World, you probably ordered or saw many unique drinks being served in hollowed out pineapples, melons, and coconuts, as well as in glasses and mugs of unique shapes and sizes. They were colorfully garnished with fruit, flowers, and bamboo parasols. You probably paid in excess of \$4 for what amounted to less than 50 cents worth of liquor and fruit juice. Nobody complained about the prices because the presentation was unique and not available anywhere but in New Orleans or at Disney World.

• **Desired check average.** One cannot rely on what is referred to as the “secondary sales effect” to reach a desired check average if entrees are priced too low. (Secondary sales effect: sell appetizers, side dishes, and desserts at a la carte prices to build check averages). The reason for this is that although every customer will buy one entree, fewer than 50 percent will likely order an appetizer, side dish, or dessert. The addition of such add-ons cannot be relied upon to upgrade a \$6.95 entree to achieve a \$10 average. Pricing structure should be designed to make it impossible for a customer to spend less than a specified amount.

• **Price elasticity.** Although related to the aspect of market standing, price elasticity for a product or service is a key element in the pricing decision. Whenever demand is high (if the restaurant has waiting lines every night), the approach to pricing can be more aggressive than if the operation were one of four similar operations all within a mile of one another. In the latter situation, supply is greater than demand. In such a market, sales volume may be very sensitive to a change in price.

However, certain items on the menu can be priced higher because of their uniqueness. Signature items or house specialties can be priced at the higher end of your price range because they are only available at your operation. You create a “monopolistic” pricing situation where you can charge the “highest price the customer is willing to pay.” This type of aggressive pricing cannot be employed on highly competitive or common items like prime rib or sirloin steak. It will be limited to unique appetizers, entrees, and desserts prepared from scratch with the owner’s, manager’s, or chef’s “secret” recipe.

In past years, operators set menu price points to cover food costs and achieve a certain profit margin. This decision was tempered according to what the competition was doing. However, today operators must study customer demographics and market trends and must give more thought to the wants and needs of their clients. In maturing and saturated markets, strategically-set price points are critical to building and holding market shares.

There is the challenge to offer high value and low menu prices. This philosophy has spawned the introduction of lower-priced and lower-cost food items on many menus. Menus are showing upgraded a la carte offerings and increased variety. When prices are lowered, check averages decline, but the hope is that traffic will increase and build unit volumes. Portions on high cost items are being reduced and combined with inexpensive accompaniments because patrons are balking at paying higher prices and seem less inclined to eat so much food at one sitting. The strategy with a la carte pricing is to build check averages through add-on sales of lower-cost side dishes and desserts. However, price-value perception does not evolve solely from low price; it is a feeling that the customers have about receiving their money’s worth when they pay their check. It is a combination of price, quality, and indirect cost factors that can turn “commodities” into “specialties.”

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