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EC92-887 Pricing for Profit

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Pricing for Profit

Carol Thayer
Small Business Entrepreneurship

Pricing is systematically determining the "right" price for a product or service.

Pricing is systematically determining the "right" price for a product or service. Setting a price is easy, but determining the "right" price is more difficult.

The "right" price must be high enough to cover all costs and allow for a profit, yet low enough to attract customers and encourage them to buy. The "right" price is not necessarily the one that will create the most business, but the one that will maximize profits. Overpricing products or services may lead customers away while underpricing may decrease or eliminate profit.

Pricing can be an educated guess or an orderly analysis. A guess can risk the success of a business. Pricing decisions must be based on information carefully collected and analyzed. The more facts available before pricing, the greater the opportunity to price effectively.

Ask yourself the following questions: What is the "going price" for similar products/services in this market area? How does my product/service compare to those already available? What do my records tell me about my direct costs and overhead expenses? Can I sell it at a comparable price, pay expenses, and have any left for self-labor and business management?

Pricing Strategy Objectives

The price should:

- be high enough to cover all costs including compensation for labor and management of the business.
- include a profit.
- be competitive.
- be flexible and change as conditions change.
- be reasonable enough to appeal to customers in the area.
- promote the long-range welfare of the business.

A price that covers only costs is the lowest price at which products and services can be sold over a period of time. A price that takes into consideration what customers will pay is the highest price that can be charged. Unless the second price is greater than the first, a business cannot be profitable.

Pricing Goal

The pricing goal of a business will help determine the pricing strategy. A business owner must set goals carefully. Is the goal to...

- maximize profits?
- obtain a specific return on investment?



The pricing goal of a business will help determine the pricing strategy.

- increase sales volume?
- increase market share?
- meet or beat competitor's prices?
- maintain or create a certain image?
- improve customer relations?

A short-term goal may include stabilizing cash flow while long-term goals may be to increase market share and profits.

What Will Customers Pay?

Customers pay a price consistent with their perceived value of the product or service. Perceived value includes much more than price and takes into account other features such as quality, service, style and other less tangible items.

Products and services should be positioned in an appropriate market to attract customers you have targeted. Clients who are status conscious and in the upper income brackets may be willing to pay a premium for superior service or for a product that has a prestigious image. Setting the price as low as possible may not attract these customers.

On the other hand, a low price on a product that can be produced in quantity may bring success in a market where customers are looking for value. Also, geographic location has a lot to do with the amount people will spend. The key to setting prices is to incorporate costs with knowledge of the target market.

Pricing Products vs. Pricing Services

Although many pricing principles are the same whether producing a product or providing a service, there are some differences.

When selling a product, there is the potential for income whether you are working or not. For example, products in retail outlets may sell at any time. In a service business, income is directly related to the number of hours worked. When work stops because of illness or vacation, income stops until work begins again. Unless employees are added, it is difficult to increase business.

Pricing a Service

Setting fees in a service business is sometimes difficult. Think through the factors that directly affect business and determine the best pricing method.

Here are some factors to consider when pricing a service:

- *Size and difficulty of project.* A detailed job takes more time and skill.
- *Skills.* Compare your skills with others in the area. Don't be afraid to value the quality of the work.
- *Speed.* You are the best judge of how fast you can work and still maintain high quality work. Remember, quality service is the best advertisement.
- *Location.* Regional differences can affect prices.
- *Direct costs.* Direct costs should be exact, figured down to the penny. Include all materials,

parts, and supplies that go into the actual delivery of the service.

- **Competition.** Investigate the common rates being charged for similar services.
- **Profit goal.** The dollar amount you want to earn in one year; in three years. It should reflect the amount left after all expenses are paid.
- **Overhead costs.** All business costs not directly related to the actual delivery of a service. Monthly expenses for overhead and supplies are:

\$ 30.00	phone
\$ 55.00	utilities
\$ 25.00	supplies
\$ 20.00	insurance
\$ 20.00	equipment depreciation
\$ 30.00	miscellaneous
<u>\$180.00</u>	<i>total monthly expenses</i>

These expenses must spread over the average number of hours worked per month. If you average 25 productive hours per week, the estimated monthly working hours would be 100 per month. Divide the total monthly expenses by the total monthly working hours to arrive at a per-hour cost for overhead.

$$\frac{\$180.00 \text{ expenses}}{100 \text{ hours worked}} = \$1.80 \text{ avg./hr. overhead}$$

Determining Service Price

As a service provider, you are "selling" time and skills. To estimate the feasibility of marketing a service, consider the price being charged by competitors. Estimate the time needed to perform the proposed service and

calculate what you would be making per hour. Subtract the per hour overhead cost.

The difference between the two is the amount for labor and management of the service business. If that proves to be an adequate amount, build the price at or slightly below the competitors' rate. If you can show that you provide higher quality services than the competition, pricing above their rate may be possible.

You will need to consider whether to charge by the hour, the day, or the job. Accurately determine the hours needed to complete a service. Some ways to keep track of time include keeping a time log by writing down start and stop time, an electric clock that you plug in when you begin a job and unplug at interruptions so that at the end of the job you will have total time, using a time clock, or noting total hours per day on a work calendar. This includes business calls, appointments with customers, and shopping trips for supplies.

Then develop a time-rate schedule. Make a list of jobs and the length of time required to complete each. Determine how much your time is worth to you. You might have more than one rate identified—one for standard skills and another for tasks requiring more skill.

To price a service:

Labor cost/hrs	\$10.00
Overhead/hrs	\$ 1.80
Per hour service rate	<u>\$11.80</u>

To determine actual earnings per hour, add up the anticipated earnings from a day's or week's

To estimate the feasibility of marketing your service, consider the price being charged by your competitors.

In most cases it is better to estimate the time needed to complete the service and to quote a complete price rather than telling the customer your hourly charge.

work. Divide the earnings by the total working time. If you are earning less than you expected, consider alternatives to become more efficient or correct practices that are reducing earning power.

Estimates and Work Agreements

Estimates are often required in service-oriented businesses. The estimate should reflect the maximum charges. Final charges may be less but should not be more unless there are circumstances explained to and accepted by the customer. Consider costs carefully when quoting a price.

In most cases it is better to estimate the time needed to complete the service and to quote a total price rather than telling the customer the per hour charge. If the estimate seems too high to be competitive, you may need to: (1) lower expenses, (2) settle for a lesser wage, or (3) sell services on the basis of higher quality. If the estimate is lower than the competition, use it as a competitive advantage or raise the charge to the going rate.

Avoid giving price quotes to customers over the telephone. A customer may consider a job "quick and easy" but in reality there may be special features and details you will need to consider to give an accurate price estimate.

Skill in giving estimates will increase with experience. Be consistent; charge the same price for the same service to each customer.

A work agreement or contract is important to the success of a service business. Both you and the customer will have in writing

what is expected such as delivery date, total cost, method of payment, etc.

Items to include in a work agreement are:

1. Name of business, address, and telephone number.
2. Date of agreement.
3. Customer's name, address, and telephone number.
4. A description of the job or work to be done. Include details, supplies needed and who is providing them, etc.
5. Total cost.
6. Completion date.
7. Payment timetable. You may have a policy requiring a down payment at the time the order is taken, with the remainder due when the project is finished.
8. Method of payment.

Some customers may question the rates and claim they can hire someone else for less money. Emphasize the unique features and the quality of service. Keep calm and be polite.

Pricing a Product

Putting a value on a product is also a challenge. The price must cover all costs and allow a profit, yet attract customers and build sales volume.

Consider the following when pricing a product:

- *Direct cost.* Costs incurred as a direct result of producing a product. Examples are parts, raw materials, supplies, handling and storage.

- **Labor.** Labor costs are calculated by multiplying the number of hours worked by the hourly wage. Include fringe benefit costs either in the hourly wage calculation or in overhead expenses. Fringe benefits can range from 15 percent on up, depending on the benefits included. Many times, new business owners make the mistake of not paying themselves. Do not fall into this trap. Also include all wages paid to employees.
- **Operating expenses or overhead.** These expenses include all the operating costs of a business not directly related to the actual production of a product. These expenses occur whether or not products are being produced.
- **Profit Goal.** The dollar amount you want to earn in one year; in three years. It should reflect the amount left after all expenses are paid. There may not be money unless profit is included in the pricing formula. "Profit" and "wages" are not the same.

Method of Pricing Products

Many methods can be used to price a product. It's wise to figure prices using more than one method for comparison. Establishing a price involves exact computations of cost factors compared to the market conditions. Ultimately, the price will be based on business goals.

In order to work with any pricing formula, a value per hour for time must be determined. Consider all the tasks to be done when producing the product and assign an average figure for labor.

Overhead cost can be figured per hour or per product. Refer to page 3 to figure the cost per hour.

It's more accurate to figure the cost of materials separately for each item produced because products generally vary in size and type of material used.

Method 1: Cost-Based Pricing

Cost-based pricing is determined by the costs of producing a product and then adding a profit margin.

Materials + labor + overhead cost + profit = wholesale price.

Add the costs incurred in the production of the product (material and labor), its share of overhead, and a profit margin.

Cost-based pricing is probably the most accurate method, but does require time and complete records. This is difficult when starting a new business because no records are available to figure overhead costs. This may result in some items being priced too low while others are too high for optimum sales.

Method 2: Market-based Pricing

When market-based pricing is used, prices are set by what the competition is charging, rather than by costs. For example, the selling price of a product you produce is currently \$35.99. Other businesses are selling comparable products for \$44.99. Options for the business owner are to sell at the same price as the competition or at a level between the two prices as an advertised "special." Either would increase profits.

Be sure the selling price covers the costs of business

The price must cover all your costs and allow you to make a profit, yet attract customers and build sales volume.

When pricing for wholesale, you are dealing with a store owner who will take a percentage markup on the goods purchased from you before selling to the public.

operation or the business may not survive. If products are superior to the competition, a higher rate may be charged by pointing out to customers why yours are better.

Breakeven Analysis

Prices charged must exceed total costs or there is no reason to be in business. A breakeven analysis shows how much must be made in dollars or products sold in order to cover all costs. Consider three pieces of information to complete a breakeven analysis:

- The average price of what is sold, either products or services. Estimate the total of each typical sale.
- The average cost of what is sold, or how much it costs to produce a typical sale.
- Total fixed costs per year, which are the total annual expenses that must be paid no matter how much is sold.

The break-even price in dollars is calculated by dividing fixed costs/(1-average cost of product or service/average price of product or service).

The use of break-even analysis allows a business owner to look at the pricing strategy using different combinations and variations in order to determine production levels, unit pricing, costs and desired profit.

Pricing Products for Wholesale

When pricing for wholesale, you are dealing with a store owner who will take a percentage markup on the goods purchased from you before selling to the public. Selling to many store owners allows you to increase the level of production and profit. Because the retailer is buying in volume, a reduced price may be offered. The retail markup averages 100 percent of the wholesale price. High value items that sell slowly may have a higher markup while low value items that sell quickly may have a smaller markup. The store owner is taking the risk that the product will sell to the public.

Carefully consider whether you can keep up with large orders from wholesalers. If you have the option to sell some of your products directly to customers, you must agree not to sell them at wholesale prices, but rather sell at or near the store retail prices.

Be sure you have a clearly stated, written contract before beginning production of wholesale orders. Consider how to handle rising costs. Decide whether it would be a better policy in the long run to give up some of the profits on an item by "absorbing" the higher costs for a while to keep prices stable, and then doing a more significant price increase. The potential for rising costs of raw materials is one important reason to build in an adequate profit margin in the beginning.

Pricing Products for Retail

If you make a product and plan to sell it directly to the customers, include the costs for travel, meals, lodging, display, and entry fees as you would other overhead costs. Add these costs to the price. In effect, you are both a manufacturer and retailer, and you have two sets of overhead costs. If you sell from home or a retail store, be sure to cover costs for display space, utilities, labor, etc.

Selling Through Consignment

In consignment selling, products are shipped or delivered in person to a dealer who will pay when the merchandise is sold. A common consignment arrangement is for the retail store to take a percentage of the selling price (generally 20 to 50 percent). You continue to own the product and are responsible for it until the time of the sale. Store owners are generally not responsible for soiling, breakage or theft, and may return unsold items to you at their discretion. Be sure that the price agreement and conditions of payment are clearly stated in writing and are signed by the store owner.

This method can broaden markets if the consignment store has quality merchandise and is in an area that will attract customers. Carefully consider whether the percentage of the selling price gives you adequate return. Add in the expense of shipping, delivering and picking up the products if they do not sell.

Price and Volume

The volume of production and the quantity of each product or service you produce are important considerations when setting a price. The greater the production volume, the greater opportunity to be flexible in pricing. The smaller the production quantity, the greater the margin per piece must be to generate the same amount of profit for the business.

Low prices may be a way to attract customers if you are producing a product or providing a service with several competitors. Low prices may be a way to build high sales volume. High sales volume does not always compensate for prices that are too low to make an adequate profit.

High profit and high volume are goals that are difficult to reach and often unrealistic. It may be wiser to think in terms of high profits with lower volume. A business may be in trouble if there are low profits and low volume.

If you sell a product purchased at wholesale, volume is the key to profit. However, if you are producing a product to sell, or delivering a service, you may find that all your energy is spent in keeping the production level up. Quality may decline when there is constant pressure for high volume. This can damage your business reputation and cause fewer sales. Compare price/volume ratios to determine optimum profitability.

The volume of your production and the quantity of each product or service you are able to produce are important considerations when setting a price.

**Be consistent
and give the same
discount to everyone
who qualifies.**

Selling to Family and Friends

Establishing rates when selling services or products to family and friends can present problems. Be prepared and explain that this is a business deal and you expect to be paid for your effort. You might consider giving an across-the-board discount after calculating the bill just as you would for any other customer. Be consistent and give the same discount to everyone who qualifies. You might suggest a "swap" of services or products. Or you might decide to give no special treatment. Another alternative is to not sell products or provide services to relatives and friends to avoid this situation.

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