



HOME-BASED AND MICRO BUSINESSES

CASHING IN ON BUSINESS OPPORTUNITIES

SETTING THE RIGHT PRICE

PREFACE

This unit includes basic information for teaching pricing to entrepreneurs. It is designed to be used in a 1-1/2 - 2 hour session depending on the size and background of the audience. A combination of lecture and hands-on approach is recommended. Participants should be given time to complete the worksheets during the session, with immediate feedback and discussion from the instructor.

Goal: Entrepreneurs will learn how to determine the price to charge for a product and/or service.

Objectives: As a result of this session, entrepreneurs will learn:

- How to calculate total costs.
- How to calculate a profit margin.
- The difference between wholesale and retail pricing.
- How to use break-even analysis.
- The psychological factors that impact pricing.

HANDOUTS

Handout 1 — Overhead Expenses Exercise

Handout 2 — Pricing Worksheet

INSTRUCTIONAL MATERIALS

PRICING

Pricing products and services is a challenging process for most new home-based business owners. Often entrepreneurs will underestimate the value of their time and expertise and find it difficult to believe that customers will actually pay the price they need to charge to make a profit.

It is very important to know your target market. Who are the consumers who are most likely to purchase your product? If you are targeting less affluent consumers, price may be more of a determinant in their purchase decision where affluent consumers may be less impacted by price. Are your target consumers willing and expecting to pay more for products with your attributes, i.e. organic products? Organic consumers generally expect to pay more for products. It is important to know your target market and how they react to prices.

The bottom line of any business is profit. If a business is going to be successful and maximize profits, accurate pricing is critical. Prices must be high enough to cover costs and earn a reasonable return yet attractive enough so customers will purchase the product or service.

Perceived value is an important factor in consumers purchasing decision. The benefits from the product or service need to be reflected in the price of the product. For example, if a low quality product has a high price, the perceived value of the product will be low, i.e., overpriced cheap product. On the other hand, a high quality product that has a relatively high price may be perceived as having a very high value. Therefore, a product or service's price has to create an acceptable perceived value to attract consumers.

A product's price also conveys information about the product. For instance, there are price points where consumers will perceive the product as being an inferior product (priced too low) and where it is priced out of the market (priced too high). For example, inexpensive clothing from a discount super store may create the perception of an inferior clothing product even though it is very similar to clothing products sold at boutique clothing shops, i.e., jeans.

The key to successful pricing is to price your product between these price points and at the same time allowing you to cover total costs, attract customers and generate a profit.

In addition to consumer perceptions, there are a number of other factors that must be considered when developing a pricing strategy for a home-based business. Pricing decisions should be based on an orderly analysis rather than making an educated (or, in many cases, uneducated) guess. By taking a systematic, step-by-step approach, you can make pricing a simple task.

It is important to determine how your product will reach the final consumer. The cost of creating a product represents only part of the product's final costs. There are additional

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costs of transporting products to distribution centers and retail outlets. For example, selling products directly to consumers from your home or through the internet may be less expensive than if you have to rent a truck and transport your product to area retailers. Transporting products will require a truck rental fee, fuel and labor as you transport your product from shop to shop. Some products may require the assistance of a broker to penetrate the market. Brokers generally have established business relationships that will allow them to market your products through a number of sales channels. However, there are costs associated with using a broker. As a result, it is very important to determine “where” your products will be sold when determining a price.

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COSTS

The prevailing element when setting prices is cost. An accurate accounting of all the costs that go into a business is necessary. In a business, the total cost to be considered include three factors: direct costs, labor, and overhead expenses.

$$\text{Direct Costs} + \text{Labor} + \text{Overhead Expenses} = \text{Total Costs}$$

These are the three basic or minimum factors that should be used for setting prices. The more exact the figures used for setting prices, the greater the chance for success.

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Direct Costs includes the materials, parts, and supplies that go into the actual production of the product or service. Direct costs should be exact; figured to the penny.

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Labor includes all wages paid to employees. Many times, new business owners make the mistake of not paying themselves. There is an opportunity cost associated with working in your own business. If you were working elsewhere, you would be paid. It is important to pay yourself. Be careful not to fall into this trap. Labor costs are calculated by multiplying the number of hours worked by the hourly wage. Be sure to include fringe benefits either in the hourly wage calculation or in overhead expenses.

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Overhead Expenses include all business costs not directly related to the actual production of the product or service. Overhead expenses include taxes, advertising, rent, office supplies/equipment, business-related travel, insurance, business permits, maintenance and repair of equipment, utilities (electricity, telephone, etc.), professional assistance (accountant, attorney, etc.), and any other costs related to the overall operation of the business.

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Overhead expenses can be determined as a percentage of direct costs plus labor. To determine the overhead percentage for the business, add up the total overhead expenses for a year. Next, divide the total amount of direct costs plus labor for the year into the first figure.

$$\text{Overhead Expenses} / (\text{Direct costs} + \text{Labor}) = \text{Overhead Percent}$$

For example, if direct costs plus labor for a year added up to be \$10,000 and overhead expenses for the year added up to \$2,000, the overhead percentage is 20% (\$2,000 / \$10,000). Once you determine the overhead percentage for the business, you can use it in calculating prices for the business. The overhead percentage should be re-evaluated on an annual basis.

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A key concept to remember is that it is impossible to stay in business if prices are set lower than the “cost of doing business.” Direct costs, labor, and overhead expenses are the bare minimum that must be reflected in the pricing strategy of any business.

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PROFIT

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Profit is the income left after all direct costs, labor, and overhead expenses have been paid. For there to be money left over, a profit factor or profit margin must be calculated in initial pricing. Remember, if you are not making a profit, you are engaged in a hobby activity. The purpose of being in business is to generate a profit. Many times, entrepreneurs/ small business owners try to sell their product at a price that will give them a competitive advantage in the marketplace. However, if you are unable to generate a profit, the business will not be sustainable. A rule of thumb may be to generate a profit of 10% to 25% depending on the volume of the business. Generating a smaller profit margin is more acceptable in high volume businesses whereas, low volume businesses may need to generate a larger profit margin in order to generate sufficient working and investment capital.

After the total costs are calculated, the profit factor is added to get the final price.

Total Costs + Profit = Price

or

(Direct Costs + Labor + Overhead Expenses) + Profit = Price

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The profit margin you add should depend on several factors, including an analysis of the unit sales cost of competing goods/services and the uniqueness of your product/service. An initial mistake made by many home-based business owners is not adding a profit margin to their pricing strategy. If this is not done, there will be no money for growth or expansion of the business.

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RETAIL PRICING

While the basic principles for pricing a product or a service are essentially the same, there are some differences that should be considered when you are wholesaling a product to a retailer. Up to this point, when pricing a product the pricing formula results in the wholesale price. To arrive at the retail price for a product, a retail margin must be added, which is usually two to three times the wholesale price.

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Wholesale Price \times Retail Margin = Retail Price

or

(Direct Costs + Labor + Overhead Expenses + Profit) \times Retail Margin = Retail Price

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The percentage a retailer adds to the wholesale price it pays for an item is called the markup. For example, a product that is wholesaled for \$10 (Direct costs + Labor + Overhead Expenses + Profit = \$10), will be marked up at least 100 percent or two times to a retail price of \$20 (Wholesale Price \times Retail Margin or $\$10 \times 2 = \20). A retailer will mark up items using the best pricing strategy developed for that business.

A wholesaler also may cross over and be a retailer at times. When this happens, the wholesaler must be careful not to compete with or undercut his or her wholesale customers. An example is an artisan who wholesales pottery to gift shops and also sells pottery directly to customers at art shows or craft fairs must be careful when it comes to pricing. The artisan should sell the pottery at retail prices at the art shows and craft fairs—the same prices the gift shops charge. If the artisan retails directly to customers at a substantially lower price than the gift shops, the artisan will lose the wholesale accounts.

A word of caution to small home-based businesses that are wholesaling to retailers or selling to retailers through a distributor or “sales rep.” Many times a retailer will ask for discounts when buying in bulk and distributors will ask for a percentage of what they sell. Both of these are overhead “costs” that must be incorporated into the original pricing formula.

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BREAKEVEN ANALYSIS

Prices charged must exceed total costs or there is no reason to be in business. A method business owners use to look the big picture for pricing is breakeven analysis.

Defined in its simplest form, the breakeven point is the point at which sales (revenues) are exactly equal to costs (expenses). At this point, zero profit is made and zero losses are incurred. This approach is helpful in determining the number of units of a product or the dollar amount of sales necessary to cover all costs. This makes it possible to determine how much of a product must be sold to cover costs.

The basic equation used for determining the breakeven point is: sales = variable expenses + fixed expenses

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Since profit is defined as zero at the break-even point, sales must, by definition, be equal to total expenses. For example, let X represent the number of units to be sold to break even (zero profit). Suppose the cost per unit of X is \$.45, the selling price per unit is \$1.00, and there is a fixed cost of \$275 to manufacture product X. How many units of X must be sold to break even? Going back to the equation and listing the known values results in:

$$1.00X = .45X + 275 \quad 1.00X - .45X = 275 \quad .55X = 275 \quad X = 500$$

In this case 500 units of X must be sold to cover all costs. In dollar terms, the breakeven point is \$500 in sales of product X (500 units @ \$1.00 per unit).

Using the same example, suppose you want a profit of 20 percent of sales. What effect would this have on the breakeven volume? Since profit is defined as a percentage of sale, the initial equation changes to include the profit calculation:

$$\text{sales} = \text{variable expenses} + \text{fixed expenses} + \text{profit or } 1.00X = .45X + 275 + .20(1.00X),$$

where .20(1.00X) is the profit term, since profit is defined as 20 percent of sales (1.00 per unit times the number of units). The equation then becomes:

$$1.00X - .45X - .20X = 275$$

$$0.35X = 275$$

$$X = 786$$

To cover all costs associated with product X and to make a 20 percent profit on sales, 786 units must be sold. Total sales volume in this case will now be \$786 (\$1.00 times 786).

Breakeven analysis permits the business owner to look at the pricing strategy using different combinations and variations of variables to determine necessary productions levels, unit pricing, costs, and desired profit.

OTHER PRICING STRATEGY CONSIDERATIONS

Competition. Determine what the competition is charging for its product or service. The prices charged may be lower, higher, or about the same. If customers question a price by drawing comparisons to the competition, point out the quality of the work, the uniqueness of the product or service, and other features or selling points. Do not let customers change prices that are based on a sound pricing strategy.

Discounts/Markdowns. Discount prices only when necessary to generate business to increase cash flow. Limit discounts for family and friends.

Estimates. Provide the customer with a written estimate to help avoid possible misunderstandings later. The estimate should reflect the maximum charges. Final charges to the customer may be less but should not be more unless there are circumstances explained to and accepted by the customer.

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Exclusivity. Custom, original, or one-of-a-kind products or services can command higher prices. Customers are often willing to pay more for items or services that are limited in availability and less for items and services that are readily available in mass quantities.

Location. Regional differences can affect prices. Generally, prices in urban, suburban, and high-income areas can be higher than prices in rural and low-income areas.

Odd Number. Odd number refers to setting prices just below even dollars. For example, a price is set at \$9.95 rather than \$10.00. Customers often perceive they are getting the item for less.

Prestige. Some customers are willing to pay above market prices for a product or service perceived to be of higher quality or with brand name prestige.

Professionalism. Businesses that look and act professional are usually worth to the customer.

Expertise. In general, the higher the skill level or level of expertise used in the production of the product or service, the more willing customers are to pay higher prices. Producers with better skills can often produce more or provide more services in less time without sacrificing quality, and time is money.

Inflation. Prices must adjust as the cost of doing business rises. It is best to anticipate rising costs when setting prices so that frequent price changes are not necessary.

Itemizing. For custom production or service work, itemizing the final bill may help customers understand the amount charged. Frequently customers do not realize

the amount of time involved and costs of materials.

Quality. In most cases, the higher the quality, the more customers are willing to pay for a product or service. Top-of-the-line products and services can command top-of-the-line prices.

Seasonality. Some products or services sell better at certain times of the year (for example, holiday items).

Volume. Increased sales volume may or may not warrant lower prices. Sometimes it is more economically efficient to produce multiples of the same product. Any added savings gained through efficiency must be weighed against the expense of selling more items (for example, extra employees may be needed as volume increases).

What The Market Will Bear. What the market will bear for price can be critical. In some cases, the cost of producing the product or service is too high. No matter how great it is, the market (your customers) is not willing to pay the price a business needs to charge to make a profit. On the other hand, there are times when the market will pay a much higher price than the actual cost of producing the product or service. Understanding the market and what customers will or will not pay directly impacts pricing.

The primary purpose in operating a business is to make a profit. You should establish prices from an accurate accounting of direct costs, labor, overhead expenses, and profit margin. In addition, consider all the psychological factors that may have an impact on the business as you establish a pricing strategy. Pricing is a skill that must be developed and continuously monitored for a business to be successful and profitable.

SUMMARY

The primary purpose in operating a business is to make a profit. You should establish prices from an accurate accounting of direct costs, labor, overhead expenses, and profit margin. In addition, consider all the psychological factors that may have an impact on the business as you establish a pricing strategy. Pricing is a skill that must be developed and continuously monitored for a business to be successful and profitable.

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GLOSSARY

- Direct costs.** All of the costs of the materials and supplies related to the actual production of a product or service.
- Break-even point.** The amount of revenue needed at a given unit price to cover all costs (fixed costs and variable costs).
- Labor.** The cost of services provided by workers for wages.
- Overhead expenses.** All of the costs of running a business that are not directly related to the actual production of a product or service. Also referred to as indirect costs or operating costs.
- Profit.** Income after all expenses have been paid.
- Retail margin.** The price mark-up retailers add on to the wholesale price of goods. The mark-up is usually two to three times the wholesale price. A retail margin of two times or 100 percent wholesale (or 50 percent of retail) is commonly referred to as keystone.
- Revenue.** Income generated through sale of products and/or services.

HANDOUT 1

OVERHEAD EXPENSES

Year _____

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PRICING WORKSHEET

$$\begin{array}{rcccccc} \text{Direct Costs} & + & \text{Labor} & + & \text{Overhead Expenses} & = & \text{Total Costs} \\ \hline & + & & + & & = & \end{array}$$

$$\begin{array}{rcccccc} \text{Total Costs} & + & \text{Profit} & = & \text{Price} & & \\ \hline & + & & = & & & \end{array}$$

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