Micro & Home-Based Business Product Pricing

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Pricing is vital to any successful business. An important question a business owner must answer is "What price is a right price?" From an economic view, the right price maximizes the owner's profit. Often business owners set prices that maximize sales or maximize customers. At times they set prices that do not even cover costs. This can only guarantee business failure.

Establishing a Price Range

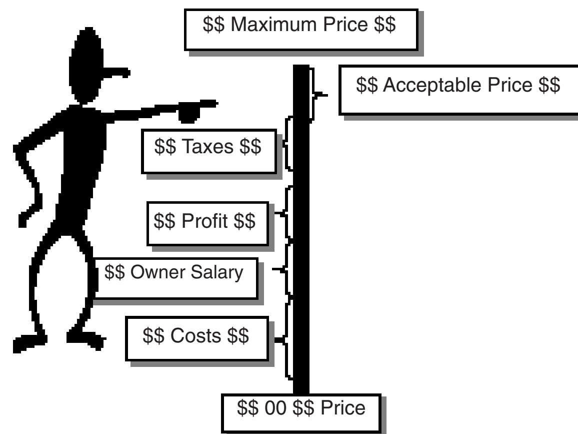
Pricing begins by determining the full range of possible market prices. The range starts at $0 and goes to the maximum amount a customer might pay for the product. The information about maximum price can come from potential customers, from the competition, or from a review of trade journals and professional organizations.

Not all of the prices in this range are acceptable. The range includes possible prices where the owner does not even cover the cost of the raw materials. So the next step is to narrow this range by determining the cost of production and the cost of running the business. Selling a product at a price that does not cover costs means failure in the long run. The major cost items to consider are **Direct costs** and **Indirect costs**.

Direct costs are the costs involved in production

- Material and supplies (For retail stores this is the cost of goods).
- Shipping charges to receive material and supplies
- Salaries, wages, and benefits paid for production labor
- Production loss - waste generated during production or from products that do not meet acceptable standards Indirect costs are the costs associated with running the business
- Fixed expenses such as rent, utilities, labor costs for office employees, property insurance, taxes, licenses, dues, and subscriptions
- Variable and occassional expenses such as office supplies, business travel, advertising, sales commissions, and marketing.

By including the cost of production plus the cost of running the business, the owner has a preliminary break-even price. That price is based on a certain level of production and will only keep the business operating in the short term. Two additional factors must be added to determine a final break-even price.



Two Pricing Issues

First, many owners who work in their own business fail to include their *own salary or wage* as either a direct or an indirect expense. They fear that to do so will cause their price to be too high and therefore unacceptable. Owners must understand that establishing the right price means covering **all** expenses including their own labor.

Starting a new business may mean sacrifice. However, such sacrifice should come with knowing the effect of the decision – i.e., cutting prices may mean the owner's salary must also be reduced. Be aware that raising prices is difficult, so discounting should be done carefully.

How does an owner value his or her time? A simple way is to calculate the salary the owner would get if working for someone else. A second way is the cost if someone else were hired to do the work. The third and most difficult way is to calculate the time spent doing the various parts of the job (i.e. production, sales, clerical, etc.). Apply a separate hourly rate for each part. When all the parts are totaled, a value is determined.

A second pricing mistake is the business owner's failure to include a *Return on Investment (ROI)* factor in pricing decisions. ROI is not the owner's salary or wages. ROI is the return to the owner for the risk involved in operating the business. A rule of thumb is that the return or profit must equal what the owner could receive had he or she simply invested the money that went into the business.

Profit margins, like the owner's salary, are sometimes seen as a limiting factor for the new business. The owner can

decide to forgo some profits. However, this should be done knowing why and the effect it will have, not because it just happened.

Product Pricing Methods

At this point, the owner has established a realistic range of acceptable prices, all of which cover all costs, pay them a salary, and provide a profit. But how is a final price determined? Four of the ways to answer to this question include **Cost pricing, Competitive pricing, Multiplier pricing,** and **Value pricing.**

Cost pricing uses information already obtained while determining the cost break-even level. While accurate, cost pricing does have disadvantages. It is the minimum acceptable level. Should this be acceptable? Again it may have been set without consideration of the owner's salary or wage. What about the competition? Is there any reason that a higher price cannot be asked? Also cost pricing is based on previous costs of supplies, materials, and labor. Nothing is included that takes future or anticipated costs into account. Cost pricing also fails to maximize sales or most importantly profit.

Because it requires the most detailed record keeping, cost pricing is the most difficult to do. An example of cost pricing follows:

Wholesale price per unit = Materials + labor + indirect costs + profit (Profit = $ amount or a percent of materials, labor, and indirect)
Wholesale price = $4 + 6 + 8 + 2 = $20 per unit
or
Wholesale price = $4 + 6 + 8 + (10% of $4+6+8) = $19.80

Competitive pricing means placing the owner's price not much higher or much lower than the competition. Although perhaps not selected as the method, all pricing decisions are controlled to some degree by the competition. The advantage to competitive pricing is the control of a major factor in obtaining and retaining customers.

The disadvantage of this method includes knowing who the competition is. Today's global market place makes this more difficult. A second issue is, if used alone it may not cover all costs. Another disadvantage is the constant monitoring of the competition that must occur. This means the owner is always reacting and not making his or her own decisions. Finally, the owner must ask if the competitor's prices fit the image desired for his or her own business.

Multiplier pricing or mark-ups require cost data gathered over time. From the data a number is developed. That number is multiplied against the costs of production (raw materials, shipping, labor, etc.) to set the final price.

For example over time it is determined that $1.17 is needed to cover overhead (indirect costs) for every $1 of production expense. If a new product is determined to have a production cost of $3.50, the final price will be $3.50 + ($3.50 x 1.17) or $4.60. While this is the typical way multipliers are used, the owner can vary what is included in the base figure and in the multiplier. It is important to be certain the two figures include all expenses, salaries, and a profit margin.

Multiplier pricing can be effective if the company's own data is used in development of the multiplier and if the data is accurate. If industry data or general multipliers are used the final price may not reflect the business's needs. In addition, the owner must question if one multiplier works equally well for a variety of products. Can the same percentage be added on to a $1 item as well as a $100 item? Since the multiplier only reacts to changes in the base figure, the owner must be continually aware of changes in direct costs. Other disadvantages may include failing to include a profit margin or basing the mark-up on past and not future costs. An example of multiplier pricing follows:

Wholesale prices
1. Wholesale price per unit = materials per unit x multiplier ($4 x 3 = $12 per unit)
2. Wholesale price per unit = materials per unit + labor per unit + (multiplier x materials and labor) ($4 + $6 + (.5 ($4+6) = $15 per unit)

Retail prices
1. Retail price = Wholesale price x multiplier ($15 x 2 = $30 per unit)
2. Retail price = Wholesale price + (percent multiplier x wholesale price) ($15 + (150% of $15) = $37.50)
3. Retail price = Wholesale price + dollar mark-up ($15 + $10 = $25)

One alternative to a multiplier is to use a fixed dollar amount to cover indirect costs. However, this creates difficulty if you produce products covering a wide price range.

Value pricing represents a pricing strategy that typically occurs within small niche markets. The uniqueness of a product allows the owner to charge extra. The customer is able and *willing* to pay for a customized product or personalized service and support.

Profitability – The Bottom Line

Talk to busy owners about their first year in business and it is not uncommon to hear stories of how they mistakenly believed the profits they were making. Typically this false sense of profit occurs when owners fail to consider ALL expenses – production and operating. New business owners may also overlook the impact taxes have on the bottom line.

Impact of Expenses

When people consider starting their own business, they often consider total revenues. In the costs pricing example and assuming sales of 20,000 units, an outside observer would see revenues of $400,000. They fail to take into account the offsetting expenses of producing and marketing those units. In reality, income before taxes in this example is only $40,000 ($400,000 revenue minus $360,000 expenses).

Impact of Taxes

The second and more common mistake is a failure of the prospective and first year business owner to account for

the effect of taxes. Often business owners are totally satisfied with their profitability until they prepare their first tax return.

The owner must prepare for three taxes they will typically pay on the business gross income.

Self employment tax represents both parts of the Social Security tax. As of September 1999, this tax is 15.3%.

Federal income tax varies depending on the business structure selected and level of gross income. For sole proprietors the two common rates are 15% and 28%. Sole proprietors must realize that business income will be merged with other income generated by the family to determine the total tax due.

Oklahoma income tax varies based on business structure and gross income.

These three taxes can reduce before-tax income by up to 50.3% (15.3% + 28% + Oklahoma tax of 7%). Continuing the previous example that had income after expenses of $40,000, the after-tax income will be:

	$40,000 – income after expenses
less (—)	20,120 – total taxes at 50.3%
	$19,880 – After-tax income

After-tax income is significantly less than before-tax income. If an owner has not considered the effect of taxes this may come as a shock. Business owners are required to make estimated payments on a quarterly basis. Failure to do so means not only is the tax due but the government can add on charges for interest and penalties.

Summary

The business owner must understand that a single price will never meet everyone's expectations. The owner establishes the price and sticks with it. Many small business owners find themselves caught up in giving special discounts to large numbers of their customers. Once started this trend is difficult to control. Written price lists help the owner avoid non-planned discounting.

Good pricing involves understanding the direct and indirect costs of the business. It generally involves not just one but a combination of the pricing methods mentioned. Good pricing means valuing the work/time plus profit and taking into account the impact of taxes.

Pricing decisions are an important part of the business image. Having the right price for a product allows both the customer and the owner to feel good about the transaction. The customer is encouraged to return and the owner has the satisfaction of selling the chosen level of quality at a price where he or she can profit.

More specific information about pricing can be found in "Mapping Your Marketing Future" (available from OCES) or in small business management texts.

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