Micro and Home-Based Business

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Pricing is vital to any successful business. An important question a business owner must answer is "what price is the right price?" From an economic view, the right price maximizes long term profits. Often business owners set prices that maximize sales or maximize the number of shoppers but not buyers. At times they set prices that do not cover costs. This can only guarantee business failure.

Establishing the right price for services is one of the most challenging tasks an owner faces. Price setting begins with gathering information about the business, the competition, and the business environment.

Establishing a Price Range

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

Not all prices in this range are acceptable. The range includes possible prices where the owner might not cover the costs of twhe supplies needed in the service. The next step is to narrow this range by determining the basic costs of doing business. Selling products 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**.

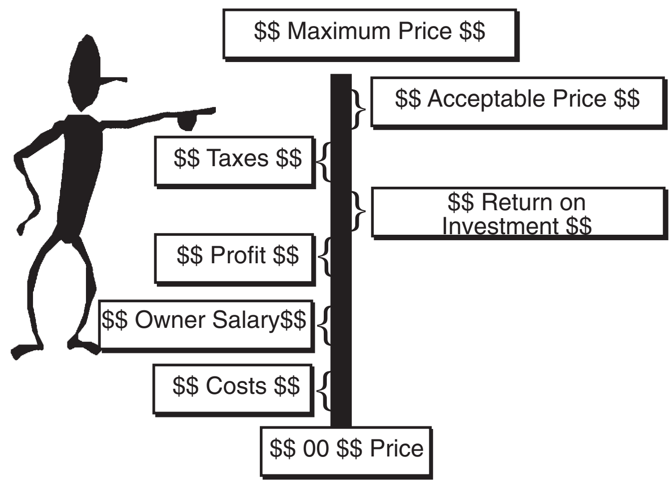
Direct costs

- Materials and supplies
- Shipping charges to receive material and supplies
- Salaries, wages, and benefits paid to produce the service
- Waste generated during the process that does 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 expenses such as office supplies, business travel, advertising, sales commissions, and marketing.

Developing the cost data allows an owner to set a price, based on a certain volume, where revenues will cover underlying expenses. For a service business however, covering your costs represents only a small part of the typical service price. Two additional factors play a significant part of the final price.



Pricing Issues

First, many owners who work in their own business fail to adequately compensate themselves for the value of their efforts. For many service businesses, this represents a significant part of the price. First-time owners fear that by including fair pay for their time they set an unacceptable high price.

Owners must understand that setting the right price means covering the expenses **and** being adequately compensated for their efforts. Owners should be compensated as well as if they worked for someone else.

During the first few years of a new business, it may not be possible to earn as much as an employee. The owner needs to look at long-term possibilities as well as offsetting non-fiscal advantages, such as being his or her own boss. Such sacrifice should come knowing the effect of the decision – i.e., cutting prices may mean the owner's salary must also be reduced.

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 to figure the cost if someone else was 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. sales, clerical, etc.). Multiply the rate for each part by the time spent. Then add the costs to determine the total value of the owner's time.

A second pricing mistake is the business owner's failure to include a *return on investment (ROI) factor* in their pricing decisions. ROI is not the owner's salary or wages. It is the return to the owner for the risk involved in operating the business. Profits are used to expand the business, buy more equipment, prepare for unplanned events, and retire early. A rule of thumb is that the return must equal what the owner could receive on a similar risky investment.

Service Pricing Issues

At this point the owner has established a realistic range of acceptable prices, all of which cover costs, pays the owner a salary, and provides a return on investment. Yet a *range* is not acceptable; customers want a set price, either by the hour, day, piece, and/or job. There are three primary ways to set the price. Pricing of services often combines all three methods: **competitive pricing**, **value pricing,** and **cost-plus pricing**.

Competitive pricing means setting the price not much higher or lower than the competition. All pricing decisions are controlled to some degree by the competition. Competitive pricing is perhaps the easiest to determine, but has disadvantages, as well. It is sometimes difficult to determine **who** the competition is, ie. very small businesses, moonlighters, or ones who do not advertise. Competitive pricing requires constant monitoring of the competition's prices, and places you in a reactive position rather than as a proactive decision-maker. Using competitive pricing may not cover all costs and the competitor's prices may not reflect the image desired for own business.

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.

The pricing of services has many unique advantages because services are individualized to the customer. Also, the customer may want to use materials that are more difficult to work with or have special requests they wish to include. They may view your business as having something no other business can offer. Value pricing means developing a service that can be positioned as a noncommodity item as opposed to a commodity item.

Cost-plus pricing is the final method. It is done starting from two basic positions. One works from a person's desired annual income and the other from a desired hourly rate. The goal of each is to determine an hourly rate charge that meets the owner's wishes and covers all costs and non-billable time. Non-billable time is time spent doing marketing, general research, travel, etc.

Service pricing decisions should also take into account other factors such as:

Size and difficulty of job. Although seemingly obvious, large jobs take more time than small jobs. Complex details take more time and skill and working with some materials is more difficult. Never give a final, guaranteed price estimate until you know all of the details of the job.

Your skills. Compare skills to others in the area. Individuals with excellent skills can command higher prices if the job demands such expertise.

Speed. Those people who can work fast and still maintain quality can give themselves more free time. At times clients will be willing to pay higher prices in order to get a job completed more quickly.

Location. Rates in rural areas will be lower than rates in urban or high income areas.

Convenience. Some people are willing to pay extra to have the work done at night, over the week-end, etc.

Desired Income. Although it is possible to price a smaller micro business out of the market, pricing of services can be based to some degree on the desired level of income.

Profitability – The Bottom Line

Talk to busy owners about their first year in business. It is not uncommon to hear stories of how they mistakenly believed they were making a profit only to find out that was not true. 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

Often service business owners overlook the impact of expenses because they are typically small. An example is a business with income of $80,000. Even though expenses may only be 25% or $20,000, this still reduces net income to only $60,000 ($80,000 revenue minus $20,000 expenses).

Impact of Taxes

Another mistake is failure of the new business owner to account for the effect of taxes. Often business owners are

***Method 1** Setting an hourly rate using desired annual income*.

a. Yearly cash needs = Desired annual income plus total expenses

b. Billable hours = Total working time less non-billable time
(non-billable time may be office work, time off, travel, research, etc.)

c. Hourly rate = Yearly cash needs/billable hours

For Example:

Desired Income $45,000

Billable hours = 1,580*

[2,080(typical work year) less 500 (non billable hours)]

Expenses = $30,000

Hourly rate = $47.47

($45,000 + $30,000 / 1580hours)

* In the first several years of business, non-billable time can easily be 50% or more. In this example that would mean a $72.11 hourly rate. However the com-

Method 2 *Service cost analysis*

Begin with the desired hourly rate and adjust for non-billable time and indirect costs.

a. Determine percentage of non-billable time per time period work
30 hours per week of which 10 hours are non billable
Non billable percentage= 10/30 = 33%

b. Determine indirect costs per hour
indirect costs/week = $400
indirect costs add-on = $20
[$400 / 20 *(billable hours / week)*]

c. Adjusted hourly rate
Desired hourly rate = $15
Adjusted hourly rate = $39.95
[$15 + $20 + ($15 x .33)]

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. This tax is 15.3% of the first $72,600 (1999) and 2.9% thereafter.

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. The most common rate is 7% for sole proprietors.

These three taxes can reduce before-tax income by 50.3% or more (15.3% + 28% + 7%). Continuing the previous example that had income after expenses of $60,000, the after-tax income will be:

	$60,000 – income after expenses
less	30,180 – total taxes at 50.3%
	$29,820 – 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 may be required to make estimated payments on a quarterly basis. Failure to do so may cause an owner to owe interest and penalties in addition to the tax. Check with an accountant to determine the tax filing requirements.

Summary

The business owner must understand that a single price will never meet everyone's expectations. The owner should establish a price and stick 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 a combination of the pricing methods mentioned. Good pricing means valuing the work/time plus profit. Good pricing means 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 providing the chosen level of service 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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U.S. Small Business Administration, Profit Costing and Pricing for Manufacturers - FM2; Checklist for small retailers - FM12; Pricing your products and services profitable FM13. Washington, DC.

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- It utilizes research from university, government, and other sources to help people make their own decisions.
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