

# Pricing Your Products and Services

Setting a fair and accurate price for your products and services is one of the most important considerations to make in your business. Price your product too high and no one will buy. Price too low and you are giving away part of your profit.

If you properly evaluated your target market then you know who your customers are. Before setting your price (or changing your price), ask yourself these questions:

1. How do my customers perceive my product?
  - Do your customers buy because of price, value, etc.? If your customers are looking strictly at price then you will need to set your prices based on the competition. If your customers are looking for value then you don't want to be the lowest as your product will be seen as inferior.
2. How do my prices compare to my competitors?
  - Know exactly what your competitors are charging, both your local competitors, and any other business a customer could buy the same or similar product. Analyzing your competitors pricing will be used in conjunction with answering these other questions.
3. Am I offering anything different than my competitors that would justify a higher price?
  - Even if you are offering the exact same product, are you offering anything that will give your product a higher perceived value to the customer? If so then a higher price might be justified.
4. Am I providing a product where there is a demand greater than the supply?
  - If you are fortunate enough to have a product or service where demand exceeds supply, then you will be able to justify a higher price. However, you want to be sure you are not seen by your customers as charging an unreasonably high price. Even if your customers are willing to pay now, sooner or later competition will increase and supply will exceed demand. Many of your customers will not be loyal to your business and will be more than happy to move to your competitor.
5. Does my product have a short life cycle?
  - Some products will have a short life cycle which means you have to charge more up front, and greatly reduce your prices in the future. A good example might be a movie video of a new hot release. You might be able to charge a premium for the first six months, but once the movie has been seen by everyone you would need to lower the

price just to move any existing inventory. This could also apply to electronics such as computers, cell phones, digital cameras, etc.

6. Can you make money at the price you need to charge?
  - If after all the evaluation of the above criteria, can you set the price at a level that will allow you to make the money you want to?

### **Pricing Your Services:**

If you are not selling any item, but a service, you need to consider how to properly price these services. Answering these questions will give you a starting point.

1. How do my customers perceive my service?
2. How do my prices compare to my competitors?
3. Am I offering anything different than my competitors that would justify a higher price?
4. Am I providing a service where there is a demand greater than the supply?
5. Does my service have a short life cycle? (example: clean up after a storm)
6. Can you charge more because you have established your business as a top notch business with an excellent reputation?
7. Can you make money at the prices you need to charge?

When pricing services you need to be sure you are comparing apples to apples. *Example: Your competitor is charging \$50 an hour as a plumber and shows up in a beat old truck three days after he says he will and does not guarantee his work. You are trying to set your pricing structure and you have a new truck, you have neat uniforms, you guarantee to show up the same day and you guarantee your work for 90 days. Do you think you can charge more even though you are both doing plumbing, and may even end with the same result for the customer? Of course you can, you are providing additional value, both actual and perceived.*

### **When Do You Raise or Lower Your Prices:**

Once your price is set, it doesn't mean you never have to change it again. There are many factors that can affect your pricing structure that may cause you to either raise, or lower your price. These can include:

- Economic conditions - This could affect the cost of your raw goods and in turn you might have to raise your price. A rise in interest rates could cause your capital purchases to increase and an increase in the cost of living could cause an increase in your payroll. Of course if the economy goes into a recession you may have to lower your price to keep customers buying your product.

- Excess capacity – You have the capability of producing more products so you might consider lowering your price in anticipation of selling more product. Of course you need to look closely at your profit margins to be sure you are not producing more revenue, but making less profit.
- Economies of scale – You may find cheaper ways to produce a product and in turn either make more profit, or pass the savings onto your customer. Passing your savings on to your customer may allow more customers to purchase your product and in turn increase your customer base.
- Competition lowers their price – Your competitors may constantly raise or lower their prices for one reason or another. You need to evaluate your pricing strategy and decide whether you want to follow.
- Increase in the demand – Your product or service may have an increase in demand. If the demand for your product or service increased, especially to the point you cannot keep up, then raising your prices will decrease your demand, but may still produce an increased profit. If demand still outpaces supply, then you may need to raise your price again. Your other option is to increase the supply chain by purchasing more equipment or hiring additional people.

This discussion on pricing is used only as a guide to understanding basic pricing strategy. There are many very sophisticated pricing models that can be used to determine pricing and would take many pages to discuss. Before pricing any product or services use these basic guidelines, but be sure you do some extensive research before finalizing any pricing strategy. The most important item to remember is the relationship between pricing and profit margin and understanding how the change in pricing, both increases and decreases, can affect your bottom line. Remember, pricing needs to be structured to maximize profits, not just to sell products.

### **Pricing Models:**

#### *Competitive Pricing:*

Base your pricing on items 1-6 above

#### *Retail Pricing:*

Retail pricing is usually based on mark-up which is determined by taking all costs of the item to include shipping and handling and multiplying it by your markup percentage.

Example 1: Cost of item is \$25 and you want to markup the item 50% of the cost (take percentage markup and add 1).  $\$25 \times 1.50 = \$37.50$ .

Example 2: In retail it is not unusual to markup an item 100% (called keystone pricing). Take the same item for \$25 and markup is 100%.  $\$25 \times 2.00 = \$50$

If you wanted to determine your gross profit margin on this item you would take the sale price and subtract your cost and then divide by the sale price.

Example 1:	Retail price	\$37.50
	Cost	< <u>\$25.00</u> >
	Gross profit	\$12.50

$$\$12.50/\$37.50 = 33\% \text{ Gross Profit Margin}$$

Example 2:	Retail price	\$50.00
	Cost	< <u>\$25.00</u> >
	Gross profit	\$25.00

$$\$25/\$50 = 50\% \text{ Gross Profit Margin}$$

Given your average markup, you can also determine what your break even point is. Determine all operating expenses other than the cost of the product. This would include payroll, rent, utilities, etc. If your operating costs for one month are \$10,000 and your average markup is 50% then you can figure your break even point.

$$\$10,000/.50 = \$20,000 \text{ break even sales}$$

Under this scenario you would need to produce \$20,000 in sales to break even.

This is only a guide to help understand the correct procedure. Normally you would have multiple items for sale and many with different markups. To properly figure your break even point, you would need to factor in all products.

#### *Manufactured Product Pricing:*

If you have a new product you will normally need to recoup your initial startup money which needs to be figured into your pricing structure. An example is you have a new type of calculator. Your startup costs to get this product to market is \$500,000. Your actual cost to produce each calculator is \$5. Your plans are that you are able to sell 100% of your production and can produce 200,000 calculators a year for a total production cost of \$1,000,000. You also need to add in your startup costs of \$500,000 giving you a total of \$1,500,000.

Your next decision is determining what return you would like to make on this product, or if you just want to recoup your costs the first year and then generate your profit in the ongoing years.

Examples:

If you want to just recoup your costs the first year:

$$\$1,500,000/200,000 = \$7.50 \text{ each}$$

If you want to make an extra \$200,000 in profit the first year:

$$\$1,500,000 + \$200,000/200,000 = \$8.50 \text{ each}$$

Of course you will also need to consider the questions 1-5 above and see how they affect your pricing structure. If your competitor is selling the same item for less, can you afford to either lower your price, or justify a higher price? If your product has a short life cycle then you would want to charge a higher price initially to offset the lower price in the future. You might also start off with one price and either raise or lower it at anytime due to unexpected costs, or changes in the factors listed above (questions 1-6).

Other factors that will affect your sales price:

- How long do you want to wait to recoup your start-up costs? Less than one year, more than one year, etc.
- What if only 90% of your product is sold?
- How much waste or non-saleable items such as gifts, display models, etc. will you have?
- Change in any of your fixed or variable costs.

#### *Activity-Based Costing:*

Activity-Based Costing (ABC) is an accounting method that allows businesses (mostly manufacturers) to gather data about all their operating costs and then including these into the product pricing strategy. All costs associated with the business are assigned a value per product produced. These costs would include your indirect costs such as telephone, internet, cost to cut a payables check, etc. Every cost in the business is an indirect cost to each product you produce. The task is determining how much time, or how much of these costs are assigned to each product unit produced.

ABC is much too complicated to be discussed in detail here. If you would like to find out more information you can talk to your accountant, or do an Internet search.