The **ENTREPRENUER'S**

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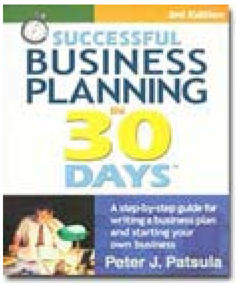

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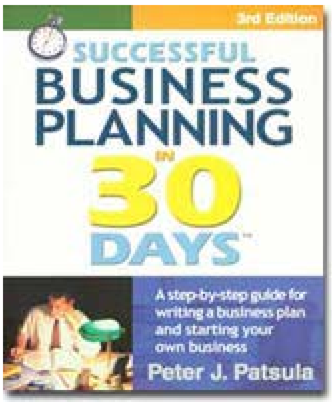

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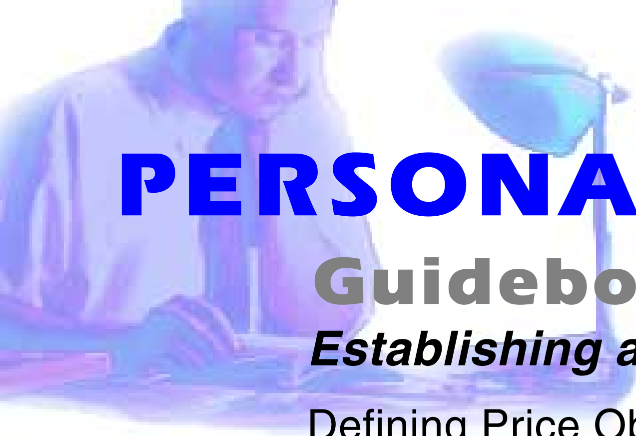


PERSONAL PLANNING

Guidebook #52:


Prices May
CHANGE
Without Pity

ESTABLISHING A PRICING POLICY

CRUCIAL to a good marketing strategy is a good pricing policy. For the prices you charge for your products and services will greatly effect your sales volume, profit levels and among other things, your business image.

To establish an effective pricing policy:

1) **Define your pricing objectives.**

2) **Establish a simple yet effective pricing structure taking into consideration all your business costs.**

3) **Choose a pricing strategy to establish a market presence.**

4) **Fine-tune and adapt your general pricing policy in response to trends, industry practices and new innovative pricing strategies to help solidify your competitive position within the marketplace.**

DEFINING PRICE OBJECTIVES

AN EFFECTIVE pricing policy can be determined only after you, as the owner-manager of your business, decide specifically what your business is, and how the objectives of your pricing policy can further support and define your identity.

A good offer starts with a great price. ***POWERPOINT***

Pricing objectives should be closely tied in with your overall business and marketing goals and as a result take into consideration what impact your prices will have on your sales volume, sales revenue, market share, competitive position, company image, and profitability.

Factors that "Price" Will Influence

When setting your price objectives consider how your prices will influence the following six factors:

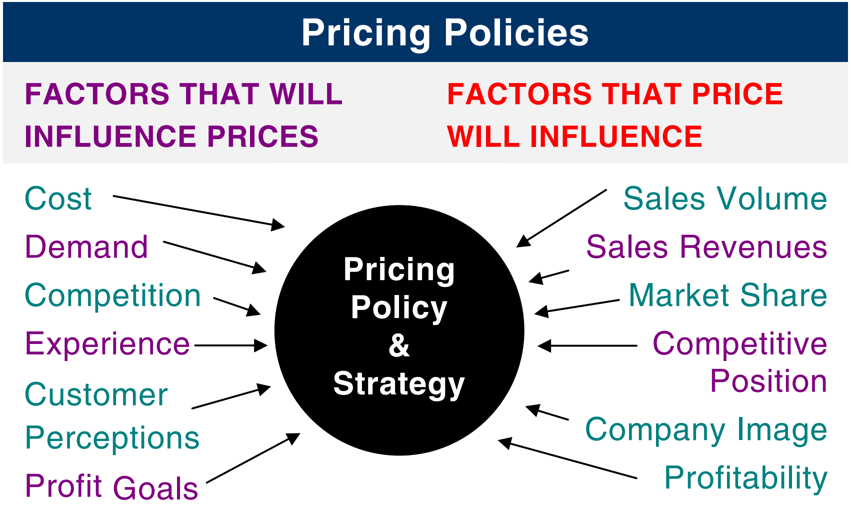
- Sales Volume
- Sales Revenues
- Market Share
- Competitive Position
- Company Image
- Profitability

Sales Volume – Sales volume is highly dependent on the prices you charge. Generally, higher prices mean lower volume and vice-versa. However, small businesses can often command higher prices because of the more personalized service they can offer.

NOTE If there is no direct relationship between pricing changes and sales volume, the sale of a product or service is relatively independent of its cost. When this is the case, it is likely that the market is saturated. This situation spells "trouble."

Sales Revenue – Setting prices, including credit policies, is a major factor affecting total revenue. Usually, when you increase the price of your product, you can expect responses to decrease by a percentage equal to the amount of the increase. However, a one-dollar item may not necessarily get twice as many sales as if the item sold for two dollars. It may get more, or it may get less. To maximize your revenue you must therefore test and research what consumers are willing to pay.

Market Share – Your prices will determine to a large extent your percentage of market share compared with your competi-



tors. Lower prices usually mean a larger percentage of the market share.

Competitive Position – Prices will affect how your product or service stands in relation to competitive products. Occasionally, you might use cheaper than normal prices to introduce products or services to get consumer attention and improve your market position.

For most businesses, profitable sales volume is a better company goal than maximum sales volume.

NOTE When setting your prices, keep in mind that your competitors will be watching closely. If you set your prices too low, and seriously threaten their market share, you could start a price war, which in the end both of you will lose (in price wars, only the consumer wins).

Company Image – Your prices will create an image in your consumer's mind. They will see you as a *discounter*, general retailer or overpriced, service-orientated *Rhodeo Drive* type operator. Discounters sell at the lowest possible price and strive for a high volume of units sold while the *Rhodeo Drive* type operator strives for high profit per sale on a lower volume.

Profitability – Your prices will affect the profitability of your company. The most profitable price can be found by testing the market with different prices on the same product. A high price will give you more profit per sale but fewer sales. A low price will give you less profit per sale but more sales. Somewhere in between lies the perfect balance between profit per sale and volume of sales. However, do not trust this as a rule. Some products cannot be sold no matter how little they cost, while other products will do poorly even if their price is very low.

NOTE For most businesses, profitable sales volume is a better company goal than maximum sales volume.

Writing a Price Objective

A written price objective usually centers around one or a combination of the above six factors. Hence, when writing a price objective include a qualifying statement, such as, to:

- increase sales volume
- increase sales revenues
- keep or building market share
- meet or preventing competition
- target low-cost buyers
- increase profits or return on investment

Specific examples of price objectives include the following:

- Earn a 15% return on investment.
- Increase market share by 30% by the end of the fiscal year.

Price Objective – *Increase market share by 30% by the end of the fiscal year.*

- Introduce new products at low prices to gain a significant share of the market. Once this presence is established, raise prices.

HOW MUCH SHOULD YOU CHARGE

IN GENERAL, the prices you charge for your products or services will depend on:

- how much you pay for inventory or supplies
- your operating expenses
- your profit goals

Furthermore, your prices will be influenced by:

- competitive pressures
- industry standards
- the perceived value of your product or service in the eyes of your customers

Fundamentally, pricing should be determined through history and mission, not be accident.
SBA

The impact of these and other factors on your price structure is explained in more detail below.

Factors that Will Influence Prices

When determining how much you should charge for your products or services, make sure to consider the following factors:

Cost – Price your product or service according to your cost structure. Above anything else, your price structure must account for all the fixed and variable costs of conducting your business, including marketing and distribution costs, such as the costs of providing volume discounts, advertising subsidies and shipping. Only then, can you factor in your profit goals. A more detailed explanation of variable and fixed costs is provided below.

For further help, consult Guidebook #80, "Preparing a Break Even Analysis, Cash Flow Statement & Income Projection" and the examples provided starting on **page 15** in "Developing a Price Structure."

Fixed Costs – Fixed costs generally refer to your operating expenses. These costs are classified as fixed because they usually do not vary with your volume of business. They include costs for wages, management salaries, rent, utilities, office supplies, insurance and any other costs attributed to the operation of your business.

Variable Costs – Variable costs generally refer to your cost of goods (inventory costs) as in the case of a wholesaler or retailer and your cost of materials or supplies as in the case of a manufacturer or service provider. These costs are classified as being variable because they increase or decrease depending upon the amount of goods, materials or supplies you purchase for resale or production They include costs for inventory, materials, supplies, freight charges, import duties, handling charges, and commissions.

For the great majority of businesses, prices are most determined by costs, competition and industry pricing practices. ***FUNFACT***

Competition – Price your product or service according to what the competition is charging. Since your products or services are competing in the market place, you must know exactly what the competition is doing before you can finalize your pricing policies. To get detailed information about your competitors' pricing polices, send in a friend, make some "blind" phone calls, or go yourself to do some comparison shopping. Find out: Is there discounting? Special sales? Loss leaders?

Customer Expectations – Price your product or service according to the expectations of your customers. Some shoppers are very price conscious; others want convenience and knowledgeable sales personnel. Because of these variations, you need to learn about your customers' desires and expectations in relation to your kinds of products to price them more effectively.

Price your product or service according to how may people want it and how badly and quickly they actually need it.

Demand – Price your product or service according to how may people want it and how badly and quickly they actually need it. Obviously, if there is a large demand for your product or service and you're the only one on the block selling it, you can pretty much charge what you want. Likewise, if your customers have a passion for your product and can't wait to have it, then again, you have more leeway in what you can charge. Of course, even though the market will likely set the price for your product or service, until you know exactly what that price is, you will have to use other pricing strategies.

NOTE Demand-oriented pricing is usually superior to cost-orientated pricing. In the cost approach, a predetermined amount is added to the cost of the merchandise, whereas the demand approach considers what consumers are willing to pay.

Experience – Price your product or service according to what people have been willing to pay for it in the past.

Final Pricing Authority – Price your product or service according to who has final pricing authority. If you are running a franchise, you may have little say in what you charge for your goods or services. Likewise, be aware that some suppliers and manufacturers can control retail prices by refusing to deal with nonconforming stores (a tactic that may be illegal).

Price your product or service according to pricing standards and guidelines set by your industry.

Industry Averages – Price your product or service according to pricing standards and guidelines set by your industry. Every industry has a standard pricing strategy or structure. For example, markups for cosmetics have always been high while markups for food staples like milk have always been low. Research your market to determine what your industry markup percentage is. Some trade associations have a schedule for service charges. Their figures will make a good measuring stick to ensure your prices are competitive.

Legal Concerns – Price your product or service according to local and national regulations and laws. In some cases, laws may restrict how much you can charge for certain items. For example, in many countries, the price of milk is set and cannot be changed.

Location of Business – Price your product or service according to how good your location is. A business with a prime location can usually get away with charging more for its products or services. For example, compare two similarly equipped hotels, except one has beachfront and the other overlooks a shopping mall parking lot. Which one would you pay more for?

**Perceived Value to Customers – ** Price your product or service according to how valuable your customers perceive it to be. Learning how your customers and prospective customers feel about your products or services will help you establish the upper limit of your price range or "what the market will bear." What they are willing to pay – its perceived value – is dependent upon to what extent it:

- makes or saves them money
- improves their quality of life
- is seen as being truly unique
- is durable and made of quality parts that are generally understood by consumers to cost more
- has real qualitative advantages over its competition
- how well it actually meets their needs

If your price ranges are high, you will need to offer more or better service to justify the higher prices.

NOTE If your price ranges are high, you will need to offer more or better service to justify the higher prices. It should also be noted that if your product is not unique but one of many similar products, you may have to lower you price to "buy" a share of the market.

Physical Appearance of Business Premises – Price your product or service according to how much money you have put into decorating both the interior and exterior of your premises. Clients normally expect businesses with posh surroundings to charge higher prices, while those with bare floors and simple shelving to give good deals.

Profit Goals – Price your product or service according to your profit goals. Naturally, your prices should motivate customers to buy, be competitive, and cover selling costs. However, there's no point starting a business unless you can get a decent return on your investment.

Merchandise should always be priced in such a way as to maximize profit taking into account both your short-term and long-term needs.

Profit has three main ingredients: cost, selling price and sales volume. ***POWERPOINT***

In fact, if you can't reach your profit goals with your present price structure and sales forecast, then you will need to seriously look at ways of reducing your costs, improving your marketing strategies, or increasing your markup without losing substantial sales. Profit goals should also reflect the fruits of your labor and plans for expansion or relocation.

NOTE In general, the more expensive the product or service you sell, the smaller the profit margin the market will bear.

Risk – Price your product or service according to the risks involved in offering certain merchandise or services. For example, very fashionable clothing often carries a higher markup than basic clothing such as underwear because the particular fashion may suddenly lose its appeal overnight and be replaced by a new fashion craze.

It is virtually impossible to beat the large conglomerates on a pure price basis, therefore the small business has to provide a value added to its goods and services.
SUPERTIP

DEVELOPING A PRICE STRUCTURE

DEVELOPING a systematic approach to setting prices is critical to building a successful business. Below are serveral methods you can use to calculate the cost and necessary markup for both retail and service businesses.

NOTE Your accountant can be an excellent resource to help you with any complications your encounter.

One technique of establishing a pricing structure is to mark up goods sold by adding an initial percentage to the total cost of the goods.

Calculating Retail Markup

One technique of establishing a pricing structure is to mark up goods sold by adding an initial percentage to the total cost of the goods. This percentage should take into consideration the two major costs associated with the product, which are the cost of:

- **acquiring the goods, called "cost of merchandise" or "cost of goods sold" –** This cost includes the price paid for the merchandise plus freight, import duties and any handling costs minus any quantity and cash discount given to the retailer by the wholesaler.
- **operating the business to sell the goods, called "operating expenses" or "overhead –** This cost includes markdowns, stock shortages and the salary of the owner.

Markup percentage should also take into account,

- **desired profit**

For example: A retailer (Sam's Shirt Shop) purchases a shirt at $20 and marks it up $8 for a resale price of $28. The markup percentage is then calculated by dividing the markup amount by the cost of the shirt.

Cost of one shirt	$20
Markup amount	$8
Selling price per pair	$28
Markup percentage	40%

This 40 percent markup should cover all operating expenses, including markdowns, stock shortages, employee and customer discounts, the owner's salary and some margin of profit.

In this example, Sam's Shirt Shop may figure **15%** for wages, **8%** for rent, **2%** for utilities, **3%** for advertising and **12%** for profit.

NOTE When first starting a business, it is difficult to determine how much goods should be marked up because a new business has no history of sales on which to base future sales projections. It is thus important to research industry trade journals for sales patterns and industry markup averages.

Expressing Markup as a Percentage of the Retail Price Instead of Cost – It is important to note that retail price, rather than cost, is ordinarily used to calculate percentage markup. The reason for this is that when other operating figures such as wages, advertising expenses and profit, are expressed as a percentage, all are based on retail prices rather than the cost of the merchandise. For this reason, most retailers prefer to express their markup as a percentage of retail price (see "Markup Table" on page 19). Using the example above you would determine the retail markup percentage as follows:

Dollar amount of markup	$8
Retail Price	$28
Retail Markup (dollar markup/retail price)	29%

**Using a Standard Markup Percentage – ** It is important to maintain a standard or average percentage of markup, to be able to get the profit percentage you establish in your pricing policy. To do this you need to establish an "Initial Markup Percentage," which becomes the "Standard or Average Markup Percentage." The initial markup is figured as follows:

Standard % Markup Formula

$$\textbf{Initial Markup} = \frac{\text{Operating expenses + Reductions + Profit}}{\text{Net Sales + Reductions}}$$

Reductions consist of markdowns, stock shortages and employee and customer discounts.

For example: *Sam's Shirt Shop* has net sales of $188,000, reductions of 6% or $12,000, operating expenses of $53,000, and a desired profit of $15,000. Initial

Markup would be caluclated as follows:

Initial Markup

$$= \frac{\$53,000 + \$12,000 + \$15,000}{\$188,000 + \$12,000}$$

$$= 0.4 \text{ or } 40\%$$

A business might choose to use a standard markup percentage on all products, or it may have different markups for different goods. The reason for this is the standard or average doesn't allow for the cost difference in selling different products. If product A costs far more to advertise or sell than product B, a standard markup percentage may produce a loss on product A and a greater-than-average profit on product B.

Calculating the Cost of a Service Method #1

Services are harder to price than goods. It is more difficult for the buying public to determine a fair price for services, and comparative shopping has much less effect in service industries than it does in hard goods industries. Services are also more difficult to price because costs may be harder to estimate and it is more difficult to compare prices with the competition.

However, although more complex, pricing a service is basically calculated in the same way as pricing retail goods:

Price = inventory cost + operating expenses (which include material, labor and overhead) + the desired profit

Calculating Material Labor & Overhead Costs

Calculating Material Costs – Material cost is the cost of material used directly in the final product, such as sparkplugs and gaskets in the repair of an engine. Supplies such as paper towels are part of overhead, not material costs. Material costs must be updated frequently. A cost list must always be used in preparing a bid or quoting a job. If there are shipping, handling or storage costs for materials, these must also be included in the total materials costs.

NOTE If you purchase materials at a lower cost, you can therefore receive a higher percent-

"Markup at Retail" and "Markup at Cost" Table

MARKUP AT

RETAIL %		COST %
30.0	=	42.9
31.0		45.0
32.0		47.1
33.0		49.3
34.0		51.5
35.0		53.9
36.0		56.3
37.0		58.8
38.0		61.3
39.0		64.0
40.0		66.7
41.0		70.0
42.0		72.4
43.0		75.5
44.0		78.5
45.0		81.8
46.0		85.2
47.0		88.7
48.0		92.3
49.0		95.9
50.0		100.0
60.0		150.0

Markup (also known as markon) is the difference between the cost of the merchandise and its selling price. It can be measured in percent or dollars. Markup is usually figured on the basis of the retail selling price. The following table shows the equivalent percent for markup at retail and cost.

For example: To arrive at a markup at retail, let us assume that you want to sell a pair of socks that cost you $3.25 at a 40% markup. The basic markup formula is:

Cost = Retail Price - Markup

Cost = 100% - 40% = 60%

Retail Price = Dollar cost/Percentage Cost = $3.35/60% (.60) = $5.42

age of profit.

Calculating Labor Costs – Labor Cost is the cost of work directly applied to a service such as a mechanic's work. Work not directly applied to the service, such as cleaning up, is an overhead cost. Direct labor costs are derived by multiplying the cost of labor per hour by the number of hours required to complete the job. Use a time card and clock to determine the number of hours of labor involved in each service.

Calculating Total Direct Labor Cost – In many businesses, when more expensive equipment is used by higher paid employees; overhead cost is more closely related to labor cost than to labor hours. In this situation, overhead cost is allocated on the basis of direct labor cost and expressed as a percentage as follows:

Overhead Rate

$$= \frac{\text{Total overhead cost}}{\text{Total direct labor cost}}$$

$$= \frac{\$40{,}000}{\$50{,}000}$$

$$= 0.8 \text{ or } 80\%$$

Calculating Total Direct Labor Hours – This format is most commonly used in businesses such as machine shops, automotive repair shops and job shop production. However, when there is relatively little difference between the hourly wages for employees, or little relationship between worker skill and equipment used, the following hourly rate formula is followed:

Overhead Rate

$$= \frac{\text{Total overhead cost}}{\text{Total direct labor hours (per year)}}$$

$$= \frac{\$40{,}000}{4{,}000 \text{ hours}}$$

$$= \$10 \text{ per hour}$$

Calculating Overhead Costs – Usually there are people on a company's payroll who perform support services that are not charged to direct labor but must be included as a cost. These costs, called overhead cost, include legal fees supplies, insurance, taxes, rent and accounting. Generally speaking, overhead cost includes all costs other than direct materials and direct labor. It is the indirect cost of the service.

This cost can be expressed as a percentage or as an hourly rate.

Overhead Rate

$$= \frac{\text{Total overhead cost}}{\text{Total direct labor cost}}$$

EXAMPLE 1 As shown in the example on **page 27**, if you calculated your overhead costs to be 80% of your direct labor costs and your employee whom you pay $10 per hour worked on a car for three hours using parts costing $70, your cost to the customer would be calculated as shown

Calculating the Cost of a Service Method #2

A simple, easy-to-understand method of calculating the cost of a service is by basing the cost on *billable hours*. Begin by determining the number of hours available for billing in a year. Then calculate the break-even point by dividing the overhead and labor charges by the billable hours and adding the cost of any materials used. Your desired profit is then added to the break-even point. This method is shown in the two examples on **page 28** and **page 29**.

EXAMPLE 2 Supposing two people experienced at bookkeeping open a business together. First they estimate their overhead expenses to be $20,400 (as shown in example 2 on **page 28**). They then decide they each want a salary of $25,000. In this case, the salary is actually an overhead expense, but it will be treated separately because the owners also decide they want to make a profit of 20 percent on their salaries but only a 10 percent profit on their overhead.

A simple, easy-to-understand method of calculating the cost of a service is by basing the cost on billable hours.

The number of working days per year is 260 (52 weeks x 5 days). Subtracting holidays, vacations and sick days, the actual number of workdays total 230. Two people working 8 hours per day results in 3,680 hours (230 x 2 x 8 = 3,680). However, the bookkeeper estimates that 20 percent of these hours (736) will not be spent working for clients. Therefore, the billable hours for this company totals 2,944.

To determine what rate to charge, the bookkeepers divide the desired revenue ($82,440) by the number of billable hours (2,944) resulting in a hourly rate of $28.00. Profit is then calculated by subtracting total overhead and salaries from the proposed revenue ($82,440 - $70,400 = $12,040). This is the profit to be realized, assuming the billable hours figure is realistic for the first year of operation.

EXAMPLE 3 In example 3 on **page 29**, ABC Repair Service employees ten repair technicians, who are paid $18,000 each. Social Security tax, unemployment tax, worker's compensation insurance, health insurance and retirement benefits cost an additional $5,400 each, for a total cost of $23,400. Because there are ten technicians, the yearly labor charge is $234,000.

To break even, ABC Repair must have a total revenue of $234,000 (labor) plus $98,000 (overhead) = $332,000. The owner of the business has calculated the billable hours as follows: Work days per year = 52 weeks x 5 days = 260 days. Subtracting 15 vacation days, 7 sick days and 8 holidays leaves 230 workdays. Work hours = 230 workdays x 8 hours = 1,840 per year for each repair technician.

From experience, the owner knows that he cannot keep his crew working eight hours per day as there is lost time between jobs. He deducts 10 percent of the hours as non-billable.

However, from experience, the owner knows that he cannot keep his crew working eight hours per day as there is lost time between jobs. He deducts 10 percent of the hours as nonbillable, leaving 1,840 - 184 = 1,656 billable hours per technician. Because there are 10 technicians, the total Billable hours = 1,656 x 10 = 16,560 per year.

To determine the hourly labor cost, the owner divides the labor cost per year ($234,000) by the billable hours (16,560). The result is $14.13 per hour.

To find total cost, overhead must be added. Total overhead per year is $98,000. When divided by billable labor hours of 16,560, overhead equal $5.92 per hour. Thus, the total hourly cost of labor plus overhead is $14.13 = $5.92 = $20.05.

Since the owner knows that if he charges only the hourly rate based on actual cost, he will merely break even. In order to make a profit so that he can reduce debts, buy new equipment, provide working capital and provide a return on investment, the owner decided to add 25 percent on his labor and 30 percent of his overhead. The owner decides to charge $25.50 per hours. This hourly rate, multiplied by the billable hours of 16,560, results in an income of $422,280.00 per year. Thus the income minus the expenses ($332,000) equals profit of $90,280.

The charge for a service equals materials plus labor plus overhead, with a profit built into each component.

NOTE Each year the above calculation must be repeated to included any changes in labor or overhead. If any materials are used in the repairs, they must be figured into the cost per job. A profit percentage may also added to the materials charges. Remember, using the above method, the charge for a service equals materials plus labor plus overhead, with a profit built into each component.

Calculating the Cost of a Service Method #3

Pricing consulting services, where primarily ones' own labor or expertise used, is somewhat different from pricing a service that uses materials and the labor of others. Most consultants price their service by the hour. If there are senior consultants, they will charge more for their own time than for the use of a junior or less experienced consultant. It is very important, however, that one charges for an adequate number of hours. Travel time must also be included; usually the travel expense is an extra charge.

A common mistake of many new or inexperienced consultants is to underestimate the number of hours and additional charges or expenses that they may incur.

NOTE A common mistake of many new or inexperienced consultants is to underestimate the number of hours and additional charges or expenses that they may incur. If the policy is to charge only an hourly rate plus travel expenses, be sure that the hourly rate will cover salary requirements, operating expenses and the profit percentage you desire.

If your clients require you to submit a contract bid for a job, you should include a more precise breakdown of your expenses. The contract bid should take into account professional time, clerical support, computer or other special services (such as printing) and overhead expenses.

EXAMPLE 4 In example 4 on page 30, Chip's Computer Consulting determines their overhead expenses for the year to be $9,200.

To figure out their chargeable hours per year they calculate their number of working days to be 260 (52 weeks x 5 days). Subtracting holidays, vacations and sick days, the actual number of workdays totals 230. Since their business operates 8 hours a day (9 to 5), their total billable overhead hours is 1,840 hours. However, they estimate that 50 percent of those hours (920) will not be spent working for clients. Therefore, their total chargeable hours per year is 920.

Everything is worth what its purchaser will pay for it.
PUBLILIUS SYRUS
Maxim 847

Their overhead rate per hour is thus calculated as follows: $9,200/920hrs = $10/hour.

NOTE In selling consulting and other professional services, it is unlikely that 100 percent of your time will be billed to clients. Therefore, hourly or contract fees must be substantial enough to cover overhead costs during slow periods. It is common for one-half of the total normal yearly working hours to be used in figuring overhead rates.

EX #1: Calculating the Cost of a Service Method #1 **(p. 18)**

Bills Auto Shop	
Material Cost	
Muffler	$70.00
Direct Labor Cost	
Hourly Wages (per hour)	$10.00
Fringe Benefits (30% of wage)	$3.00
Total Cost per Hour	$13.00
# of Hours	3
Direct Labor Total	$39.00
Overhead Cost (80% of direct labor)	
Total	$31.20
Total Costs	$141.20
Profit	
Profit on Materials (30%)	$21.00
Profit on Labor (25%)	$9.75
Profit on Overhead (20%)	$6.24
Total Profit	$37.99
Total Charge to Customer	$217.18

EX #2:
Calculating the Cost of a Service Method #2 (p. 21)

Estimated Overhead Expenses for Dundy's Accounting	
Expense	**Amount per year**
Rent	$9,600
Utilities	1,800
Telephone	1,200
Office supplies	1,200
Insurance	600
Depreciation	2,500
Advertising	2,000
Miscellaneous	1,500
Total	$20,400

Estimated Total Revenues Required	
Expense	**Amount per year**
Owners' salaries	$50,000
Profit on salaries (20%)	10,000
Overhead	20,400
Profit on overhead (10%)	2,040
Total	$82,440

Calculation of Final Hourly Rate	
Desired Revenue	$82,440
Number of Working Days	230
Billable Hours / Day	16
Wasted Hours	736
Total Billable Hours / Year	2,994
Hourly Rate	$27.53

EX #3: Calculating the Cost of a Service Method #2 (p. 21)

ABC Service Repairs Overhead Expenses	
Expense	**Amount per year**
Salaries (including Owner)	$60,000
Payroll taxes and costs	3,700
Insurance	13,000
Telephone	1,200
Utilities	2,600
Depreciation	5,000
Rent	10,000
Miscellaneous	2,500
Total Overhead Expenses	$98,000

Calculation of Final Hourly Rate	
Total Labor Costs	$234,000
Total Overhead Expenses	$98,000
Number of Working Days	230
Billable Hours / Day	80
Wasted Hours	1,840
Total Billable Hours / Year	16,560
Labor Cost per hour	$14.13
Profit on labor (25%)	3.53
Overhead cost per hour	5.92
Overhead profit (30%)	1.78
Total	$25.36

Calculation of Profit	
Charged Hourly Rate	$25.50
Billable Hours / Year	16,560
Total Revenues	$422,280
Total Labor Costs	$234,000
Total Overhead Expenses	$98,000
Profit	$90,280

EX #4: Calculating the Cost of a Service Method #3 (p. 24)

Chip's Computer Consulting

Professional Charges			
Senior Consultant	10 hrs	@ $75	$750
Junior Consultant	15 hrs	@ $35	$525
Cleric	7 hrs	@ $18	$126
Total			$1,401
Overhead expenses per year			$9,200
Chargeable hours per year			920
Overhead rate per hour			$10
Overhead rate at 32 hrs x $10			$320
Travel			
Airfare at $275 x 2 trips			$550
Per diem at $120 per day x 3 days			$375
Total			$925
Contract Total			$2,646

CHOOSING A PRICE MARKETING STRATEGY

EVERY INDUSTRY has a favorite pricing strategy. Research your market to determine what your industry pattern is and use it as a guide. However, keep in mind that the pricing strategies you use must reflect your company's profit goals and cost structures, not your competitor's. The most common pricing strategies are listed below:

Anyone who has to ask the cost can't afford it.
ANON

Break Even Pricing – In break even pricing, you base your prices on your fixed and variable costs as well as your profit goals as shown in the previous section. Much has been written on break even analysis as a rational means of determining prices and pricing policy. However, be warned that sometimes it just doesn't work.

NOTE When using break even pricing, and any other pricing strategy for that matter, it is a good idea to determine a price range for your products and services. The cost of merchandise (your BE point) will be at one end of your price range, while the level above which consumer will not buy your product or service will be at the other end.

Buying a Market Position Pricing – Using this form of pricing, you attempt to buy your way into the market by initially offering free samples or "heavy' discount coupons, for example 50 cents off a 99 cent purchase. This pricing strategy is usually reserved for big companies selling repeat goods and having ample cash reserves. It usually takes six months or more before this strategy starts to pay off.

Competitive Advantage Pricing – In competitive advantage pricing, your prices are set equal to, above or below those of your competition. This strategy requires you to constantly shop your competition. A variation of this is the "we-won't-be-undersold" approach where you offer to meet or beat the prices of all your competitors.

NOTE A small business should not try to compete price-wise with large chains, discount houses or supermarkets. These types of competitors can charge less because they buy in larger volumes and thus have lower per unit costs. Instead, base your pricing on non-price issues such as value-added services.

A small business should not try to compete price-wise with large stores, discount houses or supermarkets.

Many customers are willing to pay higher prices for merchandise if they receive better service.

Discount Pricing – In discount pricing, a retail outlet offers lower prices as a trade-off for sparsely decorated interiors and fewer sales personnel. They also use central checkouts to improve efficiency. Discount stores depend on greater volume to cover operating costs. They typically work on a 35 to 38 percent markup compared to 42.5 to 45 percent for a department sore.

Full-cost Pricing – In full-cost pricing, prices are calculated by adding the costs of the product or service plus a flat fee or percentage as the margin of profit. This pricing method is easy to implement.

However, it is important to note that during inflationary periods, business owners must closely monitor costs to make sure they are charging enough. Otherwise, when they replace their stock, they may find that their wholesale prices have risen above their retail prices, resulting in either diminishing inventories at a constant dollar investment or having to invest more money to restock their shelves to maintain normal inventory levels.

Loss leaders are items sold at a lower price to attract people into your store to buy other regularly priced items.

Keystone Pricing – Keystone pricing refers to the practice of setting the retail price at double the cost figure, or a 100 percent markup. This pricing strategy is most common with jewelry shops, high-ticket fashion shops, specialty shops, and department stores. Often, using this type of pricing strategy, frequent clearance sales are necessary or slow sellers and out of season merchandise.

Loss Leader Pricing – Loss leaders are items sold at a lower price to attract people into your store to buy other regularly priced items. A good loss leader will have a lower wholesale price than other items, look more expensive, sell at other stores at a higher price, be readily available from your suppliers, and/or be a recognized brand or item purchased frequently enough that customers recognize the savings.

Loss leaders are more effective if closely associated with other items which are sold at the regular price. An example is a shirt and tie, with the tie being the loss leader.

NOTE One of the dangers of using loss leaders is that you may develop a following of "cherry picker" i.e., customers who will whisk into your store, scoop up the specials and buy nothing else.

Matching the Competition Pricing – Using this pricing strategy, you match the prices of other businesses selling comparable products or services.

With odd pricing you use figures that end in 5, 7 or 9 such as $2.99, $4.97, $15.95 or $69.

Multiple Unit Pricing – Multiple pricing is the practice of promoting a number of units for a single price (usually used for low-cost, consumable products such as soap or toothpaste). The idea behind it is that you can increase the size of your individual sales by offering a meaningful discount for larger purchases. Example of multiple unit pricing include:

- baker's dozen
- bulk pricing in effect
- buy by the truckload
- buy three tires get the fourth free
- buy twelve get one free
- cheaper by the carton
- six-packs
- two for $1.98

NOTE Many stores find multiple unit pricing a desirable pricing strategy for sales and year-end clearances.

Odd Pricing – With odd pricing you use figures that end in 5, 7 or 9 such as $2.99, $4.97, $15.95 or $69. For psychological reasons, consumers tend to round down dollar figures when making the decision to purchase. For example they round $39.95 to $39 rather than rounding it up to $40. However, this strategy is not considered to be as effective today as it was in the past.

Penetration Pricing – In penetration pricing, you introduce your product at a substantially lower price than the competition to quickly gain a large share of the market. The purpose of this strategy is to create customer excitement and demand for your product or service in order to help establish a strong customer base, and at the same time, discourage competition. However, eventually you will have to raise your prices to start making some profit, and when you do, you will learn a lot about customer loyalty.

It is not that pearls fetch a high price because men have dived for them; but on the contrary, men dive for them because they fetch a high price.
BISHOP RICHARD WHATELY

Pre-season Pricing – Often used by manufacturers, pre-season pricing is a strategy whereby price discounts are offered as incentives to buy early. This strategy is important to manufacturers because it is advantageous for them to be able to project production requirements and order the right amount of raw materials.

This pricing strategy can also be used by retailers to even out demand. Off-season specials can also be used to even out your monthly cash flow. For example, by offering an early bird discount on snow shovels you can capture some of the lost business you would've encountered when the year's first snowstorm hits and everybody is in a panic to buy shovels to clean their sidewalks.

Price-is-no-object Pricing – Using this pricing strategy you charge high prices to create an image of exclusivity and cater only to the cream of society (anybody with money). In fact, if someone walks into your store and asks what the price is, you send them down the block to K-mart. However, keep in mind that this strategy will only work if your product or service is:

- highly innovative
- in demand
- one of a kind
- threatened by little or no competition
- within a market where price is less important than quality, outstanding service and image (i.e., Hollywood)

Price-is-no-object pricing is often used with high-ticket fashion and jewelry. Using the same psychology, expensive automobiles and boats can also be sold.

Price Lining – Price lining refers to a marketing strategy that targets a specific segment of the buying public by carrying products only in a specific price range. For example, a hardware store, may carry hammers in good, better and best categories at $4.97, $7.97 and $9.97 and a professional model at $18.95.

In pricing lining, similar products are sold in good, better and best categories e.g., $3.49, $6.49 and $9.98.

The theory behind this pricing strategy is that people buy products with different uses in mind and with different expectations for quality and length of useful life. This strategy also helps you meet the needs of customers who are looking a product at the "right" price i.e., the price they can afford.

Price lining has many advantages, among them the following:

- ease of merchandise selection
- ease of selection for customers
- merchandise can be more closely targeted to clientele
- reduced errors by sales personnel
- reduced inventory by limiting the number of items pricing
- reduced storage costs as a result of small inventory
- simplifies buying and inventory control because you buy only for the price levels that you know your customers will accept and eliminate those goods that fall outside the levels you want to carry

Price skimming refers to the practice of charging high prices for the purpose of maximizing profit in the short run.

One **disadvantage** to price lining is that by focusing too much on price, you may overlook issues of quality or consumer buying trends. It also limits your ability to meet competitor's prices.

NOTE Price lining is usually only successful if there is little or no competition. It works to the benefit of the retailer because it limits the merchandise line and makes inventory and buying easier. It is also easier for the customer to select merchandise, so that fewer salespeople may be needed.

Price Skimming – Price skimming refers to the practice of charging high prices for the purpose of maximizing profit in the short run.

It works best when:

- The product is unique.
- The product targets trendsetters who are easily bored and always looking for something new (these trendsetters bring with them legions of follower who will also buy if they accept the new product).
- The cost of development is high and there is a chance of early obsolescence or imitation by competitors.
- You have a strong patent position, or your product would be difficult to copy.

Price skimming refers to the practice of charging high prices for the purpose of maximizing profit in the short run.

The real **disadvantage** of skimming is that is attracts competition like flies to horse manure. Once your competitors get wind of your high profits, they will copy your strategy. They may even produce cheaper versions of your product (referred to as knockoffs). In fact, once you have meaningful competition, your skimming days are over and you run the risk of ending up with a warehouse full of products that cannot be sold at any price.

Pricing Above Competitors – Pricing above the competition is possible when non-price consideration are more important to buyers. These include:

- convenient or exclusive location

- exclusive brand or designer names (a store may carry well-known or high-quality brand names that are not available elsewhere under an exclusive agreement with the manufacturer or distributor)
- free delivery
- helpful and friendly sales staff
- in-home demonstrations
- satisfaction in handling complaints
- supperior product knowledge
- specialized services
- speedy service

Pricing Below Competition – Using this pricing strategy, you beat your competitor's price. However, because this strategy reduces your profit margins, it can only be effective if it greatly increase sales. Consequently, to succeed using this price strategy you must:

That which costs little is less valued.
MIGUEL DE CERVANTES

- closely control inventory
- design advertising to concentrate on price specials
- limit the product lines to fast-moving items
- locate the business in an inexpensive area of facility
- obtain the best prices possible for the merchandise
- offer no or limited services
- reduce operating expenses

NOTE Pricing below competitors can often backfire because every cost component must be constantly monitored and adjusted. Competitors can retaliate by matching the lower prices, at which point a price war begins and both businesses lose.

Suggested Retail Pricing – Suggested retail pricing is the practice of selling at prices set by your suppliers (wholesalers and manufacturers). The advantage of this pricing strategy is that it simplifies the decision-making process and the trouble of monitoring

Elements of the Selling Price for Various Businesses

OUTLINED BELOW ARE the most important elements of the selling price for manufacturing, wholesale, retail and service types of businesses:

Manufacturing Businesses – In manufacturing, the most important elements of the selling price are direct costs including direct materials, manufacturing overhead (equipment), nonmanufacturing overhead and planned profit.

Wholesale Businesses – In a wholesale business, the most important elements of the selling price are the cost of goods for resale, overhead, sales volume, competition's pricing and credit policies, and planned profit.

Retail Businesses – In a retail business, the most important elements of the selling price are very similar to those of a wholesale business except in addition, the retailer has to very concerned about how prices will affect their "business image."

Service Businesses – In a service business, the most important elements of the selling price are materials and supplies, labor and operating expenses, competition and planned profit.

the competition. It is also convenient because many product lines are already prepackaged and prepriced. However, to its disadvantage you lose flexibility. You must live with a set percentage markup.

NOTE Due in part to the fact that suggested-retail or retail-price-maintenance plans are illegal in some states, this tactic is usually a loser.

Suggested retail pricing is the practice of selling at prices set by your suppliers.

FINE-TUNING YOUR PRICING POLICY

NO PRICING policy is complete without a few strategies to help consolidate your competitive position. Use the following **14** strategies to expand and improve upon your basic pricing policy.

A fair price for oil is whatever you can get plus ten per cent.
DR. ALI AHMED ATTIGA
Saudi Arabian Delegate to OPEC

1. **Avoid advertising the prices of expensive items.** If for example you use classified ads to promote an item that cost more than $100 ($100 is considered quite expensive in this medium), it is preferable not to include the price of the item in the ad. Send a direct mail package that has the power to convince a prospect to buy.

2. **Do not lower prices without a good reason.** Dropping prices without an explanation usually means you were unable to compete at the higher price. It does not mean you are giving your buyer a bargain. Consumers catch on quickly to this and may avoid your product or service entirely being suspicious of your reasons for discounting. For example, selling books at a discount, suggests that the information in them is not worth any price.

3. **Give discounts to distributors or customers who make large orders.** Encourage large orders with bargain bulk purchases. Discounts to distribution channels (brokers, wholesaler &retailers) may

also be needed to get your products distributed to your markets.

4. **Give discounts for early or prompt payments from credit customers.** Discounts to credit customers can improve collection rates and reduce your average accounts receivable collection period, thereby improving cash flow. Discounts are usually stated on invoices and sales orders as shown below.

5. **Consider allowing trade-ins as part of any purchases.** A trade-in policy is usually important for businesses that sell appliances, televisions, autos and even musical instruments. Usu-

Terms	*Explanation*
2/10, n/30	This means that the bill is due within 30 days but the buyer can deduct 2 percent if the bill is paid within 10 days from the date appearing on the invoice.
2/10oem	This means that a 2 percent discount will be allowed if the bill is paid within 10 days after the end of the month (eom).
3/20, n/60	This means that the bill is due within 60 days but the buyer can deduct 3 percent if the bill is paid within 20 days from the date appearing on the invoice.
5/10, n/50	This means that the bill is due on or before the 50th day but if payment is made within 10 days after the invoice date, a 5 percent discount may be deducted from the invoice price.

ally the trade-in value is below what the customers could receive if they decided to sell the item themselves.

6. **Establish a markdown policy.** A markdown is a reduction in the price of any item. Markdowns are necessary when customer demand is miscalculated, seasonal merchandise is overstocked, merchandise becomes shopworn, personal sales efforts failed, promotion and advertising efforts failed, or the competition lowered their prices. Markdowns are used to avoid being left with old merchandise that is difficult o sell. If properly timed, markdowns can clear out merchandise quickly, thereby increasing cash flow and reducing inventory.

Markdowns are generally taken early in the selling season or shortly after sales slow down.

In setting a markdown price, the original cost of the merchandise should be recovered if possible. If the original selling price was high enough, a small profit is possible. The markdown price is obtained by subtracting the dollar markdown from the previous retail price.

NOTE There are a number of theories about when markdowns should be used. These theories vary greatly with the type of merchandise being makred down, the size of the initial markup, season of the year, amount of competition, how many consumers might still be interested in the product, and the amount of merchandise remaining in stock. Markdowns are generally taken early in the selling season or shortly after sales slow down.

7. **Increase prices when budget projections warrant it.** Random price increases can drive away business and destroy goodwill. However, when your budget projections warrant, it is essential to make increases. Waiting too long to increase prices, can destroy your business.

NOTE Pricing policies must be examined and reviewed frequently to be certain the desired profit level is maintained.

8. **Issue rainchecks for out of stock items.** Rainchecks should be given to consumers who come in your store to buy advertised merchandise recently sold out. Not only does this improve customer relations but in some situations is required by law. Consult your lawyer or the regional Federal Trade Commission office for specific advice regarding whether rainchecks are needed during advertised sales and under what circumstances.

Rainchecks should be given to consumers who come in your store to buy advertised merchandise recently sold out.

9. **Monitor your gross margin.** Gross margin is calculated by divided your gross profit by your total sales. The value (percentage) can then be used as a monitor for your sales-purchasing department. The gross margin calculation allows the manger to buy goods that can be sold at or higher than the desired margin.

NOTE If an item of merchandise has a low sales volume, it should have as high a gross margin as possible or else it will not be profitable. If a business does a high volume of sales, it may be possible to have a pricing policy based on a lower gross margin.

10. **Offer a rebate.** If you manufacture goods, overestimate demand, and hence have more goods than you can reasonably sell at present prices, consider offering a manufacturer's rebate to encourage sales. Rebates can also be used to discourage the competition from getting a foothold in the marketplace.

A product with a list price of $59.85, can be split into 3 payments of $19.95 plus shipping and handling and taxes.

11. **Reprice all in-stock quantities when your cost of a regularly stocked item goes up or down.** When this is not being done, it is usually an indication that good general business practices are not being followed.

12. **Split an expensive price into three or four easy payments.** This is a favorite strategy among TV direct and mail order sellers as it creates the illusions of a cheaper price and allows customers to spread out their payments. A product with a list price of $59.85, can be split into 3 payments of $19.95 plus shipping and handling and taxes.

13. **Use "department-store" pricing rather that "flat" pricing.** For instance, $19.95 is better, in most cases, than $20.00. Odd-ending prices such as $1.98, $5.99 or $399.95 are

generally felt to be more appealing. You may consider rounding prices that include all sales taxes and shipping charges.

14. **Use price tags that clearly show your markdown from the suggested manufacturer's retail price.** Some retailers and mail order merchandisers have resorted to artificially high regular prices so that they can call the announced price a sale price – although the item was never sold at the regular price. This deception is usually done in answer to competition from discount stores, which sometimes quote artificially high regular, former or retail comparative prices, in order to make their regular or discount price appear more attractive.

The value of a thing is the amount of laboring or work that its possession will save the possessor.
HENRY GEORGE

Avoid the temptations of setting artificially high regular prices. North American consumers are far too sophisticated to be fooled by this strategy. Conditioned by an ever increasing number of sales promotions, they have become more skeptical about what merchants claim to be regular prices. To win their loyalty, use only manufacturer's recommended retail prices as compared with yours.

Pricing Policy Checklist ☑

- ❑ Are groups of customers, such as students or senior citizens, given purchase discounts?
- ❑ Are cents-off coupons used to encourage sales?
- ❑ Are employees given purchase discounts?
- ❑ Are rain checks issued?
- ❑ Are relatively large reductions or markdowns due to spoilage, breakage, theft or obsolesce reflected in your cost structure?
- ❑ Are trade-ins be accepted as part of the purchase price on items such as appliances and television sets?
- ❑ Because customers often equate the quality of unknown products with their price, do you adjust prices accordingly?
- ❑ Do you constantly monitor costs and make price changes to provide for continued profitability, particularly in periods of rapid inflation?
- ❑ Do you have a markdown policy for clearing out old, obsolete or slow moving stock?
- ❑ Do you price all items at a level that provides an adequate profit margin? If not, why? Do you use loss-leaders?
- ❑ Do you regularly scout the pricing policies of your competition?

Pricing Policy Checklist ☑

- ❑ Do you regularly test your market to find the price-volume combination that will maximize your profits?
- ❑ Does your initial markup cover your variable costs, fixed costs & planned profit?
- ❑ Have you established price ranges for your product or service, where the cost of the product or service is at one end of the price range and the level above which consumers will not buy your product or service is at the other end?
- ❑ If you use price lining – the practice of setting up distinct price points, such as $5, $7.50 $12, $15 – or price zones – such as $5-10 and $10 to $15 – have you tested which method gives the best results for your type of business?
- ❑ If your jurisdiction has an unfair sales practices act that requires minimum markups on certain merchandise, do your prices comply with this statue? (such as milk).
- ❑ Is your price consistent with your product image?
- ❑ To avoid retaliation by competitors and starting a price war have you tried adding extra services and warranty coverage or paying transportation costs rather then lowering prices?
- ❑ When reducing prices, do you consider your competitors' probable reactions?