

Pricing and Costing

This factsheet covers the requirements for determining the costs of your business, identifying your break-even point and setting a price for your product or service.

Firstly - Always consider the Product/Service and its market carefully. Could product value and desirability be increased to a greater degree than cost?

FINDING A PRICE!

Some basic principles:

- The selling price must be higher than the costs
- The price is determined by what the market will stand

DIFFERENT TYPES OF COSTS

- It is helpful to divide up costs into different categories:
- Direct costs are those that can be directly attributed to the production of a particular product or service. Raw materials and sub-contract labour are direct costs. Deducting the direct cost from the sales revenue for a particular product gives its 'contribution' towards the overheads and net profit. This is also known as the gross profit
- Variable costs, as the name suggests, vary in proportion to the level of production. However, some overhead costs, such as use of electricity, may also vary with total production even though they are difficult to allocate directly. Generally, these costs will fall under fixed costs. It is only where you can easily quantify the amount of electricity or fuel used in production that you would attribute this under variable/direct costs.
- Fixed costs, on the other hand, do not vary in the short term and are not dependent on the level of production. These include rent, rates, insurance, managers' salaries etc. Whilst acknowledging that certain costs such as fuel, telephone, postage, advertising etc will vary they are still considered to be fixed costs.
- Indirect costs are opposite to direct costs - those costs that cannot be directly attributed to a specific product. Fixed costs are always indirect; variable costs might be direct or indirect. In this factsheet the term 'direct costs' will be used to refer to costs directly attributable to the product or service being offered. The term 'overheads' will be used to cover all the other expenses of running your business.

If you are self-employed (as a sole trader or partner) the money available to you is the profit, eg the sales revenue less all the costs. You will need to draw money out from the business on a regular basis. Remember that your drawings are simply an advance against profit. You are taxed on all profits. For the purpose of calculating costs, it makes sense to treat your drawings and any income tax as overhead costs.

Manufacturing costs

If you are manufacturing, you can calculate the cost per item by:

$$\frac{\text{Business overheads} + \text{Direct cost of the item}}{\text{Total items}} = \text{Item cost}$$

If you make more than one product, you need to split the business overheads between the different products, eg on the basis of the volume of each product.

Imagine that you make tables. You have estimated your total overheads for the year as £50,000 including depreciation, tax and drawings. You expect to make and sell 100 tables during the year. The cost of wood and other materials for each table is £50.

Using the equation:

$$\frac{50,000 + 50}{100} = \text{tables cost} = \text{£}500.50$$

You need to add a profit margin, say 10% (and VAT at 17.5% if you registered for VAT). This gives a selling price of £646.90

Service Based Businesses

If you provide a service, you need to know how much to charge per hour, though you may estimate the total time required and offer your customers a fixed price when quoting. This can be expressed by:

$$\frac{\text{Annual business overheads}}{\text{Annual productive hours}} = \text{hourly rate}$$

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Remember that not all working hours will be productive. Some time will be required for promoting your business, buying supplies, doing the books etc. you will need some holidays and should also allow for possible illness.

Imagine that you are a photographer. As above, your total overheads for the year are £50,000. After allowing for holidays, illness etc, you estimate that you will be able to sell 200 days of your time. You expect to average 7.5 hours per day.

$$\begin{aligned} \text{Thus, your hourly rate} &= \\ &= \frac{50,000}{7.5 \times 200} \\ &= \text{£}33.33 \text{ per hour} \end{aligned}$$

You need to add direct costs (film, developing, printing etc), profit margin and VAT. For a one day assignment you will charge time (£249.98) + direct costs (say £40) + profit (say 20%) + VAT (17.5%), giving a total price of £408.88.

BREAK-EVEN ANALYSIS

Once you know your costs and estimated selling price, then you are in a position to calculate how many products, or hours of your time, you need to sell to break-even eg to cover all your costs. Any further sales then provide you with a profit. To calculate your break-even, use the following formula:

$$\begin{aligned} \text{Number of sales to B/E} &= \\ &= \frac{\text{Fixed expenses}}{\text{Selling price less variable cost}} \end{aligned}$$

$$\begin{aligned} \text{Value of sales to B/E} &= \\ &= \frac{\text{Fixed expenses} \times \text{selling price}}{\text{Selling price less variable cost}} \end{aligned}$$

PRICING METHODS

Costs plus

(Total costs to produce, plus a margin). The simplest method, but can be misleading because the real costs often depend upon sales volume.

Market pricing

What will the market bear, and for how many sales? (All costs, plus profit margin). The price reflects product/service, market conditions, customer expectations, the competition, volume sales, seasonal trends etc

Time and materials (Fees & Expenses)

Used in non-retail business. Factors may include time, labour, materials, arising expenses, expertise etc

Backward pricing

Where the customer dictates the price they will pay. The supplier then has to work 'backwards' to tailor what can be provided to that price, ensuring all costs and profit margins are included.

Premium pricing

Quite simply the law of 'supply and demand'. If customers want the product or service and there are few suppliers, they will be prepared to pay a 'premium' to get it! Examples are innovative products, specialist areas etc.

OTHER FACTORS TO CONSIDER

There is usually a limit to the amount of activity that a business can realistically undertake. The limit is set by available resources, time, money, premises etc.

- How many productive hours can the owner manager work in a week, a month or a year? How many hours will be spent on non-productive tasks, such as bookkeeping?
- Will suppliers dictate, in terms of delivery, quality, price and availability? Consider wastage, re-work, subsequent customer alterations not included in original price/quote!
- Are there seasonal variations? Times or perhaps weather conditions that will impact on trade? Will these be favourable or not?
- Will time, energy and resources be spent on obtaining the specific materials required? There is a real cost!
- Materials purchased at trade may offer an opportunity to sell at retail.
- Will there be any storage/overdraft costs involved in purchasing materials?