

## **Finance Factsheet:** **Costing and Pricing Your Product or Service**



If you are going to make a success of your business, it is essential to cost and price your product or service accurately. This factsheet explains how to set about doing this.

### **Types of costs**

The cost is the amount you spend to produce a product or service. Of course, every business needs to cover its costs before it can make a profit, and working out exactly what your costs are is a basic first step to deciding on your prices, i.e. the amount you receive for your product or service.

There are basically two types of costs:

- **Fixed costs** - the costs that are incurred on a regular basis and are not affected by the level of production, e.g. rent and the salaries of some staff
- **Variable costs** - the costs that vary according to the level of production, e.g. raw materials, transport and temporary staff, and possibly some 'overheads', such as electricity.

Fixed costs are always 'indirect', in that they cannot be directly attributed to a specific product or service, whereas variable costs can be both direct and indirect.

In deciding on your prices, you have to take both fixed and variable costs into account. Each product or service you sell must not only cover the variable cost of producing or delivering it, but also cover part of the fixed costs.

For example, in deciding what price to charge, a computer trouble-shooter must not only consider variable costs, such as transport to customers' premises and the hardware or software necessary to repair their computers, but also fixed costs, such as the office rent and the salary of a part-time bookkeeper.

### **Manufacturing costs**

If you are in manufacturing, you can work out the cost per item using this formula:

$$\text{Item cost} = \frac{\text{overheads}}{\text{total items}} + \text{direct cost of item}$$

In a business that produces more than one type of product, you need to split the overheads between the different products, perhaps on the basis on the volume of each product.



## Service costs

If you provide a service, you can determine what your basic hourly rate is using this formula:

$$\text{Hourly rate} = \frac{\text{annual business overheads}}{\text{annual productive hours}}$$

You need to bear in mind that the 'annual business overheads' includes your salary, and that 'annual productive hours' do not include time spent managing and promoting the business, or time spent on holidays or lost to illness.

Once you have worked out your costs, you are in a position to decide what prices you are going to charge.

## Deciding on the price

There are two basic methods of pricing products and services:

- **Cost-plus pricing** - where you take the cost of producing your product or service and add an amount you need to make a profit
- **Value-based pricing** - where you charge a price based on the benefits your business offers customers and that you believe they are willing to pay.

### *Cost-plus pricing*

This type of pricing is particularly suitable for businesses with large volumes of product and operating in markets dominated by competition on price. However, cost-plus pricing takes no account of your business's image. It's also easy to forget about hidden costs, with the result that your actual profits from each sale are not as high as you think.

### *Value-based pricing*

This type of pricing depends on the strength of the benefits you can offer to your customers. If you can offer benefits that give you an advantage over your competitors, you can charge prices that reflect the value of your product or service to the customer.

Take, for example, the computer trouble-shooter referred to earlier. Using the formula:

$$\text{Hourly rate} = \frac{\text{annual business overheads}}{\text{annual productive hours}}$$

$$\text{This gives an hourly rate of } \frac{\pounds 40,000}{\pounds 1,000} = \pounds 40$$

Add to this the £10 cost of travel to a customer's home and they might charge a customer £90 for a computer-fixing job that takes two hours. However, they offer a number of benefits to the customer, including a prompt and efficient service.



The customer, whose business cannot operate without a fully functioning computer, places a high value on these benefits. So, knowing that there is no one else in the area that can provide the same service, the trouble-shooter decides to charge a total of £120.

A possible problem with this approach is that while it may be very profitable, it can alienate new customers who are concerned about price, and so give an opportunity to competitors.

### **Keeping track**

Whatever price you decide to charge, you need to keep track of your income and expenditure. If sales are lower than you predicted, you may need to reconsider your unit costs or hourly rate, and change your prices accordingly.