4.6 Pricing product

A sound pricing strategy

Good pricing strategy is based on:

> Understanding the true cost of producing your product
> Understanding what the market will pay for the product
> Deciding on where in the market your price will position you—as a premium, value or discount product
> Pricing is not an exact science and is a constant learning process.

If you have spent time understanding how much it costs you to produce your product this means that you will

> Have the information to ensure that you can sell your product for a profit
> Know how much you can reduce prices to get a sale without selling at a loss
> Know when you can give volume discounts
> If you have more than one product in your range, know which ones are the most profitable

Poor costing/pricing can result in

> Underpricing and loss of profit
> Overpricing and loss of sales
> Taking on jobs that are unprofitable (in fact cost you money)
> Offering discounts that lead to loss making
> Poor cost control, including excessive overheads
> Operating below capacity
> Unprofitable products being pursued

Ensure that you discuss the costing and pricing of your product with your accountant before going to the market.

The steps to good pricing

> Analyse and understand the true cost of producing your product
> Work out what your desired profit margin is (that will give you adequate return for the investment and your effort)
> Analyse and understand the competitors' pricing and costing
> Analyse and understand what the market will pay for your product
> Deciding on how you wish to be positioned in the market

Factors to consider

> How do you wish to be perceived by the target market?
> If you choose a premium pricing strategy can it be maintained long term?
> How sensitive is the target market to certain price points?
> Where your product is in its product life cycle—for example, in the early stages you may keep your price down to gain market share and encourage repurchase
> Can your promotional strategy influence the demand for your product or perception of the product?
> Competitor pricing—competitors may go into a price war to protect market share
> Your financial position—can you afford to have little positive cash flow for an extended period while you build up market share?

Setting your price

When considering what price you will place on your product you must decide if the price will be based on:

> The actual cost of production plus a mark up

OR

> The market price including a margin

Margin—is based on your selling price

$$\text{Margin \%} = \frac{\text{Gross Profit \$}}{\text{Sale \$}} \times \frac{100}{1}$$

Mark up—is based on your cost price

$$\text{Mark up \%} = \frac{\text{Gross Profit \$}}{\text{Cost \$}} \times \frac{100}{1}$$

Your Gross Profit is your Selling Price minus your Cost Price.

For these calculations to be accurate, you must know the true cost of production.

Retail selling price (using a distributor)

	Unit Cost	$5.00
+	Mark up (your profit) (try for at least 10%)	$0.50
	Wholesale Price	$5.50
+	Freight (*e.g.* $0.50/unit)	$0.50
	Landed Unit Cost to Distributor (LUC)	$6.00
+	Distributor mark up (*e.g.* 30%)	$1.80
	List Price (to a retailer)	$7.80
+	Retailer mark up (*e.g.* 50%)	$3.90
=	**Retail Price**	**$11.70**

Note that GST is ignored for the purpose of these calculations, as it is collected and paid to the Tax Office, and represents a timing issue only. However, it should be noted that the timing of tax collection and payments can significantly affect cash flow.

Tips

> When working out your pricing you must take into account the different channels of distribution you are considering using. You cannot use one price for all. You must work out your pricing ensuring that if you use a distributor there is enough margin so that everyone can make a profit.

> If you are selling direct to a retailer (ie not using a distributor), the money you make must cover your time, effort, samples, freight and replacement stock. Therefore you would use the List Price whether using a distributor or not.

> If you are selling products via your own factory outlet, but also have distribution to other retail outlets, you must be careful not to undercut the retailers. This is why many factory outlets carry stock that you cannot buy elsewhere. This way there is no direct comparison between your outlet and the other retailers.

> If you are considering selling to food service (eg restaurants), you would normally use the List Price but if they are buying in bulk, you could consider a bulk discount.

Costing your product

This section is derived from 'Costing and Pricing' in Business Basics and the Concepts of Marketing *by Mary Ferguson and Don Brand, and has been used with their permission.*

Costing is important because it allows owners to make decisions such as

> What products to produce

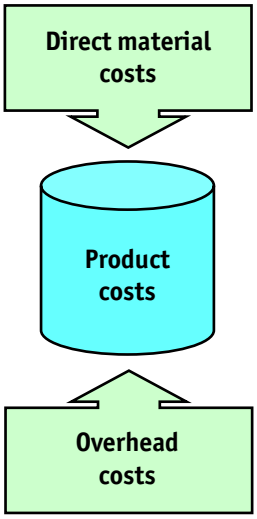
> Whom to sell these products to

> What price to sell the products

> What volume of each product to manufacture

> Will the decisions made above maximize profitability of my business

The total cost of a product comprises direct material costs, and overhead costs.



Direct material costs include all ingredients/materials used in the manufacture and packaging of the product. It also includes other expenses that are directly related to the product such as freight.

Overhead costs are all the other costs that must be paid to run the business but they exclude direct material costs. Typical overhead costs include insurance, motor vehicle costs, stationery and a reasonable salary for the owners.

The cost of a product is the material costs that directly relate to that product and a share of the overhead costs.

A note about labour costs

Direct labour costs would normally be calculated separately when working out the cost of a product. However, we have included direct labour costs in the overheads calculation for simplicity. This method is acceptable for very small food producers who don't have employees other than the owners. However, as you grow, direct labour should be separated and costed to each product.

Product costing worksheet

Calculate ingredient cost per unit

Batch Size = d

Ingredient	*Amount per batch a*	*Cost per unit of ingredient b*	*Cost for total of batch a x b*
Batch Total			***e***
Unit Total (divide e by d)			***g***

Direct material costs per unit

In the table below, list your products and the direct material costs for each product. The "Other" column can be freight to customers. Each material cost is to produce only **one** unit of that product. Total each product in the last column.

It is acceptable to estimate some costs if you are unsure, but don't leave them out.

Products *(list)*	Packaging $ per unit	Ingredients $ per unit refer *g* above	Other $ per unit	Total $ per unit *(A)*

Overhead costs

In the table below next to each heading, make an estimate of how much you will spend in a year on that item. If the cost does not apply leave it blank. If you have other costs not listed below, add additional rows. It is better to over estimate than under estimate.

Ensure you include a reasonable wage for the owners. Do not include private expenses as they should be paid from your wage.

Do not include any direct material costs listed above.

Overhead Cost	*$ per year*	*Overhead Cost*	*$ per year*
Accountancy		Bank Fees	
Advertising		Computer Costs	
Insurance		Interest Bank	
Motor Vehicle Costs		Postage	
Stationery/Printing		Rent	
Rates & Taxes		Office Expenses	
Fees and Permits		Telephone	
Travel & Accommodation		Protective Clothing	
Quality Testing		Repairs and Maintenance	
Rubbish Removal		Electricity/Gas	
Consumables		Cleaning/Laundry	
Rent of Equipment		Marketing and Promotion	
Other (list)		Consultants	
Wages—Owners ***(WO)***		Wages—Employees ***(WE)***	
Super & WorkCover - Owners	12% of (WO)	Super & WorkCover—Emp	12% of (WE)
Total Overheads ***(B)***			$

Sales budget

In the table below, make an estimate of the number of units of each product that you expect to sell during the year and put the answers in column C. Then estimate the labour hours it will take to make only **one** of each product. For example, if it takes 5 minutes to produce and package Product A then put 0.08 (5/60) in column D.

Products *(list)*	No. of Units Sold p.a. *(C)*	Hours to produce unit of Product *(D)*	Total Hours required p.a. *C x D*
Total Hours p.a. ***(E)***			

Do you have enough hours in the year to cover the total at E or will you need outside help?

Overhead rate

This rate is used to allocate the overhead over all products produced. It is calculated as:

Total Overheads ***(B)*** / Total Hours ***(E)*** = Overhead Rate ***(F)*** per hour

Overhead costs per unit

Products *(list)*	Hours to produce unit of Product ***(D)***	Overhead Cost per unit ***G = D x F***

Unit cost of your products

Products *(list)*	Material Cost per unit ***(A)***	Overhead Cost per unit ***(G)***	Total Cost per unit ***H = A + G***

Profit margin per product

In the following table, include the expected selling price for each product in column I, and then calculate the profit margin on each product in columns J and K.

Products *(list)*	Unit Cost $ *(H)*	Selling Price $ *(I)*	Profit Margin $ *J = I - H*	Profit Margin % *K = J/I*

Profit margin index

Is the profit margin on each product acceptable?

- Less than 3% — dangerously low
- Between 3% to 5% — too low
- Between 5% to 10% — average range
- Over 10% — healthy margin

A product with a profit margin of less than 5% should be reviewed.

- Can there be any savings in direct material costs at ***(A)***?
- Are there any overhead costs that can be reduced at ***(B)***?
- Can you (realistically) increase the number of units sold at ***(C)***?
- Can you reduce the hours taken to produce each product at ***(D)***? (By doing this, you are able to make more products in the same amount of hours.)
- Finally, can the selling price at ***(I)*** be increased?

Worksheets were prepared by

Chris Whelan, Director © CL Whelan and Associates. For contact details refer to our website www.clwhelan.com.au.

CLW PRODUCT COSTING SPECIALISTS

Worked example: Nectarine chutney

Ingredients:

20 kg Ripe Nectarines stoned and chopped
3.5 kg Brown Sugar
3.75 l Vinegar
6 kg Dried Sultana's
13.5 kg Chopped Onions
5 tsp Cayenne Pepper
¾ cup Salt
3 tbsp Ground Cloves
¾ cup Ground Ginger
1 cup Chopped Garlic
¼ cup Chopped Chilli

Method

Place all ingredients in a brat pan, bring to the boil slowly and cook at 150 C for 1 hour, keep product stirring while cooking. Jar and seal at 110 C. Cool and check seal.

Batch Size = 140 units

Ingredient	*Amount*	*Cost per unit*	*Cost for total*
Nectarines	20 kg	$1.25	$25.00
Brown Sugar	3.5 kg	$1.95	$6.83
Vinegar	3.75 l	$1.60	$6.00
Dried Sultanas	6 kg	$2.20	$13.20
Chopped Onions	13.5 kg	$1.25	$16.88
Cayenne Pepper	5 tsp	$0.24	$1.20
Salt	¾ Cup	$0.95	$0.72
Ground Cloves	¾ Cup	$12.00	$9.00
Ground Ginger	¾ Cup	$12.00	$9.00
Chopped Garlic	¾ Cup	$5.75	$4.32
Chopped Chilli	¼ Cup	$22.55	$5.64
Batch Total			***$97.75***
Unit Total (divide by 140)			***$0.70***

Recipe makes 35 kilograms of finished product which is packaged into 250 gram jars. This batch will make 140 jars of chutney.

Assume that Nectarine Chutney is the only product made (but you make a lot of it!!!!)

Direct material costs per unit

In the table below, list your products and the direct material costs for each product. The "Other" column can be freight to customers. Each material cost is to produce only **one** unit of that product. Total each product in the last column.

It is acceptable to estimate some costs if you are unsure but don't leave them out.

Products *(list)*	Packaging $ per unit	Ingredients $ per unit	Other $ per unit	Total $ per unit *(A)*
Nectarine Chutney	$1.13	$0.70	$0.13	$1.96

Overhead costs

In the table below next to each heading, make an estimate of how much you will spend in a year on that item. If the cost does not apply leave it blank. It is better to over estimate than under estimate.

Ensure you include a reasonable wage for the owners. Do not include private expenses as they should be paid from your wage.

Do not include any direct material costs listed above.

Overhead Cost	*$ per year*	*Overhead Cost*	*$ per year*
Accountancy	1,985	Bank Fees	120
Advertising	2,780	Computer Costs	250
Insurance	2,085	Interest Bank	120
Motor Vehicle Costs	4,670	Postage	75
Stationery/Printing	135	Rent	0
Rates & Taxes	685	Office Expenses	115
Fees and Permits	1,090	Telephone	2,280
Travel & Accommodation	580	Protective Clothing	395
Quality Testing	250	Repairs and Maintenance	765
Rubbish Removal	0	Electricity/Gas	4,875
Consumables	490	Cleaning/Laundry	575
Rent of Equipment	0	Marketing and Promotion	2,980
Other (list)		Consultants	0
Wages—Owners *(WO)*	30,000	Wages—Employees *(WE)*	0
Super & WorkCover –Owners 12% x WO	3,600	Super & WorkCover—Emp 12% x WE	0
Total Overheads *(B)*			$60,900

Sales budget

In the table below, make an estimate of the number of units of each product that you expect to sell during the year and put the answers in column C. Then estimate the labour hours it will take to make only **one** of each product. For example, if it takes 5 minutes to produce and package one jar of Nectarine Chutney then put 0.08 (5 minutes divided by 60 minutes) in column D.

Products *(list)*	No. of Units Sold p.a. *(C)*	Hours to produce each Product *(D)*	Total Hours required p.a. *C x D*
Nectarine Chutney	15,900	.08	1,272
Total Hours p.a. *(E)*			1,272

Do you have enough hours in the year to cover the total at E or will you need outside help?

Overhead rate

This rate is used to allocate the overhead over all products produced. It is calculated as follows

Total Overheads ***(B)*** $60,900 / Total Hours ***(E)*** 1,272

= Overhead Rate ***(F) $47.88*** per hour

Overhead costs per unit

Products *(list)*	Hours to produce each Product *(D)*	Overhead Costs per unit *G = D x F*
Nectarine Chutney	0.08	$3.83

Unit cost of your products

Products *(list)*	Material Costs per unit *(A)*	Overhead Costs per unit *(G)*	Total Cost per unit *H = A + G*
Nectarine Chutney	$1.96	$3.83	$5.79

Profit margin per product

In the following table, include the expected selling price for each product in column I, and then calculate the profit margin on each product in columns J and K.

Products *(list)*	Unit Cost $ *(H)*	Selling Price $ *(I)*	Profit Margin $ *J = I - H*	Profit Margin % *K = J/I*
Nectarine Chutney	$5.79	$6.52	$0.73	11.2%

Review profit margin

At 11.2%, the profit margin is healthy—but there's always room for improvement!

> Can there be any savings in direct material costs at ***(A)***?

> Are there any overhead costs that can be reduced at ***(B)***?

> Can you (realistically) increase the number of units sold at ***(C)***?

> Can you reduce the hours taken to produce each product at ***(D)***? (By doing this, you are able to make more products in the same amount of hours.)

> Finally, can the selling price at ***(I)*** be increased?