

Pricing

Covering Your Costs

The price you charge must be able to cover your costs, so determining how much profit you need to make is an important first step. An easy way to do this is to divide your fixed costs by how many units you expect to sell. The resulting number is the minimum profit you must make from each unit sold. For example:

Fixed costs = \$10,000

Expected sales in units = 5000

Minimum profit from each unit = $\$10,000/5000 = \2

Next, you must add the variable cost of producing each unit to determine the minimum price that can be charged.

Variable costs per unit = \$5

Minimum price of unit = $\$5 + \$2 = \$7$

So at the very least, you must charge \$7 for each product or service you sell. Remember, when your fixed or variable costs change, your prices must change, too.

Compare Prices

Researching the average industry price of the product or service, as well as the prices of competitors will give you a price range to work with. Visit industry web sites and gather marketing materials from competitors to aid in developing your pricing strategy.

Consider Your Customers' Perceptions

Once you have considered your competitors, you must take your customers' perceptions into account. What is your product's or service's position in the customer's mind? Does it seem more luxurious or higher in quality than your competitors'? If so, charging a higher price is necessary to maintain that image. However, focusing the production of products and services on value requires charging a low price. Think about the objectives you want to reach through your pricing strategy.

Price Elasticity of Demand

Price elasticity is another important consideration. Will people still buy your product, even if the price is high? Or do significantly more people buy the product if the price is low? If you've studied economics, you may remember that the price elasticity of demand measures the responsiveness of quantity demanded to a change in price.

If your product or service is price elastic, a change in price will cause an even larger change in the quantity demanded. This usually means that if you lower your price, the quantity demanded of your product will increase. However, some products may see an increase in demand as prices are raised, due to a perception of higher quality and luxury. If you have a product that is price elastic, careful consideration must be made when choosing a price. If the item is more expensive than competitors', be sure there are added features and benefits to make up for the difference.

If your product or service is price inelastic, a change in price will cause less of a change in quantity demanded. So, whatever price you charge, your demand will be relatively stable. Items that are price inelastic usually have no similar items available, and no substitutions for the product exist. Because of this, proprietors with price inelastic products have the ability to charge a higher price.

Retail Pricing

In the retail business, the cost of goods (costs of acquiring products) includes the price paid for the merchandise, handling, freight charges, and import duties. Operating expenses include rent, wages, advertising, utilities, and supplies.

Markup is the difference between the price you pay for the product and the selling price. The markup can be established as a percentage of the cost or as a percentage of the retail price. A price based on markup percentage on cost is determined by adding a percentage of cost to the cost of goods as follows:

Cost of shirt	\$5.00
x Markup %	50%
Markup amount	\$.250

Cost of shirt	\$5.00
+ Markup amount	2.50
Selling price	\$7.50

A more common markup strategy in retail is to base the markup on the retail price. Divide the cost of the product by the markup percentage as follows:

Cost of shirt	\$5.00	
-----		= Retail price \$10.00
Markup percentage .50 (50%)		

You may decide to use a standard markup percentage for all the merchandise, or you may have different markups for different products. The key is to make sure the average markup or gross margin is enough to cover the operating expenses and still meet your target profit margins.

Another pricing practice among retailers is to price merchandise according to the suggested retail price recommended by the manufacturer. This is the easiest way to determine prices but can get into trouble if the margin between the cost of goods and the suggested retail price is not enough to cover operating expenses.

Rationale for Pricing

In your business plan, you may want to describe the rationale for your price strategy. What do you hope to accomplish by setting a lower/higher/average price?

Also describe how you will be able to charge that price. Do you have a unique, low-cost method of manufacturing or distributing that allows you to keep prices lower than competitors'? Do you have a product that is customized, and therefore can command a premium price? Describe to the reader the internal and external factors that helped you to determine your pricing strategy