How Do You Set Prices?

An important but challenging part of running a small business is working out how to price your products or services. There are no hard and fast rules, but there are some helpful guidelines.

Cover your costs

At the very least, you want to be able to cover your costs. Calculate your fixed costs; essential business expenses such as rent, utilities and wages – because they must be paid regardless of the level of sales. Next, work out your variable costs; the costs of buying the goods from the supplier that you're going to sell, or the costs of providing your services. The total of the variable costs will rise and fall with the level of activity of your business.

Strategies

Cost-plus pricing is basically taking the cost of a product and adding a mark-up percentage which becomes your profit. The mark-up percentage can either be determined by the business owner or by industry standards. It is a popular method because it is relatively easy to calculate. One downside of this method is that it can be difficult for business owners to dictate prices to their customers since customers are able to shop around, compare and decide for themselves what they believe to be a good price.

Value-based pricing is harder to determine because you have to estimate what customers would be willing to pay for your product or service. To get this information, you may need additional market research, or it could simply come down to trial and error! Value-based pricing sets the price on the customers' perception of value instead of the actual costs. Under this method, desirable non-price variables, such as service, convenience or quality, are used to build up a perceived value in the minds of customers and then the price is set to match.

Mark-up and Margin

Mark-up is a percentage of the cost price. It's the amount that you add to the cost of an item to reach its selling price:

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

Margin is a percentage of the selling price. It tells you what percentage profit you've made on a sale, before taking your other costs into account:

$$\text{Margin} = \frac{\text{Gross Profit}}{\text{Sales}} \times 100$$

For example, an item costs $100. You sell it for $150. The mark-up is 50% and the margin is 33%. (In percentage terms, mark-up is always going to be higher than the margin for the same product.).

YOUR ACTION PLAN

☐ Calculate your fixed and variable costs and determine your required profit margin, then decide on an appropriate pricing strategy.

Contact BRJ Accountants & Business Advisors team today on
07 3862 9955
for assistance with this Action Plan!

Price setting is integral to your business strategy. Focus your sales planning and marketing on higher profitability rather than simply increasing sales.

Accountants and Business Advisors

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