Pricing

The Pricing Problem

Two major problems that cause the business to fail are under capitalization and failing to pay taxes when they are due. The next biggest problem I run into is the business owner failing to recognize how much they need to charge for their time. Many people who start in business have been receiving paychecks. If their hourly rate was $15 per hour, they have a tendency to believe they should charge $25 per hour and everything will work out just fine. They seem to think that if they charge more they will not be able to sell their services to customers or compete in the market. They soon find that even if they are fully booked, there is not enough money to pay themselves, the taxes, the overhead, let alone make a profit to grow. To pay the bills and bring in extra money, the alternative is to work longer hours. This brings in the money but has another big negative. It takes away the balance of time that a business owner to be successful needs between business, self, and family time. If family problems develop, the business success is in jeopardy. Underpricing can lead to problems. If the competition is pricing low, let them go out of business. If your customers are shopping strictly price, then find the right type of customer who is looking for a reliable source who is timely, does quality work, and is reasonably priced.

Three Times Payroll Cost Plus Materials

If you are paying a person $10 per hour, you should charge for their time at $30 per hour. If you want to make $20 per hour, you should charge $60 per hour for your time. If the two of you are working on a job, you need to average $45 per hour each.

If your employee is paid $10 per hour and works 40 hours a week, they would work 2100 hours and have an annual salary of $21,000. Will they be able to work on customer jobs the entire 2100 hours? Would you be able to? The answer is no. There are holidays, sick and vacation days, training days, lack of work time, and administrative days. So how many charged hours should you expect. I like to use 1/3 down time and 2/3 productive. That means we need to generate the $21,000 annual salary in 1400 hours. Or we need to charge $15 (1.5 times) just to pay the salary. I am going to take some liberties in my documentation. Just to meet the payroll taxes, employee insurance, and benefits, we need to be at 2 times salary. We have not paid for the truck, the accountant, the advertising, etc. This takes us to 2.5 times salary. We still have not produced a profit in order to make the business grow. This brings us to 3 times payroll plus materials cost as our base formula. If you go below 2.5 your business will probably not survive. If you are over 3.5, you are probably overpriced. This formula works for most service businesses. In retail and other similar businesses, you need to generate sales, which produce this same payroll profit. Your gross sales less purchases will result in a gross profit, which should approximate 2 times your salaries. Every industry is different. Find a national business association servicing your industry. They will have financial models for you to follow.

The Salesman's Hat

If your pricing is right, then the next step, and most important step in your success, is to put on your salesman's hat and find customers. If you do not have customers, you do not have a business. Customers do not come to you. You go to customers. If you do not sell, you probably will not succeed. If you find a way to bring in customers, do it over and over and over. Do not bring in a few customers and then just turn your effort to delivery and stop marketing. Marketing keeps the door rotating. Develop a marketing plan and keep it going even when you are backlogged with work.

Breakeven Analysis

Once we have a pricing formula in place, we need to determine how much in the way of sales do I need to generate to pay me the salary I need to take home to pay my bills, cover the taxes on that salary, and pay my business expenses. We can start by saying you need to take home $40,000. This means that based on our previous 1/3 tax partner, you need to provide $20,000 for taxes. We next go to the expense accounts in the chart of accounts and estimate what those expenses will be. There are two type business expenses, fixed and variable. A fixed expense is going to be there even if you have no sales, for example rent. No matter what your sales are your rent will remain the same. This type expense is a fixed expense. Using the chart of accounts come up with an estimated total for your fixed annual expenses. In my example I am going to use $15,000 in fixed expenses. Let's assume we sell shoes. When we buy a shoe for

$25, we sell it for $50. We only have to buy more shoes when we make a sale. This expense only occurs when we make a sale. This is called a variable expense. It varies with sales. We do not express this type expense in fixed dollars but as a percentage of sales. In our example, our sales are $50 and our costs are $25. This means that our variable expense is 50%. The formula to determine breakeven is: X= $40,000 + $20,000 + $15,000 + .5X. When you solve for x you find your breakeven sales to be $150,000. You pay the $75,000 for the shoes (50%). This leaves you $75,000 for expenses. You pay your fixed expense, salary, and taxes totaling $75,000. Your profit is zero. You breakeven. It is imperative that you know the breakeven point. The person, who sets targets, makes targets. Set your target sales at least 10% above breakeven. In this example target sales would be $165,000 and after the cost of shoes would produce a bottom live profit of $7,500.

The Three Year Myth

I hear over and over again from new business owners that they expect it to take three years to make a business profitable. This may apply to large existing businesses coming into a new location, but it does not apply to you. Most new business owners do not have the capital to last one year, much less three. I believe a new business should set goals to reach breakeven levels not later than the third quarter of operations. In our example above we would want sales to be at $37,500 in the third quarter. This is tough task to achieve and another reason why the salesman's hat must go on early and stay on.