

Pricing for Bottom Line Profit

By Bob Normand

SUMMARY: Pricing of any product or service can be related directly to the company's bottom line profit by using the four financial statement components of: Variable Costs, Fixed Costs, Overhead and Profit Margin. All four components must be taken into account when pricing.

When someone asks you, or you ask yourself, what your "profit" is on a product, on a project or on a job, how do you respond?

To help understand the question better, consider the following theoretical example:

You sold your last (remodeling) job for \$12,000. You used \$4,000 in materials and 250 man-hours of people you pay \$20 per hour wages to.

If you were asked what you made on this job how would you respond? Would you say:

- A) \$12,000
- B) \$3,000
- C) Other _____
(fill in)

In the example above:

If you chose A, you equate profit with sales revenue. Hopefully by now, most of us have been cured of that misconception (***but not all of us I'll bet!***).

If you chose B, you equate profit with the difference between sales and *direct costs*. Direct costs are those that we pay for the *materials* we sell or install plus what *direct labor costs* us. In the example, there were \$4,000 in material costs and \$5,000 in labor costs (250 x \$20). The "profit" was, therefore, \$12,000 - \$4,000 - \$5,000 = \$3,000.

Really? What about that nasty little thing called overhead?

If you chose C) and tried to fill in another number, that's *very interesting* because the fact is *not enough information is given to answer the question properly.*

We have NO IDEA OF WHAT OVERHEAD is in the example above; let alone how to account for it in our pricing. In that respect, unfortunately, the example parallels what too many small businesses exhibit, namely, a lack of knowledge on how to account for overhead in pricing. We address this problem below.

Components of a Price

We can build up a price from its components using information already established in our financial statements. A price can be constructed from its four components as follows:

Direct Cost of Materials

- + Direct Cost of Labor (Plant, Construction, Delivery, Commission or Other)
- + Overhead Absorption (on a *proportionate* basis to sales) (*Indirect Costs*)
- + *PROFIT*

= Sales Price (either unit price or sales dollars)

Normally, we can establish or estimate the *Direct* costs fairly accurately. But what about Overhead? The simple way to do this is as follows:

Go back to your Income Statement and separate costs (if not already done by your accountant – and too often this is the case) into Variable or that which is related directly to sales volume (materials, purchases, direct labor, freight, delivery) and Fixed, typically not related directly to sales volume (Advertising, Computer Expense, Insurance, Office Wages & Salaries, Officer’s Compensation, Payroll Taxes, Rent or Mortgage Interest, Telephone, Utilities, Waste Management and others).

Ratio Fixed Costs to Variable Costs (over a reasonable period, say 3, 6 or 12 months). This is your OVERHEAD FACTOR (OHF). If the ratio is .25 for example, it simply means you need \$0.25 (25 cents) to absorb overhead for every dollar spent on direct costs.

Now, let’s go back to the example above and assume their OHF to be .25 (25%). Further let’s say they are looking for a 15% NET Profit on sales (to match their budget). The price then is:

Direct Costs - Materials:	\$4,000	
Direct Costs – Labor:	\$5,000	(250x\$20/Hour)
Total <i>Direct</i>	\$9,000	
Overhead Absorption:	\$2,250	(.25 x \$9,000)
Total Costs:	\$11,250	(This is you <i>Break-Even</i>)
Profit	\$1,985	(estimated)
Price to Make 15%:	\$13,235	

Profitability Check: Profit % = Profit/Sales = \$1,985/\$13,235 = 15% ✓

But they actually sold the job for \$12,000, so their real net profit at the bottom line was = (\$12,000-\$11,250)/\$12,000 = \$750/\$12,000 = 6%.

But, You Say, I Can’t Possibly Price That Way, the Market Won’t Bear It!

The above technique is the way to relate pricing to bottom line profit, either actual or proposed. If you can’t meet the price that results in a reasonable (and budgeted) profit, then you, as

owner/CEO/President MUST: *lower the cost of your products by better purchasing or more efficient manufacturing, lower your overhead, change the markets in which you participate or change the offer (add more value so you can charge the right price).*

Just like ignorance of the law is no defense, neither is lack of knowledge on how to price for profit an excuse to accept low profitability.

The arithmetic above only tells you WHAT you have to do, not HOW you have to do it. The how is left to your business and marketing plans.

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