Costing and pricing your products and services

What are costing and pricing and why are they important?

As a social enterprise, you constantly have to make pricing decisions. This could be because you have a service or a product to sell and you need to know how much to sell it for. Or perhaps you are bidding for contracts and need to justify the budget. This requires that you have what is called a pricing strategy – i.e. a way in which you allocate prices to your products and services. In order to do this, you first need to understand your costs. This is why the two subjects are covered together here.

Although a pricing strategy involves more than just knowing your costs, such as where you want to be positioned in the market and how much your customers are prepared to pay, the starting point is always having a clear understanding of your costs. Even when seeking grant funding, the amount you will be requesting will be determined by the cost of delivering the service or project.

Understanding costs

The expenditure your enterprise incurs to operate and to deliver your services or sell your products is what is referred to as costs. You need to understand these costs and how they can be allocated differently to different parts of the organisation and different projects. This means that what you do, how you do it and why will affect the way costs are incurred. An understanding of how costs 'behave' is important in predicting them for forecasting and budgeting purposes, as well as for establishing a pricing strategy.

If you haven't started trading yet and you are in the business planning stage, you still need to have an idea of your future costs and pricing. You will be able to get relatively accurate estimates of some of your main costs such as how much you will have to pay in rent, equipment, as well as in salaries and on-costs (other costs involved in employing people). You can find these out by carrying out market research online and by speaking to the relevant people. You can also get quotes from your potential suppliers as well as an understanding of their payment terms (when and how often they need to be paid).

As a start up, you should also get practical advice on a number of other costs you may not be aware of or 'hidden costs' such as specific taxes, registrations and accreditations that you may need in order to carry out your business activities. The main legal requirements that need to be covered are set out in the guide on 'Making sure your enterprise complies with legal requirements.'

For enterprises that are already trading, two of the more common ways of understanding your costs are to identify your fixed costs and variable costs.

Fixed costs are those that are incurred regardless of the level of activity of your enterprise, such as rent. This will also apply to other costs such as management, administration, utilities, website maintenance and other overhead costs. You should be able to know exactly what these costs are by referring to the relevant bills that your enterprise is responsible for. You should always try to recover a proportion of these fixed costs to your prices.

Variable costs are those that are incurred because they are directly needed for a specific project or activity. Variable costs will change with the level of activity. For example, a community bus service using contracted drivers will have variable costs of petrol and the cost of the drivers. The cost of the drivers and petrol will change with the level of activity (i.e. how much driving, how many buses). Being aware of all of your variable costs is important to ensure that you are able to allocate them to the right projects and activities and to recover them fully when pricing your services and products.

Pricing

An enterprise's pricing strategy should be to generate enough income to:

- cover the fixed costs incurred by the whole organisation
- cover the variable costs incurred in delivering the service or making the product

- AND to generate a profit or ‘surplus’ as it is often called in the Social Enterprise sector.

Cost plus

Once you know the cost of delivering your service or product (your fixed costs and variable costs), you can begin to work out the pricing. In many cases pricing is based on an added percentage above the cost. For instance, if you have calculated that the cost of a particular project is £10,000 and your policy is to add 20% on top of the cost as profit than the price you charge for the delivery of the service is £12,000. This is called cost plus.

Unfortunately pricing strategy is not so straight forward as other factors have to be taken into account before you are able to finalise a price for your service or product. These factors include:

- who the customer is
- competition
- value
- perception

Who the customer is
What you price a service at may be affected by who is purchasing the service. This will depend on your market research and on your marketing strategy. If your service is being offered directly to beneficiaries, the price may have to be lower than the same service being offered to an organisation or commercial customer. Similarly, selling to the commercial sector may allow you to charge more than selling to the social enterprise or voluntary and community sector. If it is grant funding that you are seeking for the delivery of your service then at best you can hope for full cost recovery and there is usually no scope for any surplus.

Competitive pricing
Even though you have a pricing strategy you may not be able to apply it in full. In trying to generate new business you may take the decision to discount your service in order to win over the customer. This may be with the view that the customer will repeatedly purchase services from you and that you will be able to improve profitability in the future.

In some cases, your customers may not be in a position to pay what you are asking for and you may again take a decision to discount your prices in order to retain that customer and fit within their budget.

Alternatively you may find that you need to discount your prices because of increased competition, such as another organisation charging less for the same products or services. Again, this will depend on how you wish to position yourself in your marketing strategy and who you are selling to.

These are all marketing decisions and need to be carefully thought through. What you must not do is to discount your prices to below cost as then you will be trading at a loss. Your pricing strategy should therefore allow you to discount prices to a certain level and no lower. The strategy therefore acts as a negotiation guide for new business opportunities.

Occasionally enterprises will sell their services at a loss because there is a value in having that particular customer. It could be that it will lead to further work at a profitable rate. It could be that the customer is so well known that by promoting the fact that you are supplying them it will help you win business elsewhere. It could also be that you are taking that decision because you believe that the customer, a charity for example, is doing something that meets your social or environmental values and you are determined to support that activity even if you do so at a loss.

Unique value
If you offer a unique service or one that has a unique differentiator, i.e. you are offering something that no one else provides, then you may be in a position where you can charge as much as you like. The only barrier will be the point where the customer believes that the price is so high that there is no perceived value in purchasing that service.

In these circumstances your pricing strategy could be to maximise profit without losing too many potential customers, which means that you will get paid well for your product or service but you probably will not sell as much.

There may be reasons why you would choose to charge less because you believe in the social or environmental impact of a specific project. Remember that in this case you should at least fully cover the costs of running the project.

Perceived value
Some organisations are so well thought of that customers will purchase services from them at a price higher than that of the competition. This may be so even if the service offered is not as good as that of the competition. In this case the customer's perception of the value offered overrides the true value of the service. This dominant market position is what many enterprises aspire to, but this is not necessarily the case for most social enterprises.

Another option is if your perceived value is high amongst your customers but you still choose to sell at rates that most of them can afford. The benefits of doing so may be that you are able to increase your social and environmental impact, reach out to more beneficiaries or employ more people.

On the other hand, you must also consider the common reaction given when services or products are offered free or at a low price: the potential buyer may perceive that what you offer is not of quality or as good as others. For example, they may believe that a highly priced service or product must be good even if they may not necessarily be able to afford it.

Things to look out for when costing and pricing your products

Don't price your products or services without knowing your costs. Understanding, capturing information on costs and controlling them is very important for all organisations, even when you can only estimate those costs. Once you have a good understanding of costs you can create a pricing strategy that matches your business and marketing strategies as well as your overall vision, mission and values.

Think about all the factors involved. Your pricing strategy is affected by internal as well as external conditions which include the cost of your team, your customers, your customer's ability to pay, your competition and your customers' perception of value.

Profit is not a dirty word. Your pricing strategy should ensure that you are able to generate a profit or 'surplus', i.e. money that is not tied in to paying your costs, but that you can use for other things. This can include investing in new products or services, saving money to prevent future cash flow issues or even the ability to deliver services at a cheaper cost for people that cannot afford to pay the full price. Profit generation is important as it allows financial sustainability and allows social enterprises greater scope to deliver their social and community benefit.

Further information

Read our guides on funding and finance:
www.bllondon.com/Enable/Financeandfunding/Financeandfunding.aspx

Read our guide to vision, mission and values:
www.bllondon.com/SocialEnterprise/SettingUp/Settingobjectives/Visionmissionandvalues.aspx

Read our guide on setting and aims and objectives:
www.bllondon.com/SocialEnterprise/SettingUp/Settingobjectives/Settingaimsandobjectives.aspx

Read our guide on researching your market:
www.bllondon.com/SocialEnterprise/Marketing/Salesandmarketing/Marketresearch.aspx

Read our guide on customers, beneficiaries and key influencers:
www.bllondon.com/SocialEnterprise/SettingUp/Firststeps/Customersbeneficiariesandkeyinfluencers.aspx