DOCUMENT RESUME

ED 059 455 AC 012 327

AUTHOR	Davis, Lee D.
TITLE	Pricing in a Services Business. Instructor's Manual.
INSTITUTION	Small Business Administration, Washington, D.C.
REPORT NO	Topic-19
PUB DATE	68
NOTE	77p.; Management Development Program
AVAILABLE FROM	Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402 (No. SBA 1.24, $0.25); Small Business Administration, Washington, D.C. 20416 (on loan basis)
EDRS PRICE	MF-$0.65 HC-$3.29
DESCRIPTORS	*Administrative Personnel; Audiovisual Aids; Bibliographies; Business Administration; Case Studies (Education); *Cost Effectiveness; Course Content; Distributive Education; Educational Programs; Industry; Instructional Materials; *Management Education; Manuals; Participant Characteristics; Professional Continuing Education; *Service Occupations; Stimuli; *Teaching Guides; University Extension

ABSTRACT

The fourth booklet in a second series of subject presentations intended to advance the effectiveness of small business management is presented. The lecture is designed as the basis for a presentation to the businessman in nontechnical language. The Lesson Plan is an outline of the material covered which may be used as a teaching guide or as a framework for developing an individualized presentation. The Presentation is a carefully prepared subject presentation which may be used as written or modified to meet local needs and conditions. Visual Aids are photographic copies of the set of visual aids which are available for this topic. These visuals are 8- by 10-inch colored transparencies prepared for use on overhead projectors. The Supply Department consists of materials which can be reproduced locally for distribution to course participants. Cases in Point are short actual small-business management cases which may be used to augment the presentation and to develop discussion. The Incubator is a source of ideas for further thought and discussion by the participants. A short bibliography is provided, and field offices of the Small Business Administration are listed. (CK)

ED 059455

PRICING IN A SERVICES BUSINESS

INSTRUCTOR'S MANUAL
MANAGEMENT DEVELOPMENT PROGRAM
SMALL BUSINESS ADMINISTRATION

TOPIC NINETEEN

AC 012 324

SUBJECT PRESENTATIONS

in the

SMALL BUSINESS MANAGEMENT DEVELOPMENT PROGRAM

Small Business Administration

Subject presentations and a set of overhead projection transparencies for each are available on loan from SBA Regional Offices to cosponsors of management training courses, conferences, problem clinics, and workshops. The topic number and title of the presentations now available in each series are listed below.

Topic No.	*Title*
	First Series
1	Success and Failure Factors
2	Records and Credit in Profitable Management
3	Managing to Sell
4	The Why and What of Bookkeeping
5	Financing Long and Short Term Needs
6	Personnel Management
7	Special Aspects of Sales Promotion
8	Taxation: A Key Factor in Business Decisions
9	Communication and Control
10	Human Factors in Small Business
11	Choosing a Form of Business Organization
12	Safeguarding Your Business and Management Succession
13	Small Business Location and Layout
14	Effective Advertising
15	Sources of Assistance and Information
	Second Series
16	Why Customers Buy (And Why They Don't)
17	Marketing Research
18	Franchising
19	Pricing In A Services Business

These may be purchased from the Superintendent of Documents, Government Printing Office, Washington, D.C. 20402; or from the U.S. Department of Commerce field offices. Price: $1.25 each for No. 1, 2, 6, 7, 8, 14, 16, 18, 19; $1.50 for each of the others. Catalog No. SBA 1.24.

PRICING IN A SERVICES BUSINESS

INSTRUCTOR'S MANUAL
MANAGEMENT DEVELOPMENT PROGRAM
SMALL BUSINESS ADMINISTRATION

TOPIC NINETEEN

SMALL BUSINESS ADMINISTRATION

HOWARD J. SAMUELS, *Administrator*

PROCUREMENT AND MANAGEMENT ASSISTANCE

IRVING MANESS, *Associate Administrator*

OFFICE OF MANAGEMENT ASSISTANCE

CLYDE B. BOTHMER, *Acting Director*

EDUCATION DIVISION

WENDELL O. METCALF, *Chief*

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20420 - Price $1.25

FOREWORD

This subject presentation is another effort to serve the pressing needs of the small business community through our Small Business Management Development Program. The program was developed by the Small Business Administration to bring modern management concepts and practices to the owners and managers of small businesses. Rapid progress of this management education undertaking has been realized through cooperation of educational institutions and business associations throughout the Nation. Within 15 years, more than 9,500 courses, conferences, problem clinics, and workshops have been cosponsored with over 2,000 universities, colleges, local school systems, trade associations, chambers of commerce and other business organizations. Approximately 400,000 owners and managers, and prospective owners and managers, of small businesses have received training in this program.

This is the fourth booklet in a second series of subject presentations intended to advance the effectiveness of small business management.

Each of these booklets presents, for educators and businessmen who teach management to small business owners and managers, a complete one-session subject presentation, including a lesson plan, lecture, visual aids, case studies, study assignments, selected bibliography, and handout material. This material should be of assistance in establishing new management programs and in maintaining existing ones, particularly by emphasizing the importance of continuing self-development for small business owners and managers, by offering methods and tools for speedier more successful endeavor, and by assisting the busy instructor with his preparation.

This presentation on small business service pricing may find application with other SBA programs such as those dealing with management evaluation of loan applicants and borrowers, management assistance counseling, the reestablishment of small business resulting from urban renewal and highway construction, and minority entrepreneurship.

The preceding SBA series of administrative management subject presentations resulted from a recommendation of a committee on management education, representing the Small Business Administration and the Distributive Education Division of the American Vocational Association. It consists of 15 booklets identified by "Topic 1" through "Topic 15."

Enthusiastic utilization of the first subject presentations demonstrated the need for this type of packaged treatment and a second series was planned. The present management development series continues the number sequence and begins with

Topic Sixteen, "Why Customers Buy," followed by *Topic Seventeen*, "Marketing Research" and *Topic Eighteen*, "Franchising." This one, entitled "Pricing in a Services Business," is therefore *Topic Nineteen*.

The author, Lee D. Davis, is a recognized author of business and program publications, and former president of an audiovisual firm. Art work and visuals were designed and produced by Mi h :el J. Fontana.

This publication was prepared with the supervision of Dr. Weston R. Clark, Education Specialist, and the administrative direction of Wendell O. Metcalf, Chief, Education Division.

HOWARD J. SAMUELS
Administrator

October 1968

CONTENTS

	Page
1. Foreword	VI
2. A Word About This Session	VII
3. The Lesson Plan	3
4. The Presentation	9
5. Visual Aids*	31
6. The Supply Department**	35
7. Cases in Point	57
8. The Incubator	63
9. Bibliography	63

*A set of the visual aids is available from the nearest SBA regional office (see inside back cover for listing). These visuals are 8- by 10-inch colored transparencies for use on overhead projectors.

**Among the materials prepared as "handouts" to participants are several SBA free publications. Current information on the availability of suggested and new SBA publications may be obtained from the nearest SBA office.

A Word About This Session

"Pricing In A Services Business," *Topic Nineteen*, was prepared to aid in teaching one session of a small business management course, conference, clinic or workshop. It contains sufficient material for a 45- to 60-minute lecture which is usually followed by a discussion period. The management cases, incubator items, and significant information which might be drawn from the handout materials and bibliographical sources can be used to enrich or extend the session. They also can serve as a basis for successive sessions on the topic.

The lecture is designed as the basis for a presentation to the businessman in nontechnical language. It represents *one* teaching approach to pricing in a services business. It is expected that instructors may wish to modify or revise the lecture material according to their personal background and experience in the subject area. They may also find it desirable to supplement or adjust the treatment in order to meet more effectively the training or special needs of their participants.

Should time limitations necessitate shortening the presentation, selected changes are feasible, such as deleting parts of sections VII and VIII and condensing the treatment in sections V and X. Such modifications could be made without destroying an effective sequence of subject treatment.

This topic can best be handled by one who has specialist knowledge in business service pricing, is familiar with small business, and is experienced in conducting training sessions for small business owner-managers.

Persons or organizations interested in cosponsoring small business management training, such as courses, conferences, workshops or problem clinics, may be provided on loan a selection of needed subject presentations and a set of overhead projection transparencies for each from the nearest Small Business Administration field office. SBA offices are listed on the inside back cover. Titles of available booklets in the first and second series appear on the inside front cover. Single booklets or complete sets may be purchased from the Superintendent of Documents, Government Printing Office, Washington, D.C. 20402.

The various sections of this booklet are separated by divider sheets of different colors. These colors are given here and the contents of the sections are briefly described.

Gray—*The Lesson Plan*. An outline of the material covered which may be used as a teaching guide or as a framework for developing an individualized presentation. The lesson plan contains two columns: the left-hand column is an outline of the presentation; the right is a step-by-step indication of procedure, including chalkboard suggestions quotations, discussion points, and a keyed guide to the visual aids supplied.

Rust—*The Presentation*. A carefully prepared subject presentation which may be used as written or modified to meet local needs and conditions. It may also be used as a source of information by a person preparing his own lecture.

Buff —*The Visual Aids.* Photographic copies of the set of visual aids which are available for this topic. These visuals are 8- by 10-inch colored transparencies prepared for use on overhead projectors. The subject presentation and lesson plan are keyed to the visuals. A set of visuals for each subject in this series may be borrowed from the nearest SBA regional office.

Green —*The Supply Department.* Materials which may be reproduced locally for distribution to course participants. Your nearest SBA office can furnish information on current availability of SBA free publications, including titles published subsequent to this volume.

Yellow—*Cases in Point.* Short actual small-business management cases which may be used to augment the presentation and to develop discussion, or as the basis for a second session on the same topic.

Blue —*The Incubator.* Ideas for stimulating further thought and discussion by the participants. This material may be reproduced locally for distribution to course participants. "Assignments" are designed to aid in retention of the subject matter of the session.

NOTE: See back cover for index reference to the divider sheets.

INSTRUCTIONAL FORMAT SHOULD BE STIMULATING

Use The Three B's

- ***Base*** instruction on problems at learners level.
- ***Blend*** instruction with job experience.
- ***Brighten*** instructions with variety of ***illustrations, investigations*** and group ***participation***.

FOUR BASIC STEPS OF INSTRUCTION

Instructing is like selling - -

Selling

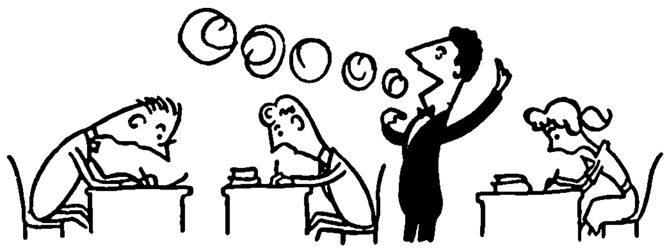
1. Approach customer
   - Promptness
   - Put at ease
   - Awaken ***interest***
2. Present merchandise or service
   - Select merchandise to fit need
   - Show one item at a time
   - Demonstrate ***selling points***
3. Have customer take part
   - Get merchandise into customer's hands
   - Let customer "try on" merchandise
   - Answer questions and meet objections
4. Bring sale to close
   - Help customers decide; ask: "which" "for whom" "when"
   - Be sure merchandise fits need
   - Summarize points of care and use
   - Handle mechanics of sale
   - Pave way for return visit

Instructing

1. Prepare the group
   - Start on schedule
   - Put group at ease
   - ***Awaken*** interest
2. Present information
   - Gauge material to needs
   - Present one point at a time
   - ***Show, illustrate, question***
3. Have group participate
   - Get group to ***discuss***
   - Have members ***demonstrate*** or ***use*** ideas
   - Answer questions and correct errors
4. Bring meeting to a close
   - Check on understanding; ask: "why" "how" "when" "what" "where" "who"
   - Be sure group now can use information
   - Summarize "take away" ideas
   - Make a definite conclusion
   - Pave way for next session

317-022 O - 69 - 2

How To Deal With "Difficult Customers"



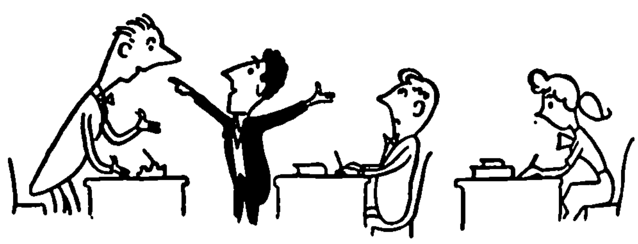
What To Do

THE "MOUTH"—wants to do all the talking.

Take the play away from him by asking others to comment on his remarks.

Deliberately turn to others and ask for their opinions. Avoid looking at him.

Tactfully ask him to give someone else a chance, or talk to him in private.



THE "ARGUER"—constantly tries to catch you up.

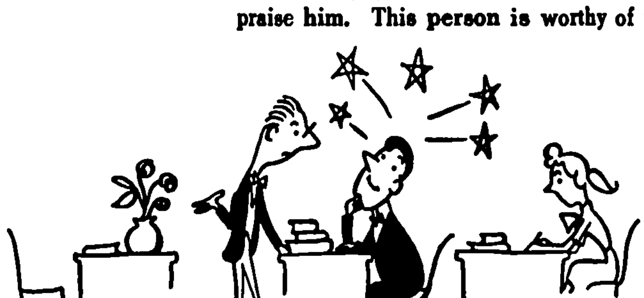
Keep cool. You can never "win" an argument. Always make him back it up. Ask for evidence.

Avoid getting personal.

Refer the question to the group and then to him.

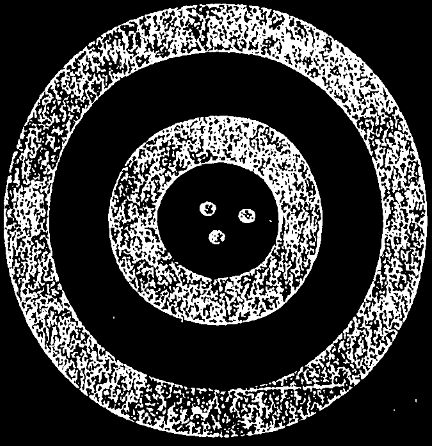
THE "MOUSE"—is in every group.

Call him by name and ask him for an opinion. Ask him an easy question he is sure to answer well, then praise him. This person is worthy of your attention.



THE "SO-WHATER"—is disinterested.

Point up something he has done as a good example of the point being stressed. Ask direct questions affecting his work.



LESSON PLAN

Topic: Pricing In A Services Business

Objectives: To indicate the need for systematic techniques in establishing prices for services.
To provide specific practical techniques for establishing realistic prices.
To suggest methods of dealing with pricing problems and controversies when they occur.
To show the importance of management planning in pricing and other policies.

Session Content	Tips and Approaches
I. Introduction	Tell the story of Abraham Lincoln's servicing pricing problems or other appropriate opening.
II. The Problem of Pricing Service	
A. Inherent value problem	
1. Customer equates price with labor rates	
2. Easy to underestimate true value of a service	
3. Service prices have been rising faster than goods (50 percent compared to 18 percent)	
B. Disparity in service prices	
III. Services Opportunities	Visual No. 1.
A. Growing faster than economy	
1. Affluence allows more for services	
2. Demand growing	
B. Prospects bright	
IV. Price Planning	
A. Need pricing policy	
1. Use standard prices	
2. Publish a price list	
B. Policy guidelines	Visual No. 2.
1. Long range welfare	
2. Stimulate combination sales	
3. Carry profit share	
4. Flexible prices	
5. Periodic review	
C. Price comparison schedule	Visual No. 3.

V. Cost-Plus Method of Pricing	
A. Many carry loss burden	
B. Accurate list of all costs plus a reasonable profit	
1. Need accurate business records	
2. Historical records determine	Visual No. 4.
a. Direct labor costs	Visual No. 5a and 5b.
b. Direct materials costs	
3. Overhead	Visual No. 6.
a. Percentage of direct costs	
b. Percentage of direct labor	
c. Percentage of direct materials	
d. Units of production	
C. Total costs	
1. Direct costs	Visual No. 7.
2. Indirect costs	
VI. Cost-Estimate Method	
A. Price may affect volume without substantially changing indirect cost	
B. Cost-estimate method based on a projection of costs	Give example of portrait photography studio.
C. Portrait studio example	Visual No. 8.
VII. Profit	
A. Definition of profit	Ask class for definition.
1. Generally, "whatever is left over after deduction of all expenses"	
2. May be also defined as "that part of the gross price of a thing or things which is a return for good management, investment capital and effective business procedures"	
B. Guidelines for determining adequate profit	
1. Trade association figure	
2. Past margin, adjusted for needs	

3. A reasonable return on investment	
C. Profit expressed as percentage of gross sales or as return on investment	Visual No. 9.
D. Recap of "cost-plus" method	Go through steps of setting a price for tire repair.
1. Direct costs	Visual No. 10.
2. Indirect costs	
3. Add profit & take total	Visual No. 11.
E. Recap of "cost estimate" method	Visual No. 12.
VIII. Negotiated or Bid Prices	
A. Considerable variance in each job requires a bid	Tell story of American astronaut about "low bid."
B. "Bid the job, not the market"	
1. Research the job	
2. Examine the location	
3. List contingencies	
C. Steps in preparing a bid	Visual No. 13.
1. Understand specifications	Use building contractor as example. Use progressive disclosure technique.
2. Visit location	
3. List contingencies	
4. List efficiencies	
5. Break down costs	
6. Detail overhead factors	
7. Check the costs	
8. Prepare the bid	
D. Other steps to take	
1. Determine customer financial responsibility	
2. Check availability of financing, if required	
3. Evaluate prospect of good customer relations	
4. Check reliability of any subcontractors	
IX. Building a Price Image	
A. Firms acquire a price reputation	
1. Don't be the "cheap" one	
2. Don't be "expensive"	

3. Strive to be considered fair and reasonable
B. Fallacy of "discounts"
1. Use for purpose
a. Faster receivables
b. Attract new customers
2. Don't give profit away
C. Promote your pricing policy

X. How To Raise Prices and Succeed

A. Give customers reasons for rise
B. Promote services
1. Takes money to make money
2. Invest in selling
C. Dress up the service
D. Make service more convenient

XI. Lowering Prices

A. May be harder than raising
B. When to lower prices
1. Changing external conditions
2. Vigorous cost cutting
C. Stay out of price wars

XII. How To Avoid a Price Controversy

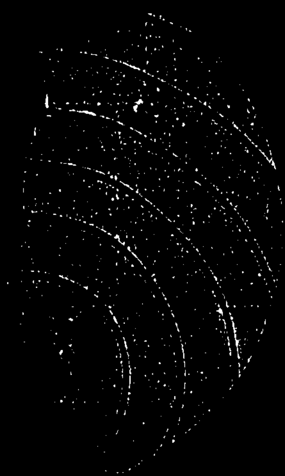
A. Give price or rates in advance — Discuss.
1. Be sure communication is complete
2. What does customer understand that he gets
3. Put it in writing
B. Handle complaints promptly
1. Explain about overhead, materials and other costs — Visual No. 14.
2. Let customer express complaint fully
a. Read back his complaint to him
b. Help him modify complaint
3. Don't leave unfinished points (to check on later)

4. Keep control of emotions
5. Don't give up the ship
6. Follow up complaint with letter

XIII. **Summation**

A. Your service has a package
B. It has a price tag
C. Would you buy a product with the "package" and price you offer?
D. Price is a matter of *value* to the customer

Hand out focal points.



PRICING IN A SERVICES BUSINESS

It may come as a surprise to you that none other than Honest Abe himself ran into problems in pricing services. It seems that when Abraham Lincoln was practicing law, he once represented the Illinois Central Railroad in a tax suit against McLean County. Upon winning the case for the railroad, he submitted his bill for $2,000. His clients objected, saying that the fee was exorbitant, and then refused to pay.

The story goes that, upon hearing the amount of the fee, a railroad official said that for that kind of money they could have had Henry Clay himself to which Mr. Lincoln replied, "Could Clay have done more than win?" Finally, Lincoln sued the railroad for $5,000, the amount stated as a "moderate" charge by a panel of attorneys. Lincoln collected the money, which was the largest legal fee he ever received.

On the other hand, Lincoln was often criticized for charging too little. He was once admonished by an Illinois judge who said; "You are pauperizing this court. You are ruining your fellows. Unless you quit this ridiculous policy we shall all have to go to farming."

The Problem of Pricing Service

Well, what is it about setting prices on services that is so difficult? Surely, if even Lincoln had that problem over a hundred years ago, there must be something inherent in pricing services that leads to trouble. And there is!

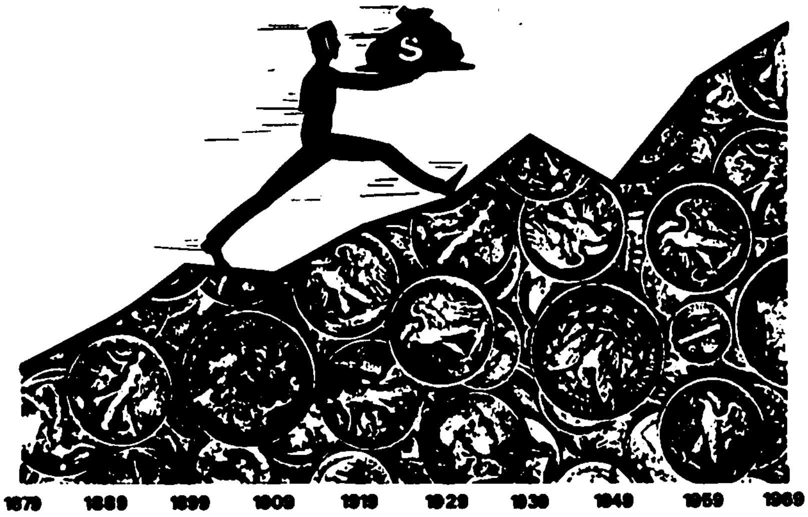
When a customer buys a product, the price is usually clearly stated and he can evaluate the total benefit of that product. But when he purchases a service, the customer sees only the expenditure of a certain amount of labor or the results of that the labor. So he tends to underestimate value of the service.

The reasons are pretty clear. The customer generally equates service charges involving labor with what he thinks is a fair wage for that labor and does not think of overhead, equipment, materials, and profit consideration. In the case of services that don't include labor, their rather intangible nature usually fails to impress their true value on the customer. And added to that is the fact that prices for services have been rising faster than prices for goods because productivity for services has not developed as rapidly as that for manufactured goods, and the high labor cost involved in services has caused their prices to soar. Since 1946, service prices have increased 50 percent compared to an 18 percent increase in goods prices.*

The matter is further complicated by the fact that there is lack of conformity in service pricing so that the customer is apt to distrust any apparent disparity even though different service quality is involved. Then, too, the service industry has not generally been effective in policing itself. A small minority of shady operators have tarnished the reputations of all the others.

Bureau of Labor Statistics, 1965.

317-022 O - 69 - 4



TREND OF EXPENDITURES FOR SERVICES

Visual 1

Services Opportunities

But don't give up hope! On the other side of the coin is the fact that service businesses are growing faster than the general economy, and prospects are excellent. As we become more affluent, a large proportion of spendable income is available for services. There are increasing opportunities for small businesses to thrive in the service area, and we are inventing and demanding a greater range of services all the time. According to figures compiled by the U.S. Department of Commerce, Americans spent $63 billion on retail services in 1965. This figure is expected to reach $100 billion within the next 5 years. There are more than three quarters of a million retail service establishments employing more than 4 million people.

Also, more and more goods retailers are seeing the advantages of offering services to their customers. Many department stores now offer decorating or insurance services; hardware and variety stores are beginning to include repair stations and home-cleaning services. Appliance dealers now have to service their customers or else risk not making the sale, and it is almost universally established that automobile dealers must have service departments to stay in business. Rental businesses that were unheard of 20 years ago now flourish. The present list is impressive: cars, trailers, tools, formal clothes, home furnishings, paintings, books, appliances, camping equipment, and even personal escorts, to name just a few. Service has become very big business and the end is nowhere in sight.

Price Planning

But regardless of all the opportunities and the problems involved, every service establishment should have a *pricing policy*. And in these days of increasing materials costs and high labor rates, the pricing policy had better be something more realistic than "what the other guys are charging" or "what the traffic will bear."

You Need a Pricing Policy

If for no other reason, you need a firm policy to avoid those unnecessary customer squabbles over prices. Nothing destroys a service business faster than for customers to get together and compare figures only to find out they paid differently for the same service. This usually means you lose both those customers and anybody they can find to tell about it. You need *standard* prices to do business. So, to the fullest extent possible, work out schedules that enable you to charge on the same basis.

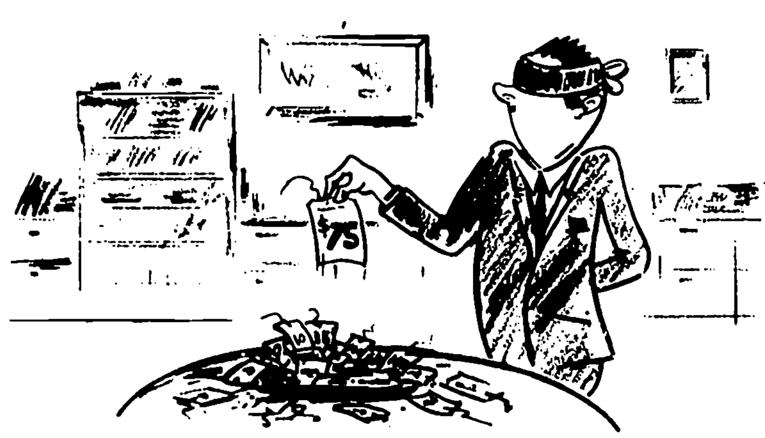
Policy Guidelines

If yours is the kind of business that allows it, *published* prices should be used in figuring all charges. Even if a customer believes the prices are high, he finds solace in the fact that he is being charged the same as others for the same service. And even if the price must be negotiated, the publishing of established rates will help satisfy questions in the customer's mind.

In regard to a policy approach in pricing, we submit that pricing is as vital a management decision as advertising, personnel, and organizational policy. But in many otherwise well-managed businesses, pricing is done "by the seat of the pants." A systematic analysis is needed and then an intelligent management decision based upon the analysis. In other words, an *established policy*.

Some guidelines for establishing this pricing policy might be as follows:

1. Set prices to promote the long-range welfare of the firm.
2. Set prices for individual services that stimulate combination sales.
3. Set prices on all services so that they carry their own share of profit (unless underpricing leads clearly to more sizable, highly profitable sales).
4. Set pricing policy that is flexible enough to meet changing economic conditions without complete reanalysis.
5. Set up schedule for regular price review (every quarter for most businesses).



DON'T PRICE BLINDLY

- KNOW YOUR COSTS.

Visual 2

Of course, the prices charged by your competition should enter into, but *not* dictate, the planning of your prices. As a part of the planning stage, gather price information on your major competitors.

Price Comparison Schedule

Do this by setting up a *price comparison schedule* of the services you want to examine and applying your competitors' rates as best you can to each of the service categories you list. Don't let emotion and wishful thinking guide you in interpreting competitive prices which may be figured on a different basis than your own. Obtaining price information about competitors is easier than it may first seem. Old bills (not too old) from their former customers, published price lists, advertising, or comparative shopping may give valid prices. You can even ask competitors for pricing information in exchange for yours. Often, explaining that you are making a pricing study of a number of firms and offering to supply copies of the information are all you need to get cooperation. In any event, don't depend on hearsay information. It is often unreliable, and even when reported accurately may be out of date, come from a special promotion, or not be for the exact services specified.

PRICE COMPARISON SCHEDULE

	Brake Adjustment	Reline	Replace Shoe
A Company	$2.50	$18.00	$10.00
B Company	2.00	21.00	12.00
C Company	no charge	19.00	14.00
Average	2.25	19.33	12.00

Visual 3

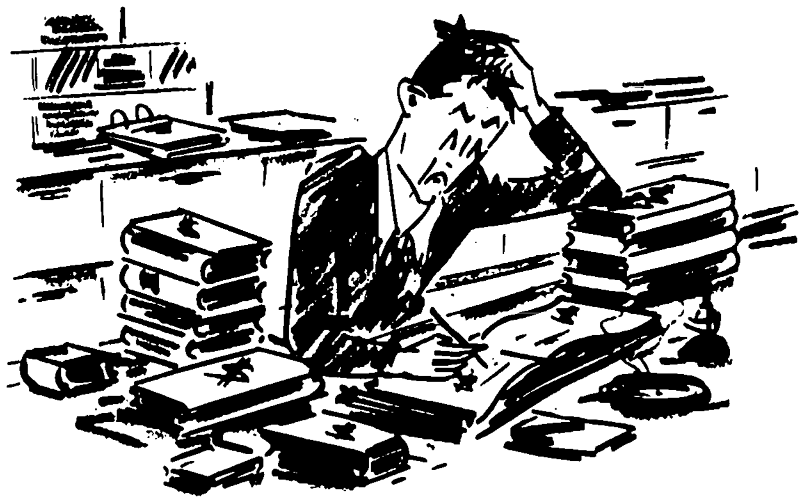
The point in price planning is to be systematic and thorough. All management decisions should be based on facts, and the important management function of setting effective prices is no less important than any other decision.

Cost-Plus Method of Pricing

Getting back to our friend Mr. Lincoln, he once said, in answer to an inquiry on how long a man's legs should be, that he thought they should be long enough to reach the ground. It's the same with prices for service. They should be high enough to cover the total costs and a reasonable profit. But as obvious as that sounds, studies have shown that service establishments too often offer some services at prices that do not cover costs. Because the businessmen have never examined their real costs in detail, or have failed to do it periodically, they go on carrying a loss burden that eats directly into services that are profitable. Obviously, they would be better off not offering such services at all unless those services are required to develop profitable business.

You Need Accurate List of Costs

So we clearly need an accurate method of setting prices. The surest way to establish realistic prices is the "cost-plus" or "full cost" method. In order to do this, you must get an accurate list of all costs involved in the particular service and then add a profit margin. Such a list cannot afford to be haphazard or merely estimated. Probably you should get the help or advice of a qualified accountant in order to ensure the completeness of the figures. To establish prices, you must have accurate business records.



THE PAST IS PROLOGUE

Visual 4

One way to apply the cost-plus method is on the basis of your *historical* records, in other words, what you did last year or for the last several years. By examining and averaging out the past costs, it is possible to come up with reasonably accurate figures.

Start with *labor costs*. From your payroll records over the past year, take the total wages paid, including overtime, for each type of job involved in the service offered. Then divide that figure by the total number of hours worked in that classification by those employees. The answer will be the average labor unit cost per hour.

Now comes a harder part. Determine how much time of that labor is expended on the average services job in question. Don't speculate. Check the hourly distributions of time, if you keep them. If not, try to check some record which shows how many of the service completions a man in that job classification normally accomplishes in a day. For example, a cleaning establishment might count the garments of a given type a presser handles in a day to determine time per garment. You could, of course, time the activity with a watch to determine the exact time it takes the presser to

TO FIGURE DIRECT LABOR COST

Formula--

Labor cost per time unit
multiplied by time required equals

Labor cost per production unit

Drycleaning example--

$.03 (cost per minute)

× 20 (minutes required)

$.60 (direct labor cost per garment)

Visual 5A

TO FIGURE MATERIALS COST

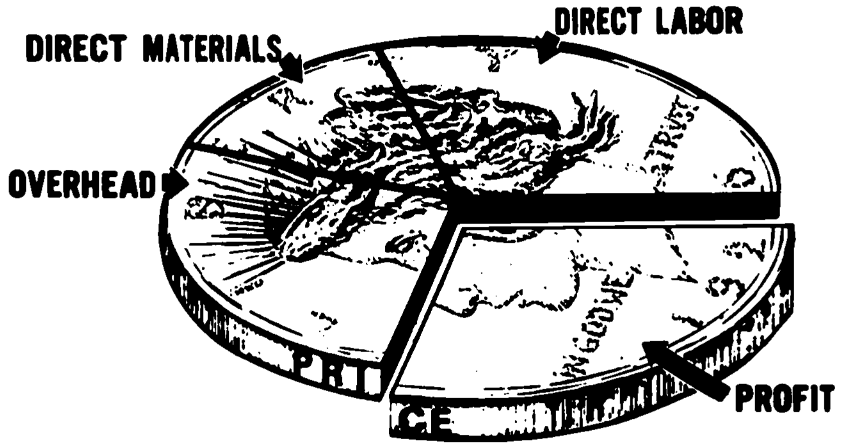
Formula--

$$\frac{\text{Materials cost}}{\text{number of production units}} = \text{materials cost per unit.}$$

Drycleaning example--

$$\frac{\$\,950}{4{,}655} = \$.208\text{, direct materials cost per garment.}$$

Visual 5B



FULL COST + PROFIT = PRICE

Visual 6

complete a garment, but this is apt to be misleading. It does not account for the inevitable interruptions. Moreover, if your employee sees you timing him, he is apt to increase his speed above the average or to question your motives. Don't forget to include any transportation time or preparation time normally allocated as direct labor for the job. (Visual 5a)

Once you have determined this figure as accurately as you know how, multiply this *normal time expended* by the *labor unit cost*. This will give you "direct labor cost." In the case of our cleaning establishment, let's assume that it takes 20 minutes of working time to clean and press the garment and the cost per minute of labor is 3 cents ($1.80 per hour divided by 60 minutes). By multiplying, we get the average direct labor cost of 60 cents. (Visual 6)

Next we take up the *materials cost* for that service. Here, again, it is important to check the record information. The more searching you do of the records, the more accurate your analysis will be and consequently the more valuable. Do not include materials for which your customer is charged separately. A good way to determine this materials cost is to take the total of such costs from your inventory or cost-of-sales records. Then divide that total amount by the total number of service jobs that you completed. This will give you an *average materials cost*. (Visual 5b)

In the case of our cleaning establishment, let's work out such a cost. The records show that expenditures last year for cleaning fluid, materials, hangers, and bags for this service totaled $950 and that 4,655 garments were cleaned and pressed. Dividing the amount spent—the annual materials cost—by the number of suits handled gives us $0.208 as an average materials cost.

If you don't have records that separate such costs, ask a responsible employee to keep a record for a period of a week or month. Then extend the current prices on those materials for a total and divide by the number of service jobs in that same time period. Because accounting procedures vary, you must ask whoever keeps your books if any of these figures are included in figuring your overhead. If they are, of course, you won't include them twice. But whether you include your materials expenditures here or as part of the overhead, it is a good idea to know just what amount of materials expenditure is involved in *each* of the services jobs your firm completes.

The next figure to establish in the cost-plus method of pricing is the one for *overhead*, or *indirect costs*. This is the dangerous one. It includes all costs except direct materials and direct labor. (Visual 6)

It is said that failure to understand overhead is a key problem in price determination in all businesses. The tendency seems to be not to believe the figures representing overhead or to ignore them out of enthusiasm and hope for future business. You would be well advised to learn all you can about your overhead and to analyze it often with an eye to both cutting costs and adjusting prices.

There are several ways to compute how much overhead to allow for in setting your prices. The most common is probably to use a percentage of total direct costs. What percentage do you use? To determine this, total your direct costs (material and labor) for a specific period—last year if it was a typical year—and your indirect costs for the same period. Then divide the total indirect costs by the total direct costs. This figure times the direct costs for an individual service will give the indirect costs for that service.

Three other methods are sometimes used for allotting overhead costs:

1. *Percentage of direct labor.* This method is the same as that described for percentage of direct costs except that *direct labor* cost is used throughout the computation in place of total direct costs.
2. *Percentage of direct materials.* This method is also the same as that described for total direct costs except that *direct materials* cost is used in place of total direct costs.
3. *Units of production.* To use this method, divide total overhead costs for a typical period by the number of units of production for the same period. This the amount of overhead to be added in computing the unit price.

Total Cost

Now that we have determined the *direct costs* of labor and materials, and the *indirect* costs of overhead (plus any other indirect costs suggested by your accountant) we are ready to add up the figures to determine the full costs of the service being

FULL SERVICE COSTS BY COST-PLUS METHOD

Direct materials

+ Direct labor

Direct costs

+ Indirect costs

Full costs

Visual 7

analyzed. Assuming that we have accurately and completely reflected a true full cost, we have only to add a margin for profit to establish price. We'll go into details later, but suffice it to say for now that the profit margin should be large enough to supply a good return but not so high that it will discourage a favorable volume of business.

Cost-Estimate Method

It might seem that the cost-plus method of figuring a price is the most realsitic way. While this is basically true, it would be an oversimplification to say that is always the best way. Take the situation where the price itself will affect the future volume of business without substantiatially changing the indirect costs which we just studied. Then the amount of indirect cost as figured on the cost-plus method is out of proportion to the price. Or suppose that the past records don't reflect a new expense that the business will face. In such situations, the small businessman should try to account for these anticipated changes.

Based on Cost Projections

Pricing based on a projection of costs is called the "cost estimate" method. Some people call it the "incremental cost" method or "marginal income analysis" but it amounts to the same thing, that is, a careful judgment of flexible cost factors and a realistic application of them in setting new prices. However, cost estimates should also be based on the accounting records, just as in the "cost-plus" method. The steps are exactly the same as for cost plus except that adjustments are made in all items that are expected to change (for example, a percentage of increase to labor costs based on anticipated raises, a lowering of materials cost due to some efficiency worked out and checked, or a change in rent reflected in indirect costs).

PORTRAIT STUDIO
COST PLUS vs. COST ESTIMATE

$ .89	Direct labor	$ .89
.42	Direct materials	.42
$1.31	Direct costs	$1.31
1.36	Indirect costs	.91
$2.67	Full costs	$2.22
.33	Profits	.28
$3.00	Price	$2.50

Visual 8

Portrait Studio Example

Perhaps an actual example will explain it more fully. Take the case of a portrait studio. The owner has determined that he has not reached a volume point that he could handle without substantially increasing his indirect costs, things like rent, heat, light, administrative costs. So he considers what would happen if he lowered his normal fee for four poses, proofs, and one 8 by 10 from the $3 he has been charging to $2.50. He believes this might increase his volume by 50 percent. Yet his accountant tells him that the full cost for such sittings in the previous year has been $2.67. It would seem that on the full-cost basis he actually would lose 17 cents on every sale.

However, if he is right about the increase, say that he will have 1,800 customers instead of the 1,200 last year, his profit will go from $396 a year for this service to $504 a year. This assumes that total indirect cost will not increase. Therefore, the indirect cost per unit will decrease from $1.36 to $0.91, as the illustration shows. Not only will profit increase because of increased initial sales but the owner knows that the prints ordered beyond the one given as a part of the package will develop additional profits. Obviously, the question is, will he actually develop a 50-percent increase in business. That can only be determined by studying the market realistically, and making careful judgments of the impact of the lower price. The studio owner might be well advised to try out his theory by adopting the special price for a promotional period and studying the results before adopting it as policy. This is no time for speculation, if it can be avoided.

Whether you use the cost-plus or the cost-estimate method, the idea is to establish a cost floor or break-even point below which you should not price unless by so doing you will generate other profitable business. In any event, you must now add a *profit* margin.

Profit

To begin, we should define "profit." How would you define it?

(NOTE: Have the class suggest the meaning of profit.)

Well, a definition that has come into general acceptance is that profit is "whatever is left over after deduction of all expenses." Strange, isn't it, that anything as positive as profit should have such a negative definition? Maybe we could also define it as "that part of the gross price of a thing or things which is a return for good management, investment capital, and effective business procedures."

In any event, profit is what makes our system of business work. It is the incentive for risking capital, the measure of business effectiveness, and the very substance of business growth. Without profit we couldn't stay in business very long.

Guidelines for Determining Adequate Profit

But considering profit from the standpoint of pricing in a services business, we have to have some basis for adding it to the cost of the services. Of course, we would like to have all the profit we can get, but just how much should that be?

Well, the margin of profit has to be realistic or else it will be self-defeating. So you should establish some guidelines for your business. One good way is to contact your trade association. If they have figures on the margin in your industry as a whole, you have a useful figure to help you compute your own profit allowance. You may not want to apply arbitrarily the industry average as your profit, but knowing what it is will give you a reference point to help you judge whether your anticipated profit is too high or too low.

Also, if you have been profitably in business for some time, you know what your margin has been. You can use this as a guide to profit consideration, adjusted perhaps to your evaluation of future growth, needs, and new business volume.

Still another method is to figure what kind of investment return you could expect from an amount of money equal to your business equity. In other words, if the proprietor's equity shown on your balance sheet were cash invested in stocks, bonds, or other securities, what would be a reasonable return? You should get an equal return as a minimum profit for your business investment.

Ways To Express Profit

There are two ways generally used to express profit: As a percentage of gross sales and as return on investment. Take as example a firm in which the owner has

WAYS TO STATE PROFIT

Investment	$100,000
Sales	200,000
Profit	10,000

$$\text{Profit} = \frac{\$\ 10{,}000}{\$100{,}000} = 10\%\ \text{return on investment, or}$$

$$\text{Profit} = \frac{\$\ 10{,}000}{\$200{,}000} = 5\%\ \text{of sales.}$$

Visual 9

invested $100,000. And suppose that the business grosses $200,000 annually, of which $10,000 is profit. Then we could say that the profit is a 10 percent return on the investment or 5 percent of sales. But in using a figure to add to costs for setting prices, we would use the 5 percent figure for profit because the price of services is related to the gross sales.

If you offer more than one service in your business, it is probable that you do not receive the same profit for all offerings. That is why it is so important to analyze each of your services separately.

Recap of "Cost Plus" Method

Now, let's put what we have considered so far to work in actually figuring a price for a service. Perhaps a service station would make a good example so let's

DIRECT COSTS -- TIRE REPAIR

$$\frac{\$350.63}{935} = \$.375,\ \text{average materials cost}$$

$$\$.034 \times 24.6 = \$.8364,\ \text{average labor cost}$$

Visual 10

COST PLUS -- TIRE REPAIR

Direct materials	$ .375
Direct labor	.9964
Direct costs	$1.3714
Indirect costs	.3089
Full cost	$1.68
Profit	.30
Price	$1.98

Visual 11

work out a price for tire repairs. We will assume that the proprietor has done a good bookkeeping job so we have some accurate records to refer to for cost figures. He could start by determining his materials cost for the average tire repair. He does this by dividing the total expenditure for repair materials last year by the number of repairs made. He finds that the station made 935 repairs and spent $350.63 for supplies. This gives us $0.375 (37½ cents) as the average materials cost. Next he figures the average labor cost by asking the tire repairmen to time themselves over the period of a week after explaining why the information is needed. Timing shows that changing the tire, pulling the casing, making the repair, and remounting takes an average of 24.6 minutes. This appears to be verified by the days when

COST ESTIMATE -- TIRE REPAIR

Direct materials	$ .375
Direct labor	.8968
Direct costs	$1.2718
Indirect costs	.2870
Full cost	$1.5588
Profit	.1912
Price	$1.75

Visual 12

a man works only on tires. Then by checking his payroll records, including overtime payments, the owner determines that the wage rate *per minute* for repairmen is \$0.034. ($3\frac{2}{5}$ cents). The per-minute rate times the average repair time comes to \$0.8364 ($83\frac{64}{100}$ cents). In addition to actual labor time of the repair, the owner observes that it takes an average of 4 minutes to write up the order so he applies the rate of the order writer at \$0.04 per minute for a total of \$0.16. The two labor averages added together gives him his direct labor cost of \$0.9964. Materials and labor costs added together give him his direct cost of \$1.3714. The owner's accountant tells him his indirect costs have been running at 31 percent of direct labor so he computes this as \$0.3089. That added to direct labor gives a full cost of \$1.68. On the recommendation of the accountant he adds a profit that will be 15 percent of the selling price and comes up with a price of \$1.98. This was figured on the *cost-plus* method.

Recap of "Cost Estimate" Method

The proprietor may consider the *cost estimate* method if he believes a new pneumatic tire mounting machine will lower his labor cost. The manufacturer of the new machine says that it will save 20 percent of the labor time. However, the proprietor believes that it will result in only a 10-percent labor saving because his men are unfamiliar with the equipment. He, therefore recomputes the costs.

He accounts for the cost of the machine in his indirect costs. That is, on the basis of the accountant's advice that depreciation would add 1 percent to indirect costs, he now uses 32 percent of labor, or \$0.2870. He also figures that lowering the price will add repair business and lead to tire sales, so he lowers his profit to about 11 percent. In that way, he can offer a price of \$1.75.

Negotiated or Bid Prices

Many services businesses don't lend themselves to this kind of pricing because there is considerable variance in each job. Such businessmen must evaluate the individual job and prepare a negotiated or contract bid price. The trick to bidding competitively, if several bids are to be received, is to use every efficiency possible to accomplish the job and still make a profit even if the bid is the low one.

Perhaps you remember the remark of the American businessman when asked what he thought about traveling by air. He said he kept thinking that the plane and all its equipment had been made by the low bidder. Still, the reason for competitive bidding is sound and seems to have been established as the best way to realize the best obtainable job at the lowest cost. By setting specifications correctly, the buyer need not expect an inferior job. But let's get down to cases on how to make a realistic bid.

Bid the Job, Not the Market

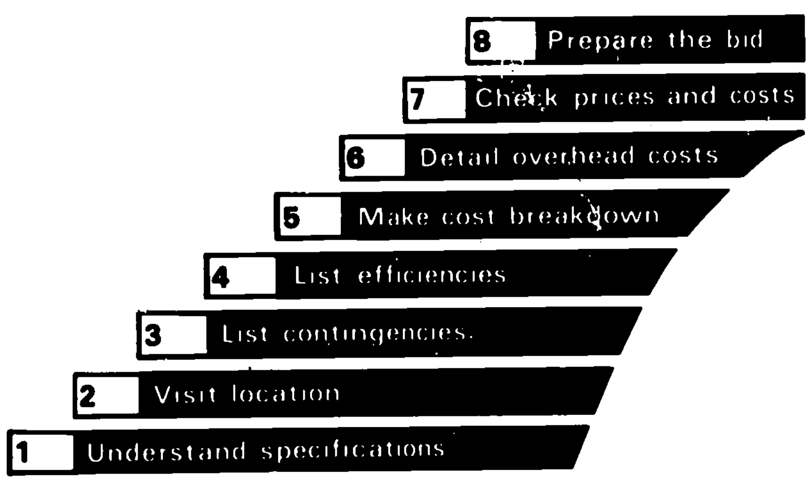
Veteran businessmen who work successfully on a bid basis will tell you that you must start by adhering to the cardinal rule for bidders: "Bid the job, not the market." This means going to considerable time, expense, and hard work in preparing a bid. Each job needs diligent research, full examination of the location or equipment on which the work is to be performed, and a listing of all the contingencies which might affect the cost of doing the job. Failing to do this has caused many firms to meet disaster. Too many bid contractors fail to account for all the elements of a project. Rather, they prepare bids by "averaging" costs.

Building contractors whose work is almost wholly on a bid basis have developed a method of bidding that is worth noting by any type of contractor. Let's follow the steps in the bid process by a successful contractor.

Steps in Preparing a Bid

Assume that the contractor has received a set of specifications for building a concrete-block store building. He starts by studying the specifications—not just reading them, but becoming so familiar with them that he *understands* them. Often there are points in the specifications which need clarification, so the contractor interviews the customer to be sure both understand exactly what work is to be performed.

Next the bidder visits the building lot. He examines it thoroughly to determine what difficulties may be encountered, whether he will have delivery problems, and



STEPS IN BIDDING

Visual 13

whether he will have to contend with interruptions imposed by businesses in the area. He even interviews neighboring businessmen regarding unusual activities or conditions during the proposed time of building so that he has all the facts possible.

While visiting the locations the contractor begins to assemble a written *list of contingencies*. He tries to determine what effect weather will have on construction, whether or not there will be other construction at the time which might hamper the project, and the prospect of any labor difficulties which might arise. He must also check on the availability of building materials.

Along with the negative aspects, the contractor *looks for efficiencies* which might lend themselves to the job. He makes a list of these as well, indicating any special equipment and any ideas which might be suggested to the customer as a way of accomplishing his purposes at less cost.

Now comes the vital job of preparing a complete *breakdown of costs*. Here, past records will be invaluable, particularly as a means of locating areas where costs have previously gone beyond expectations. He starts by listing all materials to be used, plus a realistic allowance for wastes based on his past performance. Then he determines materials costs. He takes into consideration not only on past costs but the prospect of price changes based on his knowledge of the market and recent rates of increase. Where possible, he gets a price commitment on materials from suppliers.

He does the same for equipment required, listing the days it will be needed plus an allowance for downtime which might be required. Here again, past experience in the area and at the same time of year will be valuable in estimating the allowance for this contingency.

Next, the bidder makes a complete listing of labor requirements. Again he examines carefully, being sure he is estimating as realistically as possible and again providing for delays that may be encountered. This is no time for wishful thinking—the contractor knows that there are usually some unforeseen delays which must be taken into consideration. He applies labor rates that are accurate and not likely to change.

Then the bidder prepares an overhead allowance. Because he knows each job has different requirements, he is not satisfied to merely use a past percentage rate but *lists actual overhead costs* that he knows will be involved for this particular project and compares this cost with past percentage rates. If he finds there is a disparity, he will rework the overhead costs to assure that he has accounted for all elements.

When he has done all this, he *reexamines the costs* with a practiced eye to make doubly sure he has accounted for everything. Next, he *applies a profit consideration* and adds up the totals. To avoid any blind spots, the bidder should ask a knowledgeable associate to check the bid.

Finally, he prepares the bid. Often, the contractor may include a cost breakdown for the customer's evaluation. This may prove especially valuable in a final understanding of how the project will be performed.

Other Steps To Take

Of course, the successful contractor will gather other information while the bid is being prepared. He will determine the financial responsibility of the customer, the availability of financing if that is required, the prospect of good customer relations, the reliability of any subcontractors to be used, and anything else which may have an important bearing on the successful completion of the job. The contractor should also check what impact the project would have on his other work and the overall climate for success. He will do well to examine whether this project will pay its own way and not interfere with other jobs in the offing.

Underbids by Competitors

But what if, after all this preparation, the building contractor does not get the job? If he has bid realistically he should congratulate himself on not having it because a lesser price might result in a loss. If his competitor takes the job at too low a price, the contractor will have one less low bidder to contend with on other work. There is always a danger of feeling panic when a series of jobs are lost to lower bidders, but it should not change one's resolve to continue bidding realistically. Of course, if losing bids continues, it may suggest a complete analysis of procedures and costs to determine why the firm is not competing successfully.

Building a Price Image

Bear in mind that not all contracting is done on a low-bid basis. There are other factors which do, or should, enter into a contractual arrangement. You all know of firms who have a reputation for shoddy work done at a low cost. Such firms seldom last long although they may enjoy a brief success.

You would be well advised to work for a quality image and favorable business reputation. If you do that effectively, price will become less of a factor in obtaining your share of the business. But just how do you build a price reputation in a service business?

A Price Reputation

Undoubtedly, the best way to get a good reputation on prices is to continuously offer quality service at favorable prices that are at least generally competitive and still allow a reasonable profit. But beyond that you can help the cause along.

Start by determining where your firm stands on prices. A periodic price comparison with competitors, as we indicated earlier, is always a valuable aid in setting pricing policy. Compare your prices with those of your competitors.

Then, set goals for your business reputation. What do you want it to be? Generally, you ought not become known as the "cheap" one and by the same standard should avoid becoming the "expensive" one. You would be well advised to try for an image of being fair and reasonable on prices.

A brief survey among your customers may prove helpful in determining what reputation you now have. This may be done as a followup on past work, a feedback from your sales people alerted to gather any response, or, more formally, a marketing survey made by specialists.

Then compare these findings with a written description of the kind of reputation you would like to have. If there is room for improvement, construct a program of promotion and image building that will establish that reputation. But be realistic; it is seldom possible for a firm to make a complete reversal overnight without damaging business. Build your image a step at a time.

One thing that you can do to improve your price image is to "borrow" a favorable image from your suppliers or even change suppliers in order to achieve a new image. Take for example, an automobile painting service which has established a reputation for inexpensive enamel painting using less well-known brands of paint. The owner notes a declining sales volume due to a greater interest in more expensive lacquers and the affluence of the community. He wishes to change his economy image to one of quality and moderate prices. So he negotiates a franchise for a well-known brand name that is widely advertised and promotes this fact intensely. His ads stress quality of the finishing process and the number of finish coats. He continues to offer the cheaper work so that he can make a gradual changeover, but he decreases promotion of the cheaper process. Gradually, the emphasis shifts to the more expensive service and his business begins a more favorable growth.

The Fallacy of "Discounts"

While we are on the subject of price image, we should take up the matter of "discounts". In theory, the idea of a discount is to give a customer an incentive to pay cash or buy in quantity.

There is a place for the legitimate discount in a service business and it can build sales if it is properly and intelligently handled. The first rule is to use the discount for a purpose. The most common is a discount for cash or fast pay as a means of improving the firm's cash flow. The second is as an introduction to the firm so that new customers come in to buy your services and to get acquainted. A third is to encourage quantity purchases.

However, you should be careful of liberal discounting on too many services because you may end up giving the profit away. Try to discount only on offerings which will lead to further business *without* discount or to move overstocked items. Generally, you should *not* offer discounts on labor items. Margins are usually thin, at best, and customers are seldom impressed by such discounts.

Promote Pricing Policy

But whatever your pricing policy, advertise it by promoting it in your ads and explaining it to customers. A clear-cut statement of policy is good promotion because people like to know about the firm with which they deal. Moreover, establishment of the policy will help to avoid later controversy over the pricing method.

How To Raise Prices and Succeed

Most of us are aware, I'm sure, that there comes a time when we must *raise* prices because either our analysis of costs or rising labor and materials costs demand that we get more for a service we offer. How do you raise prices without hurting business volume?

Give Customers the Reasons

Well, customers certainly don't welcome the prospect of paying more than they have been paying for anything. I am sure you resist the price rises in the supplies you purchase for your business. Perhaps you can remember a time when you changed suppliers because you thought the price boost was out of line. But the worst thing to do to a customer is to catch him unaware of the price rise, letting him discover it after the purchase is made. So you should inform your customers when prices must be raised by explaining the reason when the order is taken or on your published price list. Often, simply stating that rising costs require the increase is all that is needed. Of course, giant increases are sure to be resisted so keep the boost modest even if you have to do it in two steps over a period of time.

Promote Your Services

You can soften the blow by promoting the fact that you are making your service more valuable by adding some extra service or benefit. A photo-finishing service, after increases in the cost of photographic papers imposed by the cost of silver, successfully raised its prices by offering free film with each order. The higher price covered the wholesale cost of the film, and the promotion actually led to an overall increase in business.

317-022 O - 69 - 5

Another way to succeed in spite of having to raise prices is to do more and better selling. While you are raising prices, organize sales training, set up a sales incentive contest for your employees, and promote an improved sales attitude among them. Raising prices is a challenge. You can turn it into motivation for yourself and employees. Curiously, the need to raise prices has often been a successful turning point in many businesses.

Start a motivation program for your employees prior to raising prices by informing them of the reasons. Involve them in the process by asking them for ideas. Good employees want to help, and you can channel their desire to be on a winning team into greater sales effort.

Dress Up Your Services

Another secret to success in raising prices is to dress up the services you offer. Customers these days are more than willing to pay a little extra for prestige or premium service. One cleaning establishment in a downtown location enjoyed great success (at higher prices) by offering an "executive" press for suits. This method features uncreased sleeves and tissue paper padding for smoothness. Competitors had long given this same service free on request; but by making the "executive" press a regular offering, this firm appealed to a customer's feeling of importance.

Prestige can be added to almost any service business. A hotel made it a point to deliver a guest's hometown newspaper at his door each morning. The cost was negligible but the prestige was enormous. A home-landscaping service added prestige by changing the title of its field men from "salesman" to "landscape decorators." They were, after all, specialists on the subject, and somehow customers preferred to deal with representatives they considered idea men. A hi-fi dealer issued performance certificates with his repairs certifying that the set had met the original specifications of performance, a fact easily ascertained during the repair. A garage always left a paper seat cover as an indication that the mechnaics had taken extra care to protect the upholstery. Sometimes, an attractive uniform for service personnel helps to establish a service's premium image. But whatever the device used, the idea is to make the service more important in the eyes of the customer.

Add Convenience

Still another way to justify higher prices is *added convenience*. Drive-in windows have become a national institution for many services and have proved important. Pickup and delivery service has long been a customer attraction in many repair and cleaning businesses. It might be equally effective in rentals, keymaking, printing, data processing, or even veterinarian service. If you are going to raise prices, take a long, hard look at your services from the customer viewpoint and consider adding convenience and prestige aspects that will *not* affect your basic business costs.

Lowering Prices

On the other side of the coin is the matter of *lowering* prices for services. It might not seem much of a problem, because everyone is pleased to pay less. But lowering prices may actually be harder than raising them in some instances.

First of all, there is the problem of your current customers who may be irritated that they have just paid more than they had to for your service. But this can be avoided by announcing lower prices in advance of the actual date, but not too long before because you might lower current volume. For most businesses, 2 weeks is ample.

Secondly, there is the problem of customers wondering if there will be a lowering of quality. With our economic boom of the past 25 years, most prices have slowly spiraled upward, and the idea of someone's lowering prices seems strange to us. So when you lower prices, promote the idea that it is being done for customer benefit or because of some economy your firm has generated.

When To Lower Prices

The time to lower prices is when, and only when, you can justify it by the costing methods we have previously explored. Never lower prices out of desperation. This merely hastens the end. A business in trouble is almost always better off improving the quality of its service to meet competition rather than underpricing.

Two valid reasons for price reductions are when changing external conditions justify the cut and when there is increased efficiency within the operation.

Price Wars

One final word concerns *price wars*. Engaging in wild cost cutting to undercut a competitor is hazardous for a service business. In a price war, like most wars, both sides suffer. You simply cannot win a price war. Stay out of them even if business volume suffers. You can weather the crisis better as a noncombatant and will eventually gain by it. There is a good chance you will have less competition in the long run because few businesses have the resources to stand the losses that price wars always seem to generate.

How To Avoid Price Controversy

Getting back to our beginning story about Abraham Lincoln and his troubles with a client over charges, we have to recognize that no matter how diligently we work at price costing, the nature of a service business may lead to a price controversy. Now we can readily see that Mr. Lincoln could have avoided his troubles if he had prestated his fee so that his client understood and accepted it. Of course, he probably could not estimate a price in that instance because he could not know what legal work would be involved.

State the Price in Advance

But it still makes our point that the best way to avoid controversy is to state the price in advance, preferably in writing. Perhaps, like lawyer Lincoln, you can't accurately estimate the time. But at least provide your customer with the *rates* to be used for charges and make it clear to him that the final cost will depend on undetermined factors. Sometimes an *estimated price range* will help establish some basis for agreement.

In any event, make sure that your customer understands the basis for charges. The communication must be complete. Both of you must accept the same specifications for the work to be performed and the basis for charges and terms. The only sure way to establish your communication on prices is to test it with the customer. You might ask him, "Do you understand that the final price will depend on the number of days our men must be at the site?" Or say, "Let me sum up the pricing method to make sure we both understand it."

Again, put the pricing method, rates, and estimated prices down in writing. Make sure that the customer reads it and then ask him to sign it. Naturally, you will give the customer a copy of the estimate and keep one yourself.

Handle Complaints Promptly

If for any reason a complaint does arise concerning prices, handle it promptly. Delaying or avoiding settlement is almost sure to complicate the problem. See the customer in person, if you can, and state that you wish to handle it as promptly as possible. Suggest that you go over the charges together. Often, customers don't understand about overhead, materials costs, and costs incurred away from the site of the work.

When a Customer Complains,

HEAR HIM OUT

Visual 14

Then let the customer express himself fully. Read the customer's complaint back to him as directly as possible. Often he will modify it when he hears it from you. Help him modify it, and come to an agreement about what the real issue is, even though you don't accept his position. You need this agreement on terms before coming to grips with the problem. Discuss each point and try to reach some settlement on it as you go. Now is the time to settle the differences if you can. To wait may result in legal action at considerable expense to you both.

Keep control of your emotions. Senseless argument gets you nowhere. Be businesslike, direct, and friendly. If you believe there are points which are legitimately contested, be willing to work out a solution.

But don't give up the ship! If your position is right and you stick to it, the customer will respect you more than if you just give up in disgust. Remember that he is as embarrassed as you are at controversy and is equally anxious to make a settlement. Compromise if it is fair, but don't back down on points that are clearly in your favor. Always try to reach agreement.

Follow up the complaint with a nice letter stating your regret at the difficulty and expressing the hope that the customer's valued business will continue. If appropriate, tell the customer in the letter what steps your firm is taking to avoid any future misunderstandings.

Summation

By now, I hope you can see how important it is for a service business to have a pricing policy, to establish prices according to a cost formula, and to carry out changes and handle controversy so as not to interrupt or damage profitable business. I imagine, at this point, you have the feeling that pricing in a services business is more difficult and hazardous than pricing goods because of the greater variability involved in labor and other costs. But pricing in any business follows a certain procedure—a careful analysis of all cost factors and the addition of a realistic and workable margin.

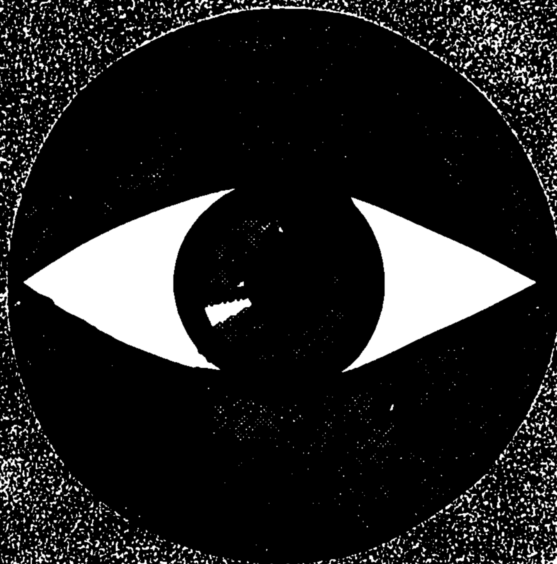
We could even go on to say that in a real sense a service business is much like a retail business, not only in pricing but in all aspects of management and procedure. In fact, the service you sell *is* a product as surely as the more tangible items in a retail store. Your service has a package, not in the form of a container on the shelf but in the sum total of the image that your service presents to customers. Like a store, you need to keep that package as attractive and desirable as possible.

And, like the store products, your service "product" has a price tag which your customers should be able to examine and evaluate just as they do for the other products they buy. You would do well to think of your service as a product and ask yourself continuously whether you would buy a product with the package and price you offer.

Finally, we must recognize that successful pricing, from the standpoint of the customer, is a matter of *value*. The price of anything is important only in relar tion to the value received. Your ultimate success rests on just how beneficial you service is to the buying public. Price is one factor which must be considered, but it is by no means the only one. Abraham Lincoln would never have been awarded the $5,000 settlement by the court if he had not proved that his services to the customer merited it.

You figure prices for services, as we have seen, by costing all elements through the cost-plus method, by carefully anticipating future costs according to the cost-estimate method, or by a detailed job analysis and cost-breakdown bid. And you handle changes and misunderstandings with an eye to customer relations and to maintaining your good reputation.

Effective pricing is the key to the growth of your service business and to the all important *profit* consideration. Don't take pricing lightly. It is one of the skills that distinguish the successful manager.



THE VISUAL AIDS

A What to Show

Section

The old Chinese proverb "One See Worth Thousand Say" is certainly borne out by experience in the fields of education and training at all levels.

The instructor who helps his participants visualize subject matter and ideas not only holds the group interest -- he also stimulates thoughtful consideration and retention of the topic.

This section contains samples of visuals that are available for this subject. Each has been carefully coded and "keyed" into The Lesson Plan as outlined in this manual.

USE OF VISUAL AIDS

WHAT TO USE — **WHEN AND HOW TO USE**

Chalkboard

Study and plan before a meeting what to put on the board and where to put it. Use it to present sketches, diagrams, outlines, definitions, key words, directions, record of class contributions, and summaries.
Suit material to board space.
Write plainly and quickly.
Keep wording simple.
Stand at one side of board while referring to material.
Talk to the group, not to the board.
Erase material no longer needed.

Posters, Charts, and Diagrams

To arouse interest and attract attention; to show relationships and trends; to inspire group.
Use device large enough to be seen.
Post where everyone can see.
Present at right time.
Discuss information illustrated.

Hand-Out Materials

To present information uniform in character and as a guide to material covered; emphasize key points; arouse interest and discussion; review or summarize discussions; and serve as permanent reference.
Select to serve a definite purpose.
Introduce at right time.
Distribute in manner to convey its importance.
Direct members how to use.

Films and Film Strips

Present an overall view; introduce a new subject; emphasize specific aspects of a subject; arouse interest; summarize.
Select carefully to relate to the discussion and plan presentation. Arrange room and equipment for showing. Alert the audience for the showing or what will be seen. Run the film. Discuss the subject matter and summarize.

Samples, Forms, and Exhibits

Keep subject matter practical; show development of a process; increase understanding.
Select only enough to illustrate, not confuse.
Pass around if necessary.
Take time to present clearly.
Comment when presenting.

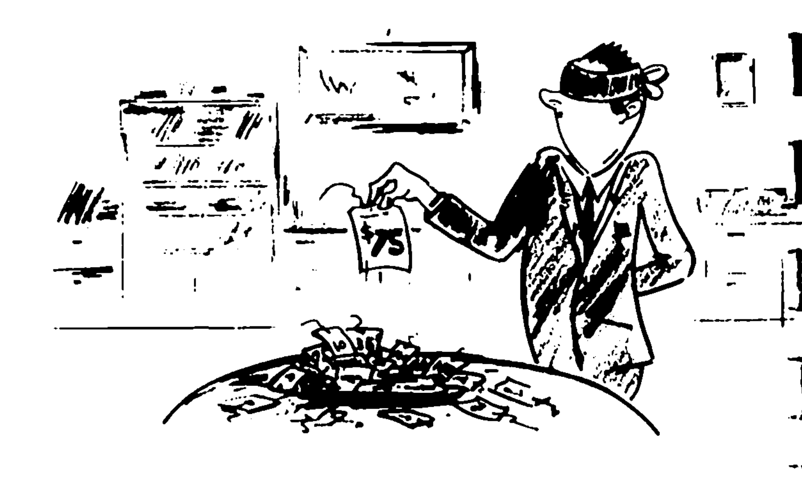
Pedestal Chart

A pad of newsprint sheets or similar paper may be used for the same purposes as the chalkboard. Material recorded with chalk or crayon may be saved for future reference by the group or by the instructor.

317-022 O - 69 - 6

TRENDS OF EXPENDITURES FOR SERVICES

1



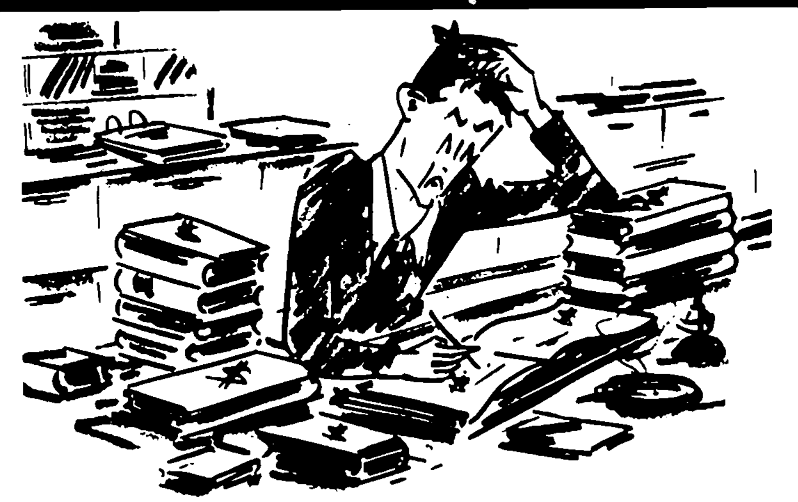
DON'T PRICE BLINDLY
- KNOW YOUR COSTS

2

PRICE COMPARISON SCHEDULE

	Brake Adjustment	Reline	Replace Shoe
A Company	$2.50	$18.00	$10.00
B Company	2.00	21.00	12.00
C Company	no charge	19.00	14.00
Average	2.25	19.33	12.00

3



THE PAST IS PROLOGUE

4

TO FIGURE DIRECT LABOR COST

Formula--

Labor cost per time unit
multiplied by time required equals
Labor cost per production unit

Drycleaning example--

$.03 (cost per minute)
× 20 (minutes required)
$.60 (direct labor cost per garment)

5 - a

TO FIGURE MATERIALS COST

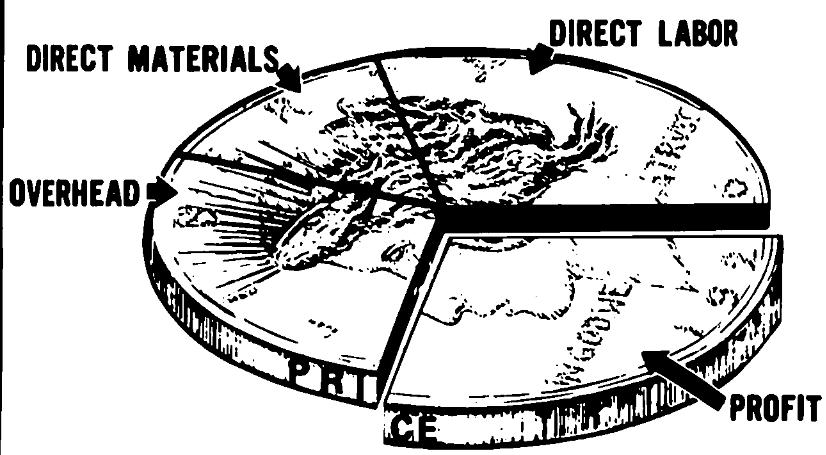
Formula--

$$\frac{\text{Materials cost}}{\text{number of production units}} = \text{materials cost per unit}$$

Drycleaning example--

$$\frac{\$\,950}{4{,}655} = \$.208, \text{ direct materials cost per garment.}$$

5 - b



FULL COST + PROFIT = PRICE

6

FULL SERVICE COSTS BY COST-PLUS METHOD

Direct materials
+ Direct labor
Direct costs
+ Indirect costs
Full costs

7

PORTRAIT STUDIO COST PLUS vs. COST ESTIMATE

$ .89	Direct labor	$ .89
.42	Direct materials	.42
$1.31	Direct costs	$1.31
1.36	Indirect costs	.91
$2.67	Full costs	$2.22
.33	Profits	.28
$3.00	Price	$2.50

8

WAYS TO STATE PROFIT

Investment	$100,000
Sales	200,000
Profit	10,000

$$\text{Profit} = \frac{\$\,10{,}000}{\$100{,}000} = 10\% \text{ return on investment, or}$$

$$\text{Profit} = \frac{\$\,10{,}000}{\$200{,}000} = 5\% \text{ of sales.}$$

9

DIRECT COSTS -- TIRE REPAIR

$$\frac{\$350.63}{935} = \$.375\text{, average materials cost}$$

$$\$.034 \times 24.6 = \$.8364\text{, average labor cost}$$

10

COST PLUS -- TIRE REPAIR

Direct materials	$ .375
Direct labor	.9964
Direct costs	$1.3714
Indirect costs	.3089
Full cost	$1.68
Profit	.30
Price	$1.98

11

COST ESTIMATE -- TIRE REPAIR

Direct materials	$ .375
Direct labor	.8968
Direct costs	$1.2718
Indirect costs	.2870
Full cost	$1.5588
Profit	.1912
Price	$1.75

12

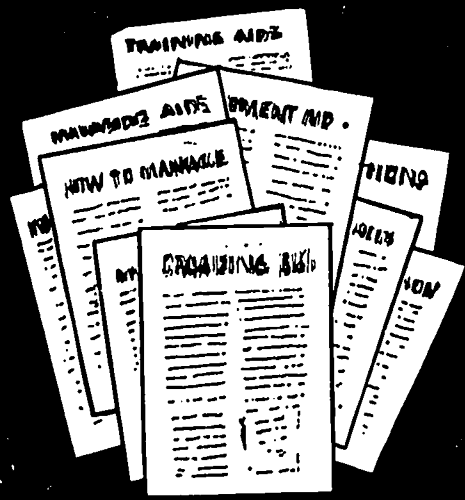
8 Prepare the bid
7 Check prices and costs
6 Detail overhead costs
5 Make cost breakdown
4 List efficiencies
3 List contingencies
2 Visit location
1 Understand specifications

STEPS IN BIDDING

13

When a Customer Complains,
HEAR HIM OUT

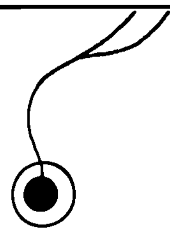
14



List of Handout Material

1. Focal Points (brochure). Order quantity needed from SBA.
2. SMA #89, Pricing Your Services For Profit.
3. SMA #105, A Pricing Checklist for Managers.
4. SMA #81, Are You Selling Enough Service?
5. SMA #82, Bid The Job—Not The Market.
6. MRS #44, Pricing Decisions In Small Business.
7. The Bibliography is intended primarily for use by the instructor but may also be duplicated and utilized as a helpful handout item.

317-022 O - 69 - 7



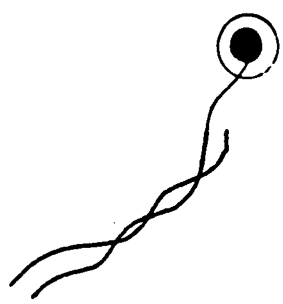
TO LOWER PRICES

- Announce in advance
- Assure customers of high quality

(Lower prices only when <u>costs</u> have been lowered)

TO RAISE PRICES

- Prepare customers by giving reasons
- Keep rise modest
- Promote new business
- Dress up services
- Make your services more valuable



Focal Points On

PRICING IN A SERVICES BUSINESS

TOPIC NINETEEN

ESTABLISH PRICES THAT-

- **Promote long-range welfare**
- **Stimulate combination sales**
- **Carry their share of profit**
- **Are flexible**

THEN –

- **Review prices periodically**

TO SET PRICES USE FULL COST FROM ACCURATE FIGURES

DIRECT COSTS

- **Wages**
- **Materials**
- **Transportation**

INDIRECT COSTS

- **Overhead**
- **Advertising**
- **Depreciation**

PROFIT

STEPS IN BIDDING

- Understand specifications
- Visit the location
- List contingencies
- List efficiencies
- Breakdown all costs
- Detail overhead costs
- Check prices and costs
- Check profit consideration
- Obtain independent check of bid proposal
- Prepare bid

This page illustrates a two-fold leaflet which summarises the subject presentation. The leaflet is available in quantity from the nearest Small Business Administration office for distribution to participants in SBA-cosponsored administrative management courses.

SMALL BUSINESS ADMINISTRATION
U. S. Government Agency
Small Marketers Aids No. 89
Washington, D. C. March 1963

PRICING YOUR SERVICES FOR PROFIT

By Alfred A. Cox
Associate Professor of Business Administration and
Rowe M. Meador
Professor of Business Administration
School of Business Administration, Division of Marketing
North Texas State University, Denton, Texas

SUMMARY

Frequently owners of small service establishments find it difficult to establish prices for their services with the knowledge that such prices are fair to the customer and contribute a reasonable profit.

This Aid (1) outlines the steps in analyzing the direct and indirect costs relative to each service and (2) presents a formula for computing selling prices. Even though the service prices may be dictated by competition or custom, it is wise for each service manager to use a method, such as this one, for checking on his prevailing prices.

Often small marketers who sell services rather than commodities find it difficult to establish prices. Sometimes small businessmen who deal in one standard service are able to overcome this difficulty fairly easy. Yet setting prices for services is more complicated for small marketers who sell multiple services, such as a dry cleaner who sells cleaning, repair, and laundry services. Additional problems are faced by those who sell both services and goods, as in the case of an automobile dealer.

PRICING ELEMENTS

In many cases, these small marketers run into trouble because they are not aware of the elements that go to make up a selling price.

These three elements are:

(1) Materials and supplies costs,
(2) Labor and other operating expenses, and
(3) Planned profit margin.

This Aid explains one logical method which you can use for determining your price for services. This method is based on your total cost of the service. It considers two things: (1) a fair price to the customer and (2) income to you (including a reasonable return on your investment).

GROUND RULES FOR PRICING SERVICES

As you examine this method of pricing services, you should keep three ground rules in mind. They are:

(1) Each service you sell should contribute to the profit position of your firm. Don't unintentionally allow one to subsidize another. Don't deliberately operate one service at a loss to promote the success of another, unless you are sure that such action will increase your overall sales and profits. Your best approach is to try to make each service bear its contribution to net profit.

(2) This ground rule concerns record-keeping. Be sure that you have an accounting or bookkeeping system that accurately reflects all operating expenses and the cost of all materials you use in providing the service. (If you sell both goods and services, be sure that your records keep the two separated.) You need these facts in order to determine various bases for allocating these costs and expenses.

(3) Knowing the difference between direct and indirect costs is important when you use the cost method of pricing. Direct costs are those expenditures which you incur because you do a specific service for a customer. If you eliminate this specific service you eliminate the cost. That is, if you stop this service, you eliminate the labor or material you would need to perform it.

Therefore, you do not need to find a base to use for allocating direct costs in determining the cost of such a service. You can easily

48

charge the amount of the direct costs against the specific service.

However, the story is different with indirect costs. They still will exist even though you eliminate a specific service to the customer. For instance, you still have to pay your rent, your utilities, and fees for professional services.

One problem connected with such indirect costs is: You have no precise way of determining how these costs benefit the customer. In other words, these indirect costs exist primarily because of all the services you are offering. Your goal is to find some basis that will allow you to distribute or allocate such indirect costs to each service in order to determine the total cost of a unit of service.

(For additional information on indirect costs see: *Management Aid* No. 118, "Keeping Overhead Costs in Line," November 1960, and *Small Marketers Aid* No. 82, "Bid the Job--Not the Market," August 1962. Both are free from SBA.)

ANALYZING YOUR SERVICE COSTS

After you have the three ground rules operating in your firm, you are ready to use the cost method in arriving at prices for the services you sell. The cost method involves five steps. They are:

(1) Determine your indirect cost per unit of service.

(2) Determine your direct cost per unit of service.

(3) Add your indirect cost and your direct cost to obtain your total cost per unit of service.

(4) Determine the percent of net operating profit you desire on your total sales. Subtract this figure from 100 percent (your total sales in dollar volume). This difference is your "cost complement."

(5) Divide the total cost per unit of service (from Step 3) by your cost complement and multiply by 100. This product then becomes your unit selling price.

For example, suppose you are selling three different services. Each of them is standard. Your account ledgers are limited to the costs and expenses listed in the cost analysis table shown in the box on page 3 of this Aid. These figures apply to a 30-day month with 26 working days, or 208 working hours.

Service No. 1 is actively producing 80 percent of the time; Service No. 2 produces 70 percent; and Service No. 3 produces 90 percent.

USING YOUR COSTS TO SET PRICES

After you know what it costs you to produce a service, you can use these costs to set your price. Using the costs analysis in the box on page 3, as an example, suppose that you want a 10 percent net profit on your service sales.

(In this example, it may be that you have learned from your trade association that an average firm of your size gets approximately a 10 percent return on sales.)

In determining this percentage figure, be sure to consider the value of your own creativity and experience. As one consultant says, "Many service businessmen who came up through the trade sell themselves short. They take their design and craftsmanship abilities for granted."

But getting back to the example of using a 10 percent return on sales. If you use a 10 percent net profit your cost complement would be 90 percent.

In order to determine your selling price for an hour of each service, use this formula:

$$\frac{\text{COST OF SERVICE PER HOUR}}{\text{COST COMPLEMENT}} \times 100 = \text{SELLING PRICE}$$

For each of the three services shown in the cost analysis table, the following selling prices per hour are obtained:

(1) Service No. 1

$$\frac{\$9.62}{90} \times 100 = \$10.69$$

(2) Service No. 2

$$\frac{\$10.68}{90} \times 100 = \$11.87$$

(3) Service No. 3

$$\frac{\$5.82}{90} \times 100 = \$6.47$$

Should it be that an average unit of service for Service No. 1 requires $2\frac{1}{2}$ hours of work, then your price schedule for that unit would be:

$$\$10.69 \times 2.5 = \$26.73.$$

You would determine other prices in a similar way by multiplying:

(1) The hours (or fractions of an hour) which the service requires by

(2) The selling price per hour.

Suppose that in your particular business the materials used by each service vary from customer to customer. In this case, you figure your cost per service per productive working hour without including cost of materials. Then you add to that figure your cost of the material plus a reasonable mark-up in order to determine your selling price on a specific service job.

USING THE MULTIPLIER METHOD

In some cases, you may be able to use the multiplier (or factor) method for pricing

ANALYSIS OF EXPENSES AND COSTS PER SERVICE PER PRODUCTIVE WORKING HOUR

Indirect Expenses	Total	Service 1	Service 2	Service 3
Rent (1)	$200	$100	$50	$50
Manager's Salary (2)	600	150	300	150
Clerical Wages (3)	200	50	100	50
Other Overhead (4)	300	100	100	100
Direct Expenses and Costs				
Labor (5)	$1,300	$500	$400	$400
Advertising (6)	600	300	150	150
Material	1,200	400	600	200
Total:	$4,400	$1,600	$1,700	$1,100
Productive Working Hours Per Month		166.4	145.6	187.2
Cost Per Service Per Productive Working Hour		$9.62	$10.68	$5.82

(1) Rent amounting to $200 is allocated on basis of floor space used by the various services of a total of 2,000 square feet of productive space; Service 1 uses $100; Service 2 uses $50; and Service 3 uses $50.

(2) Manager's salary of $600 is allocated on basis of approximate time spent in dealing with problems and activities of the various services. Service 2 requires twice as much time as does Service 1 or Service 3.

(3) Clerical wages of $200 are allocated on basis of number of "papers" processed per service. Service 2 requires twice as many as does Service 1 or Service 3.

(4) Other overhead (property taxes, insurance, postage, and so on) amounting to $300 is divided equally among the services.

(5) Known or estimated wages (perhaps salary and commissions) in this example as $1,300 are paid for labor in performance of each service.

(6) In this example, the $600 for advertising is divided among the three services. It is assumed that advertising in local media is limited at any one time to promoting one service. Thus, the cost is direct. However, if multiple services are advertised in any one advertisement, the cost will have to be treated as other than direct and a base must be found for its allocation.

services. It is particularly useful under certain conditions. These conditions are:

(1) The amount of service varies from customer to customer,

(2) The cost of labor is the most significant item in the selling price, and

(3) The hourly wage does not vary greatly among the productive laborers.

You get the multiplier (or factor) from an analysis of your operating statements over a period of several years. Or you can use only 1 year if you are sure that your sales volume and profit margins in that year were what you want them to be.

Suppose, for example, that an analysis of your operating statements looks like this:

5-YEAR AVERAGE

Total Sales.......................... $125,000
Total Productive Labor Cost ... $50,000

When you determine your total productive labor costs, you must not include office or supervisory wages. Include only those "operative" employees who are directly connected with the customer service. In this example, you compute your multiplier as follows:

$$\frac{\text{Total Sales}}{\text{Total Productive Labor Cost}} = \frac{\$125{,}000}{\$50{,}000} = 2.5$$

Now, look at this formula in action. The problem: To set the price for a service job which takes 3 hours work by the service worker. You are paying $2.50 per hour. Your service selling price would look like this:

Worker's hourly pay	$2.50
Worker's time on the job	x 3 hours
Cost of worker	$7.50
Your multiplier	x 2.5
Selling Price	$18.75

Summing up this problem, you found your price by multiplying the following three figures:

(1) Hourly wage rate of service worker,

(2) Hours of labor required by the service,

(3) Multiplier (Ratio of annual total sales to annual total productive labor cost).

When you use a multiplier, you should remember that your multiplier represents an average and therefore, it must be kept up-to-date. Plan to check your multiplier from time to time to make sure that it reflects conditions as they are at the present.

ADJUSTING TO PARTICULAR SITUATIONS

Some firms are limited in using the pricing methods discussed above in this Aid because of particular situations. In some cases, prevailing price schedules used by competing firms may mean that you have to use prices which they have established. Sometimes your superior quality of service and your location may enable you to charge "above-the-market" prices. But even here there are limitations of degree.

Some other situations to which you might have to adjust could be the limitations of a franchised dealer arrangement, prevailing practices or customs within certain service groups, and so on. For instance, practices or customs may dictate that you charge a specific fee or commission related to the value of the job.

In still other cases, some local service associations may limit you. Perhaps they adopt price schedules within the legal possibilities which may serve as a pattern for your own prices.

Finally, it may well be that the quality of your service is the most important factor in shaping your price schedule. For example, many customers are willing to pay above average market prices for above average service. Of course, if your customers feel this way about your services, then you are ahead of your competitors.

UPGRADING YOUR PROFITS

One of your main goals in determining prices for your service jobs should be the upgrading of your profits. Increasing your profits does not always mean raising your prices. Often it means improving your operating efficiency--cutting the cost of your service jobs.

Of course, the level of your co ts will be determined to a great extent b local prices for labor and materials. But even so, you can often get a competitive edge by improving your operating efficiency.

Some small service firm owners improve their operating efficiency in: (1) adequate planning and scheduling of jobs, and (2) providing for the easiest possible handling of rush jobs.

Your revenue is conditioned by your price schedules and your ability to build sales volume. Consider your market area. In what income category are your customers? Are they able to judge quality of service? Do they demand and appreciate "superior service" (delivery, promptness, personalized attention, friendliness, and credit)?

Can you build volume with advertising and promotion? How many competitors are serving the same market area? To what extent can you build greater volume by adding for-sale items or supplementary services related to your main service?

The answers to these questions will help in determining your price structure. To upgrade your profits, continue to expand and grow until your marginal costs equal your marginal revenue. In other words, you should continue to incur an additional dollar of cost so long as you receive in return more than an additional dollar in sales.

Even if your basic prices have been established largely by custom and competitors, you can still use the cost method to an advantage. When you know exactly what it costs you to produce a service, you can check on the reasonableness of the prices forced on you by outside factors.

FOR FURTHER INFORMATION

Businessmen interested in exploring further the subject of pricing for services may be interested in the following references. This list is brief and selective. However, no slight is intended toward authors whose works are not mentioned.

Price Guide for the Painting and Decorating Industry. (A guide to estimating.) Painting and Decorating Contractors of America, 2625 W. Peterson Ave., Chicago 45, Ill. 1960. $1.50.

Correct Practice in Estimating Overhead Costs and Profits. (12 articles reprinted from *The American Artisan*) by N. J. Biddle. Keeney Publishing Company, 6 North Michigan Ave., Chicago 2, Ill. 1956. $1.50.

Cost Accounting for Small Manufacturers. by R. Lee Brummet. Small Business Management Series No. 9. Small Business Administration. Superintendent of Documents, Washington 25, D. C. 1953. 35 cents.

"Depreciation Costs--Don't Overlook Them." *Small Marketers Aids* No. 68. June 1961. Small Business Administration, Washington 25, D. C. Free.

SMALL BUSINESS ADMINISTRATION
U. S. Government Agency
Small Marketers Aids
Washington, D. C.
Pricing
No. 105
August 1964

A PRICING CHECKLIST FOR MANAGERS

By Joseph D. O'Brien

Associate Professor of Marketing, College of Business Administration
Boston College, Boston, Massachusetts

SUMMARY

Pricing is a basic factor in insuring the profitable operations of small retailers. Pricing plans, objectives, and policies are important phases of management, and to set effective prices the owner-manager must: (1) know his costs and (2) understand buyer motivation, timing, and competitors. Nonpricing practices can also be used to attract customers.

The questions in this Aid are designed to help small marketers in evaluating their pricing policies and practices.

EXAMINING COSTS, SALES VOLUME, AND PROFITS

The questions in this part should be helpful when you look at prices from the viewpoint of costs, sales volume, and profits.

Costs and Prices

The small retailer who sets the price for an item by applying a standard markup may be overlooking certain cost factors which are connected with that item. The following questions are designed to help you gather information which should be helpful when you are determining prices on specific types of items.

	Yes	No
1. Do you know which of your operating costs remain the same regardless of sales volume?	____	____
2. Do you know which of your operating costs decrease percentage-wise as your sales volume increases?	____	____
3. Have you ever figured out the breakeven point for your items selling at varying price levels?	____	____
4. Do you look behind high gross margin percentages? (For example, a product with a high gross margin, may also be a slow turnover item with high handling costs. Thus it may be less profitable than lower margin items which turn over fast.)	____	____
5. When you select items for price reductions, do you project the effects on profits? (For example, if a food marketer considers whether to run canned ham or rump steak on sale, an important cost factor is labor. Practically none is involved in featuring canned ham; however, a rump steak sale requires the skill of a meat-cutter and this labor cost might mean little or no profits.)	____	____

Pricing and Sales Volume

An effective pricing program should also consider sales volume. For example, high prices might limit your sales volume while low prices might result in a large, but unprofitable volume. The following questions should be helpful in determining what is right for your situation.

	Yes	No
6. Have you considered setting a sales volume goal and then studying to see if your prices will help you reach it?	____	____
7. Have you set a target of a certain number of new customers for next year? (If so, how can pricing help you to get them?)	____	____

	Yes	No
8. Should you limit the quantities of low-margin items which any one customer can buy when they are on sale? (If so, will you advertise this policy?)		
9. What is your policy when a sale item is sold out before the end of the advertised period? Do you allow disappointed customers to buy the item later at the sale price?		

Pricing and Profits

Prices should help bring in sales which are profitable over the long pull. The following questions are designed to help you think about pricing policies and their effect on your annual profits.

	Yes	No
10. Do you have all the facts on costs, sales, and competitive behavior?		
11. Do you set prices with the hope of accomplishing definite objectives, such as a 1-percent profit increase over last year?		
12. Have you set a given level of profits in dollars and in percent of sales?		
13. Do you keep records which will give you the needed facts on profits, losses, and prices?		
14. Do you review your pricing practices periodically to make sure that they are helping to achieve your profit goals?		

JUDGING THE BUYER, TIMING, AND COMPETITORS

The questions in this part are designed to help you check your practices for judging the buyer (your customers), your timing, and you competitors.

The Buyer and Pricing Strategy

After you have your facts on costs, the next point must be the CUSTOMER--whether you are changing a price, putting in a new item, or checking out your present price practices. Knowledge of your customers helps you to determine how to vary prices in order to get the average gross margin you need for making a profit. (For example, to get an average gross margin of 35 percent, some retailers put a low markup--10 percent, for instance--on items which they promote as traffic builders and use high markup--sometimes as much as 60 percent--on slow-moving items.) The following questions should be helpful in checking your knowledge about your customers.

	Yes	No
15. Do you know whether your customers shop around and for what items?		
16. Do you know how your customers make their comparisons? By reading newspaper ads? Store shopping? Hearsay?		
17. Are you trying to appeal to customers who buy on price alone? To those who buy on quality alone? To those who combine the two?		
18. Do any of your customers tell you that your prices are in line with those of your competitors? Higher? Lower?		
19. Do you know which item (or types of items) your customers call for even though you raise the price?		
20. Do you know which items (or types of items) your customers leave on your shelves when you raise the price?		
21. Do certain items seem to appeal to customers more than others when you run weekend, clearance, or special-days sales?		
22. Have you used your individual sales records to classify your present customers according to the volume of their purchases?		
23. Will your customers buy more if you use multiple pricing? (For example, 3 for 39 cents for products with rapid turnover.)		
24. Do your customers respond to odd prices more readily than even prices, for example, 99 cents rather than $1?		
25. Have you decided on a pricing strategy to create a favorable price image with your customers? (For example, a retailer with 8,000 different items might decide to make a full margin on all medium or slow movers while featuring--at low price levels--the remaining fast movers.)		
26. If you are trying to build a quality price image, do your individual customer records, such as charge account statements, show that you are selling a larger number of higher priced items than you were 12 months ago?		
27. Do your records of individual customer accounts and your observations of customer behavior in the store show price as the important		

	Yes	No
factor in their buying? Service? Assortments? Some other consideration?	____	____

Time and Pricing

Effective merchandising means that you have the right product, at the right place, at the right price, and at the right time. All are important, but timing is the critical element for the small retailer. The following questions should be helpful in determining what is the right time for you to adjust prices.

28. Are you a "leader" or a "follower" in announcing your price reductions? (The follower, even though he matches his competitors, creates a negative impression on his customers.)	____	____
29. Have you studied your competitors to see whether they follow any sort of pattern when making price changes? (For example, do some of them run clearance sales earlier than others?)	____	____
30. Is there a pattern to the kinds of items which competitors promote at lower prices at certain times of the month or year?	____	____
31. Have you decided whether it is better to take early markdowns on seasonal or style goods or to run a clearance sale at the end of the season?	____	____
32. Have you made regular annual sales, such as Anniversary Sales, Fall Clearance, or Holiday Cleanup, so popular that many customers wait for them rather than buying in season?	____	____
33. When you change a price, do you make sure that all customers know about it through price tags and so on?	____	____
34. Do you try to time price reductions so they can be promoted in your advertising?	____	____

Competition and Pricing

When you set prices, you have to consider how your competitors might react to your prices. The starting place is learning as much as you can about their price structures. The following questions are designed to help you check out this phase of pricing.

35. Do you use all the available channels of information to keep you up to date on your competitors' price policies? (Some useful sources of information are: things your customers tell you; the competitor's price list and catalogs, if he uses them; his advertising; reports from your suppliers; trade paper studies; and shoppers employed by you.)	____	____
36. Should your policy be to try always to sell above or below competition? Only to meet it?	____	____
37. Is there a pattern to the way your competitors respond to your price cuts?	____	____
38. Have you lost certain customers because competitors match your price cuts?	____	____
39. Is the leader pricing of your competitors affecting your sales volume to such an extent that you must alter your pricing policy on individual items (or types of items) of merchandise?	____	____
40. Do you realize that no two competitors have identical cost curves? (This difference in costs means that certain price levels may be profitable for you but unprofitable for your competitor or vice versa.)	____	____

PRACTICES WHICH CAN HELP OFFSET PRICE

Some small retailers take advantage of the fact that price is not always the determining factor in making a sale. They supply customer services and offer other inducements to offset the effect of competitors' lower prices. Delivery service is an example. Comfortable shopper's meeting place is another. The following questions are designed to help you take a look at some of these practices.

41. Do the items or services which you sell have advantages for which customers are willing to pay a little more?	____	____
42. From personal observation of customer behavior in your store can you tell about how much more customers will pay for such advantages?	____	____
43. Should you change your services so as to create an advantage for which your customers will be willing to pay?	____	____
44. Does your advertising emphasize customer benefits rather than price?	____	____

	Yes	No
45. Are you using the most common nonprice competitive tools? (For example, have you tried to alter your product or service to the existing market? Have you tried stamps, bonus purchase gifts, or other plans for building repeat business?)	___	___
46. Should policies on returned goods be changed so as to impress your customers better?	___	___
47. If you sell repair services, have you checked out your guarantee policy?	___	___
48. Should you alter assortments of merchandise to increase sales?	___	___

FOR FURTHER INFORMATION

Businessmen who wish to explore further the subject of pricing may be interested in the references indicated below. This list is necessarily brief and selective. However, no slight is intended toward authors whose works are not mentioned.

Guides Against Deceptive Pricing. Free from the Bureau of Industry Guidance, Federal Trade Commission, Washington, D.C. 20580. The Federal Trade Commission issued this booklet on December 20, 1963 to supersede those in effect since October 2, 1958.

These *Guides* are designed to highlight certain problems in the field of price advertising which experience has demonstrated to be especially troublesome to businessmen who in good faith desire to avoid deception of the consuming public. The *Guides* are not intended to serve as comprehensive or precise statements of law, but rather as practical aids to the honest businessman who seeks to conform his conduct to the requirements of fair and legitimate merchandising.

The *Guides* deal with the following: I--Former Price Comparisons; II--Retail Price Comparisons; Comparable Value Comparisons; III--Advertising Retail Prices Which Have Been Established or Suggested by Manufacturers; IV--Bargain Offers Based Upon the Purchase of Other Merchandise; and V--Miscellaneous Price Comparisons.

Pricing for Profit and Growth. A. Bergfeld, J. Earley, and W. Knobloch. 1962. $12.90. Prentice-Hall, Inc., Englewood Cliffs, N.J. 07632.

Competition and Price Making in Food Retailing. Ralph Cassady, Jr. 1962. $6.50. The Ronald Press Co., 15 East 25th St., New York, N.Y. 10010.

Pricing: The Critical Decision. 1961. Report #66. $2.25. American Management Association, 135 West 50th St., New York, N.Y. 10050.

Competitive Pricing. 1958. Report #17, $3.00. American Management Association, 135 West 50th St., New York, N.Y. 10050.

"How to Price a New Product" in *Management Aids for Small Business: Annual No. 3.* Small Business Administration. 1957. Available for 45 cents from the Superintendent of Documents, Washington, D.C. 20402.

"Profits and Competition in Retail Food Pricing." *Management Research Summary* No. 140. 1963. Free. Small Business Administration, Washington, D.C. 20416.

"A Guide to Item Profitability for Retail Stores." *Management Research Summary* No. 191. 1963. Free. Small Business Administration, Washington, D.C. 20416.

SMALL BUSINESS ADMINISTRATION
U. S. Government Agency
Small Marketers Aids
No. 81
Washington, D. C. — August 1962

ARE YOU SELLING ENOUGH SERVICE?

By *Robert D. Entenberg*, Professor of Marketing and Director, Retail Research Center, Graduate School of Business, University of Pittsburgh, Pittsburgh, Pennsylvania

SUMMARY

Service sales are increasing because people want services and are willing to pay for them. Among the reasons for this growing trend are: increased incomes, a sufficiency of goods, and the desire for prestige and leisure.

In selling services certain factors tend to work to the advantage of small marketers. Among them are: some kinds of services require the personal touch, others require on-location work involving specialized skills, and customers' acceptance of non-related merchandise and service sales in all types of retail stores.

The Aid discusses types of service which small marketers can sell. It points out that selling more services can result in sales increases, in profitability, and better customer relations.

Small businessmen in increasing numbers are recognizing that one of their greatest strengths is personal service. In fact, some of them are experiencing extraordinary growth by selling service.

For example, one caterer whose capital was only $5,000 when he opened a small restaurant 6 years ago now has an annual gross of $750,000. However, 4 years ago he was barely getting by with his small restaurant. Like many other small operators, he was selling only food.

Success came when he began creative selling of a product with a strong service angle--prepared meals for home consumption. He became a caterer.

Now he delivers delicious ready-to-eat dinners to the homes of more than 1,000 families. Some of his best customers are families in which both the husband and the wife work.

PEOPLE ARE BUYING MORE SERVICES

Working wives who buy cooked dinners represent only one group of individuals who are buying more services. Consumers, in general, are spending more for them.

- <u>What Kinds of Service?</u>

Some of the types of services that people are buying in increasing amounts are: laundry, dry cleaning, linen supply, clothing alterations, diaper service, beauty and barber, photographic, shoe repair, and tailoring.

People are also buying more: credit extension, duplicating, statistical and stenographic services, blueprinting and automobile services. For the home, people buy repair services--radio, television, other appliances, and clocks--as well as decorating services such as rug and upholstery fitting.

Consumers are also spending more for amusement and recreation services, such as drive-in movies, dancing, and bowling.

The table on page 3 shows the approximate percentage growth that some service-type businesses have experienced in recent years.

WHY ARE THEY BUYING MORE?

Indications are that people will continue to buy increased amounts of services. As this trend continues such purchases could well become the largest single area of consumer buying in the next 5 years.

When this happens, non-durable goods (clothing, shoes, and so on), will rank second in consumer spending. Durable goods (major appliances, television sets, and so on) will be in third place.

There are at least three reasons why more people are spending more for services: increased incomes, a sufficiency of goods, and desire for prestige and leisure.

- <u>Increased Incomes</u>

Today the majority of American families earn more than $5,000 a year. In 1947, only 20 percent of all family units were in this income group.

Increases in the cost of living have not increased as fast as rising income. This means that real income (income measured in terms of actual purchasing power) has been steadily increasing.

With such increases in real income, consumers have larger amounts of discretionary income--money they can "technically" save or spend. Many of them put services high on their lists of wants.

During the last 15 years expenditures for services have increased not only from the standpoint of dollars but also from the standpoint of percentage allocation.

For instance, in 1960 consumers spent more than $114 billion for services of all kinds. In 1947, the comparable figure was only $67 billion. Presently the average consumer puts almost 42 cents out of each $1 he spends into services. This trend indicates that spending for services will continue to grow.

These growth trends in income and in service spending also mean that the average consumer is moving toward a higher standard of living. For example, many people are not as price conscious as they once were--a trend which started shortly after World War II. They are apparently more willing to pay for quality and service.

- A Sufficiency of Goods

Increased incomes introduced another factor. Many people who set up households in the past 10 or 15 years are pretty well caught up on goods--both durables and non-durables.

Feeling that they own a sufficient amount of "things," many of these consumers are buying larger amounts of services. This is true even though many kinds of services are 50 percent more expensive today than in 1946. During this same period the price of commodities rose only 18 percent.

- Desire for Prestige

In past years, people sought status by purchasing exclusive or fairly high-priced merchandise. However, as increasing numbers of people were able to make such purchases, this practice began to change.

Today many people no longer seek prestige through goods. As one young suburbanite says, "There's no fun in owning a super-duper wagon when everyone in the block has one."

Now, in many cases, satisfying the desire for prestige means buying increased amounts of services. For example, some parents seek status through the purchase of educational services for their children--ballet and music lessons. Or they spend more for travel, prestige-building activities, and personal appearance.

SMALL MARKETERS HAVE ADVANTAGES

Often selling services can be a natural for small marketers. They have advantages which some larger businesses don't have.

For instance, many services do not lend themselves easily to automation. One example is women's hair-styling. Expert knowledge and skillful hands are needed to achieve the results desired by the customer.

Another thing that works in favor of small marketers is the fact that many services require on-location work. Often this work requires skills and knowledge which the marketer has acquired from experience.

For example, suppose you are remodeling your store front. You want the innovation to attract customers. So you hire a decorator. Working "on location," the decorator uses his skill, knowledge, and experience to achieve a new front that emphasizes your store personality.

Another very important advantage is in the basic make-up of people themselves. They have been educated to accept "scrambled merchandising" of both services and goods. They like the idea of one-stop, convenience shopping. A classic example is the film pickup service which some small drugstores have been selling for years.

This trend of scrambled merchandising is almost a complete turn in the cycle of distribution. In many cases, specialized selling is giving way to a variety selling that reminds one of the old-time general store. Adding services even though they are not related to your merchandise lines adds to the personal element of your total operation--especially if it has been lost in attempts to provide efficiency and speed.

INCREASING SALES WITH SERVICES

With these factors working in the favor of small marketers, how can you sell more services? In one word, you do it by diversification. Just as manufacturers often increase sales by diversifying products so can small marketers diversify their offerings by selling services as well as commodities.

If you aren't already selling services, the kind you can offer will depend, of course, on your type business. For example, if you are already selling appliances and technical products such as television sets, washing machines, driers, air-conditioning, automobiles, and other motor driven products it should be fairly easy for you to sell the services they require.

When customers buy such service-use items they need installation services, as in the case of automatic dishwashers. Sometimes the retailer supplies the installation with the consumer paying for the service in the price or it can be listed as a separate cost item. In the less desirable case, the customer may have to get his own plumber and other craftsmen to install the dishwasher.

The average consumer has come to accept such installation costs as part of his expenses of living in a modern, mechanized society. He rarely complains about this kind of needed service expenditure.

Customers also want "when needed" services as they use products. Many people tend to keep appliances and other equipment in good repair rather than replacing them at the first sign of wear.

Some small marketers may be able to sell other kinds of service--those connected with the home. People in increasing numbers want help in beautifying and remodeling their homes. They are buying custom-made draperies, custom-built furniture, interior decorating, landscaping, and other services.

They are also buying home improvement products that require installation--storm windows, electronic garage doors, and so on.

Some small women's specialty stores--even those at the lower end of the price range--make fitting rooms available for their customers. This kind of service convenience brings in income indirectly in that it helps gain new customers and hold them.

• Selling Services In Dead Spaces

Some small marketers are selling services in dead spaces--remote and relatively inaccessible areas of your stores. For example, one appliance dealer installed a small snack bar in the back corner of his store.

Each day shoppers come in for quiet refreshment. Many of them are prospective customers. One woman, for instance, bought a television set after saying that she had only come in for a dish of ice cream. Formerly, this space produced neither income nor traffic!

Some customers use this "snack" corner to discuss the merchandise they've just been shown. Often after the husband and wife confer over coffee, they reach a decision and call the owner over to write up the order.

Another benefit is soothing the nerves of impatient husbands. They can have coffee while their wives browse through the store.

Of course, not all small marketers have dead spaces which tney can use profitably. In some cases, you may have to use some ingenuity in determining the kind of service you can sell. However, among the wide range of services that can be sold in dead spaces are: for-rent tools, household equipment, for-rent evening clothes for men, emergency batteries, floral arrangements, insurance, travel, and club memberships.

For example, one small marketer sells floral arrangements in cooperation with a women's gardening club. He makes a profit on the arrangements which he buys from the club and also gets credit for helping a community activity.

Another group that may be worth cultivating is retired people. In some cases, you may be able to offer unused space as the meeting place for group activities such as handicrafts clubs. At the same time, you may be able to sell items which retired people want for their activities such as specialized movies and travelogue films.

Unused in-store spaces can also be used for selling: insurance, complete home services, automobile club memberships, auto rentals, or travel arrangements. If you can't handle the details yourself, you might want to lease the dead space to someone who could operate some kind of service agency.

Coin-operated washing or dry cleaning machines offer still another way of selling services in either adjoining locations or unused non-productive spaces.

Turning non-productive spaces into pickup stations can increase your store traffic and bring income from services. For example, you

SERVICE SALES GROW

Kind of Business*	Approximate Percentage Growth in Sales Since 1954
Motels, tourist courts	90
Trailer parks, camps	50
Industrial laundries	50
Linen supply	35
Diaper service	21
Beauty shops (including combination with barber shops)	60
Barber shops	45
Photo studios, and so on.	37
Miscellaneous personal services (Turkish baths, massage, reducing salons, dress suit rentals, rug, furniture cleaning on location, checkroom concessions, and so on (SIC729)	95
Credit bureaus, collection agencies	51
Duplicating, stenographic, blueprinting, statistical	45
Miscellaneous services to dwellings (Janitorial, floor waxing, maintenance and repair to buildings and homes)	80
Auto repair, services, garages	77
Auto and truck rentals	120
Auto parking	27
Radio, TV repairs	60
Electric repairs (including refrigerator)	73
Reupholstery, furniture repair	25
Dance halls, studio and schools (including children's)	75
Bowling alleys	100

*Based on *Selected Services, U. S. Summary* 1958, *U. S. Census of Business*, Department of Commerce, and the writer's projected estimates.

might rent unused space to a dry cleaner, a film processor, or a laundry.

One service station operator got a laundry to open a pickup station next door. Some of his regular customers now drop off their laundry. And many people who come to pick up laundry park at his handy gasoline pump.

TOTAL SERVICE CONCEPT

Regardless of how it's done--in dead spaces or in non-productive spaces--selling more services can help small marketers in several ways.

For instance, one distinctive feature of selling service is that, unlike tangible goods, the "product" cannot easily be separated from the "producer." A second feature is that services are usually created and sold as wanted, so there is little, if any, problem of physical inventory handling and storing. A third feature is that, most of the time, the distribution channels are direct.

These benefits are in addition to the fact that the offering of services can result in sales increases. A final important benefit is that services can often bring intangible income in the form of better customer relations.

Customers, for a variety of reasons, want services and prefer to deal with marketers who offer them. In most cases, you probably won't be able to change your business so customers can buy every service from you. However, the closer you can come to such a total service concept, the better your chances will be of attracting and holding customers--customers who don't mind paying for services.

FOR FURTHER INFORMATION

Readers who wish to explore further the subject of selling service may be interested in the references indicated below. This list is necessarily brief and selective. However, no slight is intended toward authors whose works are not mentioned.

The Changing Competitive Position of Department Stores in the United States by Merchandise Lines, by Robert D. Entenberg. University of Pittsburgh Press, Pittsburgh 13, Pa. 1961 (rev. ed.) $6.95.

Retailing Management, by William R. Davidson and Paul L. Brown. Ronald Press Co., 15 E. 26th St., New York 10, N. Y. 1960 (2d ed.) $P.00.

How To Organize and Operate A Small Business, by Pearce C. Kelley and Kenneth Lawyer. Prentice-Hall, Inc., Englewood Cliffs, N.J. 1961. (3d ed.) $7.95.

Small Business Management, by H. N. Broom and Justin G. Longenecker. South-Western Publishing Co., 5101 Madison Rd., Cincinnati 27, Ohio. 1961. $7.75.

Merchandising for Tomorrow, by E. B. Weiss. McGraw-Hill Publishing Co., 330 W. 42d St., New York 36, N. Y. 1961. $7.50.

SMALL BUSINESS ADMINISTRATION
U. S. Government Agency

Small Marketers Aids

No. 82

Washington, D. C. — August 1962

BID THE JOB--NOT THE MARKET

By *Bert E. Calvin*, Managing Associate,
Calvin & Company, Inc., Business and Management Consultants,
San Francisco, California

SUMMARY

Althougn accurate bidding is one of the keys to profits in contract-type work, some small businessmen use averages and other unrealistic methods when figuring a bid. They tend to bid the market rather than the job.

The Aid points out that working up a correct bid requires time, patience, careful attention to detail, and sometimes ingenuity. But even so, there are steps that even small contractors can use to ease the chore of arriving at accurate estimates.

Among these steps are: understanding the job, working in sections or phases, evaluating overhead, determining job duration, evaluating human relations, ruling out impulses, and determining the profit.

Accurate bidding is one of the chief keys to profits among small businessmen who compete for contracts. However, it is not always easy to arrive at a bid that carries a profit while meeting competition.

At best, bidding is a time-consuming job. It involves the studying of specifications, the gathering of information, and the evaluating of known facts and probable events.

Some small businessmen are discouraged by uncertain elements--such as whether a subcontractor will deliver on schedule. Often their attitude toward bidding is unrealistic. "I do the best I can," they say, "and hope that everything will work out."

Or, just as unrealistic, some of these men bid the market rather than the job. For example, when there are more jobs than there are contractors bidding, prices tend to be relatively high. In lush times, many contractors become careless in figuring bids. Often they use shortcuts--such as various forms of unit pricing, unit costing, and arbitrary percentage for overhead and profit.

The danger in such shortcuts is: They don't provide for the peculiarities which any job contains.

This fact sometimes catches up with contractors, as it did, for example, in the school building business in one state. The contractors' costs were running about $12 per square foot on standard-type schools.

So some of these contractors began to figure bids on footage rather than on a proper cost estimate for each individual job. Subcontractors, such as electricians and plumbers, began to bid according to the number of fixtures or the feet of pipe.

The results were tragic. Several contractors went broke. Others lost money. The reason: Their construction costs were higher than their bids.

The results could have been different had these men used sound cost estimating to arrive at their selling prices.

Figuring a correct bid is hard work. It requires time, patience, careful attention to detail, and sometimes ingenuity.

However, by following certain steps a small businessman can ease the burden of using this important management tool. Those steps are: (1) understanding the job; (2) working in sections or phases, such as materials costs, labor costs, and equipment costs; (3) evaluating overhead; (4) determining job duration; (5) evaluating human relations; (6) ruling out impulses; and (7) determining the profit.

UNDERSTANDING THE JOB

The first step in figuring any bid--whether for a $15,000 house, a $500,000 public works job, a $200 interior decorating job, or a $75 automobile paint job-- is to be sure that you understand the job.

Do you understand what the customer wants? Are his plans and specifications clear to you?

Visit the job site or, in the case of equipment repair, inspect the machine. Don't take anything for granted.

Can you make a profit on the job? Do you have the men or are they available to do the job according to the customer's specifications? The equipment? The money? The time?

Investigate the customer's financial strength. Can he pay for the job? If you are a subcontractor, investigate the financial reputation of the competing general contractors.

ELEMENTS INVOLVED IN THE BID

After you understand the job, you are ready to begin working up your bid. First, estimate the cost of the known elements such as: the cost of materials, labor, equipment, and other direct costs.

A good way to insure accuracy is the use of a precise recapitulation sheet for each bid. Supporting this sheet with back-up and take-off sheets can help you to avoid omissions or duplications. The back-up sheets also enable you to make unit cost comparisons and to verify material quantities.

- Complete Material Costs

In bidding a job, material take-off is fairly simple. If you use anything other than the true material cost, you are speculating. Include everything at realistic price levels.

Material cost is your actual raw material cost, but it includes freight and sales taxes. Determine it accurately by sequence of installation or use.

- Accurate Labor Costs

One electrical contractor, Bill Edge,[1] had fallen into the habit of using unit prices and other "average" methods when he estimated his labor costs. Over the years he had arrived at an estimate of 2 hours each for fixtures regardless of the size, number, or location. On a job calling for the replacement of 1,100 fixtures, Mr. Edge bid as follows:

2200 man hours at $5	=	$11,000
Cost of fixtures	=	17,000
Other direct costs	=	800
Total direct costs	=	$28,800

To this base figure he added overhead costs and profit to arrive at his bid (or selling) price.

Mack Worthmore was another bidder on this job. His cost for fixtures was the same as Mr. Edge's. But labor was another story.

Mr. Worthmore did not figure labor on assumptions. He studied the job to learn the most economical way it could be done.

He saw that two men could hang one fixture in 20 minutes. He then estimated that four men could do the work within a month at a labor cost of $3,600.

Therefore, Mr. Worthmore's direct costs looked like this:

Labor	=	$ 3,600
Cost of fixtures	=	17,000
Other direct costs	=	800
Total direct costs	=	$21,400

Mr. Worthmore's bid (or selling) price was several thousand dollars lower than the one submitted by Mr. Edge. Accurate labor costs made the difference.

Although both men used the same method of accounting for overhead and profit, Mr. Worthmore was working with a lower base--direct costs of $21,400 against Mr. Edge's $28,800.

The main controllable factor in a bid, then, is your estimated labor costs. Of course, you can use unit prices and "averages" to verify the labor costs you work up for a particular piece of work. But don't rely on them alone.

A good way to figure labor costs is to list the tasks of the job--by steps or phases. Each phase will require certain man hours or man days to perform. Your bid figure must be exactly what these man hours or days will cost you. Include what you will have to pay for: payroll taxes, workmen's compensation, vacations, and other benefits.

When you are figuring labor costs--whether it's shop labor, site labor, or labor in a customer's home--always look for more efficient ways to do the work. Improved efficiency here can help to make your bid more competitive.

- Comprehensive Equipment Costs

You also have to consider any equipment that you will use on a job. How you determine your actual cost of equipment will depend on whether you rent or own it.

Your problem is to work out a unit cost--in dollars per hour, day, week, or month--for each piece of equipment. If you own the equipment, depreciation is important. (For additional information see: *Small Marketers Aid* No. 68, "Depreciation Costs--Don't Overlook Them," available free from Small Business Administration, Washington 25, D.C.)

EVALUATING OVERHEAD

Before you can add a fair charge for overhead to a bid, you have to determine two things. First, what is overhead in your situation? Second, how much does overhead cost?

Stated briefly, overhead is the group of general, continuing costs which cannot be charged to any particular task or product. Overhead includes things such as insurance, taxes, rent, telephone, office personnel, and general management salaries--yours and those of estimators or general supervisors.

You should be able to determine the general level of overhead expenses from your records. Suppose, for example, that you spent $24,000 last year for overhead items. Here your average monthly overhead last year was $2,000.

Suppose further that your gross sales last year were $160,000. On a percentage basis your overhead, in this example, amounted to 15 percent of gross sales.

Such ratios, as a percentage or a unit overhead figure (both based on past experience and historical records), make it easier for you to pro-rate overhead in terms of a short-range job. However, as with any ratios, these should be applied with judgment based on the facts of the current situation.

[1] All names in this *Aid* are disguised.

• Charging Overhead to the Bid

Various contractors use different methods for charging overhead to bids. Three most common ways are:

(1) Adding on a standard percentage to direct costs.

(2) Adding to direct costs an amount which represents what you think the market will take, and

(3) Adding to direct costs an amount that represents a carefully worked out evaluation of the specific overhead (or management services) relating to the job.

Slavishly adding a flat percentage for overhead can be dangerous. John Highspeed is a case in point. A while back he decided that 15 percent of direct costs covered his overhead.

For instance, on a bid with direct costs of $12,000 he added $1,800 for overhead and lost the job. The winning bidder also used 15 percent as an overhead ratio. But he checked his against current conditions and came up with $1,500 overhead for that job.

Tom Sharp bids the market when charging overhead. He wants the job so badly that he makes a deep cut in his overhead figure. For example, on direct costs of $12,000 he might add only $900 in order to keep his selling price down.

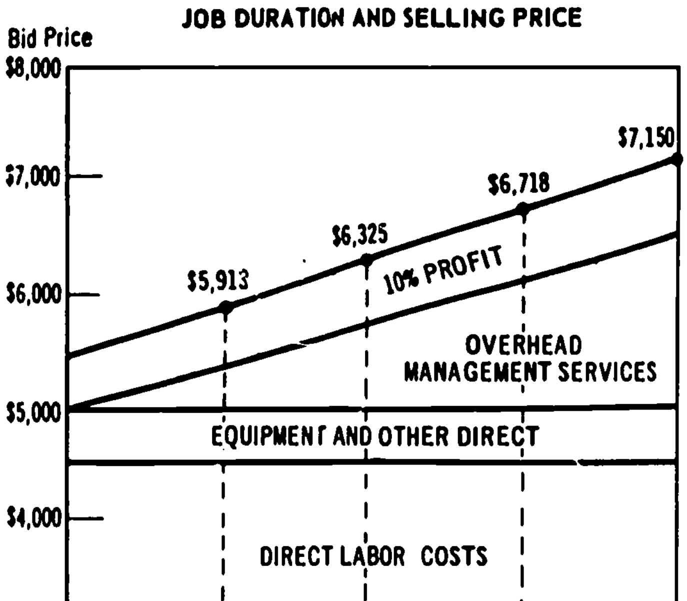
Mr. Sharp wins a lot of bids, but he's losing on overhead. "I'm busy," he says, "but I'm barely breaking even." He's lucky because others have gone broke by bidding the market.

Bob Prudence uses the third method. He adds to direct costs an amount that represents the appropriate management services actually required for the job.

For example, on one job with direct costs of $12,000, he figured $2,000 for overhead. On another with direct costs of $11,500, his overhead was $3,000. The reason: It required more labor for a longer period than the first job.

Sometimes, Mr. Prudence's insistence on adding a realistic overhead figure means that he loses a bid. But as he says, "I try to keep up with what overhead costs me as of today, and then I try to make every bid pay its proper share."

In charging overhead, always charge the proper amount. If you charge too much, then your bids will be too high and out of line with your competitors. On the other hand, if you charge too little for overhead, you are cutting into your profit before you even win the bid.



The above graph depicts a job with direct costs of $5,000. If 10 percent profit is to be enjoyed, a bid of $7,150 would be required for a 12-month completion schedule. Bids of $6,718, $6,325, and $5,913 would return the same profit with 9-months, 6-months, and 3-months schedules respectively.

JOB DURATION AFFECTS PRICE

Normally, DIRECT job costs do not vary regardless of the job duration. In practice, however, this may not be true. For instance, poor coordination, such as late shipments of materials or late completion by subcontractors, can stretch a job out.

Such events are always a bidding risk. The important point is to be aware of these possibilities when you plan the coordination of the various job elements.

As the chart on page 3 shows job duration affects your bid price--or selling price. Suppose you win a $5,913 bid on a 3 months job. However, everything goes wrong--it's a jinx--and the job takes 6 months. You've lost $412--the difference between $6,325 and your 3-months bid price.

HUMAN RELATIONS AFFECT BIDDING

Some small marketers who bid for contracts are already aware of the importance of human relations. They know that good relations with two groups of people increase the chances for getting jobs completed at a profit.

The first group is the marketer's or contractor's employees. Satisfactory relations with them are essential.

As one small garage owner says, "My two men understand that people want their cars back in a hurry. And in a heavy week all three of us can pitch in and finish a lot of work by noon Saturday."

The second group with whom good relations are vital is outside the small marketer's or contractor's firm. Among those in this group are: bankers, architects, engineers, insurance

317-022 O - 69 - 8

people, various public agencies, trade association people, trade union people, general contractors, subcontractors, and suppliers.

Good relations that result in proper coordination on the job are vital to finishing the work at a profit. As one woman who runs a small interior decorating firm says,

"I lost money on my first job because the supplier delivered the tiles 3 days late. He made me lose my place on the tile setter's schedule. Those 3 days set up a chain reaction that put my job a month behind." She solved her problem by getting a more dependable supplier.

BEWARE OF IMPULSES

Allowing certain psychological impulses to enter the bidding process can be dangerous. Watch out for things such as idle manpower, idle equipment, a heavy backlog of work, or no backlog.

Being impulsive about such items can throw a bid out-of-line. As the owner of a small grading company says, "Work was light so I put in a low bid. As it turned out I lost $15 and had my equipment tied up at the very time I needed it on another job."

Owners of small contracting firms should also watch out for complacency. As one says about a certain type job, "I've bid on so many of them that I can do it with my eyes shut but I don't."

However, the impulses of your competitors can sometimes work to your advantage. Don't panic when you see them winning several jobs in a row with low bids.

When they are tied up with unprofitable jobs, they are less likely to be submitting realistic bids.

A good rule is: Always estimate each job when you are bidding. And check out impulses before you base a bid on them.

WHAT CAN YOU EARN?

How much profit you can earn depends, of course, on the kind of contracting firm you are operating. The important point is that every bid should contain some figure for profit.

Be very cautious about submitting a break-even-bid--one in which you'll expect to be trading dollars. Too often, enough of the unexpected can happen to increase costs and turn the job into a loss.

In trying to determine how much profit to include in a bid, remember the risks. Some firms, such as earthmovers, for instance, have greater risks than others. Among risk elements may be: unclear plans, unfamiliar area, weather, tight schedules, supervision, critical material movements, severe penalties, and dependence on others to maintain their schedules.

Consider these risks when estimating your bids. Maybe you can work around some of them. For instance, perhaps you can allow extra time for the specified material supplier who has a reputation for being late in deliveries.

The important thing is to be aware of all risks--no matter how small. Then do the best you can to allow for these risks as you arrive at a selling price that includes a profit for your firm.

FOR FURTHER INFORMATION

Businessmen interested in exploring further the subject of bidding the job may be interested in the references indicated below. This list is necessarily brief and selective. However, no slight is intended toward authors whose works are not included.

Building Construction Estimating, George H. Cooper. McGraw-Hill Book Co., Inc., 330 W. 42d St., New York 36, N. Y. 2d ed. 1959. $8.25.

Electrical Estimating, Ray Ashley. McGraw-Hill Book Co., Inc., 330 W. 42d St., New York 36, N. Y. 3d ed. 1961. $12.50.

Estimating General Construction Costs, L. Dallavin. F. W. Dodge Corp., 119 W. 40th St., New York 18, N. Y. 1957. $8.50.

"Use These Tables to Estimate Man Hour Requirements for Installing Welded Piping," *Heating, Piping and Air Conditioning*. September 1961. Keeney Publishing Co., 6 N. Michigan Ave., Chicago 2, Ill. Monthly. $5.00 per year; $1.00 per copy.

SMALL BUSINESS ADMINISTRATION

JOHN E. HORNE, Administrator

Management Research Summary

Washington 25, D.C. August 1961

PRICING DECISIONS IN SMALL BUSINESS

By W. Warren Haynes, Professor of Economics,
University of Kentucky, Lexington, Kentucky

HIGHLIGHTS

Interviews with 88 small businessmen revealed the use of various methods of pricing. These included (1) full-cost pricing, in which the price covers labor, material, and overhead costs and a predetermined percentage for profit; (2) gross-margin pricing, in which a markup is added to the wholesale price; (3) suggested pricing, in which prices follow the suggestions of manufacturers or wholesalers; and (4) "going rate" pricing, in which prices imitate those of competitors.

Most of the firms taking part in the study summarized here used one of these methods as a starting point but gave some consideration to other factors.

The report points out that it is more important to develop sound reasoning about prices than to adopt specific rules, because reasoning adjusts more readily to differing or changing circumstances.

A reasoned approach to pricing involves a comparison of the effects of a price decision on <u>total</u> revenue, or sales receipts, and on <u>total</u> costs.

Prices are a basic factor in determining profits and, ultimately, in the success or failure of a business enterprise. The pricing of commodities and services is, therefore, one of the most important responsibilities of small business managers. In the study summarized here, the managers of 88 small businesses were interviewed to determine (1) their methods of reaching decisions about pricing and (2) their reasoning in the choice and application of those methods.

METHODS OF PRICING

• <u>Full-Cost Pricing</u>. Many businessmen take the view that the price on each product must cover all the costs of that product. This approach, called full-cost pricing, means that the price to be set will cover labor, materials, and overhead costs, plus a predetermined percentage for profit.

Findings of the study show, however, that few small businesses adhere rigidly to a full-cost pricing policy. Many managers express a preference for such an approach, but when it comes to actually establishing prices, their decisions are influenced by demand and other factors.

• <u>Flexible Markups</u>. A common practice is to use full costs, not as an inflexible point at which the price is to be set, but as a floor below which the price will not be allowed to fall--a reference point to which flexible markups are added. Two kinds of flexibility are found in actual pricing: (1) adjustments over the course of time to changes in demand or in competition, and (2) variations among different products at the same time, due to differences in the market for individual products.

• <u>Pricing with Product Costs Unknown</u>. Some firms cannot use a full-cost formula

AVAILABILITY OF THE FULL REPORT

Copies of the full report, titled "Pricing Decisions in Small Business," may be purchased for $3.50 from the University of Kentucky Press, Lexington, Kentucky. Make checks payable to University of Kentucky Press.

This report was prepared under the 1959 Small Business Management Research Grant Program of SBA. It may be reviewed at any SBA field office or at certain depository libraries whose addresses may be obtained from the SBA field offices or the Small Business Administration, Washington 25, D. C.

for pricing because their costs cannot be figured precisely enough. Garden and landscape nurseries illustrate this situation. Their products develop over a period of years and are subject to uncertain damage from weather, disease, and shifts in buyers' requirements. It is difficult to allocate labor costs, overhead, and funds tied up in growing materials. In such cases, pricing decisions are strongly influenced by demand and competition, with attention to the results on the income statements.

• Gross-Margin Pricing. Another widely used pattern of pricing is that of adding a markup to the wholesale cost. This method, sometimes known as gross-margin pricing, is customary in retailing and wholesaling. Some firms compute the markup as a percentage of wholesale cost; others, as a percentage of selling price.

As in full-cost pricing, firms using the gross-margin method of pricing usually do not apply the same markup on all items nor at all times. It is more profitable to take into account the effect of different prices on sales volume and then to decide which products will bear high markups and which require low ones.

• Suggested and "Going Rate" Prices. Still another approach to pricing often adopted by small firms is to follow an external guide. Some managers prefer not to make their own pricing decisions. This study found a widespread acceptance by retailers of the prices suggested by manufacturers or wholesalers. Still other managers simply follow the prices set by similar firms.

• A Reasoned Approach to Pricing. Any one of the above methods of pricing may be the logical method under certain circumstances. But it is more important to develop a way of reasoning about prices than to adopt specific rules. Rules, once set up, tend to remain in effect when they no longer apply. Sound reasoning adjusts to differing or changing circumstances.

A well-reasoned approach to pricing is, in effect, a comparison of the impact of a decision on total sales receipts, or revenue, and on total costs. It involves the increase or decrease in revenues and costs, not just of the product under consideration, but of the business enterprise as a whole. If a proposed price change leads to a greater increase in total sales receipts than in total costs, it will increase profits and should be favored. Or if it leads to a greater reduction in costs than in revenue, the decision should also be favorable.

It is quite possible that an item or service sold at less than a full-cost price may nevertheless make a worthwhile contribution to total revenue (1) if the facilities used would otherwise be idle or less profitably employed, or (2) if the sale of the item at the lower price has a favorable effect on other phases of the business.

On the other hand, a price that appears satisfactory from the viewpoint of strict full-cost pricing will sometimes be seen as unprofitable when its overall effects are taken into consideration.

It is evident, then, that sound reasoning about pricing requires attention to a number of factors besides the actual costs of the product or service involved.

PRICING PRACTICES

The firms interviewed reported a wide variety of pricing practices. Some of these are described briefly here.

• A Nursery. This firm, with about 12 employees and 75 acres, sells plants at wholesale to retail nurseries, garden stores, and so on. The firm propagates and grafts most of its plants, but buys some as seedlings.

The owner appears to be governed by overall profit. Also, he wishes to help retailers make a profit. "As long as we are making a satisfactory profit, there is no reason to raise list prices," he said. And, "We sell to people who have to sell for profit."

The firm does not change prices often. The quality for a given price may improve slightly if the growing season has been good, and less is charged for imperfect plants. The owner thinks that keeping price changes at a minimum helps customers and helps maintain goodwill. He does not cut prices often, but sometimes does when he is over-stocked. If he cuts prices, he notifies regular customers so that they will benefit.

The owner seems to believe that if a line is "moving" it is profitable. He has abandoned many lines that he has felt were unprofitable, concentrating on a narrow selection of large-volume items.

The owner does not believe that it would pay to measure costs. He does attempt to forecast roughly trends in volume of demand, and he changes his plantings accordingly. He does not, however, give much attention to price-volume relationships.

The wholesale nursery market contains a large number of firms, but the price competition among them does not appear to be severe. This owner says he does not pay much attention to prices of other firms.

• An Automobile Repair Shop. This is a one-man concern with three employees. There are several dozen competitors inthe city, but only a few specializing in body repairs, as this firm does.

This company estimates parts prices according to national manuals that give the manufacturers' suggested prices. The markup is the difference between the retail prices listed in the manuals and the wholesale prices on the invoices. The company gives an insurance company a 10-percent discount on parts.

Time is estimated in two ways: (1) from national time standards in the national manuals (this company can usually beat those standards) and (2) from experience. On body repair work, experience and judgment are the bases. The estimate is a guaranteed bid except for motor trouble that might not be detected at first.

Time is charged at $4.00 an hour. The owner states that he arrived at the charge in this way: (1) It is the price charged by some of his competitors. (2) While other competitors charge $4.50, he wants to keep his rate down in order to win a sufficient number of bids. He also mentioned that his overhead costs are lower, so that it is not necessary to charge so much to cover costs.

There are ways of varying prices that are not obvious at first. For customers seeking competitive bids and watching estimates closely, the company avoids any frills. In times when business is off, the management does not go below full costs but makes certain that no unnecessary items go into the estimate. Flexibility is achieved by varying the number of extras to include--for example, painting scratches that might be ignored under some conditions.

The firm can reduce costs by making replacements with used parts, a practice of which the customer should be aware.

One regular customer with a large number of vehicles is given more favorable bids. He is informed and can shift his business rapidly.

• A Men's Clothing Store. A men's and boys' wear shop in a city of more than 100,000 climbed, under new owners, from bankruptcy to a $12,000 profit in 5 years. The store caters to middle-income and college trade and emphasizes price competition and volume.

The owner emphasizes that he has no reluctance on ethical grounds about charging what the traffic will bear. But the store experiments continually with various measures that emphasize price savings.

The owner readily admits selling a nationally advertised line at less than the advertised price to create volume. This practice caused a competitor to complain to the manufacturer. On many occasions, ties, socks, and so on are advertised at prices less than cost to get volume and possible sales of other items. The store always has a sale in process on some items.

Variable markups are used, but the owner tries to maintain an average 40-percent markup. Now that he is making money, he plans to become more conservative in his pricing tactics.

The owner engages in agressive advertising that emphasizes the price advantage offered by the store. The cost of advertising, he reports, has been more than offset by additional profits. However, the advertising is now being cut back and rigidly budgeted at 3 percent of sales.

• A Job Printing Shop. This shop, with 10 employees, is one of the smaller of more than 80 firms in a city of more than 100,000 population.

The company operates fairly strictly on a full cost plus 20-percent markup basis. There is very little reference to demand or to market conditions. The cost information is estimated from outside sources (nationally published manuals that provide regional breakdowns) but is checked against the outcome in this company. If company revenue does not give adequate coverage of costs, the company may boost rates. There is a constant check on the individual job to see whether it covers costs. The management is also influenced by overall income statements.

There is little evidence of price differentials. There are lower unit charges for larger lots, but these appear to be related to cost estimates--there is, for example, a spreading of makeready costs over larger lots. The owner may charge more on rush jobs if the plant is busy, but if it is idle he may overlook this. There is only a 10-percent markup on envelopes and letterheads. The company is not making money on these lines but maintains them as a service to customers.

The owner keeps a careful watch on equipment needs. In moving into his new plant, he sold types of equipment not fully utilized. He has disposed of some presses handling large pages because he does not do much of this business and can farm it out. The company has given up bidding on some kinds of business because too much management time is involved.

There is no exploitation of the differences in what the traffic will bear. At the same time, it would appear that the ability to raise prices is limited by competition. The owner resists the shading of prices to get business.

The firm does not usually quote a price in advance. It saves management time not to quote. But the firm computes actual costs very carefully and checks them against national cost estimates. The firm is careful not to overcharge in this situation because of the effect it might have on future business. In fact, on some jobs on which the actual costs are running high, the firm reduces the markup.

- A Furniture Manufacturer. This firm, a sole proprietorship with 40 employees, specializes in antique reproductions. It is located in a town of 10,000 to 20,000 population.

The firm does not have a formal system of pricing. In making price decisions, the owner is influenced by his overall income and by his cash position. He is also influenced by the desire to maintain employment.

He believes that competition from lower quality, mass-produced furniture places a ceiling on what he can charge. In fact, he suggests a markup on the retail level below that which is general because of the danger of being priced out of the market. Some stores refuse to handle this furniture because of the low markup.

Despite the high importance of competition, the owner is influenced to some extent by costs. He recently increased prices by 4 percent--the first increase in 10 years--to make possible an increase in wages.

He maintains a published price list with wholesale prices and suggested retail prices. He makes no attempt to enforce the suggested retail prices; in fact, he appears to favor flexibility. Most retailers buy at his published wholesale price, but he is willing to negotiate prices with individual dealers and with ultimate consumers. He feels that this willingness to negotiate has contributed to his success. But he does not negotiate a special price in cases that will affect cities where he has established "accounts."

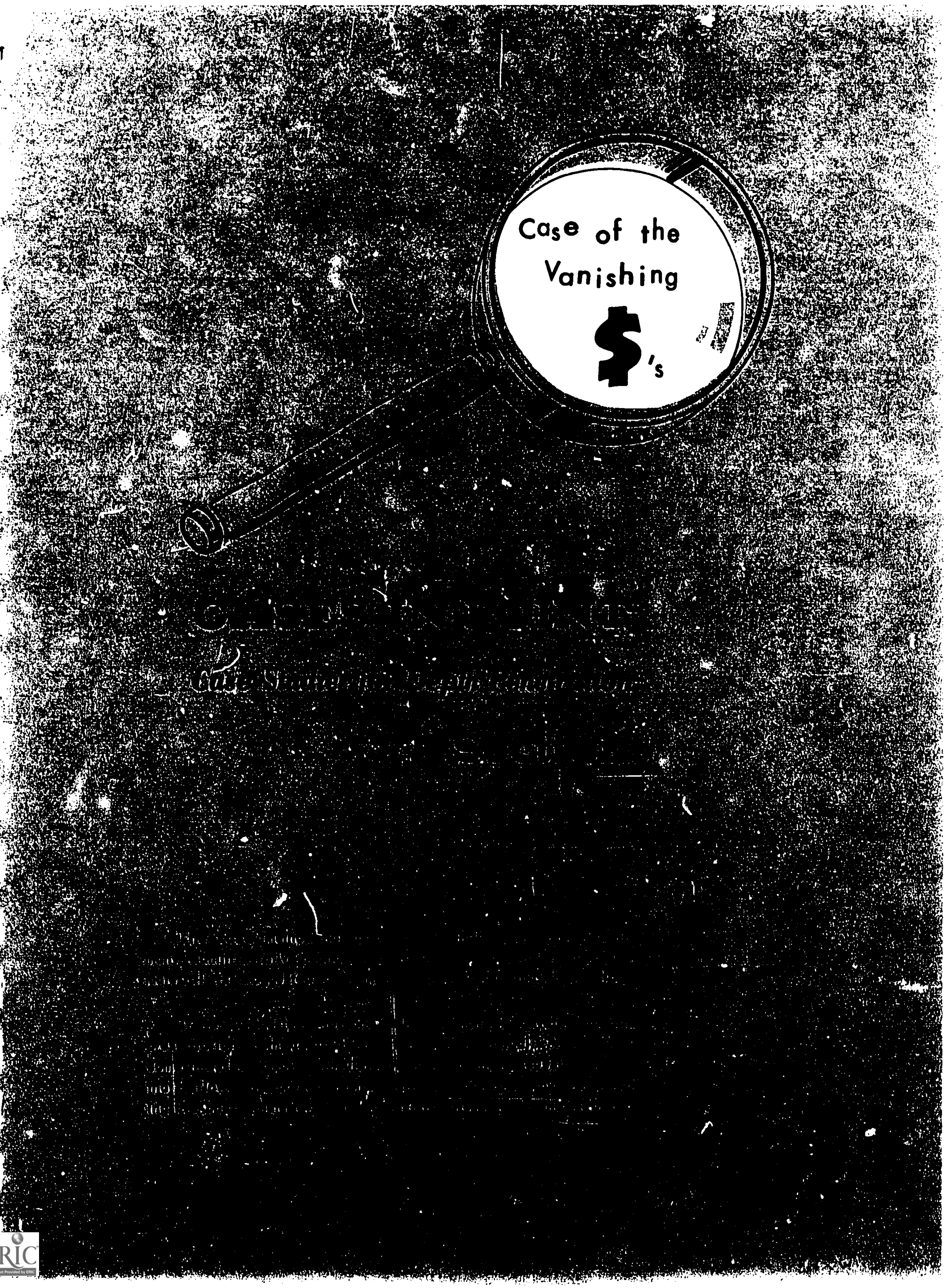
There is no evidence that he takes advantage in pricing of a big backlog of orders, when this occurs, or that he lowers price much in poor times. The owner claims that his objective is not maximization of profit. He is interested in a cash flow that will give him a moderate income and will finance expansion and replacements.

ABOUT THE STUDY

The study is based on intensive interviews with managers of 88 Kentucky firms ranging in sizes from 1 or 2 employees to more than 200. The firms included 26 retailers, 6 wholesalers, 21 service firms, 2 combined retail and service firms, 28 manufacturers, and 5 garden or landscape nurseries.

The full report includes a discussion of pricing theories presented in this and other published studies, case histories of the firms interviewed, and an analysis and evaluation of the data gathered.

MRS 44


Case of the Vanishing $'s

THE CASE METHOD OF STUDY

The case method is a teaching device that helps the student learn through the processes of reasoning and decision making. Other popular teaching techniques stress learning or memorizing other people's knowledge on a given subject. The case method stresses thinking abilities rather than memory; it is dynamic, not passive.

What is a case? It is a description of an actual or true-to-life business situation. It is a statement of facts, opinions, judgments—in short, a problem having no pat answer but lending itself to discussion and analysis.

The case method is particularly helpful in teaching businessmen because it uses real, practical problems rather than abstract situations. Properly used, it involves the participants in a way that will hold their interest and stimulate their thinking. It is particularly useful in developing in the individual (1) the ability to make decisions on administrative tasks (without incurring the penalties of a wrong decision on the job); and (2) the habit of thinking analytically and constructively.

The case method also highlights the value of group discussion and analysis. Each member of the group contributes from his unique experience, and each participant gains from the others. The group's knowledge and experience will exceed that of any one participant—including the instructor.

The following checklist can serve as a procedure for conducting case study and analysis:

Suggestions for Case Study

1. Read the case carefully for general content.

2. Arrange the facts of the case in order of importance.

3. Recognize and define the major problem(s) needing solution.

4. Analyze the problems and their relative importance.

5. Search for and establish alternative solutions.

6. Select the most desirable of the appropriate solutions.

7. Analyze your probable solutions; set up the pros and cons, giving value to each.

8. State your choice, decision, or final conclusion—and be prepared to defend it.

9. Set forth the plan or plans you would follow to implement the decision.

MID-TEXAS HELICOPTER

John Simunac recently retired as an Air Force helicopter pilot and returned to his hometown in central Texas to open a helicopter charter service. He has thoroughly researched his prospects for business in this area over the past 2 years. Among other things, he wrote to the local Chamber of Commerce and contacted all

317-022 O - 69 - 9

major pipeline companies, oilwell suppliers, and drillers in that part of Texas. He has reason to believe that his service is needed and will be well received.

John has established himself with a local bank, applied for credit with a petroleum company, and established a line of credit with a major helicopter repair service. Now he has rented a house, moved his family, and rented hangar and office space. He has negotiated a rental contract with a helicopter company for a four-place helicopter of the design he was most familiar with in the Air Force. Mrs. Simunac will run the office, keep books, and answer phone calls while John does the flying.

Everything is ready to start business, but John has the problem of pricing his service. He knows that similar services for comparable aircraft in Dallas and Houston are priced, generally, at $30 to $35 an hour, but he isn't sure whether he can command that price in his trade area. However, he does have some cost information that may help guide his decision.

John knows that other operators say they keep their aircraft busy about 60 percent of the normal business hours, or about 120 hours a month. John himself has promises of work that he believes will allow him to meet this average.

He will pay monthly rental on the aircraft of $600 a month including insurance, plus $4 for each hour of engine time. Rent for his office and hangar runs $300 a month. He knows that aviation fuel will cost him 28 cents a gallon and that he can expect to use 15 gallons an hour. Oil costs 50 cents a quart, and he can expect to average 1 quart an hour, including oil changes. Minor repairs not covered in his helicopter contract will average about $36 a month, according to the manufacturer.

His office expense—including supplies, telephone, licenses, and depreciation—he figures at about $100 a month, and he is arbitrarily going to allow $100 a month for advertising. He estimates that he and his wife will need to take out $600 a month to supplement their retirement income and keep up their standard of living.

Assume that John will have no other cost factors and will add 10 percent of costs for profit. This is equivalent to 9 percent of sales. (To convert profit as a percent of sales to profit as a percent of cost, use this formula: *Profit-as-a-percent-of-sales* divided by *100-minus-profit-as-a-percent-of-sales* equals *profit-as-a-percent-of-cost*.)

Use the cost-plus method to find the lowest price John could charge.

Instructor's Notes

The student must first convert the monthly figures to hourly figures. Since it has been established that the helicopter will work 120 hours each month, the monthly costs can simply be divided by 120. Following are the conversions:

Helicopter rental ($5 + $4)	$9.00
Hanger and office rental	2.50
Minor repairs	.30
Office expenses	.83
Advertising	.83
Salary	5.00

Now the price can be figured by the cost-plus method:

Direct costs:		
Helicopter rental and insurance..........	$9.00	
Aviation fuel.........	4.20	
Oil..................	.50	
Minor repairs........	.30	
Labor (salary)........	5.00	
Total direct costs........		$19.00
Indirect costs:		
Hanger and office rental..............	$2.50	
Office expense........	.83	
Advertising..........	.83	
Total indirect costs.................		4.16
TOTAL COST................		$23.16
PROFIT......................		2.32
		$25.48

Therefore, John Simunac should charge a minimum of $25.48 per hour.

MARQUIS DECORATING COMPANY

Henry Marquis has just met with his accountant. As he suspected, the figures for the year just past show that profit has again declined about 2 percent, just as it did for the previous year.

Marquis Decorating engages primarily in painting interiors and in hanging wall coverings. The firm was founded 10 years ago and, in general, has done well through the years. It employs five full-time painters and paperhangers. The business volume is good, and the firm seems to get its share of bid jobs.

There does not seem to be much prospect for higher rates, however, because the business is highly competitive. The problem of declining profits seems to be caused by rising costs of materials and labor.

Clearly, Henry must take some management action to increase profits, but he does not want to change his prices at this time. He goes over one of his typical bids and concludes that there is no way to cut his materials cost and keep his high quality. He is sure that his men are as efficient as he can expect them to be. It occurs to him, however, that he might accomplish some economies by purchasing two spraying outfits and using them for the routine room wall finishing that constitutes most of his business. Two of his men are already experienced on the equipment.

The manufacturer claims that the equipment saves 15 percent of the cost of materials and 50 percent of the labor costs. But Henry isn't sure. He knows that the cost of the equipment and its maintenance will offset some of the savings.

Following is a typical bid on one of Henry's jobs:

Direct costs:		
Roller man—10 hours at $1.95	$19.50	
Trim man—7 hours at $2.20	15.40	
Wall paint—4 gallons at $4.20	16.80	
Enamel—1 gallon at $6.95	6.95	
Transportation—20 miles at $0.14	2.80	
Total direct costs		$61.45
Indirect costs:		
Equipment and supplies	$8.95	
Overhead (60 percent of labor)	20.94	
Total indirect costs		29.89
TOTAL COST		$91.34
Profit (10 percent of costs; 9 percent of price)		9.13
PRICE		$100.47

Assume that you are a management consultant called in to help Henry with his pricing. Also assume that the spray equipment cost for this job (depreciation and maintenance) has been worked out by his accountant and would be $7.98. Using the cost-estimate method, show Henry that the new equipment will bring him more profit at the same price.

Instructor's Notes

Point out to the class that the time for the trim man will not be affected by the new equipment. They may assume, however, that the roller man's time can be cut from 10 hours to 5 hours and that the cost of wall paint can be cut from $16.80 to $14.28. Also state that the cost of other equipment will remain about the same. The new bid will look like this:

Direct costs:		
Spray man—5 hours at $1.95....	$9.75	
Trim man—7 hours at $2.20.........	15.40	
Wall paint (for sprayer).........	14.28	
Enamel...........	6.95	
Transportation—20 miles at $0.14....	2.80	
Total direct costs.................		$49.18
Indirect costs:		
Equipment, supplies, and depreciation....	$16.93	
Overhead—60 percent of labor.....	15.09	
Total indirect costs................		32.02
TOTAL COST...............		$81.20
Profit.......................		18.80
PRICE......................		$100.00

His profit, at $18.80 has more than doubled. It is now 23 percent of cost, or 18.8 percent of the selling price.

SUGGESTED INCUBATOR ASSIGNMENTS

1. Draw up a pricing policy for your business or a contemplated one. Such a policy should be in writing. Describe how prices will be set and set forth any pricing formulas to be used.
2. Make a list of things you can do to make your service offerings more valuable that might be used to help command higher prices.
3. Draft a form letter which you would send to regular customers telling of lower prices which you are going to offer.

BIBLIOGRAPHY

Topic—*Pricing in a Services Business*

These references to publications are useful in a study of small business service pricing. They can be obtained from many libraries and bookstores or from the publishers. No slight is intended to authors and sources not included.

Albaum, G. *Price Formulation.* 1966. University of Arizona, College of Business and Public Administration, Division of Economics and Business, Tucson, Ariz. 85721. ($1)

Bergfeld, Albert J. and J. S. Early and William R. Knobloch. *Pricing for Profit and Growth.* 1962. Prentice-Hall, Inc., Englewood Cliffs, N.J. 07632. ($17.95)

Backman, Jules. *Price Practices and Price Policies.* 1953. Ronald Press Co., New York, N.Y. 10010. ($8)

Harper, D. V. *Price Policy and Procedure.* 1966. Harcourt, Brace and World, Inc., New York, N.Y. 10017. ($4.50)

Haynes, William Warren. *Pricing Decisions in Small Business.* 1962. Small Business Administration, Management Research Report. University of Kentucky, Lexington, Ky. 40506. ($3)

Lennon, Victor A. "What Is The Best Selling Price?" March 1968. *Management Aids No.* 193. Small Business Administration, Washington, D.C. 20416. (Free)

"Pricing Arithmetic for Small Business Managers," Small Business Administration. *Management Aids No.* 100 in *Annual No.* 7. 1961. U.S. Government Printing Office, Washington, D.C. 20402. (30 cents)

Pricing: The Critical Decision. 1961. American Management Association. AMA Management Report No. 66. New York, N.Y. 10020.

317-022 O - 69 - 10

U.S. GOVERNMENT PRINTING OFFICE: 1969—O-317-022

SMALL BUSINESS ADMINISTRATION FIELD OFFICES

Agaña, Guam
Albuquerque, N. Mex.
Anchorage, Alaska
Atlanta, Ga.
Augusta, Maine
Baltimore, Md.
Birmingham, Ala.
Boise, Idaho
Boston, Mass.
Buffalo, N.Y.
Casper, Wyo.
Charleston, W. Va.
Charlotte, N.C.
Chicago, Ill.
Cincinnati, Ohio
Clarksburg, W. Va.
Cleveland, Ohio
Columbia, S.C.
Columbus, Ohio
Concord, N.H.
Dallas, Tex.
Denver, Colo.
Des Moines, Iowa
Detroit, Mich.
Dover, Del.
Fargo, N. Dak.
Harlingen, Tex.
Hartford, Conn.
Hato Rey, Puerto Rico
Helena, Mont.
Honolulu, Hawaii
Houston, Tex.
Indianapolis, Ind.
Jackson, Miss.
Jacksonville, Fla.
Kansas City, Mo.
Knoxville, Tenn.
Las Vegas, Nev.
Little Rock, Ark.
Los Angeles, Calif.
Louisville, Ky.
Lubbock, Tex.
Madison, Wis.
Marquette, Mich.
Marshall, Tex.
Miami, Fla.
Milwaukee, Wis.
Minneapolis, Minn.
Montpelier, Vt.
Nashville, Tenn.
Newark, N.J.
New Orleans, La.
New York, N.Y.
Oklahoma City, Okla.
Omaha, Nebr.
Philadelphia, Pa.
Phoenix, Ariz.
Pittsburgh, Pa.
Portland, Oreg.
Providence, R.I.
Richmond, Va.
St. Louis, Mo.
Salt Lake City, Utah
San Antonio, Tex.
San Diego, Calif.
San Francisco, Calif.
Seattle, Wash.
Sioux Falls, S. Dak.
Spokane, Wash.
Syracuse, N.Y.
Toledo, Ohio
Washington, D.C.
Wichita, Kans.

The addresses and telephone numbers of these field offices are listed under U.S. Government in the respective city telephone directories.

GRAY — The Lesson Plan

RUST — The Presentation

BUFF — The Visual Aids

GREEN — The Supply Department

YELLOW — Cases in Point

BLUE — The Incubator

TO LOWER
PRICES

stomers by
ons

nodest

w business

ervices

services
ble

- Announce in advance
- Assure customers of high quality

(Lower prices only when costs have been lowered)

O
PRICES

Focal Points On

PRICING IN A SERVICES BUSINESS

TOPIC NINETEEN

Management Development Program
SMALL BUSINESS ADMINISTRATION

☆ GPO : 1968 O - 317-023

TO LOWER PRICES

- Announce in advance
- Assure customers of high quality

(Lower prices only when <u>costs</u> have been lowered)

TO RAISE PRICES

- Prepare customers by giving reasons
- Keep rise modest
- Promote new business
- Dress up services
- Make your services more valuable

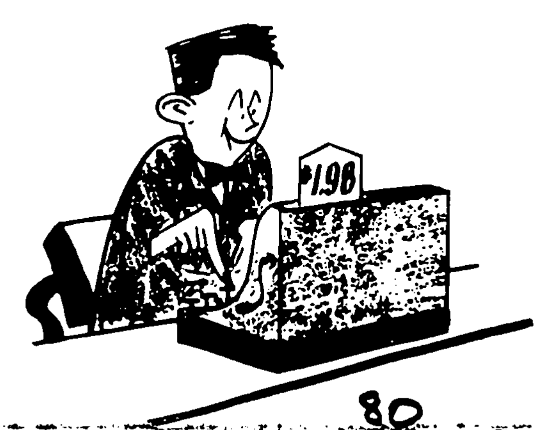
☆ GPO : 1968 O - 317-023

ESTABLISH PRICES THAT-

- Promote long-range welfare
- Stimulate combination sales
- Carry their share of profit
- Are flexible

THEN –

- Review prices periodically



TO SET PRICES USE FULL COST FROM ACCURATE FIGURES

DIRECT COSTS

- Wages
- Materials
- Transportation

INDIRECT COSTS

- Overhead
- Advertising
- Depreciation

PROFIT

THAT-

elfare

sales

rofit

ally

TO SET PRICES USE FULL COST FROM ACCURATE FIGURES

DIRECT COSTS

- Wages
- Materials
- Transportation

INDIRECT COSTS

- Overhead
- Advertising
- Depreciation

PROFIT

STEPS IN BIDDING

- Understand specifications
- Visit the location
- List contingencies
- List efficiencies
- Breakdown all costs
- Detail overhead costs
- Check prices and costs
- Check profit consideration
- Obtain independent check of bid proposal
- Prepare bid