made simple guides

Made Simple guides are aimed at finance professionals working in charities. They cover technical areas such as risk assessment, accounting, tax and VAT treatments and aim to provide practical guidance to busy accountants in charities.

The content of guides is correct at the time of going to print, but inevitably legal changes, case law and new financial reporting standards will change. You are therefore advised to check any particular actions you plan to take with the appropriate authority before committing yourself. No responsibility is accepted by the authors for reliance placed on the content of this guide.

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Acknowledgements

This guide was produced with help from the partners and staff at Sayer Vincent, as well as support from staff and trustees of CFDG.

CFDG (Charity Finance Directors' Group) is the professional body for finance directors within the sector, and has nearly 1,500 members. CFDG provides assistance to charities on a range of issues, such as accounting, taxation, audit and other finance-related functions. CFDG's mission is to deliver services that are valued by members and enable those with financial responsibility in the charity sector to develop and adopt best practice.

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Published by CFDG
First published 2008

Introduction

Many charities will have to put together bids and make pricing decisions, whether they are seeking funding or trying to earn income. Pricing is an important expression of an organisation's strategic approach to its activities and how it wishes to achieve its objectives. So you need to be clear about your pricing strategy.

While you need to understand your costs to help you make good pricing decisions, there is much more to pricing than costing. You need to think about the reasons why you want to provide the service, who your 'customers' are and how they will pay for the service. If the price is too high, the service may be beyond the reach of the people it is designed for, or you will not get enough customers.

Perceptions of a service (or goods) may vary according to price – for example, people may think that a training course is likely to be poor quality if the price is very low. Conversely, a high price will make some people think it must be a very good course, although not everyone will be convinced by this. So part of the pricing decision needs to consider how you want to be perceived.

If you are bidding for contracts, you do need to consider whether the contract fee will be enough to cover all your costs. For this you do need enough information about your costs and the impact of expansion on organisational costs. This will help you to decide whether you are prepared to subsidise or need to recover all the costs.

This short guide will cover just some of the points to consider from a financial point of view and will focus mainly on charities. It will be relevant to charities offering goods and services to individuals as well as seeking funding through grants and services.

1 Understand your costs

We need to consider different types of costs as a starting point:

- Fixed costs are usually the overheads of an organisation or department and are costs that will be incurred regardless of the level of activity. It does not mean that the actual amount in the budget is fixed; it means that the volume needed does not vary greatly, even though the price may vary. So, for example, you would need the same amount of heating in a building regardless of the number of projects being run from it.
- Variable costs are closely related to a particular service or activity and so will vary in relation to the level of activity. For example, a project to provide tea and coffee will have the variable costs of the ingredients – the costs of buying these will vary in direct proportion to the number of cups of tea and coffee served.

Classifying costs as direct or indirect is another way of looking at them that is how they relate to the structure of the organisation and the 'department' in which the cost arises.

- Direct costs can be identified as the costs directly attributable to a particular project or department.
- Indirect costs are costs that relate to the organisation as a whole. Central administration costs are indirect costs to the organisation, since they cover all projects but generally do not relate specifically to any one.

Both these methods of analysing costs can be relevant at the same time. Variable costs tend to also be direct costs. Variable or fixed is a question of how the costs behave in relation to the level of activity; direct or indirect is a question of where the cost arises.

2 Contribution analysis

The income for an activity, such as fees or grants, has to cover the direct costs of the activity as well as contribute towards the fixed costs of the organisation. The surplus income after direct costs have been covered is called the *contribution*. Break even point is reached when the contribution is equal to the fixed costs.

Case study Break even analysis

Access for All wants to publish a book for parents and others on how to get specialist equipment for disabled children. The design and print costs are about £12,000, and fees for a freelance writer and an editor will be about £5,000. They plan to spend £1,000 on the book launch. The cover price will be £19.95 and they will print 5,000 initially. They will offer discounts to wholesalers and bookshops of 33% of cover price and they estimate that 50% will be sold through these channels.

All the costs are fixed costs for this activity as you have to commit to the expenditure early:

Writing and editing	£5,000
Design and print	£12,000
Publicity	£1,000
Total fixed costs	£18,000

For the sales to the trade, the sales price will be £13.37, so with half the books being sold at this price, we need to use an average sales price of £16.66. The break even point is calculated by dividing the total fixed costs by the average sales price (£18,000/£16.66). This number is 1,080.43. This means that Access for All needs to sell 1,081 books to break even.

We can use this concept for an activity or for a whole organisation. If we are considering a new venture, then it will help us to understand the point at which it will break even.

If we assume that additional activity can be taken on within the same level of fixed costs, then we only need to raise sufficient income from the additional activity to cover the additional direct costs of the activity. This is called *marginal costing* and can be a basis for making pricing decisions, for example as a way of establishing the lowest price for a service.

Obviously you will only be able to expand so far on this basis, as you will run out of space in your premises, or admin staff will be over-stretched. So you may need to move to new premises or hire more staff. Usually this means a significant and sharp increase in fixed costs – a step increase. The point where this step increase is needed is called *break point*.

If an additional activity such as a new contract requires your organisation to go beyond break point, then the logic of marginal costing is that the income from the new activity has to be sufficient to cover all the additional costs. So the new contract is only worthwhile if the fees cover all the costs that are triggered by taking on the contract.

The alternative approach is to use *absorption costing* principles. For a certain level of activity, you can estimate the fixed costs and then spread those costs across all activities on a fair basis (known as the absorption rate). If you face a step increase in fixed costs, then you need to re-calculate the absorption rate. You may face problems in terms of recovering a higher level of fixed costs on existing services.

In terms of making pricing decisions, you need to have a consistent approach and be clear about the impact of a decision. If you take on a major new service at the old absorption rate, then you may not be charging enough if the level of fixed costs is rising.

3 Know your market

Charities may be pricing a service for:

- individual users or customers – for example, you may sell books or places on training courses
- organisations and companies who are your customers – for example, local authority staff may be sent on your courses
- a contract to deliver services or a service you are seeking a grant for

You need to understand what value your service has for your customer. Factors which would influence a customer's opinion of value might include:

- the level of specialist knowledge in your charity
- the relevant experience of the staff and volunteers
- an understanding of their problems and the challenges they face

So, for example, if your charity is the only organisation with specialist knowledge in a particular area, then it is likely that your service will be valued highly by potential customers. The upper limit to the value will be the price they would have to pay another organisation to develop their knowledge sufficiently to deliver the same service. A customer may be prepared to pay a little more than this, as your charity can offer the service immediately.

If your charity is in this position, it can set the price quite high as a way of paying for the past cost of acquiring the knowledge and experience. On the other hand, if your charity is offering a service that is already widely available, then your customers will be able to compare prices and will seek the lowest price.

4 Pricing strategies

You need to decide what your objective is in relation to the activity or service as this will inform the pricing strategy you adopt.

- You are entering a new area of activity and are prepared to suffer some losses initially while you build up your portfolio. Hence you may have to offer low prices to undercut existing competition and win the work.
- You have highly specialised skills and your customers are prepared to pay a premium for help with a very difficult problem.
- You want to make the service accessible to all and so deliberately want to keep prices low.
- You want to recover all the direct costs and a fair contribution towards the overhead and governance costs of the organisation. This is known as full cost recovery.

You may find it helpful to be explicit internally with trustees and staff on the pricing strategy you are adopting for a particular service or activity. If you choose to subsidise a service, then you should be clear on the extent of the subsidy and how this is being funded. Overall, you need to be balancing out the contribution from various activities to cover fixed costs.

It may also be useful to explicitly state to customers that you are offering them reduced or subsidised prices. Their perception of the quality of the service will be different if they realise that it is high value service that they are receiving at a subsidised price. In the realm of charity services, you will probably want to avoid being perceived as either ‘cheap’ or ‘expensive’ and prefer to be seen as charging fair prices that represent good value.

5 Pricing decisions

An inherent part of a pricing decision is your assessment of risk factors. Risk is always present even in existing services, but will obviously be greater in a new service. The level of risk will depend on how you are providing a service and receiving funding.

If you provide services under a block contract then you will usually have a degree of commitment from your funders in terms of the volume of services they are committed to buying. For example, a residential care service will have high fixed costs because of the requirement for premises and certain staffing ratios to comply with regulations. These costs will be incurred even if they have some empty spaces.

Spot contracts describe the type of arrangement whereby a purchaser does not underwrite any costs, but only pays for the services they use. Under this arrangement, you are at risk that you will have the costs of employing staff and other fixed costs without any income. You should therefore charge a higher rate for the spot contract compared to the block contract.

Research undertaken by New Philanthropy Capital and published in *Surer Funding* (see references and further information) highlighted risk issues for charities providing services. You may need to invest in services at the outset and so need some reassurance that the funding will be secure for the future. If, however, your charity is required to take on the risk on future funding, then your price should reflect the risk and additional costs.

Case study Pricing for extra risk

Access for All has arrangements in place with the social service departments of local authorities to assess the mobility needs of disabled children. In the case of Local Authority A, the department is prepared to commit to a fixed grant for the year and expect Access for All to provide some input into policy, attend certain meetings and advise on children's mobility. If a child needs specific services, this is undertaken as a separate service. Local Authority B, however, only wants the specific service for a child.

Access for All have taken the decision that the specific service for a child should be more expensive per child in the case of Local Authority B as there is a greater risk that more time will be needed because there is no prior contact.

If you are selling services in an open market to many customers who are going to behave as consumers, then you may need to approach pricing in a different way to funding bids. For example, if you publish a book, you do not know how many books you are likely to sell, but you have to commit to most of the costs in advance. Consequently, publishing is a highly risky venture. You have to assess what the likely sales are going to be at different price levels. Set the price too high and no-one will buy the book. Set the price too low, and although you may sell more, the market for the subject may still be restricted and so you will still only sell a limited number of books and your overall income from sales will be lower than it needs to be.

So you need to research the prices charged for similar products or services, as you want to charge a comparable price. You also need to use experience within the organisation as far as possible to learn about the price/volume mix. How do your customers or users behave when prices are decreased or increased? You may find it worthwhile to experiment and pilot different approaches to pricing so that you can learn about their reactions. Often, managers believe that customers will react negatively to price increases, but this is not borne out when they try it out.

The best result is usually obtained when you operate differential pricing in some form. If you keep your prices low for the products or services that are available from competitors, then you may be able to achieve high enough volumes to make it worthwhile. However, your prices for specialist or unique products or services should be higher as your customers will be prepared to pay more for them.

Differential pricing may be effective for different customers. For example, you may charge a higher rate when providing consultancy services to a government department compared to the rate charged to a small voluntary organisation. In this way, you are maximising the contribution made in each situation.

Case study Pricing decision

With their accumulated knowledge and skills, Access for All think they should run training courses for professionals working in health and social service areas in the public sector as well as individuals in other charities and some private sector organisations. They have undertaken some market research and discovered that there are very few specialist courses of this type – most of their competitors run general courses that do not specifically address children's issues.

They plan ten one-day courses initially, two a month – each one has capacity for 20 people. They would use their existing premises for the courses, so there are no additional costs for the room. They would need to make an initial investment in furniture and equipment, likely to amount to £3,000. They would provide refreshments and lunch within the price, and have received a quote to supply this at approximately £20 a head.

They will publicise the courses through their network, on their website and through free events listings in the relevant press. However, to gain initial interest, they think they need to post a brochure to all their contacts about three months before the first course. This is likely to cost £1,500. After this, they will use email to remind contacts of the forthcoming events. They will use their own staff to lead the training; hence they are only planning to run ten courses. Any more than this and they would have to get in external trainers costing approximately £500 a day including travel expenses. They anticipate that they will receive about 30 bookings a month.

Based on the above Access for All has prepared an initial costing:

Variable costs – 200 @ £20	4,000
Fixed costs – publicity	1,500
Furniture and equipment	3,000
Total costs	8,500

Factors in the pricing decision

- They may not fill all the places on the courses
- Their premises may not continue to be available
- Staff may be unable to deliver the training and they have to get in outside trainers
- If staff are spending time devising and delivering courses, then they are not able to undertake other activities, so this represents an opportunity cost.

If they keep the training activity in-house without additional premises or trainer costs, then the contribution from each course will be very high. Therefore, from a financial point of view, there is little incentive to increase the number of courses. Providing fewer courses allows them to keep the price high – they do not need to charge a low price to increase the number of people attending courses. If they can get the balance just right, then they will maximise the contribution from courses.

There is a risk in setting high prices that some people from smaller organisations will not be able to afford the fees. Access for All could offer bursaries or reduced rates for people in these situations. In this way, they maintain the perception of high quality and value to the training, but still achieve their charitable objective of making the knowledge available to others. To maintain the overall level of income from each course, they could limit the number of bursaries or reduced rate places on each course.

6 Conclusion

Pricing decisions are very important as part of the financial strategies used in a charity. All funders and purchasers are making judgements about value. So as well as thinking about the costs of an activity as you prepare a bid or grant application, consider the value from the point of view of the funder. What is it that they want to achieve? What benefits need to be delivered for the beneficiaries of the service? What problem will you be solving?

If the funder does not consider that the price you are quoting is good value, then they may reject your bid or ask you to provide the service at a lower price. Care is needed at this point. You need to establish whether a cheaper service is needed and therefore you can lower your price and your costs. However, it may be that you have misunderstood the nature of the service required or the problem they are trying to tackle. Value is in the eye of the beholder.

If you are finding that there is a lot of pressure on fees or prices, then do some research on the market in which you are operating. It may be that other providers have moved into your market. This will exert downward pressure on prices and you will have to consider your position. Either you find ways of standardising the service to reduce costs or you need to consider whether you should stop the activity.

Pricing is therefore mostly about the external marketplace in which you are operating and the external environment for your charity. Costs may be easier to study, but research and knowledge about your external environment will provide important information for your charity's decisions.

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