The "targeted return on investment" approach to pricing provides a means for allocating overhead. It is based on beginning with pricing to meet a targeted return on investment (ROI). The procedure provides an estimate that covers all costs including overhead plus the pre-selected return on equity. The procedure has been widely supported by the Association of Landscape Contractors of America (ALCA). Broader and more varied applications are presented by Tucker in his book "Pricing for Higher Profits." Although the procedure is no cure-all, it does provide a framework for using already available accounting data.

**Projected income**

In order to get a specific price based on ROI, the income statement for the year ahead must first be projected. This is necessary in order to arrive at the price based on conditions when the service will be performed.

For a business engaged only in landscape construction, landscape maintenance, or retail nursery sales, departmental accounting is probably not worthwhile. However, since many horticulturally-related businesses offer all these products and services, I shall assume a three-activity firm.

The basis for projecting the income statement is the previous year's income statement, being sure to consider coming trends. If the previous year was abnormal, adjustments will be necessary.

Table 1 reflects the income statements for contracting and merchandising. The contracting department (landscape construction) was chosen for detailed illustration purposes. However, the same analysis was applied to the service department (maintenance) and merchandising (garden center).

Begin the process of projecting the next year's income statement based on a targeted ROI by re-classifying items on the income statement for the previous year. The data in Table 2 are the classified cost items for the contracting department as shown in Table 1.

**Direct and overhead costs**

Two major classifications are direct costs (those costs which are a direct function of the product or service) and overhead costs (those which do not vary with the volume of sales).

The overhead category is further divided into variable and fixed costs. Variable overhead costs fall between direct and overhead fixed. These costs vary somewhat in direct relationship to the volume of sales. If possible, this group of costs should perhaps be charged directly to the product or activity.

The data in Table 3 represent regrouped data from Table 2. Costs of goods have been shifted from the accounting format to an item of direct costs.

**Consider net worth**

The next item of information needed is an estimate of the owner's equity—or net worth—for the next year.

Suppose balance sheet values have been assigned to the three departments the same way as the departmental income statements. Then, each department gets its pro rata share of equity based on book value of equity.
Equity then needs to be adjusted to current market value so that the selected return is comparable to the best possible earnings on this sum of money if it were invested elsewhere. Suppose that the book value of the equity in the contracting department is $95,000. However, some assets appreciated, some fully depreciated. A conservative estimate of market value of equity is assumed to be $120,000.

Add previous year data

After estimating equity for the next year, data for the previous year are used along with budgeted fixed costs and targeted profit to find the sales to sustain fixed cost and profits. The historical relationship for direct costs and variable overhead, along with the projected fixed overhead and profit, generate the projected income statement.

Suppose that we select a 15 percent ROI as a goal. Profit then would be estimated at:

$120,000 x .15 = $18,000

Fixed costs last year were $71,554 and are expected to increase by 12 percent next year.

The total percent of sales figure is called the marginal ratio, or the amount of each dollar needed to cover fixed costs and profit. If these percentages of sales reflect trend, we use the marginal ratio in the next step. If not, we use a trend line to arrive at a representative value.

We now have the basis for completing the next year’s income statement (Table 5). Direct cost items are increased by the same percentage amount that sales for the next year are projected to increase above sales for the previous year. Variable overhead costs are expected to maintain the same proportional relationship as for the previous year. Since fixed overhead costs were projected to increase by 12 percent over the previous period, each cost item in this group is multiplied by 1.12. Profit is the goal of $18,000.

Subtotals

Next, the subtotals of costs are first multiplied by 1.12 and then the resulting numbers are added to the previous year’s fixed costs. This gives the total overhead costs for the next year.
from the values of a year earlier.

A new column called percent of exposure is added. These are calculated as a percentage of total direct costs. This value means that total direct costs must be marked up nearly 44.5 percent in order to break even if about $343,600 in sales are achieved.

An example

Let’s examine the procedure used to reach a bid price which meets the goal of 15 percent ROI.

Suppose the proposed job contains $10,000 of direct costs (materials, labor, etc.).

Overhead mark-up to direct job cost:

$10,000 × 1.4448 = break-even price

Target price = profit + break-even price

Target price - profit = break-even target price

Profit may be expressed as target price × profit as percent of sales which in this case is 5.24 or .0524. Substituting, we get:

Target price = .0524 target price = break-even target price

.9476 target price = break-even price

Target price = break-even price × .9476

$14,448 / .9476 = 15,247

Check:

$15,247 - $14,448 = $799

$899/15,247 = 5.24%.

Alternative: (Adjust exposure factor for profit)

1.4448 / .9476 = 1.5247

Illustrating with the job containing $10,000 direct costs:

$10,000 × 1.5247 = $15,247 target price

Material markup fixed

Often it is not possible to markup some of the materials to achieve the firm’s goal. When this is the case, other direct costs must be marked up more to compensate.

Suppose we have the following situation:

However, materials can only be marked up 20 percent instead of the 52.47 percent needed for targeted profit.

Therefore, labor and other direct costs must be marked up by 1.8494 instead of 1.5247 when they carry equal weights in total direct costs.

The service department

The past year’s income data are contained in Tables 5 and 6.

Next year’s income statement was projected on basis of a 15 percent return on equity with a market value of $50,000. Fixed costs in the department were also expected to increase by 12 percent.

Since profits in the previous year were negative, the negative value is used in calculating the marginal ratio:

Sales for the next year were projected as $132,750 = ($29,683 + 7,500)/.2801. The next year’s income statement is contained in Table 7.

Another strategy often used in pricing results when one item of direct costs greatly dominates, or when a major cost item such as labor maintains a fixed relationship to the other direct costs. When this is the case, this key factor may be used for bidding or pricing rather than using all direct costs.

The 1.4779 is multiplied by the ap-
For example, we shall use labor:

Sales $132,750

Direct costs $8,316
Cost of goods 16,551
Vehicles 59,968
Labor 4,966
Labor burden 3,276
Total direct 5,744
Overhead-variable 29,683
Overhead-fixed 125,250
Total costs $125,500

For example, we shall use labor:

Total Direct + Overhead + Profit = 1.4779

Thus, the markup is 2.2129 times direct labor instead of using total and direct cost.

Merchandising department

Tables 8 and 9 contain the data for the previous year for the merchandising department. Profit for the year ahead was projected as 15 percent on an equity with a current market value of $80,000. Fixed costs were projected to increase by 12 percent.

In order to achieve the $12,000 desired ROI, sales were projected at $220,189 (Table 10).

This required a factor of 1.3006 markup on direct costs to break even or 1.3755 to cover all costs and profit. Rather than pricing merchandise at retail as a function of direct cost, a more common policy is to mark it up as a function of merchandise (purchase) cost.

For example:

Sales $220,189

Direct costs Purchase $116,187
Vehicles 1,002
Labor 39,612
Labor burden 3,276
Total direct costs 160,077
Overhead-variable 11,318
Overhead-fixed 36,794
Total costs $208,189
Profit $12,000

Using the total of direct cost:

Total Direct + Overhead + Profit = 1.3755

$220,189 (Table 10).

The asking price

Note that we have looked at alternative applications of arriving at the price, what price do we actually ask? The asking price—cost of goods—is what price do we actually ask? The asking price is designed as the average realized by the department. Since some merchandise will
be lost, damaged and marked down, the initial asking price should be adjusted upward. Also, competition may make it difficult to get a full markup on some items so that other items must compensate. In some cases the exact calculated price may not fit conventional pricing strategy.

For example, almost no one would price a product at $10.51. So the calculated target price should merely be a starting place for arriving at the price finally used.

Adjusting the bid
How badly you want the job and the degree of competition influence the adjustment process. But how low and how high can you go?

Typically, we would say that on the low side, the bid should not be below variable or out-of-pocket cost. In the language we have been using, this would be all direct costs plus most of variable overhead costs. After all, in the short run, we are going to incur fixed overhead regardless of business volume.

At least two exceptions should be mentioned about the low price. In the case of contracting, for short periods of time it may pay to subsidize the labor cost in order to keep a valuable crew member. In merchandising we take whatever we can get for perishable merchandise such as Christmas trees at Christmas.

The higher bid
Consider at least two factors when bidding on the higher end of the spectrum: competition and the price/volume of business sales relationship.

For some products and services, a relatively high price sells fewer units, but total sales are higher than if a lower price were charged.

On the other hand, when price is increased, the percentage decrease in quantity sold exceeds the percentage increase in price. In this case the price increase results in a decrease in total sales.

If you have considerable competition and the services you offer are not particularly exclusive, the higher price may lead to lower total sales. In this case lower prices result in greater total sales. In this case knowing the price which meets your goal becomes especially important because you must, on average, meet your goal.

Weaknesses of price systems
All pricing systems have weaknesses, starting with the information put into the system. Even though you may not have started with the information from your income statement for the previous year, expenses and cost allocations are relatively arbitrary. Depreciation may be used for the expected life of the item or may be based on the fast write-off system allowed in recent years.

The targeted ROI approach has much appeal because it provides a method of allocating overhead costs. At least three warnings should be sounded:

1) Allocation of many costs among categories is somewhat arbitrary. Many cost items have some elements of more than one category.

2) The method works only if realized sales are in the vicinity of that amount projected. If you come up short, overhead costs not covered come from profits.

3) The method tends to place equal weight of overhead on each dollar of direct costs. Obviously, there are different demands on overhead for each job. Calculated bid priced may have to be adjusted in order to be competitive, but if downward adjustments are made on some, upward adjustments must be made on others to be offsetting.

A time of competition
There is no magic formula for pricing landscape services. However, some methods which recognize that general overhead must be recovered do not necessarily tell you how to price a product or service to cover it. The targeted ROI has the appeal of making the allocation, but caution is needed in applying the technique.

Competition in providing landscape services is increasing as more firms enter the business. Those firms which price their services in accordance with their costs are likely to be those which survive.

For some products and services, a relatively high price sells fewer units, but total sales are higher than if a lower price were charged for the service.

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