Z A Z E N T A X

Pricing for Profit

What your products really cost, what they can carry, and how to price them so the numbers work

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A practical guide for people who sell things online

zazentax.com

What is in this book

This is a short book about one chain of arithmetic. Each link is simple. The trouble is that most sellers only ever look at one or two of them, and the links they skip are usually the ones costing them money.

Why the price on your website is usually a guess

Ask a seller how they set a price and you will usually get one of three answers. They doubled what it cost them. They looked at what a competitor charges. Or the number felt about right.

None of those are unreasonable starting points. All three are guesses dressed up as decisions, and they share a common weakness: they start from a cost that is not the real cost, and they stop before the costs that arrive later.

A price has to carry more than the supplier invoice. It has to carry the freight and duty that got the product here, the fee the payment processor takes, the postage out, the occasional return, the advertising that found the customer, and then, at the end of all that, some profit. If it does not carry all of those, the shortfall does not disappear. It comes out of you.

This book follows one chain from end to end, using one real-shaped example throughout: a small homeware store selling a candle set at £45. By the last chapter you will know exactly what that £45 has to do, and how to work out the equivalent for anything you sell.

> A NOTE ON WHAT THIS IS NOT
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> This is not tax advice and it is not a pricing strategy book. It is the arithmetic underneath both. What you do with a healthy margin, or a product that turns out not to work, is a commercial decision. Knowing the number first makes it a decision rather than a hope.

1 The number you are pricing from is probably wrong

The supplier invoice is not what the product cost you. It is the first instalment.

A seller buys 500 units at £6.20 each. The invoice says £3,100, so the cost per unit is £6.20. That figure goes into the spreadsheet, the price gets set at three times it, and everyone feels the margin is comfortable.

But the goods had to get here. There was freight and insurance to the border, there was duty at the commodity code rate, and there was a customs clearance fee at the other end. None of that appeared on the supplier's invoice, and all of it is part of what the product cost.

The same shipment, counted properly

	What the invoice said	What it really cost
Goods, 500 units at £6.20	£3,100.00	£3,100.00
Freight and insurance	not shown	£880.00
Duty at 4% of the customs value	not shown	£159.20
Clearance and handling	not shown	£120.00
Total	**£3,100.00**	**£4,259.20**
Per unit	**£6.20**	**£8.52**

The true cost per unit is £8.52, not £6.20. That is 37 per cent higher than the number that went into the spreadsheet, and every margin calculated from the invoice price was overstated by the same amount.

> THE TRAP
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> Duty is charged on the goods plus the freight, not on the goods alone, so a shipment with expensive freight attracts more duty as well. Clearance fees sit outside that calculation, but they are still real money and they still belong in the cost.

If you are not VAT registered there is a fourth element: import VAT, charged at 20 per cent of the customs value plus the duty. On this shipment that is another £827.84, taking the unit cost to £10.17. A registered business reclaims it and it never touches the cost of the product. An unregistered one carries it, and competes against businesses that do not.

2 What a unit actually costs you

One shipment usually carries several products, and shared costs have to be spread across them.

Freight is charged for the container, not for the mugs. Clearance is charged for the entry, not for the teapots. So when a shipment carries three products, the shared costs have to be allocated, and how you allocate them changes the cost of every product in the box.

The standard method is to allocate by value share: a product that represents 40 per cent of the goods value carries 40 per cent of the freight. It is simple, it is defensible, and it is what most accountants will expect to see.

One shipment, three products

Product	Units	Goods	Freight	Duty	Per unit
Mugs	300	£1,860.00	£411.36	£90.85	£8.06
Coasters	800	£720.00	£159.24	£35.17	£1.17
Teapots	100	£1,400.00	£309.40	£68.38	£18.20
Shipment	**1,200**	**£3,980.00**	**£880.00**	**£194.40**	

Notice that the allocated freight and duty sum back exactly to the shipment totals. That is the test of any allocation method: nothing may be created or lost in the spreading.

Value share is not the only defensible method. If you ship something heavy and cheap alongside something light and expensive, allocating freight by value will understate the true cost of the heavy item considerably. Weight-based allocation suits that case better. What matters is that you choose a method deliberately, apply it consistently, and can explain it.

> **WORTH KNOWING**
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> Whichever method you choose, be consistent between periods. Switching from value to weight allocation halfway through a year makes your margins incomparable with last year's, which is the main thing you wanted to compare them with.

3 Margin is not markup

These are two different numbers and confusing them is the quietest way to undercharge.

Margin is profit measured against the price. Markup is the same profit measured against the cost. A product that costs £15 and sells for £25 has a £10 profit, which is a 40 per cent margin and a 66.7 per cent markup. Same product, same profit, two very different-sounding percentages.

The problem arises when someone decides they want a 40 per cent margin and applies a 40 per cent markup to get there. Cost £15 plus 40 per cent is £21, and £6 profit on a £21 price is a 28.6 per cent margin, not 40. They have undercharged by £4 on every unit and will not find out from the sales report.

What each margin actually requires

If you want this margin	you need this markup	so £15 of cost becomes
20%	25.0%	£18.75
25%	33.3%	£20.00
30%	42.9%	£21.43
40%	66.7%	£25.00
50%	100.0%	£30.00
60%	150.0%	£37.50

The two formulas are short enough to memorise. To turn a margin into a markup, divide the margin by one minus the margin. To go the other way, divide the markup by one plus the markup.

> THE SHORTCUT WORTH REMEMBERING
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> To price from a target margin, divide the cost by one minus the margin. Cost £15 at a 40 per cent target margin gives £15 divided by 0.6, which is £25. Never add a percentage to a cost and expect it to be a margin.

One boundary is worth noting: a 100 per cent margin is impossible, because it would mean the product cost you nothing. As the target margin approaches 100 per cent the required price runs away to infinity. If your pricing calculation ever produces an absurd number, check whether someone has typed a margin where a markup belongs.

4 The costs that arrive after the sale

Landed cost tells you what the product cost. It does not tell you what the sale costs.

Between a customer clicking buy and money settling in your account, several things happen that all cost money. None of them are in the landed cost, and most sellers underestimate all of them.

The four that always apply

- The payment fee. Typically a percentage of the whole transaction plus a fixed amount per order. On a £45 sale at 2.9 per cent plus 30p, that is £1.61. The fixed part is what makes small orders disproportionately expensive.
- Fulfilment. Picking, packing, the box, the tape, the label and the postage. Easy to underestimate because much of it is bought in bulk and never allocated to a single order.
- Returns. Not every order, but a predictable proportion of them. A return costs you the postage out, the fee the processor keeps anyway, often the postage back, the time to inspect it, and sometimes the item.
- Advertising. If a proportion of your orders come from paid traffic, then a share of that spend belongs to each order, whether or not you allocate it.

What the £45 candle set actually carries

	Per unit	Running total
Selling price	£45.00	£45.00
Landed cost	£14.00	£31.00
Fulfilment and postage	£4.50	£26.50
Payment fee at 2.9% plus 30p	£1.61	£24.90
Contribution before advertising	**£24.90**	

So the £45 is really £24.90 by the time the parcel is gone. That is still a healthy 55 per cent, and it is a completely different number from the £31 that a seller pricing off landed cost alone would believe they had.

> THE ONE MOST PEOPLE MISS
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> Payment fees are usually not refunded when you refund a customer. You give back the full £45 and the processor keeps its £1.61. A refund therefore costs you more than the sale ever made, before you have even counted the postage.

What a return actually costs

It is worth doing this arithmetic once, because the answer is larger than almost anyone expects. A returned candle set costs you the £4.50 postage you already spent, the £1.61 fee the processor keeps, perhaps £3.20 to get it back, and £2 of someone's time to open and check it. That is £11.31 before you know whether the product can go back on the shelf. If it cannot, add the £14 it cost you.

So a return costs somewhere between £11 and £25, against a contribution of £24.90. Every return roughly cancels one sale, and on cheaper products it cancels rather more than one, because postage and handling barely shrink when the price does.

This gives you a number worth knowing for every product: the return rate at which it stops making money. It is the contribution divided by the contribution plus the cost of a return. At £24.90 and £16, that is around 61 per cent, which is comfortably above any normal return rate. On a £9 product with £7 of return cost, it is 38 per cent, which apparel sellers can genuinely approach.

5 Contribution, the number that decides everything

Contribution is what one sale puts towards your fixed costs, and after those are covered, towards profit.

It is the single most useful number in a product business, and it has a precise definition: the price less everything that varies with the sale. Landed cost, fulfilment, payment fees. Not rent, not salaries, not software, because those happen whether or not you sell anything today.

Once you know contribution, four other questions answer themselves almost immediately.

What contribution tells you

- How many sales you need. Fixed costs divided by contribution per unit is your break-even volume. £4,500 of monthly fixed costs against £24.90 of contribution needs 181 sales a month before you have made a penny.
- The most you can pay for a customer. You cannot spend more than £24.90 acquiring a sale of this product and still be ahead. That is your absolute ceiling on cost per acquisition, before any profit.
- How many returns you can absorb. If a return costs you £16 and a sale contributes £24.90, then somewhere around a 60 per cent return rate the product stops making money. Most products are far below that, which is reassuring, but cheap products with fixed handling costs are not.
- Whether a discount is survivable. A 20 per cent discount on a £45 product costs £9, which is 36 per cent of your contribution. You would need to sell 56 per cent more units to stand still.

The same product at different prices

Price	Variable cost	Contribution	Margin	Units to cover £4,500
£38	£19.60	£18.40	48.4%	245
£42	£19.72	£22.28	53.0%	202
£45	£20.11	£24.89	55.3%	181
£50	£20.25	£29.75	59.5%	152
£55	£20.40	£34.60	62.9%	131

Two things stand out. The variable cost barely moves, because only the percentage fee scales with the price. And the units needed to cover the fixed costs fall much faster than the price rises: a 22 per cent price increase from £45 to £55 cuts the break-even volume by 28 per cent.

Why discounting hurts more than it looks

A discount comes entirely out of contribution, because none of your costs fall when you drop the price. Twenty per cent off a £45 product is £9, and £9 out of £24.90 is 36 per cent of everything that sale was going to give you.

To stand still you would need to sell enough extra units to replace that contribution. At £15.90 of contribution instead of £24.90, you need 24.90 divided by 15.90, which is 57 per cent more units, not 20 per cent more. A discount that lifts sales by a third still leaves you worse off than not running it.

> **THE DISCOUNT TEST**
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> Before running any promotion, work out the percentage uplift in units you would need just to break even on it. If that number is larger than any promotion has ever delivered for you, the promotion is a way of buying revenue with profit, which is fine as long as it is a decision rather than a surprise.

6 What advertising does to your price

Break-even ROAS is one divided by your contribution margin. That single fact explains most failed ad accounts.

Return on ad spend is revenue divided by advertising cost. A 3x ROAS means £3 of sales for every £1 spent. What matters is not whether 3x sounds good, but whether it is above the point where your product stops losing money, and that point is set entirely by your margin.

The arithmetic is short. If your contribution margin is 50 per cent, then every £1 of sales gives you 50p to spend, so you break even at 2x. At a 25 per cent margin you only get 25p per £1 of sales, so you need 4x. Thin margins make advertising brutally hard, and no amount of creative testing changes the arithmetic.

The ROAS you need, by margin

Contribution margin	Break-even ROAS	To keep 10% of revenue	Max ad spend per £45 order
25%	4.00x	6.67x	£11.25
35%	2.86x	4.00x	£15.75
45%	2.22x	2.86x	£20.25
55.3%	1.81x	2.21x	£24.89
65%	1.54x	1.82x	£29.25

The candle set, at a 55.3 per cent margin, breaks even at 1.81x and needs 2.21x to leave a tenth of the revenue as profit. A seller reporting 2.5x on that product is genuinely making money. A seller reporting 2.5x on a 25 per cent margin product is losing it on every order, while the ad platform reports success.

> TWO HONEST CAVEATS
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> Ad platforms claim credit generously, so the ROAS in the dashboard is usually better than the ROAS in your bank account. Judge against blended ROAS, which is total revenue over total ad spend. And if customers genuinely reorder, a first order below break-even can be rational, but that is a decision to make deliberately, with a repeat rate you have measured rather than hoped for.

7 Pricing backwards from the margin you need

Most pricing works forwards from cost. It is more useful to work backwards from what the price has to carry.

Start with the margin you need rather than the cost you have. If you know that you want to advertise this product at a realistic 2.5x ROAS and still keep 10 per cent of revenue, that dictates a contribution margin, which dictates a price.

The method, in four steps

- Work out the variable cost of one unit, properly. Landed cost, fulfilment, and the fee. Everything that only exists because the sale happened.
- Decide the contribution margin the product must earn. If you advertise, work backwards from the ROAS you can realistically achieve: a margin of one divided by your target ROAS, plus whatever profit share you want to keep.
- Divide the variable cost by one minus that margin. That is your price before VAT.
- Sanity check it against the market. If the answer is far above what anyone charges, the problem is the cost, not the pricing method, and chapter nine deals with that.

Worked through

Step	Working	Result
Variable cost, excluding the percentage fee	£14.00 + £4.50 + £0.30	£18.80
Target contribution margin	1 ÷ 2.5x, plus 10%	50.0%
Price before the percentage fee	£18.80 ÷ (1 − 0.50 − 0.029)	£39.92
Round to a sensible shelf price		£39.95
Contribution at that price		**£19.99**

The percentage fee has to be inside the divisor rather than added to the cost, because it scales with the price you are solving for. Adding 2.9 per cent to the cost first and then applying the margin will leave you slightly short every time. It is a small error per unit and a large one per year.

8 Raising a price, and what it is actually worth

A price rise drops almost entirely through to profit. A volume increase does not.

This is the most underused piece of arithmetic in small retail. When you sell one more unit, you keep the contribution on it, which on the candle set is £24.90 out of £45. When you raise the price by £1, you keep the whole pound, less only the percentage fee on it. Roughly 97p of every pound of price increase is profit.

Five per cent more price against five per cent more volume

	5% more volume	5% higher price
Price	£45.00	£47.25
Units sold	1,050	1,000
Contribution per unit	£24.89	£27.08
Total contribution	**£26,135**	**£27,080**
Change against today	+£1,245	+£2,190

The price rise is worth roughly three quarters more than the equivalent volume increase, and it costs nothing to implement. No extra advertising, no extra stock, no extra parcels to pack.

How much volume you can afford to lose

The obvious objection is that a higher price sells fewer units. That is usually true, and the question is how many fewer you can afford. The answer comes from the same numbers.

At £45 you contribute £24.89 per unit. At £47.25 you contribute £27.08. To stand still on total contribution you need £24.89 divided by £27.08, which is 91.9 per cent of your previous volume. In other words you could lose more than eight per cent of your units and still be no worse off, and anything better than that is straight profit.

> THE RULE OF THUMB
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> The fatter your margin, the less a price rise buys you and the more volume you can afford to lose. The thinner your margin, the more a price rise is worth and the less volume you can afford to lose. Thin-margin businesses have the most to gain from pricing and the least room to get it wrong.

9 What VAT registration does to your price

Crossing the VAT threshold is a pricing event, and it arrives whether or not you have planned for it.

Once your taxable turnover passes £90,000 in any rolling twelve months, registration is compulsory. From that point a fifth of everything a consumer pays you belongs to HMRC, and you face a choice you cannot avoid: put your prices up, or absorb it.

Most sellers assume absorbing it costs them twenty per cent. It does not, because registration cuts both ways. You start charging VAT on sales, but you also start reclaiming it on your costs, and for a business buying stock and services that reclaim is substantial.

The candle set on the day after registration

	Before	Absorbing it	Passing it on
Shelf price to the customer	£45.00	£45.00	£50.50
VAT you hand over	none	£7.50	£8.42
Revenue you keep	£45.00	£37.50	£42.08
Landed cost, net of reclaimed VAT	£14.00	£11.67	£11.67
Fulfilment, net of reclaimed VAT	£4.50	£3.75	£3.75
Payment fee, VAT exempt	£1.61	£1.61	£1.76
Contribution	**£24.89**	**£20.47**	**£24.90**

Absorbing the VAT costs about eighteen per cent of your contribution, not twenty. And restoring it does not require a twenty per cent price rise either: lifting the shelf price from £45 to £50.50, a rise of twelve per cent, puts you exactly back where you started. The reclaim on your costs does the rest of the work.

> THE NUMBER WORTH KNOWING BEFORE YOU CROSS
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> Twelve per cent, not twenty. That is a very different conversation to have with your customers, and a very different judgement about how much volume you might lose. Sellers who assume they must raise prices a fifth often conclude that registration will ruin them, and quietly hold their turnover below the threshold instead.

Two things that change the answer

— Who your customers are. If you sell to other VAT-registered businesses, they reclaim the VAT you charge, so passing it on costs them nothing and the whole problem largely disappears. If you sell to consumers, every penny of it is a real price rise to them.

- What you sell. Zero-rated goods, which include most food and children's clothing, carry no VAT on the way out but still let you reclaim on the way in. For those sellers registration is usually worth volunteering for well before the threshold forces it.

The mirror image is worth stating too. If you are below the threshold, buy a lot of stock, and sell mainly to businesses, voluntary registration may pay for itself immediately. It is one of the few decisions in tax where doing it early can be straightforwardly better.

10 When the numbers say no

Sometimes the arithmetic produces an answer you do not want. That is the arithmetic doing its job.

Occasionally you will work through this chain and find that the price required is higher than anyone in your market charges, or that the contribution is so thin that no realistic ROAS makes the advertising work. This is useful information, arriving before you have spent the money rather than after.

Three ways out, in order of how often they work

- Reduce the variable cost. Better freight terms, a larger order at a lower unit price, lighter packaging, a cheaper fulfilment route. This is the least glamorous option and the one that most often works, because a pound off the cost is worth exactly as much as a pound on the price.
- Raise the price and accept fewer units. Chapter eight showed how much volume you can afford to lose. It is usually more than people expect, and a smaller number of better orders is a perfectly good business.
- Change what you are selling. Bundles raise the order value without raising the fee much, because the fixed part of the payment fee and the postage are spread across more goods. A £45 order and a £90 bundle cost almost the same to ship and process.

And one that does not work

Selling more of a product that loses money on every order. If contribution is negative, volume makes the loss bigger, not smaller. There is no break-even volume, no ROAS that rescues it, and no marketing budget that helps. The price or the cost has to change first.

> **BEFORE YOU DELETE A PRODUCT**
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> A loss-maker is not automatically a mistake. It might be the thing that brings first-time buyers who then buy the profitable range, or the item that lifts an order over your free shipping threshold. Look at what it does for the basket before you cut it. What this book gives you is the cost of keeping it, so the decision is made with a number rather than a feeling.

11 The whole thing, end to end

One product, one page, every link in the chain.

Here is the candle set from the supplier's invoice to the profit on an advertised sale, with every number from the previous chapters in one place.

	Amount	Notes
Supplier price	£6.20	the number most sellers price from
Freight, duty and clearance	£2.32	allocated across the shipment
Landed cost	**£8.52**	**37% above the invoice**
Selling price	£45.00	excluding VAT
Less landed cost	−£14.00	this product, larger unit
Less fulfilment	−£4.50	
Less payment fee	−£1.61	2.9% plus 30p
Contribution	**£24.89**	**55.3% margin**
Break-even ROAS	1.81x	1 ÷ margin
Target ROAS for 10% profit	2.21x	
Advertising at 2.5x achieved	−£18.00	£45 ÷ 2.5
Profit on the order	**£6.89**	**15.3% of revenue**

Every number in that table came from a rule you can apply to anything you sell. The landed cost came from the shipment, the contribution came from subtracting what varies, the break-even ROAS came from one divided by the margin, and the profit came from what was left.

A seller working from the supplier invoice would have believed this product cost £6.20 and carried a 86 per cent margin. The real figure is 55.3 per cent before advertising and 15.3 per cent after it. Both are perfectly good numbers for a small store. The difference is that one of them is true.

What to do on Monday

Three things, in this order, and none of them take an afternoon.

Work out the landed cost of your best seller

Take your last shipment, add the freight, duty and clearance, allocate them across what was in the box, and divide by the units. Compare the answer with the number you have been using. If they are the same, you are ahead of most sellers. If they are not, every margin you have calculated this year was wrong in the same direction.

Work out its contribution and its break-even ROAS

Subtract the landed cost, the fulfilment and the payment fee from the price. Divide the price by what is left. That is the return your advertising has to clear before it is doing anything for you, and it is worth knowing before the next campaign rather than after it.

Do the same for your worst seller

Not your smallest seller: your worst. The one where the margin is thin, the returns are frequent, or the advertising has never quite worked. It is usually a different product from the one you assumed, and finding out costs nothing.

> THE FREE TOOLS THAT DO THIS ARITHMETIC FOR YOU
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> Every calculation in this book has a free calculator on zazentax.com: landed cost, cost of goods sold, profit margin, break-even, and break-even ROAS. Each one also comes as an Excel workbook with a worked example, and they all use the same numbers as this book.

And when it stops being arithmetic

Pricing is arithmetic. What sits around it, whether to incorporate, how to treat stock at the year end, what your VAT position does to your pricing, and how much of the profit reaches you rather than HMRC, is not. That is where an accountant earns their fee, and it is a conversation worth having while there are still choices to make.

Zazen Tax

Accountants for people who sell things. zazentax.com/contact