PRICING & COSTING for Small Business

Setting a price for goods and services has always been difficult for small businesses. In fact, a survey of Australian small businesses found that arriving at a price was often the most difficult decision facing the owner/manager.

There are no firm rules; no ideal method for setting a price, but there are many indicators that can help you. It is a matter of discovering a reasonable price by careful consideration.

Pricing is a critical marketing decision. The price you set for your goods and services is a key determinant in the final profit (or loss) that your business will make.

Even though it is so obviously vital, there is evidence to suggest that the attention paid to pricing among some small businesses is scant. Problems that develop of because of inattention to pricing, range from poor margins on products sold, through to losses on specific products/services due to cost inflation and failure to re-price. At worst it could mean the difference between making a profit or a loss.

The factors that affect your prices can be grouped under four headings:
- Your costs
- Your marketing strategy
- Controlled prices
- Market conditions

The ***right*** price is often a combination of these factors.

Obviously the price you set must cover all the costs of running your business.

DETERMINING YOU COSTS

The costs of running your business will greatly affect the prices you must charge. If you determine the all-inclusive cost of an article or service you will be in a much better position to determine if your price is realistic. Yet determining the exact cost of an item is never easy. You may determine fairly easily how much the materials cost you or how much you bought the item for. But what about all your other costs? What about your labour and all you other expenses? How much of that do you add to you price?

Take a close look at the extent and range of costs facing your business. (See Business Costs Checklist) and ensure that you apply all of these costs to specific products and services to ensure that they are recovered in the price charged.

THE NATURE OF COSTS

To be able to project costs at various levels of production we need to understand how each cost will behave in relation to business activity – will it increase, decrease or remain static? The nature of costs can be divided into three categories: fixed, variable and semi-variable.

Fixed Costs are those costs that do not vary with the level of business activity. These are costs that you must pay irrespective of whether you make or sell one unit or 1,000 units. ***Examples*** include rent, depreciation, lease costs, loan repayments and insurance.

Variable Costs vary directly with the level of business activity or sales. Your variable costs are therefore much higher if you sell or make 1,000 extra units. ***Examples*** include the purchase of stock, raw material, manufacturing labour.

THE NATURE OF COSTS Cont'd..

Semi-variable Costs vary with the level of business activity but not in direct proportion. ***An example*** would be a telephone bill that would have a fixed component (i.e. rental charge) and a variable component (i.e. charge per call). If you business relied on telephone sales, a busy period would see an increase in your telephone bill but not in direct proportion to the increase ins ales.

IDENTIFYING COSTS

The first step in costing is to identify the type of costs that have gone into the article manufactured, the stock item sold or the service provided. To do this costs are classified into **direct costs** and **indirect costs**

Direct costs are costs which are directly traceable to a specific job or sale. ***Examples*** include cost s of stock, labour or raw materials,
Direct costs are usually variable because they vary directly in relation to the number of articles produced, goods sold or services provided. Direct costs are usually divided into ***direct materials*** and ***direct labour***.

Indirect costs are costs which cannot be directly traced to the specific job or sale.
Examples include financial expenses, advertising or administration costs.
Indirect costs are those costs which cannot be directly identified with the product behind made, the service being performed or the article being sold. They are often ***fixed*** in nature as they do not fluctuate in direct proportion to the number of articles being produced or sold. Instead indirect costs tend to remain constant over a given period of time. These costs are generally called overhead expenses and are often classified as selling, financial or administration expenses. Some more examples of Indirect Costs found in many small businesses include:

▪ Rent ▪ Insurance ▪ Lease payments ▪ Rates & taxes	▪ Office utilities ▪ Interest on borrowings ▪ Advertising ▪ Legal Fees

None of these costs can be directly allocated to specific products or services, but must be shared by all.

In Manufacturing and some service industries (e.g. building industry) there is another type of cost called ***indirect manufacturing expenses***. These expenses include all those costs incurred in the production process which cannot be considered direct materials or direct labour.

For example, in constructing a frame, the amount of glue used could possibly be measured with a reasonable degree of accuracy. However, the cost of the time and effort involved in doing so would outweigh any benefit. From a practical viewpoint, we classify such items as indirect manufacturing expenses.

These costs can be fixed, variable or semi-variable in nature. As they are considered to be part of the cost of manufacturing an item or completing a job, they are separated from other indirect costs (i.e. selling, administration and financial expenses) so that a true picture of the cost to complete an item/job can be found.

IDENTIFYING COSTS Cont'd….

Some examples of the indirect manufacturing expenses include:

▪ ***Manufacturing supplies*** – All materials which are difficult or impossible to identify with specific jobs e.g. glue, nails, wrapping, machine lubricants, cleaning materials	▪ ***Workers compensation insurance*** – Includes amounts relative to all personnel associated with manufacturing activities.
▪ ***Depreciation on machinery*** – Covers amounts for deprecation on all machinery and equipment used in the manufacturing process	▪ ***Factory light and power*** – Strictly speaking, only light and power consumed in the factory should be charged to this account, while that used by other non-manufacturing sections should be charged to a separate account. In a small business this would not be practicable and only one account would be used.
▪ ***Indirect wages*** – Costs of labour involved with manufacturing activities, but which cannot be charged directly to specific jobs, e.g. Wages of estimators, supervisors, store-persons etc.	▪ ***Motor vehicle running costs*** – In the building industry, where workers would travel from site to site, the running costs of motor vehicles would be an indirect cost of completing the jobs. In most other businesses, motor vehicle costs would be considered an overhead expense.

TRANSPORT COSTS

An area often under-estimated when identifying costs is that of transportation.

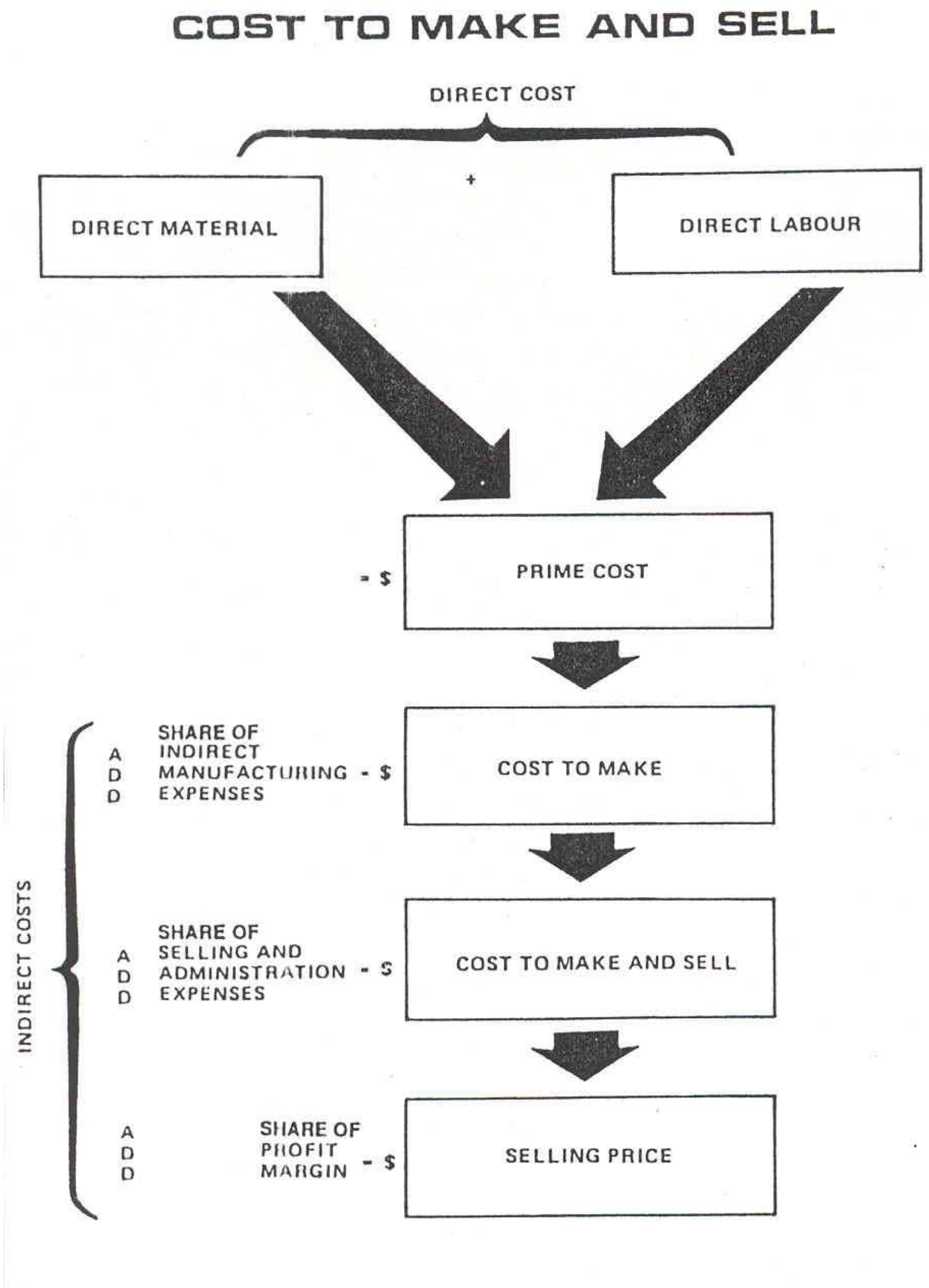
If you are the buyer o stock or raw materials, you must take account of the point on the transport chain at which the price is quoted. The will need to be sure that all costs (transport rates, insurance, handling, other charges) are allocated to the specific goods purchased.

Cost to you of an item is not just the purchase price, but the total cost of the item to arrive at your store. In other words the direct material costs will include the purchase price and freight. If this is too difficult to calculate, the freight should be included as an indirect manufacturing cost.

Transport costs (freight, delivery charges) can be a significant proportion of the total cost of an item. When pricing your products and services it is important to consider how the goods will be transported between buyer and seller.

COST TO MAKE AND SELL

Having identified your direct and indirect costs you can now calculate the total cost to make and sell a product/service as in the following diagram.



The **Price Cost** includes direct material and direct labour, with an appropriate share of indirect expenses and profits being added to it to arrive at a selling price.