

COSTING & PRICING

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Costing is the process of working out how much it costs to provide a product or service.

Pricing is the process of working out what price you will sell your product or service, taking into account costs, profit margins and what the market will bear.

The main focus of this guide is on costing products. Costing services follows the same process except no allowance is made for materials. To effectively operate a business you need a good understanding of costing and you need an accurate costing system.

To cost a product you add the profit margin you want to the cost of labour, overheads and materials. The process of calculating labour, overheads and material costs is explained in the following pages and illustrated using the example below. A summary of costings for Tom's business is provided on the back page of this guide.

EXAMPLE

Tom Brown is starting a business producing jewellery. In addition to normal annual, statutory and sick leave Tom expects to have 25% non-chargeable time for travelling, administration, quiet times, etc. He will take \$20,000 drawings per annum and has budgeted \$18,260 overheads for the first year of operation. Material costs per pendant are estimated at \$10.00.

LABOUR COSTS

- The steps for calculating the cost of labour are:
- Calculate total hours before any allowance is made for down time. In our example this amounts to 40 hours per week x 52 weeks per year = 2080 hours.
- Make a provision for time you will need to be paid for but you will not be at work eg. annual holidays, sick leave, statutory holidays, training courses etc. In Tom's example this adds up to 248 hours per annum. This leaves 1832 hours when Tom will be at work.
- Work out chargeable hours available. Deduct from hours at work non-chargeable hours for travelling, administration, personal breaks, quiet times, etc. In Tom's example this is 25% of 1832 hours or 458 hours. This leaves chargeable hours of 1374. Although Tom is working full-time, the business only has 1374 chargeable hours to generate income. Forty-four percent of the time Tom needs to be paid for is non-chargeable.
- Decide on annual salary or drawings required. The business needs to be able to provide reasonable compensation for time and efforts. However don't go overboard or you will price yourself out of the market. Tom has decided on drawings of \$20,000 per annum.

- Divide annual salary by number of chargeable hours available to get the charge out rate required for labour. Tom's labour charge-out rate will be $\$20,000 / 1374 = \14.56 .
- Multiply labour charge-out rate by the number of hours needed to produce the product or service. A jewellery piece takes Tom 1.5 hours to produce which means a total labour charge out of \$21.84.

OVERHEAD COSTS

When costing a product or service in addition to covering labour and material costs you need to cover general operating expenses such as phone, rent, repairs and maintenance, etc. These costs are called overhead costs.

The steps to follow in allocating overhead costs are as follows:

- Estimate overheads for the year ahead. Tom has budgeted for \$18,260 for his first year of operation.
- Allocate overheads to the job. There are different ways of doing this. In Tom's example we calculate this as a rate per chargeable hour, then multiply by 1.5 (the number of hours spent on an item). ($\$18,260 / 1374 \times 1.5 \text{ hours} = \19.93)

This system of allocation suits businesses with a high labour content and a similar ratio of labour to materials for all products or services.

This allocation method does not suit all businesses. Another common method of allocation involves calculating overheads as a percentage of the materials and labour costs of a job. If you are unsure how to allocate overheads discuss it with your accountant or business adviser.

MATERIAL COSTS

If you are providing a service with no material usage you can ignore this step.

If you incorporate any materials in your product you need to calculate their cost as follows:

- Calculate the cost price of materials used in each product.
- Add an allowance for the following costs, if applicable:
 - Freight or transport.
 - Cost of holding materials, eg. finance, insurance, etc.
 - Wastage, damage and reject materials.

Over time you will learn what add-on allowances need to be made. In Tom's example, each piece will use \$6 of material and \$4 for the plaited necklace. Total costs

Costing & Pricing

are \$10 which includes a 25% adjustment for the above mentioned factors.

TOTAL COST

To establish total cost of product, add labour cost, overhead cost and materials cost.

In Tom's example cost of product is;
 $\$21.84 + \$19.93 + \$10.00 = \51.77 .

PROFIT AND SELLING PRICE

The calculations we have worked through show you how to find the cost price of your product. At that price you will only be breaking even. Your selling price should include some profit (generally called profit margin).

Profit provides a reward for risk, time and effort and a fund to expand and develop your business. It also provides reserves for down times.

Your profit margin will depend on what pricing strategy you adopt. Three pricing strategies and the logic behind them are listed below:

1. Meet the Competition: You pitch your price at a similar price to your competition.
2. High Pricing (Skimming): Under this approach you put a high price on your product due to lack of competition or to reinforce an image of quality and exclusivity.
3. Low Pricing (Penetration): With a low pricing strategy you are aiming to attract custom on the basis of price. Lower prices generally mean greater demand (all other things being equal) but may also infer inferior quality. Remember, you can't price your product lower than your costs.

Your decision as to what pricing strategy you use will depend on:

- i Volume of sales sought.
- i Influence of competitors.
- i Quality of Product.
- i Image of product sought.
- i What the market will bear.

Even if you are adopting a low pricing strategy you must make sure you are making some profit. Remember, profit is not a dirty word. It is a necessary element of all healthy and growing businesses.

The following example summarises the costing and pricing process used for Tom's business. A 20% profit margin is assumed.

TOM BROWN COSTING EXAMPLE

LABOUR COSTS	\$	\$
40 hours x 52 weeks		2080
Less:		
Annual Holidays 8hrs x 15 days	120	
Statutory Holidays 8hrs x 11 days	88	
Sick leave 8hrs x 5 days	40	
		248
Hours Tom will be at work		1832
Less 25% of 1832 of non-chargeable time		458
Chargeable hours available		1374
Drawings pa	\$20,000.00	
Divided by	1374	
Labour charge-out rate per hour		\$14.56
Number of labour hours per item		1.5
Total labour charge-out for item		\$21.84
OVERHEAD COSTS		
Overheads budget for year	\$18,260.00	
Divided by chargeable hours	1374	
Overhead charge-out rate per hour		\$13.29
Number of overhead hours per item		1.5
Total overhead charge-out for item		\$19.93
MATERIAL COSTS		
Cost of materials and plaited necklace		\$10.00
TOTAL COST OF PRODUCING ITEM		\$51.77
Plus profit margin of 20%		\$10.35
SELLING PRICE OF ITEM		\$62.12

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