ANNEAL
BUSINESS COACHING

How Much Does it Cost?

"MIXING FIXED AND VARIABLE COSTS CAN LEAD TO SOME SERIOUS ERRORS IN JUDGMENT."

HOW MUCH DOES IT COST?

"How much does it cost?" Such a simple question.

At least it is if you have a receipt in your bag from the store where you bought "it." For those of us who bid jobs or price our manufactured products, cost can be one of the most confounding issues in business.

We all want to know our costs because that's what we subtract from sales to see if we made a profit. No problem there, just add up all our expenses and that's our total cost. But many of us also use cost to price our bids and products.

That requires a different understanding of cost, and that's where the confusion sets in.

VARIABLE AND FIXED COSTS

My experience has shown that confusion about using cost for pricing decisions comes from a misunderstanding of the behaviors of variable and fixed costs.

Variable costs, such as material and production labor, go up and down with sales. If we double our sales, we also double our variable costs.

Fixed costs, also called overhead, are independent of sales. They remain the same, or very nearly so, from month to month.

That means that the cost of a job or product is its variable cost and does not include all or any portion of overhead.

Let me expand on that.

If we win the sale, we incur additional variable costs. If we lose the sale, we avoid those additional variable costs, but in either case, our fixed costs remain the same. Variable costs, then, are the costs of production. Overhead is the cost of maintaining the capacity to produce.

HOW MUCH DOES IT REALLY COST?

"Okay," you're thinking, "but I still have to pay overhead. Don't I have to add those costs to my products?"

The short answer is "No."

Allocation of overhead to products is known by various names such as "burdening" or "cost absorption" or sometimes as: "I gotta charge something for overhead." It's usually done in an attempt to get to the "real" cost of a product.

The problem with allocating fixed costs to jobs or products is that the allocated amount is always arbitrary. As sales change, the "real" cost changes, so in what sense is it real? (A fixed amount of overhead divided by different sales volumes gives a different cost for each volume).

MIXING COSTS LEADS TO ERROR

Mixing fixed and variable costs can lead to some serious errors in judgment such as this one by a former client:

My former client is a job shop that provides welding services. Their actual variable labor costs, including insurance, benefits and taxes, were about $25 per hour. In order to, as they put it, "make something to cover overhead," management burdened each labor hour with an overhead charge of $55 per hour.

No one could tell me the origin of the $55, but there it was, imbedded in a labor "cost" of $80 per hour.

To be clear, there is nothing wrong with selling $25 labor for $80, which is a pricing decision. The problem was that the $80 figure became actual "cost" in their minds, replacing true variable costs.

That led to the bad decisions.

The company not only lost work due to overpricing bids, but also routinely passed on work paying less than $80 per hour because they believed they would lose money.

I hope you recognize the fallacy in that logic. A job paying $55 per hour is not as nice as one paying $80 per hour, but would still contribute $30 per hour toward paying overhead and profit.

RECOVERING YOUR COSTS

So how do we recover overhead costs if we don't add them to the cost of our products?

The answer is margins.

Margins are the difference between our selling price and our variable costs. Instead of adding overhead cost to our products to determine price, we apply margins from product price to pay overhead.

Once the overhead is paid, our margins become profit. Big difference. Where burdening creates confusion and leads to bad decisions, margins lead to clear thinking and rational decisions. To see how it works, see my article "The Most Important Number in Business."

COST HAS NOTHING TO DO WITH PRICE

As a final word, I want to be sure I haven't misled you.

I have been talking about using cost to determine price because that's what many of us do. However, pricing decisions are really easy: just charge as much as the customer will pay, but never less than variable cost.

Beyond that, cost has nothing to do with price. To illustrate, if you found a diamond in the street, would you sell it for pennies because your costs were low? On the other hand, would you expect a customer to pay a premium because your guys messed up and had to redo an entire project?

The obvious answer to both questions is: "Of course not."

In spite of that, we've all seen competition drive prices down toward the lowest-cost competitor, at least for "commodity" services or products.

The secret to higher prices is to differentiate ourselves. Buyers look for reasons to choose one competitor over another. If there are no meaningful differences between them, they will choose based on price.

Give customers reasons other than price to choose us, and we have the opportunity to raise prices. When that happens, it is important not to sabotage our pricing with preconceived notions about a link between cost and price.

HOW ABOUT YOU?

Do you know your variable costs? Do you add "something" to your variable costs to recover overhead? Do you base your pricing decisions on your cost or on what the customer will pay? Have you ever tested higher prices to see what customers will pay?

If you have any further questions, please don't hesitate to mail me at Martin@annealbc.com or visit www.annealbc.com

Martin Holland

Martin Holland is the son of a successful entrepreneur. He grew up hearing about margins and markets, R&D and sales, risk and return on investment. He learned to love the language and rigors of business and grew to believe that business is both the most human of all endeavors and the highest calling. After selling a company in 2011, Martin became a coach in order to help other owners build profitable businesses that do not require their day-to-day involvement.

A native of Norman, Martin earned a B.A. degree from Hastings College in Hastings, Nebraska and a Masters in Business Administration degree from the University of Oklahoma. Over the past 7 years he has written business plans that have raised over $52.4 million in bank and investor financing. He has helped 157 (and counting) business owners reduce stress and increase performance through clarity of purpose, better marriages, more money, and more free time away from the business.