

Business Advisory Group

The Small Business Doctors

Activity Based Costing

In a recent consultation our client was seeking an advice on the proper costing of a product to optimize his sales potential without overpricing or under pricing. We also felt that this is a very common question many small business owners face, particularly in the current climate of a strong competition. This column deals with some of the salient points that each business owner must address to arrive at the price that s (he) should assign to the product(s) or service they intend to sell on the open market. The activity based costing [ABC] would provide a broad based assessment of what is needed to reach that “optimum” pricing:

Activity Based Costing (ABC) can replace traditional accounting systems or operate as standalone model. To build an ABC system, companies should:

- Determine key activities performed [cutting, milling, packing, etc.]
- Determine cost drivers by activity
- Group overhead and other indirect costs by activity using identified drivers
- Collect data on activity demands [by product]
- Assign costs to products (based on activity usage)
- Most companies use the results of the ABC analysis to either re-price products or reduce costs
- Assign a value for the margin [20%, 30 % or 40%] you wish to add to the basic cost

In “Re-Pricing” products, companies can more accurately analyze product profitability by combining the ABC cost data with “price information”. Re-pricing or eliminating unprofitable products increases profitability. Traditionally, this is referred as “cash cows”, or “dogs”. Lowering prices on products that have been subsidizing unprofitable products, increases volume, and thus profits.

Reducing costs on the other hand, stems from the ability of the analysis to identify the company’s overhead costs and the drivers of cost variability. Owners can reduce costs by decreasing the cost of an activity or reducing the number of activities required per unit of production.

In conclusion, the Activity Based Costing (ABC) system provides a means of estimating the optimum costs of new products. In understanding cost drivers, owners or managers can design and price products more accurately and thus stay competitive. Remember, next to the product quality and superior service, cost is one of the key factors that ultimately prompts people or corporations to decide whether to buy or not to bury a product or service.

The Business Advisory Group (BAG) is an incorporated, not-for-profit organization whose members volunteer their time and expertise to provide solid business advice based on a lifetime of experience.

We operate in Oakville, Burlington and Hamilton, offering meetings in a number of convenient locations.

One of our most popular service offerings is a half-day client meeting with typically three of our members who will develop an understanding of your situation, offer suggestions, and follow-up with a written summary of the major points. The fee for this is \$150, which provides funds to cover expenses such as liability insurance for our members, who provide their skills free of charge.

Call toll-free: 1-877-381-1990, or (905) 381-1999 which is local in the Burlington area. Leave a message (name, phone number and best times to call) and one of our volunteer coordinators will get back to you.

BAG@smallbusinessadvisory.com
www.smallbusinessadvisory.com