Price and Cost Analysis

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One of the fundamental aspects of running a successful business is conducting effective price and cost analyses. However, several different strategies and techniques can be used, and the technique that works best in one industry may not be helpful in another. Identifying a strategy that will work best in a particular industry or in a specific business depends on several factors, and the best choices are usually made by analysts with over a decade of experience in a variety of industries or by those who have been educated in classes taught by these knowledgeable individuals.

The efficient utilization of resources is imperative in determining fair and reasonable prices in a marketplace overrun by competition, but first the resources must be identified. Price analysis strategies cover the identification of resources, and these strategies are based on comparing competition in the marketplace. Cost analysis strategies are much more complex and require that both direct costs and indirect expenses of products and services are figured into the price equations.

After price and cost analysis strategies are applied, resources identified and total expenses figured, the next step in the process is negotiations. Negotiations are not always necessary, but many analysts believe that this step is indispensable in receiving the best prices.

The factors that are relevant to price and cost analysis and a few of the leading formulas associated with these strategies are detailed in the sections below.

Price Analysis vs. Cost Analysis

While price analysis and cost analysis may seem analogous, they are two different processes and require different strategies. Price analysis refers to discovering and choosing the best price for a particular product in a specific market, and cost analysis is the process of examining what goes into the total cost of a product and how this cost should be reflected in the price at which it is sold to customers.

A large part of price analysis is deciding upon a price that is seen as fair and reasonable to customers. This entails comparative analysis with similar products sold by competitors. However, the fair and reasonable price must also be high enough for the company to make a profit at the expected volume of sales. In instances where a product is familiar and common, price analysis can be used without having to go through the more complicated steps of cost analysis.

Cost analysis must be used when a fair and reasonable price is not in line with the profit margin required by the business. It is also necessary for products that are completely new or marketed to a new demographic. Cost analysis is a thorough process, and it results in a set of data that can be used in multiple ways, such as the confirmation of price competitiveness, understanding the true cost of products and as a tool in budgeting. Discovering the true cost of a product entails analyzing several different factors. These factors include the costs of materials, labor, transportation and marketing.

Price Analysis Overview

The primary element of an effective price analysis strategy is the comparison of the target product or service with ones that are similar. The similar products may be sold by the same company or by competitive businesses. Key components of a thorough analysis include current market prices, published prices and historical price changes. The goal of price analysis is to develop a reasonable price in a specific market that will allow for both ample sales and maximum profit.

Price Analysis Techniques

Several techniques can be used in price analysis. Some companies may use only one of these techniques for a particular product, but when a more thorough analysis is required, several techniques can be used in conjunction with each other. Basic techniques that can be used to conduct a price analysis are as follows:

• Research the product online to discover how much it is being sold for by Internet retailers or wholesalers. Using a variety of search engines and visiting several prominent shopping websites will yield the best results.

• Contact representatives of the manufacturer to ask if they have a suggested retail price for the product.

• Contact manufacturers with similar products in an attempt to discover prices of the competition.

When basic techniques are not enough, a more comprehensive technique can be used. It may also be important to verify the information obtained by consulting several sources or using more than one of the following techniques:

• Competitive bidding – One of the best means for identifying and validating the price of goods or services is through competitive bidding. It is recommended that three or more suppliers of the product be contacted in order to determine how reasonable the bids are. However, care should be taken not to use this method as a replacement for cost analysis. The lowest and highest bids may not accurately represent the lowest and highest costs. Only a comprehensive cost analysis should be used to measure cost because some factors may not be obvious.

• Price quote comparison – Price quotes may be obtained from several manufacturers so that they can be compared in a side-by-side analysis. Quotes received within the past 24 months can be used when time does not allow for new quotes to be obtained.

• Published price comparison – Instead of obtaining individual quotes directly from a manufacturer or distributor, it is possible to use the prices published for the general public. Of course, this technique assumes that the product or service is available in the consumer market. Published prices are considered inferior to quotes because they do not always reflect industry discounts or discounts for bulk purchases.

• Regulated price comparison – The prices of some products and services are regulated by federal or state law. In such cases, the prices quoted in the regulation or the formula presented in the regulation may be used to conduct a price analysis.

• Similar product comparison – If the product that needs to be analyzed is unique, comparisons will have to be made to similar products from the same manufacturer or from other manufacturers.

• Yardstick comparison – If comparable products cannot be found, a rough comparison can be made by using measurable aspects of the product, such as price per pound or price per volume. It is often best to avoid this type of price analysis and go straight to cost analysis, which will provide data that is more useful.

Cost Analysis Overview

In many instances, the specific breakdown of product cost is a mandatory function of the purchasing department, and cost analysis can be an integral part of business audits. Cost analysis procedures are more complex than price analysis procedures are. This is because costs are not always direct like they are with prices. Indirect costs can often be higher than the direct costs of products, and if they are not included, then any resulting analyses will be severely flawed. While cost analysis can be useful for all types of products, it is most useful for products that do not fit into a price analysis technique. Cost analysis is also necessary for products that are manufactured in-house.

Cost Analysis Preparation

Some preparation is required before beginning cost analysis procedures. It is recommended that communications are first established with the product manufacturers. The process will be easier with their full cooperation. This will also let the manufacturers know that cost analysis is a standard procedure for the business instead of a one-time process. Some manufacturers will not respond positively to these requests, but the key to getting them to accept information requests for the purpose of cost analysis is to convince them that the intention is not to reduce their profits.

Cost Analysis Technique

The technique used for effective cost analysis begins by discovering and listing the direct costs of a product. The primary direct cost of a product is its material cost. However, labor and distribution costs are also considered direct costs.

Indirect costs are more difficult to identify than direct costs are. Examples of indirect costs are as follows:

- Marketing and advertising
- Legal expenses
- Taxes
- Insurance
- Warehousing
- Administration
- Maintenance

An important factor in cost analysis is determining overhead rates. Overhead rates vary in each industry, but they also vary in each business because businesses do not operate at the same levels of efficiency. To simplify the process, many businesses that perform cost analyses create an in-house formula to calculate overhead rates. One formula that is commonly used is to divide the total of the indirect costs by the total of the direct costs. Using this formula, the average overhead rate in all industries ranges from 1.35 to 2.90.

A more comprehensive approach to cost analysis is to calculate a break-even multiplier in addition to an overhead rate. A break-even multiplier can be calculated by adding direct and indirect costs and dividing the result by the total of the direct costs. This multiplier can then be used to determine the break-even cost by applying it to the direct costs of a product. For example, if a company has a break-even multiplier of 3.5, then it means that for every dollar of direct costs, the manufacturer must spend $3.50 to avoid taking a loss.

Conclusion

Price analysis and cost analysis are both important tools in operating a successful business. Some businesses can get away with only conducting price analyses, but cost analyses are more thorough and can be used for products that cannot be analyzed by price.