**Keep Things Running**

Business owners and managers must keep operating costs in mind every time they engage in important business activities, such as setting organizational goals, determining whether or not to launch new products, setting budgets, etc. Though most businesses try to keep operating costs as low as possible so they can focus on production, these expenses are still vital for success. A realistic budget, for example, plans for operating costs (both fixed and variable) appropriately.

**Pay the price**

Operating costs have a great influence on a product’s final selling price. The **total cost** of a product is the sum of the overhead and direct costs required to produce it. Let’s say the total cost of producing a pair of basketball shoes is $25 ($5 in operating costs and $20 in materials). To make a profit, then, the company must set a selling price that is higher than $25. Don’t forget that there will be **price markups** between the manufacturer and the wholesaler, between the wholesaler and retailer, and between the retailer and the customer. The final selling price of the shoes that cost $25 to make may be $100 or more.

To learn more about markups and how they affect selling price, read Tamara Monosoff’s article “Demystifying Profit Margins and Markups” at <http://www.entrepreneur.com/article/170964>.

Many different factors go into setting a product’s final selling price, and there are several pricing methods businesses can follow. One is **cost-based pricing**, in which the business figures out a product’s total cost and then charges a predetermined markup. For instance, if a piece of jewelry costs $50 total to make, the company charges $75 for it to create a $25 profit. The downside of cost-based pricing is that it is easy for competitors to undercut. Another company can come along with a similar piece of jewelry and charge just $65 or $70 for it.

Another method for setting selling prices is **“price-based costing,”** in which the business determines how much customers will pay for a certain product, then figures out how to produce it for a cost that still leaves room for profit. Let’s say the same jewelry business conducts market research and determines that it can reasonably expect customers to pay $65 for the piece of jewelry in question. The business then determines how it can make the jewelry for just $40, so it can still make $25 in profit for each piece. This means whittling down costs, either operating costs or direct costs. In most cases, a business will look to reduce operating costs first.

Cutting operating costs *too* deeply can affect product quality, so businesses must be careful. This risk can be especially evident in service businesses. Consider a hair salon. Its owners may cut down on operating costs by having only three stylists on duty at one time. However, if walk-in customers are kept waiting too long, the overall product suffers, and the salon may lose business.

One way for businesses to combat high operating costs is to create **economies of scale**. Economies of scale happen when a business creates enough of a product to spread out and “dilute” its fixed costs. Let’s say that a manufacturer’s monthly operating costs are $20,000. If it produces 10,000 products a month, each product carries $2 of operating costs into its total cost. However, if the company can manufacture 15,000 products in that same time period, that number is only about $1.33. This economy of scale allows the company to reduce the impact of its operating costs without actually lowering them at all. Read more about economies of scale at <http://www.economist.com/node/12446567>.

**The bottom line**

As you can see from our discussion on selling prices, operating costs have a major impact on a business’s profits. As costs go up or down, profits fluctuate as well. More costs equal less profit, and fewer costs equal greater profit.

A company’s **gross profit** is the revenue it makes after subtracting the costs of the products it has sold. For example, if a company made $1 million last quarter and spent $200,000 producing its goods, its gross profit is $800,000. Gross profit is a good indicator of how well a company keeps its costs under control. You see, a similar company may also have made $1 million in revenue during the same quarter; however, it spent $300,000 producing its goods. This company’s gross profit is only $700,000. It is spending more money to make the same amount of revenue. Clearly, the first company is more efficient.

Learn more about gross profit at <http://www.entrepreneur.com/article/226158>.

A company reaches its **breakeven point** when total expenses equal total sales. At this point, the business has covered its costs but has not yet made a profit. The formula for calculating breakeven point is:

**Fixed costs / (Price per unit- Variable costs per unit) = Breakeven point**

*Example: A company incurs a total of $20,000 in fixed costs, and each product carries $3 in variable costs. If the company sells each product for $10, it will break even after selling 2,858 products: $20,000 / ($10 - $3) = 2,858.*

When budgeting for operating and production costs, companies should consider the breakeven point to see if it’s feasible to sell the number of products that will ensure a profit. You can find a breakeven calculator online at <http://www.calculatorpro.com/calculator/break-even-calculator/>.

Operating costs are just “a part of life” for every business and organization. They relate to the everyday routine, but they are anything but ordinary. Operating costs can mean the difference between profit and loss, failure and success. Prosperous businesses are mindful of operating costs and work to keep them in line.

**Summary**

Business owners and managers should keep operating costs in mind with every business activity and decision. Operating costs influence a product’s final selling price. The selling price must cover the total cost of making the product and leave room to make a profit. An effective way to price products is to determine how much customers will pay for them, then to control costs in a way that will still allow for a profit. One method for lowering the impact of operating costs is to create economies of scale—making more products at the same level of operating costs. Operating costs also influence a company’s overall profits. Gross profit is a good indicator of how well a company is keeping costs under control. When creating a budget for operating and other costs, a company should consider its breakeven point to ensure that it can still make a profit after production.