

Stabilizing Costs

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My costs keep going up and down, as if they have a mind of their own. Is it possible to keep them more constant, and if so, how do I do it? This question comes from the owner of a service company. Their single biggest cost to produce and deliver their services is their labor cost. In their case, virtually everyone who answers the phone and speaks with an existing customer, is involved in delivering their services.

Controlling and predicting costs is a critical function in every business. There are several ways to tackle this problem. First, figure out what costs are going up and down. Second, figure out if they should be going up and down. Third, plan for the future, and be sure you have a profitable model.

Start by grouping costs into Cost of Goods Sold, or COGS, and Overhead Costs. Cost of Goods Sold category is for any costs – labor and material – that you incur if you sell your product or service. An example of COGS is the labor used to produce your service. Since almost anyone who answers the phone and talks to your customers is involved in the delivery of your services, count all of that labor as COGS. Remember, COGS, in pure dollars, should go up and down, as revenue goes up and down. COGS, as a percentage of revenue from sales, should be pretty constant.

Overhead is for costs that you have to carry, whether you sell products or services, or not.

This would include the cost of yourself, as owner, since you are likely to collect a base salary regardless of how much sales go up and down. It also includes any other staff not directly involved with servicing your customers – from bookkeeper to filing clerk and receptionist. Traditional overhead expenses include rent, heat and electric, computers, maintenance, basic equipment such as phones and copiers. Overhead are the costs that don't go away if sales drop, and also that don't increase much if sales go up.

Another category you want to set up is Sales and Marketing costs. These are any expenses you incur to promote your product or service. Typical Sales and Marketing costs include website, promotional materials, advertising, direct mail, telemarketing, sales force. Sales and Marketing costs should go up and down in inverse proportion to sales. If your overall sales go down, you should increase the amount you spend on Sales and Marketing costs, to promote the business and get sales back on track. Most businesses make the mistake of not spending enough on sales and marketing, and then wonder why they have trouble growing.

A fourth category of expenses is investment in the business. Every

year, you need to invest in the future of the business. Investments can include upgrades in software, training staff to perform better, more efficient work space, to name a few. These investments should increase the efficiency, and ultimately the profitability of the business. Think of it as maintenance and improvement costs of the business.

Once you have expenses grouped, look at the groups, and line items within the groups, to see exactly what is going up and down. If you have to hire someone to help support customers, but you don't have enough work to keep that person busy full time, you may find the increased salary causes a temporary spike in your COGS percentage. Conversely, letting someone go and asking everyone else who supports your customers to carry additional workload may cause your COGS percentage to drop. Also, when you get busy, if your overtime costs escalate, you can find that will increase your COGS percentage. You may find that supplementing your workforce with a couple part timers, or hiring people at 30 hours / week and flexing them up to 40 hours, as needed, without incurring overtime, may help.

Remember, when trying to lower your COGS percentage in order to improve your bottom line, focus on improvements in productivity.

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You may find that hiring someone with greater skill, at a higher cost / hour, will yield you significantly greater productivity because that person can accomplish more.

As for overhead costs, there are a few things to look for. Gas, and anything related to gas, is going up significantly. That means heat, electricity, and any service provider who uses gas, including your cleaning service which has to travel to get to your office. Look at office supplies and phone costs – those are items that can jump quickly, and not necessarily in relation to more business. Watch for unusual charges, and don't overlook the possibility that things are being mis-used or going missing. Often swings in costs are one of the first indicators of problems with security or waste. Challenge anything that is going up – don't assume it is a necessary cost of doing business.

Lay out a plan for 2006. Plan COGS as a percentage of your 2006 monthly revenue projections. Vary monthly COGS in pure dollars, up and down, as you project sales revenue to go up and down; keep your COGS constant as a percentage of sales revenue. Determine how much you will have to spend in sales and marketing, to achieve your sales goals for the year. Fix overhead and investment costs at a steady monthly rate throughout the year. Subtract all costs from your projected revenue, and see

if you are going to make enough profit to make the year worthwhile. If not, go back and tweak the plan, cutting out expenses wherever it is realistically possible to do so. If you still are not making enough profit, you probably have to increase sales and marketing expenses, early on, in order to increase revenue to a level where your company will turn a profit. Build a model for 2006 that demonstrates enough profit to make the plan worthwhile.

Looking for a good book? Try Rich Dad's Cashflow Quadrant, by Robert T. Kiyosaki.

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