

Making Money with Unit Costs

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The owner of a company that provides medical services asks the following questions. How important is it to determine my unit cost and how difficult is it to do? What is activity based costing, and how does that come in to play? If you want to figure out how to make more profit, tracking and improving unit costs is your way to go. In a nutshell, as one client used to say, the truth is in the numbers, and the numbers don't lie – but you have to know which numbers to look at.

Let's start with unit costs. A unit cost is figured by simply adding up what it costs to produce your goods or services, divided by the number of units you produce and sell. If you sell more than one kind of product or service, you can look at overall unit costs, as compared to specific individual unit costs.

The first thing you want to do is establish your model, relating the cost of doing business to units sold. The owner may want to look at total potential unit cost, based on total potential units that could be produced and sold, and actual unit cost based on actual activity produced and sold. For instance, in theory, if the medical provider's office was fully booked, 100% of the time, that would be the total potential number of units that could be sold. As we all know, it is unlikely that the facility will be fully booked 100% of the time, what with cancellations and no-

shows, gaps in slow periods, and days when staff is out. The actual unit cost, then, would be based on the number of units the company actually sells in a given period.

What do I include when determining the unit cost? You want to include both direct costs, such as specific labor and materials that you know go into producing and delivering your product or service, indirect costs, and profit. In the case of our medical service provider, the direct costs are labor, minimal charges for materials used up during treatment, and the cost of a treatment room. Indirect costs include overall rent and electricity less any cost already assigned for treatment rooms, excess labor, such as the time providers stand around between treatments, overhead labor such as reception, billing, and administrative staff, all other overhead costs, and marketing / selling costs. Profit is the total amount the company expects to make, after all costs, for a given period.

You need to allocate costs appropriately, in order for your numbers to have meaning. However, once you've set up and agreed to the model for allocating costs, the hard work is mostly done. From there on, it is simply a matter of updating the costs and units produced and sold, insuring your inputs are correct, and letting the model run.

Activity based costing comes in to play when you are figuring out how to allocate your indirect and overhead costs and profit. It is a way of assigning costs that typically get lumped together, and relating them to the actual activity, or output, of the business. In setting up your model to allocate overhead and indirect costs and profit, you may want to tap into the advice of your accountant, your controller or bookkeeper, as well as your sales, marketing and operations staff.

One of the challenges is fairly allocating overhead and indirect costs and profit. For example, our medical service provider will have to decide if a 15 minute treatment consumes as much overhead as a one hour treatment. It may take as much effort to schedule, bill, prepare the room, and clean up the room, regardless of the length of treatment.

Profit may need to be allocated differently, based on the value customers place on the services provided. Your sales and marketing staff may be able to advise you, based on their understanding of customer needs and desires. In the case of our medical service provider, they find that the length of treatment is less of a driver in determining profit, than is the relief the patient perceives resulting from treatment. Consequently, they should consider allocating profit

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based on customer demand for services provided.

Setting a goal for what each unit produced should cost, gives everyone in your company something to focus on. You may also want to try and figure out the optimum unit cost, the point at which the business realizes its greatest profit per unit sold. Our medical service provider can use their unit cost model to figure out if staying open later, or opening earlier, or adding weekend hours will truly be more profitable.

The unit cost model with activity based costing can help identify products or services that don't measure up, because they cost more to produce than customers are willing to pay, once overhead, variable costs and profit are counted in the mix. Use the model to evaluate price increases per treatment, which can add up to big dollars, when multiplied by all of the treatments the company provides in a year. Compare the result of a price increase vs. what the company can make by selling more of the most profitable treatments at current or higher prices.

Knowing if a product is, or isn't profitable, helps the company focus its efforts and make choices. Perhaps profitability can be improved by producing more units, and disbursing overhead costs over a greater number of transactions. Profit may also go up if marketing dollars are

focused on educating the public on the value of a particular service, so that customers are willing to pay more. Sales may want to focus on getting more customers interesting in the high profit treatments. Operations may want to look at how to reduce cost / unit by reducing waste. For example, they can reduce the time people stand around by putting staff on per diem hours, adding staff to reduce overtime, and by scheduling treatments closer together. Additionally, the company owner will want to look at how services are sold and booked, to be sure that the most profitable services, on a fully allocated unit cost basis, get priority, and low profit services are minimized, removed altogether, or made more profitable.

Looking for a good book? Try Activity Based Costing, An Executive's Guide, by Gary Conkins.

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