

# Understanding Costs, Profits and Cash Flow

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## Cost Dynamics

In this first of three segments, we discuss cost reduction and why it is so important for business owners to understand the dynamics of costs and their effect on profits and cash flow.

Why is it so important to understand cost dynamics? Because costs have gotten a bad reputation. You probably tend to consider costs as negative influences on your business, something you must reduce at any “cost.” Look more closely, and you will begin to understand that not only are costs necessary but they may be utilized as strategic weapons to reinvent your company’s competitive advantage.

## Is cost reduction always a good idea?

Some cost reductions have little or no impact to the company’s operation, such as a reduction in rent or reductions based on efficiencies. Others may have a ripple effect throughout the organization.

Many owners fail to understand that “costs” are an assemblage of different forces that behave according to business activity. Some costs are fixed and will not change when there are small to moderate sales increases or decreases. Other costs rise and fall according to sales activity. Here is the beginning point to better understanding cost dynamics.

Many people are familiar with those corporate management memos dictating the requirement to reduce departmental costs by 10% or else. Unfortunately, oftentimes these reductions, if not measured, may have a direct or indirect detrimental effect on personnel, customers and revenue.

Consider the manager of accounts receivable who receives such a memo and decides to reduce staff and consolidate collection regions to reach the 10% requirement. Five regions are now to be consolidated into three resulting in a 65% increase in workload across the three remaining regions. While the salaries and benefits of two headcount have been reduced, company-wide collections of receivables slows from an average of 34 days to 39 days. In other words, it takes six more days a month to collect a receivable.

Suppose this company does \$1 million a month in sales. Without going into the math, this six day addition to average monthly collections results in the company losing access to one month’s collections annually or \$1 million in cash flow. Since the company will be collecting \$1 million less each year, it may have to borrow that amount to balance its cash flow needs. Suppose the cost of borrowing from the bank is 8%. This company has now traded \$80,000 a year in salary and benefits savings and replaced them with \$80,000 of new borrowing costs – and it may get worse.

Now suppose this company’s credit policy states those customers with outstanding invoices of 45 days or more will have current shipments held until payment is made. If the number of 45-day accounts has grown by **the same 6%**, shipments averaging \$60,000 a month (6% x \$1 mil) will be delayed. Angry customers and salespeople will begin calling, the accounts receivable staff will be restricted in their time because they have to handle all these calls, and

the number of collection calls will begin to drop. Inventory builds and the warehouse is short on space. **{Where did the 6% come from????}**

Finally, the company sees its turnover in collections personnel increasing. Staff is frustrated by the increase in workloads and pressure from the top to collect more money, faster. Perhaps some of the salespeople leave or even worse, the company begins losing customers.

### **Let's start at the beginning**

There are basically two types of costs, Fixed and Variable. Here's an example to clarify the difference between these two types of costs. Suppose a tornado destroyed a portion of your manufacturing building, crippling your shipping and manufacturing capabilities for 90 days. Think about the types of cost-cutting procedures you might think about taking.

- Cut back part time help
- Postpone selected inventory purchases
- Cancel new advertising promotion
- Outsource certain products temporarily

These costs are considered *variable* because they can be controlled to match production levels. In other words, costs that are incurred as a direct result of producing or selling products and services are variable. Relatively speaking, you can turn them off and on as volume dictates.

Now think of those costs that continue in full force regardless of production or sales levels:

- Rent
- Basic Utilities (Lights, Heat, AC)
- Salaries/Benefits
- Bank interest payments
- Insurance

These are examples of fixed costs because they are affected very little, if at all, by changes in production or sales levels. From a valuation perspective, when fixed costs, as a percent of all costs, is very high, the company is deemed "higher risk" and is typically less attractive to buyers or investors. Companies with higher variable costs are typically more attractive to buyers or investors since these costs can be manipulated when unanticipated interruptions or economic slowdowns occur.

The best way to analyze any cost is as an investment. If the investment cannot be tracked to a corresponding "return," i.e., incremental cost savings or incremental profit, it must be eliminated.