

Panning For Your Business Gold Mine . . . The Search Continues!

by Terry Soifer
Consulting CFO, Inc.

In our first article, we learned that the key to analyzing sales is deciding which parameters need to be analyzed and the importance of developing support systems (manual or computerized) which provide this information. The same is also true for controlling and reducing expenses. This article will look at systems and strategies to accomplish this objective.

Most companies just report actual expenses; they report them as a percent of sales, and believe they have done a good job of controlling expenses. A few companies compare actual to budgeted expenses and believe they are controlling expenses. However, the first key to understanding how to control expenses is to realize that there are two types: fixed and variable. Fixed expenses are those which do not change with different levels of production or sales. An example of a fixed expense would be our monthly office rent. Variable expenses, however, do change with different levels of production or sales. For example, the amount of commission a salesman earns may be directly dependent upon how much he sells. As sales and production levels change, we must understand how expenses are affected.

Secondly, once we understand which expenses are fixed and which are variable, we need to implement systems to give us more detailed information. For example, successful manufac-

turing companies do not report just variable and fixed expenses. They do further analysis in such areas as: usage and yield variances; machine speeds and efficiencies; calculation of pounds per machine hour and man hour; and equipment utilization. They also spend a considerable amount of time analyzing the prices they pay for materials, supplies, services and labor. This is an area where all types of firms have to pay more attention, and one which we will explore in more detail.

The first key to understanding how to control expenses is to realize that there are two types: fixed and variable.

Manufacturing companies calculate the effect that price increases have on the bottom line by using a concept called **purchase price variance analysis**. This variance is simply calculated by subtracting the price actually paid from the budgeted price (or price previously paid, if a budgeted price is unavailable) and multiplying the difference by the quantity purchased.

The calculation is the easy part. The success comes from the development of a strategy (or strategies) to minimize the impact on the bottom line. Some of the strategies a company might

follow are:

1. Attempt to pass this price increase to customers. Recognize, however, that due to competition this might be a difficult strategy to implement and may result in the loss of market share.
2. Invest in capital equipment. For example, for years the XYZ company has been buying product in 40 gallon drums. As a result of recent price increases, they have decided to invest in a storage tank in order to purchase the product in bulk. Therefore instead of a price increase, they will experience a significant price decrease.
3. Obtain competitive quotes. It's too easy to get in a rut and always do business with the same company. They give us good service and the salesman has become a friend. But the fact of the matter is that our attitude has made it easy for them to raise their prices. We must never lose sight of the fact that our job is to do everything possible to improve our profitability and not the profitability of our suppliers. Therefore, at least once a year competitively bid the major items being purchased.
4. Look for alternative materials, supplies, and services. With today's technology and global economy, there are always new products coming into the marketplace which can give the same or better performance, at possibly cheaper prices.

We must never lose sight of the fact that our job is to do everything possible to improve our profitability and not the profitability of our suppliers.

Besides controlling and reducing material and services costs, we also need to do the same

for labor. Two areas of labor costs which need to be controlled are labor rates and headcount. Let's assume that our business plan calls for hiring someone for \$6.00 per hour but, instead, we decide to hire someone for \$6.25 per hour. When we do something like this, do we really understand the effect of that decision? One obvious effect of that decision is a reduction in planned profitability of \$520 per year (2,080 hours per year X \$.25 per hour). But this decision has other costs to the organization in terms of:

1. Higher FICA taxes.
2. Higher workmen's compensation insurance premiums.
3. Higher general liability insurance premiums.
4. Higher retirement and profit-sharing costs.

But the cost of this decision isn't limited to just the year of hire. Costs continue to be adversely affected each and every year this individual is in our employ. For example, let's assume our plan calls for giving this person a 5 percent raise next year:

Original plan rate	\$6.00/hr x 1.05 = \$6.30/hr
Actual rate	\$6.25/hr x 1.05 = \$6.56/hr

Difference per hour	= \$.26/hr
Original difference	= \$.25/hr

Increase in Year 2	= \$.01/hr
--------------------	------------

Therefore, the real cost in year 2 is \$540.80 (2,080 hours per year X \$.26 per hour) plus more FICA, workmen's compensation insurance, etc. Not a big cost if there is only one employee. But it starts to add up quickly as the size of the organization grows and it continues to increase year after year after year.

In the area of headcount, most of us understand the importance of controlling the number of employees who work for us. However, to do an effective job in this area requires that we understand our manpower requirements at different levels of production and sales. It also

requires a system which will allow us to effectively monitor our headcount on a weekly or monthly basis.

One of the best tools we have in this regard is our payroll system. Unfortunately, most of us view our payroll system merely as a means to pay our employees. The fact of the matter is that when it's used properly it is an effective means of assisting management to control labor costs.

It can be used to calculate both actual and equivalent headcount and as an effective tool to monitor overtime; it can be used to state production or sales figures as a function of hours worked; and most importantly, it can be used to help us calculate our operating cost per hour. The only limiting factor in the use of payroll data is our imagination.

In summary, effective control and reduction of expenses requires:

1. **An aggressive attitude** towards control and reduction of expenses.
2. **An understanding** of which expenses are fixed and which are variable, as well as an understanding of how these expenses change with different levels of sales and production.
3. **Development of systems**, in addition to profit and loss statements, which will assist in the analysis of key expense components and measure performance towards stated objectives.
4. **Concentration on analyzing price increases** for key material, service and labor costs, and the development of strategies to deal with these increases. Don't be content to just contain these increases; the real objective should be to reduce costs.

Panning For Your Business Gold Mine . . . The Search Continues! is the second part of a four-article series available from Consulting CFO, Inc. Additional topics include: *asset management, inventory management and sales analysis. For additional articles, or for additional reprints of this article, contact Terry Soifer, President, Consulting CFO, (407) 628-5534.*