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Musings

#51: Knowing your Costs
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There is a difference between knowing your expenses and knowing what things cost. Let me explain.

The standard model is to track expenses in a general ledger by "type" or "natural account." So you get a monthly report that shows labor expenses of X and rent expenses of Y. You can see which ones are growing faster than revenue (inspect!) and which ones are growing slower than revenue and thus giving you leverage in your operating model.

If you are in a smaller environment, you might look through the payables check run every two weeks and certainly should sign any checks over a certain amount.

However, to really know what is going on, you need to have good reporting which matches up the expenses to the revenue they generate and thus really know your costs. Obviously, this starts with gross margin accounting and tracking those expenses related to a product or service line. These direct expenses are usually pretty easy to identify. With a services business, you will need to track time and allocate labor costs accordingly. It is key to make sure you fully burden your labor costs with the nonproductive time, benefits. There are 2080 work hours in a year using standard 40 hour week but between vacation, sick days etc, most people use a number like 1600 for the calculation of per hour costs. You also then need to include the costs of your benefits programs which vary with labor but are usually between 20-30% additional expense. This benefits expense is often undermanaged and underappreciated. This is why California is suing Uber and Lyft on their classifications of drivers. 1099 contractors do not get the benefits programs while W-2 employees do.

The real art form comes when you get to "overhead" and allocations. There is true overhead that comes with running a business like the C suite and corporate office. The category that can swell on you and be under-scrutinized is the "middle management" overhead. For instance, if you have a project management office who helps organize activities of the delivery team, you need to make sure their time is tracked and allocated up into delivery expense. If you have one activity that uses more real estate than another (let's say a culinary program vs a business program), that real estate expense needs to be allocated accordingly.

Many universities do a poor job of this. Often expenses are just tracked at an institutional level and there are not department P&Ls tracking costs against tuition revenue. Many schools also apply a huge overhead allocation to any new revenue stream making innovation difficult. In 2004, I was encouraging a university to offer an online program that would generate 20% incremental margins and the CFO said that when he allocated his overhead they would then be losing money and so they couldn't do it. This ignores the incremental nature of the new margin which would help absorb some of that overhead.

Hospitals have also been notoriously bad at really knowing their costs. When the government rolled out DRG (Diagnosis Related Group) codes in 1983 which said how much CMS would reimburse for a given activity, most hospitals didn't know what that would mean financially because they didn't know there costs for that activity.

I am a big fan of running a "contribution margin" line between gross margin and your overall operating margin. The contribution margin would factor in the "overhead" associated with that particular product line, program or service that is not direct costs but is not overall corporate expense. In a unit model, these would be your store margin. These contributions lines than need to throw off a margin to cover the overall corporate overhead and make money. This way you would know the contribution margin of the new business program, the new store in Peoria or the new office supplies product line.

Sales and marketing expenses need to be measured against the bookings they generate. Client acquisition costs (CAC) is a key metric to ensure you are getting the return on your sales expense.

I would use public comps (discussed last week) to get an idea of what your margins should be. If you truly know the costs of your product, plant, business, you can drive appropriate pricing and create competitive advantage. I think you will see some deflation coming out of Covid-19 as those with good technology capabilities leverage them with the increasingly digital consumer and offer lower prices. Free enterprise at work to the benefit of the consumer.

Be safe. Work hard.

jml

Second Thoughts

JC Penney filing for bankruptcy on Friday.

House democrats have proposed another $3 **trillion** in stimulus. We must get the economy going again. The government can't just write checks.