



Cost Behavior: Turning your small business into a profit power-house

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One certainty in the life of a small business is change. Today, business people are riding the wave of economic change, looking for ways to maximize the profitability of their business amid lower consumer spending and higher prices from suppliers.

Every small business has powerful information at its fingertips that can assist them in adjusting to change. The key is costs. Entrepreneurs who understand how the costs of their business respond to changes can make more informed decisions, allowing them to better utilize limited resources.

The first step is to explore the two basic types of costs in a business – fixed and variable.

Fixed costs are those that remain constant regardless of a firm’s volume or level of sales. These costs decrease per unit as volume increases, and increase per unit as volume decreases. For example, a restaurant may pay monthly rent of \$500. That cost is the same whether the restaurant serves two people or 200 people. However, as the restaurant increases the number of people it serves, the average cost per unit of rent decreases: Serve two people and rent will cost \$250 per unit; Serve 200 people and rent costs drop to \$2.50 per unit.

Variable costs, on the other hand, vary in total with changes in volume but remain constant per unit. The same restaurant may see food costs change from month to month based on how many people are served, but cost-per-serving doesn’t vary.

Let’s say the restaurant owner is having a hard time making a profit at the end of every month. She would want to determine the menu items that contribute the most toward profit. This can be found by exploring contribution margin – the selling price of a menu item minus the variable cost of that menu item. For example:

	Menu Item #1	Menu Item #2	Menu Item #3
Selling Price	\$ 4.50	\$ 6.95	\$ 7.95
Variable Costs	\$ 2.03	\$ 3.48	\$ 4.77
Contribution Margin	\$ 2.48	\$ 3.48	\$ 3.18

The restaurateur would want to promote the second item above the rest because it would contribute the most toward fixed costs and profits. Item No. 3, for example, is more expensive to produce and has a lower margin.

Now let's say the restaurant owner wants to determine breakeven – the number of meals that must be sold to cover costs. Using the same approach, a contribution margin income statement can be constructed. This income statement is slightly different from a traditional income statement in that it organizes costs by their behavior.

A contribution margin income statement begins with the firm's sales, and then deducts variable expenses to create the contribution margin. Net income is calculated by subtracting fixed expenses from the contribution margin.

Returning to our example, let's assume for simplicity that our struggling restaurateur only sells one item – item No. 2. The first column in the table below represents the cost of making and selling a single serving. The other columns are different volume levels. Notice that while sales, variable cost and contribution all change with volume, fixed costs do not. In the case of our restaurateur, she will have to serve between 500 and 1000 servings to break even. The breakeven point occurs when the contribution margin equals fixed costs and is calculated by dividing fixed cost by the contribution margin of one unit ($\$2500/3.47$). The answer here is 721 servings.

	Contribution Margin Income statement				
# of Items Sold	1	500	1000	1500	2000
Sales	\$ 6.95	\$ 3,475	\$ 6,950	\$ 10,425	\$ 13,900
Variable Costs	\$ 3.48	\$ 1,740	\$ 3,480	\$ 5,220	\$ 6,960
Contribution Margin	\$ 3.47	\$ 1,735	\$ 3,470	\$ 5,205	\$ 6,940
Fixed Costs per Month	\$2,500	\$ 2,500	\$ 2,500	\$ 2,500	\$ 2,500
Income		\$ (765)	\$ 970	\$ 2,705	\$ 4,440

You can create a very simple contribution income statement template in Excel using your selling price, unit variable cost and total fixed costs. If you have more than one product or service, you can create a multi-product income statement. Plug in different sales figures and adjust your costs to see how those changes impact your net income. That will help you unlock the secrets to your business' profit centers.

The amount of time you invest in understanding the costs of your business is well worth the effort. Harness the power of your small business to make your resources work harder for you!

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