

Reducing costs in a down economy

By Jeffrey L. Schmittgen

Today's business climate has everyone scrambling.

Sales are lagging, costs are increasing, profits are decreasing, and business owners are taking hits to their income. That pretty much defines most businesses today.

How do you maintain profitability? Successful managers look in two directions, improving efficiency in all processes and reduction of fixed costs.

Businesses have two kinds of expenses, variable (moving up or down with sales) and fixed (staying constant if sales change). Most expenses are somewhat blended between fixed and variable, and it's important to know the breakdown for each expense category. Both kinds of expenses require a different type of analysis in order to impact profitability.

When analyzing variable costs, there are two key concepts: efficiency and pricing of direct costs. Inefficient processes anywhere within an organization are costly. However, they are an easy area to tighten up to improve variable cost percentages. Managers need to step back and analyze even the most efficient areas and squeeze out changes. Sometimes upfront costs must be incurred to create savings. In that case a cost-benefit analysis should be done to justify the use of capital.

Pricing of direct costs is somewhat easier to analyze. Negotiating with suppliers, employees, fringe benefit providers and other subcontractors is vital as businesses work to maintain profits. In some cases, companies must do this just to survive. In analyzing direct costs, look to your income statements cost of sales section. Compare your performance to that of the best performers in your industry. This will help you identify specific areas where improvements

CASE 1		
<u>Normal year</u>		
Sales	1,000,000	
Cost of sales	<u>400,000</u>	40%
Gross profit	600,000	60%
Variable costs	250,000	25%
Fixed costs	<u>200,000</u>	
Net income	150,000	15%
CASE 2		
<u>Sales reduction of 20% and no decrease in fixed costs</u>		
Sales	800,000	
Cost of sales	<u>320,000</u>	40%
Gross profit	480,000	60%
Variable costs	200,000	25%
Fixed costs	<u>200,000</u>	
Net income	80,000	10%
CASE 3		
<u>Sales reduction of 20% and 70,000 decrease in fixed costs</u>		
Sales	800,000	
Cost of sales	<u>320,000</u>	40%
Gross profit	480,000	60%
Variable costs	200,000	25%
Fixed costs	<u>130,000</u>	
Net income	150,000	19%

can be made.

Fixed expenses are another matter. A reduction of a fixed expense falls right to the bottom line of a company's income statement. Salaried employees, underutilization of space, insurance costs and tax costs are a few examples of fixed expenses to scrutinize. The example above shows a simple progression where in Case 1 a normal year

turns to Case 2 with a 20% decline in sales. After reducing fixed costs, Case 3 shows elevated profits.

We work with our clients all the time on these kinds of analysis and assist in helping make what can be some very difficult decisions. Times are tough, we all know it. If you haven't gone through this kind of analysis in a while, it's probably time.



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