

Understanding Costs



and Profit

A guide to help you broaden your understanding of the most common types of business costs applicable in small businesses and how they influence profit margins

Understanding and monitoring your costs and margins is vital for any business owner and failure to get this area right can mean that whilst you may well be busy you are not converting that into profitability. In fact, many small businesses that appear to be thriving often fail because their prices are too low or their costs are too high and they can't make a profit. You will want to avoid falling into that trap and the information here will help you to better understand costs and margins so that you can avoid pricing problems, losing money on sales, and ultimately stay in business.

The prices that you charge for your products and services must be sufficient to enable you to cover all of the costs of running your business and to make a profit. However, before considering your pricing (details of which are available in a separate guide) you need to understand the costs associated with the provision of your products and services.

Understanding Costs and Profit

This short guide has been developed to help broaden your understanding of the most common types of business costs applicable in small businesses and how they influence profit margins. The information here is designed to provide you with a general overview of the key issues on this topic and support can be found on the Business Tools website.

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1. Cost, Pricing and Value

Successful businesses maximise their profits by matching their pricing with the value that customers place on their products or services.

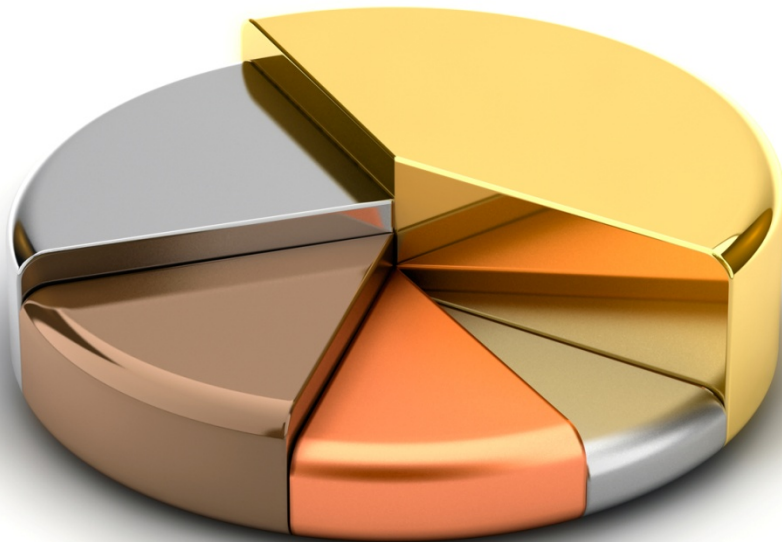
The **cost** of a product or service is your total outlay in creating that product or service.

The **price** of a product or service is your financial reward for providing that product or service.

The **value** of a product or a service is the 'worth' that your customers place on that product or service. The higher the worth of a product or service to a

customer, the higher the price that you can charge.

Example: In the Liffey B&B the cost of providing breakfast for each guest is €3 in food costs, €2 in staff costs and €1 for indirect operating costs (e.g. gas, electricity). The value to a customer of receiving a fresh, cooked, breakfast is higher than the cost of producing the breakfast (€6). So, if the B&B sets a selling price of €12 for the breakfast and the customer is happy to pay this amount, €12 is the value of the breakfast to the customer.



2. Understanding Business Costs and Break-Even

Understanding costs provides a base figure below which one cannot price the product. Unless you understand the level at which your overall business breaks even, you will never know if you are making a profit or a loss. After looking at the break-even point for your business or individual departments within the business, you can then investigate how sensitive your business' profit is to changes in key elements of the Profit & Loss Account e.g. price, costs and sales. You can also use this information to forecast your manpower needs and income and expenditure requirements.

When money gets tighter there are essentially two solutions: sell more and cut costs.

Cutting costs has the added benefit of reducing how much cash your business needs to stay functioning, so this is the first place to start. If you can reduce your overheads and reduce your cost of sales, then you will get even more benefit out of selling more. Ideally, decisions on the pricing of products and services should be made on the basis of a detailed understanding of the cost of providing those products and services.

“ *break-even* ”

Fixed costs are costs that must be paid whether or not a sale has been made. These costs are 'fixed' over a specified period of time. Fixed costs include property costs, mortgage/lease payments, business rates and water rates, insurance and salaries for permanent staff.

Variable costs are costs that vary directly with the number of services produced. For instance, employment costs for seasonal temporary or casual staff, utility costs, including gas and electricity

(and water if metered), purchase of food, drink, cleaning products and other raw materials, purchasing stock of saleable items, replacement of equipment, furnishings and fittings, office costs, including stationery, postage, telephone, Internet and photocopying costs, bank charges, motor vehicle costs, marketing costs and commission payments.

Using the fictitious example below, we can calculate the sales level at which the business will break-even in the following way:

Fáilte Surf School Budgeted Profit & Loss Account for Month of July

Sales (estimated no. of surfers 500 x average spend per head €20)	€ 10,000
Cost of Sales (variable - 40% of sales)	€ 4,000
Gross margin	€ 6,000
Other costs (variable - 15% of sales)	€ 1,500
Contribution margin (45% of Sales)	€ 4,500
Other costs (fixed)	€ 2,500
Profit	€ 2,000

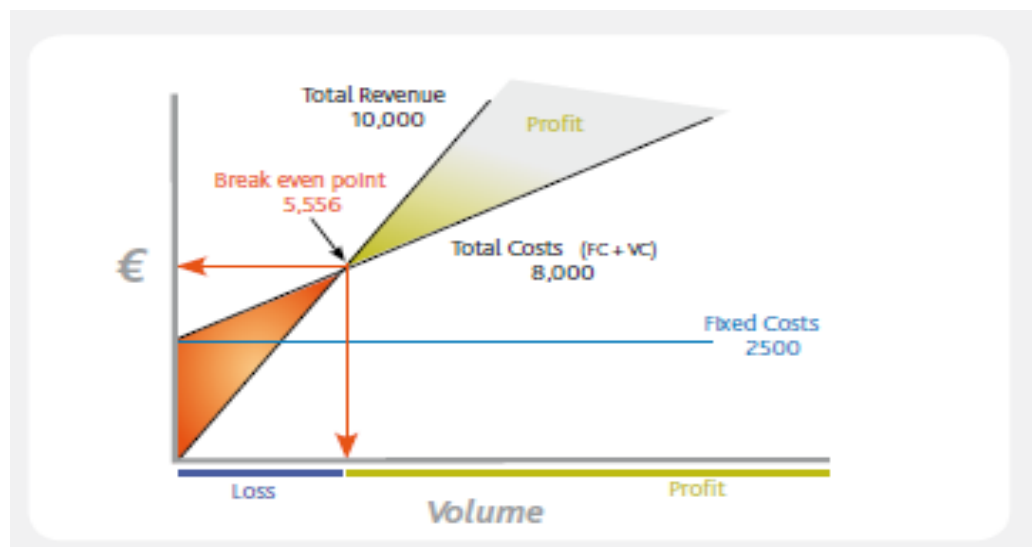
$$\frac{\text{Fixed Costs}}{\text{Contribution Margin \%}^*} = \frac{€ 2,500}{45\%} = €5,556 \text{ (break-even sales value)}$$

$$\frac{\text{Break-even sales value}}{\text{Average spend per surfer}} = \frac{€5,556}{€20} = 278 \text{ (break-even number of surfers)}$$

$$*\text{Contribution Margin \%} = \frac{\text{Contribution Margin}}{\text{Sales}} \times 100$$

So, with Sales of €5,556, and 278 participants each spending on average €20, this Surf School will be making no profit/no loss. Management would now know that only sales above that point will be generating profit.

Understanding your break-even point allows you make informed financial decisions about the future of your business. Here's an illustration of a break-even chart for the previous worked example:



3. Budgets, Targets and Monitoring Performance

A quick way to monitor costs is to generate a monthly profit and loss report and compare it with last year's figures and this year's targets. Most accounting programmes allow you to produce instant reports and budgets - very useful provided you keep your accounts up to date.

Budget reports allow you to compare actual costs with your estimates. For example, you estimate the August electricity bill will be €300 (based on last year's figures), but the actual bill is €450. The key point about rising costs

is not to accept them without asking the hard questions:

Why has this cost risen?

What can we do about it?

In this example, was August cooler than average? Did you install more electrical equipment? Do you need time switches or more modern energy saving appliances? Should you change suppliers? Some increases may be unavoidable, but it's still important to cast a cold eye on all increases rather than simply accepting or ignoring them.

3.1 Set a sales target

Once you know how much your business needs to earn in sales each year (or each tourism season) to break-even, you can work out your monthly targets. For example, the owners of the Fáilte Surfing

School calculate they need 2,100 customers a year to break-even. Using this total they draw up a simple monthly table based on a typical five-month tourism season pattern as follows:

Month	Minimum customers to break even	Target for this year +20%	Actual results	Notes on results
May	200	240		
June	400	480		
July	600	720		
August	600	720		
September	300	360		
Season total	2,100	2,520		

You may find it helpful to drill down further so that you can see how many customers or sales your business needs each week or even each day to meet your targets. If you're running several business activities, try to separate them out in your accounts so you can check whether each part is contributing to your business; lumping them all together can disguise the loss-making parts of your

business. The risk is then that these 'hidden' loss makers will drag down the profitable parts of your business. Most accounting systems allow you to separate your activities in performance reports. You can then identify your main 'cash cow' and take steps to protect and improve its profitability. You can also decide whether some activities are worth continuing or not based on returns.



3.2 Set improvement targets

The break-even point for your business is of course always your minimum target. Achieve this and you stay in business. Fall below the break-even point and your business is in danger.

But you're in business to make a profit, not just stay in business. Profits are what motivate and encourage all of us to keep developing our businesses. To improve your business, you need targets.

In the example above, the owners set a budget target of 20% above the required customer minimum. If they achieve this then next year they can set a new, perhaps more challenging target.

Whatever targets you decide to set for your business, it's important that they are sufficiently tough to take you out of your 'comfort zone' (and require some innovative thinking), but not impossible to achieve. Targets should give you and your staff great satisfaction when you celebrate achieving them. Targets also need regular stepping stones towards your goals. For instance, you may have a medium or longer-term target for your business, for the year or for the next three years, but you and your staff will be more immediately motivated by the targets you need to meet today, this week or this month. So, turn your major targets into the smaller stepping stone targets that will get you to your goal.

3.3 Measure your performance

What you don't measure, you can't manage. In the Fáilte Surfing School's Required Customer Numbers table, the targets are clear and simple. That's one key to ensure things do get measured.

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celebrate
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If you meet a monthly target then you can celebrate that achievement with your staff. If you don't, then it's time for some fresh thinking.

For instance, is a drop in your expected visitor numbers caused by circumstances outside your control, such as an epidemic scare or a sudden rise in travel costs, or do you need to market your business more creatively? If the latter, get some tips from the marketing section of the Business Tools.

Simple benchmarking

Your accountant or bank manager may be able to supply you with typical cost and profit percentages for similar businesses. This gives you two measuring sticks to use: the figures from your own business and the industry average.

For instance, suppose you learn the average profit margin for a tourism business like yours is 43%. Yet you only achieved 36% last year, and your latest figures this year show the profit margin has slipped back to 32%. That's a disturbing slippage - so what caused it? You'll need to take some remedial action before your profits get damaged any further.

Time to sit down with your accountant and dig deeper for the causes, including looking for what costs may have increased.



4. Profit and Profit Margins

Profit may be defined as the amount of money that you retain from the sale of goods and services, after deducting all of the costs associated with the provision of those goods and services and your fixed costs. This is more commonly known as net profit.

The **Profit Margin** indicates the percentage profit a business makes on a sale. The Profit Margin is normally calculated as the Gross Profit, which is the excess of income over the costs (excluding payroll) directly associated with making the sale (e.g. the cost of

food sales or the cost of beverage sales).

Example: if you sell a meal for €20 (net of VAT) and the cost of the ingredients used in preparing the meal for sale was €10, the Gross Profit is €10. The Gross Profit Margin is 50% (e.g. €10 profit margin divided by the sales price of €20, x 100).

Two terms are frequently used when discussing prices and they are **markup** and **margin**. These are different ways of calculating profit, and the difference can be confusing.

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margins and markups are
”
different

Margin: the margin is the percentage of the final selling price that is profit.

Markup: a markup is the percentage of the cost price you add on to get the selling price.

Although this can often be a little confusing to small business owners, margins and markups are different: a selling price with a margin of 25% results in more profit than a selling price with a markup of 25%.

To understand why margins are higher, imagine an item that costs €100. If you sell it with a margin of 50% - that means fifty percent of the selling price should be profit i.e. if you sell it at €200, half the selling price is profit - margin 50%. If you sell the same item (cost €100) with a markup of fifty percent, you add fifty percent of the cost price. Fifty percent of the cost price is fifty euro. This makes the total selling price €150. A fifty percent margin is higher than a fifty percent markup.

4.1 Improving profit margins

Successful businesses continuously seek ways of improving their profitability. In circumstances where gross profit margins can be improved the overall net profit of the business can be uplifted. The following actions may be taken to improve profit margins:

- Increasing prices.
- Reducing your cost of sales through more effective purchasing (e.g. use of tendering - more than one supplier ensures competition, both for price and supply of a quality product; regular checking of suppliers prices).
- Reducing payroll and other direct costs (are you over-staffed? - do you plan your staff requirements on the basis of known demand? If not, an opportunity exists to improve your productivity).
- Reducing fixed and variable costs (such as insurance, fuel, electricity costs) by requesting quotations from a number of service providers, encouraging clientele to become aware and involved in good environmental practices on site (switching off lights when not required, re-using towels), raising staff awareness of company policy (e.g. switching off heating in areas of the premises not in use).
- Maximising income from high margin products. For example, accommodation sales typically generate a higher profit margin than food and beverage sales. In circumstances where accommodation sales are low relative to other sales, there may be a substantial opportunity to increase profit through an increased level of accommodation sales.

For food and beverage operations, additional actions can be considered:

- Maintaining consistency through applying strict principles of portion control, achievable initially through establishing an agreed portion size; providing sufficient standardised equipment (including both production and service/presentation utensils); training of staff in portion control and presentation; supervision and monitoring of standard operating procedures.
- Consider reducing food portion size, particularly if your clientele are not 'regulars/repeat business' and custom and practice has not been established.
- Reducing wastage (if wastage particularly with regard to food and beverage sales is a problem you need to assess the causes of that wastage) through staff awareness and training, regular stock control and good stock rotation practices; 'specials' will ensure efficient use of food and beverages particularly when approaching their 'best before' dates, ensuring corporate/function numbers are finalised prior to purchasing of food/beverages, particularly if high cost goods are required by the client.

4.2 Try the Four Fives Rule and surprise yourself

Try tweaking your business using something called the Four Fives Rule. It works on the simple principle that modest changes of only 5% in four key areas of your business can add up to surprisingly impressive improvements in your profit. Most businesses can meet these targets through some creativity and determination:

- ① Raise the level or number of sales by just 5%.
- ② Raise the average price of sales by 5%.
- ③ Lower your cost of sales by 5%.
- ④ Lower your fixed costs (overheads) by 5%.

Here's a sample of how a restaurant used this rule:

Restaurant Budget Forecast			
Projected Sales for the Year <i>(Based on last year's performance)</i>	Euros	Applying the Four Fives Rule <i>(To see how this enhances our profitability)</i>	
Sell 10,000 covers @ €20	€200,000	We now plan to sell 10,500 units @ €21	€220,500
They cost 10,000 @ €8 per unit	€80,000	We reduce the cost per cover by 5% , so 10,500 units at the lower cost of €2.85 per unit	€29,925
Subtract unit costs to get Gross Profit	€170,000	The Gross Profit jumps to	€190,575
Subtract fixed (overhead) costs of 50%	€100,000	We reduce overheads by 5% so they become	€95,000
So the Net Profit (before tax) is	€70,000	Giving an enhanced Net Profit of	€95,575

Making just these four small changes therefore accumulates into an extra €25,575 in pre-tax profit - a 36.5% improvement. In some businesses this alone can make all the difference between a borderline business and one that is beginning to show pleasing profits.

5. Yield Management

In seeking to maximise sales revenue, yield management is a useful activity. Yield management is about allocating the correct capacity to different customer types at the most beneficial price to maximise revenue (or “yield”). The concept of yield management was developed in the 1970’s by the US Airline industry. It has evolved from a highly specialised concept to one of the most commonly used pricing tools in the airline and the hotel industry. Typically, yield management is applied to accommodation operations, however the concept is also used for other services (e.g. functions or restaurant bookings at Christmas). It is normally underpinned by specialist computer software packages which utilise detailed historical trading patterns as the basis for predicting future demand trends.

If you are an accommodation provider, ideally you would prefer to sell all bedrooms at the highest rate possible. However this is rarely feasible, so as a ‘trade-off’, there will be times when rooms will be sold to ‘low price’

customers. The objective of yield management is to balance the trade-off by selling rooms at the highest price when demand is high while stimulating room sales during periods of weak demand by offering discounted room rates.

Although the concept appears simple, yield management systems are highly complex. However, the basic principles of yield management can be applied by any size of business operating in the tourism industry to improve sales and profitability, without the need for computer software packages. The basic principles can also be applied to a range of business types other than accommodation providers, such as restaurants, night clubs, activity centres and so on. The basic principles of yield management are to:

- Maximise revenues during periods of peak demand.
- Improve revenue during off-peak periods.
- Control and improve profitability.



In order to apply the basic principles of yield management, you will require the following information:

- ! Details, on a day by day basis, of demand for your products and services. This will enable you to identify when demand is at its peak, and when it is weak.
- ! The source of that demand (e.g. is bedroom demand from the corporate market, leisure market, conference market etc.).
- ! On which occasions did demand for your products and services (e.g. accommodation) exceed the number of bedrooms available.
- ! What were your room rates during periods of peak, excess and weak demand? Could you have sold bedrooms at a higher price during your peak and excess demand periods? Would a lower price during weak demand periods have led to increased accommodation sales and the possibility of generating income in other departments (e.g. food and beverage)?
- ! Details of upcoming events in your locality and an estimate of the demand for accommodation stock. This will enable you to establish whether you can sell rooms at your highest rate, despite having to turn away business which is prepared to pay a lower rate only.
- ! The prices being charged by your competitors at various times during the year. You will need to monitor your competitors' rates closely. If they offer a rate that is below your rate there is a risk that they will capture a large proportion of the demand for bedroom accommodation. However, if you are confident that they are offering lower rates during a period of peak, or excess demand, you should keep your rates high as you may sell your bedrooms anyway.
- ! Details of advance bookings already secured (number of bookings, room rate). In circumstances where you are certain that demand for bedrooms will increase for a particular night, or during a particular period, and you have been selling bedrooms at a discount, you should consider reducing the level of discount offered for that period. You may consider reducing the discount in stages (e.g. if you have 10 bedrooms, and two are already sold for a particular night at a discount of 50%, try reducing your discount to 25% for the remaining rooms. If two more rooms are sold for that night, monitor demand if you reduce your discount to zero).

Steps you can apply in your business

Identify and monitor all your costs.

Use accounting reports to compare budget costs to actual costs.

Calculate the break-even point for your business activities.

Set some challenging improvement targets and celebrate their achievement.

Benchmark your business against industry averages and your previous performance.

Make sure you are pricing for profit, not just sales.

Use the Four Fives Rule to see how you can improve profits.

Separate your activities so you can monitor their profitability.

Get help from your accountant to identify and monitor some key business indicators.



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