

KNOW YOUR HOURLY COSTS

SUMMARY

When calculating your company's hourly cost as a basis for quoting, make certain your operating figures are accurate and up-to-date. Knowing all your costs is a track to success, while insufficient or inaccurate cost data is most assuredly a road to disaster.

Your costs, like those of every business, have no doubt risen at irregular rates in recent years. Even during periods of price stability, your mix of hourly costs will change as your direct labor hours increase or decrease.

FIXED COSTS

Fixed costs (for example, building rent) remain the same (in dollars) for a certain period regardless of the number of direct labor hours worked during that time. Because the total dollar amount does not change, the dollars PER DIRECT LABOR HOUR will decline with an increase in total direct labor hours during the period. For example, a company paying building rent of \$45,000 per year will find that rent will decrease from \$3.00 to \$2.25 PER DIRECT LABOR HOUR as monthly direct labor hours rise from 1,250 to 1,666. Of course, the reverse is also true; fixed costs per direct labor hour will increase during slow production periods.

VARIABLE COSTS

Other expenses, such as payroll burden, are VARIABLE costs — costs which rise as production increases and decline as production falls. Variable costs remain roughly the same PER DIRECT LABOR HOUR whether direct labor hours are increasing or decreasing, provided that management takes timely action when backlog is shrinking.

Certain expenses, which are generally termed SEMI-VARIABLE, tend to rise in an uneven, stair-step fashion as production increases. Supervision is an example of a semi-variable expense. In some cases, however, expenses which are semi-variable on the upside (increasing with increases in direct labor hours) become essentially fixed (since the costs may continue even as direct labor hours decline). Management, for instance, may be reluctant to lay off a good supervisor despite a drop in business activity.

ACCURATE COST RECORDS

Because your expenses per direct labor hour will obviously change as your total direct labor hours increase or decrease, and because certain expense items are more drastically affected by inflation than others, it is extremely important that you maintain up-to-date figures for both costs and direct labor hours as the basis for calculating your hourly expenses.

If you are quoting on a vary large job which will significantly increase your direct labor hours during a particular period, you should consider the effect of the higher level of production on your fixed and semi-variable expenses. Substantial expansion will generally result in an increase in your fixed cost base. Chances are a portion of these higher costs will continue, even after direct labor hours decline toward their previous level. This potential development — and the need for ongoing marketing of the sales activity to support expanded facilities — should be seriously considered when working up the quotation.

RECOGNIZE ALL COSTS

Accurate and profitable quotations depend upon recognizing all costs associated with the continuing operation of your plant — not just the direct costs which apply to a specific job. You should work closely with your accountant to make certain that every expense is recorded according to a logical and easily understood chart of accounts. Because your company, like all others, is constantly changing fringe benefits, developing new sales/advertising approaches, acquiring new production equipment, purchasing new computer hardware

and software — as well as taking other management actions which affect your cost structure — you should review your chart of accounts from year to year to make certain that the expense classifications properly reflect your current operating conditions and procedures. The NTMA Costing, Pricing and Financial Management Manual provides helpful guidance in establishing a workable system for capturing and analyzing the information you need.

Accurate accounting is not only important in arriving at profitable quotations, but it is absolutely essential in analyzing your company's overall progress. The annual Operating Costs and Executive Compensation Report published for you by NTMA will help you consider the adequacy of your chart of accounts and evaluate your financial performance. Comparing your company's profitability with that of similar

metalworking companies will enable you to evaluate competitive conditions, identify your operating strengths and weaknesses, and improve your pricing.

This BMA was prepared by Barry E. Miller, Financial Management Consultant, Reading, PA. The Barry E. Miller Company prepares the Operating Costs and Executive Compensation Report and the Wage and Fringe Benefit Report for NTMA. Mr. Miller serves as a consultant to NTMA members and has appeared as an expert witness on behalf of member companies.