Where you want to be with your Costs

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1 Introduction

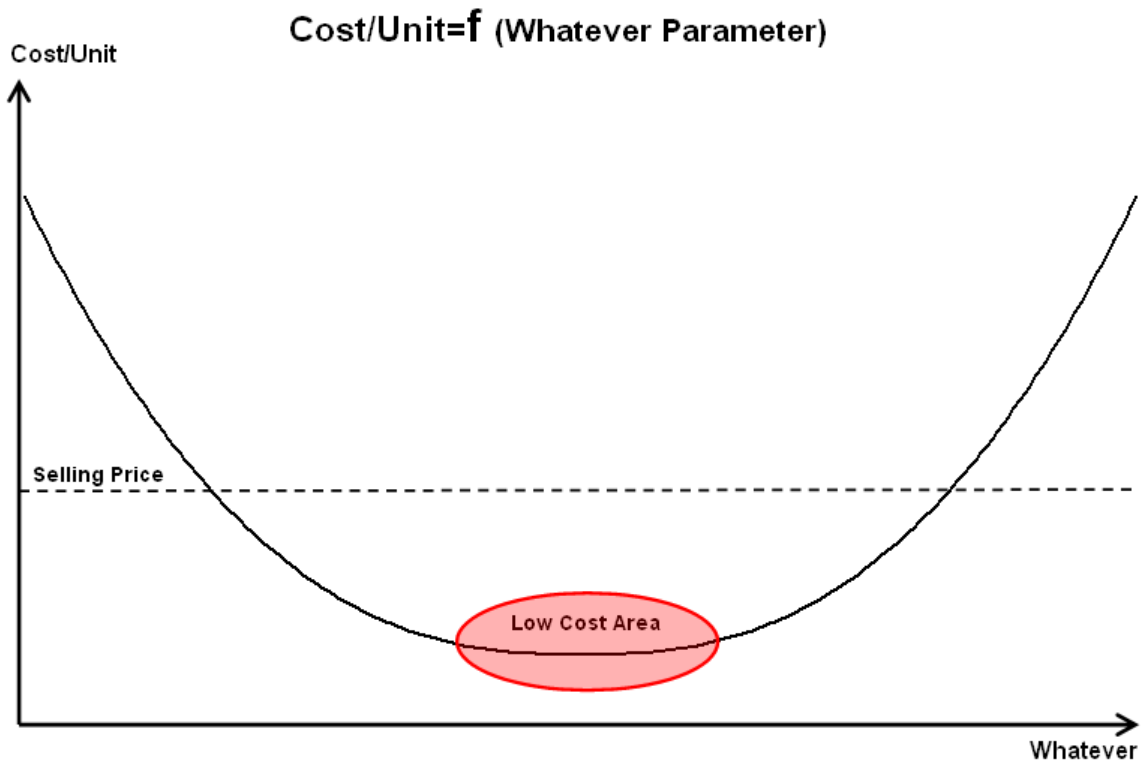
Very few organizations have the privilege to charge for their goods or services whatever they want. For all others, their prices are more or less set by the market (or by some form of regulations). Every organization lives off the difference between the selling price and the costs per unit. So if you can not set your prices, you want to minimize your 'Costs per Unit'.

If you deem the following as absolutely trivial, you are correct. I nevertheless think it is worth mentioning because I have witnessed too many cost cutting exercises with simplistic approaches like 'slash overhead costs', 'minimize your inventory' (preferably to zero), etc. where this basic truth got lost in the heat of the battle.

2 Costs per Unit

Organizations are more or less complex entities with tens of parameters influencing each other. It is not possible to minimize your 'Costs per Unit' by minimizing each of these parameters.

If one looks realistically at the relationship between the costs for a specific parameter and the 'Costs per Unit', the resulting graph looks something like this.



This graph is a two dimensional depiction of a reality with tens of interrelated dimensions. As the environment you operate in changes, the graphs will change too.

To maximize your earnings, you want to operate your organization in the 'Low Cost Area'. The graphs are generally wide troughs. This means that if your organization operates in the low cost area, small changes will not influence the 'Costs per Unit' dramatically.

3 Examples

To give a clearer picture of what this graph means, here are two examples.

3.1 Wages

Everybody knows the old wisdom that ‘what you pay is what you get’. If your organization pays minimum wages you normally get people with minimum skills (and often low ambitions). Depending on how your organization is set up, this skill set can raise your ‘Costs per Unit’ considerably above the costs you could achieve with a higher paid workforce due to lower productivity, higher quality costs (scrap, rework, etc.) and higher turnover rates.

3.2 Engineering

If your organization involves manufacturing, chances are you also have an engineering department. As a rule of thumb, the better engineered your products, the more productive your plant. Another of these rules also knows that the better you already are the more costly improvements. To make matters worse, the optimal level of engineering for your organization also depends, among many other parameters, on the skill set of your workforce on the floor (see 3.1, Wages).

4 Conclusion

There are no mathematical formulas that allow calculating the optimal point; you have to ‘find’ it. If you want to operate your organization at the lowest ‘Costs per Unit’ the best approach is probably:

- Define the main parameters influencing your ‘Costs per Unit’
- Analyze each of them critically and honestly, also considering the impact of other parameters (see 3, Examples)
- Decide on which side of the optimal point you are currently operating
- Start changing the parameters in the right direction.
- After the implementation period, review the results and repeat the process on a regular basis.

Owl Database Application’s Sensitivity Analyzer is an effective tool to support this process. It allows you to easily run through ‘What-If’ scenarios that are based on *your* reality.