How to Spend Money Wisely: Crash Course Entrepreneurship #14

Crash Course: Business - Entrepreneurship
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One of the most common reasons startups fail is -- Because they didn't talk to customers?

There's no market for their product and no one wants what they're selling? They didn't research the competition and someone's already offering their service?

Okay... so we've learned a lot of strategies to fight off failure. But we could be doing all this right and still fail if we straight-up run out of money. Expenses can pop-up, supplies can suddenly be hard to find, or delivering the most value to customers can involve some expensive choices.

Businesses can run out of money -- it happens. But it doesn't have to happen to us. I'm Anna Akana, and this is Crash Course Business: Entrepreneurship. [Theme Music Plays] There's a common saying that you have to "spend money to make money." Well, when you're just starting out, there are lots of opportunities to spend money, and lots of different terms to describe it all.

We better pull out the "Finance to English" Dictionary again. First, let's establish that all of these things we're going to talk about fall under the broad category of operating costs or expenses. These are all the things you pay for to do business on a day-to-day basis.

But you COULD NOT POSSIBLY use the same word to refer to product costs as you do administrative costs. That would just be madness! So underneath the umbrella of operating costs are two smaller groups: cost of goods sold and selling, general, and administration costs or SG&A;.

Cost of goods sold, also called direct costs, refers to all the expenses that are directly tied to producing a product or service. So if we want to print an irreverent lit magazine, what we pay writers to create satirical content would fall under cost of goods sold, and so would the printing costs of the magazine. And SG&A;, also known as indirect costs, are basically everything else we need to run the business.

This could include salaries for people in management, or even rent, utilities and supplies that aren't part of manufacturing. So the distribution costs of getting our magazine out to people, the marketing budget, and the salary of the head editor (since she's an administrator) would fall under SG&A;. And also the cupcakes we bought to celebrate Dave's birthday last week.

Breaking expenses down with these two categories helps us figure out where our money is being spent in broad strokes -- on our product or service, or on everything else. But there's another way to split up expenses that can help us pay attention to what expenses will change as we grow. There are fixed costs, which don't change in the short term based on the number of goods or services we produce.

So, for example, the rent for our co-working space where we create and edit the magazine layout is a fixed cost. No matter how many copies we sell, the rent isn't changing. And there are variable costs, which are expenses that fluctuate based on how our output changes.

The amount of ink and paper we need, or the shipping costs change based on how many magazines we want printed. And we're going to need a lot. Who wouldn't want to read our hot take on goat yoga?

This is a very basic overview of some ideas and vocabulary to get started. After all, jargon can be one of the most intimidating barriers to overcome in entrepreneurship. So now that we know about different kinds of costs, we can decide what roles they're going to play in our business.

At this point, we've thought a lot about our business and know our customers pretty well. We know what they value and where their pains are. So we want to make sure our business model reflects that, even in how we handle expenses.

And we can choose to prioritize minimum costs or maximum value. In a cost-driven structure, we try to minimize costs wherever and whenever possible. This will show up in our value proposition -- if we're working to deliver something to customers at the lowest possible price, keeping costs lean will be a key part of our business.

We might maximize automation, outsource expensive tasks, or devote lots of resources to optimize every step of the process. If you live in Canada, you've probably seen the in-your-face yellow signs with NO FRILLS in giant block lettering. And they mean it.

For 30 years, the No Frills grocery chain has allowed customers to trade "frills" for savings. Store displays? That's a frill.

Someone to bag your groceries for you? Frill. Taking products out of their cardboard shipping boxes instead of just cutting the sides and stacking them?

You guessed it -- frill. They work incredibly hard to keep their SG&A; costs low. And customers love it.

Losing all the frills means saving money, and they know the low prices aren't coming from low quality, but low frill count. And they haven't stopped with de-frilling the stores, they've even de-frilled products to keep down the cost of goods. No Frills' parent company created a generic brand called "no name." It's literally yellow labels with a basic description of the product in bold sans serif font.

They've leaned in hard to their cost-driven identity, show that priority to customers, and they've managed to take that success across Canada. You can see lots of other examples across industries. Airlines like Southwest or Ryanair, big box stores like Walmart, or giant thrift stores like Goodwill or the Dollar Store all have cost-driven structures.

Maybe not with the sense of humor of No Frills... but still. On the flip side is a value-driven structure, where companies are less concerned with how much a particular business model costs and more with how much value it creates for customers. Don't get me wrong, they're not handing out iPads like candy.

Everyone has to be conscious of expenses in order to turn a profit, but value-driven companies often splurge on pricier things like very personalized service. The Ritz-Carlton Hotel company has won awards for its customer service. The tales of employees going to extravagant lengths in the name of The Customer are the stuff of legends or viral tweets.

There are elaborate photo shoots of stuffed animals before they're mailed back to their owners with handwritten notes, and employees who flew cross-country to deliver lost laptops before important presentations. And these aren't one-off stories. Every employee, from the highest level of the company to the kid who's been there a week, is given up to $2,000 to delight a customer with service.

While The Ritz still probably does work to keep costs down (that's why it's $2000 and not 2 million) they're willing to spend money if it creates more customer value. The value-driven end of the spectrum is full of luxury car brands, clothing lines, or even watchmakers who sell $500,000 watches that pro tennis players casually advertise as they sweat all over the court... wat? Most businesses, including

your business, will probably fall somewhere in between the cost-driven and value-driven range.

The balance is up to you, but there are certain ways to be more cost-driven without sacrificing value. As we discussed when we talked about key partners, an economy of scale is a cost advantage a business can have if it produces larger quantities and spreads fixed costs around more products. Or an economy of scope is a cost advantage a business can have by sticking its hand in multiple metaphorical cookie jars.

With several product lines or services, one set of marketing techniques and distribution channels can support multiple key activities. Even though the total bill might be bigger, with an economy of scale or scope, bigger really is better. You can do more with the expenses you've already invested in to make sure your profits -- your revenue minus your expenses -- are bigger too.

To see an example, let's go to the Thought Bubble. [start Thought Bubble] Piper couldn't find reasonable professional painter options in her town, so she painted her own house inside and out, and the neighbors showered her with compliments. So Piper decided it'd be worth the risk to start her own LLC, "Big P's Small House Painting." At first, Piper buys the materials necessary for each job -- the paint, primer, drop cloths, tape, brushes, rollers… you get the idea. She rents extra equipment on a case-by-case basis, like a pressurized paint sprayer, and pays contractors by the hour when she needs to do a rush job.

Together, these go into the cost of goods sold because they're specific to her house painting. Once Piper has some revenue, she'll set up a website and marketing budget which count as selling, general, and administration expenses. Word is starting to get out and she has a steady flow of customers, but somehow she's not making ends meet.

At the end of the week, she barely has enough in her bank account for frozen pizza. What happened?! Luckily, she kept diligent records and realized she forgot some things in the chaos of starting a new business, like the gas for hauling supplies and driving from house to house, or paying to store her equipment in a local facility.

She even overlooked a pretty major direct cost -- the time it takes to plan each house-painting project. If Piper is going to make this work, she's going to need a much better system. There's still time to turn things around with some accounting software and cost structure changes.

Maybe instead of buying everything for each job, she can work out an economy of scale to buy paint and rollers in bulk. But she'll need to move fast -- not sit around watching paint dry -- to be successful! Thanks, Thought Bubble!

Understanding where your money is going (to fixed costs, direct costs, all that stuff) will help us plan strategies that keep us profitable rather than spiraling and going bankrupt. Our money is pulled in a lot of different directions when we're getting a business into the world, so planning is absolutely essential. Entrepreneurs also pay close attention to expenses because we care about where our money is going.

For example, social entrepreneurs mix for-profit goals with creating a positive return for society. These are nonprofits or B-corps that make choices that may be less profitable to maximize their impact on social, cultural, or environmental goals. Businesses like Warby Parker, who donate one pair of glasses for every pair sold, were started by social entrepreneurs.

And tracking expenses is really important to make sure they're budgeting effectively so they can make those less profitable decisions. They don't just want to maybe donate profits later on -- the higher purpose is infused directly into the fabric of their business. So sales drive any business, but careful expense-tracking drives a profitable and responsible business.

The bottom line is: Pay attention and plan. Be cost-driven, be value-driven, or be somewhere in between, but know where your money is going so you can keep delivering value to customers. You have to spend money wisely to make money effectively.

Since we've finished filling out the Business Model Canvas yay!, the next three episodes will be all about money and growth. Next time, we'll delve into the exciting underbelly of any business -- the accounting department. Thanks for watching Crash Course Business, which is sponsored by Google.

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