MONTANA CHILD CARE BUSINESS CONNECT

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What is Cost-Informed Rate Setting

It seems fair to suggest that many childcare providers have already heard the concept of the “Iron Triangle” created by co-founders of the Alliance for Early Childhood Finance, Louise Stoney and Anne Mitchell.

“The three sides of the Iron Triangle—maintaining full enrollment, collecting fees in full and on time, and collecting revenues that fully cover costs.” (1)

Each of the three make sense on their own and in concept. Getting each of the three into practice is substantially more difficult.

Full enrollment is tied to licensed capacity and a provider’s ability to retain staff and corresponding ratios.

Collecting full fees, and collecting on time, is its own can of worms related to a family’s household income, their eligibility for subsidy, an ability to pay on time, and a provider’s collection policies.

The third, collecting revenues to cover costs, seems clear but is far from it.

A series of assumptions need to be made when setting tuition rates at a level that covers the costs of doing business. One assumption can relate to a provider’s daily enrollment average – or occupancy rate – and the number of full-time children enrolled versus the scheduling problems created by enrolling part-timers.

This is where the concept of setting cost-informed rates jumps into the sandbox as a solution for calculating.

Pricing Methodologies

To fully understand how the cost-informed rate method fits into the overall approach of rate-setting, it is important to know the three primary methods business owners have at their discretion when setting prices for products and services.

- Competition-based methods for rate-setting require an understanding of what direct competitors in your immediate vicinity charge for the exact same types of services.
- Market-based methods require a provider to understand what their customers can pay and/or are willing to pay. (There are some fun psychological approaches to this method which include promoting your business as the best out there. Another approach here is suggesting to the customer how much value they’re receiving from your service.)
- Cost-informed methods calculate and quantify what your business, regardless of your competition and the market, must charge to cover 100% of operating costs.

Components of Costs

To be able to use the cost-informed method of setting rates, a provider must know what their costs are, what they could be, what they should be, and how those costs behave within a business. How costs behave requires us to know how they connect with revenue.

- Variable costs are business expenses that are proportional to revenue. If revenue goes up, variable costs follow. If revenue goes down, variable costs also go down. In childcare, think classroom materials, the food fed to children, and educators in the classroom with the kids.
- Fixed costs are those expenses that do not directly link to revenue. They may vary over time, like insurance, but they are not caused by revenue. Think administrative labor, professional development, accounting and tax preparation fees, repairs, maintenance, vehicle, and principal and interest payments on debt. (Oh, and there are about 100 others.)

Cost Structure

Now that we know how costs behave, we can categorize them accordingly and use those two categories for calculating a break-even point for your unique and individual business. We can also adjust to more accurately reflect an idealized reality, like paying our staff more or adding health insurance to a benefits package.

The concept of cost structure is how providers can truly identify how their business is different from direct competitors.

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Calculating Cost-informed Rates

This is a four-step process. It's called break-even.

Step 1

Gather your financial statements. Ideally three years, if you have it. If not, we can do this by month, quarter, or semi-annual periods as well. Calculate variable costs. Calculate fixed costs.

- Example for Year 1: Variable Costs = $412,770
- Example for Year 1: Fixed Costs = $197,670

Step 2

Divide variable costs into total revenue. This will provide a percentage called the variable cost percentage.

- Example for Year 1: Revenue = $696,000
- Example for Year 1: Variable Costs = $412,770
- Formula: Variable Costs/Revenue
- Formula Example: $412,770/$696,000=59% Variable Cost Percentage

Step 3

Calculate the contribution margin percentage by subtracting the variable cost percentage from 100%.

- Total Revenue = 100%
- Variable Cost Percentage = 59%
- Contribution Margin Percentage = 41%

Step 4

Divide the fixed cost dollar amount by the contribution margin percentage. This number will be the break-even point for your company by period.

- Example for Year 1: Fixed Costs = $197,670
- Contribution Margin Percentage = 41%
- Formula: Fixed Cost in Dollars/Contribution Margin Percentage
- Formula Example: $197,670/41% = $485,748 Break-even Point

To calculate break-even by unit (aka: the per child rate), we can then divide the break-even amount by period into the number of children enrolled, children in daily attendance, or some other per-unit basis.

- Break Even Revenue = $485,748
- Total Days Open per Year = 250
- Daily Enrollment = 63 children daily
- Formula: Break Even Revenue/Total Days Open per Year/Daily Enrollment = Cost informed Rate
- Formula Example: $485,748/250/63=$30.84 Break-even Point unit (per child per day)

Summary

The example presented above indicates this sample company does not have a revenue problem. This would be abnormal for most childcare providers struggling with cash flow and profitability. However, this formula can be used to make decisions and take action. And rest assured, it works.

The formula also requires some degree of financial history, which not all readers of this article have. Startups and early-stage companies can use financial projections, industry financial benchmarks, and the process of successive approximation (aka: a series of assumptions) to achieve a cost-informed rate.

Most importantly, providers need to use a hybrid of all three pricing methodologies to price accurately. But if the cost-informed method is omitted, it is likely the tuition being charged is not unique enough to your cost structure and how money flows through your business.

To learn more about this topic, please check out this free, 30-minute webinar.

- https://www.youtube.com/watch?v=Jg4RkNflEdQ&t=5s

Sources:

1. https://childcareta.acf.hhs.gov/sites/default/files/public/delivering_quality_strengthening_the_business_side_of_ece.pdf

For additional assistance with your childcare business, contact Zero to Five Montana's Senior Child Care Business Advisor Jason Nitschke at JasonN@ZerotoFive.org.

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