

How to Create a Comprehensive Cost Model

At this point, you should have completed three (3) steps towards your financial plan:

1. Estimate Total Startup Costs – <https://startup-financial-plan.com/startup-costs>
2. Develop a Funding Plan – <https://startup-financial-plan.com/funding-plan>
3. Prepare a Credible Sales Forecast – <https://startup-financial-plan.com/sales-forecast>

This brings us to Step 4 – Build out a complete cost model to form the bottom sections of the Income Statement or Profit and Loss Statement. The Cost Model has three cost components:

1. **Variable Costs** – Expenses that vary with sales revenues which typically are captured and reported as Cost of Goods Sold. It can also include any all costs to deliver the product or service to the customer such as shipping or sales commissions paid on the sale. Variable Costs have a “direct” relationship to the product or service sold.
2. **Fixed Costs** – Expenses that tend to be more or less the same month to month and these costs do not vary much as sales go up or down. Almost all of these expenses are considered Operating Expenses. They are not directly related to the product or service delivered to the customer.
3. **Non Operating Costs** – Some expenses are not related to the core operations of the business. Two common examples are Interest Expense on debt payments and Depreciation Expense on Fixed Assets. You can also have non-operating expenses that are infrequent and unusual in nature such as litigation expense and natural disaster expenses.

Variable Costs

Let's start with the Variable section which relates to all costs to put the product or service in the hands of the customer. This can include everything to manufacture and produce the product itself – raw materials, labor, factory overhead, inspection, storage. If someone else makes the product, what is the cost to fully land the product in your warehouse?

If a service is delivered to a customer, what was the entire level of effort involved – time spent at an hourly rate. If the service is a project, everyone working on the project will charge their time to the project. This can also include ODC – Other Direct Costs such as travel and supply expense that was consumed and used on the project.

Variable cost are captured to a cost object – products, projects and customers are the three most common cost objects that collect variable costs. Here is a table that breaks down variables costs by cost object (products, projects and customers):

Cost Category	Products	Projects	Customers
Labor	Direct manufacturing labor, Assembly labor, Production wages	Professional/billable labor hours, Project manager time, Consultant hours	Account management time, Customer service labor (if tracked by customer), Sales time on customer-specific work
Materials/Supplies	Raw materials, Component parts, Subassemblies, Packaging materials	Project-specific materials, Supplies consumed on project, Office supplies for project	Customer-specific materials, Customization materials, Promotional items for customer
Outside Services	Contract manufacturing, Outsourced production processes	Subcontractor fees, Third-party consultants, Specialized testing services	Third-party services for customer orders, Custom fulfillment services
Equipment/Tools	Tooling and dies (if product-specific), Equipment rental for production run	Equipment rental for project duration, Specialized tools purchased for project	Equipment needed for customer-specific requirements
Travel/Transportation	Freight-in on raw materials, Inbound shipping costs	Project site travel, Lodging for project work, Mileage to customer site	Travel to customer location, Delivery costs to customer, Freight-out
Technology	Product-specific software licenses	Project management software (if allocated), Project-specific software/subscriptions	Customer portal costs (if tracked individually), Customer-specific integrations
Other Direct Costs	Royalties per unit, Product testing/inspection, Scrap and rework	Permits specific to project, Project-specific insurance, Bonding costs	Sales commissions, Customer-specific discounts/rebates, Customer-specific warranty costs, Returns and allowances

Key Distinction: The critical factor is traceability - can you specifically and economically trace the cost to that particular product, project, or customer? If yes, it's direct. If it benefits multiple cost objects and requires allocation, it's indirect/overhead.

For example, a factory incurs rent, utilities and exists to produce multiple products. Indirect resources are consumed by the cost object and we would allocate a portion of these expenses to the various cost objects. Cost pools are often set up to capture indirect costs and a driver is used to allocate the cost from the cost pool to the cost object.

Example:

HR Recruiter fills positions for projects, but is non-billable to clients. The average cost to interview and bring a person on board is approximately \$ 1,900. Each time a position is filled on a project, the project is charged with a non-billable expense of \$ 1,900. The goal is to convert in-directs (overhead) to directs for a more accurate representation of the true cost of the cost object. In this case, we are converting HR Overhead (indirect) to direct – charge to project (cost object)

Measuring Variable Costs

There are two approaches to measuring variable costs:

1. Bottoms Up Detail Estimate – You calculate all of the actual expenses including an allocation of overhead to arrive at the total cost of the cost object which is usually a product or service.
2. Top Down Industry Benchmark – For businesses with numerous products and services, it can be difficult to calculate variable cost for every single product and service. Every industry has a range of variable costs common to that specific industry.

The detail bottoms-up approach is accurate and preferred where you want high control over what it is you deliver to the customer. The trade off it takes a lot of analysis and quality data to get this right and many businesses have too many products and services.

Example:

Your business makes blue jeans and sells them online. You have estimated the actual cost to make a pair of blue jeans as follows:

Cost Element	Unit Cost (1 pair)
Materials – Fabric, Zipper, Button, Thread	\$ 27.10
Labor – Seamstress \$ 20 x (10 min / 60 min)	\$ 3.33
Overhead – Machine, Shop Floor	\$ 1.05
Cost to Make	\$ 31.48
Press, Label, Sort and Store	\$.80
Shipping to Customer	\$ 4.50
Local Inventory Tax	\$.20
Order Fulfillment	\$.70
Other Variable Costs	\$ 6.20
TOTAL VARIABLE COST	\$ 37.68

The second approach is to know the gross margin for your respective industry. Every industry has a gross margin range and the difference between 100% Sales and the Gross Margin percent is the Variable Cost percent that the business will apply this variable cost percent to Sales in estimating its Variable Costs.

Industry (NAICS 2-Digit Code)	Gross Margin Range	Variable Cost Range
11 - Agriculture, Forestry, Fishing & Hunting	35-45%	55-65%
21 - Mining, Quarrying, Oil & Gas Extraction	40-55%	45-60%
22 - Utilities	45-60%	40-55%
23 - Construction	20-30%	70-80%
31-33 - Manufacturing	25-40%	60-75%

42 - Wholesale Trade	15-30%	70-85%
44-45 - Retail Trade	25-40%	60-75%
48-49 - Transportation & Warehousing	25-40%	60-75%
51 - Information	50-70%	30-50%
52 - Finance & Insurance	70-85%	15-30%
53 - Real Estate & Rental/Leasing	55-75%	25-45%
54 - Professional, Scientific & Technical Services	40-60%	40-60%
55 - Management of Companies & Enterprises	50-70%	30-50%
56 - Administrative & Support Services	30-50%	50-70%
61 - Educational Services	45-65%	35-55%
62 - Health Care & Social Assistance	35-55%	45-65%
71 - Arts, Entertainment & Recreation	40-60%	40-60%
72 - Accommodation & Food Services	60-70%	30-40%
81 - Other Services (except Public Admin)	40-60%	40-60%

Choose your approach and complete this first cost component – **variable expenses** within the cost model. All of this will get reported as **Cost of Goods Sold** on the Income Statement. Cost of Goods Sold is an expense that is incurred as you sell products and services.

Fixed Costs

Fixed costs for the most part are Operating Expenses. Operating Expenses include:

FIXED / OPERATING EXPENSES	
Salaries & Wages (Non-Production)	Licenses & Permits
Payroll Taxes & Benefits	Dues & Subscriptions
Rent / Lease Payments	Bank Fees
Utilities (Electric, Gas, Water)	Merchant Services Fees
Insurance (General Liability)	Repairs & Maintenance
Insurance (Property)	Vehicle Expenses (Gas, Maintenance)
Insurance (Workers Comp)	Travel & Entertainment
Insurance (Auto - enter in applicable month)	Training & Development
Insurance (Professional Liability)	Security & Alarm Services
Telephone & Internet	Waste Removal
Office Supplies	Janitorial Services
Computer & Software Subscriptions	Postage & Delivery
Marketing & Advertising	Printing & Copying
Website Hosting & Maintenance	Miscellaneous Operating Expenses
Professional Fees (Legal)	TOTAL FIXED / OPERATING EXPENSES
Professional Fees (Accounting)	
Professional Fees (Consulting)	

If you want to reduce this list down, you can group some of the expenses into a category such as General and Administrative Expense (G & A). G & A would cover all office personnel including HR, Accounting, Legal Support, office supplies, licenses, permits, phone, bank fees, and insurance.

Here are some guidelines to help with estimating operating expenses:

Rent & Occupancy Costs

Where to look:

- **Commercial real estate listings**
 - LoopNet
 - Crexi
 - Zillow Commercial
- **Local commercial brokers** (often free estimates even if you don't lease yet)
- **City or county assessor's office** – property taxes (often public records)
- **Current lease comps** from nearby businesses (ask owners directly if possible)

What to confirm:

- Base rent vs. triple-net (NNN) charges
 - CAM fees (common area maintenance)
 - Annual rent escalations
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Utilities (Electric, Gas, Water, Internet, Phone)

Where to look:

- **Local utility providers' websites** (many publish average commercial usage)
- **Ask the landlord** for past tenant utility averages
- **Current business owners in the same building**
- **Internet & phone providers** (Comcast Business, AT&T Business, Verizon, etc.)

Pro tip: Utilities can vary wildly by square footage, hours open, and equipment—restaurants and gyms especially.

Payroll & Labor Costs

Where to look:

- **Bureau of Labor Statistics (BLS.gov)** – local wage data by job type
- **Indeed / Glassdoor / ZipRecruiter** – real market wages
- **State labor department websites** – payroll taxes, workers' comp rates
- **Payroll providers**
 - Gusto
 - ADP
 - Paychex

Don't forget to add:

- Employer payroll taxes
 - Benefits (health insurance, PTO)
 - Workers' comp insurance
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Insurance (General Liability, Property, Workers' Comp, etc.)

Where to look:

- **Business insurance brokers** (Hiscox, Next, The Hartford)
- **Industry associations** (often have group rate data)
- **State insurance commissioner websites** (minimum requirements)

Tip: Ask brokers for **monthly equivalents**, not annual premiums.

Marketing & Advertising

Where to look:

- **Ad platforms**
 - Google Ads (keyword planner)
 - Meta Ads Manager (Facebook/Instagram)
 - **Local marketing agencies** (often publish starter packages)
 - **Competitor analysis**
 - Facebook Ad Library
 - SEMrush / SpyFu
 - **Industry benchmarks**
 - SBA
 - Trade associations
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Software & Subscriptions

Where to look:

- Vendor pricing pages (QuickBooks, Shopify, Square, HubSpot, etc.)
- Capterra / G2 reviews (often show real pricing tiers)
- “Best software for [industry]” comparisons

Commonly missed costs:

- Payment processing fees
 - POS software add-ons
 - CRM and email tools
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Professional Services (Accounting, Legal, Consulting)

Where to look:

- Local CPA and law firm websites (many list monthly retainers)
 - SBA Small Business Development Centers (SBDCs)
 - Upwork / Fiverr (for fractional or startup-phase services)
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Licenses, Permits & Regulatory Fees

Where to look:

- **City and county business licensing offices**
 - **State Secretary of State website**
 - **Industry regulatory bodies** (health department, alcohol control, etc.)
 - SBA.gov license lookup tool
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Repairs, Maintenance & Miscellaneous

Where to look:

- Equipment vendors (maintenance contracts)
- Trade forums or Reddit (industry-specific subs)
- Ask existing operators what breaks *most often*

One of the BEST Reality Checks

Talk to 3–5 existing business owners in:

- The same industry
- Similar size
- Same city or region

Most will give you surprisingly honest monthly numbers if you ask respectfully.

Non Operating Expenses

The last cost component in the cost model are expenses that do not relate to the core operations of the business. Operations is the main activity of the business and this gets split between Variable (direct – cost objects) and Fixed (indirect – operating expenses). The two most common non-operating expenses are Taxes and Interest.

Taxes are corporate taxes for C Corporations as opposed to a Limited Liability Company that will not pay any corporate tax. Interest is related to outstanding loans – part of your loan payments are for Interest Expense.

It is possible that you might have a few non-operating expenses not related to Taxes and Interest. An expense that is infrequent in occurrence and unusual in nature is most likely a non-operating expense. Two examples of this are litigation expense and natural disasters. These are unusual and do not occur frequently with the core operations of the business.

Monthly Breakdown

Both revenues and expenses for the projected Income Statement should be broken out by months. There are changes that you want to reflect in your projections – the fact that you did not bring on payroll until needed or some purchases were delayed until late in the year. Additionally, many businesses have a seasonal flow to their financial results:

Ski Resorts – Most business is in the winter

Tax Preparation – Most business is around tax filing time

Home Improvement – Most business is in the Spring and Summer

The goal at this point is to combine our Sales Forecast (monthly) with our Cost Model (monthly) so we can produce a Forecasted Income Statement by months:

\$	40.00	Jan	Feb	March	April	May	Jur
Unit Sales:		50	100	150	300	400	50
Revenue: (\$40/hat)		\$2,000	\$4,000	\$6,000	\$12,000	\$16,000	\$20,000
Cost of Goods (\$ 22/hat)		\$1,100	\$2,200	\$3,300	\$6,600	\$8,800	\$11,000
Gross Margin		\$900	\$1,800	\$2,700	\$5,400	\$7,200	\$9,000
Rent		\$0	\$0	\$2,500	\$2,500	\$2,500	\$2,500
Personnel		\$1,800	\$2,600	\$2,600	\$3,200	\$3,200	\$3,200
Utilities		\$600	\$600	\$600	\$600	\$600	\$600
Marketing		\$2,900	\$2,200	\$1,900	\$1,600	\$1,600	\$1,600
Gen Admin		\$800	\$800	\$800	\$800	\$800	\$800
TOTAL OPEX		\$6,100	\$6,200	\$8,400	\$8,700	\$8,700	\$8,700
Interest on Debt		\$0	\$0	\$220	\$205	\$195	\$195
Depreciation		\$0	\$0	\$0	\$83	\$83	\$83
TOTAL EXPENSE		\$7,200	\$8,400	\$11,920	\$15,588	\$17,778	\$19,000
PROFIT (LOSS)		(\$6,300)	(\$6,600)	(\$9,220)	(\$10,188)	(\$10,578)	(\$10,000)

TOTAL OPEX refers to your Total Operating Expenses which we consider fixed and we will use this 12-month total to calculate a breakeven in terms of units we must sell. Likewise, we can quickly add back our Non-Operating Expenses to the Profit total to arrive at the primary benefit stream used to assign a valuation to our business model. This is why it is important to organize all costs into a well organized model – it helps the small business owner quickly calculate key financial metrics.

If you have questions or need assistance, feel free to drop me an email:

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