COSTING FOR EXECUTIVES

by Paul Pinkus

A company's ability to contend with changing business conditions, customers, and employees is predicated on knowing costs. Unfortunately, the overwhelming majority of companies in the store fixture industry don't really know their costs.

To estimate properly, you need to measure costs and understand them. Every manufacturer's products have three cost components: material, labor, and overhead. Overhead is a little difficult to define because what one company might consider overhead, another might consider to be labor or material. Generally, if you assign a cost using an allocation method, it's an overhead item.

You also can categorize the costs associated with manufacturing a product as direct or indirect costs. A direct cost is directly associated with the product—if you didn't manufacture that product, the cost would not be incurred, and it varies in direct proportion with the number of units manufactured. Direct costs are usually limited to materials and direct manufacturing labor associated with the specific item being produced.

Indirect costs—also called factory burden, factory overhead, manufacturing expenses, and manufacturing overhead—comprise all costs other than direct materials and direct labor that are associated with the manufacturing process. Within indirect costs there are fixed costs—which are operating costs that don't vary with changes in the level of manufacturing activity—variable costs, and step-variable costs. Variable costs are costs that increase as the level of that activity increases. And step-variable costs are costs that remain fixed for a range of an activity and then move to a new level for the next range of activity.

SYSTEMS FOR MEASURING COSTS

Different cost accounting systems are used to measure costs, but the primary ones are the standard cost system and the job order (or project) cost system.

A standard cost is the anticipated cost of a specific product under an assumed set of circumstances. In essence, when you're using standard cost as your cost accounting system, you're creating an estimate at the beginning of the year for every single item that you're going to manufacture.

A job order accounting system is used by organizations that identify products or services by individual units or batches, each of which receives varying inputs of direct materials, direct labor, and factory overhead.

For standard cost accounting to be effective, there must be good reporting of actual costs. But this is tough, because many standard cost accounting systems don't capture actual costs well. The system then becomes a liability: If you don't accurately capture the actual costs you incur, you can delude yourself all year long about how your business is doing. The standard cost system also requires a variance analysis—and requires the company to use the information generated by this analysis.

Job order cost systems are best used in make-to-order environments, where each job is unique and different. All direct costs, including materials, labor, and outside processing, are assigned to a particular job, but overhead must also be assigned. The difference is that with the standard cost system, if you developed a standard cost for an item, there would be only one value, even though it was made up of all of the components connected with the cost of that item.

In a job order cost system, there's an allocation of overhead cost assigned to the job, instead of the item. But the overhead is still based on allocation, even though it's a job order cost, where in theory, you have a bucket for each job and all costs for that job are thrown into that bucket. (You still need to do your variance analysis periodically to make sure that you're putting enough of the overhead in that bucket.) For companies that use project cost accounting, the critical element is assigning costs to the job.

The classic method of allocating overhead, regardless of the cost accounting system used, is called full absorption. Classic full absorption accounting is required for financial statement reporting purposes under Generally Accepted Accounting Principles (GAAP). This includes the statements that you furnish to your investors and your lender.

Direct costing has a very simple method of allocating overhead. There is none. Not that there is no overhead; the overhead is just not allocated. Indirect costs are not allocated but instead treated as a period cost. A period cost is a cost you incur in a given accounting period independent of the other activity within the time period.

Don't get wrapped up in accounting rules that are all very logical and make all the sense in the world for historical financial statements but are inferior for managing your business effectively. Use a more intelligent, realistic way to manage.

HISTORICAL DATA NOT RELIABLE

Historical financial statements, balance sheets, and income statements are poor tools with which to run your business. They're wonderful tools to be able to compare your business's performance to other businesses. You need them, you have to have them, but that's not how you want to operate your business on a day-to-day, month-to-month, and year-to-year basis.

Most financial statements are hypersensitive to the valuation of the inventory and project costs, sometimes to the point of becoming a liability or actually worthless. Companies have deluded themselves into bankruptcy with very valuable inventory project costs on their books. One reason this happens is that companies tend to value the material that they bought for that custom job at exactly what they paid for it.

The traditional view of costing includes direct costs (raw materials, outside processing, components, and direct labor) with the addition of indirect costs on some sort of an allocation basis.

The reality view of costing includes only direct costs—no indirect costs. Raw materials, outside processing, and assembly labor are all direct costs. Design, engineering, project management, and general overhead—generally allocated in some fashion—are not, and are not allocated in the reality view of costing.

REALITY CHECK FOR COSTS

Arm your staff with real information they can actually use, not information based on assumptions and allocations.

You're also providing a better sense of what you should get from the job.

First, identify your indirect costs. Based on this information, calculate the margin that you need to fund the indirect cost. This isn't difficult. Divide the total of your indirect costs to your typical or your budgeted sales for the year. That's the margin you need.

Of the many manufacturing companies that have gone out of business, somewhere along the line almost all of them had a significant inventory adjustment. It's not because they're perpetrating fraud. It's because they used genuine, legitimate, accounting rules to value their inventory well beyond what they could possibly have realized from it.

Taking a reality view allows you to manage more effectively. Some of your former competitors who aren't here today failed to do this.

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