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Generating Profits Through an Objective Review of the Cost System

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The classical definition of profits describes them as the excess of revenues, proceeds, or selling prices over related costs. Stated in another way, they are the monetary benefits arising from commercial operations or transactions. Although technically correct, these definitions imply that profits are residues or excesses left over from business transactions; that profits are passive rather than active; and that they are more in the nature of by-products than the principal product of the business organization. This is a mistaken impression held by many business managers and accountants. Subconsciously these attitudes influence their business judgment and decisions, which in turn are often reflected as losses in the financial statements or as inadequate returns on investment. More properly, however, profits are the principal product of management. They are dynamic and can be influenced through the skillful use of management tools.

For purposes of illustration and in support of the latter definition, let us compare the activities required of management to generate a profit with those required to manufacture a product. From our academic knowledge we recall that there are five basic management functions or activities required in any successful business organization. They are planning, organization, motivation, coordination, and control. Each of these five activities must be applied in some form, at proper stages of completion, to manufacture a product that will be accepted by the ultimate consumer. In the planning stages the product is designed; detailed drawings, blueprints, and bills of material are prepared; and specifications and tolerance are precisely engineered. Organization is furnished when route sheets are prepared, materials are ordered, and the manpower and machines are scheduled. Through the functions of production control, timing and coordination are introduced into the manufacturing processes. Wages, incentives, and fringe benefits provide the motivation for skilled labor to produce a quality product, in a reasonable period of time. And finally, through a program of inspection, measurement, and comparison with product
specifications, management provides quality control over the finished product.

If we agree that a reasonable return on investment is the product the manager has been hired to produce for the owner of a business, then it is reasonable to assume that he should apply all the available management skills, to the fullest extent possible, to produce this return for the owners. Modern management methods are frequently referred to as management sciences. Their application requires proper management tools, used with the touch and imagination of the skilled craftsman. Ironically, however, many managers, who wouldn't think of producing even the simplest product without detailed drawings and specifications, begin each new fiscal year without adequate sales and profit objectives, without budgets, forecasts, standard costs, or even a reasonable breakdown of fixed and variable expenses. Many managers who insist on the finest equipment and technology for their manufactured products, will undertake to build profits with inadequate or antiquated management tools.

THE COST SYSTEM

Business managers have numerous management tools available with which to plan, form, build, and develop profits. Cost accounting, the related cost system, and their principal output, management reports, can be management's greatest servant if designed and administered properly. This is particularly true in an industrial enterprise. When I talk about costs and the cost system, I am referring principally to product costs and costs of sales. Please note, however, that the same basic principles apply as well, in most cases, to distribution costs, administration costs, and all other costs not directly related with the product.

DESIGN OF COST SYSTEM

A properly designed cost system can furnish data with which to plan, forecast, set standards, develop budgets, set sales prices, and form policies. Control over materials, manpower, and machines can be provided by comparison with standards or norms. By incorporating the principles of responsibility accounting, management reports can motivate action, if designed properly to highlight problem areas. To serve its masters properly, cost accounting and the related cost system, like any machine or tool, must be well designed for the purposes in-
tended. A cost system is dynamic. It requires periodic maintenance and lubrication to keep it running smoothly, generating timely data. It must be replaced when obsolete, and modified, if changes in products and processes occur. Like any tool, the cost system or its output, will only continue to be used by management as long as it can generate desired results. Cost accounting in many businesses has degenerated to, or has never risen above, a historical record of costs incurred, thereby serving little or no useful management purpose.

The responsibility for an effective and smooth-running cost system rests jointly on management, which uses the data generated, and on the cost accountant, who generates it. The business manager should keep the accountant informed of what information he needs, and when he needs it, to do his job most effectively. He should keep the accountant adequately informed on projected changes in products, processes, or policies that might affect costs. On the other hand, business managers must rely on the accountant to keep him updated on what management data is available or can be made available from the system. In some cases the accountant may find it necessary to educate members of management to the proper interpretation and use of this data.

MODIFICATIONS IN COST SYSTEM

The responsibility for initiating modifications in the cost system rests primarily with the cost accountant because of his technical knowledge and experience, plus the fact that his close contact with the system should disclose needed changes. Accordingly, the cost accountant should periodically emerge from the mass of details and objectively appraise the effectiveness of the system and management reports being generated. This, quite often, is easier said than done. As a result, needed changes never get made and, in time, weaknesses in the system pyramid, producing inadequate or incorrect data on which management is basing its profit-planning decisions. As auditors and as management services specialists, we frequently must make an objective appraisal of the effectiveness of certain cost controls or data, without making a detailed survey of the cost accounting system. In so doing, we are constantly on the alert for flags or smoke signals, as they are known in the trade, which are symptoms of weaknesses in the system, related controls, and management reports. Like many physical symptoms discovered by your family doctor, they are not conclusive evidence that a serious problem or disease exists. Like most physical symptoms, the flags require further investigation to
isolate any serious problems that may exist. Solving cost-system problems generally is not simple; but the recognition of their existence, quite often, is a giant step toward their cure.

**REVIEW OF COST SYSTEM**

To guide you in making your own cost-system review, I would like to discuss some of these flags and cite some examples of how costly management problems are uncovered. Probably the most common flag is the abnormal inventory adjustment or variance. Frequently serious management problems are covered up by stereotyped explanations of inventory adjustments and variances. I know of just such a case. The company manufactured and assembled fabricated metal products. The annual physical inventory disclosed a very significant adjustment of the in-process and finished goods inventories. The size of the adjustment was unreasonable in consideration of the highly controlled and sophisticated engineered standard cost system in use in the plant. The adjustment was at first explained as probably due to a poor cut-off at the time of the last physical inventory. Top management was not satisfied and demanded a full investigation. It was established that proper cut-offs had been made. A new physical inventory was taken six weeks later, which disclosed a further downward adjustment in the in-process and finished-goods inventories. By combing the production reports prepared during the six-week period between physical inventories, it was discovered that more scrap was being sold than was being reported. Investigation disclosed that the night-shift employees were dumping generated scrap into railroad cars on a siding within the plant without properly reporting it, thus overstating production. Further evidences of over-reported production were discovered, which in turn disclosed the real problem. Over a year prior to the physical inventory, the plant made certain changes in its production incentive system without reviewing its control over production reporting, thus making it very lucrative for production employees to devise means of overstating their production. By isolating the real problem, management was able swiftly to initiate proper controls.

**DISCOVERING WEAKNESSES**

Indications from employees, or by other means, of a lack of confidence in data prepared by the cost accounting department is generally a sign of serious weaknesses in the cost data or system. An unusual
case in point was discovered in connection with a cost study made under a cost-plus agreement for certain outside conversion work. In assembling basic data for the study, the accountant noticed that a certain product carried a different code on each of three reports examined. Inquiry disclosed that the reports were prepared by the cost department, the sales department, and the mill office. Investigation disclosed that the sales department and the mill office developed product codes to assemble their own cost information, because they lacked confidence in the data prepared by the cost department or because the cost department's data was inadequate for their management needs. Top management was aware of these three codes, but was unaware of the degree to which useless duplication of effort had progressed because of a lack of confidence in the data generated by the cost department.

COST-SYSTEM CONTROLS

The absence of many of the usual cost-system controls are flags that reflect unfavorably on the effectiveness of the system and the reliability of the cost data generated for management's use. Examples of the controls most frequently missing in cost systems are the absence of standards or norms against which performance can be measured, the absence of cost-center responsibility accounting, the use of general overhead rates in preference to easily determinable cost-center rates, or the use of a memorandum cost system which cannot be tied into the general ledger. As for the latter, I heard a management services consultant who specialized in cost-system problems, summarize his experience with memorandum cost records as follows: "A cost system which isn't good enough to tie into the general ledger, generally produces reports which aren't good enough for management needs."

COUNTERACTING THE STATUS QUO

A feeling of contentedness with the status quo in a cost system should raise a flag for possible weaknesses. For instance, if you get an indication that the standards aren't periodically reviewed and updated, or that the system is so perfect it hasn't needed any revision in years, it's time to look closely, because chances are there is plenty of room for modification and improvement. One sheet metal manufacturer, going through a very serious economic period, began to look into ways of reducing costs. When the question was raised as to why
the company operated entirely on a job-order system, the old timers in management responded: "We've always operated on a job-order basis; it's the practice in the industry." They explained that their customers, who are principally machine manufacturers, insist on a great variety of metallurgical compositions, and sizes with varying tolerances. After the smoke cleared it was decided to look into the matter. Considerable similarity was discovered in a great percentage of the orders. In cooperation with the customers, the range of sizes and metallurgical requirements were narrowed down substantially. From this the customers also learned that their engineers lacked coordination in developing their materials specifications, which was costing them money. These changes resulted in the processing of larger quantities of certain products, to be stocked in intermediate sizes. As orders were received, these semi-finished products were transferred into job orders for final processing and finishing. The end result to the company was more economical purchasing, reduced quantities of mill overruns, improved scheduling, and generally reduced processing costs.

Another example of the status quo mentality is presented by a company that didn't believe in updating standards when technological or processing changes occurred. The company had a very substantial punch-press operation. A rather simple stacking device was developed and added to the presses which automated, to some degree, the previous manual operation. New standards were not developed on the machines. Production increased approximately 10 per cent, which reflected a favorable variance for the department. Management was satisfied. Over a year later, during a general revision of standards, it was discovered that reasonable production capacities for the punch presses were 10 to 15 per cent greater than actual performances to date. Old standards in this case had covered up sub-standard performance and lulled management into a costly complacency.

ANALYTIC REVIEW OF MANAGEMENT POLICIES

Unusual ratios quite often flag serious management problems if noticed and investigated. An unusual case of this nature arose in a manufacturing company that operated quite an extensive network of field sales stores. It came to management's attention that, on the average, one and one-half sales invoices were being prepared by the stores for each purchase invoice. This was abnormally low, consider-
ing the thousands of small priced items that were stocked and handled through the stores. This fact initiated a review of what appeared to be very costly purchasing and store sales policies and practices. In this case it was not the usual practice to make this comparison, but an alertness on the part of one individual, to somewhat unrelated data, raised the flag for action.

Service department budgets that do not take into consideration the level of operations should raise a flag to the reviewer. In such situations budgets quite often are set too high, encourage padding, and result in costly waste. In maintenance departments, for instance, the level of operations is often measured by production hours or number of work orders completed. The level of operations in the billing department can be measured by the number of invoices prepared, in the drafting department by the number of drawings produced, and in the storeroom by the number of requisitions filled. Average cost per invoice is particularly useful to management in establishing sales policies on small orders. With increasing clerical costs and decreasing profit margins, management must know the breakeven points.

The cost system without adequate perpetual inventory records and without a plan for periodic review of inventories for obsolete, damaged, or slow-moving stock should alert you to system improvements and cost-savings possibilities. In practically every company there are those individuals who, probably with good intentions, keep "squirreling" away supplies or machine parts on the premise that some day they just may need these items. This can be costly from the standpoint both of record-keeping and of idle investment. If the cost accounting system doesn't provide for easy identification of inactive stocks, then a periodic review should be provided. This nibbling can be minimized by a demonstration of what it costs to maintain these stocks, and what cash would be freed if idle stocks are promptly used or disposed of. Periodically identifying slow-moving finished goods for management is necessary to stimulate sales pressure on these items.

MECHANIZATION

As outside auditors or management services consultants, we probably have the distinct advantage of complete objectivity in uncovering areas of data processing that are ripe for mechanization. Empire-building, whether done consciously or unconsciously, is very common in many of the larger organizations. Either as a result of close personal relationship or in the preservation of personal stature through
the control of large numbers of people, many supervisors are reluctant to initiate broad mechanization of manual clerical operations unless forced to do so by the pressures of top management. Where there are many people in an organization, seemingly engaged in performing a great deal of repetitive clerical work, the auditor should be alert to the possibilities of mechanization.

When we talk about mechanization, many people visualize very expensive electronic computer installations, utilizing sophisticated mathematical, statistical, and operations-research techniques. Computers are tremendous tools for some companies, particularly in the areas of cost accounting, but they are, by no means, cure-alls for every company's problems. They have their limitations just as much as any man or machine. I read a definition of a computer recently, which humorously illustrates their limitations. "A computer is an electronic machine that's remarkably human, except that it hasn't learned yet to stop for coffee breaks."

In the smaller organization where computers have their greatest limitations, a high degree of mechanization is still possible at a reasonable cost, through the use of a great variety of general-purpose or special-purpose accounting or data-processing machines. Alertness to mechanization possibilities and investigation of available equipment can either realize direct cost savings by displacement of personnel or free personnel from repetitive clerical functions to utilize them in more productive planning and control functions.

OTHER WARNING SIGNALS

Many other flags or smoke signals can lead to fires in the system, which are burning away profits. Without elaborating, I would like to mention some of the more common ones, which we have not previously discussed. Excessive or recurring overtime or unemployed time in productive or service departments, and recurring bottlenecks in the processing of product or paper work, may be signs of more serious problems. The use of "fudge factors" and reserves in arriving at the monthly cost of sales, or to cushion adjustments, tends to create misleading management reports. They are also devices used by accountants who are too lazy to isolate and correct the basic problems. Signs of poor housekeeping in clerical and tabulating departments may also be clues to attitudes and carelessness in record-keeping, which in turn filter into management decision reports.
CONCLUSION

In conclusion, I would like to summarize with the following three principal points:

• Profits are the principal product of top management.
• Profits can be influenced by the skillful use of management tools.
• Cost accounting and the related cost system as a principal tool of management, must be maintained and operated at maximum efficiency in order to be used effectively.