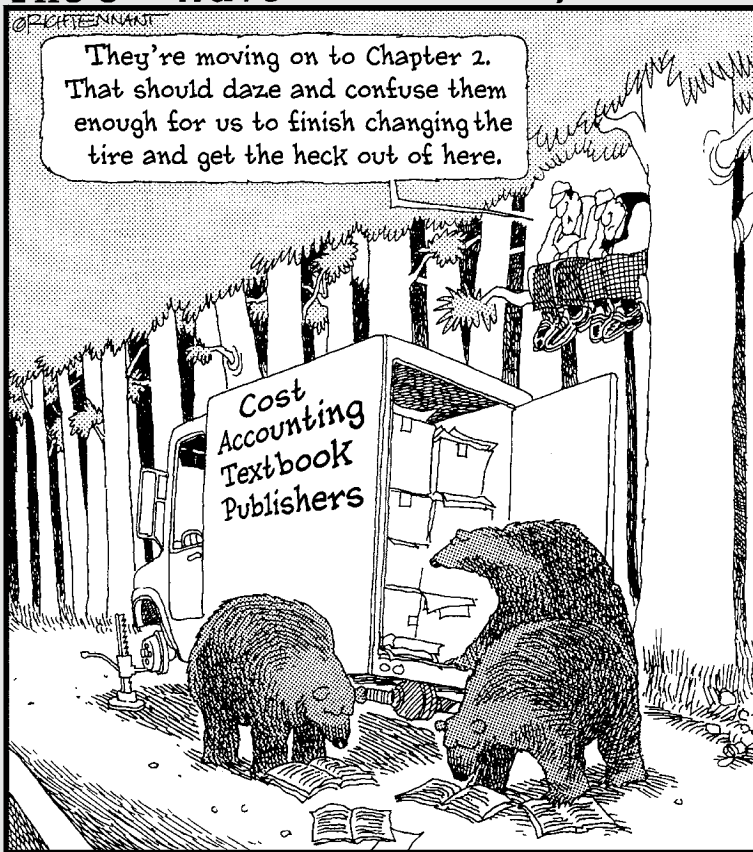


Part VI

The Part of Tens

The 5th Wave

By Rich Tennant



In this part . . .

Forget the loss, but don't forget the lesson. The chapters in this part are brief and filled with useful information . . . lessons learned by managers using cost accounting. Chapter 20 walks you through the ten mistakes that can lead to losses in your business. Chapter 21 lists ten improvements you can make to improve the profit level in your business. This wisdom makes the cost accounting process easier.

Chapter 20

Ten Common Costing Mistakes and How to Avoid Them

In This Chapter

- ▶ Allocating product costs more accurately
 - ▶ Understanding types of costs
 - ▶ Following up on variances
 - ▶ Planning when costs will be incurred
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This chapter covers the most common mistakes related to costs. Reducing your costs can lead to a higher profit — without the need to raise your product price. Unfortunately, making costing mistakes can lead to lower profit (or losses). As an accountant, you can make a big impact on your company's bottom line by addressing these mistakes.

Pricing a Product Incorrectly

Overhead is the most commonly mishandled cost. Overhead should be allocated based on an activity level (labor hours and machine hours, for example). If a business owner doesn't understand cost accounting, the overhead costs may not be allocated at all, or too much or too little cost may be allocated to the product. As a result, the full product cost isn't accurate, so the product price also isn't set accurately.

Listing Fixed Costs As Variable Costs

Accountants must price a product to cover all costs and generate a profit. Because total fixed costs are difficult to change, it's particularly important to focus on them. You can't reduce or eliminate fixed costs easily in the short term. So make sure you sell enough to cover those expenses.

You should analyze fixed costs in total dollars, not fixed cost *per unit*. Using a per-unit calculation implies that every unit sold generates more fixed costs. In reality, you may cover all of your fixed costs with only a portion of your total sales.

You need to spend enough on fixed costs to have enough capacity to produce. When you analyze fixed costs, however, focus on total dollars, not a per-unit calculation. See Chapter 8 for more on fixed and variable costs.

Labeling Period Costs As Product Costs

Period costs are incurred with the passage of time. For example, you incur interest costs on a loan each month. Product costs are incurred when you make your product or deliver your service.

It's critical that you define period costs correctly for two reasons. You must do so to be in compliance with financial reporting standards. And if you incorrectly label a period cost as a product cost or vice versa, the profit you show on your income statement may be incorrect.

If you reduce your production by 50 percent during the month, your product costs (material and labor costs, for example) also decline by 50 percent. Your period costs *are still incurred*, regardless of your level of production.

If you label a period cost as a product cost, those costs may not be recognized as expenses until the product is sold. If they are truly period costs, they should be expensed every month or year. The mistake leads to errors in your product costing.

Misusing Target Net Income

Target net income is the goal a business owner sets for his or her profit. After you set target net income, you can adjust the variables in the formula to reach your profit goal. For example, you might change the number of units sold, and that affects sales and profit.

Business owners often make the mistake of projecting an unrealistic target net income — either too high or too low. As an accountant, you can help the owner address this issue.

Target net income may be too high if your *actual* results come in lower than planned and generate a loss. Because the target is an estimate, actual results may vary. You want your target net income to be some amount above the break-even point (greater than zero), but you want to make a conservative estimate so that you leave some room for error.

Your target net income's level of sales may also be unrealistic. There's no point in selecting an income target using a units sold number that's unreach-able. Also, don't project net income with a sale price that's so high no cus-tomer will pay it.

Forgetting About Taxes

After-tax income is your profit after paying taxes. Think of your take-home pay. The income that matters to you is the money you keep after deductions for taxes — what you take home. When computing profit, don't forget to allow for taxes.

When you know your tax rate, you can compute your after-tax income. Say your target net income is \$10,000. If your tax rate is 30 percent, your profit after paying taxes is 70 percent (100 percent less the 30 percent tax rate). So your net income after tax is $\$10,000 \times 70$ percent, or \$7,000.

Assigning Costs to the Wrong Product

You may identify all of your costs, but assign costs to the wrong product. This means that the full costs of *individual products* are wrong. The situation can cause serious problems with your sales mix.

Sales mix is the proportion of your total sales that any one product repre-sents. Assume you sell two sweaters — a rock-climber model and an ocean-surf model. Maybe the sales mix is 40 percent rock-climber sweaters and 60 percent ocean-surf sweaters.

Each sweater has a different profit margin. You plan your total sweater profit by adding the profits from both lines of sweaters.

If you don't assign costs correctly, your product cost and your profit calcula-tions won't be accurate. As a result, your sales mix won't generate the profit you expect. Unfortunately, you may not catch the error until the month or year is over. At that point, it's usually too late to make corrections.

Not Reviewing Variances Correctly

A variance is defined as a difference between actual and budgeted (standard) costs. If a variance is unfavorable, you should analyze the variance and consider taking action to improve your results going forward. Understanding whether or not a variance is unfavorable can be a challenge.

If actual costs are higher than budgeted, the variance is unfavorable. You spent more than you planned. If actual revenue is higher than standard (budgeted), the variance is *favorable*. Keep in mind that higher actual costs are a problem, but higher actual sales are a good result. Higher costs are a warning that you need to make changes. That's not the case with higher sales.

If you notice a large favorable variance, analyze those variances, too. Sure, a favorable variance is a good thing. But you need to know why your actual results were so different from your plan.

Redlining: Pushing Production Activity Above Relevant Range

If you don't have sufficient capacity, you may not be able to deliver your product or service. To ensure that you have enough capacity, you need to know the relevant range of your assets (machinery, equipment, and staff).

Sometimes, business owners operate at the top end of their relevant range for too long. If you push too hard, your assets eventually lose some productivity. The situation is similar to pushing your car's engine too hard for too long. *Redlining* the engine causes it to break down.

A better choice is to add capacity. Rather than run your machinery at 100 percent capacity, consider investing in another machine. You can spread production across two machines.

Note, however, that you need to analyze the cost versus benefit of adding another machine. If the second machine is only used at 10 percent capacity, it probably won't be worth it. This strategy reduces the risk of a breakdown due to overuse.

Ignoring the Timing of Costs

When you analyze costs, you should consider timing. Although the amount of cost is important, it's just as critical to know *when* you will incur the cost.

A common business mistake is not planning your cash needs for production. When you collect cash from clients, you need to budget some of that cash for future material and labor costs. If you don't have sufficient cash, you can't make your product.

Not Implementing Activity-Based Costing

Activity-based costing (ABC) is a method of analysis that allows you to assign costs more accurately. You should consider implementing ABC. If you don't, you're spreading costs across all of your products evenly. Your costs won't be assigned to individual products accurately. Check out Chapter 5 for more on activity-based costing.

Chapter 21

Ten Ways to Increase Profits Using Costing

In This Chapter

- ▶ Selling the most profitable products
 - ▶ Forecasting a reasonable profit
 - ▶ Planning to identify more costs
 - ▶ Training to improve performance
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Cost accounting's big payoff is making improvements to a business. This chapter covers some of those improvements. You can use cost accounting to identify costs and reduce them. Better cost control results in a lower total product cost — and a higher profit. As an accountant, you can apply these ideas to the business and be a hero.

Selling More Of The Right Products

Your company wants to sell more of the most profitable products because those sales increase the company's overall profit. You can compare profit levels using cost accounting. When you know the correct full cost of a product, you can compare it to the sales price. The difference between the two is the profit for the product.

Compare the profit generated by each product. To make a fair comparison, compute profit as a percentage of sales, or $\text{profit} \div \text{sale price}$. The products with the highest percentages are the most profitable.

Implementing Sales Mix Analysis to Increase Total Profits

After you determine which products are the most profitable, you're ready to use sales mix analysis to increase total profits.

You can compute the percentage of total sales any one product represents. That percentage is the sales mix percentage. The idea is to sell more of your most profitable product and shift sales away from other products.

Change the focus of your marketing and sales efforts to move sales to more profitable products. If your efforts generate more interest in those products, sales and, more important, profits will increase.

Building a Higher Margin of Safety

A higher margin of safety means that your company can remain profitable even if actual results differ from your plan. *Margin of safety* is the difference between your planned level of sales and your breakeven level of sales.

Say your planned sales level is \$1,000,000, and your breakeven point is \$700,000. If actual sales come in at \$800,000, you're still profitable. Always include a margin of safety in your plan for sales.

Deciding How Much You Need: Production and Scheduling Issues

Accountants can make improvements to the production process to reduce costs. If you move products between departments, make sure that each department is ready for production and has work in process available from the previous department. This planning helps avoid costs for downtime.

Plan purchases so that materials are available for production when you need them. Schedule enough labor hours to meet your needs. All of these efforts will ensure smoother production and help minimize your costs.

Who Does What: Handling Costs and Employee Issues

If your company manages employees effectively, those efforts can have a tremendous positive impact on costs and generate more profit.

Each worker should have a written job description. The staff must receive clear instructions about what needs to be done and when. These steps minimize labor costs; otherwise, you pay for worker time that isn't productive.

Reducing and Managing Scrap

If your production process generates scrap, consider how you can reduce it. This requires an analysis of your entire production process. Assume you make cotton shirts, for example. If you use machines to cut the cotton fabric, mull over whether or not the machine's setup can be changed to reduce the amount of material wasted.

Maybe the machine can be reset to cut fabric more precisely, which would reduce scrap. Better employee training may result in more careful use of materials. Take a look at the whole process. If you can reduce the amount of scrap, it's worth it. For more info on scrap, see Chapter 17.

But sometimes, scrap is inevitable, and you may end up with unused materials. Keep in mind that scrap is a cost, but your decisions about scrap can reduce your costs.

Consider creating a list of other companies that could use your scrap in their product. The more companies you identify, the more likely you are to find a buyer for your scrap. Also, think about whether or not you can use your scrap to produce another product.

Moving It off the Shelf: Inventory Issues

Inventory is often the largest cost for a business, particularly for a retailer. Perform an analysis to compute your economic order quantity (EOQ). The EOQ formula is designed to minimize your ordering cost and carrying costs for inventory.

Make sure that you take advantage of purchase discounts, whenever possible. Finally, consider how frequently you have to restock your shelves with inventory (inventory turnover). Try to balance the costs of ordering and carrying inventory with the need to fill customer orders in a timely manner. Check out Chapter 9 for more on inventory.

Effectively Taking Special Orders

A special order allows you to use excess production capacity to generate revenue. Use your cost accounting skills to determine a unit sale price that makes the order profitable. Keep in mind that fixed costs are irrelevant to your special-order decision.

Be proactive about special orders. If you have excess capacity, tell your customers. If they place a special order, the extra business generates more revenue.

Making Accurate Cost Allocations

When you allocate indirect costs to your product, you need an accurate allocation method. Make sure that the costs you allocate are closely related to the *driver* of the costs. If the cost and the cost driver are closely related, the cost allocation is more accurate.

Say you're allocating cost for machine setup. That cost can be allocated using the number of setups. In that way, the setup cost is connected to the activity that causes the cost to occur — setups. This process generates a reasonable cost allocation.

Addressing the Issue of Spoilage

There's nothing worse than producing a product that can't be sold to a client. You can take some steps to prevent spoilage before units start rolling off the assembly line. Consider whether the production department understands the product design.

Your production staff should be able to understand the design and produce the product without complications. Your design staff should be able to design products that are easier to manufacture. A good example is a product design that minimizes the number of moving parts. The more streamlined the production process, the less likely there are to be spoiled units.

If spoiled units are a problem, beef up your employee training. Maybe your staff is making production errors because they aren't properly trained to use your machinery.

Most important, if you do have spoilage, strive to rework every spoiled unit. If you spend money to make a product, make sure that you can sell it to someone. See Chapter 17 for more on spoilage.