Introduction

I am sure we have each heard the quote dozens of times – *“A journey of a thousand miles must begin with a single step.”* I will tell you that the journey to accelerate profitability needs to be approached in the same manner. This journey will be a series of steps. My objective with this book is to show you that each step is both individually important and accumulatively significant in achieving an understanding of cost management and accelerating profitability.

Just like any journey, we need to be clear on where we intend to go. We do not want to be like Alice without a specific destination in mind. I make the assumption that since you are reading this book, you have a designation in mind. And that designation is to address your Vehicle’s Profitability. It may be to revive, or to restore, or to achieve, or to sustain, or to accelerate, or a combination of these actions. I believe the steps are exactly the same no matter which journey you are on; it’s a journey of profitability.

I would suggest that prior to taking any journey that we do some background review on the key concepts of profitability. It would be presumptive on my part to assume that each of you understands costing and pricing to the same degree, so I feel it appropriate to lay the foundational ‘cost management roadbed’ that I believe your profit journey will travel on. Back a few pages in this book, in the Abstract, I introduced some literary foundations (terms) that I will be using in this book. I repeat some of them here and introduce a few additional ones because it frequently happens that someone else may have hijacked the term and my definition could be in conflict. The terms are:

- Vehicle - Your business

- Fuel - The profits generated by the products or services your business provides.

- Economic Engine - The primary or key or principle products or services that your business delivers.

- Value Added - It’s your ‘Check Book’ . . . the dollars you have available to convert your customer’s order into a finished deliverable. It’s typically Revenues minus Cost of Sales.

- Conversion Costs - Labor plus Overhead (for a product-based business, this would be Manufacturing Overhead).

With these descriptions in place, I suggest we begin by clarifying the terms ‘Cost Management’, ‘Cost Management Principles & Systems’ and ‘Strategic Cost Management’. Once again, my objective is not to spend a considerable amount of time digging deep and/or regurgitating lengthy literary explanations of either one, but to clarify how these fundamental elements of business fit your vehicle. Therefore, I propose the following clarifications:

- Cost Management
  You need to generate and retain profits to survive and grow. That’s a given. Therefore, Cost Management is a process that you establish, implement, and maintain to ensure that you can realize the projected profits.

- Cost Management Principles & Systems
  Dictionary.com defines the word principle as *“an adopted rule or method for application in action.”* Therefore, Cost Management

Principles, as used within the context of this book, are the rules or methods that I suggest be used to accelerate profitability.

In foundational terms, there are two primary cost management systems that you will encounter:

- Traditional – Traditional systems are geared for financial reporting. Costs are recorded, tracked, and reported in general ledger format and used for profit and loss statements, balance sheets, and income statement reporting. This approach incorporates direct costs and allocates indirect and overhead costs based on the units of products or services produced. A common issue with this approach is that some products are burdened with costs that they did not incur.

  Example – A business has three business units – Business Unit A makes laminated wood sheets. Business Unit B makes closet storage units with materials from Business Unit A. Business Unit C makes high-end wood products for corporate entities and uses no product from Business Units A or B. The business utilizes seven forklifts (with drivers) and employs six maintenance personnel, eleven manufacturing engineers, five quality engineers. These indirect costs are spread over all the business units equally.

The problem – Business Unit A is 98% automated and only occasional uses a single forklift. In addition, this business unit has one manufacturing and quality engineer assigned. Business Unit B is a flowing production line and uses the same level of resources as Business A. Business Unit C consumes all the remaining indirect resources of forklifts and engineers. Business units A and B are charged for the resources consumed by Business Unit C. As an aside note, Business Unit C was profitable under this approach. In reality, this business unit consumed nearly 65% of all profits generated by the company. As a stand-alone business unit, it was under water.

- Activity Based Cost Management (ABC/M) – Activity Based Costing (ABC) has been around since the 1980's. The first launches of ABC were classified as too complicated to maintain. I believe that has changed. In brief, ABC/M incorporates a method of assigning or attributing costs, directly consumed by a product, service, or business unit, to that product, service, or business unit. By using this method, a more accurate analysis of costs can be established and utilized to determine profitability.

- Strategic Cost Management – Strategic Cost Management is the 'Grand Poobah' of Cost Management. Poobah, as defined by the Urban Dictionary, is *"a title of respect and often is linked to might in a role."* It's the strategy of cost management that you need to define. This will be the combination of cost-related methods, principles, and systems that are integrated and communicated. It will drive the actions and activities used to plan, complete, and control the decisions needed to ensure that cost data is accurate and assigned. In brief, Strategic Cost Management consists of the following primary components:

    1. An in-depth analysis of costs based on defined definitions and clarity of purpose. The what, who, when, where, and how of activities. What acidities are tied to a product, process, or service? Who is involved . . .from direct labor, indirect labor, support personnel, and administration? When does the activity occur . . . sometimes, all the time or only when 'X' happens? Where does the activity occur . . .throughout the operations or only on product or service lines 'Y' and 'Z'? How are these activities measured, recorded, and assigned . . .are there designated reporting codes to differentiate?

2. Availability and accuracy of cost-related data. There is a difference between accurate and precise. For the engineers, Pi = 3.14159265. That's a precise number down to ten digits. It just may not be accurate for what is needed.

   Example – The Bill of Materials (BOM) states that a part was supposed weigh 2.459 lb./piece. You make and sell 8,000 pieces per month. That's 19,672 lbs. of material per month at $4.04/lb. Your material cost is therefore estimated to be $79,475/month or $953,698/year. But wait, the actual weight of the part out of the machine is 2.551 lb./piece. That's the difference of 1.5 ounces of material (about the weight of a sparrow). Therefore, total cost is actually $989,379/year. A difference of $35,681. Now assume you make 100 different parts at the same rates and have the same degree of inaccuracy; now we are talking serious dollars! Can't happen? I rarely lose a standing bet for a company to randomly select five BOMs and find that all five are 100% accurate.

3. Assignment and acceptance of responsibility. The proverbial quote "What gets measured, gets improved" comes into play here. We assign responsibilities for a purpose because we want and/or need accountability for a designated purpose. In the world of costing, we need accountability to ensure that the basic components of your Strategic Cost Management journey are tracked, trended, reported, and accurately maintained.

The approach that I use, recommend, and incorporate into Accelerating Profitability is ABC/M. I see ABC/M as a 'Profitability Verification Methodology' that you will use for management decision making and strategic guidance. It does not, nor should it, replace the financial reporting that you generate and provide to your financial institutions or accounting firm. Should you make modifications to your current financial reporting? My short answer is - most likely you will. Why? Because by the time you complete this profitability journey, you will likely uncover a variety of reporting issues (i.e., that general ledge entry should not be spread over all the products, services or business units; it needs to be specifically allocated to designated account).