Does Your Business Count?

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In a time long ago in a place not so far away a wise old CEO said to this once young CFO "Son if you can't measure it you can't manage it". It took many years to fully comprehend the breadth and depth of that statement. However, a few growth companies and turnarounds later I truly understand the meaning of those words. You simply cannot manage a company properly if you do not first establish your cost structure, set your goals, select a sound accounting system that is capable of producing management data, and then integrating the data from your budgeting and accounting systems to measure your performance against those budgets.

Ok let's break that down.

First, what do we mean by establish your cost structure? Well it means we must study our business to determine what factors drive profitability. If we have multiple products or services, have we designed our cost collection structure so we can determine which costs are incurred as a result of the production or delivery of each product or service? If we have common support, management, or other overhead costs have we put in place an allocation method that properly reflects the absorption of those costs by each product or service. Finally, have we grouped our costs into buckets that properly reflect the nature and source of those costs?

Second, setting goals in this case means establishing budgets. Have we put together budgets for each of the products, services, and overhead pools we created in our first step? Can those budgets be aligned with the reports we obtain from our accounting system? In addition to revenue and expense budgets, we

also need to produce cash flow forecasts and balance sheet projections. These would include estimates on financing requirements, loan amortizations, and asset acquisitions. Budgets should be living documents. Although our baseline budget that we use to establish our targets should not be changed throughout the year, we should have the ability to revise our budgets if business conditions materially change during the year. These changes could be either positive or negative and could be required as a result of either external or internal forces.

Third, selecting an accounting system that can produce management data is critical to our ability to measure our performance. Management data (sometimes called cost accounting data) is simply the traditional revenue and detailed cost data organized into the cost structure design we created in step one.

You should select a system that provides an integrated financial and management accounting system. The management/cost accounting components should provide capabilities for the management of individual jobs, processes (activities), and overhead cost pools. The system should provide an extensive management reporting system that provides detailed information required to measure performance of projects, programs, departments, and divisions.

The system should also contain an overhead management component that provides overhead management and application capabilities. It should allow overhead costs to be grouped into logical cost pools for distribution to other overhead pools or final

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cost objectives. The overhead management component of the system should provide for the automated application of the costs accumulated in overhead pools to final cost objectives and/or other overhead pools. Many systems still require that users manually make these allocations and distributions which can be immensely time consuming. Be sure to choose carefully.

Although some systems can provide these capabilities through the judicious use of multiple accounts, a better approach is to utilize a system that contains a cost and management accounting layer separate from the general financial accounting system. These types of systems usually consist of a collection of cost ledgers which collect job, activity, and overhead cost data. This approach removes the cost detail from the general ledger which then contains control accounts for each of the cost ledgers.

Finally, we need to integrate the data from the budgeting and accounting system to compare budgets to actual results. Although you can purchase tools to accomplish this task you may find that a Controller with well developed skills in Excel may be able to tailor tools to complete this task.

Ok, let's drill down a little deeper into each of these topic areas.

Establishing your cost structure

Well if "a picture is worth a thousand words" then consider this Cost Flow Diagram. This diagram graphically displays the movement of costs though a company.
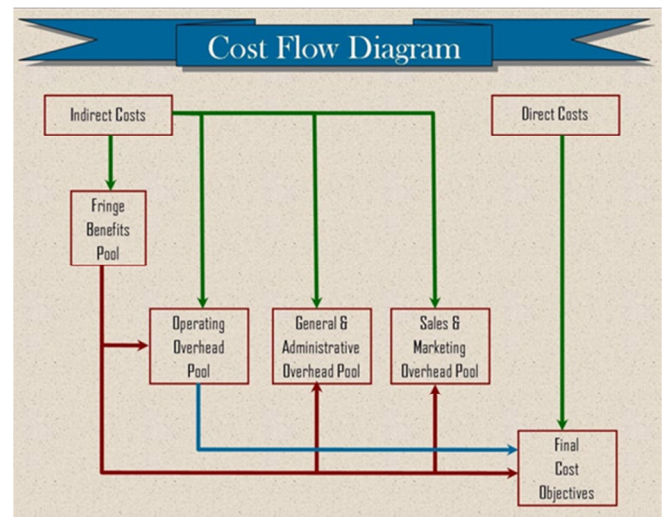
Our goal is to recognize where costs originate and where we receive the benefits from those costs.

First let's define a few terms. It will help to first discuss what we mean by Final Cost Objective (FCO). This term is used to describe the final point in your cost system where all costs eventually end up. They are usually represented by jobs in a job cost system or activities in a process cost system or both in a system that permits hybrid approach. Jobs could represent contracts you have with customers or internal efforts such as research and development projects. Activities could represent the manufacturing process used to produce your products or the service operations of your company. Direct costs are those costs that can be directly attributed to one specific FCO. For example they could be, the material you purchase to meet the

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requirements of a contract with one of your customers, or the labor expended by employees working on the contract. Indirect Costs are those costs that cannot be identified with any one FCO. They are costs that benefit more than one final cost objective and are usually collected at an intermediate point. For example, the rental cost of your office or manufacturing facility is clearly a cost in providing your service or manufacturing your product. However, you cannot practically identify that cost with any single FCO. Therefore, we collect those costs in overhead pools for later allocation to FCO's. The overhead pools we define depend upon the size and complexity of your company. When we decide how to group costs into overhead pools we examine the commonality of the costs. A very simple overhead structure might include a fringe benefits pool, an operations overhead pool, a general & administrative overhead pool, and a sales and marketing overhead pool.

The Fringe Benefits Pool collects costs associated with the benefits provided to your employees and would include items such as health benefits, payroll taxes, and life insurance. Source costs such as supplies, rent, and supervisorial labor might be distributed to one or more of the remaining overhead pools. In our example, the Operating Overhead Pool could represent the overhead for our manufacturing operations. The General and Administrative pool would collect those costs associated with the accounting, human resource, and general management functions of the company. The Sales and Marketing pool would collect those costs associated with the promotional efforts of your company. This would include the salaries and commissions of

your sales personnel, advertising costs, trade show costs, etc.

Now we have to allocate those costs. However, before we look at these allocations let's define a few terms. We have used two terms "*distribute*" and "*allocate*". In this article we use the term "*distribute*" to refer to the action of recording the costs in our accounting system. We manually enter the costs using the account numbers and the job, activity, or pool codes in accordance with the guidance discussed above. When we talk about "*allocation*" we are referring to a method which we use to direct the total costs collected in an overhead pool to FCO's and in some cases to other overhead pools. This method is a mathematical formula derived from an analysis of the benefit of the costs in each overhead pool. For example, the Fringe Benefit Pool costs are typically allocated based upon a formula "FBR = $FBO/(DL+IL-ILDTF)$" where FBR = Fringe Benefits Rate; FBO = Fringe Benefits Overhead; DL = Direct Labor; IL = Indirect Labor; and ILAF = Indirect Labor Distributed to Fringe Benefits. Labor distributed to fringe benefits would include items such as vacation time, sick time, etc. Now that you know the rate you can add that amount of fringe benefits overhead to each FCO and overhead pool that contains labor charges. For example, if your rate is 35% then you will add 35 cents of fringe benefits overhead for each dollar of labor in an FCO or overhead pool. Some overhead pools are allocated to both other overhead pools and to final cost objectives. Final cost objectives can be a combination of jobs in a job cost system or activities in a process cost system.

To summarize all this we can say that source costs identify the type of cost incurred,

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distribution describes where the cost was incurred, and allocation describes where we receive the benefit of the costs.

Establishing budgets

Forecasting and budgeting are critical components of a company's overall planning process. Both are living documents that require revision on a regular basis. A forecast is a prediction tool whereas a budget is a measurement tool. Forecasts are used to predict profitability and sustainability. Budgets are used to plan and to measure performance. When actual results are combined they can show us how we performed in comparison to our plans.

The three primary components of a forecast are revenue projections; expense projections, and the cash flow forecast. Revenue projections are derived from sales estimates developed for each product, service, or business unit. Initial forecasts are often derived from the revenue and expense budgets.

When you develop your budgets you should ensure each overhead pool has its own budget. Also, each Final Cost Objective (FCO) or group of FCO's has a budget. Final Cost Objectives are usually grouped into business units and direct cost budgets are then prepared for each business unit. These direct cost budgets are usually called cost of sales budgets. In a simple one product/service company you may have only one cost-of-sales budget. In more complicated companies where multiple products and/or markets exist we will find multiple cost-of-sales budgets.

In order to determine how we might want to group our FCO's we might examine synergistic factors such as markets, distribution points, or production commonalities. For, example a company that sells to both the consumer and business markets might group their FCO's into those two market segments. You might also group them by geographic location such as domestic and foreign. The most important factor in choosing your grouping criteria is to ensure that you obtain usable information from your selection. Therefore, you should have an item you want to measure that is provided by the grouping.

Finally, budgeting systems are often used to compare budgeted revenues and expenses to actual results. You should carefully select both your budgeting system and your accounting system to ensure that you can easily transfer data from your accounting records to your budgeting tool. Both your accounting system and your budgeting system should be engrained into the regular business processes of your company.

Critical factors in selecting an accounting system

An "integrated financial and management/cost accounting system" must be able to perform the many financial accounting tasks, including, accounts receivable management, accounts payable management, payroll and labor management, general ledger maintenance, and general financial reporting. In addition, it must have the ability to provide data for the management of individual jobs, processes (activities), and overhead cost pools, and should include an extensive management reporting system capable of providing detailed information required to measure performance

of projects, programs, departments, and divisions.

The overhead management component must provide the capability to group overhead costs into logical cost pools for later allocation to other overhead pools or final cost objectives. Overhead application must be automated to ensure complete allocation of costs to all jobs, activities, or overhead pool, and to reduce the manpower required to perform this arduous task.

Additional components may include cost of production management, credit management, order entry processing and invoicing, lead management, and contract management.

Accounting systems that provide both financial and cost accounting capabilities usually provide it in one of two ways. In less well developed systems the cost and financial data are usually maintained in the same data layer. In more sophisticated designs, systems may have a robust cost and management accounting layer which exists beneath the general financial accounting system. This layer, which should be capable of both job and process cost accounting, will allow you to provide the capabilities required to: (1) account for service business jobs and activities; (2) account for manufacturing operations; (3) account for government contracts; and (4) account for departments, profit centers and divisions.

Finally, one of the most powerful aspects of a well developed accounting system is its ability to provide for the automated application of the costs accumulated in overhead pools to final cost objectives and/or other overhead pools. Very capable systems will support both chart of

accounts based and departmental application methods.

Account based allocation methods simply use the amount of one or more accounts as the allocation base and will then allocate the costs in the pool based upon the distribution of the base account(s) to FCO's or other overhead pools. Departmental allocation methods usually allocate the costs in an overhead pool based upon the distribution of the labor costs of the department to the FCO's and/or overhead pools. In this case the allocation base is either the direct labor or total labor of the department.

When evaluating accounting systems you should examine the flexibility of the system in permitting both simple and complex overhead application structures.

The cost and management accounting aspects of the a capable accounting system are intended to aid the user in the cost effective maintenance of the data required for government contract accounting, manufacturing accounting, departmental, profit center, and divisional accounting, and overhead management.

Companies that operate in a manufacturing environment have additional needs from their accounting system. These systems need to provide the ability to account for both cost of production and for a matching of revenue and expenses.

In some systems "Production Activities" are used to collect manufacturing costs. Labor costs, materials requisitioned for production, manufacturing overhead, and other direct production costs are charged to the production

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activities. These activities are accumulating the work-in-process costs for the product. At the end of the accounting period (usually a month), a Cost of Production report is prepared. The costs associated with completed production from the Cost of Production report is then charged to the standard activity associated with the product. In these systems cost of production for the goods completed are transferred to a Finished Goods account.

The factors listed above deal entirely with the cost accounting components of systems. You should also consider other capabilities required to satisfy your needs such as order entry, accounts receivable and payable, credit management, and labor cost management.

Measuring Performance

As stated earlier, you need a budgeting system to create your revenue and expense plans and an accounting system to collect the results of our efforts. We need to combine the data from both of these systems in order to measure our performance.

Although you can buy expensive analysis tools to conduct your analysis, you may find your trusty spreadsheet the best tool for this job. With the three dimensional modeling capabilities and the power of the simple programming tools available in these systems, you can create models that fit your company rather than try to pack your company into one of the many analysis tools on the market.

Conclusion

Well now you know it means when someone tells you "if you can't measure it you can't manage it". Hopefully we have helped you think about how you can establish systems and procedures that will help you manage your company effectively. Don't count on your financial statements to provide anything but the most basic information. Those statements are meant to inform individuals external to the company on its performance and are not intended to expose the critical information you need to make management decisions. These documents after all are meant to address separate audiences; after all, you would not want the critical information contained in your analysis to end up in the hands of a competitor or other adversary.

Discuss these issues with your team today and find out if your company is measuring up or if it is time to improve your management systems.

Mr. Castaldo has been a member of management teams in both growth companies and company's experiencing financial difficulty. Within these organizations he has served in numerous roles including Chief Financial Officer, Chief Operating Officer, and Chief Executive Officer.