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Is Cost Accounting Fatally Flawed?

The subject of accounting is really rather boring, and cost accounting is particularly boring. Unfortunately, there are serious pitfalls in cost accounting for the unwary. I'd like to relate two true stories. Both occurred at a Midwestern pump and valve manufacturer.

The first involved the decision to purchase a custom, very specialized work cell that allowed one operator to both braze a corrosion resistant sleeve onto the working end of a pump shaft, and then finish the diameter and end of the sleeve on a precision grinder. The justification for the purchase of this cell was that there was a routine shortage of shafts for the pump assembly department. Well, the shortage continued. The reason? The purchaser of the work cell did not address the bottleneck, the real problem. Yea, fewer labor minutes were spent brazing and grinding the shafts, but the assembly department was still starved. Accordingly, sales did not increase, nor did profitability. But the cost accountants proved the wisdom of the purchase! This would be like purchasing a large atmosphere furnace without having the endo-gas to feed it, nor the tempering capacity to support its output.

A second situation arose with the successful launch of a new line of butterfly valves. Because of demand, more production capacity was justified, and so a very sophisticated machining center was purchased for nearly \$1,000,000. (Now, this was 35 years ago when a million dollars was real money.) The start-up of the new center was perfect, Manufacturing was producing excellent valves in quantity with ease and the Sale Department was finding a ready market, anxious to by the new product. Then enter the accountants.

I became aware of the issues on a day when several "chiefs" from corporate were in the conference room with division leaders, including Sales and Manufacturing. The discussion was loud and very intense. So, spotting me (minding my own business, I might add), the comptroller called me into the meeting. He asked the Sales and Manufacturing folks to explain their positions, and then he explained the Accounting Department position. Then he asked me for my opinion.

Here is what became apparent. Sales wanted Manufacturing to return production to the old machine tools because the cost of manufacture on the new machining center made the product line unprofitable. Manufacturing did not understand how the product was now unprofitable when they were producing valves so much better and faster. And Accounting Department explained that the large capital investment necessitated the attachment of a 1500% burden rate to the machining center, driving



standard costs out the roof. You see, they were only at about a quarter the capacity of the machine center at that point, but the accountants wanted that quarter to cover all the overhead!

I asked Sales if they were firm on the vitality of the market for the new line. They said that they were certain of a fine, growing market. I asked Manufacturing where it took less time to machine the valves, on the old or the new equipment. They said that the new equipment was nearly twice as productive, and produced a much higher quality valve, as well. So then I asked the Comptroller if the new machine center was leased or purchased. He said, "Purchased." I asked him how the purchase was justified, and he explained increased sales and market share. "OK then," I said, "The only thing that matters is minutes; run the parts where they take the fewest number of minutes to machine. The purchase price of the machine center is sunk cost and therefore has NO BEARING on actual product cost. The purchase was justified by other calculations. By jacking up the indirect burden rate, we are effectively corrupting allocated expenses by including depreciation expense in our cost accounting system. That is flawed because depreciation is a non-cash expense."

What is the lesson for us? First, price is determined by what the market will bear, not by your costs. Second, if you cover more than your out-of-pocket expense with the price the market will bear, then you are covering some overhead. Third, the best way to cover overhead and increase profitability is to win market share. Finally, your time is much better spent building market share than trying to figure out your "actual" costs.

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