National Tooling &
Machining Association

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AC06 **File: ACCOUNTING AND FINANCE**

COST CONTROL FOR HIGHER PROFITS

SUMMARY

Controlling costs is an unending process. To achieve maximum profitability at any level of sales, cost control is absolutely vital. And, to keep costs under control requires; (1) an attitude of cost consciousness; (2) accurate and timely records; (3) regular performance reviews; (4) a plan of action; and (5) delegation of cost control responsibility and authority.

The term "cost control" should not be interpreted as "cost minimization." Some expense increases, such as higher salaries, more expensive facilities or additional advertising, may result in increased profitability — if they are wisely planned. Cost control involves holding costs to designated levels consistent with management plans. Let's examine the five elements for effective cost control.

COST CONSCIOUSNESS

The first and perhaps most essential cost control element is an attitude of cost consciousness. By being alert to the cost implications of daily operating activities, the owner or manager will recognize potential "profit leaks" and be able to take corrective action before a serious profit drain takes place. And, equally important, a consistent attitude of cost consciousness on the part of management will tend to create a similar concern for controlling costs among employees.

ACCURATE, TIMELY RECORDS

The second vital ingredient in successful cost control is accurate and timely records. In order to take informed action, management must know — in dollars and cents — what is happening. Although a cost-conscious owner or manager can often detect operating problems without relying on formal records, determining the extent of the problem and making the appropriate adjustments require solid facts and figures. In fact, overreacting or reacting without full knowledge of the problem could be worse than no action at all.

An accountant should be consulted to establish, and review periodically, your record-keeping system. Your system should be capable of providing you with monthly income and expense figures so that you can spot trends at an early stage. These income and expense figures should be displayed both in dollars and as percentages of net sales. You or your bookkeeper can convert the monthly dollar figures to percentages in a matter of minutes with a pocket calculator.

Operating expenses must be classified in a meaningful way before any intelligent management action can result. Indirect labor and supervision should be separated from direct labor in order to identify the costs associated with each hour of direct production. Consistent allocation of costs to specific categories is also important for trend comparisons.

The regular monthly expense reports should be short and to the point. However, supporting records showing who is responsible for individual expenses (tools, supplies, telephone, etc.) may become necessary as your company grows. It is difficult to enforce cost control measures if you don't know who is incurring the expenses. From time to time, you may also need to check detailed supporting records for expenses such as employee benefits and insurance, which range from group health insurance to unemployment compensation and from automobile coverage to fire insurance, to see whether cost savings are possible.

The NTMA Costing, Pricing and Financial Management Manual provides a step-by-step guide to developing a workable record-keeping system.

REGULAR PERFORMANCE REVIEW

The third essential element in controlling costs is a regular performance review. By taking a few minutes each month to examine your income and expense figures, you will be able to see where they differ from your budgeted amounts and from the figures for the previous month and the comparable month a year earlier. Because monthly shipments are subject to considerable fluctuations in many companies, you should not become alarmed or take hasty action based on a single month's report. You should, however, be able to explain month-to-month changes and plan to remedy any problems that persist beyond three months.

Each year you should review your company's operating performance in relation to the industry-wide results shown in your Operating Costs and Executive Compensation Report published by NTMA. The figures in the OCEC Report represent a real-life picture of the performance of several hundred tooling and machining companies throughout the country. By referring to these figures and the step-by-step explanations in the report, you will gain valuable ideas for cost control and profit improvement.

ACTION PLAN

Cost control must be based on a plan of action. In a strictly logical sequence, the plan of action is the first step in cost control. But, as a practical matter, a plan of action is part of a circular process which involves cost consciousness, accurate and timely records, and regular performance review. Without these other vital ingredients, the plan of action has no value. And cost control has little meaning without an action plan.

Here again, it is important to emphasize that cost control does not mean holding every expense to the barest minimum. Cost control is intended to assure that every expense is incurred for the purpose of achieving a profit and supporting business growth.

The heart of the planning process is a budget which specifies the level of sales projected for the following period and sets forth the operating expenses required to produce that sales level. Presumably, a net profit will be planned after all expenses have been subtracted from total sales. Many metalworking firms have experienced periods of unprofitable operation which could have been avoided or minimized through careful planning.

Your accountant should be involved at some point in the budget planning process — to help you get started, to evaluate the feasibility of your draft budget, and, if necessary, to work with you in pulling the information together.

The traditional budget covers a one-year period, although some companies use plans for time spans as short as three months and as long as five years. A quarterly budget forces management to look critically at the events of the past three months and (particularly in periods of declining orders) to consider significant budget revisions, including personnel changes. A three-year or five-year budget requires management to consider whether more comprehensive actions (such as new approaches to employee training, a change in marketing and selling methods, implementation of operator process control, or a long-range equipment acquisition plan) should be initiated during the next few months instead of postponed until "whenever." Even the traditional one-year budget may require periodic modification as wage and price levels change or as unforeseen and irreversible developments occur.

The sales component of your budget will require considerable thought, combined with some measure of guesswork. You should, first of all, make an estimate of the number of direct labor hours that your company can realistically work, considering your production trend for the past three years, your current backlog, your new business resources (such as new equipment, better-trained employees, or modern process control), your customers' prospects, your sales plan, and the best available projections for the national and regional economy.

Then you must calculate a figure for your price per direct labor hour, based on the "guesstimated" rate of inflation for the coming year, taking into consideration local competitive pressures on your prices. Multiplying your projected total direct labor hours by your anticipated price per direct labor hour will yield your estimated net sales for the period. In recent years, a number of contract metalworking firms have established differential rates for work performed in various work centers, based on significant differences in labor expenses and/or equipment costs (including "cash" expenses, such as utilities and allocated occupancy charges, as well as the "non-cash" charge for depreciation, adjusted for utilization rate).

Expense projections should be calculated in relation to your anticipated direct labor hours. Some expense items will rise in proportion to direct labor hours, while other costs might not change with production increases during the period. Even the so-called "fixed" costs, however, will probably rise to higher levels if production is greatly increased. For example, occupancy costs will obviously become greater if larger facilities are required, and the higher rent will then become a fixed cost for the remainder of the period.

Projecting expenses requires two steps:

- Relating each item, in current dollars, to anticipated direct labor hours; and then,
- Applying a separate inflation factor to each specific item.

Each cost item will be affected in a somewhat different manner by significant changes in direct labor hours. A 10% increase in direct labor hours may, for example, result in an estimated 7% current-dollar rise in utility cost, but supervisory expenses may be essentially unchanged.

Current-dollar projections for each expense item must then be adjusted for anticipated inflation. Vast differences in the rate of cost increases — such as materials, Social Security taxes, utilities, and clerical wages — make a single inflation factor for expenses unrealistic. Examining the potential inflation rate for each cost category is not designed to arrive at precise estimates, but the process is intended to help you anticipate those expense areas that are particularly subject to upward pressure.

After calculating the inflation-adjusted amount for each expense item and comparing your projected total costs with your anticipated net sales for the next period, you may find that revisions are necessary in your planned price per direct labor hour, your total cost structure, or your estimated production in order to generate a satisfactory profit. Can you realistically raise your prices? Where can you cut costs? Are more orders possible and can production be increased to a higher level than originally planned?

Because it is obviously impossible to put an exact number on future sales or expenses, you should not waste time striving for ultra-precise figures in your budget. You should be seeking a realistic "best estimate" of your expected activities and potential profits. Rather than using the term “budget,” which implies a restriction on activity, you might instead consider calling it a “profit plan.”

DELEGATION

The fifth key element in a cost control program is delegating responsibility and authority. You should make an effort to identify who actually incurs costs in each accounting category, both in the shop and in the office. Is the decision-making process organized and properly controlled? Are individuals held directly responsible for the costs they incur? Do they have authority to control those costs by changing procedures or requesting such a change? If not, you should tighten up your administrative and supervisory procedures before assigning responsibility for various budget areas.

Once you are satisfied that your organizational structure will meet your needs for the coming year, you should carefully define the cost-control responsibilities of each person who reports directly to you and inform them of their specific duties and accountability for keeping costs within the profit plan. In fact, you should involve key supervisory and administrative employees in developing a plan for those areas over which they have responsibility. If they are able to contribute specific ideas for profit improvement, they will have reason to consider the plan realistic and will be more likely to implement it enthusiastically. Then, give those employees authority to take corrective action at any time that expenses start to get out of line. Hold them individually accountable for costs related to the activities they supervise.

Your monthly performance reports should be designed so that you can identify responsibility for any variances or deviations from the profit plant. Keep your employees informed. Feedback is essential to encouraging cost-consciousness and top performance.

A cost control plan can never substitute for sound business judgment based on experience. But as a management aid, it can significantly improve operating efficiency and company profitability.

This BMA was prepared by Barry E. Miller, Financial Management Consultant, Reading, PA. The Barry E. Miller Company prepares the Operating Costs and Executive Compensation Report and the Wage and Fringe Benefit Report for NTMA. Mr. Miller serves as a consultant to NTMA members and has appeared as an expert witness on behalf of member companies.