We lost money on that job! What do you mean, we didn't?

By Dr Lisa Lang and Brad Stillahn

Cost accounting is alive and well in machine shops, even though it is an invalid, old technology. The continued—and unquestioned—use of cost accounting has led directly to the loss of competitiveness and long-term decline of American manufacturing. Stop using it!

Brad: You give a lot of speeches to business owners. Tell me again, what drives you nuts?

Dr. Lisa: When someone says "We lost money on that job".

Brad: That's cost accounting talking. It's amazing the owner is still in business, saying something like that. If his competition didn't all think the same way, he would be out of business.

Dr. Lisa: Truly variable costs—materials, outsourcing, freight, sales commissions—are normally just a fraction of the selling price. There are only two ways to lose money on a job: 1) charge less than your truly variable costs; or 2) re-work a job over and over again causing you to incur the truly variable costs multiple times and the total of all the truly variable costs are more than the price you charged.

Brad: The all-industry average for truly variable costs is 40%. And machine shops are usually much less than that, depending on the type of work they do. So why does the business owner think he "lost money on that job"?

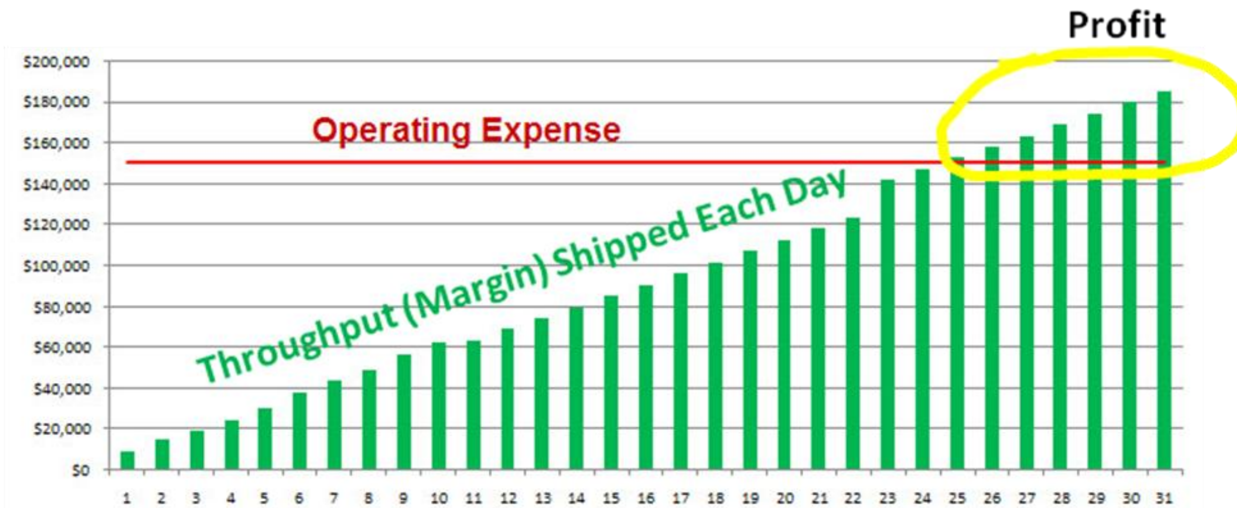
Dr. Lisa: It's the allocation of overhead cost, the number one conceptual mistake of cost accounting. Remember, cost accounting was invented back at the turn of the last century, when labor was paid piece rates and overhead was less than 10% of total costs.

What **really** happened was that the job took more time than estimated. And since cost accounting allocates "cost" to that time, the job "cost" more than expected, perhaps more than the price. But this is a mirage. The margin received—the sales price minus the truly variable costs—is the same no matter how long the job took to produce.

Brad: So, the problem is that by using more time than estimated, there is less time left in the month to produce and ship the margin on subsequent jobs. Sometimes, what margin is shipped in total is less than the fixed costs for the month, and then there is a loss for the month.

Dr. Lisa: Yes, and that is the problem that most owners are trying to avoid. And the way we were all taught to do that is -- cost allocation. However, you can make sure that you make enough margin in total **without** allocating any costs and it's actually simpler and more straight forward.

Just plot the Margin dollars you ship everyday (what we call Throughput) and compare that to your Operating Expenses. And remember, if you work overtime, you've increased your Operating Expenses. Once you understand the relationship between Throughput and Operating Expenses, you have all the information you need to ensure you ship enough work in total to make money.



A company can lose money, but a job rarely does. Jobs aren't unprofitable, and for that matter, products are rarely unprofitable and customers are rarely unprofitable. Companies lose money because the margin in a month does not cover the fixed costs for a month. Otherwise, the margin on all jobs, products, and customers in excess of that month's fixed costs <u>all</u> collectively add to the overall profits for that month.

Brad: Who cares? Is this really that important? In the last 20+ years since Throughput Accounting was invented to replace cost accounting, not very many business owners have even heard of it, much less felt a need to change.

Dr. Lisa: True. Most just went out of business slowly. Like the frog in the pot when the heat slowly increased, and never jumped before it was cooked.

Brad: When I switched the label printing business I own from cost accounting to throughput accounting back in 1997, it was uncomfortable. The process took time and perseverance. And there wasn't much help available for me back then. But I found the sweet spot where conventional cost accounting leads business owners to believe they'd be losing money on jobs, and where throughput accounting clearly indicated we were making a load of money.

Dr. Lisa: It is really unfair to competitors when you understand throughput accounting, and price accordingly. We call that "competing with blind kittens" because cost accounting is such an inferior technology.

Brad: Cost accounting was invented before the Model T. Why do business owners that are so up-to-date with other types of technology, and appreciate keeping up with the rate of improvement in technology, not think to look for improved technology in business methods?

Dr. Lisa: I don't know the answer to that, but my guess is that they are more comfortable with new technology in their area of expertise and less comfortable with new technology where they are not an expert – financial management. And, even if they have some interest in this new Throughput Accounting technology it's hard to give up the old until you fully understand the new. Hmmm…that sounds familiar.

Brad: Whoa, you're right! It did take me a lot of time to make the change. I guess that does explain why it's easier to stay with the old technology.

Want to catch up with technology? Have Dr. Lisa present "Maximizing Profitability and Achieving a Viable Vision" to your company, and/or have us help you with a Pricing Project to apply Throughput Accounting to your business. Your increased profits are guaranteed, and well as competitor's indigestion and insomnia.

The Science of Business helps companies rapidly increase sales and profitability by implementing the Theory of Constraints (TOC), Lean, and Six Sigma. Check out their Mafia Offer Boot Camp (for all types of companies) and Velocity Scheduling System for highly custom job shops.

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