

## **Keeping the lights on**

### **Part 1 Costing**

As the economic down turn begins to take hold in China many companies are looking to the accounting department to help control costs. Unfortunately some of the accounting tools in use are a double edge sword one in particular is standard costing.

#### **Standard costing**

Most FIE's that have manufacturing operations in China are on some type of a standard costing system. For the laymen a standard costing system could be thought of as a budget for one unit of a product.

The standard is set during the budgeting processes at the beginning of the year. All manufacturing costs are absorbed into the product including direct labor, materials and overhead. At each month's accounting close, actual costs are tracked against the standards and variance reports and analysis of variance reports enable management to quickly see a problem and take action if needed.

This is a great control tool. Disaster can strike when management however well meaning, set sales policy based on this standard as they believe it is their true cost. Unfortunately there are fixed costs in this calculation that are incurred whether a product is produced or not. This often causes the sales team to reject a sales order because they believe it to be below their cost.

Economic cost calculations prevent this problem. However; the records, systems and company culture of most firms are not set up to measure these costs.

As economic activity decreases the orthodox approach is to reset the standard for the new budget at a lower volume. When this is done more overhead is absorbed into a smaller number of units. Doing this causes the standard cost per unit to increase.

A company can quickly find itself priced out of the market because it follows the above sales policy and refuses orders below their standard cost. This refusal of orders will again cause more overhead to be absorbed into fewer products.

#### **A new standard for overhead absorption**

An alternative is to set the standard cost at full capacity of the plant less any planned down time for maintenance. Setting the standard in this way allows management to continue to enjoy the control benefits of standard costing while aligning the cost accounting system with cash outlay and economic profit and accounting profit become aligned.

At month end, under absorbed overhead is immediately expensed into a separate COGS account. Breaking out overhead in this way shows management the cost of its extra capacity or its "real option" for future orders and other product lines.

Any finished goods Inventory is recorded at the full capacity standard.

This helps management to manage the inventory and thus cash more effectively. Chinese managers are notorious for only managing the income statement and will often overproduce as they are usually incentivized based on the bottom line only. This over production shows up on the income statement as higher profits as more overhead is absorbed by the inventory on the balance sheet.

By absorbing labor, usually a fixed cost in China, and overhead as if producing at full capacity, there is no management incentive to build up unnecessary inventory.

At year end, ending inventory can absorb under absorbed labor and overhead for statutory accounting and PRC GAAP purposes and as management is not incentivized to build inventory this should not be a very large adjustment.

### **Optimization of cost components**

Standard cost is usually set in three components: a budgeted cost for: direct labor, overhead and materials. Each department is incentivized for keeping their department's costs under budget.

This naturally causes tension between the purchasing and production departments as there are tradeoffs between material and labor inputs into a finished product.

When the plant is running at full capacity, a gain by using a lower cost raw material will often be offset by higher direct labor costs as processing time and rework is usually traded for a lower cost material. During these times the total cost of a product is usually optimized if management uses a higher quality material.

However, in economic downturns, when there is a lot of excess capacity, the trade off between material and labor is not important, as labor in China is usually a fixed cost. In this instance it pays to widen the raw material specifications as total cash outlay is reduced in this instance while accounting and economic profit is maximized.

In conclusion by adjusting the standard accordingly management can take advantage of the control functions that standard costing provides while reducing the normal downsides of traditional standard costing.

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In part two of “keeping the lights on” we will discuss managing for cash maximization.