

You can't Spot Serious Shareholder Value? Check Your Paradigms

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Part 5

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*Winner of the 1999
PricewaterhouseCoopers award
for the best article on Shareholder Value Add*

Full Absorption Costing:

This means product or service costing in a way that all overheads (burden) are allocated to products or services. The intent is to know whether or not a product or service is profitable – should we keep it or...? This practice has led to a lot of mistakes in businesses – for example, the out-sourcing example given above

Another example is a service organisation, one that executes projects for its clients. In this company project managers are evaluated on the profitability of their projects. They must buy internal resources at a fully allocated cost – with all the overheads. In a discussion about resource availability one project manager stated he had no problems with this. He does not even try to use internal resources, since this just leads to conflicts. He always hires sub-contractors. In this way he has no resource problems and he makes greater profits – because internal resources cost him more than the same kind of people from subcontractors. What has he done? He has optimised his (local) performance and probably he has hurt company performance (if internal resources are under utilised). What drives him to do this? Performance measures and full absorption costing.

Full absorption costing (no matter how it is done) has another problem. It gives a profitability ranking to be used by sales and marketing which does not take into account how we are using our constraint. In other words it often happens that those products that use our constraint most efficiently are not very far up the profitability ranking. What happens? Sales sells the products with the highest margins on a full cost basis and profits go down. For serious SVA DO **NOT** use any sort of full absorption accounting – not even ABC (Activity Based Costing). Use a system which tells you which products generate the most variable margin (sales – raw materials costs).

There is yet another way Full Absorption costing hurts a business. Many companies value their inventories at 'fully absorbed cost' – with all expenses allocated 'appropriately' to all products. This practise and the way it is implemented results in some counter productive effects. You ask your people to reduce their inventories. Good. They do it and because of this their profits decline in the short term – and they are punished. You want them to increase earnings. No problem, they will just increase inventories and 'hide' some costs there. These are the sorts of games managers will play to optimise their personal performance.

The easiest thing in the world is to keep another set of books – the books by which you will manage. (Wall Street is not a reason to not do it. Financial analysts understand very well the problems of full absorption and the games companies play with it.)

Full absorption costing of products and inventories helps no one make good decisions. In fact it often leads to decisions that hurts your company. On top of that 'good' product costing takes so much time and effort and yields so little, and it is obsolete almost immediately. If a business stops doing it a lot of talent is freed to concentrate on increasing profits.