Two Major Problems with Accounting and Management Systems in Manufacturing Businesses.

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Introduction

There are a number of common problems that inhibit the potential speed of innovation and growth of SME's particularly manufacturing companies.

They are:

- Lack of a clear well defined strategic business plan
- Poor recognition of the fundamentals of quality, cost and delivery
- Not defining and using effectively their Strategic Advantage for Winning (SAW).
- Lack of capital.
- Poor management.
- Poor understanding of the fundamentals of the profit and loss account and the balance sheet.
- Late financial information
- The use of outside accounting assistance and advice from people who do not understand the business.

This paper will attempt to deal with the accounting issues caused by the poor structure of the accounting profit and loss account and balance sheet in SME's and finish by asking a series of simple questions that beg answers.

Fundamental Problems in the Accounting System

- Standard Costing
- Not linking Inventory costs with manufacturing costs for made to stock lines (MTS).

Over the last 30 years in particular I have performed many assignments on a wide range of companies, from $5M turnover to $1.3 Billion turnover. What follows are real examples of recent assignments both aimed at redesigning and re-engineering the management system to restore profitability. The names of the companies must remain confidential but the results are true and the data is normalized to protect their identity.

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The first case is an illustration of poor management and a poor understanding of the links between marketing strategy and inventory holding costs and manufacturing costs. This company was transformed from a loss of $0.5M to an EBITA of $40M with another $18M released from finished goods inventory and waste reduced by $2.5M.

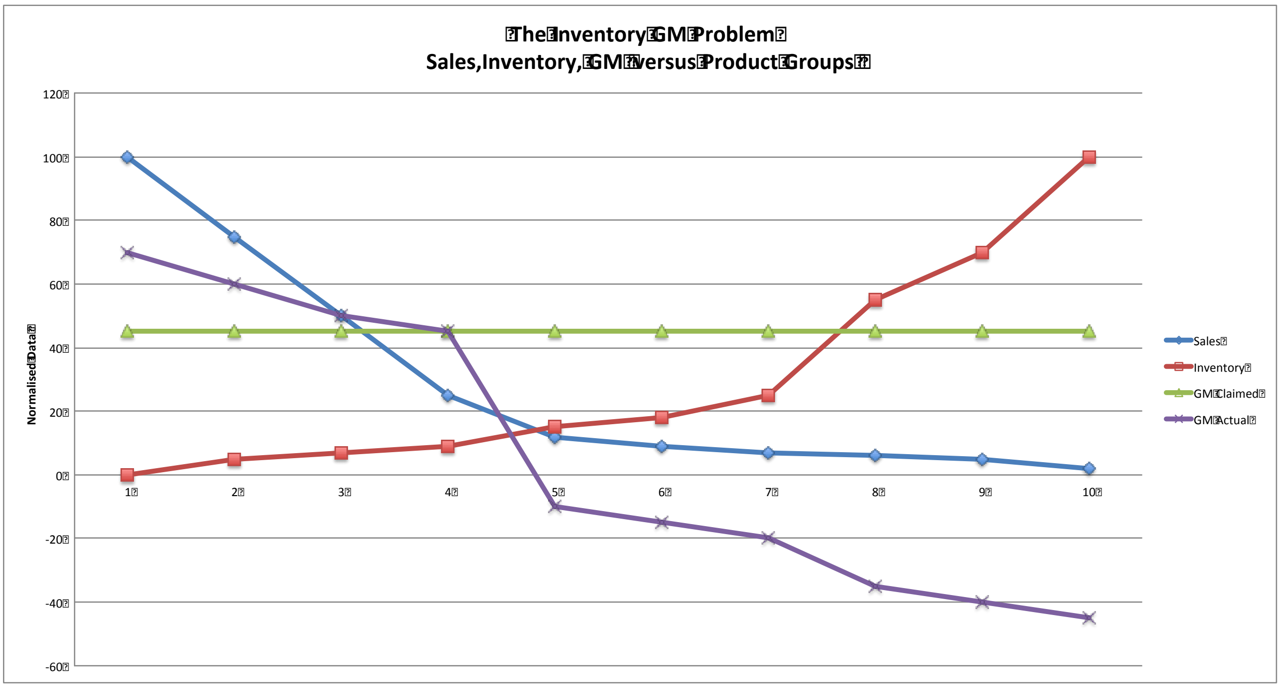
For the second case the company was losing approximately 5% on sales of approx. $100 Million and this could be restored to a profit of approximately 6% EBITA on sales with a redesign of the accounting system so that the CEO is aware of where he is making money and where he is losing money, and a rationalization of the products which was held back by the accounting anomalies.

Case 1 Inventory Costs

Figure 1 is an illustration of what can happen when the link between stock movement and stock holding costs are not included in the calculation of net profit. It is a plot of Sales, Inventory, Gross Margin Actual if the inventory cost is included in the cost of goods sold. This company was making a loss of approximately $0.5M per year until this problem was exposed and solved. Then, sales of high volume lines surged and the manufacturing time in the past used to make items that would not sell and were in stock was released to make more of the high sales lines since the demand had not been previously satisfied.

The net result of this was that sales soared, capital was released for innovation and paying off debt and the EBITA soared to $40M EBITA in 2.7 years.

Figure 1 An Illustration of How Inventory Costs can erode an assumed net Profit



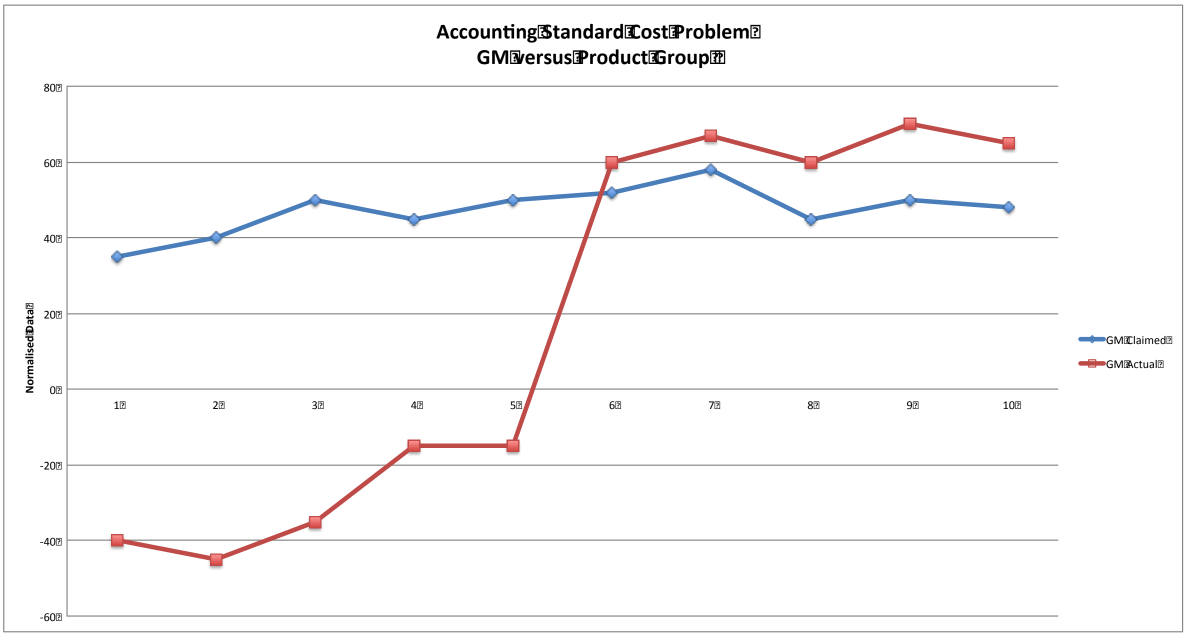
Case 2 Standard Costing

Figure 2 is an illustration of what can happen when a standard costing system is used. In this case the product range is showing that the gross margin is approximately constant and independent of the product type.

It is an illustration of how standard costing systems can distort the strategies needed to drive profitability. It is a simple graph of the gross margin claimed and the real gross margin. In this case all product was made to order so that the inventory problem in case 1 did not interfere with the data.

When the real manufacturing cost was determined by abandoning standard costing, then it was clear that the company could not make certain lines at a profit and these unprofitable lines were using up, valuable production time.

Figure 2 An illustration of how a Standard Costing System has Hidden the real Gross Margins



Questions for Business Schools

In the two cases above the CEO's were all trained at University level and had MBA graduates working for them. In one case three Directors had been working on the inventory control problem for 5 years and made no progress. They were all University trained with accounting management and engineering training with MBA's working directly for them.
For the second case the CEO was an Engineer with a highly qualified accountant working for him directly and numerous other graduates, one an MBA reporting dire3ctly to him.

Therefore the fundamental question is the Julius Sumner Miller one "Why is it so?" Perhaps readers of this article may like to offer suggestions and remedies. Why aren't our University trained managers able to solve such simple problems?

Stop blaming the high Australian dollar!