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What is profitability accounting?

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Profitability Accounting Is Versatile . . .

companies ranging in annual sales volume from less than ½ million to 100 million have used profitability accounting successfully. They include . . .

TV Station
Bank
Paint Manufacturing
Luggage Manufacturing
Electronic Components
Automotive Parts Supplier
Structural Steel Fabricator
Tool and Die Manufacturer
Metal Extrusions Company
Shoe Manufacturer
Women's Clothing Manufacturer
Heavy Machinery Manufacturer
Manufacturer for Government Contracts

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We are all aware that the roots and customs of accounting go back many centuries. Much of what we now call accounting, however, has been developed step by step over only a couple of generations.

Accounting in the very early days was concerned primarily with the listing of transactions — a diary of notations which could be referred to at a future time. Accounts were also set up quite early to record business transactions between a buyer and a seller. Double entry bookkeeping gradually developed and the more sophisticated concepts of what we now call custodial accounting

WHAT IS PROFITABILITY ACCOUNTING?

emerged. The double entry system facilitated drawing off periodic balance sheets and profit summaries from the accounts.

Custodial Accounting

Custodial accounting can be defined as accounting for the assets entrusted to an enterprise. This concept of accountability, it should be noted, is basically concerned today with preparation of reports and data for groups of persons other than management — such as stockholders, creditors, and governmental agencies like the SEC or the Internal Revenue Service.

Any system that is directed solely to the custodial aspects of accounting has limitations from the management viewpoint. More recently, two new areas have been evolving — performance accounting and decision accounting.

Performance Accounting

Performance accounting is the quantitative matching of performance against some plan by organizational responsibility. It implies the use of standards and budgets. Its distinguishing characteristic is that it serves to measure by responsibility, actual performance against planned performance.

Decision Accounting

Decision accounting is the quantitative evaluation of alternative courses of action. It includes all disciplined techniques for providing quantitative information in the form which can best assist a specific management decision at the time when the decision has to be made. This includes decisions as to product pricing, make-or-buy, inventory policies, and choice of alternative production methods. It is the area in which business has historically depended on special analyses and memorandum accounts for information rather than the accounting or cost system as such.

Profitability Accounting

Profitability accounting is a broad concept of modern accounting, aimed at simultaneously serving performance accounting and decision accounting objectives without disturbing traditional financial accountability. It does this by use of a completely integrated accounting system which places at least as much emphasis on managerial control by insiders as on financial accountability to outsiders.

As the name suggests, it focuses attention on the reasons for the relative profitability of business products and business operating periods, such as sales volume, sales mix, departmental or functional cost control, inherent product profitability, return on investment and many other less important reasons for profitability.

There are perhaps two characteristics which most clearly distinguish profitability accounting from previous attempts in modern accounting methods to lay before management the tools with which to control a business. First is the classification of all planned costs into three distinct groups — variable, programmed, and standby.

Variable costs are those which vary, but not necessarily directly, with volume. These include direct material and labor, variable manufacturing and commercial expense, and specific product costs such as freight and sales commissions.

It is important to emphasize that variable costs can vary in significantly different ways. They may vary directly with volume or in step fashion. They may vary with specific products, specific operations, or general company-wide activity. They cannot always be realistically assigned to product, and the method in which they vary cannot always be accurately determined by fitting a line to a few historically plotted points. The profitability accounting treatment of these costs will often have to be "tailor-made" for the particular business.

Programmed costs are those costs which are incurred for some time period by a specific management policy decision. Once this decision is taken, the costs become fixed for the time period. Advertising and engineering research programs are examples of this.

Standby costs are the fixed costs which would be incurred at zero volume of business if there is full expectation that normal operations will be resumed within two or three months. This would include wage and salary costs of that essential nucleus of supervisory and maintenance personnel who would be retained under such "ready to serve" conditions, as well as taxes and depreciation.

Costs have at least three important dimensions — kind of cost, responsibility for cost, and allocability of cost. The above grouping partially reflects all three, and thus tends to reduce the manipulations required to obtain useful cost data from the accounts.

The second distinguishing characteristic of profitability accounting is the distribution of actual revenues — but only *planned* costs — to product lines. The foregoing technically produces not "actual" profits by product lines, but rather "profitability" results which, because of their method of portrayal, are conducive to management decision and action. The difference between total costs and the planned costs which enter into the profitability results are drawn off to variance accounts where they are significantly portrayed departmentally or functionally. They are not shown as a part of total product costs.

Difference From Direct Costing

Though profitability accounting incorporates some of the features of direct costing, it differs in the following ways:

1. Profitability accounting presents the full cost of inventories in the balance sheet in accordance with accepted accountability and absorption cost theory. Direct costing advocates, on the other hand, generally would like to eliminate standby costs from inventories,

and handle it as a period cost in the same manner as commercial expenses.

2. Profitability accounting develops a profit or loss for each product line after the deduction of all planned costs, including standby, whereas direct costing generally develops only a so-called "profit contribution" or "profit/volume" ratio for each product line and allows the standby and programmed expense to become a general charge against operations without assignment to product lines.

3. Profitability accounting also spells out a product line profit contribution net of all standard variable costs before proceeding to deduct standby costs. This profit contribution includes many specific selling and other commercial expenses which are frequently considered fixed under direct costing. Generally, a greater portion of costs is considered as fixed under direct costing than under profitability accounting.

Difference From Absorption Accounting

While profitability accounting seeks to produce total annual net income results identical with those which would be reported on the absorption cost basis, it does call for a rearrangement of cost collection and reporting in terms of the variable, programmed and standby classification. It discards completely the philosophy of over- and unabsorbed manufacturing overhead as a management control concept, though it may still provide for memo volume variance in the budget structure. In many cases, it borrows somewhat from the direct costing theory by not adjusting interim inventories and earnings for the effect of seasonal inventory changes in standby costs. In such cases, standby costs in inventory remain fixed during the year.

Profitability accounting speaks of unit product cost in terms only of variable costs, excluding standby and programmed costs. The unit cost of a product under absorption accounting, on the other hand, of course refers to full product cost. Profitability accounting advocates maintain that the absorption viewpoint is inflexible for purposes of rapidly changing management decisions and that, while standby and programmed costs should not be eliminated from product lines as direct costing would have us do, they should be assessed against a product *line* in terms of total dollars, and not against a product *unit* in terms of an assumed static condition of volume.

A Chain of Requirements

Successful development of profitability accounting within a company is unlikely unless the following elements exist or can be developed. These elements may even be thought of as a chain of requirements leading to profitability accounting.

An organization chart which clearly and unequivocally designates functional responsibility and authority as actually practiced.

A chart of accounts co-ordinated with the organization chart.

A standard cost system, where practicable, but in any event some form of cost system which provides pre-determined and, preferably, *engineered* standards for all elements of cost.

A budgetary control system tied in with the financial and cost accounting system which gives recognition to the effects of volume changes.

A profit plan which converts sales forecasts into product line profit forecasts based on cost standards and budgets.

A reporting system which

Shows the profit plan goals and compares performance against them—highlighting variations from plan by responsibility.

Shows profit contribution at standard by product lines.

Shows standby costs which are specifically related to product line and the rational allocation to product line of all other standby costs.

Shows programmed expenses by product lines.

Shows any special arrangements of accounting data which are directed toward special managerial decisions.

The first four elements can and often do exist in a business which has never heard of profitability accounting. A profit plan and some kind of useful reporting system may also be present in such a business. It is the philosophy underlying these elements rather than the existence or absence of the elements themselves which makes up profitability accounting. A few brief remarks about these elements may help to illustrate some of this philosophy.

Chart of Accounts

A profitability accounting chart of accounts should insure that the planned portion of all costs, whatever their character, may eventually be charged against a product line to reveal product profitability, and that variances therefrom *may* be charged departmentally or functionally for control purposes. A profitability accounting chart or chart of accounts should insure that overhead costs are collected initially by responsibility. This means that costs may have to be transferred from department spending to department charged before the planned portion of the cost may be extracted and assessed against a product line. **This succession of steps from department spending to department charged to product line is a cardinal feature of profitability accounting.**

Cost Systems

The cost system of memorandum accounts is primarily directed at developing performance variances from standard for direct costs by responsible function or cost center. These variances are charged against the function and excluded from the standard input to inventory. (Continuing and consistent unavoidable variances can be included in the variable overhead rate for assignment to product.)

Profitability accounting favors use of the four-wall inventory concept and the bulk of the cost system effort is devoted to controlling the input to this inventory. Though product standards are quite useful for costing sales, the system for doing this should be simple and is secondary in importance. Memorandum accounting is used to allocate standby costs to the product line income statement.

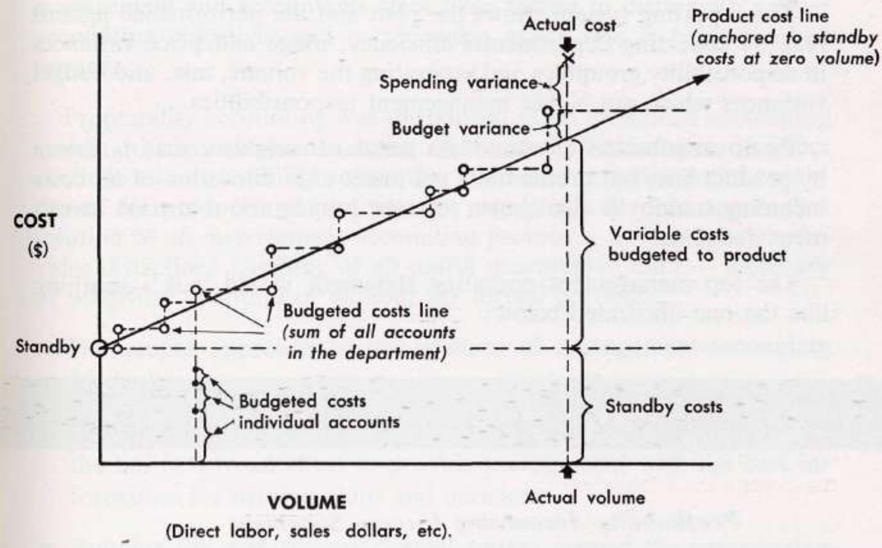
Consideration should be given to the possible use of NIFO or replacement cost standards for determining the trend of interim net income on the basis which is most current and most significant for management evaluation.

Budgetary Control

A fundamental feature of budgetary control under profitability accounting is that the budgetary control system must be tied in with the general accounting system and not be independent of it. As a by-product of departmental expense control it also produces variable, standby and programmed cost levels departmentally or functionally summarized which are useful for purposes of product costing, statement presentation and various management decisions.

The budgetary control system has three major considerations. It must enable a realistic forecast of what costs should be for any volume to be converted into budgeted costs at planned volume. It must provide for comparison of budgeted with actual costs — hence the need for being tied to the accounts. It must also develop an administratively workable method for allocating these budgeted costs to products. How this is done can best be illustrated by the graph immediately below. Note that a budget variance is developed whenever the product cost line does not coincide with budgeted costs. Note also that detailed budgets of individual accounts underlie the department budget summary which is plotted below.

Budgeted Costs & Product Costs vs Volume



Profit Plan

The profit plan of course brings together in one place the operating results which are to be expected, generally for a year, based on a realistic forecast of sales volume and planned costs as built up from the standards and budgets previously discussed.

The significant details of the profit plan cannot be presented in a few sentences. It is worth emphasizing that the profit is planned for each product line by deducting all specific costs and the allocated portion of all other costs. These allocations are based on the current year's sales volume and mix forecast and the longer range forecast as to expected use of facilities. The plan also includes processing the forecasts through the budget system to establish cost goals for each organization responsibility.

In setting up a profit plan, consideration must be given to properly weighing and relating costs to various management decision options. The plan should also provide the flexibility to subsequently distinguish between costs that arise because of *deliberate changes in plan* and costs which result from *failure to perform as planned.*

Reporting System

The reporting system shows the plan and the performance against plan by collecting departmental efficiency, usage and price variances in responsibility groupings and separating the volume, mix, and budget variances which are higher management responsibilities.

Profit contribution (revenue less standard variable costs) is shown by product line, but product line net profit after allocation of all costs including standby is also shown to assist pricing and return on investment decisions.

The top management operating statement would look something like the one illustrated below:

Profitability Accounting Income Statement

STATEMENT OF NET EARNINGS																
MO.	Net Sales		Standard Profit Contribution		Standby	Pro-grammed	Budget Variance	Other Variance	Earnings Before Tax		Taxes		Net Earnings		Per Share	MO.
	Over (Under)	Fore-cast	Over (Under)	Fore-cast	Fore-cast	Fore-cast	Actual	Actual	Over (Under)	Fore-cast	Over (Under)	Fore-cast	Over (Under)	Fore-cast	Actual	
J																J
F																F
M																M

To summarize the foregoing, accounting can be divided under three primary objectives:

Custodial accounting: for satisfying external (custodial) requirements and internal control needs.

Performance accounting: for evaluating how well the business is doing—oriented toward operating results in terms of the people responsible for the operations.

Decision accounting: for providing quantitative information to aid in deciding what the business should be doing—oriented toward alternative courses of action in terms of operations and products.

Many of the controversies which arise regularly between operating management and accountants stem from failure to distinguish among accounting objectives and to recognize which one is being worked toward.

Profitability accounting was introduced as an integrated accounting system which incorporates many of the desirable features of direct costing and responsibility accounting (that is, it provides useful breakdowns for product and performance reporting). It only approaches solution of all management accounting problems, however, as it provides disciplined handling of all useful quantitative data — monetary or otherwise — within or without the formal accounts.

The proper approach to the solution of management-accounting problems lies in

- Relating decision accounting to the decision-making structure of the business in an effort to provide management with the best information for making plans and decisions.

- Building the performance control system around the organization chart structure so as to measure actual results against planned results by responsibility.

- Preserving the financial integrity of the accountability system.

- Integrating the efforts of each system as much as possible without sacrificing one of the objectives.

- Providing reconcilement where data used for one objective seems to be in conflict with similar data used for another objective.