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The High Cost of Cost Absorption

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I overheard a father drawing upon the wisdom of Aristotle not long ago during a teachable moment with his young son: *Everything in moderation.* CEOs would do well to remember those words when it comes to cost absorption, as too much of this good thing can and all too often does lead metalcasters to ruin. As proof, consider that much of my turnaround work has been precipitated by CEOs who were heedless in pursuit of sales growth and certain that more volume would cause more absorption and more absorption would generate more profit. They were immoderately pursuing absorption-driven management and, rather than more profit, what they generated was over-full molding lines and increasingly alarming bottom lines.

Don't get me wrong, cost absorption is real, but absorption-driven management carries with it the harshest of consequences. Of those consequences, the worst befall CEOs who allow absorption-driven management to blind them to the fact that some volume can actually be lethal to their businesses. Lethal? Yes, because absorption-driven management ignores compatibility, drives metalcasters to take on work that doesn't fit or flow, and goads managers into accepting the "contribution delusion"—the false belief that just about any volume will boost profits by absorbing fixed or other costs.

But instead of absorbing costs, jobs that neither fit nor flow cost metalcasters big. These "loser" jobs suck the life out of the business by generating excessive scrap and overtime, creating costly chaos on the shop floor, monopolizing technical and management resources, ruining delivery performance, squandering customer goodwill, and bloating both fixed and variable cost structures. Worst of all, the distortions caused by these jobs warp financial analyses as well as management's perceptions of the business and, in a final irony, cause CEOs to draw precisely the wrong conclusion—that more absorption is needed.

Absorption-driven management also causes metalcasters to price too low. For some, it's enough that new work "contributes" to fixed cost absorption, so pricing for them becomes a race to the bottom. For others, the thinking goes like this: We must price low to get more volume and, once we get the business, we must keep prices low to prevent customers from taking their work elsewhere. Unfortunately, like nearly everything in this distorted reality, the results invariably defy expectations and, instead of volume growth leading to more profit, the income statement takes a turn for the worse. But for those with eyes to see through the distortions, a clear message is right there in the P&L: low prices and high costs are starving the business for margin. It's more margin that's needed, not more absorption.

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Adding insult to injury, in the chaotic world created by absorption-driven management, metalcasters are so busy re-running high scrap jobs and otherwise putting out fires that they are unable to grasp profit making opportunities. Existing customers take new projects elsewhere because lead times are noncompetitive and on-time delivery is anything but dependable. New and prospective customers experience jobs languishing in startup for months, even years, as pattern tweaking never seems to end and samples remain just one more run from approval. They recognize this reality for what it is, and soon enough move on to suppliers that are in control, free from absorption-induced problems, and able to seize opportunities.

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On top of everything else, absorption-driven management compels metalcasters to perpetually seek volume growth and causes them to spend money they shouldn't—and all too often don't have—on new capabilities and new capacity. This compulsion ensnares businesses in the mature industry cash trap, where big investment dollars go into the plant but don't provide necessary returns to owners or noticeable improvements in bottom-line performance. Moreover, taking on new capabilities and installing new equipment invariably creates more operational chaos, heaps on more cost, fails to turn anticipated productivity gains into profit, and causes management to be even more distracted, less able to capitalize on opportunities, and further than ever from fulfilling its profit making mandate.

Aristotle and his peers also advise each of us to "know thyself" and thereby acquire inner strength sufficient to resist the opinions of the multitude. CEOs must likewise resist the conventional wisdom of absorption-driven management and eschew volume for absorption's sake, boldly reduce cost and manage price to strengthen margin, and employ an investment strategy which appreciates, in concept and in deed, that profitability can only be maximized in an environment of limited capacity and finite capabilities. Taking this road less travelled allows CEOs to create the effective operating environment needed for cost absorption to actually work as the textbooks say it should, which in turn opens the door to sustainable double-digit pretax profitability. MC

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