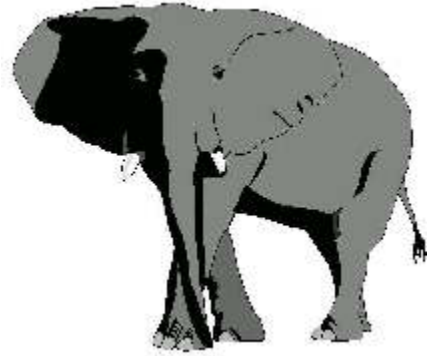


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Dear Executive:

During January I was the after-dinner speaker at the monthly dinner meeting of the IMA's Ann Arbor, Michigan Chapter. After the meeting, I had an opportunity to "bend an elbow" with John Daly, President of Executive Education, Inc., Author of *Pricing for Profitability*¹, and a consultant and educator I've know for nearly two decades. During our conversation, John made the observation, "Don't you think these zealots for concepts like Grenzplankostenrechnung or GPK (I was impressed, John can actually pronounce the word), throughput costing, and lean accounting sound like 'the blind men and the elephant?'"



I hate to admit it (since I didn't think of it first), but John hit on the perfect analogy to describe the current dilemma in management accounting. To begin, let's review the fable of the blind men and the elephant. American poet John Godfrey Saxe (1816-1887) based the following poem on the fable:

The Blind Men and the Elephant

It was six men of Indostan
To learning much inclined,
Who went to see the Elephant,
(Though all of them were blind),
That each by observation
Might satisfy his mind.

The First approached the Elephant,
And happening to fall
Against his broad and sturdy side,
At once began to bawl:
"God bless me! But the Elephant
Is very like a wall!"

The Second, feeling of the tusk,
Cried, "Ho! What have we here
So very round and smooth and sharp?
To me 'tis mighty clear
This wonder of an Elephant
Is very like a spear!"

The Third approached the animal,
And happening to take
The squirming trunk within his hands,
Thus boldly up and spake:
“I see,” quoth he, “the Elephant
Is very like a snake!”

The Fourth reached out an eager hand,
And felt about the knee.
“What most this wondrous beast is like
Is mighty plain,” quoth he:
“’Tis clear enough the Elephant
Is very like a tree!”

The Fifth, who chanced to touch the ear,
Said: “E’en the blindest man
Can tell what this resembles most;
Deny the fact who can
This marvel of an Elephant
Is very like a fan!”

The Sixth no sooner had begun
About the beast to grope,
Than, seizing on the swinging tail
That fell within his scope,
“I see,” quoth he, “the Elephant
Is very like a rope!”

And so these men of Indostan
Disputed loud and long,
Each in his own opinion
Exceeding stiff and strong
Though each was partly in the right,
And all were in the wrong!

So oft in theologic wars,
The disputants, I ween,
Rail on in utter ignorance
Of what each other mean,
And prate about an Elephant
Not one of them has seen!

Although in his final stanza, Saxe equates the blind men’s situation with debates over theology, he could very well have been describing debates over “costology.” Accurate and relevant cost information is a critical factor in almost every management decision or action. If a company’s costing methodology is designed around the perception on one blind man probing only one part of the elephant, that company is destined to fall far short of its value creating potential.

Visualize Figure 1 as a diagram of an organization’s “cost information elephant.” The diagram shows the variety of body parts our blind men can touch as they reach out a hand.

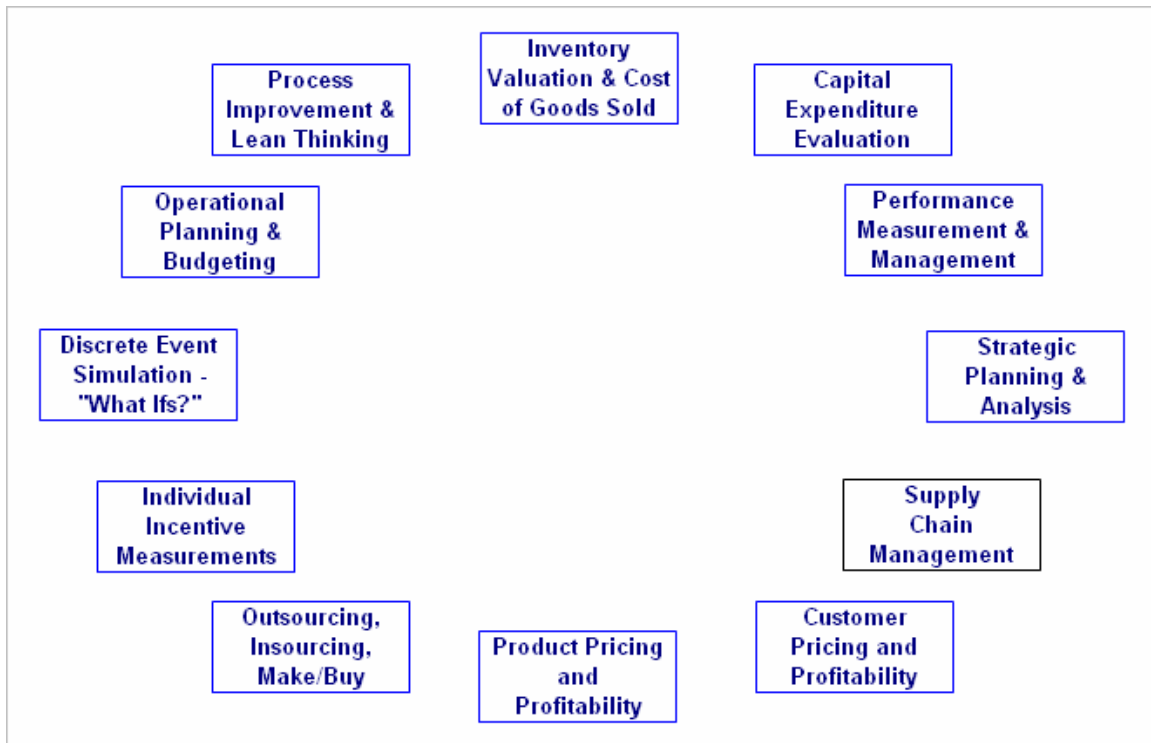


Figure 1 – The Cost Information Elephant

Suppose the first man touches “Process Improvement & Lean Thinking.” He will devise a costing model that assigns all costs to a value stream and minimizes the number of individuals in the cost accounting department. Such a model will work fine when supporting tactical actions related to process improvement and lean thinking, but it will be almost useless when applied to any of the other parts of the elephant.

The second man touches “Inventory Valuation & Cost of Goods Sold.” He will devise a costing model that takes into account only inventoriable costs and that accurately measures inventory and cost of goods sold for the organization as a whole, but cannot be relied on to measure the cost of any individual item. This would be a nice simple model – like having overhead rates based on direct labor – and will also be useless when applied to other parts of the elephant.

A third man touches “Performance Measurement and Management.” He might come up with a model like Grenzplankostenrechnung – the giant flexible budget favored by large German enterprises. It will generate great budgets and variances, but will require an enormous amount of time and resources to develop and maintain and be of limited use when applied to other parts of the elephant.

These individuals will argue with each other incessantly about the appropriate way to design a cost model....

The disputants, I ween,
 Rail on in utter ignorance
 Of what each other mean,
 And prate about an Elephant
 Not one of them has seen!

Now I can understand the frustration of a lean organization with the inadequacies of traditional western costing practices in supporting their endeavors. I can understand the desire of financial accountants to better apply inventoriable costs for valuing inventory and calculating cost of goods sold. And I can understand the concerns of managers when their system does not adequately support performance measurement and variance reporting. But the solution to the problem is not to devise a cost model that looks like their portion of the elephant only. The solution is the development of a valid economic cost model that describes the entire elephant.

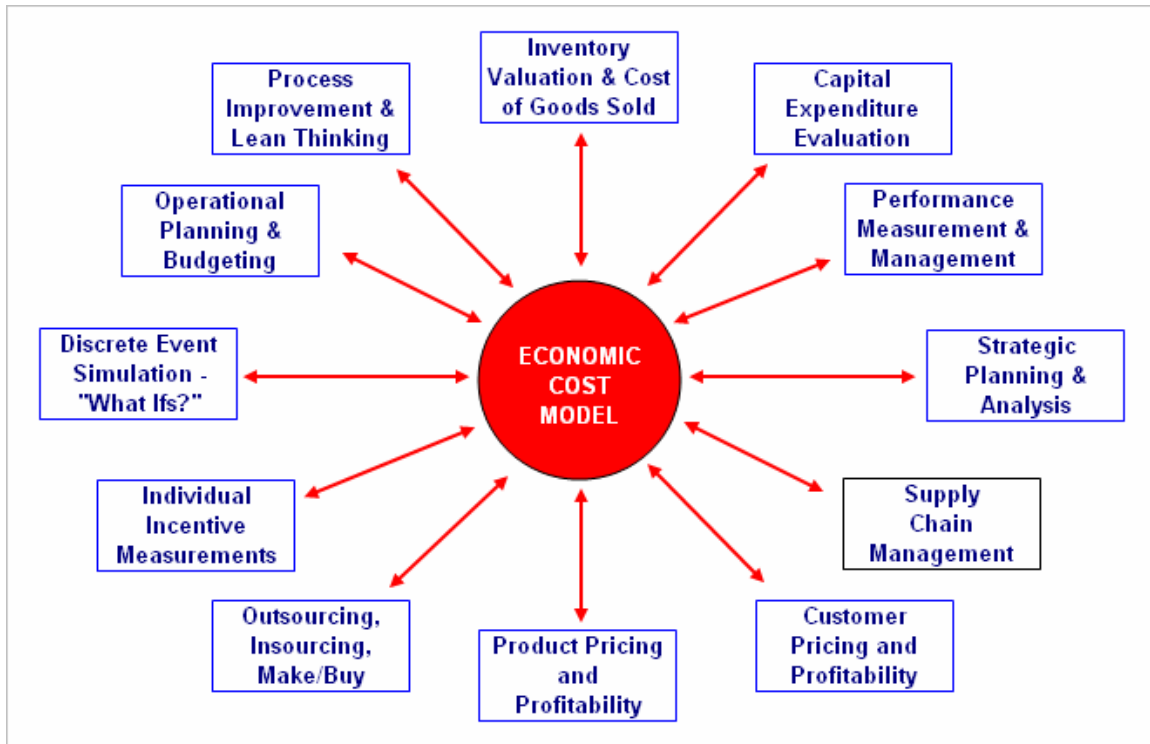


Figure 2 – An Economic Cost Model that Represents the Entire Elephant

A valid economic cost model serves the needs of all interested parties in an organization. Such a model is an accurate representation of the company’s internal cost economics. By populating it with the appropriate data – data that will differ from one usage to another – a valid economic cost model will generate the accurate and relevant cost information required by all parts of the elephant. It will work whether the decision at hand is strategic or tactical. It will work whether the information needed is fully-absorbed or incremental. It will work using historical information or projected information. It will measure process costs, product costs, service costs, and customer costs. As shown in Figure 2, it is the engine that takes the relevant data and processes it appropriately to provide support for management decisions and actions of all types.

Constructing a cost model based on only one blind man’s perception of an elephant is a terrible waste of a company’s resources. It solves only one problem, ignores all the others, and often adds many more. Until management accountants understand that *a valid economic cost model of the entire organization* is the key to providing management with the information it needs to survive and grow in an ever more competitive world, they will continue to **“Rail on in utter ignorance of what each other mean, And prate about an Elephant not one of them has seen!”**

Update

I will be one of two speakers at a half-day conference sponsored by the IMA's Grand Rapids (Michigan) Chapter on March 21st. Penny Weller of The Hackett Group will be presenting in the early afternoon and I will follow with *Driving Improvement with Activity-Based Concepts at Small and Mid-Sized Businesses* from 3:00pm to 5:00pm. The abstract for my session reads:

Soon after they were introduced nearly two decades ago, the development of activity-based concepts was sidetracked by the headlong gold rush of consulting and software firms clambering to sell services and products that were based on immature and incomplete ideas. This resulted in high-cost, limited-value solutions whose success has fallen far short of expectations.

Activity-based concepts are, however, the most powerful tools yet developed for creating valid economic cost models of business organizations. By using the "lens of ABC" businesses of all sizes and types can develop the valid economic models required for their executives and managers to make value-creating decisions and take profit enhancing actions.

This session will present an alternative perspective on activity-based concepts and show how three small to mid-sized businesses have used the insights provided by ABC to improve their operations and enhance their bottom lines – all without implementing specialized software or changing their day-to-day cost accounting systems.

As the time approaches, you can learn more about the one-half day conference at the Grand Rapids Chapter's website - http://www.imagr.org/events_upcoming.htm.

I hope you all had a great holiday season. I look forward to hearing from any of you who have questions or comments regarding this month's letter. As always, please feel free to forward a copy of this letter to anyone you believe would be interested.

Very truly yours,

Doug

Douglas T. Hicks, CPA, CMC
President

DTH/jmh

1 Daly, John, L., *Pricing for Profitability: Activity-Based Pricing for Competitive Advantage*, New York, John Wiley & Sons, 2002.