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Spring 2007

Dear Executive:

Due to some new (at least to me) problems that have come to light in recent years, this quarter's letter will again touch on one of my favorite subjects – depreciation expense (also known as “the worst concept in the history of management accounting”).

DEPRECIATION REVISITED

During the past two years, I've become involved with at least a half-dozen organizations that have either just been created through the acquisition of a number of existing manufacturing facilities or have recently emerged from a Chapter 11 bankruptcy. In every case, financial accounting for the transaction resulted in capital assets that were valued on the balance sheet at far below their actual market or replacement values. In several of the cases, property, plant and equipment ended up being valued at zero (\$0.00).

Following generally accepted accounting principles, these organizations took each capital asset's value, selected a depreciation method and life, and began recording depreciation expense just as they would had every asset been newly purchased. Those with assets having no value on the books recorded no depreciation expense. This depreciation expense (or lack thereof) was then rolled into their costing rates. Those rates, in turn, were used to value inventory, determine cost of goods sold, measure product profitability, and develop rates for use in quoting new business. Although I see no problem in using such costs to value inventory and measure overall cost of goods sold, using them for measuring product profitability is at best misleading and using them for quoting new business could prove to be disastrous.

In my Summer 2005 executive letter on the idea of a Capital Preservation Allowance (or CPA), I stated, *“As a company sells its products and services, it must not only generate profits, it must also generate the funds necessary to preserve its current productive capabilities. Existing products and services should not be viewed as paying for past capital outlays, they must generate the funds for future capital outlays. This means that current operations should be generating the funds necessary to make principal payments on debt incurred to purchase capital assets and pay cash for those capital assets that are not financed. In the past, many assumed that including depreciation expense in product and service cost provided for these future expenditures. But the calculation of depreciation expense has nothing to do with the future – it focuses entirely on past actions! Companies with older assets are probably not accumulating enough capital funds to finance the future. Companies with newer assets may be providing more capital than needed and may be charging prices that put them into an uncompetitive position.”*¹

That statement was made with “normal” firms in mind – firms whose assets were purchased at market prices and were then depreciated in the standard, GAAP-approved manner.

Consider, however, a company that owns millions of dollars worth of capital assets, assets that comprise its productive capacity and need to be preserved over time, but that records little or no depreciation expense due to acquisition or bankruptcy accounting. As it moves forward measuring the profitability of its products and quoting new business, it will not be taking into account the need to preserve its existing productive capacity. A substantial portion of the profit it records will be illusory.

Figure 1 shows the buildup of a target sales price at a company recently emerged from Chapter 11 that now shows no depreciation expense – and therefore no provision for preserving its existing capital assets – on its books.

Product Costing Example	Company Without Depreciation
Material	\$6.000
Labor	\$2.000
Cash Overhead @ 130%	\$2.600
Depreciation	<u>\$0.000</u>
Manufactured Cost	\$10.600
General & Administration @ 10%	<u>\$1.060</u>
Total Product Cost	\$11.660
Profit @ 10% of Sales Price	<u>\$1.296</u>
Target Sales Price	<u>\$12.956</u>

Figure 1 – Target Price Buildup with No Provision for Preserving Capital Assets

At a sales price of \$12.96, this company believes it will be generating a \$1.30 per unit profit. Based on the nature of profit, it should be able to assume that the \$1.30 per unit will be available to make the investments required to grow the business and pay dividends to the owners. If it makes that assumption, however, it will be mistaken. Part of that \$1.30 per unit will need to be used just to maintain the company's existing capital – to preserve its current capital base.

Let us assume that after a careful analysis of the level of future capital spending necessary to simply “tread water” – to maintain its existing productive capacity – the company finds that it would need to add 30% to its current 130% overhead rate – a rate that represents only currently payable indirect expenses. Figure 2 shows the implication of adding this 30% Capital Preservation Allowance. Instead of having \$1.30 available to make growth oriented investments and pay dividends, only 64¢ will be available. 51% of the profit is an illusion.

Over time, this company's sale of products will not generate the funds required for it to thrive and grow. It will not be able to maintain its base, grow, and reward its owners. One or more of those objectives will have to be sacrificed to attain the other(s).

Product Costing Example	Company After Adding 30% CPA
Material	\$6.000
Labor	\$2.000
Cash Overhead @ 130%	\$2.600
Capital Preservation Allowance @ 30%	<u>\$0.600</u>
Manufactured Cost	\$11.200
General & Administration @ 10%	<u>\$1.120</u>
Total Product Cost	\$12.320
Established Sales Price	<u>\$12.956</u>
Product Profit	<u>\$0.636</u>
Profit % to Sales	<u>4.9%</u>

Figure 2 – Actual Product Profit with 30% Capital Preservation Allowance

Executives at companies finding themselves in this situation are often quite excited at the competitive advantage they believe this gives them. Some even get so carried away that they decide to fill up their plants with products at a slightly lower profit. If management decides to accept an 8% profit margin, they would calculate a target price as shown in Figure 3.

Product Costing Example	Company Without Depreciation
Material	\$6.000
Labor	\$2.000
Cash Overhead @ 130%	\$2.600
Depreciation	<u>\$0.000</u>
Manufactured Cost	\$10.600
General & Administration @ 10%	<u>\$1.060</u>
Total Product Cost	\$11.660
Profit @ 8% of Sales Price	<u>\$1.014</u>
Target Sales Price	<u>\$12.674</u>

Figure 3 – Target Price Buildup with an 8% Profit Margin

The actual profit from such a move is not 8%, but only 2.8% as shown in Figure 4. Hardly enough profit to allow a firm to thrive and grow for very long.

Product Costing Example	Company After Reducing Profit to 8%
Material	\$6.000
Labor	\$2.000
Cash Overhead @ 130%	\$2.600
Capital Preservation Allowance @ 30%	<u>\$0.600</u>
Manufactured Cost	\$11.200
General & Administration @ 10%	<u>\$1.120</u>
Total Product Cost	\$12.320
Established Sales Price	<u>\$12.674</u>
Product Profit	<u>\$0.354</u>
Profit % to Sales	<u>2.8%</u>

Figure 4 – Actual Product Profit at an Apparent 8% Profit Margin

Of course, this example is over simplified to make a point. I warned you about accepting over simplified examples as a “proof of concept” back in my September 2004 executive letter. But the fact remains that using depreciation expense as a factor in measuring actual profitability is misleading in the best of circumstances. In cases where capital assets have been written down as part of an acquisition or emergence from bankruptcy it can be one way to assure that the organization will struggle to survive in the long run.

UPDATE

I’ll be presenting a session titled *Developing Activity-Based Models that Work* at the Michigan Association of CPAs Current Accounting Issues Conference in Lansing, Michigan on May 10th. Also on my near-term schedule are a presentation on “*Sorting Through ‘The Clutter’ in Management Accounting*” for the IMA’s Grand Rapids and Kalamazoo Chapters on May 15th and a breakout session on the same topic at the IMA’s Annual Conference in Phoenix in June.

For those of you interested in Lean Accounting – the subject discussed in a special edition of this letter last fall – Jeff Thomson and Anton van der Merwe authored an excellent article titled “The Lowdown on Lean Accounting” for the February issue of *Strategic Finance*. If you missed the article and would like read Jeff and Anton’s analysis, I’d be happy to send you a copy. Just e-mail me your request.

The article I co-authored with Gary Cokins for the March/April 2007 issue of *Cost Management*, “Where Does ABC Fit Amongst the Clutter of Management Accounting” should also be available soon. If you’d like a copy just let me know and I’ll send one to you as soon as it is available.

Full-Day Seminar Returns

As I mentioned in the Winter 2007 letter, after a seven year hiatus, I will again be presenting an updated version of my one-day seminar for the Michigan Association of CPAs. The session’s new title is “*Decision Costing: Using Activity-Based Concepts to Improve ‘The Bottom Line’.*” This seminar’s predecessor was one of the most popular one-day sessions presented locally by the Michigan Association of CPAs and nationally by the Institute of Management Accountants during the 1990s. Two Metro Detroit area sessions are scheduled for April 25th and June 18th. Information on the seminar and how to register for the April 25th session is provided at the end of this letter.

I hope you all survived the winter in good shape. 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

- 1 If you began receiving these letters after the summer of 2005 or can’t find your copy of the Summer 2005 issue and would like more details about the idea of a Capital Preservation Allowance, send me an e-mail requesting another copy and I’ll send one ASAP.

CMC (Certified Management Consultant) is a certification mark awarded by the Institute of Management Consultants USA as evidence of meeting the highest standards of consulting and adherence to the ethical canons of the profession. Less than 1% of all consultants have achieved this certification. See [Why hire a CMC?](#)

The Michigan Association of CPAs and D. T. Hicks & Co. Present...

**Decision Costing:
Using Activity-Based Concepts to Improve “The Bottom Line”**

MSU Management Education Center – Troy, Michigan
Wednesday – April 25, 2007

Developed and Presented by: Douglas T. Hicks, CPA, CMC

The first session of D. T. Hicks & Co.’s new one-day seminar ***Decision Costing: Using Activity-Based Concepts to Improve “The Bottom Line”*** is now open for registration on the Michigan Association of CPAs website.

This new seminar is an update of D. T. Hicks & Co.’s popular MACPA and Institute of Management Accountants seminars *Decision Costing: Activity-Based Costing in Action* and *Activity-Based Costing for Small and Mid-Sized Organizations* that were presented throughout the United States in the 1990s – sessions for which Doug Hicks was awarded the Institute of Management Accountants’ *Instructor of the Year Award* in 1998.

Decision Costing: Using Activity-Based Concepts to Improve “The Bottom Line” is not about cost accounting. It is about developing and using the accurate and relevant economic cost information decision makers need if their organizations are to thrive and grow in an ever more competitive world. It is designed for both accountants and non-accountants alike.

Simply use the link below for a description of the session, its objectives and major subjects, as well as information for registration and overnight accommodations.

<http://www.michcpa.org/Public/Catalog/CourseDetails.aspx?courseID=07HABC>

Developer and presenter Doug Hicks is a practitioner and educator who has been helping organizations develop the fact-based economic information they need to succeed for over two decades. His two books have sold over 15,000 copies worldwide and his articles have appeared in a wide variety of professional and trade periodicals including *Journal of Accountancy*, *Cost Management*, *ActionLine*, *Plastic Technology*, *Modern Casting*, *Precision*, *Printing Manager*, *Manufacturing Engineering*, *Leadership Excellence*, and *Management Accounting*.

Don’t miss this opportunity to learn how you can develop the accurate and relevant economic cost information that will help your organization improve its “bottom line.”