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Dear Executive:

While researching an unrelated topic on the internet, I came across an article titled “Product Costing as a Rare Event” that Richard Schonberger – of World Class Manufacturing fame – wrote back in 1994.¹ In the article, Schonberger emphasized that there is a vital role for accurate cost information in managing an organization, but that the decisions requiring such accurate cost information arise infrequently. As a consequence, he suggests that instead of trying to enhance the old day-to-day, monthly, or quarterly cost reporting system with newfound activity-based accuracy, an “as-needed” method of using activity-based costing information would be much more effective.

These statements are consistent with his comments twelve years later during the 2006 Lean Accounting Summit which I reported in a November 2006 Special Edition of D. T. Hicks & Co.’s Executive Letter. In that letter I reported that “Richard Schonberger emphasized that cost data was required for ‘infrequent decisions’ – his examples included pricing, outsourcing, drop/add – and further he stated that cost information should be the output of ‘periodic ABC analyses.’”

At the time of Schonberger’s 1994 article, most of the “hype” over Activity-Based Costing was related to its superiority in measuring product costs and in understanding product and customer profitability. Purveyors of software and the consulting services required for implementation expounded on the financial rewards that would accrue to any organization having ABC’s accurate product costing data updated constantly and available to use in managing their operations. As a prime mover behind the Total Quality Management movement, Schonberger took exception to the overhyping of Activity-Based Costing as a tool for managing an organization’s day-to-day operations and pointed out that “since competitive product decisions are made infrequently, product cost information should be reported infrequently.” Schonberger added, “In mainstream TQM, however, non-monetary process data are the lifeblood of improvement projects. Associates collect and categorize the data using process flow charts, check sheets, fish-bone charts, Pareto diagrams, process control charts, histograms, and scattergrams (the ‘seven basic tools’). In addition, they measure flow distances, videotape machine setups, calculate throughput times and response ratios, monitor rework, and use customer survey data.”²

As a proponent of using cost data based on activity-based concepts in supporting management decisions, *I agree with Schonberger’s basic contention wholeheartedly!* There are many management tools equal to or greater than Activity-Based Costing when it comes to managing a company in the short- or even mid-term – especially in organizations that have made a strong commitment to initiatives such as TQM or Lean Thinking. The one oversight in

Schonberger’s argument, however, is that product costing is only one of the many areas in which a valid, activity-based cost model of an organization can prove to be invaluable.

Figure 1 – which is based on Gary Cokins’ insightful “Accounting Taxonomy” diagram³ – represents a breakdown of accounting into its various components. Our area of concern – management accounting – can be broken into three categories; cost accounting, cost autopsy, and decision support. Cost accounting represents the calculation of cost of goods sold and the valuing of inventories. Cost autopsy, some of which uses data from cost accounting, represents the analysis of what has already taken place in the business in order to track performance. Decision support represents using accounting *and other economic cost information* in order to make decisions that lead to a financially successful future.

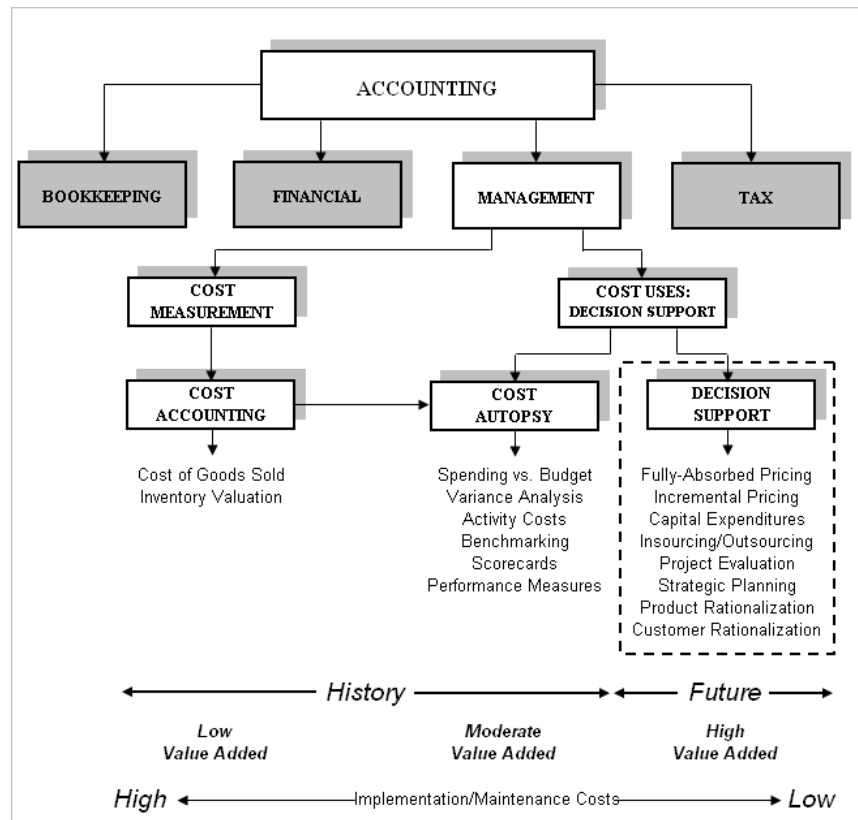


Figure 1 – Breakdown of Accounting into its Components

Although it is somewhat useful in measuring past performance, the value of activity-based cost information is in its ability to help management create a more profitable future. Ironically, it is also in its use as a decision support tool that the application of activity-based concepts requires the least amount of time and resources.

Activity-Based Costing’s Basic Premise

The premise underlying activity-based concepts is simple; products and services cause activities and activities cause costs. Following this premise, a company should be able to determine what activities are required based on the volume and mix of its products and services. Knowing what activities need to be performed, it should then be able to determine the cost of performing those activities. In Figure 2, this is represented on the left or “bottom up” side of the

diagram. It is also the way in which activity-based concepts can be used to predict the total cost of running an organization based on the volume and mix of its outputs. Once the total cost of running an organization is known, the process can be reversed. Costs can be assigned to the activities that caused them and the cost of each activity can be assigned to the products or services that made them necessary. This is represented by the right or “top down” side of the diagram in Figure 2.

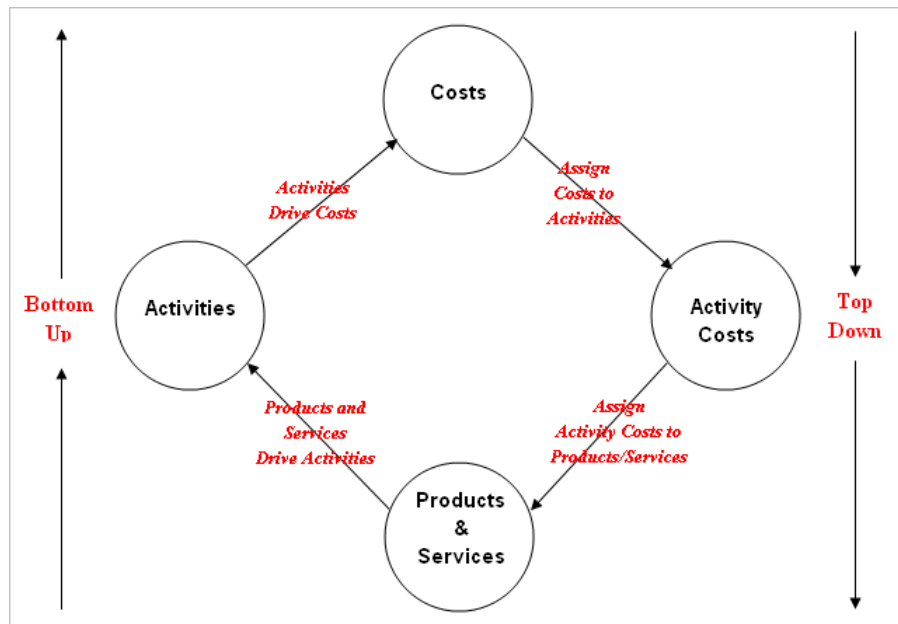


Figure 2 – The Fundamental Concept of Activity-Based Costing

Activity-Based Costing is not just about taking historical costs from a general ledger and assigning them along the “top down” path shown in the diagram. It’s about having a valid economic model – both intellectual and physical – of an organization that enables management to 1) accurately measure the costs of its products and services *under any volume and mix scenario*, 2) know the cost of its major operating processes (or activities), and 3) accurately measure the total or incremental cost of any proposed business decision or action under consideration. The first two items are accommodated by the “top down” view of ABC while the third is enabled by the “bottom up” view. Its most powerful uses are the first and third although some organizations have found the second one to have the greatest impact on its bottom line.

Product / Service Costing Information

As Schonberger states, there are companies where product cost data is needed infrequently; like when doing product/customer profitability analyses or when setting catalog or list prices. There are, however, many organizations that do not set prices infrequently. Instead, they must quote individual jobs to a wide variety of customers each and every day. They must understand how each item quoted would fit into the company’s overall portfolio of business – sometimes on a fully-absorbed basis and at other times on an incremental basis. For such organizations, it is essential that they be able to accurately measure the cost of products – many of which they will never actually produce – every day. This is especially true since one bad pricing decision based on one bad cost estimate could hamstring the company for years to come.⁴

Process Costing Information

Although cost information is not always a prerequisite for identifying and executing operating improvements, it often serves that purpose. At one client, we identified in-process movement as a significant activity and measured the cost of “picking up a basket of parts and putting it down somewhere else” at \$3.50. The discovery that “moving parts costs money” and being able to measure that cost set off a chain of actions that resulted in significantly lower inventory levels, shorter lead times, reduced operating costs and improved profits. Had this company been committed to TQM or Lean Manufacturing initiatives, it might have identified and solved this problem without cost information. But the fact is that they had never even given it a thought. In-process movement was just one of those costs buried in their overhead expenses. At another manufacturing client, their activity-based cost model identified and measured the cost of processing orders as well as picking order line items and consolidating parts for shipment – all costs that had been buried in overhead. Once identified, they took actions to improve all of their post-manufacturing process. In the absence of other initiatives, activity-based cost information can often be a prime mover for improving operations.

Total / Incremental Cost Information

Perhaps the most powerful use of an activity-based cost model is in its “bottom up” mode – the calculation of total or incremental costs resulting from a possible course of action. Most management decisions require this type of cost information. The items listed in Figure 1 under decision support list some of these decisions. Incremental pricing, capital expenditures, in- and out-sourcing, and product or customer drop/add decisions are just a few examples. The ability to accurately measure the net impact of these types of decisions is critical to the quality of management’s decisions. For example, one client had all but decided to close down a line that manufactured one of its primary components because it found a vendor that would sell that component to them at an extremely attractive price. Their costing and pricing manager – who was “the owner” of the company’s activity-based cost model – convinced them to “run it through the model” before making a final decision. The fifteen minutes it took to run “before and after” scenarios saved the company from making a mistake that would have cost it \$2.5 million annually.

Conclusion

Believing that activity-based costing is all about product costs is like believing that dentistry is all about pulling teeth. Just as “tooth extraction” is only one tool in a dentist’s repertoire of solutions to dental problems, “product costing” is only one of many tools in activity-based costing’s decision support tool bag. Although it can be an insightful tool for day-to-day operations, it’s most powerful uses are in situations where either the long-term sustainable economics of the business or the incremental impact of a proposed major business action are required. Costs based on long-term sustainable economics are needed to support core business pricing, product line, and market decisions. Incremental cost information is needed to support almost every other business decision – from special order pricing to capital expenditure selection to in- and out-sourcing.

Although an activity-based cost model of their organization is not something most companies will use every day, I would not go so far as to say that a company would only need to use the output of such a model “infrequently” or “rarely.” Initiatives like TQM and Lean

Thinking are designed to continuously improve the day-to-day operations of a business. An activity-based cost model is not. Instead, it is designed to provide management with the accurate and relevant cost information necessary to support critical business decisions – decisions that require an understanding of a proposed action’s incremental impact on the organization or its impact on the long-term sustainable economic structure of the business. It is a *rare* company indeed that would *rarely* need such information.

Cost Information in Today’s Economic Environment

In today’s economic environment, margins have gotten thinner, competition fiercer, and credit tighter. It has never been more important for an organization to understand the fundamental economics that drive its costs and profits. In today’s business environment, where most companies are walking on an economic precipice, every decision an executive makes must be supported by accurate and relevant cost information. It only takes one inappropriate decision based on faulty cost information to ruin an otherwise sound organization.

Although it may be effective in reporting historical results to outsiders, relying on the cost information generated by a GAAP-based accounting system when making management decisions seriously undermines a company’s ability to survive and grow. This is especially true for organizations that place their reliance on traditional, over-generalized costing methods that are known to generate decision support information that is false and that lead executives to make decisions that are prejudicial to their organization’s overall well-being.

Fortunately, developing the accurate and relevant cost information needed to support sound decisions does not require a massive investment in time or technology. What it does require is a change in mindset and some basic computational tools. It is an intellectual exercise more than a physical exercise. This places accurate and relevant cost information well within the economic means of any business decision maker who wants to base his or her decisions on economic facts instead of GAAP-based fiction.

If you’re organization is still relying on GAAP-based cost information to support key management decisions you would do well to consider developing the accurate and relevant decision costing necessary to navigate through these difficult economic times.

A Couple of New Quotations

In my Spring 2008 executive letter I responded to three comments about adopting activity-based concepts that I often hear from financial executives. One of them was “ABC is too complicated – we can understand overhead as a percentage of direct labor.” I’ve recently found two new (at least to me) quotations regarding that subject. The one from Albert Einstein I found while “looking for something else” on the internet and the one from Alexander Hamilton Church is quoted in Gary Cokins’ new book. These two quotations are as follows.

“No facts that are in themselves complex can be represented in fewer elements than they naturally possess. While it is not denied that many exceedingly complex methods are in use that yield no good results, it must still be recognized that there is a minimum of possible simplicity that cannot be further reduced without destroying the value of the whole fabric. The snare of the ‘simple system’ is responsible for more inefficiency...than is generally recognized...”

- Alexander Hamilton Church

“We can’t solve problems by using the same kind of thinking we used when we created them.”

- Albert Einstein

Whether you believe that activity-based concepts are the solution or not, the fact remains that the misinformation (or non-information) accountants perpetuate about process, product, service, and customer costs has been a significant contributor to the underachievement of our organizations and sometimes a major cause of their failure. It’s not just the numbers – it’s the dysfunctional behavior and inappropriate decisions invalid economic cost models cause that make business success so elusive. Management uses information generated by their accountants to judge their performance and direct their actions. When that information is based on invalid models of the business, financial performance suffers.

Update

My new book, *I May Be Wrong, But I Doubt It: How Accounting Information Undermines Profitability*, has been selling well and receiving good reviews. You can now purchase the book from www.amazon.com as well as from my publisher www.lulu.com. Unlike my earlier books that required purchasers to mortgage their homes, this one sells for under \$20.

Registrations for the 6-CPE hour sessions Ravi Nayar and I are conducting for the Metro Detroit Chapter of the Institute of Management Accountants on March 31st are running well ahead of schedule. You can learn more about our “Decision Costing Four Pack” and register for the event on-line at <https://www.123signup.com/event?id=zcvqb>. The cost for the day is \$110 for IMA members and \$120 for non-members...a bargain if there ever was one.

As I mentioned in last quarter’s letter, Gary Cokins’ new book, *Performance Management: Integrating Strategy, Execution, Methodologies, Risk and Analytics*, is due to hit the market soon. You don’t want to miss this excellent book by the premier writer and lecturer on performance measurement and management. Keep your eye out for its upcoming release.

I hope you survived the winter in good shape. If you have any questions or would like further information, please do not hesitate to contact me. I’d be glad to discuss this or any other related subject with you. As always, please feel free to forward a copy of this letter (or mention our website) to anyone you believe would be interested.

Very truly yours,

Doug

Douglas T. Hicks, CPA, CMC
President

- 1 Schonberger, Richard J., “Product Costing as a Rare Event,” *Target*, November-December 1994, pp.8-16
- 2 Schonberger, p. 12
- 3 Cokins, Gary, *Activity-Based Cost Management: An Executive’s Guide*, (John Wiley & Sons, New York, 2001) pp. 32-42.
- 4 I once had a \$24 million manufacturing client that made one bad pricing decision based on cost information from a poorly designed cost model. That one decision reduced their bottom line by \$1 million annually until it was corrected – once it was discovered – six years later.