

## D. T. HICKS & CO.

Cost Measurement and Management Consultants  
25882 Orchard Lake Road – Suite 207  
Farmington Hills, Michigan 48336  
Tel: 248.761.3706 – Fax: 248.471.6572  
[www.dthicksco.com](http://www.dthicksco.com)

*“There are three classes of people: Those who see. Those who see when they are shown.  
Those who do not see.”*

- Leonardo de Vinci

Summer 2009

Dear Executive:

Prior to the 1980s, it was well known among thought leaders (“those who see”) in managerial and decision economics that reliance on the over-generalized, backward-looking cost information generated by traditional cost accounting systems was detrimental to the quality of an organization’s business decisions. But business conditions were generally favorable back then and while world-wide competition did exist, it was not yet seen as a serious issue. As a result, any concerns about money being lost due to decisions based on inaccurate and irrelevant cost information were considered secondary and unimportant.

As the business environment became more complex and world-wide competition intensified, it became apparent that the negative impact resulting from the misinformation generated by GAAP-based costing methods would become more and more serious as the new economy evolved. Thought leaders began sounding the alarm in the mid-1980s and started warning of the dangers and proposing possible solutions. An unparalleled, twenty-five year blitz of publicity, discussion, and debate followed. This blitz was directed at accountants, in whose hands the responsibility for accurate and relevant decision costing information was placed years earlier. The result has been a small minority of accountants (“those who see when they are shown”) who have recognized the problems and have at least begun taking corrective action.

Unfortunately, the vast majority of accountants (“those who do not see”) have either failed to recognize the seriousness of the problem or simply chosen to ignore it. It’s not because they haven’t been shown. Twenty-five years of widespread publicity can only have been missed by those who consciously chose to block it out. Most accountants have simply buried their heads in the sand and continued providing their management with economic *misinformation* as their organization tries to survive in a difficult and unprecedented economic environment.<sup>1</sup>

Perhaps we’ve simply been asking our accountants to do things outside of their range of competence and comfort. Maybe we delegated the responsibility for providing management with accurate and relevant decision costing information to a group singularly unqualified for the task. Maybe allowing accountants to even touch cost information violates “the law.” The following excerpt from *I May Be Wrong, But I Doubt It: How Accounting Information Undermines Profitability* more fully examines this proposition:

## **Don't Let Accountants Touch Cost Information – It's The Law! <sup>2</sup>**

Ever since I read Robert Kaplan's article "Yesterday's Accounting Undermines Production" in the *Harvard Business Review* nearly a quarter century ago, I've spent my days (and many of my nights) assisting businesses of all types and sizes overcome the decision making problems caused by using traditional, out-of-date costing practices. In the process I've met and exchanged ideas with a myriad of academics, consultants, practitioners, and business executives from a wide variety of industries. I've also had the opportunity to share the knowledge I've gained through three books, scores of articles, dozens of executive letters and over one hundred presentations, seminars and webinars throughout North America. Based on feedback from these publications and events, the vast majority of those receiving the message have agreed that traditional costing methods are a serious problem that needs to be remedied if decision makers are to have the fact-based information they need to make quality decisions.

With such consistent positive feedback, it has always been puzzling to me why so few organizations have actually made a serious effort to correct the major deficiencies inherent in their methods of developing and presenting cost information to those executives that must make their organization's critical management decisions. The *2003 Best Accounting Practices* survey conducted by the Institute of Management Accountants and Ernst & Young added to this quandary when it reported that 98% of the surveyed financial executives believed that the cost information they provided to their management for decision making was inaccurate, but only about 20% planned on doing anything about it. My discussions with practitioners and executives since 2003 suggests that things have actually gotten worse, not better, since the survey.

Throughout my twenty-four years as a consultant, the most consistent obstacle I've encountered in convincing organizations to adopt more accurate and relevant costing practices has been the accountant – the trusted financial advisor of management who should be most concerned that the output of his or her labors has a positive effect on the organization's bottom line. In comparing notes with others in the business, I've found that accountants appear to be the universal obstacle to quality cost information.

In considering this issue over the years, I've explored many possible reasons. Are accountants just too lazy? Don't they understand how the cost information they provide can undermine their company's success? Is their influence so inconsequential that top management pays little or no attention to their suggestions? None of the answers to these questions has proven to be satisfactory. I can't believe that accountants are that lazy, don't care, or have so little influence. So why haven't they pressed the issue?

The conclusion I've come to is that accountants are simply not "wired" for costing. It's simply a matter of management putting the responsibility for decision costing information into the wrong hands. As a matter of fact, it's "the law" that causes the problem.

### **"The Law" and Cost Information <sup>3</sup>**

The word "law" has two quite distinct meanings. It may describe *arbitrary regulations* made by human consent in particular circumstances for a particular purpose, and capable of being promulgated, enforced, suspended, altered, or rescinded without interference with the general scheme of the universe. On the other hand, the word "law" is also employed to designate a generalized statement of observable fact.

In the first sense we may talk of tax laws, the laws of civilized warfare, or the laws of baseball. Such laws frequently prescribe that certain events will follow upon certain others; but the second event is not a necessary consequence: the connection between the two is purely formal. For example, if a fielder catches a batted ball before it touches the ground, the batter is “out.” There is, however, no inevitable connection between the capture of an in-flight baseball by a leather glove and the return of a human body from a patch of freshly mown lawn to a hard wooden bench. The two events are readily separable in theory. Should the rule-making body of baseball choose to alter the law; no cataclysm of nature would be involved.

Accountants are very adept at dealing with these types of laws. Their very existence is driven by laws; federal, state and local tax laws and regulations, FASB pronouncements, GAAP rules, SEC regulations, federal laws (like good old Sarbanes-Oxley), and many others. To keep abreast of these constantly changing laws and insure that their organizations comply with them while at the same time minimize the damage caused to its “bottom line,” accountants must show exceptional intelligence and ingenuity.

In the second sense, we talk about the *laws of nature*. Such laws cannot be promulgated, altered, suspended, or broken at will; they are not laws at all in the sense that the laws of baseball or tax laws are laws. They are statements of observable facts inherent in the nature of the universe. Anybody can enact that murder will not be punishable by death; nobody can enact that the swallowing of a tumbler full of pure hydrocyanic acid shall not be punishable by death. In the former case, the connection between the two events is legal – that is, arbitrary; in the latter, it is a true causal connection. The second event is a necessary consequence of the first.

Unfortunately, accountants are not nearly as adept at dealing with these types of laws as they are at dealing with *arbitrary regulations*. Despite their intelligence and ingenuity, accountants view *laws of nature* against the background of the *arbitrary regulations* they have mastered. Their approach to internalizing these laws is to fit them into the context and constraints dictated by those *arbitrary regulations*. As a result, the way they view the economics of their organizations – and communicate that view to their management – seldom matches reality. The manner in which accountants handle cost information is a glaring example of this shortcoming.

Costs follow *laws of nature*, not *arbitrary regulations*. Costs do not care about GAAP, FASB pronouncements, tax rules, or SEC regulations. Costs are the result of actual cause-and-effect relationships. Operating a machine causes certain costs. Filling a customer’s order causes certain costs. Moving and storing in-process inventory causes certain costs. Dealing with a high-maintenance customer causes costs. Outsourcing parts or processes not only reduces certain costs, it also causes new costs to be incurred. It doesn’t matter what FASB says, what the SEC says, or what the IRS says, costs will react in a way dictated by *laws of nature*.

### **Accountants, Costs, and the Law**

Putting the development and maintenance of cost information into the hands of accountants is like putting the development of a new snack food into the hands of chocoholics. Just as it is inevitable that the new snack food will be some form of chocolate regardless of what new product the market wants or what products the plant is good at manufacturing, it is inevitable that the main focus of any cost information developed by accountants will be focused on complying with the *arbitrary regulations* that are their *raison d’être*. Costs will not reflect reality; instead they will reflect years of compromise by countless committees influenced by endless interest groups and government agencies.

How many accountants have created cost information systems that do not tie into or support the general ledger? There are very few indeed. This observation alone should highlight

the accountant's agenda when put in charge of cost information; namely, the cost system exists to support the financial accounting system. If that is all a cost system is intended to do, a company might just as well save the money and go back to the "pickle barrel" system (count how many pickles are in the barrel when you start, add the number of pickles you bought, subtract the pickles in the barrel when you finish and the difference must be the number of pickles you sold).

Consider the cost information at a typical manufacturer. The cost accounting system only includes "inventoriable" costs – those costs the promulgators of *arbitrary regulations* consent to have treated as an asset in the manufacturer's general ledger. Further, it is only required that the method of applying these costs to the individual items in the manufacturer's inventory result in a reasonably accurate valuation of the manufacturer's inventory *as a whole*. It is not necessary for any individual item to be valued accurately as long as it all averages out when applied to entire organization. It is not necessary for any manufacturing process to be measured appropriately. It is not necessary for any non-manufacturing costs to be measured and it is forbidden that such costs be included. The cost system focus is on value in inventory not cost to the organization – two totally different objectives – and it ignores non-manufacturing costs altogether.

Since the *arbitrary regulations* which guide the accountant are so focused on value in inventory, anything that seems superfluous to attaining that goal is generally cast aside as being unnecessary. The result is minimalist, "short-cut" costing. It is costing that Mo Bayou at the University of Michigan – Dearborn describes as "going around a company's processes, not through them." If all you need is an accurate value of total inventory, why do more work than is necessary to meet that objective? The accountant sees no cost / benefit in measuring the cost of manufacturing processes, definitely sees none in measuring the cost of non-manufacturing processes, and doesn't see why costing that goes around a company's processes does not provide good enough numbers to apply to individual products and services.

As suggested earlier, paying attention to the *laws of nature* – not just *arbitrary regulations* – clearly identifies costing issues that the typical accountant will totally overlook. How about including a cost of capital to understand the economic impact of carrying raw, in-process and finished inventory? How about looking through the windshield and incorporating the cost of preserving the company's capital asset base instead of simply looking in the rear-view mirror and writing off the irrelevant sunk costs of past capital acquisitions? How about post-manufacturing activities? Is there no cost related to storing finished goods prior to shipment? Are order processing, picking, assembly, packing and shipment activities all free? How about the different levels of effort required to acquire, handle and store the company's variety of raw materials and purchased goods? How about the costs required to support offshore vendors or the outside contractors to whom the company has outsourced former in-house manufacturing processes? How about the disproportional amount of work that goes into managing the company's biggest "jerk" customer?

Accountants have too many other things to do – most of them legally required as the result of *arbitrary regulations* – to pay much attention to the decision support needs of management. Even when they do address those needs, however, they make sure they comply in ways that help solve accounting's problems first and foremost.

### **If Not Accountants, Then Who?**

In nearly a quarter century of working the field of cost measurement and management, I have found that those most effective at developing and maintaining effective cost systems are individuals with backgrounds mathematics or engineering. Individuals with accounting backgrounds rank near the bottom, just ahead of those from sales.

I believe those with math and engineering backgrounds are effective in the field of costing because effective costing is driven by a quest for “the truth” and both mathematics and engineering are disciplines that attempt to understand “the truth.” Mathematicians are trained to replicate the *laws of nature* in terms of mathematics and are not afraid to tackle relationships slightly more complex than  $a \times b = c$ . Engineers – particularly industrial engineers and their derivative specialties – must understand the *laws of nature* if they are to develop solutions to problems that are constrained by and must comply with them. This has become especially true during the past few decades as industrial engineers have cast off the image of stop-watch-wielding efficiency police and become innovative problem solvers who regularly apply principles that would have been considered heresy just two decades ago.

Accountants rank low because they are allowed – and are often required – to ignore *laws of nature* and simply comply with *arbitrary regulations*. Their obsession with “the rules” and reporting history have blinded them to the responsibility they bear in providing management with accurate and relevant cost information on which to base its decisions. Although their work is critical to a business’ success, sales professionals have shown themselves to be the “court jesters” of costing. They’ve become preconditioned to disbelieve uncomfortable truths that might make a sale difficult while firmly believing favorable untruths based on very shaky rationale that might make a sale easier. Their view of logic changes to fit their desired results.

As I reflect on the hundreds of individuals I have worked with during the past twenty-three years – both as clients and as consulting partners – I cannot think of a single individual with a mathematics background who did not prove to be extremely competent at developing, maintaining, and using cost information. I would rank three-quarters of the engineers I’ve worked with in the same category. Accountants often start out strong, but within a short period of time all but about one-quarter regress back to their “blue blankets” by returning their focus to compliance with *arbitrary regulations* at the expense of the *laws of nature*. Finally, although we cannot live without good sales professionals, I can remember very few who took cost information seriously. To them it was all a game. They believed what was convenient for them to believe and disbelieved what was convenient for them to disbelieve.

### **The Solution – Don’t Let Accountants Touch Cost Information**

The solution is to recognize that cost accounting and cost information are not the same thing. Cost accounting supports financial accounting systems. Cost information supports decision making systems. The only thing the two have in common is the word “cost.” One reports history for outsiders while the other projects future possible outcomes for insiders. One is driven by *arbitrary regulations* while the other is driven by *laws of nature*. The knowledge, experience and mindset necessary to master the two disciplines are vastly different.

As a consequence, those individuals responsible for decision costing should be separated from those responsible for cost accounting and placed under the direction of a non-financial executive. Those responsible for cost information that supports decision making should understand the business thoroughly, have top-notch problem solving and modeling skills, be skilled at decision economics, and understand how to convert the laws of nature into simple mathematical algorithms. Decision costing is not brain surgery; it is the application of common sense to real life situations – common sense that should not be constrained by the *arbitrary regulations* that form the lens through which accountants view all business activity.

I understand that this solution is not original; that responsibility for developing cost information to support management decisions lies outside of finance and accounting in many European and Asian companies. Companies in those parts of the world mastered total quality and lean thinking before North American companies took notice, maybe they’re right about the

organizational positioning of those who develop and maintain decision costing information as well.

## **Conclusion**

It is inadvisable to place the development and maintenance of cost information that is intended to support critical decisions made by a company's management in the hands of accountants. Accountants are experts on the *arbitrary regulations* created by human beings to regulate and control society. Organizations cannot function in a complex society without the intelligence and ingenuity of a group of competent accountants. This does not, however, make accountants experts on everything. A typical accountant's education and experience has little or nothing to do with understanding *laws of nature* and translating those laws into truthful, insightful, and understandable tools that will help their company's decision makers make good decisions and take effective actions.

Individuals with mathematics or engineering backgrounds, on the other hand, have spent their entire careers trying to create valid models of reality – models that reflect *laws of nature*. Prior to the Securities and Exchange Acts in the early 1930s – *arbitrary regulations* that changed the focus of cost information – these were the primary types of individuals employed to measure and manage costs. From Josiah Wedgwood to Alexander Hamilton Church, the pioneers of costing were not accountants. Maybe now is the time to begin obeying the *laws of nature* again and move the responsibility for developing and maintaining cost information away from *arbitrary regulation-oriented* accountants to the mathematicians and engineers who understand that business must operate in a world of reality.

## **Post Script to Excerpt from “*I May Be Wrong, But I Doubt It*”**

Over the past two decades, I have developed some very successful strategic partnerships with a variety of CPA firms – from one-man firms to multi-state regional practices. As we build our partnerships, I spend a good deal of time teaching these CPAs how to identify client organizations whose costing practices put their future success at risk. The intent is to provide these experienced, successful and talented accountants with the wherewithal to proactively identify those client organizations that could most benefit from reevaluating the economic cost models that underlie their managements' decisions.

In only a small minority of cases, however, does an opportunity arise because the CPA identifies a potential problem and brings it to the attention of his or her client. In over 95% of the cases, an opportunity arises because the client realizes they have a problem and asks the CPA for help. The process is entirely reactive.

Last summer, I developed and presented a one-day seminar for the Manufacturing and Distribution practice at one of the nation's Top 20 CPA firms. The session was specifically designed to provide accountants with four to six years of experience – those who have developed personal client relationships and are familiar with those clients' costing practices – with the ability to identify those manufacturing and distribution clients whose costing practices put them at risk. To make the process simple, the one-day session concluded with a simple five-point checklist of the most common problems found at manufacturers/distributors. The session was attended by the 25-30 of the firm's most highly-regarded staff members.

From the firm's 1,000+ manufacturer/distributor client base, exactly one opportunity has arisen as a result of one of the attendees' proactive efforts...and that isn't even an existing client of the firm – it's a prospective client. Of all the manufacturing clients with direct-labor based

overhead rates, no knowledge of material ownership costs, no costing of post-manufacturing customer-driven fulfillment costs, or no measures of in-process non-value-adding costs (like movement and storage), not one was identified. Of all the distributors that have their receiving, put-away, storage, and order fulfillment costs buried in “warehousing costs” and all marketing and distribution channel costs buried in “selling, general and administration,” not one was identified.

In no way do I believe that the result is due to any lack of intelligence or ability among the CPA firm’s staff or the accounting personnel at its clients. I’m sure they are all extremely talented and well-qualified accountants. The result is due to the fact that they are accountants and see the world through the lens of the *arbitrary regulations* that drive the world of accounting. The fact that accounting information that simply complies with arbitrary regulations can mislead management and put an organization’s future at risk just doesn’t register. When it comes to costing issues, most accountants fall into de Vinci’s third category; “those who do not see” (even after they have been shown).

If accountants haven’t been able to solve the costing problem during the past twenty-five years, what makes anyone believe they will solve it in the next twenty-five years? Maybe it’s time to reassign the responsibility for providing management with the accurate and relevant decision costing information they need to make economically sound business decisions.

### Upcoming Free Webcast

Chris Kuehl, Ph.D., chief economist for the Fabricators and Manufacturers Association, and I will be sharing “the stage” for a one-hour webcast titled “*Economic and Accounting Trends: How Will They Affect You?*” from 10:00am – 11:00am CDT on July 15, 2009. The webcast is sponsored by BKD, LLP and is part of the BKD National Manufacturing & Distribution Webcast Series. Chris will be discussing recent trends in the nation’s economy while I will address the question: “*Does your company’s accounting information undermine its profitability?*” You can register for the session at [www.bkd.com/webcast/manufacturing&distribution](http://www.bkd.com/webcast/manufacturing&distribution).

I hope you all have a great summer. I look forward to hearing from any of you who have questions or comments regarding this quarter’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

- <sup>1</sup> This statement is not based on a scientific survey, but on the intelligence accumulated during dozens of site visits, discussions with hundreds of participants at scores of conferences and symposiums, and conversations with many others in the management accounting community during the past half-decade.
- <sup>2</sup> Hicks, Douglas T., *I May Be Wrong, But I Doubt It: How Accounting Information Undermines Profitability*, (Lulu Publishing, 2008), pp. 105-111.
- <sup>3</sup> The discussion of “laws” in this article is based on Chapter One, “The ‘Laws’ of Nature and Opinion,” from Dorothy L. Sayers classic 1941 book, *The Mind of the Maker*.