D. T. HICKS & CO.

Cost Measurement and Management Consultants
6905 Telegraph Road – Suite 325
Bloomfield Hills, Michigan 48301
Tel: 248.761.3706 – Fax: 248.792.6026
dthicks@dthicksco.com
www.dthicksco.com

"Christmas-time…a time for finding yourself a year older and the cost information you rely on to support your critical management decisions not an hour better."- E. Scrooge

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Dear Executive:

We're about to begin 2013, nearly three decades since the dangers of using traditional – especially direct labor-based – costing methods to develop decision support and performance measurement information were clearly documented by the likes of Kaplan, Cooper and Johnson. Since then a vast body of knowledge and experience has been accumulated, documented and liberally disseminated, including solutions to the "costing problem" for organizations of any size and in any industry. Yet as we enter 2013, a vast majority of organizations continue to use over-simple and outdated costs models that provide their decision makers with an irrational jumble of nonsense – disguised as accurate cost information – as support for making decisions critical to the survival and growth of their organizations. Is it any wonder that organizations whose cost information provides its decision makers with a distorted picture of economic reality consistently underachieve (that's if they're lucky…the unlucky ones ultimately fail)?

Business success is dependent on the quality of business decisions and the quality of those decisions is dependent on the quality of the company's decision models and the information that supports those models. Dysfunctional cost models generating an irrational jumble of nonsense – like most of today's costing models – might be acceptable for GAAP reporting, but they are major obstacles to a business in its quest for financial success.

Perhaps 2013 would be a good year for your company or your firm's clients to stop basing critical business decisions on economic fantasy and begin basing them on economic facts.

How Effective is Your Company's Gatekeeper?

A gatekeeper is an individual who controls access to something. Ancient cities had gatekeepers whose job was to keep out undesirables. A college admissions officer is a gatekeeper who controls the makeup of the school's student body. A newspaper editor is a gatekeeper who decides which stories will be included in that day's edition. Gatekeepers are critical to an institution's security, quality and overall success.

Businesses have gatekeepers as well. They control access to the company's resources. Their job is to insure that only business that enhances the company's ability to meet or exceed its financial objectives is permitted through the gate. They must be constantly on the alert because it only takes one gatekeeping failure to wipe out the financial benefits generated from scores of gatekeeping successes.

A key member of the gatekeeping team is its cost estimator. Although the market – not cost – determines the price a company can charge for its products and/or services, the cost of manufacturing those products and/or providing those services is a critical component in determining whether that business should be allowed through the company's gate. An effective cost estimating process must exist before gatekeepers can consistently admit only desirable business and turn away the undesirable work.

Cost estimators have been able to keep up with changes in their company's business by developing new, more sophisticated processes for estimating and optimizing the cost of "direct" items. In manufacturing, for example, cost estimators have taken steps to better estimate the prices to be paid for raw materials, purchased components and assemblies, outside manufacturing services, and other "direct" items purchased from vendors. At the same time, most manufacturers have continued to provide their cost estimators with outdated and inaccurate methods of linking the company's operating costs with the products, services, contracts or customers whose potential value to the company is being evaluated. Most often, these methods take the form of a direct labor-based assignment of manufacturing costs to products and a single SG&A "add on" percentage to assign non-manufacturing costs. Consider the experiences of two mid-sized manufacturers:

> $8 million of a $24 million stamping company's annual sales came from a product it viewed as "the jewel in its crown." After replacing its direct labor-based costing practices with a methodology that more closely matched its actual operations, it found that it was losing $1 million annually on this product. When it met with its customer to discuss the situation, the customer said, "We wondered when you'd figure it out. Every time we've re-bid this product during the past six years you've always been 30% lower than the next lowest bidder." A single bad cost estimate/quote made six years earlier cost the company millions in the years that followed.
>
> For several years, a mid-sized forging company sold a product to an auto manufacturer for $9.18. Since its direct labor-based costing model showed the product's cost to be $7.80, it was elated as it shipped several thousand units monthly. After developing a costing methodology that better matched is plant's operations, it found that the cost of the product was not $7.80, it was $9.88. Instead of a $1.38 profit per unit, it was selling this high-volume product at a $.70 loss per unit.

In both cases, undesirable business was welcomed through the company's gate by a dysfunctional, direct labor-based cost model. In both situations, the business had a negative impact on financial performance for many years after being admitted. And at both companies, elimination of the unprofitable product led to a significant improvement in profitability.

These problems are not exclusive to manufacturers. The same problems exist at distributors who cannot relate service and fulfillment costs to customers, exhibit and marketing service companies whose wide variety of services cannot be accurately linked to individual contracts or customers, or financial institutions who cannot accurately link operating costs with the financial products the provide.

To be successful, 21st Century companies must insure that only business that will help it reach its financial objectives is admitted through its gates. The likelihood of that being accomplished, however, is reduced when a key member of the gatekeeping team is provided with a seriously flawed model to use in evaluating potential business.

“f-Laws” and the Output from Your Management Accountant

I was recently reintroduced to the work of the late Russell Ackoff whose work in operations research and systems thinking I studied in the mid-1970s. Late in his career, he teamed with Herbert Addison and Sally Bibb to develop a series of “f-Laws” – observations of bad leadership and misplaced wisdom that often surrounds management in organizations. I found three of them particularly apropos to the inaccurate and irrelevant decision support information that continues to come forth from so-called management accountants more than twenty-five years after traditional methods were proven to be ineffective and misleading.

> *“You can’t teach an old dog or executive new tricks, or even that there are any new tricks.”*
>
> *“The only thing more difficult than starting something new in an organization is stopping something old.”*
>
> *“It is very difficult for those inside a box to think outside of it”.*

Is it any wonder that decision making at 21st Century businesses is hamstrung by management accounting practices from the 1950s? Accountants will not volunteer to improve the quality of the management accounting information they provide – management and other users of that information must either demand better quality from them or continue to base their decisions on fantasy, not fact.

“Is Depreciation Expense a Misleading Illusion?”

Those of you who have been receiving these letters over the years are well aware of my belief that GAAP-based depreciation expense is one of “the dumbest concepts in the history of management accounting” and a bane to executive decision makers. It’s been a topic I’ve expounded upon for twenty years – since my article “A Modest Proposal for Pricing Decisions” appeared in the November 1992 issue of *Management Accounting*.

This past October, *Bonezone* – a publication for the orthopaedic device manufacturing industry – allowed me about 2,000 words to make my case. You can find and electronic version of the resulting article “Is Depreciation Expense a Misleading Illusion?” at the link below:
http://www.bonezonepub.com/component/content/article/582-is-depreciation-expense-a-misleading-illusion

Feel free to give me your take on the topic after reading my accounting heresy.

Have a great holiday season! 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
President