MANAGEMENT ACCOUNTNG'S MOST DANGEROUS MYTHS

IMA – Ann Arbor Chapter

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MANAGEMENT ACCOUNTNG'S MOST DANGEROUS MYTHS

- Your organization wants you to measure costs accurately
- Financial accounting is appropriate for use in internal decision making
- Depreciation is an appropriate expense for use in managerial costing
- Profit as a percentage of sales is an accurate representation of a product's or service's value to an organization
- Annual budgets are an effective management tool

MYTH #1

Your organization wants you to measure costs accurately

SUPPORT OR VALIDATE DECISIONS?

My 12-Year, Informal, One-Question Survey:

What percentage of your management accounting information is provided before a decision has been made and how much afterward?

The relatively consistent result:

25% Before
75% After

HOW EXECUTIVES MAKE DECISIONS

It is assumed that by providing decision makers with accurate and relevant information on which to base their decisions, management accountants can help drive economic value – decision makers will make higher quality decisions.

This assumes that business executives base their decisions on the financial and economic analytics provided by their financial support group.

HOW EXECUTIVES MAKE DECISIONS

But is the “Utility Theory” espoused by Adam Smith in *Wealth of Nations* true?

Are business executives’ decisions based on which option gives their company the most economic utility?

HOW EXECUTIVES MAKE DECISIONS

Which option would you select?

- A 100% chance to win $3,000 or an 80% chance to win $4,000?
- A 100% chance to win $3,000 or an 60% chance to win $6,000?
- A 100% chance to win $3,000 or a 40% chance to win $9,000?
- A 100% chance to win $3,000 or a 5% chance to win $200,000?

There is something other than accurate and relevant information at work in the decision making process.

That "other thing" is emotion

HOW EXECUTIVES MAKE DECISIONS

Decision making is a balance of the emotional and the rational and it appears that although decisions can be made without facts, they cannot be made without emotion.

HOW EXECUTIVES MAKE DECISIONS

Emotions are the psychological and physical signals and their evoked feelings that are consciously or subconsciously associated with past outcomes. They are inferences made based on past experience.

These feelings and signals bias human's decision making towards certain behaviors and away from others.

Among the bases for these emotions are: memories of previous experiences, perceptions of why certain results followed earlier events, personal goals and personal fears.

COGNATIVE BIASES

- *Confirmation bias* – tendency to interpret information in a way that confirms one's preconceptions.
- *Status quo bias* – favoring alternatives that perpetuate the status quo.
- *Recency bias* – tendency to place more attention on recent information and either ignore or forget past information.
- *Selective search for evidence bias* – tendency to gather information that supports certain conclusions but disregards other facts that support different conclusions.
- *Information bias* – tendency to seek information even when it cannot affect action.

COGNATIVE BIASES

- *Source credibility bias* – rejecting something if we have a bias against the person, organization, or group to which the person belongs.
- *Anchoring bias* – decisions are unduly influenced by initial information that shapes the viewpoint of subsequent information.
- *Loss aversion bias* – tendency for people and groups to strongly prefer avoiding losses over acquiring gains.
- *Focusing bias* – tendency for groups to place too much importance on one aspect of the decision and placing too little value on other salient factors.

HOW EXECUTIVES MAKE DECISIONS

The Brain

The Reptilian Brain (or brain stem) – controls functions like heart rate, body temperature and balance

The Cortical Brain (cerebrum and cerebellum) – seat of our conscious thought, language, analysis, strategy, organization, goal setting, planning, solving complex problems

The Limbic Brain – emotion, behavior, motivation, long-term memory, smell, value judgments, non-verbal communication

The Amygdala – controls emotions and mediation of the “fight or flight” reactions and underpins the decision process

HOW EXECUTIVES MAKE DECISIONS

The Amygdala

Removal or damage of the amygdala tends to have one of two effects on decision making:

- The inability to make decisions
- The increased tendency to make risky decisions

Story of Elliot

Story of Paul

HOW EXECUTIVES MAKE DECISIONS

Decisions need to be a blend of emotion and analytics that is appropriate for each decision

Emotional	⟷	Rational
Automatic		Controlled
Things done quickly but prone to errors		Consider carefully and continuously correct errors

HOW EXECUTIVES MAKE DECISIONS

The role of management accountants in decision making in not just to provide decision makers with sound economic data, but to understand the decision making process and develop the ability to influence the manner in which its those decision makers use that information.

SUPPORT OR VALIDATE DECISIONS?

Pricing decisions – whether or not to accept an order at it's market price

Offshoring decisions – components, tooling, customer service

Capital expenditure decisions – cost savings, expansion, new technology

Make or buy decisions

SUPPORT OR VALIDATE DECISIONS?

Decision makers want management accountants to provide them with economic information that validates their emotional decisions much more often than they want accurate and relevant economic information with which to support the decision making process

SUPPORT OR VALIDATE DECISIONS?

To be effective, management accountants must:

Clearly understand the decision making process

Learn how to have influence in areas where they have no authority

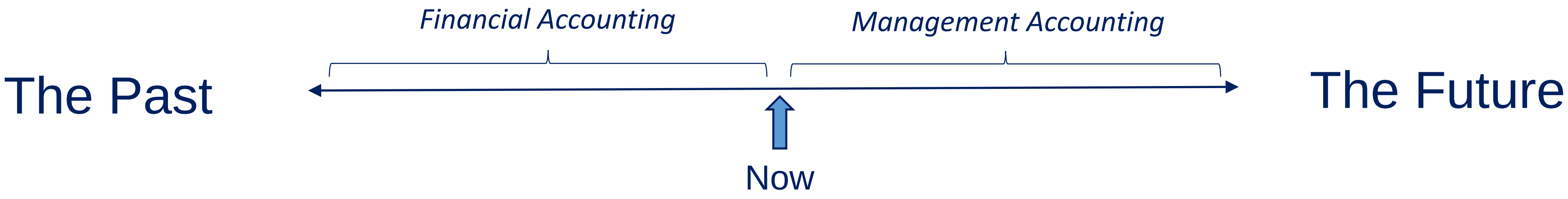
Recent Article

"When Managers Make Emotional Business Decisions," *Strategic Finance*, September 2017.

MYTH #2

Financial accounting is appropriate for use in internal decision making

FINANCIAL ACCOUNTING & DECISION MAKING



Measure past performance	Optimize future performance
Specific periods relevant	Long-term success relevant
Sunk costs relevant	Sunk costs irrelevant
Profit is paramount	Cash flow is paramount
Cannot be changed	Can be influenced / created

FINANCIAL ACCOUNTING & DECISION MAKING

- The dangers of “teaching to the test”
- “Dawn of civilization to date” and “now until the end of time” adjustments
- Expenses vs. investments
- Non-annual and unmade expenditures
- Cost of capital (lack thereof)
- Cost recovery vs. cost “precovery”

MYTH #3

Depreciation is an appropriate expense for use in managerial costing

DEPRECIATION EXPENSE

Sunk Costs Are Irrelevant

Costs required to maintain a company's existing productive capability are legitimate business costs

Does depreciation expense reflect any kind of economic reality?

DEPRECIATION EXPENSE

- Take the original (sunk) cost of a capital asset
- Select one of the allowable chronological lives of that capital asset
- Select one of the allowable depreciation methods for that capital asset
- Apply the selected life and method to the irrelevant, sunk cost of the asset to arrive at depreciation expense

Does this arrive at a meaningful measure of cost?

DEPRECIATION EXPENSE

What if the company recently purchased all new assets and is using the double-declining balance method?

What if the company just emerged from bankruptcy and its capital assets have no value on its books?

What if the company's capital assets are old and already fully depreciated?

DEPRECIATION EXPENSE

For decision making purposes, accounting depreciation expense is an irrelevant, inaccurate, and misleading concept and should be ignored.

HOWEVER…some provision must be made for the costs required to maintain a company's existing productive capability

THE CAPITAL PRESERVATION ALLOWANCE

The funds that must be collected as part of a company's ongoing revenue stream to preserve its existing capital base

The on-going accumulation of the funds required to maintain the company's established volume of business and technological position in the industry – like a "sinking fund"

THE CAPITAL PRESERVATION ALLOWANCE

The two ‘drivers’ of the need to fund the preservation of capital assets…

Time

The assets become obsolete

Usage

The assets wear out

THE CAPITAL PRESERVATION ALLOWANCE

One additional complicating factor…

Leases

An ongoing – usually time-driven – cost of preserving the assets

THE CAPITAL PRESERVATION ALLOWANCE

- Time-driven:
  - Office equipment
  - Technology
- Usage-driven:
  - Production equipment
- Leases:
  - Both of the above

MYTH #4

Profit as a percentage of sales is an appropriate representation of a product's or customer's value to an organization

% OF SALES MEASURES

	Product A	Product B	Totals
Sales	$500,000	$500,000	$1,000,000
Gross Margin	$125,000	$125,000	$250,000
Gross Margin % to Sales	25.0%	25.0%	25.0%
Profit	$50,000	$50,000	$100,000
Profit % to Sales	10.0%	10.0%	10.0%
Investment			$500,000
Return on Investment			20.0%

Are these two products of equal value to the company?

% OF SALES MEASURES

	Product A	Product B	Totals
Sales	$500,000	$500,000	$1,000,000
Purchased Material/Component	$150,000	$300,000	$450,000
Manufacturing Activity Costs	$225,000	$75,000	$300,000
Cost of Goods Solds	$375,000	$375,000	$750,000
Gross Margin	$125,000	$125,000	$250,000
Non-Manufacturing Activity Cost	$75,000	$75,000	$150,000
Profit	$50,000	$50,000	$100,000
Gross Margin % to Sales	25.0%	25.0%	25.0%
Profit % to Sales	10.0%	10.0%	10.0%
Investment			$500,000
Return on Investment			20.0%
Profit as a % of Value-Added			18.2%

Value-Added

Sales minus Materials & Components = Value-Added ($550,000)

% OF SALES MEASURES

	Product A	Product B	Totals
Sales	$500,000	$500,000	$1,000,000
Purchased Material/Component	$150,000	$300,000	$450,000
Manufacturing Activity Costs	$225,000	$75,000	$300,000
Cost of Goods Solds	$375,000	$375,000	$750,000
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Non-Manufacturing Activity Cost	$75,000	$75,000	$150,000
Profit	$50,000	$50,000	$100,000
Gross Margin % to Sales	25.0%	25.0%	25.0%
Profit % to Sales	10.0%	10.0%	10.0%
Investment	$375,000	$125,000	$500,000
Return on Investment	13.3%	40.0%	20.0%
Profit as a % of Value-Added	14.3%	25.0%	18.2%

Estimated in proportion to manufacturing costs

Which measure more closely reflects the value of each product to the company ?

% OF SALES MEASURES

Reduce A's sales by 1/3 and use freed up capacity to double the sales of B.

What if manufacturing was split 50/50 between A & B at existing prices?

	Product A	Product B	Totals
Sales	$333,333	$1,000,000	$1,333,333
Purchased Material/Component	$100,000	$600,000	$700,000
Manufacturing Activity Costs	$150,000	$150,000	$300,000
Cost of Goods Solds	$250,000	$750,000	$1,000,000
Gross Margin	$83,333	$250,000	$333,333
Non-Manufacturing Activity Cost	$37,500	$112,500	$150,000
Profit	$45,833	$137,500	$183,333
Gross Margin % to Sales	25.0%	25.0%	25.0%
Profit % to Sales	13.8%	13.8%	13.8%
Investment	$250,000	$250,000	$500,000
Return on Investment	18.3%	55.0%	36.7%
Profit as a % of Value-Added	19.6%	34.4%	28.9%

Redistributed in proportion to sales

Profit up from 10%

ROI up from 20%

MYTH #5

Annual budgets are an effective management tool

PERFORMANCE vs. BUDGETS

What’s Broken About Budgeting?

- **Obsolete Budgeting** – obsolete with weeks after published
- **Bean-Counter Budgeting** – a fiscal exercise disconnected from strategy
- **Political Budgeting** – “don’t get me fired because of a budget”
- **Over-scrutinized Budgeting** – constantly reconciling old budgets to revised budgets

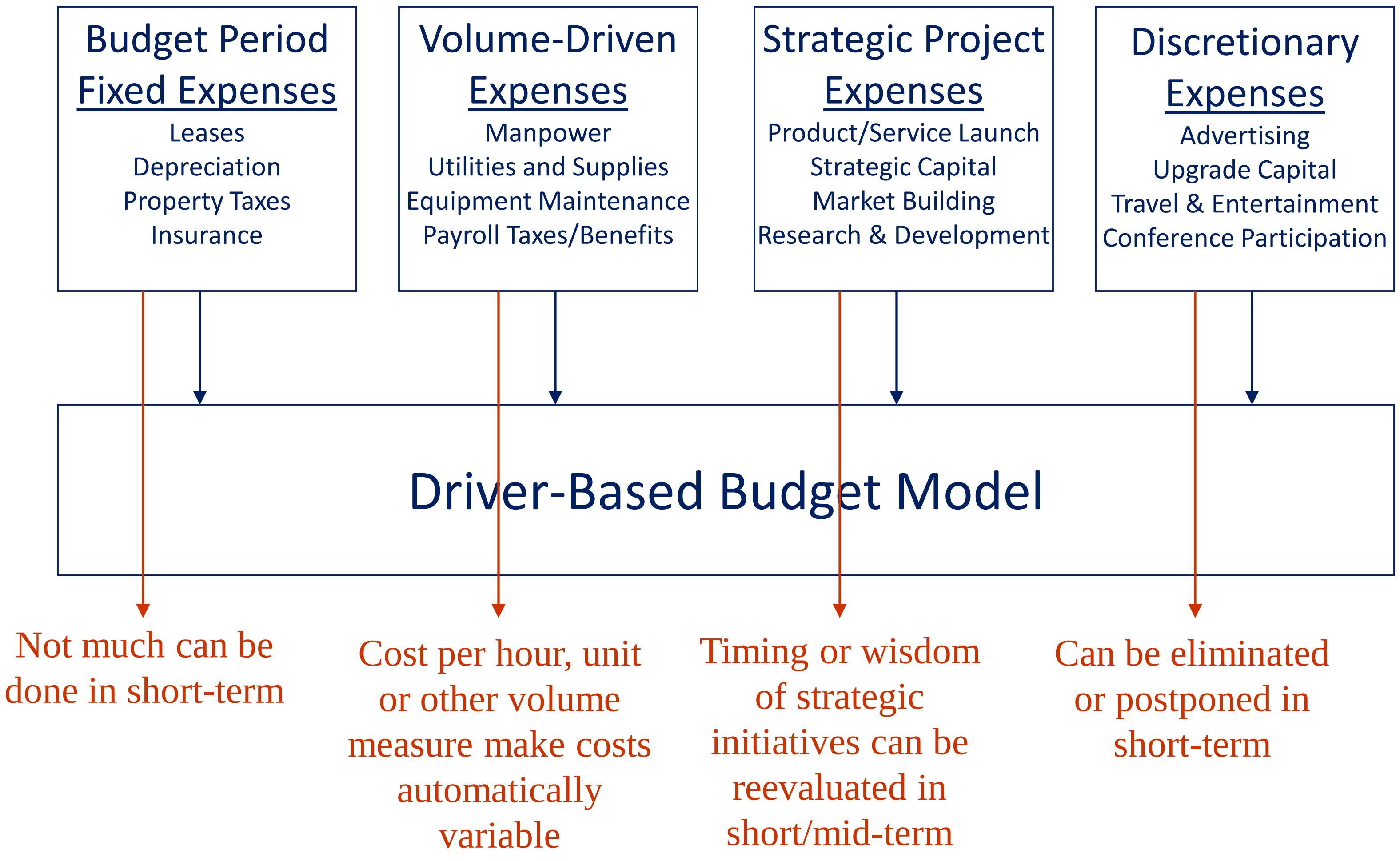
PERFORMANCE vs. BUDGETS

What's Broken About Budgeting?

- **Sandbagging Budgeting** – savvy managers sandbag budgets that roll up into one giant sandbag
- **Blow-it-all Budgeting** – "use it or lose it"
- **Wasteful Budgeting** – waste not identified; inefficiencies from one year "baked into" the following year's budget

ROLLING FORECASTS / BUDGETS

Driver-Based Budgeting/Planning



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