

# COST INFORMATION FOR A SUCCESSFUL 21<sup>ST</sup> CENTURY ORGANIZATION

## *Navigating the Future: Management Accounting's Role in the 21<sup>st</sup> Century*

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# PHILOSOPHICAL MISTAKE #1

## *Cost Accounting ≠ Cost Information*

The primary purpose of cost information is not to support the financial accounting system.

The primary purpose of cost information is to provide management with the accurate and relevant economic information it needs to *make economically sound decisions and take economically effective actions.*

# THE IMPORTANCE OF MODELS IN DECISION MAKING

# THE IMPORTANCE OF MODELS

- Most phenomena are too complex to be completely understood.
- People must function in a world where those phenomena exist and have an effect their decisions and actions.
- To function effectively they create “models” of those phenomena.

# THE IMPORTANCE OF MODELS

- Models represent an individual's “internal version” of the outside world that makes that world more understandable and easier to deal with.

# THE IMPORTANCE OF MODELS

*“It is our models of phenomena that determine our behavior, not the phenomena themselves.”*

**Alfred Oxenfeldt**

# THE IMPORTANCE OF MODELS

- “The validity of our decisions depends on our perception and understanding of reality.
- **Good decisions require good models,**
- ...and the caliber of our decisions reflects the quality and validity of our models.”

# THE ECONOMIC COST MODEL

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...to provide *accurate* and *relevant* cost information  
that provides a *factual basis* to  
support business actions and decisions *of all kinds*

# THE ECONOMIC COST MODEL “ELEPHANT”

It was six men of Indostan  
To learning much inclined,  
Who went to see the Elephant,  
(Though all of them were blind),  
That each by observation  
Might satisfy his mind.

*John Godfrey Saxe (1816-1887)*

# THE ECONOMIC COST MODEL

## “ELEPHANT”

- Its Side → “a wall”
- Its Tusk → “a spear”
- Its Trunk → “a snake”
- Its Ear → “a fan”
- Its Tail → “a rope”
- Its Leg → “a tree”

# THE ECONOMIC COST MODEL “ELEPHANT”

So oft in theologic wars,  
The disputants, I ween,  
Rail on in utter ignorance  
Of what each other mean,  
And prate about an Elephant  
Not one of them has seen!

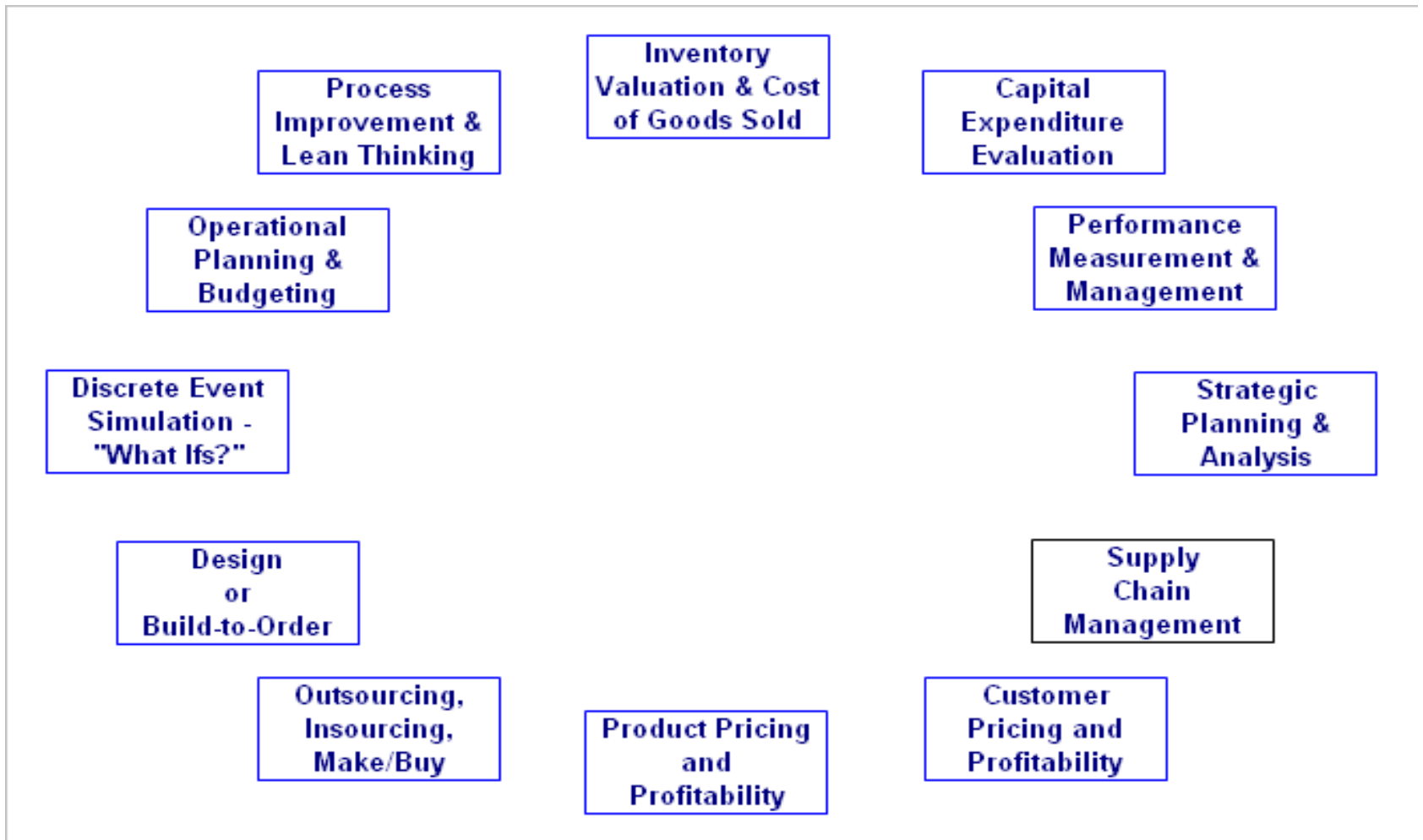
*John Godfrey Saxe (1816-1887)*

# THE ECONOMIC COST MODEL “ELEPHANT”

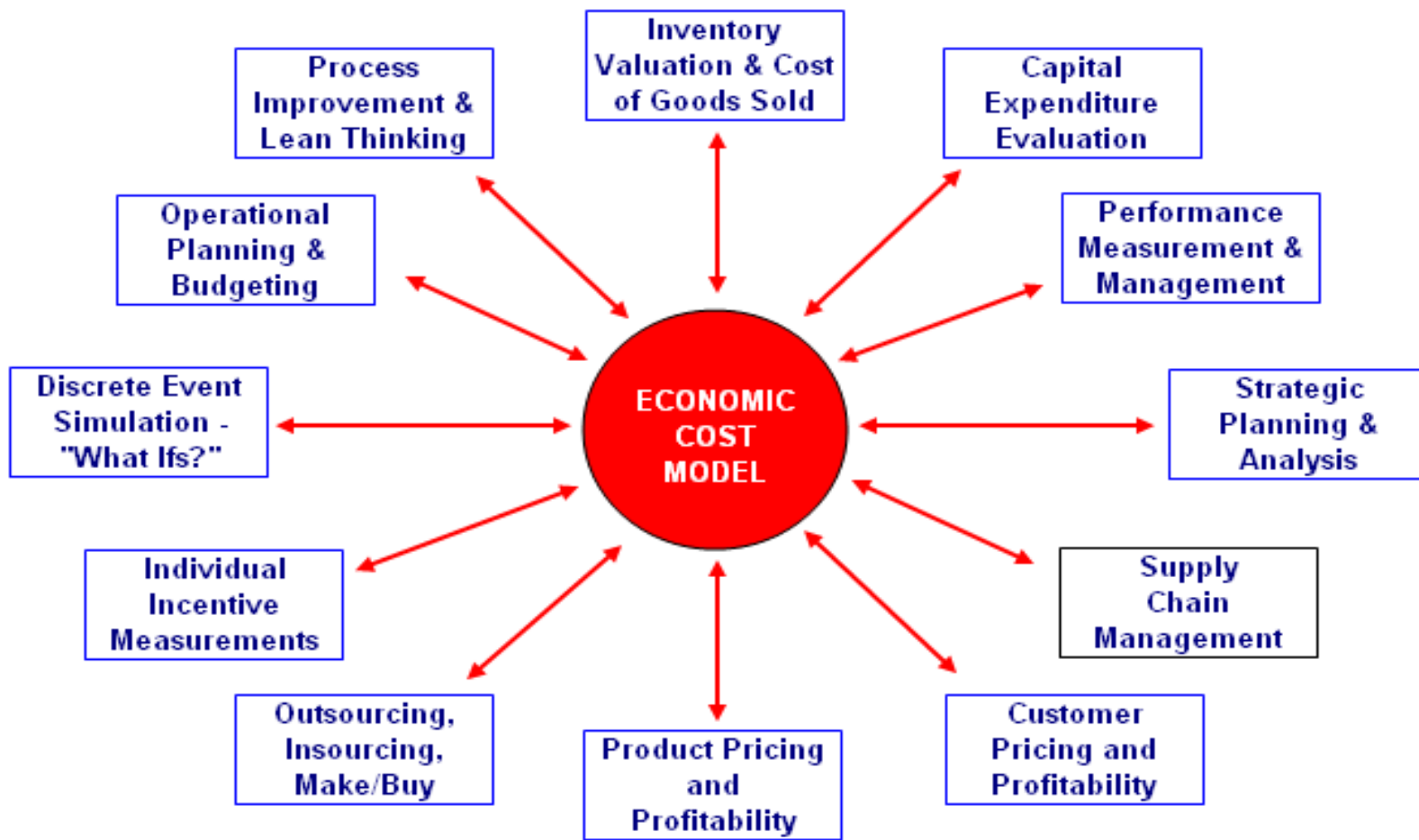
So oft in **costologic** wars,  
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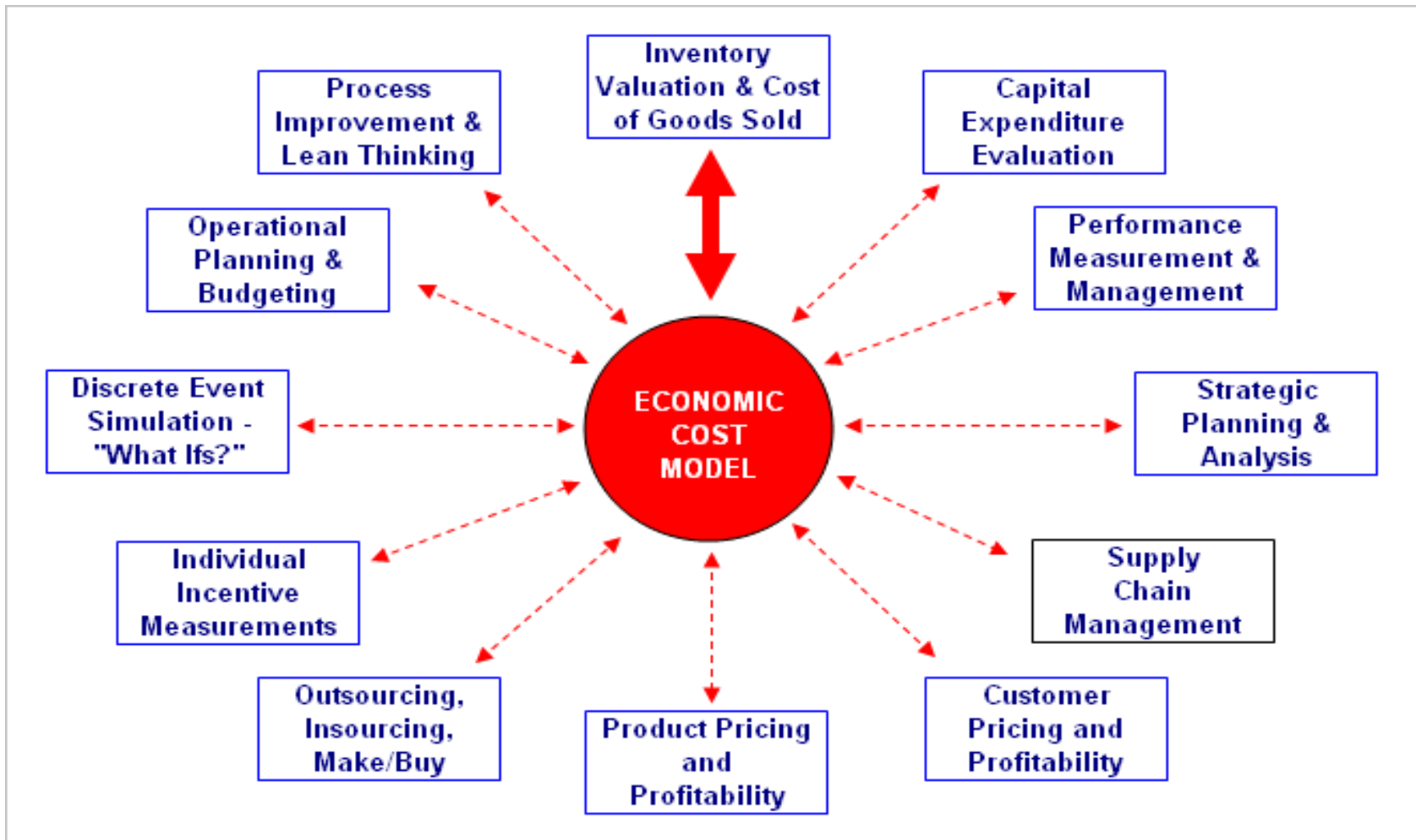
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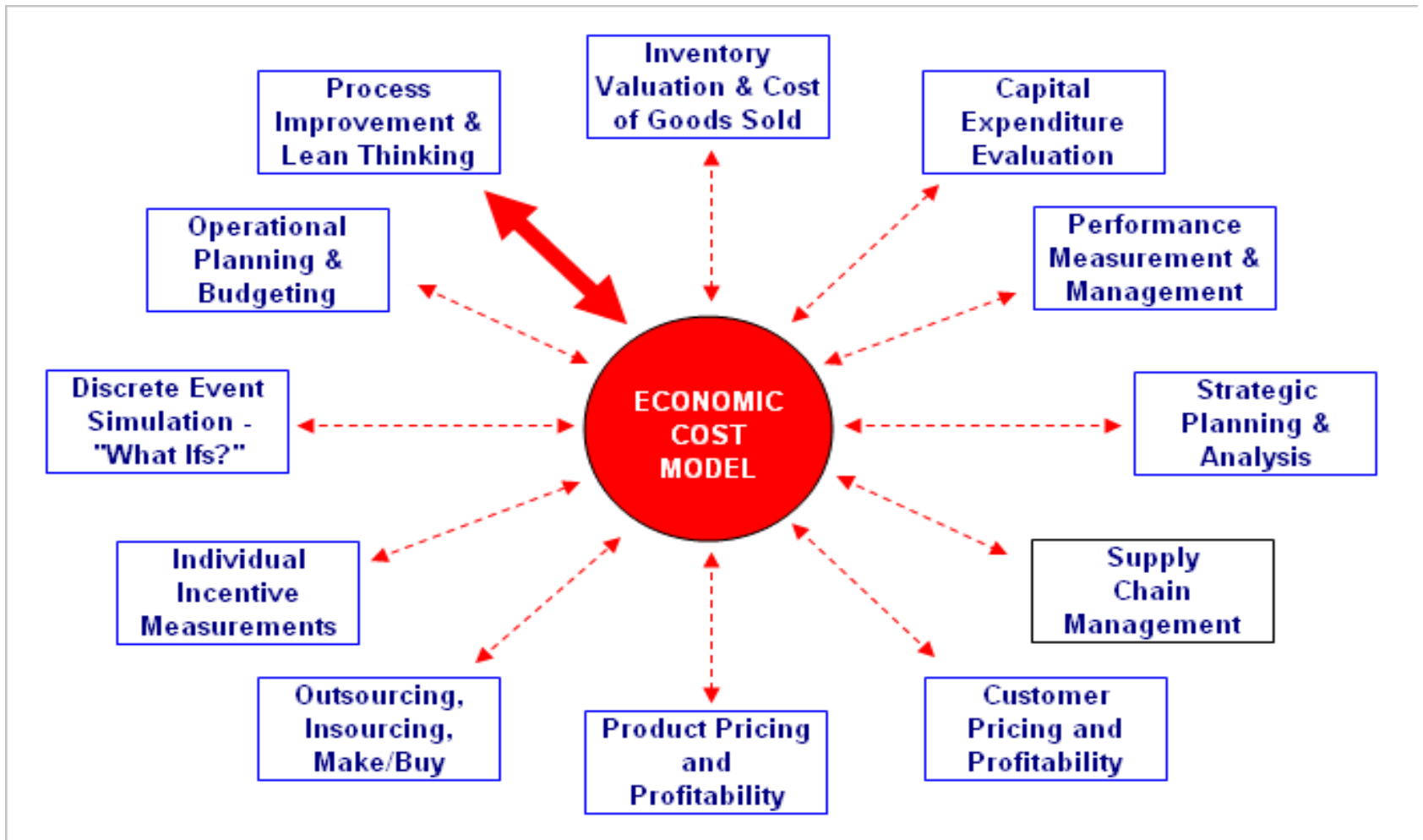
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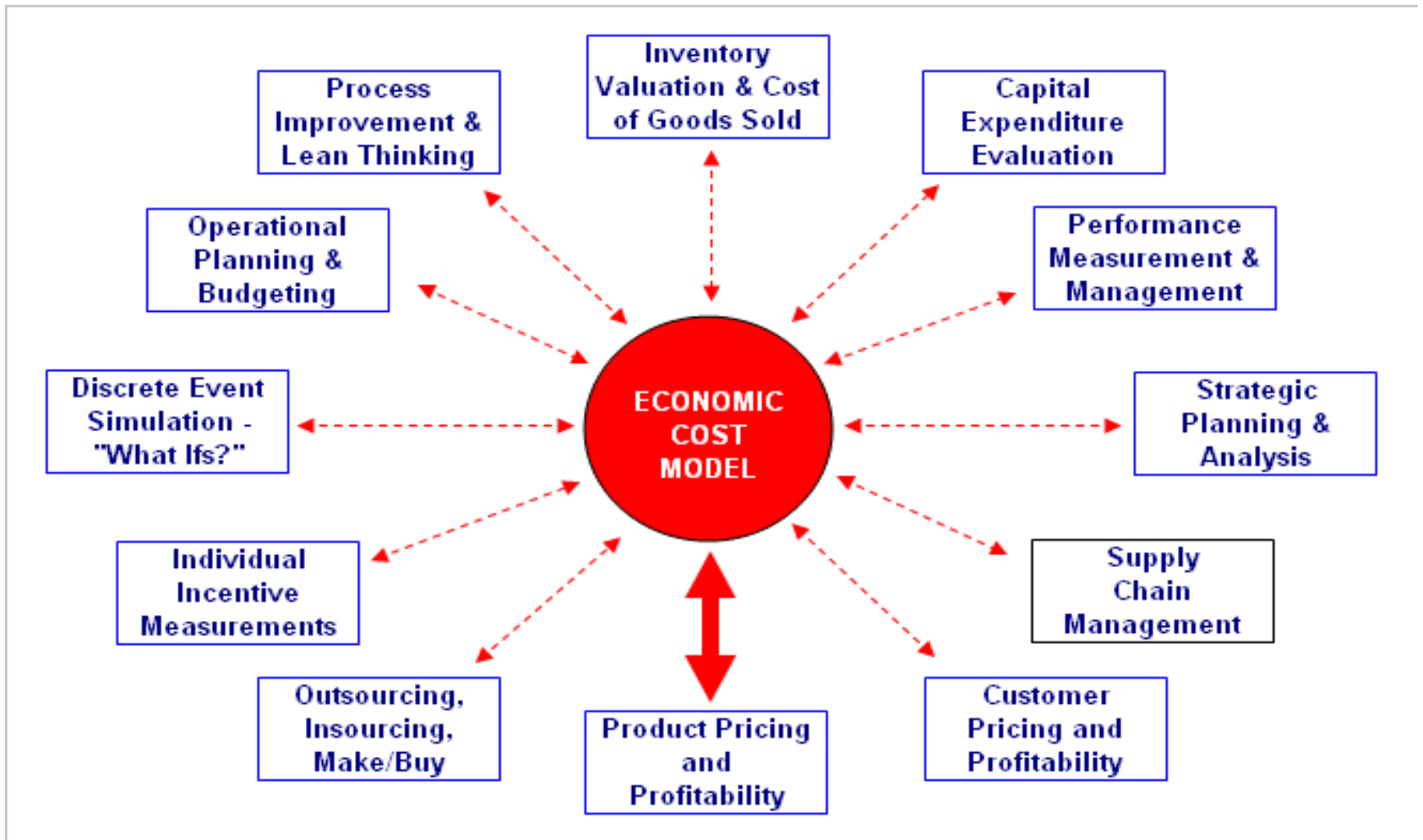
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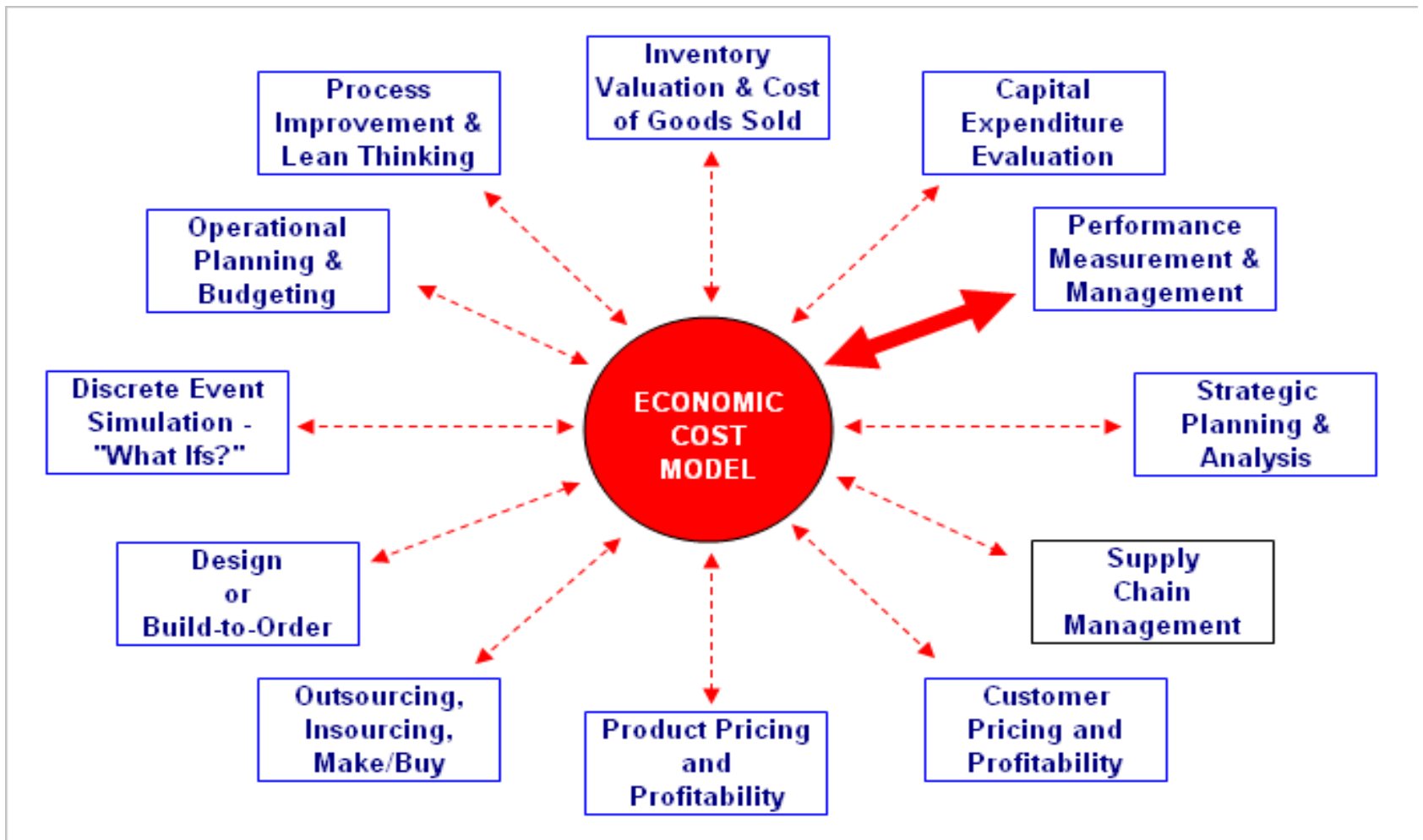
# THE ECONOMIC COST MODEL “ELEPHANT”



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# THE ECONOMIC COST MODEL “ELEPHANT”



# THE CONCEPT OF COST

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*Financial Accounting Costs  $\neq$  Decision Costs*

**“The Deadly Virus of GAAP”**

# THE DEADLY VIRUS OF GAAP

- Periodicity Problems
- Depreciation and Amortization
- Investments vs. Expenses
- Unmade Expenditures
- Non-Annual Cost Cycles
- Cost Recovery vs. Cost Precovery
- Volume & Mix
- Cost of Capital

# ACTIVITY-BASED CONCEPTS

# ACTIVITY-BASED CONCEPTS ARE...

the “lens” through which management can view the company to develop a valid economic model of the organization

# THE THREE KEY TYPES OF COST INFORMATION

- *Fully-absorbed costs* – calculable at various volumes and mixes of business
- *Incremental/total costs* – calculable under various business assumptions
- *Process costs* – the cost of performing the organization's primary business activities

# ACTIVITY-BASED CONCEPTS

Activity-Based Concepts (ABC) are a “lens” for taking the complex operations of a business enterprise and developing a *cost model* that accurately reflects the *relationships between the company’s costs, activities, and products.*

# ACTIVITY-BASED CONCEPTS

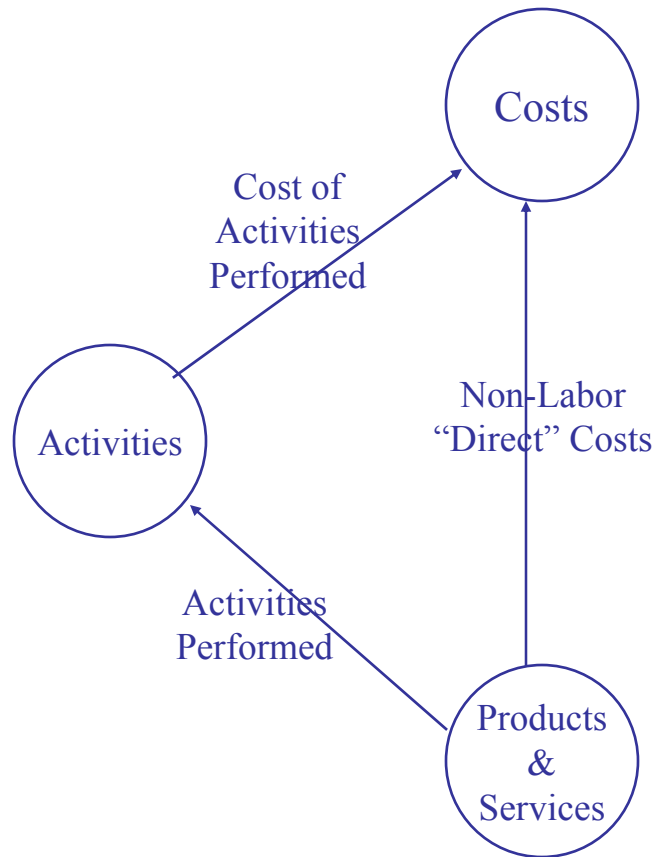
The purpose of Activity-Based Concepts is  
*insight*, not calculations.

# ABC's BASIC PREMISE

- Products and services cause activities and those activities cause costs.
- Associate costs with the activities that make them necessary and then associate accumulated activity costs with the products or services that make them necessary.

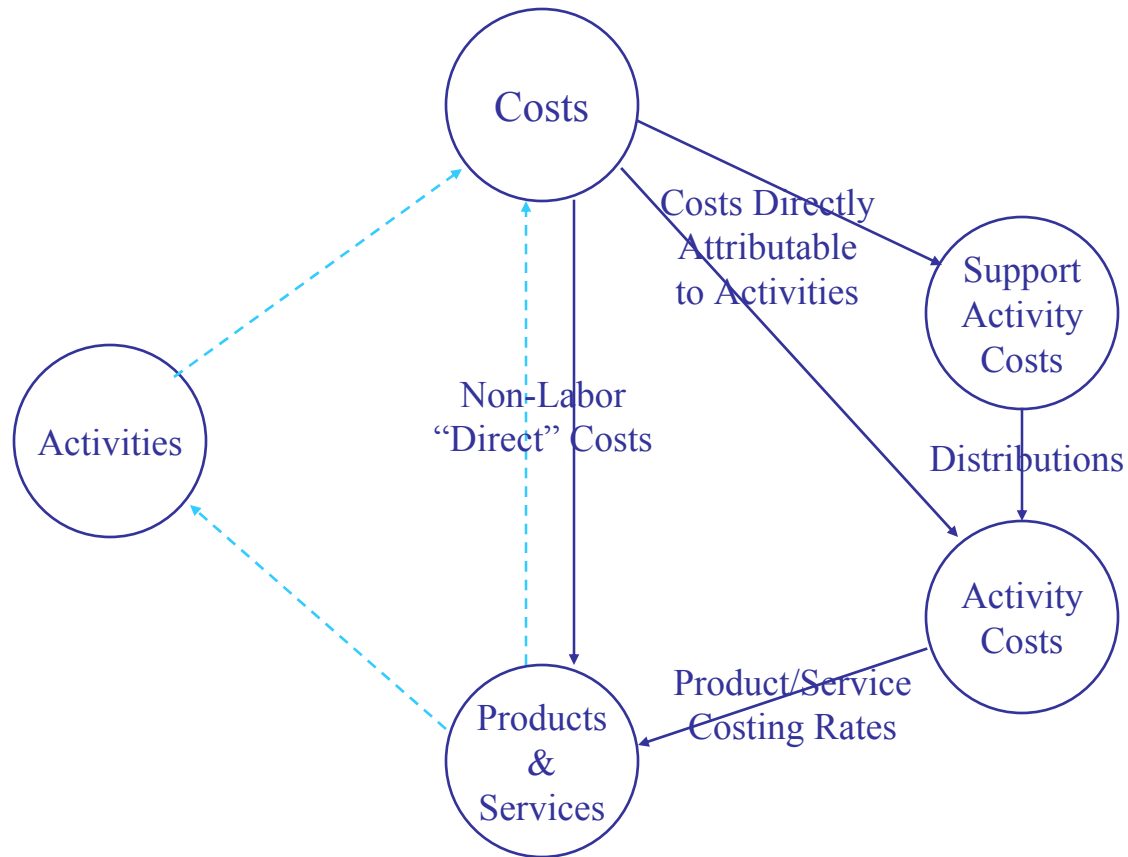
# BASIC “ABC” COST /ACTIVITY FLOW

*“bottom up”*

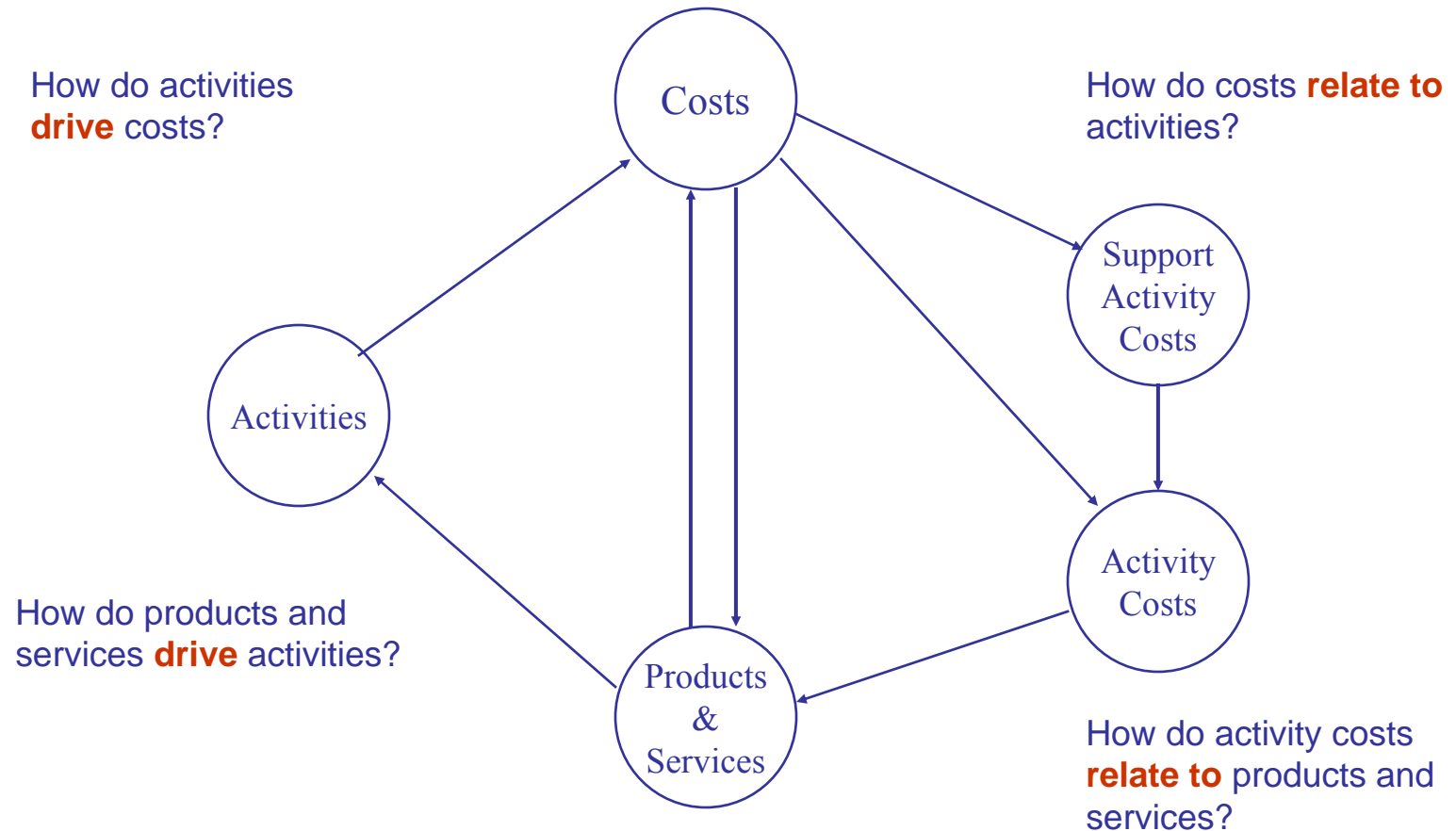


# BASIC “ABC” COST /ACTIVITY FLOW

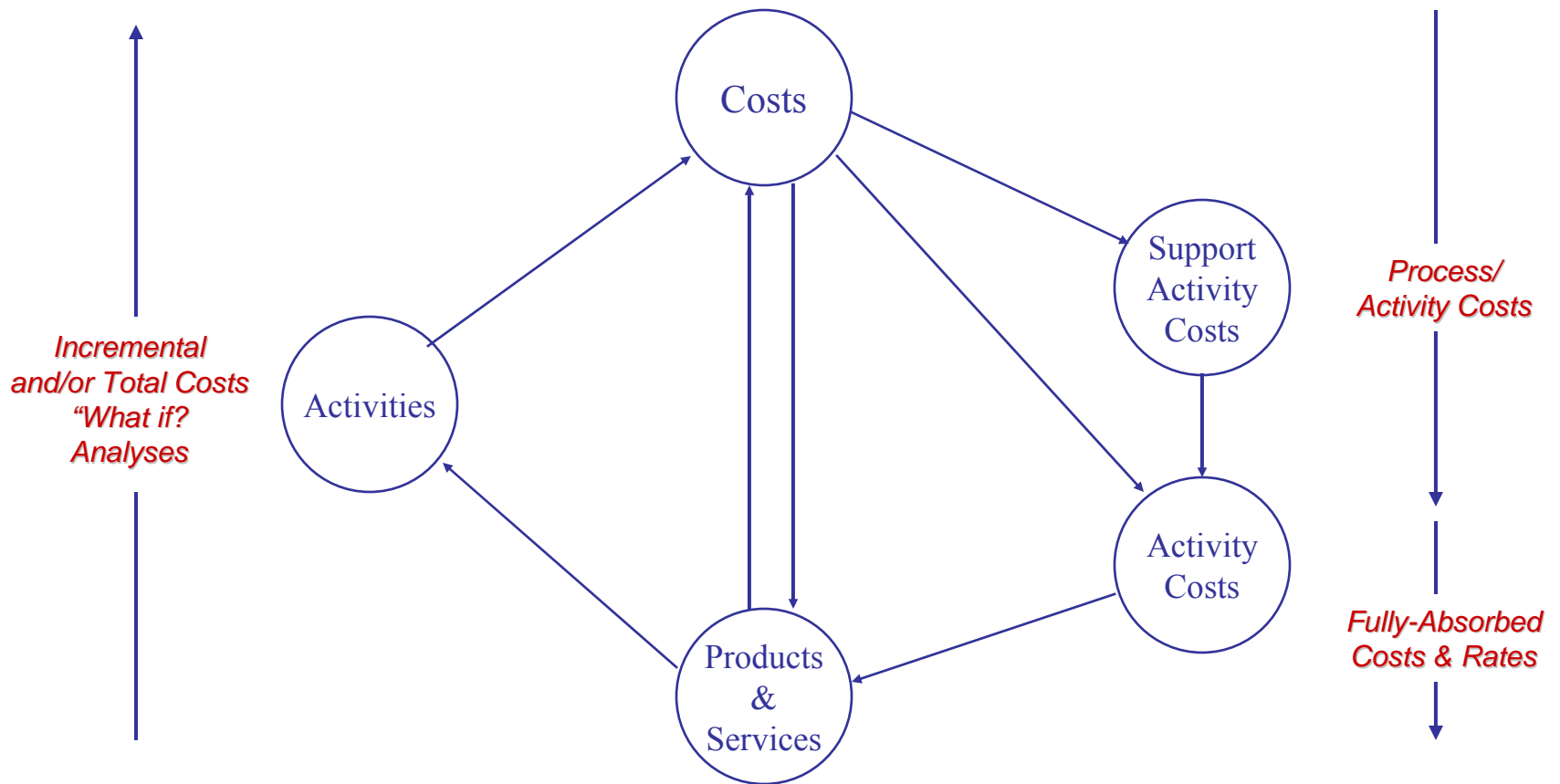
*“top down”*



# BASIC “ABC” COST /ACTIVITY FLOW

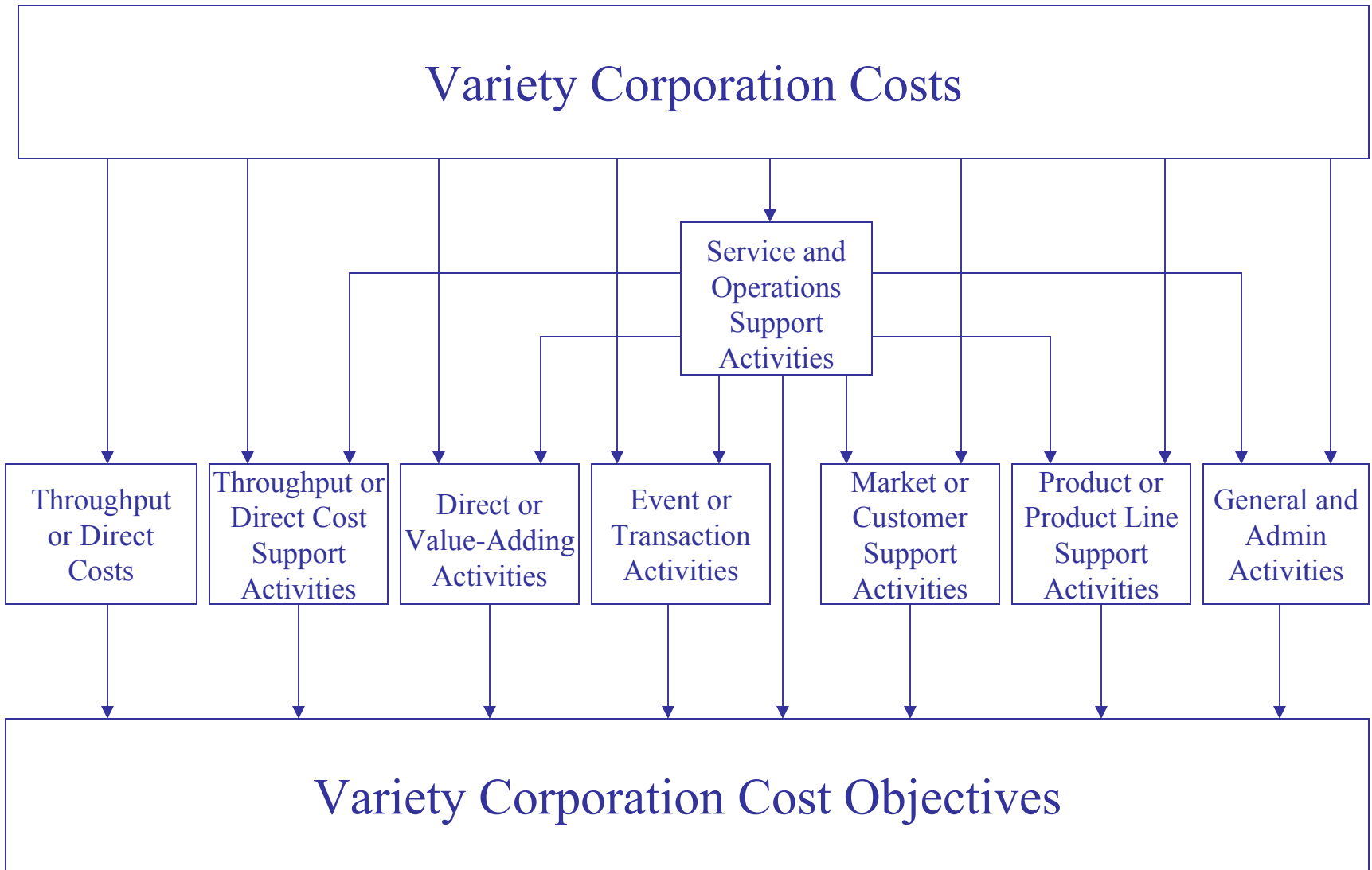


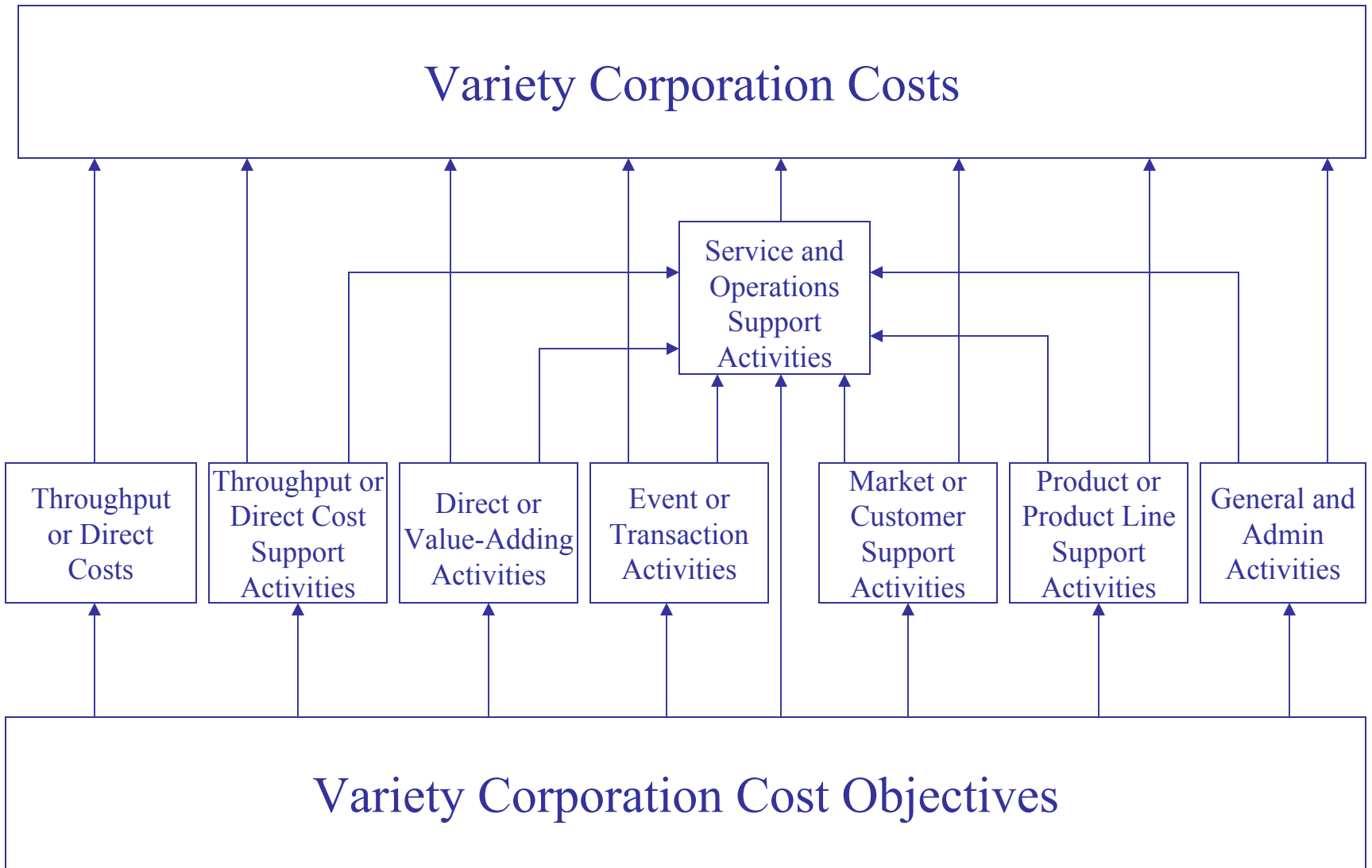
# BASIC “ABC” COST /ACTIVITY FLOW



# CATEGORIES OF COSTS/ACTIVITIES

- Throughput or Direct Cost Support Activities
- Direct or Value-Adding Activities
- Event or Transaction Activities
- Market or Customer Support Activities
- Product or Product Line Support Activities
- General and Administrative Activities





USING  
ACTIVITY-BASED CONCEPTS TO  
IMPROVE  
THE BOTTOM LINE

# ABC & BUSINESS DECISIONS

- pricing decisions
- capital expenditure decisions
- make/buy decisions
- drop/add decisions
- offshore sourcing decisions
- performance measurement
- lean initiatives and continuous improvement efforts
- strategic planning
- etc.

# COST INFORMATION FOR A SUCCESSFUL 21<sup>ST</sup> CENTURY ORGANIZATION

- Cost Information  $\neq$  Cost Accounting
- Cost Model Must Be Valid and Fit All User Perspectives
- Cost Information  $\neq$  GAAP-Based Accounting Information
- Activity-Based Concepts Provide “a Lens” for Creating a Valid Cost Model
- The Focus of Cost Information Must be on Decision Support not on Bookkeeping

# COST INFORMATION FOR A SUCCESSFUL 21<sup>ST</sup> CENTURY ORGANIZATION

*Thank You!*

*Questions?*

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