

# DOES YOUR COMPANY'S COST INFORMATION UNDERMINE ITS PROFITABILITY?

*Institute of Management Accountants  
Metro Detroit Chapter*

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# Does Your Company's Cost Information Undermine Its Profitability?

- Why it's an important question...
  - Because what gets measured gets done!
  - Inappropriate or inaccurate accounting measures will lead to low quality business decisions
  - Low quality business decisions lead to poor financial performance

# Accounting for What Purpose?

- To record provable, historical, organization-wide performance segmented into convenient, but often irrelevant, time periods.  
 Almost all accounting systems are designed for this...
- To provide insightful business intelligence that will enable managers to make economically sound business decisions.  
 ...very few for this
- But companies use the accounting system as if it were designed to provide detailed business intelligence anyway

# Areas of Concern

- Cost Measurement
  - Does accounting provide accurate and meaningful measurements of cost?
- Cost Assignment
  - Does accounting take into account the cause-and-effect relationships between costs and their root causes?

# Three Key Problems with Cost Measurement

- GAAP Distortions caused by the periodicity problem
- The irrelevance and deception of depreciation expense
- The failure to incorporate a cost of capital into decision costing

# The Periodicity Problem

- “Dawn of civilization to date” and “now until the end of time” adjustments
- Volume and mix assumptions
- Non-annual and unmade expenditures
- Cost recovery vs. cost pre-recovery

# The Depreciation Problem

- Funds must be generated by sales to provide for preservation of the company's asset base
- Case that proves the point – companies emerging from bankruptcy
- *Time* only drives the need to preserve a part of the asset base – *Usage* drives the balance

# The Cost of Capital Problem

- The purpose of a for-profit organization is to maximize the owners' return on investment (profit/investment)
- Failure to incorporate a cost of capital into the organization's cost structure totally ignores the investment portion of the objective

# The Profit as a Percentage of Sales Fallacy

	Product A	Product B	Product C	Product D	Product E	Totals
Sales	\$2,000,000	\$2,000,000	\$2,000,000	\$2,000,000	\$2,000,000	\$10,000,000
Costs:						
Material	\$400,000	\$600,000	\$800,000	\$1,000,000	\$1,200,000	\$4,000,000
Activity Costs	<u>\$1,400,000</u>	<u>\$1,200,000</u>	<u>\$1,000,000</u>	<u>\$800,000</u>	<u>\$600,000</u>	<u>\$5,000,000</u>
Total Costs	<u>\$1,800,000</u>	<u>\$1,800,000</u>	<u>\$1,800,000</u>	<u>\$1,800,000</u>	<u>\$1,800,000</u>	<u>\$9,000,000</u>
Operating Profit	<u>\$200,000</u>	<u>\$200,000</u>	<u>\$200,000</u>	<u>\$200,000</u>	<u>\$200,000</u>	<u>\$1,000,000</u>
Profit % to Sales	<u>10.0%</u>	<u>10.0%</u>	<u>10.0%</u>	<u>10.0%</u>	<u>10.0%</u>	<u>10.0%</u>

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Material	\$400,000	\$600,000	\$800,000	\$1,000,000	\$1,200,000	\$4,000,000
Activity Costs	<u>\$1,400,000</u>	<u>\$1,200,000</u>	<u>\$1,000,000</u>	<u>\$800,000</u>	<u>\$600,000</u>	<u>\$5,000,000</u>
Total Costs	<u>\$1,800,000</u>	<u>\$1,800,000</u>	<u>\$1,800,000</u>	<u>\$1,800,000</u>	<u>\$1,800,000</u>	<u>\$9,000,000</u>
Operating Profit	\$200,000	\$200,000	\$200,000	\$200,000	\$200,000	\$1,000,000
Investment in Equipment	\$8,000,000	\$8,000,000	\$8,000,000	\$8,000,000	\$8,000,000	\$8,000,000
% Equipment Utilization	<u>28.0%</u>	<u>24.0%</u>	<u>20.0%</u>	<u>16.0%</u>	<u>12.0%</u>	<u>100.0%</u>
Investment Attributed	<u>\$2,240,000</u>	<u>\$1,920,000</u>	<u>\$1,600,000</u>	<u>\$1,280,000</u>	<u>\$960,000</u>	\$8,000,000
Profit % to Sales	<u>10.0%</u>	<u>10.0%</u>	<u>10.0%</u>	<u>10.0%</u>	<u>10.0%</u>	<u>10.0%</u>
R.O. I.	<u>8.9%</u>	<u>10.4%</u>	<u>12.5%</u>	<u>15.6%</u>	<u>20.8%</u>	<u>12.5%</u>
Profit % to Activity Costs	<u>14.3%</u>	<u>16.7%</u>	<u>20.0%</u>	<u>25.0%</u>	<u>33.3%</u>	<u>20.0%</u>

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# The Profit as a Percentage of Sales Fallacy

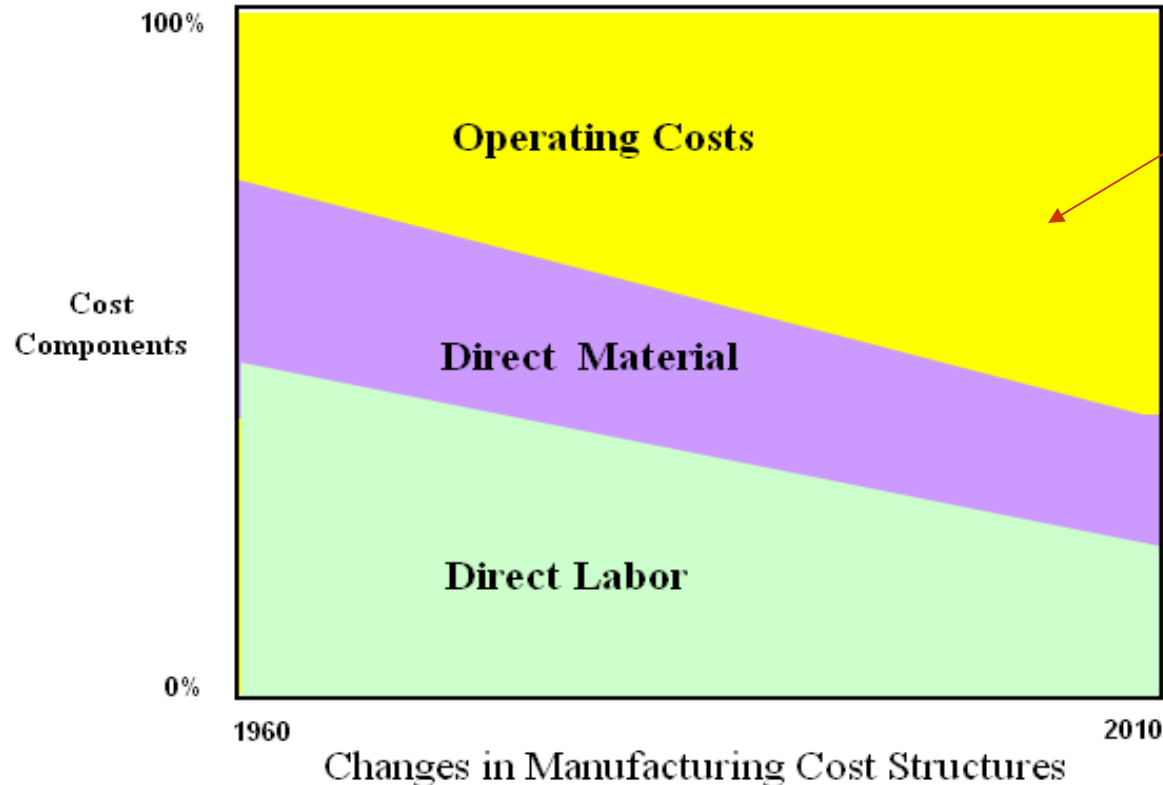
	Product A	Product B	Product C	Product D	Product E	Totals
Sales	\$2,000,000	\$0	\$2,000,000	\$2,000,000	\$6,000,000	\$12,000,000
Costs:						
Material	\$400,000	\$0	\$800,000	\$1,000,000	\$3,600,000	\$5,800,000
Activity Costs	<u>\$1,400,000</u>	<u>\$0</u>	<u>\$1,000,000</u>	<u>\$800,000</u>	<u>\$1,800,000</u>	<u>\$5,000,000</u>
Total Costs	<u>\$1,800,000</u>	<u>\$0</u>	<u>\$1,800,000</u>	<u>\$1,800,000</u>	<u>\$5,400,000</u>	<u>\$10,800,000</u>
Operating Profit	\$200,000	\$0	\$200,000	\$200,000	\$600,000	\$1,200,000
Investment in Equipment	\$8,000,000	\$0	\$8,000,000	\$8,000,000	\$8,000,000	\$8,000,000
% Equipment Utilization	<u>28.0%</u>	<u>0.0%</u>	<u>20.0%</u>	<u>16.0%</u>	<u>36.0%</u>	<u>100.0%</u>
Investment Attributed	<u>\$2,240,000</u>	<u>\$0</u>	<u>\$1,600,000</u>	<u>\$1,280,000</u>	<u>\$2,880,000</u>	<u>\$8,000,000</u>
Profit % to Sales	<u>10.0%</u>	<u>0.0%</u>	<u>10.0%</u>	<u>10.0%</u>	<u>10.0%</u>	<u>10.0%</u>
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Profit % to Activity Costs	<u>14.3%</u>	<u>0.0%</u>	<u>20.0%</u>	<u>25.0%</u>	<u>33.3%</u>	<u>24.0%</u>

Was 12.5%  
and 20.0%

# Two Key Problems with Cost Assignment

- Only “inventoriable” costs are considered
- Crude average costing rates are assigned using irrelevant bases deemed more than adequate

# Cost Assignment: Inventory Only Costing



Due to changes in diversity and complexity of products, services and customers, increases in quality level and rates of change

# Cost Assignment: Inventory Only Costing

- But what about....

The ownership cost of raw materials and components?

The cost of supporting outside processors?

The cost of post-manufacturing activities?

# Cost Assignment: Inventory Only Costing

- But what about....

The cost of distribution channels?

The cost of high-maintenance customers?

The cost of multiple product lines?

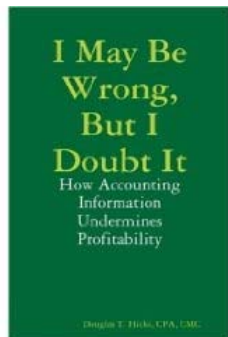
# Cost Assignment:

## Crude Average Rates & Irrelevant Bases

- Direct labor-based cost assignment bases, especially plant-wide rates
- Failure to separate accounting for labor-driven and equipment-driven costs
- Failure to isolate major direct, but non-value adding costs like in-process movement and storage and setup

# The Result

- Accounting information that
  - does not reflect economic reality
  - misleads decision makers
  - provides inappropriate incentives
  - ignores critical operating issues
- In short, accounting information that undermines a company's profitability



## **I May Be Wrong, But I Doubt It: How Accounting Information Undermines Profitability**

By Douglas T. Hicks, CPA, CMC

It may be effective in reporting historical results to outsiders, but relying on the information generated by a GAAP-based accounting system when making management decisions seriously undermines a company's ability to grow into a profitable future. The case is presented in Doug Hicks' new book *I May Be Wrong, But I Doubt It: How Accounting Information Undermines Profitability*

Included in the sixteen essays that comprise this book are arguments describing why:

- Profit as a percentage of sales is an incomplete and misleading measure of product or service profitability
- Depreciation is not only totally irrelevant for decision makers, it can be one of the most damaging concepts in accounting
- Evaluating management performance using financial accounting turns managers into “game players” whose actions are directed at generating the best short-term scores at the expense of long-term success
- Popular solutions to today's cost information problems (ABC/M, Lean Accounting, GPK, Resource-Driven Accounting, etc.) are so narrowly focused as to be irrelevant for a majority of decision makers
- The phrase “Management Accountant” might qualify as an oxymoron and true management accountants may be as rare a Boston Red Sox fan living in New York
- Traditional accounting has trouble distinguishing among a cost, an investment, and a profit
- The discipline of accounting is so focused on arbitrary rules and regulations that accountants may be incapable recognizing economic reality when they see it
- The best solution may be to relieve accountants of their duties as providers of decision support information and assign those duties to individuals whose thought processes have not been tainted with GAAP.

Does your company's accounting information guide or misguide management? Does it promote or undermine your company's profitability? Does it result in management making decisions based on fiction instead of on reality? Find out how your company stacks up by reading *I May Be Wrong, But I Doubt It: How Accounting Information Undermines Profitability*.

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## Questions?

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