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*“People who shut their eyes to reality simply invite their own destruction”*

- James Baldwin

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Dear Executive:

During the past year, I’ve had the opportunity to explore the question, “Why is 21<sup>st</sup> Century cost management still stuck in middle of the 20<sup>th</sup> Century?” with many of my fellow members of the Society of Cost Management in both one-on-one discussions and in formal teleconferences. When added to the other comments I’ve read and heard over the years, it appears we are mired in a “chicken or egg?” dilemma. On one hand, accountants are said to be at fault for their unwillingness to make themselves knowledgeable about advances in cost management concepts or, if they do keep current, their failure to make management aware of the danger in using outdated costing practices or encourage them to pursue change. On the other hand, management is said to be the culprit for being satisfied with outdated, inaccurate costing methods and failing to put pressure on their accountants to bring those practices up-to-date.

When it comes to the “blame game,” my view is that the blame lands squarely on the shoulders of accountants. Blaming management is akin to blaming smokers for ruining their own health after doctors have expounded on the virtues of smoking. Just as the smoker is the victim of the doctors’ bad counsel, management is simply the victim of accountants’ bad counsel. Accountants are purported to be experts at cost measurement and management and their failure to advise their management teams appropriately makes them eminent value-eroding members of their organizations.

What follows is my non-scientific analysis of the situation, based not on measureable, factual data, but solely on observations made during the quarter century I’ve focused exclusively on cost and management accounting issues.

The problem can be divided into two categories: lack of knowledge and lack of initiative. Accountants have either failed to understand the danger and gain the knowledge necessary to effectively guide their organizations or they have made themselves knowledgeable but failed to advocate – and often actually obstructed – change. The matrix in Figure 1 quantifies the extent to which my observations would attribute the various factors.

I’ve divided the “Level of Understanding Cost Concepts and Principles” into three categories: Zero Understanding, Basic Understanding and Advanced Understanding.

*Zero Understanding* includes individuals who know how to maintain existing cost systems and provide traditional reports. They have little or no understanding of the cost concepts or principles that underlie quality cost measurement and management. Unfortunately, these are the individuals who are most sought after in hiring cost accountants. Whereas most ads for cost

accountants require experience in working with the potential employer’s existing cost or ERP system, few, if any, include a requirement for experience in applying 21<sup>st</sup> Century cost measurement and management concepts.

Level of Understanding Cost Concepts and Principles	Initiative			
	Total	Obstruction	Apathy	Advocacy
Zero understanding	65%	50%	15%	0%
Basic understanding	25%	15%	10%	0%
Advanced understanding	<u>10%</u>	<u>0%</u>	<u>5%</u>	<u>5%</u>
Totals	<u>100%</u>	<u>65%</u>	<u>30%</u>	<u>5%</u>

Figure 1 – Failure of Cost Accounting Matrix

*Basic Understanding* includes individuals who do have a “novice-level” understanding of cost measurement and management concepts, but their experience is limited in its length or breadth (usually both) making it difficult for them to communicate the need for change to top management – or even to their bosses.

*Advanced Understanding* includes individuals who have reached or are nearing “mastery” of the subject and understand how the means and methods of measuring and communicating cost information impact the quality of their company’s decisions.

I’ve also divided “Initiative” into three categories: Obstruction, Apathy, and Advocacy. *Obstruction* includes individuals who do everything they can to block or delay change. *Apathy* includes those who would willingly accommodate change, but who will do nothing to initiate that change. *Advocacy* includes those individuals who will do everything in their power to educate management, encourage them to change, and then lead that change.

Of the thousands of accountants I’ve interfaced with during over two hundred projects, nearly three hundred presentations, hundreds of company visits, and scores of conferences, I estimate that no more than 5% can be categorized as Advanced Understanding/Advocates – probably less. On the other hand, I would categorize nearly two-thirds of the accountants as individuals who obstruct any attempt to change costing methods, most often through their passive-aggressive behavior. I’ve even encountered several who out-and-out sabotaged attempts to change to status quo.

Although many top-level decision makers are able to grasp the dangers of believing the claptrap cost information handed to them by their accountants, we cannot expect the majority of them to learn it on their own. Cost accountants must become more than data managers feeding an obsolete cost model that is guaranteed to generate the wrong answers. They cannot remain like Dufus, feeding precise information into dysfunctional models, but become like Rufus who gets accurate answers by feeding well-estimated information into models that reflect economic reality. They must gain the knowledge and take the initiative if their organizations are to survive and grow in a new, highly-competitive, world-wide economy. The doctors have to convince the smokers that smoking is hazardous to their health.

## **Is Anybody There? Does Anybody Care?**

I shared the following with many of you and posted it on several LinkedIn groups last month, but for those of you who didn't see it, I'll repeat it in this edition of the Executive Letter.

Over the 4<sup>th</sup> of July weekend I watched the old musical "1776" for the umpteenth time. Often, when I'm musing about the apathy shown toward cost information by a majority of management accountants I begin singing to myself the song sung by John Adams toward the end of the movie, "Is Anybody There? Does Anybody Care? Does Anybody See What I See?" when it looks as if the Continental Congress will vote "Nay" to the Declaration of Independence.

Having a little time on my hands, I composed some new lyrics to the song that I thought to be apropos to the current situation in today's cost and performance measurement and management. I'm not a poet, although my grandmother Marcella DeCou Hicks was accomplished at the craft. Perhaps some of her genes were able to come through.

### **Is Anybody There?**

Is anybody there? Does anybody care?  
Does anybody see what I see?

It's too tough to change; they say  
"Just give up the fight,"  
Still to all of them I say,  
"Your numbers just aren't right!  
Your cost models do not match  
your business with precision,  
They misstate, they mislead for every key decision."

The protesters say, at the end of the day,  
"Our results will still be the same.  
But if they are not, and they come out depressed,  
We accountants will never get blamed."

Is anybody there? Does anybody care?  
Does anybody see what I see?

I see losses! I see failures,  
I see business writhe in pain.  
And worst of all I see  
More manufacturers down the drain  
And then I see Americans - more Americans  
Out of work again

How quiet, how quiet it will be  
When all our goods arrive  
After traveling 'cross the sea.

Is anybody there? Does anybody care?  
Does anybody see what I see?

After he finishes his song, Dr. Hall of Georgia comes in and says, "In trying to resolve my dilemma I remembered something I'd once read, 'that a representative owes the People not only his reading but his judgment, and he betrays them if he sacrifices it to their opinion.'" It was written by Edmund Burke, a member of the British Parliament. He walks over to the tally board and changes Georgia's vote from "nay" to "yea". Let's hope more management accountants do the same in the years to come.

### **The Parable of the Blindfolded Race**

Matt, Mark, Luke and John were high school athletes and buddies whose close friendship had endured – despite their different career paths – during the two decades that followed graduation. Matt became an agent for the Internal Revenue Service, Mark went into the priesthood and was appointed Rector for both St. Peter & St. Paul, Luke studied Osteopathy and started a successful family medical practice, and John ran a charter fishing business. Like most aging athletes, the four had been competitive on the athletic field in high school and remained competitive “weekend warriors” as the years passed.

One summer another of their old high school friends, Joshua, decided that he would spend a few weeks in the old hometown on his vacation. Josh had not been an athlete; he was the class genius. But unlike many studious types, he had always been a close friend to most of the “jocks” and helped many of them survive their Chemistry, Physics and Trigonometry classes. After graduation, Josh had gone east to an Ivy League school and spent the last decade ascending the corporate ladder and, as a result of his savvy decision making, was considered the savior of a major corporation that had been on the brink of bankruptcy. At age forty, Josh was financially set for the rest of his life.

One evening during Josh's vacation, the five friends met at the local bar owned by Mark's cousin Barnabas for a few drinks. As often happened, the four aging “jocks” began arguing over who was the best athlete. Josh, who always had an impish nature and was amused at how his four friends with their expanding waistlines could never seem to let go of their athletic past, came up with a proposal he didn't think any of them could turn down.

“Gentlemen,” he said, “I would like to sponsor a little athletic contest for you. I propose that the four of you have a race – a fairly short one since I don't want any of you to keel over – and I will donate \$10,000 to any charity chosen by the winner.” All four friends readily agreed to Josh's proposal.

“You will, however,” he added, “have to run the race blindfolded.”

“Blindfolded?” they all responded in unison. “Why blindfolded?”

“Because I want to test out a business hypothesis using your race as an experiment,” was Josh's answer. “I will put clues about the race into four envelopes. Each of you will draw one of the envelopes and be allowed to read your clues before putting on your blindfold. That way you won't be totally in the dark about the nature of the race.”

The next day they all met – along with several dozen spectators – at the high school's track. Each contestant lined up at the starting line of the 220-yard sprint track and drew one of the envelopes. Matt's envelope contained a note saying that the race would be only 100 yards long. The clue in Mark's envelope said that the race was 100 yards long and would include four hurdles. When he looked in his envelope, Luke learned that not only would the race be 100 yards long and include four hurdles, but that the hurdles would be at the 20, 40, 60 and 80 yard points of the race. The note in John's envelope included all the information in Luke's, but also indicated

that the height of each hurdle would be 29 inches. The blindfolds were put on each contestant after they had read their clues. After a short delay while the hurdles, which had been standing next to the track, were quietly moved into position, the contestants were guided into the starting blocks.

At the sound of the starter's gun, Matt – who knew the race would be a short one – came flying out of the blocks and took a quick lead until his collision with the very first hurdle resulted in a total wipeout. Being a good friend, Josh had arranged for several spectators to be at Matt's first hurdle to catch him as he fell thus avoiding any injury to his old friend.

Knowing that there would be hurdles, Mark trotted slowly out of the blocks with his hands outstretched feeling for the obstacles he knew would be there somewhere. Upon reaching each hurdle he hopped over and moved carefully forward again searching for the next one. After a good minute, he reached the end of the race, removed his blindfold and saw Luke and John waiting for him and Matt sitting on the ground laughing 80 yards back.

When the starter's gun sounded, Luke and John moved ahead quickly until they thought they might be near the 20 yard mark. Each then felt for the hurdle, hopped over it and sprinted to the next hurdle where they repeated the process. After about 30 seconds they reached the finish line, took off their blindfolds and saw each other. They then looked back and saw Mark fumbling along the track and Matt in his undignified position 80 yards behind.

As the five friends assembled after the race Josh shook their hands, handed each of them a beer, and apologized saying, "Sorry for the deception guys. You've proven my hypothesis. And, by the way, I'll donate that \$10,000 to each of your charities."

"What kind of hypothesis could you possibly have tested," asked Matt. "Was it the fact that you could make your old friends look like idiots?"

"No," answered Josh, "although that could be inferred from our little contest. I wanted to test a managerial costing concept I've always believed and followed."

"Managerial costing?" interjected Luke, "What the heck is that?"

"The use of cost information in decision making," answered Josh. "Many years ago I heard an old professor from Columbia named Alfred Oxenfeldt state that 'An error in measuring the magnitude of an effect usually is far less serious than mistakes due to wholly overlooked consequences.' Basically, he was saying that the economic consequences of a decision will be much worse if you fail to take a critical factor into account – like the fact that there are hurdles blocking the track – than if you take it into account but fail to measure it precisely.

"In your race, being aware of the hurdles' existence was the first critical factor and knowing that they were about 20 yards apart the second. Matt's wipeout showed the critical nature of knowing there were hurdles on the track and Mark's poor finish showed the critical nature of knowing where they were located. The fact that they were exactly 29 inches tall was not a critical factor as Luke was able to ascertain their approximate height by feel once he encountered them. John's extra bit of advance knowledge was really of no practical use to him."

"But what's that got to do with managerial costing?" asked Matt.

"The accountants I've dealt with over the years have all been obsessed with the precision of the numbers they generate. Unfortunately, most of their numbers failed to take into account critical factors. They failed to include all of the critical processes; like the cost of acquiring, storing and handling materials, the cost of in-process movement and storage, or order fulfillment

costs. When they gave me process cost information, it was all linked to direct labor without taking into account how those processes actually run. And they failed to incorporate a cost of capital into their costs. As a consequence, the product cost information they gave me failed to reflect the cost of the processes that were used to produce those products. They gave me customer profitability information without taking into account the type and level of service I provided to the various customers. In short, their precise measurements were always incomplete, irrelevant, and inaccurate because there were too many ‘wholly overlooked consequences.’”

“Then how were you so successful?” responded John.

“My decisions were based on models I created myself that took all of the critical factors I could identify into account. Using the model, I then estimated the cost of those factors. Armed with valid models that incorporated all of the critical factors I could substantially improve the quality of my decisions and, as a consequence, improve the performance of my company. By estimating the impact of all the critical factors I was able to overcome the danger of believing the very precise – but totally inaccurate – measurements my accountants provided.

“Now let’s all get over to Cousin Barnabas’ bar. The drinks are on me.”

In the words of Bob Dylan, “you’d better start swimmin’ or you’ll sink like a stone ‘cause the times, they are a changin’.”

I hope you’re summer has been enjoyable despite the record hot weather many of us have been experiencing. As always, I look forward to hearing from any of you who have questions or comments regarding the letter and you should feel free to forward a copy to anyone you believe might be interested (or at least amused).

Very truly yours,

*Doug*

Douglas T. Hicks, CPA, CMC  
President