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Dear Executive:

It's been about eighteen months since I was last fired up enough to sit down and compose one of my executive letters. I remember when it used to be every three months or so that I'd want to share one of my "rants" with you. I guess it takes more to get me all wound up than it did before I qualified for Medicare. However, the discussions I've been part of as a member of the Institute of Management Accountants' Costing Task Force as well as some of the new connections I've made during the past year have given me some valuable insights into the "costing problem" I've been working to help solve for the past thirty years. Ergo, another letter so that I can share those insights with my long-suffering readers.

It's been over thirty years since the serious deficiencies of traditional cost and management accounting practices were brought to the attention of the business community by a wide range of well-respected and widely-read business thought leaders. Beginning with articles like Robert Kaplan's "Yesterday's Accounting Undermines Production" in the July 1984 issue of *Harvard Business Review* and warnings like Eli Goldratt's proclamation that "Cost accounting is productivity's public enemy number one" at the National Association of Accountants (now the Institute of Management Accountants) 1984 annual conference, new and more effective methods of developing accurate and relevant management accounting information have evolved to address the issues raised by Kaplan, Goldratt and scores of other management accounting critics.

Today, management accountants have many options for enhancing the performance measurement and decision support information they provide management. Yet surveys (as well as my personal observations) have shown that very few have taken steps to improve the accuracy and relevance of the information they provide their management. Back in 2003, an Institute of Management Accountants / Ernst & Young survey of management accounting practices indicated that 98% of the financial executives surveyed believed the cost information their company used to support decisions was inaccurate, but less than 20% planned to do anything about it. A 2013 update of that survey by the IMA indicated that little had changed since the survey ten years earlier.

Leaders in management accounting have been trying to understand why management accountants in industry have been so slow to adopt what are obviously more accurate, relevant and value-adding practices in their organizations. Those of you who have been receiving these executive letters over the past few decades have read many of my theories on the topic. **Well, I think I've finally figured it out.**

Most accountants will only initiate change when it is either required by an authoritative outside body (FASB, SEC, IRS, etc.) or demanded by their management. Authoritative outside bodies constantly require changes in accounting practices, but management does not. The most frequent "excuse" I'm given when criticizing accountants for failing to adopt more accurate and relevant management accounting practices is that "management is happy with what we give them…and if they don't think it's broke, I'm not going to fix it." Management is satisfied with the outdated, irrelevant and inaccurate information they are given to support their decisions. This leads to the questions, "*Why are decision makers satisfied with low quality decision support information? Why don't they demand better decision support information from their accountants?*"

I've recently begun a dialog with Jonathan Citrin, a speaker, author and expert on human behavior and decision making. The insights he has provided in the human decision making process have meshed almost perfectly with the observations I've made, experiences I've had and discussions I've engaged in with countless management accounting leaders over the past quarter century. Not wanting to base my understanding on his views alone, I've added my own research on both the neurology and psychology of human decision making and that research confirmed Jonathan's observations.

Decision making is a blend of emotion and analysis. In this context, emotions are the psychological and physical signals and their evoked feelings that are consciously or subconsciously associated with past outcomes. These feelings are the emotions that 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. When a situation arises requiring a decision, emotions provide a simple and quick way that does not involve a lot of analytical thinking. Although these emotional decisions are not particularly sophisticated or precise, their speed and utility often make up for what they lack in sophistication and precision. The ability to make emotion only-based has been critical to our survival as a species. After all, our ancestors would have been in big trouble had they taken the time to do an analysis of the best way to escape from a tiger when one suddenly confronted them while strolling across the savanna.

Humans cannot make a decision without emotion, but they have no problem making them without supporting information. There is a well-known case about a man named Elliot who had his amygdala (the portion of the brain that controls emotions) removed as part of his treatment for a medical condition. Prior to the surgery, Elliot was a successful business executive, so you can imagine the myriad of decisions he was required to make every day. After the surgery, he would continue to logically analyze issues in great detail, but he could not make a decision; even decisions like what color socks to wear or when to schedule his next doctor appointment. His decision making ability had totally vanished without emotional input.

Business executives have a great deal of experience and have made a myriad of connections between decisions they have made personally (or have observed others make) and the outcomes of those decisions. These are critical when making split-second decisions that allow little or no time for more comprehensive analysis. These executives also have their own personal (including financial) goals as well as a multitude of fears. Failure is, of course, one of those fears. But so are the fears of varying from the norm in making decisions or possibly learning that the emotional bases they use to make their decisions are faulty. When confronted with a decision situation, an executive must blend his or her emotion with relevant factual information to evaluate the alternatives and reach a decision. *Which factor do you suppose is more important to the decision maker; emotion or accurate and relevant factual information?*

About a decade ago, I was having lunch with a former financial analyst for one of the big three domestic auto manufacturers. On a whim, I asked her the question, "How much of your financial analyzing took place before a decision was made and how much after?" Her response surprised me. She indicated that only about 25% took place before a decision was reached and 75% afterwards. Most of her work was done to justify decisions that had already been made. Since then, I've casually popped the question out a few dozen times to the controllers, cost accountants and financial analysts I've encountered and found their answers to be just about the same. The vast majority of their analysis work was done after a decision was made, not before. The obvious inference here is that **decision makers don't want accurate and relevant financial information on which to base their decisions, they want financial information that justifies the emotional decisions they've already made**

Solutions to "the costing problem" that have evolved over the past thirty years have all been designed to get closer to "the truth" and accurately reflect the fundamental economics that underlie an organization and the decisions its executives need to make. But emotion-driven business decision makers aren't really interest in "the truth;" they're interested in justifying the emotion-driven decisions they've already made. Consider this: As the quality of an organization's cost and performance measurement practices improve, the ability to use them to prove an "untruth" declines. If a decision maker's objective is to justify his or her emotional decisions, not aid in the decision making process itself, why would he or she ever want to have an economically valid way of measuring cost or performance? It would be much more difficult to prove an "untruth" if an organization's analysts used a valid economic cost model of the organization. Playing with the numbers to prove an economically unsound but emotionally attractive decision was "the right one" would be more difficult than ever.

So it seems that those of us who have spent the better part of our adult lives promoting improved cost and management accounting practices (at least the past three decades) have been making two fundamental assumptions whose validity I now find extremely questionable:

1) Business decision makers have the interest of their organizations at the forefront of their minds when making decisions, and
2) Decision makers strive to make rational decisions and, as a consequence, want more accurate and relevant information on which to base those decisions.

In reality, the interest most decision makers have in mind when they make decision is their own personal interest; any benefits accruing to their organization could be considered "collateral benefits." As I described in my Winter 2007 executive letter they are game players, not stewards. It's simply human nature. "Personal interest" does not just mean personal financial interest, however, it includes things like the avoidance of pain and discomfort, appearance of mastery over the process, evidence of superiority over competing executives and any of a myriad of other considerations. All of these interests work into the emotions of decision making. In a perfect world, decision makers would continuously match their emotions against accurate and relevant data to both make better decisions and to update the internal "data base" that drives their emotions. Unfortunately, our real world is not perfect and accurate and relevant information is either ignored or takes a back seat to emotion.

I'm sure you can all recall instances of seeing decision makers ignoring "the facts" in making their decisions. I see this regularly when companies make pricing decisions. A sales opportunity presents itself and the decision makers are so intent on landing the job that they incorporate highly questionable data in measuring the estimated cost of the job. Impractical or never before attained throughput, scrap and equipment rates as well as efficiencies, material costs and other data are used to estimate the job's cost. Anything so that the price they negotiate will show an acceptable profit on the job. Economic reality is never considered. Then, when they get the job and it proves to be unprofitable they can't understand why.

One particular case "takes the cake." The CEO of an auto supplier who had been in the industry for many years firmly believed – based on the observations and mental connections he made during his years selling the same type of product – that any price that was twice the product's material cost would turn a profit. During one stretch of time, he overrode the cost estimates made by his cost department and accepted a significant number of jobs at "twice the material cost." Unfortunately, these jobs all had conversion and administration costs that exceeded the material cost and all the jobs lost money – so much money that the company was out of business within eighteen months.

Offshoring is another area where accurate and relevant data has often been ignored and component parts sourced offshore because either 1) the customer said we had to do it, 2) the corporate office said we had to do it, or 3) everyone else was doing it. The decision makers ignored "the data" and had the parts resourced anyway. Quite often, the result was not as expected. In one case, a manufacturer offshored parts to China for a price that was $3 million less than its domestic supplier. Unfortunately, the cost of activities required to support these offshored parts amounted to $3.5 million. A loss that could have been avoided had attention been paid to "the facts."

So for the past thirty years we've been trying to get financial executives (who appear to have little or no interest in selling) to sell the idea of improved management accounting practices to decision makers whose highly-emotional decision making process would be adversely effected by the adoption of those new practices (making them uninterested buyers). Unwilling suppliers selling to uninterested buyers. Hardly a formula for success, is it?

Our focus should be on creating demand for more accurate and relevant management accounting practices, not promoting the better mouse traps that have been developed. The only people who can create demand are the users of management accounting information; the engineers, marketers, manufacturers, service providers, inventory managers, buyers, and C-level executives who can significantly improve the quality of their decisions and enhance the performance of their organizations by incorporating a better balance of emotion and information in their decision making.

A good example of the successful "selling" of decision makers on the use of accurate and relevant data and its use to enhance decisions can been seen with many of today's baseball managers. Until recently, the vast majority of managers based their decisions on the same emotions that governed the decisions made by Hall of Famer managers like John McGraw in the early 20th Century or Earl Weaver in the latter part of the century. As analytics began to enter baseball, many managers were hesitant to incorporate them into their decision making. Almost all left-handed hitters were still assumed to hit right-handed pitchers better than right-handed batters. Managers always positioned two infielders on the left side of the field and two on the right side. The best relief pitcher was always saved to pitch in the ninth inning. These "obvious truths," known by every fan of the game, were learned through years of observation and experience. Making a decision inconsistent with these "truths" and having that decision prove unsuccessful simply left the manager open to criticism and scorn. However, an unsuccessful decision that was consistent with them was just considered bad luck and not the fault of the decision maker.

To most managers, many of the analytics developed by baseball's 21st Century "nerds" were interesting, but seemed too risky to put into practice. A few, however, believed in these analytics, left their comfort zones and had the courage to put on radical infield "shifts" against left-handed pull hitters, more critically analyze "righty vs. lefty" situations, pitch the best reliever at critical points in the game instead of the ninth inning and make many other unorthodox moves suggested by "the data." These managers are now some of the most successful in the game; managers like Joe Madden of the world champion Chicago Cubs and Terry Francona of the American League champion Cleveland Indians. Their decisions are still made by emotion – remember a decision cannot be made without emotion – but they were made only after that emotion had been influenced by analytics.

It is a big obstacle to overcome, but if the value-adding potential of management accounting is ever going to be realized it must be accomplished by the converting users to a more information-driven decision process, not the creation and promotion of new practices.

IMA Detroit's 2017 Spring Management Accounting Conference

On March 16, 2017, the IMA Detroit Chapter will host its 2017 Spring Management Accounting Conference at Laurel Manor in Livonia, Michigan. Much of the conference will focus on this letter's topic and discuss how we can make management accounting work more effectively in the 21st Century. The lineup includes:

Jonathan Citrin – *Human Behavior & Decision Making*
Raef Lawson, Gary Cokins & Doug Hicks – *The IMA's Costing Task Force*
Doug Hicks – *Decision Leadership*
John Daly – *Critical Thinking for Management Accountants*
Ruediger Stern & Martin Voight – *The Better You Are at Costing – The Better You Are at Quoting*
Ed Potoczak – *Emerging Technologies for Reducing Non-Value-Adding Costs*
Doug Hicks – *A 21st Century Framework for Management Accounting*

I'll send along additional information as the time approaches.

As always, I look forward to hearing from any of you who have questions or comments regarding this letter and you should feel free to forward a copy to anyone you believe might be interested (or at least mildly amused).

HAVE A JOYOUS HOLIDAY SEASON AND A HEALTHY, HAPPY AND PROSPEROUS 2017!

Very truly yours,

Doug
Douglas T. Hicks, CPA
President