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Dear Executive:

Although you wouldn't believe it based on the weather here in Metro Detroit, it is springtime and time for me to come out of hibernation and give you an update on what's going on in the world of managerial costing.

The Conceptual Framework of Managerial Costing

Former Institute of Management Accountants' Chair and Executive Director of the Resource Consumption Accounting Institute, Larry White, gave a talk at the IMA-Detroit's 2018 Spring Accounting Conference on "The Institute of Management Accountants' Conceptual Framework of Managerial Costing." Larry began his session by clearly defining four monikers given to sub-sets of accounting that are often misunderstood, misused or simply mistaken for each other:

- Financial accounting – principles established to provide consistent and understandable financial information to investors and creditors in public capital markets that lack the power to demand additional information. Created by social consensus of a standard setting body.
- Cost accounting – a rules and standards-driven tool to support financial accounting in valuing inventories and measuring cost of goods sold whose rules and standards are also created by social consensus of a standard setting body.
- Management accounting – all of the various activities of professional accountants in industry encompassing areas as varied as financial reporting, risk management, planning and budgeting, and **managerial costing**.
- **Managerial costing** – reality-based cost information used to enhance an organization's decision making processes and aid it in achieving its strategic objectives. It's only "rule" is that the cost information provided reflect the economic realities of the decision under consideration.

Academics, consultants and practitioners have tended to describe managerial costing in terms of *methods* that begin with *financial accounting's* expenses and turn them into accurate, relevant and actionable cost information. Unfortunately, managerial costing is not a *method*; not activity-based costing, resource-consumption accounting, lean accounting, throughput costing, standard costing, nor any other such mechanical costing process. Neither is its source of "costs" the expense measurements generated by *financial accounting's* rules and regulations. Instead, managerial costing is comprised of economic cost and operational information processed through a valid operational model of an organization.

There is no one method that fits all organizations. Each method, however, is based some "nugget" of truth that is important to those who espouse that method, but each one fails to encompass the totality of managerial costing. Some work well for supporting financial accounting while failing to prove accurate and relevant information for investment, make/buy, pricing, resource usage, offshoring, process improvement, performance measurement, drop/add or other critical decisions. Others may effectively support process improvements and performance measurement but fail to provide support for other decisions. Effective managerial costing must support all the various types of decisions that must be made to insure an organization reaches its strategic objectives.

Although there is no single method that meets all of managerial costing's needs, there is a conceptual framework within which an effective managerial costing system can be created and maintained. That framework, however, is not very sexy, cannot be explained during an elevator speech, nor can it be encapsulated in an easy-to-use software package. As a consequence, it doesn't have the makings of a profitable product or service to be sold by consultants and software suppliers or a topic likely to result in high speaking fees for academics. With little chance of making a fortune peddling conceptual framework-based products and services, little, if any, attention has been paid to the fundamental structure within which all effective managerial costing must fit.

As a worldwide association of accountants and financial professionals in business with over 110,000 members, the Institute of Management Accountants took the initiative and began the process of "cutting through the managerial costing clutter" that has accumulated during the past three decades, stripping it down to its fundamentals and providing a solid foundation on which effective managerial costing systems can be constructed.

The first step in this process was to create a task force that would research and then author a Statement on Management Accounting (SMA) addressing managerial costing's structural framework. The leaders of this task force were Larry White and Doug Clinton. Larry is a CMA, CPA, CFM and CGFM, Executive Director for the Resource Consumption Accounting Institute, a former Chair of the IMA Global Board of Directors and long-time, high-ranking officer in the U. S. Coast Guard. Doug is a Ph.D., CPA and CMA and the Alta Vista Consulting Professor of Management Accounting at Northern Illinois University. Together with their task force members, they developed the SMA titled "The Structural Framework of Managerial Costing."

The framework is based on two core principles: *causality* and *analogy*. *Causality* (or cause-and-effect) tells us that cost models must clearly reflect the relationship between a managerial objective's quantitative output and the input quantities that must be, or must have been, consumed for the output to be achieved. It should be obvious, even self-evident, that cost models designed to support decision making by managers throughout an organization cannot stray far from this principle. Most managers don't manage money, they manage resources. Causality emphasizes the operational cause and effect relationships and costs must reflect those relationships. *Analogy* is the use of causal insights to infer past or future outcomes. This principle emphasizes the use of logic. It states that information generated from cause and effect relationships must be logically connected to inferences about past performance or future outcomes.

The framework then goes on to delineate the key concepts and constraints that must be considered in creating a causality-based cost model and in using that model to effectively support management decisions. It concludes by outlining eight steps that can be followed to develop appropriate managerial costing for any organization. The SMA can be downloaded by anyone from the IMA's website at: http://operationalincomestatement.com/roi/wp-content/uploads/2016/11/IMA-Conceptual-Framework-for-Managerial-Accounting-Nov-2014.pdf

The Center for Managerial Costing Quality

To further help management accountants and the broader business community recognize and understand the need, the benefits, and a path forward for improving cost information for internal decision support the IMA established a Managerial Costing Task Force. This task force has been given the assignments of:

- Engaging the accounting profession, including accounting educators, and the broader business environment by publishing articles, holding webinars, engaging via social media, making presentations, holding workshops, and developing professional and education content.
- Establishing managerial costing (cost information for internal decision support) as a specific function and discipline within the accounting profession with distinctly different principles and requirements from GAAP and external financial accounting.

Members of this task force include both Larry and Doug as well as Raef Lawson – Vice President of Research and Policy at IMA, Kip Krumwiede – Director of Research at IMA, Gary Cokins – Principal of Analytics-Based Performance Management LLC, Monte Swain – Deloitte Professor at Brigham Young University and, for some inexplicable reason, me.

Since its inception, the task force has been actively working to address the myriad of issue in its charter. To aid in communicating with the business community, it has established a Center for Managerial Costing Quality (CMCQ) with a website (thecmcq.org) that will be the repository for much of its work. Although the website is still under construction and will continue to grow, you are welcome to visit it at any time.

In the pipeline are SMAs on evaluating the level of a managerial costing system's sophistication and an outline for developing an appropriate managerial costing system for your organization, as well a quick assessment tool for managerial costing systems, articles slated for IMA's monthly periodical *Strategic Finance* and many other tools to aid in developing and using managerial costing information. In addition, we have been reaching out to other professional and trade organizations to get them involved in demanding quality managerial cost information and then using it effectively in supporting their decisions.

A recent success in this area is our partnering with APICS to conduct a survey on "Working Together to Enhance Supply Chain Management with Better Costing Practices." Subsequent to its initial press release, the APICS report on the survey was picked up and published by nearly dozen other organizations. You can read APICS press release at http://www.apics.org/about/overview/apics-news-detail/2018/01/31/study-reveals-need-for-more-accurate-costing-information-in-supply-chain.

Stay tuned for additional information on the CMCQ and its activities.

Yeah, I know our cost information is inaccurate and misleading, but….

And now, for one of my "rants."

Management accountants are generally aware that their current costing practices do not reflect the basic economics that underlie their organization's operation. This fact was made clear in 2003's Ernst & Young (E&Y) / Institute of Management Accountants (IMA) "Survey of Management Accounting" which revealed that 77% of financial executives were dissatisfied with their company's decision support information and 38% believed it to be significantly distorted. A follow-up survey in 2013 indicated that there had been little or no change to those attitudes in the intervening decade. The cost of critical processes continue to be buried in large, general pools of expenses that are assigned to products, services and customers using a "driver" – often direct labor – that fails to link those costs with their causes. Not only does this result in inaccurate product, service and customer costs, but it makes the cost of those processes invisible as they get buried in general pools along with all of the organization's other processes.

Despite recognizing the deficiencies in their costing practices, management accountants are reluctant to take on the task of solving the problem. Both the 2003 E&Y/IMA survey and its 2013 follow up revealed that, despite their understanding of the problem, less than 20% planned on doing anything to solve it. The reasons for this apathy toward improving managerial costing practices are many. Here are some of the most commonly heard excuses together a discussion of their validity:

"Our management is happy with our current practices and haven't directed us to change."

If you were the navigator on a sailing ship and knew that your navigation instruments were miscalibrated, wouldn't you think it important to let the Captain know and take steps to make sure they're calibrated correctly? Failure to do so would result in the Captain basing decisions on the inaccurate navigation information that you knowingly provided; decisions that could put the ship and crew is serious jeopardy.

A management accountant is the navigator of an organization; he or she provides the measurements that indicate where the company has been, its current condition and the impact its decision makers' choices will have on the organization's financial future. If those measurements are based on tools that are miscalibrated, decision makers will be provided with inaccurate information; information that will seriously affect their ability to make quality decisions.

Management relies on the management accountant to provide accurate, relevant and actionable cost information. Executives have too many other responsibilities to expect them to keep up-to-date on the development of new, more appropriate managerial costing practices. It is the management accountant who is responsible for keeping management appraised of the quality of the cost information they use to support decisions, make them aware of the negative impact current costing practices can have on the organization's success, and champion the effort to bring the organization's costing practices in line with its economic and operating realities.

A management accountant does not simply provide executives with the information <u>they request</u>; that is the job of the standard-issue, garden-variety accountant. Management accountants are professionals who provide executives with both the information <u>they need</u> and an understanding of how that information can be used to enhance the quality of their decisions.

"Changing our cost accounting system would be a major undertaking involving hundreds of man-hours and thousands of dollars in software costs."

While it is true that many organizations have chosen to adopt more appropriate costing practices by implementing a new day-to-day cost accounting system, it is a choice they have made – not a requirement. Cost accounting is a subset of managerial costing designed to comply with historical financial accounting's very general and minimalistic rules and regulations, not to drive management decisions. Costing to support decisions must be much more granular and reflect the fundamental economics and causal relationships that underlie the organization's operations.

Many organizations have adopted more effective decision support information by developing a conceptually valid, causality-based cost model of their business and then creating the necessary computational tools using Excel or cost modeling software. These tools then allow them to generate accurate and appropriate costing rates, product or service cost estimates and "what if?" analyses for capital expenditure, drop/add, and sourcing decisions as well as identify the firm's major cost drivers, high-return areas for process improvement and accurately measure product and customer profitability. And they do all this without changing the organization's day-to-day costing system.

The "major undertaking" required to repair invalid and ineffective costing practices has nothing to do with software, hardware or systems; it is the intellectual undertaking required to effect changes in the perspectives and attitudes of both users and providers of cost information. Turning the new perspectives and attitudes into actionable "numbers" is the easier task.

'If we're the only ones in our industry to adopt more accurate and relevant managerial costing practices, we might quote higher prices on some of our products and lose the business to competitors."

So, what's the problem here? Product or service cost does not determine the price a company can charge, it determines how profitable the work will be if it is sold at the market price. A higher price may be necessary to meet the company's profit target, but – if you want the job for some strategic reason – you can always meet the market's lower price; you will just be <u>knowingly</u> accepting a job that does not meet your profit target. Without accurate cost information, you may win the job <u>in total ignorance</u> of its sub-par profitability and tie up valuable capacity on a job that does not generate an acceptable return.

There are valid business reasons for accepting work at low – or even negative – margins provided you do it on purpose. You do not, however, want to do it by accident. Winning work that was unknowingly under costed by invalid cost models has led to the underperformance – and even failure – of many organizations. Knowing product or service cost based on a valid cost model of the business enables management to make informed pricing decisions. You might even find that you can charge lower prices, win contracts and earn your target profit on jobs you would have overpriced using an invalid cost model.

The key concept to understand is, "Cost does not determine price; it determines the desirability of business at the price required to win the business." A cost model that reflects the economic and operational realities of the business is a prerequisite to making that measurement of desirability.

"We're profitable, so why does it matter?"

Ignorance is bliss! In the 1960s, domestic auto makers thought "we're profitable, so why does our mediocre quality matter?" In the 1990s, brick-and-mortar retailers thought "we're profitable, so why does the internet matter?" Complacency is the first step toward failure. As novelist Joyce Carol Oates observed, "*The great menace to the life of an industry is industrial self-complacency.*" A 21st Century organization that relies on an early- to mid-20th Century cost model for the information on which it bases critical business decisions may soon find itself on a slippery slope that leads to underperformance and, in the worst cases, failure. It may not show up in today's financials, but it will in tomorrow's.

Consider the following cases of profitable companies that were complacent with their invalid cost model:

- A 30-year-old, consistently-profitable manufacturer of servo valves for the aerospace industry lost its most profitable business when several of its customers resourced products that had been over costed by its outdated costing model and, therefore, overpriced. Within five years, all of the company's manufacturing activities had ceased and it became a service firm supplying engineering services.
- A 70-year-old, consistently-profitable precision gear manufacturer's cost model over costed its labor-driven manufacturing activities while under costing those manufacturing activities whose costs were equipment-driven. The company eventually lost almost all of its assembly work – work that was overpriced and highly-profitable due to the company's outdated cost model – while it retained its machining work – work that was underpriced and unprofitable due the cost model's

deficiencies. Despite these business losses, the company continued to rely on its outdated cost model's for decision support information. The company went out of business within 10 years.

But not all companies are so complacent:

- A profitable forging company developed a valid cost model and used information relating to in-process movements, die changeovers and product costs to increase its profits by over 500% in four years.
- A profitable manufacturer/distributor developed a valid cost model and used information relating to order fulfillment to adjust its discount policies and modify customer behavior resulting in a 50% increase in profitability.
- A stamping company developed a valid cost model and used information relating to product line profitability to downsize by 33% and double its profits in less than a year.

Just because a company is profitable today does not mean: 1) it is not leaving a lot of money "on the table" or 2) it is going to be profitable tomorrow.

Cost information is a key factor in almost every business decision. When the quality of that cost information is poor, it leads to poorly informed decisions which lead, in turn, to underperformance. In today's highly competitive, worldwide marketplace, quality cost information is a key factor in determining which organizations thrive and which simply struggle to survive.

I hope spring comes soon to your area and that you're 2018 has started out profitably. 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).

Very truly yours,

Doug
Douglas T. Hicks, CPA
President