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Dear Executive:

It's been a little over a year since I last sent out one of my executive letters. I've been subjecting readers of these letters to my observations, opinions and frequent rants about management accounting topics for nearly a quarter century (I remember all the envelope stuffing and stamp licking when we began sending them in the mid-1990s – thank goodness for e-mail), but age must have mellowed me since I no longer feel the need to 'blow off steam' through these letters every quarter. On the other hand, I haven't completely 'dropped out' and am still spending my days (as well as some nights and weekends) working to get managerial costing practices out of the dark ages and into the 21st Century. I figure that as long as I'm still at it, I ought to keep readers posted at least once each year.

Center for Managerial Costing Quality

In my Spring 2018 letter I mentioned that the Institute of Management Accountants' established a Managerial Costing Task Force – which has since evolved into the Center for Managerial Costing Quality (CMCQ) – to serve as an instrument for helping 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 six members of the group are Raef Lawson – Vice President of Research and Policy at IMA (Chairman), Larry White - Executive Director at Resource Consumption Accounting Institute, 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 yours truly.

We've been working on many different fronts, from reaching out to professional groups that represent individuals who rely on cost information in performing their duties to providing resources for those who wish to adopt more effective costing methods. Those efforts take on many forms; some simple and some complex. For example, to raise awareness of the costing problem among users, we've created a "**Bill of Rights for Users of Managerial Costing Information"** that goes as follows:

> ***Definition:*** *Managerial costing supports the decisions of managers and employees trying to optimize the use of their organization's resources. All managers and employees should be provided managerial cost information that:*
>
> 1. *Clearly reflects the causal operational relationships of resources, their capacity and the processes that rely on those resources*
> 2. *Calculates and reports reasonably accurate costs of processes, products, service lines, channels and customers*

3. *Provides information on the drivers causing the consumption of the resource expenses.*
4. *Reflects the economic realities of the decision at hand, not hindered by external regulatory accounting rules*
5. *Is consistent with the organization's creation of long-term sustainable value or the long-term execution of the organization's mission*
6. *Doesn't create argument and debate about its usefulness and accuracy*
7. *Is readily available, provides transparency, and is efficient to analyze to obtain insights*

Resolution: *Decision making is challenging in all circumstances. Those entrusted with making an organization's decisions must demand that those providing costing information for decision making honor these rights that are essential to effectively perform and execute their responsibilities.*

Does the information you currently receive meet these requirements? If not, talk with your organization's accountants and demand your rights! By working together, and getting the information you need, you will be better able to do your job and help your company achieve its goals.

The phrase "talk with your organization's accountants and demand your rights!" implies that accountants are the problem; or at least a big part of the problem. Although that's something you've been hearing from me for more than two decades, my influence was not the basis for the tenor of that statement. It was the input of supply chain professionals.

As part of our outreach to users of cost information, the CMCQ partnered with APICS to conduct and then publish the results of a survey of upper management supply chain professionals to assess the impact of issues related to costing systems and practices. In speaking of the report's findings, APICS CEO Abe Eshkenazi stated, "Supply chain professionals rely on cost information when making decisions, but have indicated a need for that information to be more accurate and effective. This report highlights the necessity for supply chain and finance departments to work more closely and adopt costing practices that are progressive and focused on informing internal decisions."

The report identifies three root causes of why supply chain professionals are not receiving adequate costing information:

1. **An overreliance on external financial reporting systems:** Many organizations rely on externally-oriented financial accounting systems that employ oversimplified methods of costing products and services to produce information supporting internal business decision making.
2. **Using outdated costing models:** Traditional cost accounting practices can no longer meet the challenges of today's business environment, but are still used by many accountants.
3. **Accounting and finance's resistance to change:** With little pressure from managers who use accounting information to improve data accuracy and relevance, accountants are reluctant to promote new, more appropriate practices within their organizations.

So you see, it's not just me. You can download the APICS survey's report from:
www.apics.org/docs/default-source/industry-content/ima_costing_survey_reportv5.pdf?sfvrsn=6

Developing an Effective Managerial Costing Model

We've also been developing tools to help those who do want to improve the quality of their organization's managerial costing information. Among these tools are several Statements on Management Accounting (SMAs) issued by the IMA. Although the process of having six "experts" – each with a unique background and perspective – agree on the content, structure and wording of a 30-40 page SMA and then getting it all through the IMA's editors can be quite time consuming, the IMA has recently issued our Statement on Management Accounting (SMA) that focuses on effective cost modeling – the foundational element that most determines the ability of cost information to support the organization's decision making needs. It describes a six-step methodology that organizations can use to develop a costing model appropriate for their specific needs. Each step is explained in detail and illustrative case examples are provided to help understand the process. You can download a copy of this SMA titled **"Developing an Effective Managerial Costing Model"** from IMA's website at:

https://www.imanet.org/insights-and-trends/strategic-cost-management/developing-an-effective-managerial-costing-model?ssopc=1.

Costing System Attributes that Support Good Decision Making

Another SMA in the development stage is one tentatively titled "Costing System Attributes that Support Good Decision Making." The purpose of this SMA is to provide a practical evaluation tool for assessing or developing managerial costing for internal decision support. The primary uses of this SMA will be:

1. To assess the level of internal decision-support cost information needed from each of the 10 cost modeling concepts to enable managers to meet their organization's goals and objectives.
2. To evaluate an organization's current managerial costing capability and identify areas of cost modeling it should enhance to improve decision-support information.
3. To evaluate managerial costing solutions, such as software and methodologies, to see if they match an organization's information and decision-making needs.

We hope this SMA will be published by the end of this year.

Both of these SMAs build on the foundation provided by the "**Conceptual Framework of Managerial Costing**" issued by the IMA in 2014. Much of my Spring 2018 letter covered this important document. A copy of "the Framework" SMA can be found at:

http://operationalincomestatement.com/roi/wp-content/uploads/2016/11/IMA-Conceptual-Framework-for-Managerial-Accounting-Nov-2014.pdf.

Profitability Analytics

The last CMCQ initiative that I'll mention is an effort to move the focus of accountants in industry from "management accounting" to "profitability analytics;" a new perspective on financial planning and analysis (FP&A) that recognizes the importance of traditional accounting tasks such as financial reporting, record keeping, and cash management but focuses most of the attention on the developing areas of nonfinancial and financial data analytics and modeling that support the building of robust forward-looking scenarios and analyses based on causality.

Two of our CMCQ members, Raef Lawson and Larry White, recently penned an article promoting Profitability Analytics that was published in the July issue of *Strategic Finance*. The article can be found at:

https://sfmagazine.com/post-entry/july-2019-profitability-analytics/.

Managerial Costing for Buyers, Estimators and Engineers

Mastering managerial costing principles and practices was not the focus of most business executive's education (for that matter, it wasn't the focus of most accountant's education) and keeping up-to-date on the advances in those areas has probably not been very high on most of their continuing education priority lists. Even when it has, most of the courses available simply rehash much of the same oversimplified information taught in financial accounting classes, propagate ancient industry myths about costing or focus one of the "fad" costing methods that only addresses a small section of the managerial costing spectrum; they do not provide the kind of down-to-earth, practical information supply chain executives can use to help facilitate the "transparent and collaborative" supply chains they seek to establish.

> Although 21st Century systems and technology are being used to process data, most cost-related data is still being processed through unsophisticated, early-20th Century cost models; models that view all costs as either direct material, direct labor, burden or "G&A." Although such models were proven to be inaccurate, uninformative and misleading decades ago, they continue to be the basis for critical cost-related discussions and negotiations between buyers and sellers all along supply chains.
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> The most advanced and sophisticated costing or ERP software will not provide users with accurate and relevant cost information if that software encompasses an invalid cost model. It will only be more efficient at providing the user with inaccurate cost information – information with which they will be very confident because it came from an advanced and sophisticated system.
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> To recast a presidential campaign motto from 1992 – **"It's the cost model, stupid"**

To address this situation, D. T. Hicks & Co. has developed a two-day course titled "Managerial Costing for Buyers, Estimators and Engineers" – three groups in the supply chain who rely extensively on cost information – based on my four decades of experience as a controller, consultant and thought leader in the managerial costing community. Although accounting and finance professionals can benefit from this course, it has been designed specifically for supply chain professionals. An outline of this two-day session is attached to this letter.

If you are interested, the course is available as both in-house training and as a public course. The public course is sponsored by FACTON – a leading enterprise product costing software provider – and is scheduled for three sessions this fall. You can learn more about and register for these public sessions at www.facton.com/en-us/ces. If you would like information about holding this as an in-house course, you can contact me directly by e-mail at dohicks@aol.com or by phone at 248.761.3706.

I hope you're having a great summer. 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

Managerial Costing for Buyers, Estimators and Engineers

D. T. Hicks & Co.

Course Outline

DAY ONE

I. Introduction
   A. Course Objectives and Design
II. A Brief History of Cost Accounting
   A. Key People and Events from 1772 through 2019
III. Cost Accounting vs. Managerial Costing
   A. Definitions
   B. Taxonomy of Accounting
      1. Managerial costing's disassociation from financial accounting
IV. The Framework of Managerial Costing
   A. Causality - using causality to create a model of the enterprise
      1. The impact of using a non-causality-based cost model
      2. A general outline for a supplier's causality-based model
   B. Analogy – using the model to simulate costs under different decision scenarios
      1. Different Costs for Different Purposes
   C. The "Framework" vs. The "Methods"
      1. The Blind Men and The Elephant
      2. The Managerial Costing Elephant
V. Some Fundamental Concepts
   A. Hicks' First Law of Pricing
   B. "Precise" vs. "Accurate" Cost Information
      1. Oxenfeldt's Rule
   C. Accuracy Without Exertion
      1. Complexity vs. Simplicity
      2. Using "weights" for accuracy without complexity
   D. The Production Labor Demand/Supply Equation
      1. The Indirect Activity Allowance
VI. Designing/Evaluating a Supplier's Cost Model
   A. The Causality Principle for Work Activities
   B. A Cost Model for Manufacturing
      1. Throughput and Direct Cost Support Activities
      2. Direct and Value-Adding Activities
         a. Segregation of labor and equipment costs
      3. Event and Transaction Activities
      4. Market or Customer "Attributable" Activities
      5. Product or Product Line "Attributable" Activities
      6. General and Administrative Activities
      7. Unused and Invested Activities
   C. Causality-Based Cost Distributions and Assignments
V. Case Study
   A. Forge & Machine, Inc.

Managerial Costing for Buyers, Estimators and Engineers

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Course Outline

DAY TWO

VI. Diving Deeper Into a Supplier's Cost Model
- A. Direct Assignment of Activity Costs
- B. Driver-Based Assignment of Activity Costs
- C. Equipment Uptime's Chain Reaction
  - 1. How changing "uptime" changes almost everything
- D. Non-Production Labor
  - 1. Using the Production Labor Demand/Supply equation to project non-production labor needs
- E. Distribution of Costs Among Activities
  - 1. Statistical bases
  - 2. Estimates based on activity analysis
- F. Assigning Costs to Purchases of Direct Materials and Services
  - 1. Special issues related to "reclaiming" raw materials
- G. Assigning Production Costs
  - 1. Labor-Related Costs
    - a. Skill categories
    - b. Contract labor
  - 2. Equipment-Related Costs
    - a. Creating Capability Pools
    - b. Cells and Lines
      - (i) "Fugacious" Manufacturing Cells
    - c. Muti-Use Equipment
    - d. Feature Costing
- H. Assigning Event/Transaction Costs
  - 1. Using "Weighted" Events
  - 2. Program Launch/Engineering Change Costs
  - 3. Die Cycle Costs
- I. Assigning "Attributable" and G&A Costs
  - 1. Percentage "Tack On" Issues

VII. Product Value Measurement
- A. Profit % of Sales vs. Profit % of Value-Added

VIII. Cost Measurement
- A. Economic Costs vs. Accounting Costs
  - 1. Recovering costs vs. pre-covering costs
- B. The Deadly Virus of GAAP
  - 1. Accounting's periodicity problems and cost measurement
- C. Major Manufacturing Cost Measurement Issues
  - 1. The Irrelevance of Depreciation Expense
    - a. The Capital Preservation Allowance
  - 2. The Omission of a Cost of Capital

IX. Putting it Together – Small-Time Manufacturing
- A. An Excel-based model that incorporates many of the concepts and techniques discussed during the course.

X. Conclusion and Wrap-Up