THE FOUNDATION OF TRUTH IN MANAGERIAL COSTING

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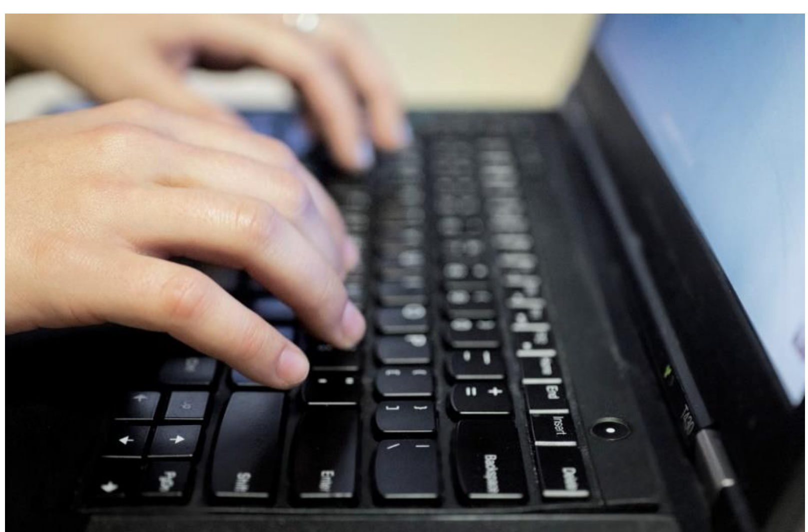

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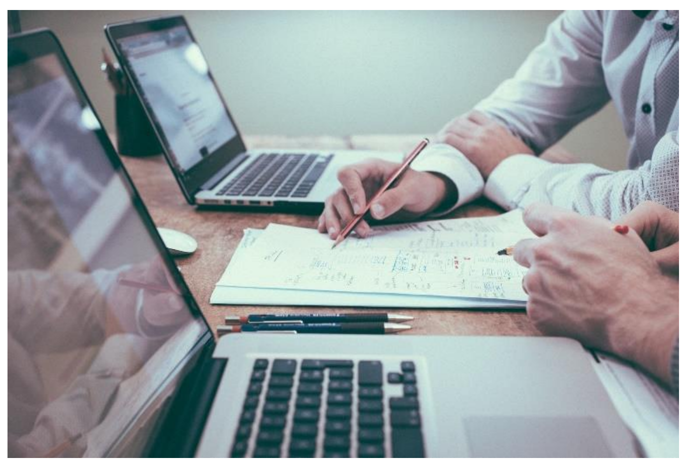
Introduction

Any management accountant can spot a wayward cost allocation from a mile away; in fact, every manager can, particularly when it looms large on a cost report with no clear causal relationship to the output. The claim that managerial costing must be based on a foundation of truth captures this reality. This foundation of truth will be our focus here.

"There are wrong ways to do costing, and therefore there must be better ways to provide decision-support information."

Just as scientists follow the scientific method and its principles so too do we follow the principles for managerial costing. These principles—causality and analogy—enable us to deal with causes and their effects in different time frames and with that enable a better understanding of events in the past.

While managerial costing is not a science in itself, it supports decision science with the information it gathers, and decision science *is* a science.



Managers make inferences about future outcomes of decision alternatives based on cause and effect insights.

Cost information, therefore, needs to be compiled using principles that support managers' application of decision-science practices.

However, a healthy dose of caution should accompany any insistence on absolute truth in managerial costing: one can be off by mere pennies and reflect a profitable customer or product as unprofitable. The world is just not that simple and in practice defies such outright idealism.

Therefore, the first order of business is to define what is meant by the following statement: Truth is the foundation for managerial costing. We will explore this first by pointing out what the statement does not mean, followed by a more in-depth discussion of what it does mean.

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The Ultimate Objective is Not Precision

In line with this caution, the first objection we commonly encounter on the topic of truth in managerial costing is; “To consistently obtain an absolutely truthful number in managerial costing is cost-prohibitive, if not impossible.” Without fear of contradicting our assertion we agree: an absolutely precise cost number is often an unrealistic objective.

Accuracy is a constraint of managerial information and not the overarching objective. The degree to which the precision and accuracy criterion can be satisfied will vary based on a variety of factors. For example, for a company with very thin margins, a highly competitive environment, and a diverse product portfolio, accuracy will be more important than for a company with 80% gross margins and very little competition. Other managerial costing tools allow ample room to evaluate degrees of accuracy, and the principle of analogy guides the management accountant toward management’s decision support needs.

For example, a customer who is only marginally profitable or marginally unprofitable is almost always unwanted. Neither the capital markets nor the entrepreneur seeking ample reward for the risk taken tolerates a business that squeezes out a profitability measured in decimals.

The reality is that managers do not need an absolutely precise number to select the optimal outcome from among the alternatives under consideration.

Moreover, the objection conflates truth with meticulousness in managerial costing. Truth is the foundation for managerial costing and not an idealistic and precise number that must be achieved at all cost and at all times.

The reality of imprecision or the degree of accuracy achieved in managerial costing is not an argument against truth in managerial costing. Instead, the principles guide cost model design towards information that is more representative of the underlying absolutely accurate cost number. This is due to the inherent recognition of truth as the foundation for managerial costing, and not as the explicit objective. When it comes to accuracy, it is better to be approximately right than completely wrong in a very precise manner. To put it in an elementary way: 4 arrows on the target beats 4 arrows in the same spot in the ground.

The Meaning of Truth as the Foundation

Having identified what truth does not mean as a foundation for managerial costing, it is important to define what is meant by truth as a foundation for managerial costing.

➢ Tying Truth to the Essence of Managerial Costing

First, it means recognizing the essence of what managerial costing sets out to achieve. That is, it is a discipline that provides managers with insight into their operational resources, their consumption, and their outputs in monetary terms. This information is essential for various processes and to achieve an organization's strategic objectives

The representative nature of managerial costing information is paramount for two reasons: (1) it highlights how managers use managerial costing information, and (2) it points to an appropriate definition for truth in managerial costing. These two aspects are discussed in the next two sections.

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The Meaning of Truth as the Foundation

➢ The Laws of Logic

Managerial costing communicates to managers the state, capabilities, application, and outputs of an organization's resources in monetary terms. As with all communications, certain ground rules apply. These rules ensure the information communicated is logical and understandable. For example, consider the statement:

"We are going out of business because of a superseding technology; therefore, we will be investing $5 million in the old technology."

Also, consider the following:

"We sold zero of Product 123 last month, but our gross sales for Product 123 last month was $1 million."

The need for the managerial cost model to not violate any of the laws of logic is obvious; managers cannot and should not be misled or misguided in their attempts to understand the financial implications of a particular decision alternative or operational outcome. Managerial costing is a crucial tool in the manager's toolbox that aids them in their optimization endeavors.

Ex. #1 – "We are going out of business because of a superseding technology; therefore, we will be investing $5 million in the old technology."

Ex. #2 – "We sold zero of Product 123 last month, but our gross sales for Product 123 last month was $1 million."

These examples each violate one of the two laws of logic that underlie managerial costing's ability to provide accurate reflective insights to managers.

The first example violates the law of rational inference: That is, the reasoning is simply irrational.

The second example violates the law of non-contradiction: That is, the first part of the statement is contradicted by the second.

For example, managers often observe a result, such as an unprofitable product, and attempt to understand the reason or cause behind it (i.e., managers reason inductively from an effect to its cause). Or in decision making, managers evaluate a number of alternatives and select the one with the optimal outcome (i.e., managers reason deductively from the cause (decision) to its effect).

The Meaning of Truth as the Foundation

This understanding of how managers use cost information crystallizes what it means for the cost model to represent operations. Managerial costing must reflect operational cause and effect relationships and express them monetarily to support managers' inductive and deductive thinking processes. These processes include all aspects of planning, analysis, control, simulation, and decision making.

The law of rational inference (i.e., the relation between a cause and its effect) determines the structure of managerial costing information, and it is embodied in the principle of causality. This is how far the law of rational inference will take us in demonstrating managerial costing's foundation of truth. It falls to the law of non-contradiction to anchor managerial costing to the bedrock of truth.

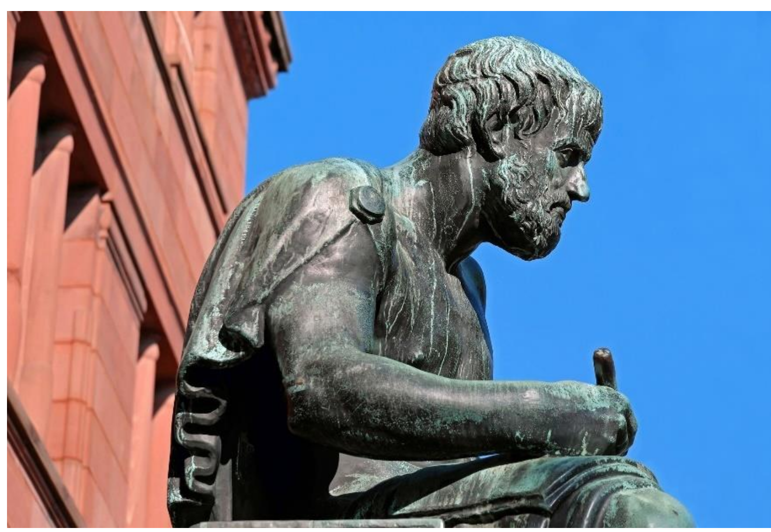
➢ The Foundation for Managerial Costing

In presenting managers with cause and effect insights, managerial costing should provide financial information that accurately reflects the reality (the operational facts) that managers seek to understand and change. The requirement is simply this: Cost information must be a true reflection of the underlying operational facts.

In epistemology (the branch of philosophy that deals with the theory of knowledge) such a definition of truth has existed for more than two millenniums. Aristotle (384–322 BC) is credited with the correspondence definition of truth:

"To say of what is that it is not, or of what is not that it is, is false; while to say of what is that it is, and what is not that it is not, is true." [1]

-Aristotle



This definition comes across as verbose, but it can be more succinctly expressed as "telling it like it is." A modern version of the correspondence definition of truth is: a statement or opinion is true if what it corresponds to is a fact.[2]For managerial costing, this means the information it provides corresponds to the facts of the operations. The law of non-contradiction, exemplified in the correspondence definition of truth, anchors managerial costing to a bedrock of truth.

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The Meaning of Truth as the Foundation

The recognition of the need for truth is so fundamental that it often goes without saying. Above, we have used a philosophical basis (two of the laws of logic) to show that truth in managerial costing is indispensable. But one finds truth permeating the profession throughout its history. For example, in the early 1900s, Church wrote about managerial costing:

> **“It is very important that costs should not be regarded as something that may be manipulated, nor should they be thought of as representing anything but the cold truth, however unwelcome that may be.”[3]**

A concerted effort in the 1940s and 1950s by the Committee on Cost Accounting Concepts and Standards (CACS) to define principles for management accounting culminated in a number of principled statements. CACS recognized that

“the cost accountant was concerned not merely with the presentation of facts, but his objective was, in so far as possible, a presentation of the truth of the facts.”[4]

In the current business environment, truth finds an even more forceful application in accounting generally. For example, when CEOs and CFOs certify a company’s financial statements—for which managerial costing provides key inputs—with the declaration that the information “does not contain any untrue statement” and is “not misleading” and “fairly represents... The financial position,” truth can hardly be more in the forefront.[5]

The law also ties clear punitive consequences to any misstatements (untruths) in accounting information. The basis of truth upon which C-level executives are prosecuted and imprisoned (as has happened) is in plain view and recognized by all.

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Objections to Truth

As fundamental and necessary as truth is to managerial costing, it could be argued that objections border on the bizarre and should be summarily dismissed. However, answering a number of common objections to truth as managerial costing's foundation serves three purposes:

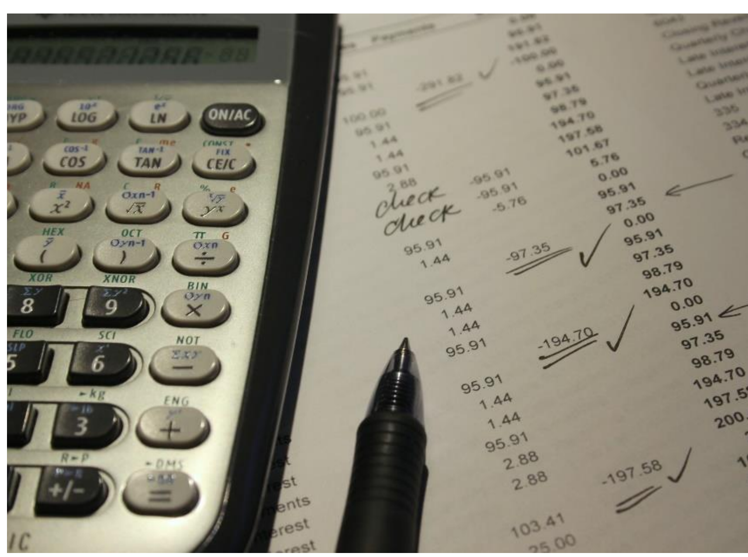
(1) to better understand truth in managerial costing,

(2) to clarify truth's application in managerial costing, and

(3) to preemptively defend truth as the foundation by pointing out weaknesses and fallacies in common objections. For these reasons, this section will address a number of commonly encountered objections.

- **The Highbrow Objection**
- **The Subjective Agent Objection**
- **The Ruse Objection**
- **The Dumbing Down Objection**
- **The Stifling Objection**
- **The Progression Objection**
- **The What Works Objection**
- **The Feel Good Objection**

The objections to truth as the foundation of managerial costing span the gambit. They include a highbrow disdain for truth in general, confusing the subjective nature of the agent in managerial costing (i.e., the management accountant) with the profession's overarching objective, and perpetuating cultural relativism. The latter refers to the denial that absolute truths exist at all. We will address all of these on the following pages.



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Common Objections:

- ***The Highbrow Objection***: "Insisting on truth as the bedrock of managerial costing is pious, arrogant, and hypocritical." On the contrary, acknowledging—as the bedrock of truth does—that there is something bigger to managerial costing than each of us, or even all of us, is humbling. It is the exact opposite of arrogance, highbrow piety, and hypocrisy to admit that the best we can do is strive to attain an accurate reflection of operational cause-and-effect relationships. In this regard, the managerial costing framework acknowledges the many compromises required in applying its concepts and constraints.

- ***The Subjective Agent Objection***: "Accountants are subjective 'constructors of reality' presenting and representing the situations in limited and one-sided ways."[6] In other words, the notion of truth in managerial costing is indefensible since each management accountant brings her/his own biases, preferences, and motivations to model construction. The subjective nature of the agent is no doubt the case, and this is one of the aspects that the managerial costing framework seeks to address. The subjective agent aspect inherent in managerial costing is a prime reason for having a framework with a clear foundation based on truth and corresponding principles. This is not an objection; it is an affirmation!

- ***The Ruse Objection***: "Truth in managerial costing is a ruse since everything is based on assumptions." This objection usually surfaces with cost estimates or other predictive uses of cost information. The objection itself, of course, is a ruse because much concrete, factual information is known about the organization's resources, their capabilities, the products and services, and related strategic objectives. Such known facts form the basis upon which assumptions are logically formed; no manager will be tolerated for assuming they were in the bread business, and purchased tons of flour when the company has been solely focused on making computer chips right under his nose for 15 years. Assumptions require a basis of truth and a causal structure to produce useful predictive information. Like the previous objection, the ruse objection is an argument for cost information based on truth and logic.

- ***The Dumbing Down Objection***: "Truth cannot be absolute because knowledge is ever growing and expanding." Or, what is true today may be false tomorrow. For example, activity-based costing (ABC) broke the standard costing truth-mold and revealed the pitfalls of assigning indirect costs based on volume. This objection fails to note that it is not the truth that changed but our understanding of it. ABC's insight was not a case of moving from an old truth to a new one; it was instead forsaking an old error for a more complete insight into an existing truth.

Common Objections:

- ***The Stifling Objection:*** "Adopting an absolute truth perspective stifles progress and innovation." However, knowledge expands on the back of truth. As the ABC example shows this objection has no leg to stand on. Adopting an absolute truth view does not prevent new facts from being uncovered nor more complete insight into the truth. On the contrary, truth provides a foundation for critical evaluation and real progress.[7]

- ***The Progression Objection:*** "Costing approaches are not equals, but merely stages in the development to a mature/ultimate solution." The fact that pundits do not readily admit the inferiority of their respective approaches should not be lost on the reader. Moreover, when it comes to costing solutions, managers (the clients) seem to have lost interest as they have grown confused. The many methods and claims concerning costing solutions must appear to them not as progress but as endless spin. Nevertheless, this objection has merit insofar as it affirms that a mature/ultimate solution can be known. As illustrated above, truth in costing provides the foundation and structure for understanding the path toward a mature/ultimate solution and the compromises in striving for such a solution.

- ***The What Works Objection:*** "You take what works for you and I will take what works for me."[8] This is an objection predicated on relativism in which people attempt to come to terms with the anomalies in a relativist culture by adopting the pragmatic view of truth. The problem is that dishonesty has been known to work for those who don't get caught; it even works to fudge the numbers for the company's financial statements. Obviously what works is not the same as what is true or right.

- ***The Feel Good Objection:*** "Just do what you feel is right, or just do what makes you feel good." This is another relativist reduction of truth. However, the consequences of such a subjective view in a discipline like managerial costing (where objectivity is essential) should be sufficient to severely discount this approach. Even the term "discipline" seems to imply a contradiction here. The complete disconnect between "what feels good" and truth is illustrated by the fact that bad financial results do not make the executive or the management accountant feel good but are nevertheless true.

Disadvantages of the Relativist View in Managerial Costing

As stated above, relativism is the opposite of acknowledging the existence of truth. At a very fundamental level, relativism's claim that there are no absolute truths precludes its own claim from being true. That is, the relativist's truth refuting claim needs itself to be true and so it violates the law of non-contradiction discussed earlier.

Relativism is self-defeating and, as an alternative to the bedrock of truth, generally, it is scoffed at in epistemology.[9] In its managerial costing disguise, relativism fails for the same reason; one cannot claim that there is no single right costing approach while in the same breath establishing an approach that considers all views valid.

Going beyond the pure philosophical argument against relativism, the following are undesirable consequences that result from applying the relativists view in managerial costing:

1. Ambiguity, confusion, and frustration are the order of the day. *If anything goes, nothing gets done.*

2. If there is no standard or truth, on what basis are rogue theories challenged? Relativism not only allows for a cacophony of contradicting theories and practices but there is no way to right the ship as long as it is deemed en vogue.

3. The frequent bias resulting from those protecting vested interests causes the discourse within the profession to swing wildly from factual statements to character assassination.

4. If there is no truth, there is also no lie—no error. A manager can confuse operational costs (fixed and variable) with decision cost concepts (unavoidable and avoidable) all day long and be none the wiser for it—ever.

5. Real progress is stifled under relativism; practitioners cannot see the forest for the trees to identify causes worthy of further pursuit. And, critical thinking—a key ingredient to progress—is diminished. Who is to say that any one approach is better than any other?

6. The lack of a recognized common frame of reference makes effective communication with those looking in from the outside (i.e., managers) difficult.

7. Management accountants are not able to make a convincing case for and demonstrate how they add value to the enterprise beyond the limited application established in standards for financial reporting.

Citations

[1] Tom Morris, Philosophy For Dummies, Hungry Minds, Inc., New York, N.Y., 1999, p. 46.

[2] Peter A. Angeles, The HarperCollins Dictionary of Philosophy: In-Depth Explanations and Examples Covering Over 3,000 Entries, Harper-Collins Publishers, Inc., New York, N.Y., 1992, p. 317.

[3] Alexander Hamilton Church, “Production Factors in Cost Accounting and Works Management,” The Engineering Magazine, New York, N.Y., 1910, p. 37.

[4] L.J. Benninger, “Development of Cost Accounting Concepts and Principles: Role of the Committee on Cost Accounting Concepts and Standards,” The Accounting Review, January 1954, p. 35.

[5] The Sarbanes-Oxley Act, 2002, Section 302-2.

[6] Gareth Morgan, “Accounting As Reality Construction: Towards a New Epistemology for Accounting Practice,” Accounting Organization and Society, 1998, p.478.

[7] Tom Morris, Philosophy For Dummies, Hungry Minds, Inc., New York, N.Y., 1999, p. 103; “Truth is the raw material for creativity.”

[8] Peter A. Angeles, The HarperCollins Dictionary of Philosophy: In-Depth Explanations and Examples Covering Over 3,000 Entries, Harper-Collins Publishers, Inc., New York, N.Y., 1992, p. 317.

[9] Tom Morris, Philosophy For Dummies, Hungry Minds, Inc., New York, N.Y., 1999, p. 47.

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About

Alta Via Consulting is a niche service provider in the areas of management information, decision support and advanced cost management with the aim to better enable the management processes of planning, control, analysis, and corrective action for an organization to optimally achieve its strategic objectives.

Alta Via is a services firm who empowers our clients with deeper operating insights leading to greater operating profits.

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With skilled resources located across North America, Europe and Sub-Saharan Africa you will always find resources for your key projects.

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