MANAGEMENT ACCOUNTING PHILOSOPHY I: GAPING HOLES IN OUR FOUNDATION

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The first in a three-part series, this article highlights the problems in management accounting before identifying the root cause and pointing to the first step to recovery.

For most of the 20th century the management accounting (MA) profession in the U.S.stagnated. The mid-1980s ushered in a period of explosive growth in tools, theories, and approaches. This development unfortunately also fueled infighting and bickering across self-erected fences within the profession. The lack of disciplined fundamentals to guide learning resulted in MA, already besieged by the demands of compliance reporting, drifting further away from its customers—managers. [1]

Research reveals an alarming degree of indifference by managers towards MA. It will take a concerted effort by everyone in the profession to drag MA back from the brink of extinction in the boardroom. Fortunately, there is growing recognition of the need to “sort out the clutter.” [2] The starting point for MA has to be to address its own internal strife and inconsistencies before attempting to convince managers of the value we can add.

This series of three articles endeavors to chart that course. This first article begins by highlighting the extent of the problem in MA before identifying the root cause and pointing to the obvious first step to recovery. The second article will build on that foundation and propose two principles to serve as the cornerstones for MA's restoration. The final article will aim to shore up the proposed structure by critically evaluating some of the assertions of prevailing approaches in MA.

Current MA practice

The first order of business is to level the playing field on the current state of affairs in MA. A series of factual statements from extant MA literature are presented, but no judgments are passed on the soundness (or lack thereof) of any of the alternatives. The intent is to demonstrate that MA in its current state is contradictory, confusing, and often absurd. These examples cover four key areas in MA, namely: MA principles, modeling consumption relationships, utilizing MA concepts, and decision support application. [3]

A few key *MA principles* are featured prominently throughout the three centuries that mark the existence of the discipline. Primary amongst these is the principle of causality. [4] Church, for example, in his emphasis on “production factors” made a clear distinction between “a definite relation to cost of production” which he contrasts with “arbitrary and artificial” views of cost relationships. [5] In current practice the application of the principle of causality is subject to gross inconsistencies. Moreover, some approaches go so far as to introduce a completely different set of principles. Lean accounting (LA) proposes the concept of a flow-path as the overriding principle in deriving monetary management information. [6] Causality takes a back seat as LA includes non-causal costs (e.g., value stream excess/idle capacity costs) in the information used for product-related decisions. Which principles are appropriate for deriving monetary management information? Should a fundamental principle, once recognized, be applied inconsistently?

Modeling consumption relationships practices range from including primarily direct material costs (e.g., throughput methods) to full costs as in traditional standard costing and many earlier activity-based costing applications. [7] Between these two extremes lies lean accounting that assigns facility costs to its value stream but not any other support costs, and Resource Consumption Accounting (RCA) with its focus on providing attributable cost information. [8] Which approach is right? How should managers handle the fact that they get two conflicting answers to the same question? What should the scope/extent of cost modeling be to provide for the range of decision support information managers need?

The *usage of MA* concepts is also subject to incongruent treatment. The view that operational cost behavior concepts (i.e., fixed and variable) are synonymous with decision support cost concepts (e.g., avoidable and unavoidable) is commonplace. For example, "In most organizations, the only variable cost—those where spending would change based on accepting or rejecting an individual order—are the material costs …." [9] On the other hand, the traditional view with regard to operational cost behavior and relevant information in decision support is the following: "The concept of relevance is independent from the concept of cost behavior." [10] Is a variable cost the same as an incremental cost? Can one blend operational cost concepts and decision cost concepts—always view a fixed cost as synonymous with an unavoidable cost?

As can be expected, *decision support* has the most potential for inconsistency since it lies on the receiving end of a cascading effect, i.e., the convergence of implemented MA principles, consumption relationship modeling, and MA concept usage. But even when the information is the same, MA approaches differ on how the decision should be viewed. Consider the following example, in which two prevailing approaches are applied in a single short-term decision scenario.

Company XYZ makes a number of different products. The product manager during his daily review of new orders notices two orders that must be processed on the same machine. The machine has ample capacity, but due to the customers' requested delivery dates only one of the orders can be accepted. The revenue from each order is the same and their respective product costs are as follows:

On Machine A:

Order #1:

Material: $50

Variable Conversion Cost: $100 [11]

Order #2:

Material: $60

Variable Conversion Cost: $80

The product manager considers using "totally variable cost" and would accept "Order # 1" since this maximizes throughput using only sales less direct material cost. [12] When he validates his approach with the controller she insists that the opportunity cost of an order (approximated by the order's more conventional variable costs) is appropriate and that "Order #2" should be accepted. She argues that committing the least amount of total resources for the contribution generated leaves more resources free for subsequent orders. [13] Which approach is correct? What resources should be considered in the decision—material only or all resources occupied by a decision alternative?

Understanding MA's problem

These contradictory examples provide only fractional insight into the current state of the profession. Volumes can likely be written about all the contradictions and inconsistencies that exist in MA. For example, consider a lengthy paper dedicated to highlighting the inconsistencies in Canadian textbooks with regard to the treatment of ABC—a topic that covers a mere sliver of the total MA discipline. [14]

It is important to note that the argument here is not for an idealistic world, with no differences of opinion—that is what fairy tales are for. Neither is it that there is too broad a spectrum of processes, methods, and tools in the MA toolbox. Most of these have their respective and appropriate focus and application in enterprise optimization, e.g., capacity management. [15] The problem is that more often than not contradictions and inconsistencies result when prevailing approaches are applied, which can invariably be traced to differences in interpretation of the underlying fundamentals. [16] It is this disparity in the laws and principles (the gaping holes in MA's foundation) that is at issue.

Moreover, given our biased views and tendency toward turf protection, many of us have our own opinions on which alternatives are valid (or invalid) and why. Unfortunately, these opinions are often not factually or open-mindedly determined; and when challenged, escalation of commitment to our position readily follows. This of course merely exacerbates the problem. Given that MA is the discipline that must serve as the primary source of monetary management information for decision support, the current state of affairs in the profession is unacceptable.

MA's problem is nowhere more pointedly underscored than by the attitude of its customers towards it. Research revealed that eighty percent of managers consider MA information important while ninety-eight percent say their information is distorted. [17] Despite distorted information, high levels of dissatisfaction and admitting to the importance of MA information—eighty percent of managers indicated that change is not a priority. Clearly, MA has managed to alienate its customers and no entity has a future without customers.

MA is in dire need of righting its ship and in the process placing managers' needs front and center. How is this to be accomplished? MA in charting a course back to relevance in the eyes of managers must start by getting our own house in order. This requires a set of disciplined fundamentals that the profession subscribes to which, when applied consistently will serve as the foundation for learning and communication (internal and external) and demonstrates the value MA adds to achieving enterprise objectives.

Getting help

As with any last ditch effort, help is always welcome. In identifying those disciplined fundamentals that all in the profession can and should subscribe to, help comes from one of the oldest disciplines around—philosophy. Philosophy devotes itself to unearthing and knowing truths, pointing to error, establishing principles, and identifying fallacies—all things MA must accomplish in its own recovery process. Philosophy will be helpful in two respects: (1) through its laws of logic; and (2) in the structure for the ordered and ultimately conclusive reasoning it provides.

The four *laws of logic* are considered self-evident and self-explanatory. [18] In this series of articles there is need for only two of the four, namely: (1) the law of non-contradiction; and (2) the law of rational inference. [19] The law of non-contradiction holds that two contradictory statements cannot be true at the same time and in the same sense, e.g., a company cannot be a going concern and be out of business at the same time. This law is also the cornerstone behind the concepts of truth and falsehood. The law of rational inference states that if A=B and B=C then A=C. The quintessential philosophical example of inference is Descartes' famous: “I think, therefore I am.”

Structured reasoning is based on: (1) deductive logic; and/or (2) inductive logic. Deductive logic reasons from the cause (general) to the effect (specific)—e.g., all management accountants work with numbers; John is a management accountant therefore John works with numbers. Deductive reasoning—if sound—provides absolute proof. Inductive logic, on the other hand, starts with the effect (specific) and attempts to arrive at the cause (general)—e.g., John and his MA friends were found (through interviews) to be unhappy with the state of their profession, therefore all management accountants are probably unhappy with the state of the profession. Inductive reasoning usually provides only probable proof unless the entire population is observed. [20] In this article, deductive logic and the law of non-contradiction find application, while inductive logic and the law of rational inference comprise the mainstay of the second article.

The current MA environment is clearly not leaning towards being squeezed into a square box. Moreover, many will claim that allowing for a diversity of practices in MA has the potential to enrich the profession. The search for MA's enduring fundamentals therefore comprises two components: (1) showing that the view “everything and anything goes” is the root cause of the problem; and (2) proving that enduring laws and principles *do* exist.

The root cause

If we ignore for the moment the anomalies discussed previously, the prevailing view is that each of the various approaches in MA is legitimate and in some sense justified. “Upon closer inspection, various costing methods do not necessarily compete; they can co-exist …” [21] This “everything is valid” view is common in contemporary culture and is well recognized in philosophy where it is termed relativism. In an attempt to accommodate often disparate views an “all inclusive” approach is adopted. Relativism is most often encountered in the claim: “Truth is relative,” i.e., what is true for you is not necessarily true for me and vice versa. Formal relativism states: “There are no absolute truths.” [22] Relativism in management accounting says: *There is no single approach or one correct approach to MA*. Relativism, although at first blush an apparently sensible compromise between different and/or opposing views, is fatally flawed.

At a very fundamental level, relativism's claim that there are no truths also precludes itself from being true. Relativism is self-defeating. [23] The relativist view needs to be true to refute the existence of truth—it violates the law of non-contradiction. In its MA disguise it fails for the same reason; one cannot claim that there is no single right approach while in the same breath establishing an approach—that considers all views valid—as *the one approach*.

Going beyond the pure philosophical argument against relativism there is a whole host of undesirable consequences that result from this view in MA:

- Ambiguity, confusion, and frustration are the order of the day; this should be evident in the examples from extant MA literature presented previously.
- If there is no standard/truth, on what basis are *rogue* theories challenged? Thus, not only does relativism allow for a cacophony of contradicting theories and practices but there is no way to right the ship as long as the relativist flag is flown.
- The frequent bias resulting from those protecting vested interests causes the discourse within MA to range from factual statements to character assassination.
- If there is no truth there is also no lie—no error. You can commit the blended cost concept error (i.e., confuse operational costs of fixed/variable with the decision concepts of unavoidable/avoidable) all day long and be none the wiser for it—ever.
- Real progress is stifled under relativism; practitioners cannot see the wood from the trees to identify causes worthy of further pursuit. Moreover, critical thinking—a key ingredient to progress—has no place in the relativist view. Who is to say that any one approach is better than any other?
- The lack of a recognized common frame of reference makes it difficult for the profession to effectively communicate with those looking in from the outside, i.e., managers.
- Management accountants are not able to make a convincing case for and demonstrate how they add value to the enterprise.

One way in which people come to terms with the anomalies in a relativist environment is to adopt the pragmatic view of truth, i.e., *you take what works for you and I will take what works for me*. [24] The problem with this view of truth is that dishonesty has been known to *work* at times; for those who don't get caught it even *works* to fudge the numbers on the company's financial statements. Obviously, *what works* is not the same as what is true or what is right.

Another way of operating within relativist boundaries is to consider truth to be that which feels good. However, the consequences of such a subjective view in a discipline like MA (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 they are nevertheless true.

Truth

The fact that relativism self-destructs means that the existence of absolutes cannot be denied. This is good news for MA because it means enduring fundamentals *do* exist. This conclusion is underscored by the pervasive nature of the concept of truth in business. “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.” [25] Moreover, when CEOs and CFOs now certify financial statements with “*does not contain any untrue statement*” and is “*not misleading*” and “*fairly represent … the financial position*”—truth is right there. [26] For the summary level financial statements to be true the MA mortar and bricks that go into it have to be true first and foremost.

Pontius Pilate famously inquired of Jesus, “Quid est veritas?” (What is truth?) Curious that he should ask; a definition that has stood the test of time and predates Pilate's question by about 380 years was penned by Aristotle: “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.” [27] This definition of truth (the correspondence definition) is awkwardly formulated in the ancient rendering, but it can be simply stated as telling it like it is. A more recent rendering of the correspondence definition of truth is: A statement or opinion is true if what it corresponds to is a fact. [28] In MA, this would mean to say that a product is profitable when it is in fact profitable or to say that a customer is unprofitable when the customer is in fact unprofitable.

Yes but ...

It seems a reality check would be in order at this stage, i.e., it is not that easy in practice, and the world is not that simple. As any crusty old cost accountant will tell you, an absolutely accurate cost number is impossible to attain. One can be off by mere pennies and state a profitable customer as unprofitable or vice versa. The point is well taken, but this objection should be seen in perspective: (1) the reality of imprecision is not an argument against the need for truth in MA; and (2) at worst, this justifies circumspection by managers when using MA information. The objection also overstates the effects of imprecision. A marginal customer, whether marginally profitable or marginally unprofitable, is generally undesirable.

A second objection is that truth cannot be absolute because knowledge is ever growing and expanding. [29] What is true today may be false at some other time; 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 management accountants' understanding of it. It was not a case of moving from an old truth to a new one, rather it was forsaking an old error for a more complete insight into an existing truth.

A third objection is that adopting an absolute truth perspective stifles progress and innovation. [30] But since knowledge does expand on the back of truth, as indicated above by the ABC example, this objection has no leg to stand on. The objection also ignores the problem of absurdities, which abound in a relativist environment, e.g., a fixed cost and an unavoidable cost are not the same thing. There is an obvious need to stifle certain things. Adopting an absolute truth view does not prevent new truths from being uncovered, nor does is it hinder more complete insight into existing truths. On the contrary, it provides a foundation for critical evaluation and real progress. [31]

A final objection is that the approaches in MA are not considered equals but that they are merely stages in the development to a mature/ultimate MA 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 MA solutions, managers seem to have lost interest in what must appear to them to be a revolving door, not progress. Nevertheless, the objection has merit in so far as a mature/ultimate MA solution can be known. The foundation and structure of exactly such a solution is of course the objective of this series of articles. Establishing such a target is essential in helping to break out of the current cycle.

“Corresponding to the facts” in MA

The question that remains is exactly what the facts are that MA information must correspond to, i.e., what is to be told as it is in MA. The business of commerce (whether for profit or not) deals with the flow of goods and services, acquired for and consumed in a conversion process to produce outputs (goods and services) in the marketplace.

Managers are tasked to influence this flow of goods and services for the purpose of achieving the enterprise's mission in an optimal manner. MA in turn strives to facilitate managers' optimization efforts as they perpetually plan, monitor, adjust, and optimize various aspects of the flow of goods and services in and through the enterprise. The correspondence requirement on the part of MA is therefore exactly that—to reflect economic activity in the manner it occurs.

Conclusion

In one fell swoop the law of non-contradiction exposes the root cause of MA's problem as well as the solution. The existence of absolutes is undeniable; such a denial itself needs to be an absolute (the very thing it denies). This is very helpful with regard to this article's two previously stated objectives: 1) the root cause of the problem in MA is evident: the view that anything and everything goes is fallacious; and 2) the solution to the problem is similarly obvious: the correspondence definition of truth is wholly appropriate to MA.

Unfortunately, that is as far as deductive logic will take us. The specifics of how the correspondence definition of truth is to be incorporated into management accounting fall outside the domain of deductive logic. For the moment it is clear that absolutes do exist and that MA's correspondence requirement is to reflect enterprise economic activity in the manner it occurs. The details of how this is to be accomplished falls to the other law of logic previously introduced (the law of rational inference) and the second branch of reasoning—inductive logic. Their application in fulfilling the correspondence requirement in management accounting is the subject of the second paper in this series.

[1] The term “disciplined practice” is also often used but in this regard there is a need to clearly distinguish the diversity in practices from those enduring laws and principles to which all in the profession should subscribe. The latter is implied here.

[2] Thomson, J. & Gurowka, J. August 2005. “Sorting Out the Clutter” *Strategic Finance*, Vol. 87 No. 2.

[3] Although revenue is not explicitly addressed in this series of articles it is considered an integral part of any management accounting solution.

[4] Shillinglaw, G. 1978. Causality is a relation between a cost and a cost objective whose nature is such that the cost must be or must have been incurred if the cost objective is to be achieved. From “*Cost Accounting Principles for External Reporting: A Conceptual Framework*.” Essays to William A. Paton: Pioneer Accounting Theorist. Edited by Zeff, S; Demski, J. & Dopuch, N. Division of Research, Graduate School of Business Administration. Universityof Michigan. p. 162.

[5] Church, A. Hamilton. 1910. “*Production Factors in Cost Accounting and Works Management*”. The Engineering Magazine. New York, NY. Reprinted by ArnoPress in the History of Accounting Series New York, NY 1976 p. 15.

[6] Huntzinger, J and Kennedy, F. 2005. “*Lean Accounting for Operations.*” Target Innovation at Work. The periodical of the Association of Manufacturing Excellence. Vol. 21, No. 4 p.8.

[7] Corbett, T. April 2006. “Three Questions Accounting,” *Strategic Finance*, Vol. 87, No. 10. p. 49-55; Horngren, C., Foster, G. & Datar, S. 2000. *Cost Accounting: A Managerial Emphasis*. Prentice-Hall Inc.: Upper Saddle River, NJ. p. 301; Glad, E. & Becker, H. 1994. *Activity-based Costing and Management*. Juta & Co, Ltd.: Kenwyn, SA. p. 50.

[8] Kennedy, F. & Brewer, P. Nov. 2005. “Lean Accounting: What's it all about?” *Strategic Finance*, Vol. 87 No. 5. p. 26-34; Shillinglaw, G. 1963. “*The Concept of Attributable Cost.*” Journal of Accounting Research. Chicago, IL. p. 73-85.

[9] Kaplan, R. & Cooper, R. 1998. *Cost and Effect*. Harvard Business School Press: Boston, MA. p. 119.

[10] Edmonds, T. et al. 2006. *Fundamental Managerial Accounting Concepts*. 3rd Edition, McGraw-Hill Irwin: New York, NY. p. 138.

[11] Assume variable conversion costs comprise direct production labor only.

[12] Luther, R. & O'Donovan, B. 2000. “The aim is to illustrate that it is the rate at which the factory earns money that determines profitability, not the contribution of each product.” *Cost-Volume-Profit Analysis and the Theory of Constraints*. Republished in *Emerging Practices in Cost Management*. The RIA Group: Valhalla, NY. p. K2-2.

[13] Shillinglaw, G. 1982. “In its simplest form, the analysis of a capacity rationing problem calls for a new measure of product profitability known as *contribution margin.*” *Managerial Cost Accounting*. Richard D. Irwin: Homewood, IL. p. 89.

[14] Beaulieu, P. & Lakra, A. 2005. “Coverage of Criticism of Activity-Based Costing in Canadian Textbooks,” *Canadian Accounting Perspectives*, 4 (1), 87-103.

[15] Clinton, B. D. & Van der Merwe, A. 2006. “Management Accounting—Approaches, Techniques, and Management Processes.” *Cost Management*, May/June Issue. Vol. 20 No. 3. RIA: New York, NY. p. 14-22.

[16] Ibid. Clinton & Van der Merwe. p 15. “Approach” as used in this series refers to MA approaches, which attempt to offer comprehensive monetary management information and enable key managerial and/or organizational processes.

[17] Garg, A; Ghosh, D; Hudick, J & Nowacki, C. “2003 Survey of Management Accounting and Benchmarking Tool,” Ernst & Young LLP and “Roles and Practices in Management Accounting Today,” *Strategic Finance*. July 2003.

[18] Geisler, N. & Brooks, R. 1990. *Come, Let Us Reason: An Introduction to Logical Thinking*. Baker Book House: Grand Rapids, MI. p. 16. “Logic is built on four undeniable laws. There is no “getting behind” these laws to explain them. They are self-evident and self-explanatory. There is also no way around them. In order to reject any of these statements, one must assume the very principle he seeks to deny. But if you must assume that something is true to say that it is false, you haven't got a very good case, have you?”

[19] The other two laws of logic are the law of identity (A is A) and the law of excluded middle (either A or non-A).

[20] Morris, T. 1999. *Philosophy for Dummies*. Hungry Minds Inc.: New York, NY, p. 52.

[21] Cokins, G. 2006. “*Implementing Activity based Costing*.” A Statement on Management Accounting. Institute of Management Accountants. p. 1. *http://www.imanet.org/publications_statements.asp#C*

[22] See note 20 above, p. 46.

[23] See note 20 above, p. 47.

[24] Angeles, P.A. 1992. *HarperCollins Dictionary of Philosophy*. Harper-Collins Publishers, Inc.: New York, NY. Second Edition. p. 317.

[25] Church. 1910. p. 37. Emphasis is the author's.

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

[27] See note 20 above, p. 46.

[28] See note 24 above, p. 317.

[29] See note 24 above, p. 158. In re a posteriori knowledge.

[30] See note 18 above, p. 122.

[31] See note 20 above, p. 103. “Truth is the raw material for creativity.”