Lies, Damned Lies, and Cost Accounting:

How Capacity Management Enables Improved Cost and Cash Flow Management

By Reginald Tomas Lee, Sr.
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Reviewed by Ronald J. Baker

One of the 20th century's most influential accounting academics was William Paton, who in a 1922 treatise described what he believed to be the cost accountant's chief activity:

The essential basis for the work of the cost accountant—without it, there could be no costing—is the postulate that the value of any commodity, service, or condition, utilized in production, passes over into the object or product for which the original item was expended and attaches to the result, giving it its value.

Fortunately, Paton later repudiated this notion in a speech he gave at a conference in 1970:

The basic difficulty with the idea that cost dollars, as incurred, attach like barnacles to the physical flow of materials and stream of operating activity is that it is at odds with the actual process of valuation in a free competitive market. The customer does not buy a handful of classified and traced cost dollars; he buys a product, at prevailing market price. And the market price may be either above or below any calculated cost figure.

In 1987, H. Thomas Johnson and Robert S. Kaplan published Relevance Lost: The Rise and Fall of Management Accounting, which is credited with launching the activity-based costing (ABC) revolution. But ABC is just a new way to be wrong, which Johnson proved in his next book, Profit Beyond Measure, a study of how Toyota does not use standard cost accounting.

Enter Reginald Tomas Lee, author of Lies, Damned Lies, and Cost Accounting: How Capacity Management Enables Improved Cost and Cash Flow Management. Lee posits three reasons why cost accounting is a bad practice:

- Getting a cost requires creating and forcing numbers and relationships that do not exist.
- Doing this leads to losing touch with operations.
- It also creates meaningless numbers that people consider as gospel (a single representation of an artificial reality).

The simple truth is, depending on the cost accounting method used, one can calculate radically different cost allocations. There have been many approved cost accounting methods—standard costing, total absorption costing, average costing, lean costing, marginal costing, activity-based costing—all of which will all result in a wide range of costs per unit that have nothing to do with cash. For example, using the above methods, assume Apple calculated its cost to make the Apple Pencil for its iPad Pro as between $10 and $40. Does this mean if it doesn't make one Apple Pencil, it will save $10–40 in cash?

This is why Lee argues that cost accounting forces mathematical relationships that don't make sense, confusing metrics with measurements. Walking outside with two thermometers will probably yield a relatively accurate temperature reading from each. That is a measurement. Cost accounting, depending on the method used, yields a wide range of possible numbers—those are metrics. This explains the old joke about the accountant who, when asked what 2+2 is, replies, "What would you like it to be?"

Furthermore, Segall's Law applies to cost accounting: "A man with one watch knows what time it is; a man with two watches is never quite sure." Yet cost accounting data is treated as gospel, providing a false sense of accuracy. Cost accountants would rather be precisely wrong rather than approximately right.

The important point is that costs need to be known before building the product or doing the job, not after. It does no good to know cost allocation to the penny if the customer does not agree with the value or price. Furthermore, most costs, especially in a professional firm, are for capacity: labor, rent, equipment, and technology. These costs do not vary with how that capacity is utilized; this is why airlines, hotels, and cruise ships do not use standard cost accounting either, but rather focus on pricing, cash flow, and capacity modeling. Witness how Uber, for example, uses pricing to match capacity with demand, deploying surge pricing in areas with high demand to incentivize more drivers into the area. Managers should never confuse being busy, or being at full capacity, with being profitable.

Furthermore, to add insult to injury, cost accounting does not help companies price better, earn more profit, conduct project management more effectively, qualify customers better, predict the performance of team members, manage capacity, model cash flow, or measure what matters to customers—in fact, it is a lagging indicator. This is exactly what Johnson meant when he wrote that "quantitative measures can only describe [relationships], they cannot explain them."

One of Peter's Principles is that bureaucracy defends the status quo long past the time when the quo has lost its status. Cost accounting does not deserve to be the apotheosis of pricing or operations; it focuses leaders' limited attention on absolutely the wrong things. The profession's cost accountants are collectively plunging a ruler into an oven to determine its temperature—it's the wrong measuring device.

This may sound like the ultimate apostasy, but like the mythological Cassandra, Reginald Lee has spoken the truth, even if no one is prepared to believe it. Read his book.❑

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