GDI Consulting & Training
Making Breakthrough Changes at Breakneck Speed!

Friends-of-the-Firm Briefing

To Be the Executive Director of FASB!

A Tongue & Cheek Article Describing How Accounting Rules *Really* Do Drive Performance

By
Alan G. Dunn, President
GDI Consulting & Training Company

GDI Consulting & Training Company provides practical solutions to complex business and managerial problems. Focusing mainly on the manufacturing and distribution industries, GDI has developed a reputation as one of the most innovative and hardest working professional services firms in these industries.

Last Revised on January 28, 2020

GDI Consulting & Training Company
P.O. Box 205 ● Temecula ● California ● USA ● 92593
Telephone 951-587-2003 ● www.gdiconsult.com ● agdunn@gdiconsult.com

Forward by Alan G. Dunn

Dear Friends-of-the-Firm,

My father used to tell me, ***"you get what you measure and you continue to get what you reward!"*** I did not know how insightful he was about leadership until I spent 30 years visiting hundreds of manufacturing facilities that all seem to experience the *"end-of-period shipping frenzy."* **And now I know… making the numbers IS NOT necessarily making money!** Sometimes it is little more than making a good showing in order to impress someone higher up the corporate food chain.

This GDI Friends-of-the-Firm Briefing initially came about as an attempt to inject some creative writing skills into the otherwise dry subject of accounting rules. But what happened along the way surprised even me. It seems that everywhere I looked in manufacturing companies, management behavior was being driven by accounting rules… sometimes antiquated accounting rules. Leaders at all levels were issuing strange orders and edicts that rarely were in the best interest of the owners. In fact, we observed numerous management decisions that seemed to be totally void of any benefit that would accrue to the owners of the manufacturing enterprise. To say the least, this was shocking!

This briefing explores two accounting principles that often create a dysfunctional mindset in most manufacturing enterprises. They are:

- How inventory is accounted for.
- How knowledge worker salaries and people development costs are accounted for.

In addition to these two accounting principles, which are driving incorrect behavior, this Briefing also explores a novel, (if not crazy) mechanism for determining the *"know how"* value of the knowledge worker. By recognizing knowledge workers as <u>true assets</u> in a complex system of decision making, we have described an interesting approach to *"people value."*

I think you will enjoy this briefing. After you recover from the briefing's unconventional approach, I am sure you will also see the relevance of the ideas in your enterprise.

Happy reading.

Alan G. Dunn
President
GDI Consulting & Training Company

To Be the Executive Director of FASB!

by Alan G. Dunn

On a recent business trip, characterized by a particularly long and grueling international flight, I miraculously fell asleep while leaning my head against the airplane's unforgiving carbon filament window-frame. Perhaps it was the rhythmic rocking of the airplane or maybe the grueling activities of the preceding day that caused me to fall soundly asleep. In any case, I almost immediately began dreaming about what is wrong with the North American accounting profession.

I dreamed I was killed in a nasty airplane accident. Fortunately, I went quickly and suffered little perceptible pain. When I arrived in Heaven (yeah!), I met God at the *Main Gate* and was told the painful news… I was very dead and worse; I did not qualify to enter this Holy of Holiest place… yet. You see, even without barcodes, God had kept track of me for over fifty-five years and knew I had made most of my living in the consulting and training industries. He also knew that I had an unusually difficult time grasping and accepting the traditions of finance and accounting during my years on earth. God knew I was a pitiful creature.

But God is a caring and loving entity. In all His heavenly wisdom, God felt I should be reincarnated and given a final chance to redeem myself to add value to the human race. This however required that I learn significantly more about high-finance and cost accounting, a weakness God had recognized in me and seemed solemn about changing. To accomplish this, God insisted I return to Earth and assume the only recently deceased body available at that moment. I just about died a second death when he told me the body belonged to the recently deceased Executive Director of FASB!

For those who are unfamiliar with FASB (pronounced Fas-B), this four-letter acronym stands for the **F**inancial **A**ccounting **S**tandards **B**oard… a group of intellectuals who establish all the rules of accounting. It has been said that all stockholder truth and corporate deception can be traced to one or more of the Board's decisions. This heavenly opportunity was sure to be a nightmare for me… mainly because of my refusal to understand and accept the customary rules of accounting. God had decided that even Hell was not good enough for me!

What was I to do? I could either hang out at the *Main Gate* for eternity or return to life as head of this old boy's club… a club often characterized by long winded and esoteric discussions of "*interesting"* subjects such as depletion allowance accruals, disclosure statement formats, special purpose accounting vehicles and contingent liability reporting. I reluctantly accepted the challenge and agreed to return to earth as the Head Honcho at FASB.

I have a tough time recalling what occurred next, but I think God waved His hand over me, sprinkled me with some heavenly dust and gave me a saintly kick in the rump. I immediately woke up somewhere in downtown Stamford, Connecticut, staring at a partially corroded bronze name plate on **my** door… ***"Executive Director, FASB."*** I could hear a dozen or so secretaries clattering about in the alcove outside my intimidating mahogany office door. I thought, *"Maybe this is not all bad? I am clearly an especially important individual who with a single stroke of my pen, can establish some new and arbitrary accounting rule to replace some old and archaic one. I am surely at the very foot of God!"* I was becoming happy again.

As I leaned back in my all-too-high and overstuffed Naugahyde chair *(the one with the arms ripped from repeated battles with the vicious desk drawers),* I contemplated my first actions. I wondered if I could add value to the accounting profession, and more importantly, add value to the manufacturing industry through the influence of my newly ordained position? I wondered if I could make a real difference on my second trip through the corporate world.

With my newly acquired enthusiasm, I contemplated three wonderful ideas that had the potential to disrupt the entire accounting profession and make miserable the lives of the regulators. I quickly became certain that if I could see these ideas through and implement them completely, I would be thought of as the Henry Ford, Fred Smith, Jack Northrop or perhaps the T. Boone Pickens, of the accounting profession. I could go down in FASB history as *the* Director who changed the nature and character of the accounting profession. Before me lay the opportunity to modify the very fabric of the manufacturing industry, making not superficial changes, but fundamental changes to the guiding rules of the accounting profession. Without question, I was pumped up for this new challenge.

----- *My First Executive Directive… Inventory Accounting Rules* -----

My first idea was sure to stop the pacemakers in all the Executive Committee rooms of all the Tax & Audit firms in North America. **It was to change the very *nature* and *character* of inventory accounting**. As I sat in my overly ornate and cigar smoke filled office, it occurred to me that my manufacturing industry predecessors were wrong when they defined inventory as an asset. *"This is ludicrous!"* I thought, *"How can anyone consider the trading of **green-back cash** for a bunch of greasy weldments and unrecognizable subassemblies to be converting one asset into another."* I asked myself, *"How is it that cash and inventory are both thought of as current assets, with a current value which is equivalent in a liquidation?"*

Clearly, as companies progress and as products utilize modern technologies, inventories can become obsolete at an ever-increasing pace. Spending good money to purchase inventory and treating the transaction as an asset account transfer is crazy. Inventory is inventory… it is not cash... it is not liquid. It is crazy to consider its value on par with that of cash.

And yet, as I sat in my tattered naugahyde chair, *(what accountant would ever pop for genuine leather?)*, and let my eyes wander around the room trying to feel the ever-present wisdom of my predecessors, I discovered there is something crazier than considering inventory a current asset. **It is that banks will loan a manufacturing company money, using the inventory as collateral!** *"If my manufacturing company goes broke,"* I asked, *"do the bankers really have a use for my obsolete weldments, partially finished subassemblies, and millions of unidentifiable components? Do the banks really know how to combine these valuable assets into a finished product which, when sold, will recreate the cash I originally traded for?"* Somehow, I doubted that any banker ever studied production theory or knew how to apply it. I honestly could not find an acceptable rational for using inventory as collateral on an asset-based loan.

Keeping in mind that inventory, though considered a *current financial asset*, is really a *current financial drag* on any manufacturing company, I decided to execute my **first order** as Executive Director of FASB. I reached for my special Executive signing pen and a handful of my preprinted Executive order stationary. I then wrote the following:

> **FASB Executive Directive #1:**
>
> Effective immediately, inventory will no longer be considered a current asset on any manufacturing company's balance sheet. When inventory is received, it will immediately be expensed in the current accounting period. Inventory is no longer a balance sheet account. It is now a P&L account. No exceptions!
>
> **Approved… Alan G. Dunn, Executive Director, FASB… October 8, 2020**

Oh, what a beauty this directive was! The anticipation of what the CPA's, the IRS, the Federal Trade Commission and eventually the Federal Drug Enforcement Agency would think about this change delighted me. In fact, I was so delighted and at such intellectual peace that I drifted off into yet another dream. My new *"dream-within-a-dream,"* (I hope you are following this), was really a fast-forward, approximately 20 years into the future.

All manufacturing companies have now been period-expensing inventory for 20 years, eighty quarters and twenty annual tax statements. I drifted in a ghostly fashion into several manufacturing companies and discovered to my amazement, the companies now have Just-In-Time (JIT) inventory management! Yes folks, period-expensing the inventory created a "*natural propensity*" to run the company with a Just-In-Time philosophy. Material arrives just-in-time to be used. Finished goods are shipped just-in-time to support customer requirements and work-in-process levels are kept to an absolute minimum. I thought to myself, *"Oh God, what have I done? My ruling encouraged companies to eliminate inventory, treat it as waste and bring it in at the last minute so they would not have to pay for it early."* By taking inventory off the balance sheet and slamming it square into the expense side of the P&L, manufacturing America now had natural JIT!

Now quickly rewind and go back to the *"original"* dream.

----- *My Second Executive Directive… Know-How Capital Accounting Rules* -----

Wow! If period-expensing inventory did not send you into the Twilight Zone, my second executive order certainly will. Since it is galactic law that all debits must have equivalent and balancing credits, my previous desire to pull something off the balance sheet and restate it into the income statement must be offset by pulling some equally important set of numbers from the income statement and slamming them back into the balance sheet.

As I pondered my years before my untimely death in the manufacturing industry, I reflected on how manufacturing costs are collected, and even more importantly, what actually constitutes manufacturing costs. I know that instructors in cost accounting classes have taught that manufacturing costs are made up of labor, material and burden, and that cost can be perceived as either fixed or variable. I also recollected that most of these costs can be and usually are *"absorbed"* into cost-of-goods-sold (COGS). As work was performed in a manufacturing company, we tended to absorb direct labor, direct material and assigned burden charges into the cost-of-goods-sold account. I somehow even remembered days when an old college professor insisted that all costs are variable in the long run. *"Silly professor!"* I thought, *"anyone who works in a manufacturing company knows that most costs are fixed in the short and intermediate term... and if you can't get past these periods, you can't afford to worry about the long term!"*

As I dozed in my ragged Executive Director chair, I remembered the discussions I had with a Controller at one of my previous client companies. The Controller insisted that labor should be considered a variable cost. Yet, I remembered that even when the labor was variably absorbed, it did not change in value or in the size of the bank check we wrote each month, even with short-term volume fluctuations. In my argument with my friendly Controller, I purported that in the short and intermediate terms, labor was fixed, as were most charges. Irrespective of how the accounting profession *"absorbed"* them, we still wrote fat paychecks every month. No one could convince me in those days, and no one could convince me in my post-mortem days that direct labor was anything but a form of fixed expense.

Before I decided to start drafting my new ruling regarding this issue, I also remembered noticing as I walked around factories, more *"knowledge workers"* showed up for work each day. In my illustrious past career, I remembered seeing many Design Engineers, Manufacturing Engineers, Industrial Engineers, Accountants, Lawyers, Schedulers, Planners, Buyers and that sometimes delirious group called Managers. I further remembered that these *"people's cost"* was summed up as *"G & A."* This was code for *"nobody-really-knows-what-they-do-but-we-don't-want-to-lay-them-off-just-because-we-had-a-short-term-dip-in-the-production-plan; or the acronym: "NRKWTDBWDWTLTOJBWHASTDITPP."* In other words, they were one big, fixed expense that varied little in relationship to production volumes!

All of this leads to my second executive directive. I once again clutched my special Executive signing pen and wrote:

> **FASB Executive Directive #2**
>
> In all manufacturing companies, the sum of the annual salaries and training costs of all knowledge workers will be capitalized in a fiscal year-end General Journal adjustment. Knowledge worker salaries, wages and training expenses will be credited and a new account, "*Capitalized Human Assets*," will be debited. This adjustment will result in the recognition of people as assets instead of as expenses. "*Know-How Capital*" will finally exist!
>
> **Approved… Alan G. Dunn… Executive Director, FASB… October 9, 2020**

Since the bulk of my fixed costs seemed to be in the salaries and benefits of the knowledge workers, and since I cannot seem to part with them or run my company without them, they must truly be some form of a valuable management asset. Therefore, I must capitalize them (even if accounting rules in my pre-death days considered them a period expense). My new executive order would force the capitalization of knowledge worker salaries every year.

The mechanics of this action are relatively easy. We simply identify our knowledge workers, add up the values on their W-2 forms, and at the end of each year, perform one General Journal entry, debiting the new *"Capitalized Human Assets"* account and crediting the various salary sub ledger accounts. By the stroke of a single journal entry, I have now capitalized the cost of my knowledge workers. I have finally presented a managerial asset in financial terms. But my changes did not stop here.

----- My Third Executive Directive… Capitalized Human Asset Valuation -----

We all know that most Capital Assets must have a Contra-Asset account for recording a depletion or depreciation allowance. I am not sure why this occurs… it is an accounting principle which has been around since the first accountant sized his first green eye shade. When you think about it, this thing called depreciation has the strange effect of taking today's cash expense and spreading it over tomorrow's cost of running the operation, (it also provides an easy excuse for a new executive to explain poor operating performance). By doing so, product costs and product marketing decisions are based not necessarily on cash flow but on the amortization of cash flow. This is an oxymoron because cash flow is a *"now and today"* sort of thing, while amortization is an allocation sort of thing with the incremental allocation values being based on some arbitrary rule which seeks to guess the future life of the capitalized asset. I noticed both in my dream and in my past life that few people have ever been able to predict the life of a piece of equipment, an employee, a technology, or a facility. Thus, this thing called *"depreciation"* can really goof-up one's understanding of cash out-flow and cash in-flow.

But now for my third wild and crazy directive. Since I am powerless to change the principle of the Contra-Asset Account, I decided to create my own account and financial transaction, focusing on the process of revaluing my previously described Capitalized Human Asset account. Again, I grab my special pen and put to paper a FASB directive that will send all knowledge workers scrambling:

> **FASB Executive Directive #3**
>
> Each year, between the Christmas and New Year holiday, all knowledge worker employees whose costs were previously posted to "*Capitalized Human Assets*," (see FASB Executive Directive #2) will be tested for competency in their respective positions. The test will provide an analysis of the employees' skills as they relate to those specific job skills predicted to be needed the following year.
>
> Each employees' test scores will be compared to the respective employees' scores from the previous year's test.
>
> The "*Capitalized Human Asset*" value in the General Ledger for employees' whose test scores decline from the previous year will be reduced by posting a credit value to the contra-asset account, "*Accumulated Capitalized Human Asset Depreciation*" with an amount that fairly represents the individual employees' reduction in value to the company. The offsetting debit will be posted to the "*Capitalized Human Asset Depreciation*" expense account.
>
> This adjustment will result in a fair recognition of each employees' continued value to the organization.
>
> **Approved… Alan G. Dunn, Executive Director, FASB… October 10, 2020**

Can you believe this one? We can now appreciate an employee if he or she gets smarter every year and conversely, we can depreciate an employee if he or she gets dumber each year! Think of the possibilities suggested by this accounting change:

- If all knowledge workers face depreciation, they will accept <u>personal responsibility</u> for improving themselves!
- Companies will begin training these people to improve the net worth of the company! Perhaps companies will spend as much time worrying about the quality of each employee with the same vigor they worry about the quality of the Xerox machine!
- Asset managers and investors will look at the company with a new perspective. Treat the *"mobile capital"* wrong and the balance sheet deteriorates almost immediately!
- Emphasis will be placed on <u>developing</u> and <u>maintaining</u> managers instead of <u>replacing</u> managers!

And most significant of all, subjectivity in the termination process will be eliminated. When an employee's *"book value"* hits zero… termination scores!

I really like this directive… more than the others. If companies had thought of people as assets and nurtured them accordingly, the people would have always raised the questions this article raises. They would have questioned old institutions instead of blindly accepting them. If they knew they faced depreciation, they might have focused less on parochial politics and short-term decisions and more on improving the fundamental quality of their position.

Yes, it is time we made dramatic changes to the fundamental philosophy of management accounting.

Executive Directives to Come

I had a fourth idea in my dream, but I honestly do not believe I should discuss it here. After my (1) period-expensing of inventory, (2) capitalizing knowledge workers salaries and (3) depreciating knowledge workers if they do not get smarter each year, it is best to leave alone my FASB Executive Directive regarding methods of valuing R & D. There is only so much a knowledge-seeking executive can take and perhaps only so much damage my career can take because of dream dissemination! Sometime in the future I will present more rulings from the New FASB.

Waking Up

I can't begin to tell you what a shock it was to wake from my dream and find that my beautiful, ornate, overstuffed office had been replaced with a cheap cloth seat in an equally cheap airline that serves food that looks like a genetic engineering experiment that tried unsuccessfully to crossbreed an Egg McMuffin with a 10-year old overly used and dilapidated Frisbee! I must also admit the trappings of being Executive Director of FASB were wonderful! Yet, as I look around the tattered but functional interior of my budget minded airline carrier, I realize this is the real world. I also see a more realistic picture of how cash *should be spent*. I also see that inventory, certain extraordinary perks and glamorous facilities can sometimes be justified through the stroke of some accounting and amortization genius. And yet I know cash is the chemical that breathes life into the very heart and soul of the corporation much like blood carries nourishment throughout the biological being.

My dreams have taught me the difference between financial and managerial assets. They have taught me that I must manage cash, yet I must not ignore my human assets. My dreams have taught me how to re-think the social and economic aspects of manufacturing.

As I wiped the sweat from my brow (you would be sweating too if you lived even for a minute in the FASB ranks!), I realized that the old business school adage, *"cash is king, but people make kings"* is truer in today's competitive world than ever before. Thanks to my dream, I have gained a bit of intelligence and a new ability to look at things differently and question all the old traditions… even those of the accounting profession.

I am now convinced that we must approach our understanding of product cost from a different perspective. No longer can we look at product costs using the traditional accounting approaches. We must now consider certain managerial costs that include the cost of supporting production with knowledge workers, maintaining our knowledge worker's skills and supporting lower inventory levels. We must get smarter.

We must recognize that its not how much we make that is important… it is how much we keep. Thus, working smarter means rethinking old perspectives and traditions.

I have seen the light of change… have you?

About the Author

Alan G. Dunn is currently President of GDI Consulting & Training Company and founder of the Manufacturing Executive Institute (MEI). He is also the creator and lead-instructor of the 18-month Next Generation Global Supply Chain Leadership Development Program at the California Institute of Technology's (Caltech) Center for Technology & Management Education (CTME), where he has taught since 1984. Mr. Dunn also serves on the University of California at Riverside's (UCR) Advisory Board for Transformative Leadership in Disruptive Times.

Mr. Dunn specializes in supply chain management, strategic planning, manufacturing management, operations management, leadership development, cost management and business finance.

Previously, Mr. Dunn was a Vice President at Gemini Management Consulting and a Partner at Coopers & Lybrand. In both positions, he led large technical manufacturing teams through innovative productivity enhancement projects. Mr. Dunn has participated in >188 significant manufacturing and distribution projects inside >118 companies. He has worked in 24 countries and across most manufacturing sectors.

Over his 40-year career in global supply chain consulting, Mr. Dunn has served on the Boards of Directors of numerous public, private and non-profit companies. He is the recipient of the National Association of Corporate Directors (NACD) prestigious *"Director of the Year"* award in 2007.

Alan is a career Association of Supply Chain Management (ASCM) volunteer, having served as the President of the Orange County Chapter in 1984 and Chairman of ASCM in 2015. He was inducted into the *"ASCM New England Supply Chain Conference Hall of Fame"* in 2022.

Mr. Dunn has a degree in business management from California State University, Fullerton.

Contact Information

Alan Dunn, President
GDI Consulting & Training Company
P.O. Box 205
Temecula, California 92593 USA
951-587-2003
agdunn@gdiconsult.com
www.gdiconsult.com