

**GDI Consulting & Training Company**  
*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, Gerald E. Dunn, Inc.**

*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.*



*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 didn’t know how insightful he was about leadership until I spent 20 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 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 seemed to be 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 true assets 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 really wrong with the North-American accounting profession.

I dreamed I was killed in a rather nasty airplane accident. Fortunately, I went quickly and suffered no pain. When I arrived in Heaven, 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. You see, even without barcodes, God had kept track of me for over thirty-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 individual. In all His heavenly wisdom, God felt I should be reincarnated and given a final chance to redeem myself, that is to say, to add value to the human race. This however required that I learn significantly more about high finance and cost accounting, a weakness that God had recognized 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 Financial Accounting Standards Board . . . . . a group of intellectuals who seemingly 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 wasn't 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 and contingent liability reporting. I reluctantly accepted the challenge and agreed to return to earth as the Head Honcho at FASB.

I have a difficult time recalling what occurred next but I think God waved His hand over me, sprinkled me with some heavenly dust and gave me a Sainly kick in the rump. I immediately woke up somewhere in downtown New York City

staring at a partially corroded bronze nameplate 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 isn't all bad? I'm clearly a very 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 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 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***

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 new 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 *real* leather?), and let my eyes wander around the room trying to feel the ever present wisdom of my predecessors, I discovered there is actually something crazier than considering inventory a current asset. **It is that banks will actually 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 rationale 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 a 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*

Alan G. Dunn, Executive Director, FASB  
October 8, 1998

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, 80 quarters and 20 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 actually 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***

Wow! . . . . If period-expensing inventory didn't 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 and 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 generally 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 NRKWTD BWDWTLTOJBWHASTDITPP)!"* 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:  
Since the bulk of my fixed costs seemed to

### **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*

Alan G. Dunn, Executive Director, FASB

October 9, 1998

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***

We all know that most Capital Assets must have a Contra-Asset account for recording a depletion or depreciation allowance. I am not really sure why this occurs . . . . it seems to be 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 probably

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 ultimately 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 re-valuing 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*

Alan G. Dunn, Executive Director, FASB  
October 10, 1998

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 probably accept personal responsibility for improving themselves!
- ◆ Companies will actually begin training these people in order to improve the net worth of the company! Perhaps companies will actually 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 developing and maintaining managers instead of replacing managers!

And most significant of all, subjectivity in the termination process will be eliminated. When an employee's "book value" hits 0 . . . . . termination scores!

I really like this directive . . . . . probably 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, I think it's time we make 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 don't get smarter each year, I think 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 as a result-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 cross breed an Egg McMuffin with a dilapidated Frisbee!. I must 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 of manufacturing.

As I wiped the sweat from my brow (you'd 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 then ever before. Thanks to my dream, I have gained a bit of intelligence and perhaps a new ability to look at things differently and question all of 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 cost 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 . . . . . its 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*



**G. Dunn** is President of GDI Consulting & Training Company and Chairman of Gerald E. Dunn, Inc. (GDI), a business investment firm. Before founding the GDI companies, Mr. Dunn was a Vice President at Gemini Management Consulting and a Partner at Coopers & Lybrand. For the ten years prior to joining Coopers & Lybrand, Mr. Dunn was President, (and Founder) of ADI, a successful consulting and training company that Mr. Dunn sold to Coopers & Lybrand in 1990.

In addition to his consulting experience, Mr. Dunn has many years of line management experience in manufacturing and distribution environments. He has extensive background in most functions within a manufacturing company and participated heavily in many significant projects.

Mr. Dunn's consulting clients include, American Cyanamid, Boeing, Hughes Aircraft, Amgen, Baxter, Allied Signal, United Technologies, Johnson & Johnson, the Department of Energy, the Department of Defense, the Justice Department, General Motors, Loral, Tellabs, SmithKline Beckman, Hyland Labs, Chiron-Cetus, AT&T, General Instrument, Pacific Telesis, Intel and Toshiba. In addition to his consulting practice, Mr. Dunn regularly presents executive workshops at the Industrial Relations Center of the California Institute of Technology (Caltech) in Pasadena, California. Programs include:

- ❑ Business Process Innovation: *Achieving Breakthrough Improvements In Core Business Processes* (2 days)
- ❑ Manufacturing Cost Strategies for Sustainable Bottom Line Improvements (2 days)
- ❑ Activity Based Costing: *Strategies, Tactics & Tools for Accelerated Implementation* (2.5 days)
- ❑ Implementing Statistical Process Control (2 days)
- ❑ Rapid Prototyping & Agile Manufacturing: *Using New Technologies To Slice Product Development Time In Half* (2 days)
- ❑ Symphonic Manufacturing: *A Comprehensive Manufacturing Enterprise Simulation* (4 days)
- ❑ Business Performance Measurement: *Aligning Strategy, Metrics & compensation* (2 days)
- ❑ Managing For Shareholder Value (2 days)

Mr. Dunn also presents executive level "Operational Due Diligence" courses nationally for the American Management Association (AMA).

Alan has conducted training programs in North America, Central America, South America, Europe, Africa, the Far East and Southeast Asia. He is a noted speaker and author in the areas of manufacturing systems, information systems management, cost management, value engineering, business process reengineering, facility and equipment maintenance, statistical process control, just-in-time production management, demand flow manufacturing, business transformation, and business finance. He has spoken widely for the American Production and Inventory Control Society (APICS), the Council of Logistics Management (CLM), the Society of Manufacturing Engineers (SME), and the National Association of Accountants (NAA).

Articles he has authored have appeared in numerous publications including The Los Angeles Times, Journal of Manufacturing Systems, Material Handling Engineering, Automation, Production and Inventory Review, Managing Automation, Warehouse Cost Digest, Transformation Magazine and Industrial Engineering Management. In total, Mr. Dunn's articles have been published in over thirty five magazines and journals.

Mr. Dunn has developed a significant number of consulting methodologies, the most notable being the 2<sup>2</sup>4<sup>2</sup> Process Reengineering Decision Matrix<sup>sm</sup> that is used to determine which reengineering projects will simultaneously provide the highest financial payback and the greatest probability of implementation success.

Alan is a past president of the Orange County Chapter of APICS. He served as Chairman of the 1989 APICS International Conference and Technical Exposition. He also served as Chairman of the APICS Education Strategy Committee.

In addition to his own Boards of Directors, Alan currently serves on the Boards of Directors of *Tomorrow Morning Inc.*, a publicly held literacy publishing and software company; *Ennex Corporation*, an automation design and technology development company; *Idaho Asphalt Corporation*, a western states producer of asphalt paving and coating products and *Air Logistics Corporation*, a producer of fiber optic strength components and motive equipment fueling systems. Alan has served on a number of other Boards of Directors over his career.

Mr. Dunn holds a Bachelor of Science degree in business management from California State University in Fullerton.