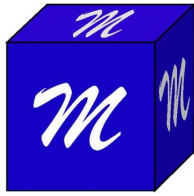

Middle Market Methods™

2023: 3rd Quarter

The Virtues of Cost Accounting

By

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Introduction

As an undergrad, I found Psychology 101 and Accounting 101 to be as exciting as watching paint dry. This is a humorous reflection given their relevance to change-agency and empiricism, respectively, central to value-creation. Regarding the latter, the matching principle is an essential tenet of accounting. A corollary thereof is the virtue of cost accounting. The objective of cost accounting rigor is to accurately allocate the costs associated with the invoice representing the sales price of goods and/or services. Despite the risk assessment expertise that middle market private equity investors bring to portfolio company stewardship, the granularity of their cost accounting analysis may be insufficient during both diligence and the hold period. This is both a call to action and the topic of this quarter's value-creation installment.

The Pareto principle, i.e., the 80/20 rule, has several manifestations. One such aphorism is that a material portion of small business leaders concede that they are losing money on at least some SKUs and customers, but they do not know with certainty on which and whom, respectively. Indeed, this jibes with my four decades in the trenches with entrepreneurs. The laissez-faire justification often comes via rationalizing loss leaders. However, if one does not know with a reasonable degree of confidence on what or whom they are losing money, how may they accurately ascribe the burden supported by the winners?

The cost accounting matching principle is essential, but not necessarily simple.

Experiences which Resonate

We are a byproduct of our experiences—good and bad. George Bernard Shaw reflected that "if history repeats itself, and the unexpected always happens, [then] how incapable must [we] be of learning from experience." The older we get . . . (scratch that: seasoned) . . . the more recurring patterns we may observe. One such personal

observation is the retirement of lending institution senior credit officers ("SCOs") after surviving a recession. Priceless tribal knowledge tends to accompany them to The Villages (or a similarly appealing hideaway) for a long recuperative period in retirement, leaving their successors to relearn many painful lessons.

When "toting the bag" in my early career, I pressed our SCO on approvals like Lawrence Taylor pressed quarterbacks on blitzes. My comeuppance was eventually being the account executive on some of the deals I wrangled into our portfolio. The karma was so profound that my guilt compelled me to track down the brilliant, retired SCO and confess that I understood what he was trying to teach me when I was unconsciously ignorant. (He could have retorted that I was consciously ignorant, but he also wielded excellent emotional intelligence.)

Other such trips down my personal memory lane trace back to asset-based lending field examiners. They were called auditors in "the good ole days" but the inferred liability compelled legal counsel to advise adopting a euphemism for the skillset. Another risk managing sage from my "early years" wielded a Spidey sense that eclipsed anything Marvel comics ever envisioned. He platooned a field examiner who promptly detected a sizeable "soft" fraud. The perpetrator's motivation was loan covenants. Our unit shared credit exposure with a commercial lender. When our shop disclosed the size of the fraud, the co-lender was indignantly dismissive. Our wizard calmly replied that the fraud was hiding in plain sight on the balance sheet, and he politely invited the condescending "professional" to find it. In the meantime, our hero platooned a turnaround specialist and saved everyone's bacon—including the surly commercial lending partner. The answer to the hidden losses lay in accruals and prepaids in interim statements on this highly seasonal business. They looked normal by fiscal year end standards but contrasted dramatically with interim periods for previous years. The former underestimated legitimate liabilities; the latter ghosted a would-be reduction in cash. Collectively, the fancy CFO footwork had a solid seven-digit impact at a time when (i) that was a material sum in absolute dollars and (ii) the covenant calculation timing was critical.

Risk management veterans of variation are a trove of keen insights to avoid missteps.

On yet another occasion, the field examiners quickly confirmed the counterintuitive culprit of increased losses concurrent with growth on seemingly stable gross margins. Scrap was not being allocated in cost of goods sold, but rather buried in selling, general and administrative ("SG&A") expenses; hence, the faux gross margins. Growth would have only accelerated inevitable bankruptcy absent detection and remediation.

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Three Basic Methodologies

From the 40-thousand-foot altitude perspective, there are three general cost accounting methodologies: standard, activity-based, and hybrid. Standard cost accounting works best for repeatable and reproducible workflows with nominal variation. These business models tend to be lower margin and higher asset turnover models. For example, an OEM parts manufacturer in a heavy equipment supply chain may know that there are literally thousands of parts in a particular production run. Therefore, overhead allocation calculations may be applied with reasonable accuracy.

Ironically, these business models may be safely less reliant on *dynamic* management information as periodic reporting suffices. Negative variances to standard are handily identified by production veterans. Three episodes make this self-evident: (i) unscheduled maintenance on a mission critical piece of equipment such as a metal press, (ii) quality issues inducing abnormal scrap and/or rework, and (iii) excessive labor costs.

Activity-based costing ("ABC") is best suited for "job-shop" scenarios. If you have ever seen a ZZ Top music video, you understand a vehicular example. TV shows like "Iron Restoration" rehabilitate junkers (sic) to customized dream machines. Some of the parts must be manufactured from scratch considering baren junkyards. Some of the parts on the bill of materials ("BoM") may be available as a commodity (e.g., fasteners procured from Granger), but those items may be unique to the job. Having excess parts at the end of a custom job is probably a sunk cost because they may not be on the BoM of any other deliverable. Especially regarding direct labor, the ability to track hours specific to a job is critical. There is a strong inference for excellent operating systems for tracking. Coincidentally, such systems are often an Achilles Heel via their absence. The more variation leaders expect in producing a marketable product, the more likely they may opt for time and materials contracts. The bad news is that their margins are more transparent to customers.

Cost accounting methodology should be attuned to the value-stream(s).

The third scenario is a hybrid of standard and ABC. The coined term M3 encountered in the field is "job-shop to scale." Essentially, the value-chain is scrutinized by its distinct functions. Some functions lend themselves to standard cost accounting; other functions may be more suited to ABC. An example may provide useful perspective. An electronic diagnostic machine in life sciences may have common chassis sizes built in a metal fabrication shop. They might also outsource this "commodity" as it is not a differentiating core competency. However, the circuit boards, processors, pumps, valves, tubing, labor

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for configuration, and labor for programming relative to spec are “unique” and should be tracked with ABC rigor.

Another advisable hybrid scenario is when a business offers two seemingly complementary lines of business; however, their execution value-streams are disparate. Suppose one value stream regards risk management inspection and the second involves remediation of potential issues found. Several of the former may be done in a day with the items lugged on a technician’s toolbelt. However, the latter may be a protracted quasi-construction project, replete with permitting requirements, for which even the revenue recognition method may be different (e.g., percentage of completion).

The Learning Loop

Heraclitus observed that “nothing endures but change.” For sure, change in all business ecosystems is inevitable. The primary questions regard timing and materiality. All cost accounting systems are subject to some of the same variables. Each may have unique variables to consider. Companies with robust cost accounting rationalization may enjoy a competitive edge on fixed-price contracts.

Beware the critical variables which disrupt cost accounting integrity.

Standard cost accounting caveats are anchored in anything that drives variance between expectations versus actual results. At a high-level these common variables loom large:

- *The number of units produced.* If actual produced units exceed the number against which the allocated cost standards were set, then the pro rata actual overhead per unit is lower than expectations. Thus, a favorable variance results. If the opposite happens, i.e., fewer produced units, a negative variance results.
- *The cost associated with each unit of product*. This entails standards for labor, raw materials, and overhead. If more units of these are used per widget produced, a negative value-stream variance results. Suppose personnel turnover is high. It is logical to assume that new hires must be onboarded and trained to achieve competency before graduating to proficiency. Is this efficiency curve reflective of the impact of turnover baked into the standards? Less experienced labor may likely be correlated with waste in various forms, e.g., excess hours and materials scrap. Is this rationalized in the standard? A BIG issue is the assumption for uptime on capital assets. Standards assume

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a certain period of downtime for scheduled maintenance. Unscheduled maintenance is a wildcard with potential far reaching adverse impact.

- *Input prices*. Even if labor is seasoned and processes are robust, the cost of labor and materials is subject to supply and demand forces. The COVID pandemic was a practical primer for this phenomenon. In some instances, the vulnerabilities to a global supply chain revealed that some “inputs” were not available at any price.
- *The product line mix.* Whereas, each type of product may have standards, its relative percentage utilization of pooled resources can induce considerable variation. This is one of the issues which reframes the methodology critique to ABC.
- *Process improvement.* Whether Lean, process reengineering, Six Sigma, or Lean Six Sigma, there are many means by which processes are made more productive. Was cost accounting recalibrated to reflect the new normal?

ABC has its own considerations. The integrity of ABC is reliant on tracking resources consumed by the job.

- *Precision matters.* Unless systems can track labor and materials dynamically, the alternative may be isolating labor teams and kitting parts. However, isolated labor with downtime creates waste. Moreover, kitting can drive excesses labor and inventory.
- *Complexity is a consideration.* Whereas navigating complexity may be a competitive differentiator and facilitate higher margins, it also begs the question of enabling systems for reliable information on demand. Requisite systems are not cheap.
- *An audit trail is essential.* When a vast number of unique and expensive parts are assembled by highly skilled labor following unique assembly methods, specific identification tracking may be required. Part serial numbers may be a requirement for certain industries. This may expedite risk mitigation when failure occurs. For example, pharmaceutical companies utilize lot numbers.

All cost accounting methodologies impact pricing strategy. Projected margins from customer retention should be utilized in justifying acquisition cost of new relationships. Stated another way, companies should not spend more acquiring new relationships than the profits expected therefrom. The longer the sunk costs accumulate on protracted solicitation, the more critical becomes the required longevity of profitable customer relationships. This is an internal rate of return principle.

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The C-Level Numbers Leaders

There are many C's to choose from for financial expertise: Certified Financial Planner ("CFP"), Chartered Financial Analyst ("CFA"), Certified Public Accountant ("CPA"), Certified Managerial Accountant ("CMA"), and Chief Financial Officer ("CFO"). There is room for all in the private equity ecosystem, but I do not ever recall a conversation in which all were simultaneously in scope. Let us consider some points.

There are many cooks in the governance kitchen.

A CFP is a professional who a business owner should consult well in advance of deciding to sell the business. This qualification is conferred by Certified Financial Planner Board of Standards, Inc., whose website conveys that "test topics include the financial planning process and principles, tax planning, income and retirement planning, estate planning, risk management, and insurance."

Some bios of private equity professionals available on firm websites include CFA credentials. This certification is conferred by the CFA Institute whose website explains that "the CFA Program is a three-part exam that evaluates the fundamentals of investment tools, valuing assets, portfolio management, and wealth planning. The CFA Program is typically completed by those with backgrounds in finance, accounting, economics, or business."

The CPA qualification is ubiquitous. However, as is the case with an MD (medical doctor), the term serves as an umbrella under which a panoply of specialties resides. The scope of a large CPA firm includes, but is not limited to personal, professional, corporate, public, private, profit, non-profit, tax, management, systems, estate, etc. The CPA exam is administered by the American Institute of Certified Public Accounts (AICPA). According to their website, the exam covers "four sections: auditing and attestation, business environment and concepts, financial accounting and reporting, and regulation."

When managerial accounting is more critical to predictable value-creation, a CMA may be the better pedigreed leader.

The CMA exam is under the purview of the Institute of Management Accountants. Membership is about a third of the AICPA. Simon Sinek would love some of the prose on their website: "experts at explaining the 'why' behind the numbers, not just the 'what'." The two-part exam has a vast scope: external financial reporting decisions; planning, budgeting, and forecasting; performance management; cost management; internal controls; technology and analytics; financial statement analysis; corporate

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finance; decision analysis; risk management; investment decisions; and professional ethics.

A company CFO may have no, or some, combination of the aforementioned credentials. We will explore this further in the next section.

Financial Stewardship

At inception, small entrepreneurial businesses may lack a pedigreed CFO at the helm. Books and records may abide a cash basis on a perfunctorily simple platform. The titles associated with financial responsibilities in these scenarios are revealing. In smaller companies, a bookkeeper may control the checkbook—and this may be a part time role held by someone without an accounting degree. Controller is a higher inferred level of technical education and expertise in the governance maturation process.

As the business scales the lifecycle curve, the sophistication of the financial leadership role needs advanced skills. The advent of professional investors, e.g., private equity firms, catalyzes and accelerates significant changes. The CFO is the senior steward of financial integrity in an "institutionalized" organization. The role leans heavily on governance best practices. CFO responsibilities eclipse the general ledger balance of debits and credits. A logical progression of titles may ensue—Vice President of Finance and ultimately, CFO. Unless and until that level of insourced expertise is available, fractional outsourcing may bridge the gap. Even so, a CFO is not necessarily a CPA—but he/she may have one on an evolving Financial Planning & Analysis staff.

Cost accounting scrutiny is a worthy operational and/or QoE diligence scoping decision.

The veracity and integrity of financial performance is essential to all wise investments—even more so with a leveraged capital structure. Private equity professionals excel on matters of analytical acumen. Their pedigrees often include MBAs from world class institutions. This does not mean, however, that those investors have commensurate operating experience. Moreover, cost accounting veracity may be more of an assumption than a curiosity. In preparation for this article, M3 conducted an informal poll which hinted that cost accounting is not automatically included in the Quality of Earnings ("QoE") diligence scope. This begs a question: Who is responsible for "officially" verifying the robustness of the cost accounting methodology?

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Another revelation about "finance" in the lower middle market is that the focus sometimes is skewed toward knowing the score after the game is over instead of dynamically knowing performance with sufficient precision to adjust the game plan. Private equity metrics tend to be EBITDA-centric, i.e., an output metric. Opportunity pipelines (i.e., inputs) are appropriately garnering more attention, particularly for protracted solicitation scenarios. However, it often matters how the sausage is made in the middle—especially when the value-creation steps are complex, and the product mix is diverse.

First time portfolio companies commonly cross the audited financial statement Rubicon. The management letter from the auditor covers many appropriate risk mitigating and best practice observations. These should, but do not always, include cost accounting commentary. The board of directors' fiduciary responsibility includes an audit committee whose scope should include cost accounting integrity as a risk management hedge.

Conclusion

The lower middle market private equity fraternity relies on strong financial leadership within its portfolio companies. I respect those CFOs for having the toughest job in private equity. They have two distinct primary constituencies: the portfolio company leadership team and the private equity deal team. M3 has worked with many talented CFOs whose managerial accounting skills were developed in the trenches. In terms of career pathing toward the portfolio company CFO role, the rhetorical question is thus framed: Would the portfolio company CFO position be better served by a CMA than a CPA profile?

Cowboy humorist Will Rogers observed that "good judgment comes from experience, and a lot of that comes from bad judgment." For the same reason a patient wants a board-certified surgeon wielding the scalpel when under general anesthesia, M3 defers to CMAs on cost accounting as it may be more likely they focused on cost accounting as an essential core competency to be continually nurtured and honed. M3 often raises these points with its clients, for whom M3 occasionally interviews C-level candidates. Interestingly, awareness of CMAs is less pronounced than CPAs. Moreover, M3 infrequently encounters cost accounting expertise as an interview priority in CFO recruitment. This seems paradoxical for an industry hyper-focused on cost, profitability, and risk mitigation.

Cost accounting questions are advisable in CFO recruitment.

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Past M3 articles have highlighted diligence deficiencies: leadership, technology, and operations. Cost accounting is a fourth and could be scoped within operations diligence appropriate to the business model. Collectively, this could be a prudent precursor to QoE diligence. Operations diligence (scoped to include cost accounting) combined with QoE, could produce something as influential as the management letter if the company were already auditing its books.

Let's return to the Pareto principle for a corollary. For any company plotted in earlier phases of the maturation curve, it is more likely there are things to improve than not. If we apply this to cost accounting integrity, it stands to reason a higher level of scrutiny should be applied to key variables and assumptions.

This article thus ends with three calls to action:

- *Diligence:* Scrutinize cost accounting—especially if the investment thesis anticipates changing the mix of business.
- *CFO:* Assure that the present and future financial leaders either wield cost accounting expertise or have ready access to a specialist who covers their blind spot.
- *Profitability:* Verify on what, with whom, and how the business makes money. Utilize this wisdom in the pricing model to reconcile acquisition cost with account churn.

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Our firm offers a value-creation toolbox of growth, productivity, and cultural solutions to portfolio companies of private equity firms. The premise is that best practice adoption correlates with a smoother investment hold period, resulting in higher exit multiples. Consequently, deal team time is liberated from operational surprises to invest in new transactions.

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