The Case for

RECENT SURVEYS demonstrate the continuing frustration of senior managers in the United States with the lack of cost and resource management capability within their corporations. Now is the time to address this problem. A number of factors are converging that make it both urgent and feasible to transform the world of management accounting—asserting a more appropriate, influential role for qualified and disciplined accountants who are focused on serving organizations from the inside. A new of set of management accounting logic is emerging, directing attention toward a greater strategic role for management accountants.

Most important is the fact that the world authority on accounting, the International Federation of Accountants (IFAC), is pushing a new vision for management accounting premised on optimized deployment of resources. It's time for practicing management accountants to take up the challenge.

Critical to the success of management accounting are new ways to analyze and measure cost information as methods such as activity-based costing (ABC) still have not been widely adopted. One suggested approach, Resource Consumption Accounting (RCA), has been used by manufacturers in Europe for several decades but is new to the U.S. It is premised on, but not modeled on, flexible German cost accounting methods called Grenzplankostenruchnung or, more simply, GPK, and Prozesskostenrechnung,

Management Accounting

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a style of activity-based costing. RCA has triggered the search for a meaningful made-in-the-U.S. approach to management accounting.

THE NEED FOR CHANGE

As illustrated in past and current literature, the financial reporting mentality dominates accounting to the detriment of good management accounting. The result: Organizations have inadequate information with which to plan, monitor and control performance, and support enterprise decision making.

In their 1986 seminal book, *Relevance Lost*, Robert S. Kaplan and H. Thomas Johnson described how the emphasis on statutory financial reporting requirements had created a system that's both undeniable and unstoppable. Every quarter, accountants and their organizations are obliged to prepare and deliver reports to external parties. Yet there's no equivalent legal requirement for accountants to do even an effective job in providing managers with proper information with which to operate the business. An organization's need for relevant information is the driving force for change. This force, however, is muted by financial accounting concerns. Meanwhile, Sarbanes-Oxley (SOX), driven by the events at MCI WorldCom, Enron, Barings Bank, Tyco, and Arthur Andersen, has created even more demands for attention to financial reporting and governance.

Sections 302 and 304 make significant demands on CEOs and CFOs to ensure that the organizations they manage are properly controlled, that numbers and events are reported truthfully and reliably, and that they have taken steps to ensure that processes and controls are effective. While CEOs and CFOs have responsibility well beyond governance and reporting, they also have to satisfy the primary purpose of producing a competitive return on their stakeholders' interests. The combination of planning and running a competitive, responsible organization under conditions in which accountability clearly belongs to these executives demands that management accountants step up to their responsibility.

A 2003 IMA and Ernst & Young survey, which was featured in the July issue of *Strategic Finance*, demonstrates the frustration of roughly 2,000 CFOs and controllers with the current situation.

- 80% reported that cost management is important to their organizations' strategic goals, but
- 98% reported cost information is distorted (due to a large degree of emphasis on overhead allocation), and
- 80% said implementing new cost management tools is of a low to medium priority.

Another survey in 2003, this one of 145 senior financial managers by the RCA interest group of the Consortium of Advanced Manufacturing-International (CAM-I), identified, among other findings:

- 80% of U.S. organizations still use traditional cost-allocation systems.
- Only 23% of respondents were satisfied with decision-support information.

Recent research also points to the lack of a comprehensive and robust cost accounting approach that engenders management's trust in decision-support information and delivers sustainable benefits (see sidebar, "What About Activity-Based Costing?", p.46). Also, CFOs see implementing new cost management tools as a low to medium priority, perhaps because they don't see a viable professional source of employees to deliver the goods. As emphasis for this point, significant government departments are obliged to hire big consulting firms to undertake and maintain their activity-based costing systems because they believe this will provide a long-term cost accounting solution.

Why would CFOs be willing to commit funds to improve their cost management systems when the primary source of management accounting solutions in the U.S. appears to be consulting firms, whose projects are often very costly, unworkable, and unsustainable? (In fact, for a significant number of consulting firms, other than for their IT practices, much of the revenue comes directly from their cost management work.) The answer is that executives feel obliged to turn to suboptimal solutions because there's no coordinated long-term robust management accounting resource pool in the U.S. That being said, it's hard to blame the consulting firms who have simply capitalized on the lack of an authoritative management accounting profession in the U.S. Compare this to public accounting, where there's significant discipline for the development of methods, regulations, and certification. Meanwhile, in Britain, Canada, and Germany, public accountants and management accountants often work in separate departments on equal footing.

TECHNOLOGY DEMANDS CHANGE

Increasing competition fueled by global growth and supply demands more sophisticated management techniques. And the continued influence of computing and communications technologies is driving the need for more knowledgeable and professional management practitioners. Too many organizations have spent hundreds of millions of dollars to implement an ERP system only to discover that, over time, the application of their old management accounting methodologies fails to meet the promised capability on an expensive new IT engine. Of 3,000 SAP client organizations that use the cost accounting modules in the U.S., we would be hard-pressed to find many that use much of the software's cost or management accounting capability. In Germany, it's claimed that 60% of organizations use German Cost Accounting Methods (GCAM) discussed earlier, the core of SAP's management accounting system. This problem isn't limited to SAP. Microsoft Navision has developed resource consumption modeling capability also. The tools are emerging. Now all we need are informed management accounting professionals to dictate how they will be developed and applied properly.

In the mid 1980s, Johnson and Kaplan recognized that management accounting had failed to meet organization requirements. *Relevance Lost* was hailed as the beginning of change for the better in the world of accounting. Sadly, the hoped-for change never occurred, but not for lack of trying. Significant efforts have been made by organizations around the world to implement new cost and performance management tools. These include activity-based costing and the balanced scorecard, both of which were strongly associated with Kaplan. Activity-based costing in particular was perceived to be the solution to the management accounting needs of organizations. Yet, while each methodology has its success stories, neither has achieved its potential. If anything, the management accounting profession was sidetracked by the headlong gold rush that ensued when consulting and software firms clambered to implement them.

At the same time these new methods were being deployed, there was a movement in North American management accounting associations to distance themselves from "accounting." Efforts were made to place management accounting in a more strategic framework, with emphasis on the management aspect. Moving to a strategic emphasis was correct, but the need for accounting remains vital to organizations everywhere, and the need to place it in the broader context of management is critical since the details of accounting—and management accounting in particular—are essential for effective management. The management accounting professional associations missed the point. What is required is inclusion rather than abandonment of accounting (i.e., a stronger profession with disciplined and prescriptive methodologies).

Provision of information for operational, tactical, and strategic purposes that's consistent and draws on a single source is central to effective management accounting and to the development of a strong profession. Just as financial accounting has the general ledger, management accountants need to make use of the tools available to them, including operational, quantitative data from ERP systems and properly developed and deployed methods such as GCAM. It really is time that we seriously examined traditional cost allocation and full-absorption accounting to assess their impact on organization performance. Other methods such as GCAM should be promoted.

MANAGEMENT ACCOUNTING IN THE 21ST CENTURY

According to IFAC, things are changing in the environment in which management accountants serve. The degree of sophistication needed is much greater than it was in the mid-1980s. The opportunities for management accountants to advance are available for us:

- Information systems have advanced to the degree that accounting systems are deeply dependent on nonfinancial operating systems to function. Indeed, ERP systems are highly oriented to management accounting requirements, more so than we've experienced in the past.
- Analytical software permits data to be gathered, manipulated, projected, and reported in ways that were unimaginable 10 years ago.
- Emphasis on shareholder interest has shifted from prior-period profits to value creation premised on expected future cash value of inherent advantages.
- More dynamic, externally driven forecasting methods are replacing insensitive and misguided budgets.
- Decentering of accounting knowledge is happening as the financial impact of operational decisions is better understood by nonaccountants.
- Commercial orientation recognizes the need of managers to apply better and quantitative methods to simulate different profit scenarios.

What About Activity-Based Costing?

Bain and Company report that their own recent survey demonstrates that activity-based costing (ABC) has been attempted by perhaps as many as 60% of organizations in the United States but that only 20% have sustained it. Therefore, the large majority of ABC implementations weren't sustained. Another survey by the RCA interest group of CAM-I demonstrated that only 30 of 145 respondents employ ABC. Perhaps the most interesting finding of both surveys is that 80% of organizations continue to use old-style full-absorption standard costing, absorption, or full-absorption costing methods (i.e., traditional cost-allocation systems). This is interesting because the primary objective of ABC was to correct the distortion created by traditional cost allocation. If 60% of organizations have tried ABC but most haven't replaced their traditional allocation system, then we must assume that there were insufficient reasons to make the change.

Many articles, books, and case studies address ABC. When viewed as a whole, it becomes possible to draw some insight on why ABC has not been sustained. A frequently cited reason is that ABC systems design was too complex. That may be true, but there are other things to be noted also.

In practice, ABC implementation has failed because:

- Software was not IT integrated. Accountants and operating managers want cost accounting to be part of their integrated general ledger, monthly reporting, analysis, performance measurement, and the associated network of operational systems. Small start-up companies developed ABC systems, generally in the late 1980s, as PC-based modeling tools. To this day they haven't been integrated enterprise-wide.
- ABC/M/B/P applications are generally not integrated into organization measurement and management systems. Central to managers going about their business is accountability for their actions. Accountability is accomplished by having managers develop a plan, act upon the plan, and then monitor their performance. Because ABC was largely deployed as a retrospective modeling analysis of prior-period results (often too late to be of any relevance), managers weren't required to use ABC logic as part of the planning process. Successful applications of ABC use it to do planning.
- Most applications have been implemented poorly. The most daunting problem has to be the lack of agreement of what ABC is and how it should be deployed. No institution took responsibility for developing standards for the development and deployment of ABC early in the process. Every consultant, software company, and author took it upon himself or herself to become "the" definitive source. Yet the most successful were the ones with the best connections, not necessarily the greatest experience and competence. It has been quite common to see the presidents of ABC software companies making presentations on the subject to define what they perceived as appropriate practices for ABC, and yet none of them had any management accounting experience. Writings are awash with advice on how to do and how not to do ABC. There's little consistency. Certainly, there hasn't been a serious process for the development, exposure, and creation of consensus of what represents good practice.

The frustrating part of ABC's lack of sustainment is that it remains a good and valid analytic methodology. The methodology needs to be incorporated into future management accounting practices, but in such a way as to overcome the causes of its lack of sustainment. Furthermore, all those managers in 60% of the organizations who have already tried but failed to sustain ABC need a better solution.

Perhaps most important, accountants are recognizing the shift in management accounting. IFAC has changed its definition of management accounting in International Management Accounting Practice Statement (IMAPS) 1, "Management Accounting Concepts," between the first issue in 1988 to its revised version in 1998. In its revised form, management accounting is provided a rich and complex set of guidance, the central theme of which is the idea of resource utilization.

Paragraph 28 of IMAPS 1 states: "Management Accounting refers to that part of the management process which is focused on organization resource use. Thus, it refers to managerial processes and technologies that are focused on adding value to organizations by attaining the effective use of resources in dynamic and competitive contexts." IFAC has a complete definition of management accounting on its website at http://www.ifac.org/.

GCAM OR SOMETHING LIKE IT

The profession also should look at GCAM, which, many people claim, overcome many traditional shortcomings of cost allocation. It's important to note that GCAM are well-founded German cost accounting approaches that emphasize the role of resources while drawing on the evolution of computing technologies and ERP systems.

In GCAM, proper modeling of resources is essential to good understanding of business economics. German cost accountants developed some essential concepts in the 1960s and 1970s that involved responsibility (cost) centers as the focal point of cost planning, cost control, and product costing to monitor and control organization efficiency. Within each center, costs are segregated by resource-consumption behavior characteristics, whether proportional to resource output or fixed. Different measures are employed to quantify resource-consumption characteristics, which might include things like machine hours or number of orders processed.

An important aspect of GCAM is the development and application of a well-designed multi-pool cost accounting system in an interrelated network of resource, activity, and object cost pools. For example, a cost pool would be established for major equipment categories whereby general ledger accounts are actually assigned to the resource cost pool rather than to activity cost pools as in ABC. Explicit and disciplined designation of resource cost pools facilitates proper calculation and application of capacity, as well as the isolation of cost of idle capacity that is treated as a business sustaining cost in product/service P&Ls. Finally, activities and other resource pools can be assigned to a resource cost pool, e.g., maintenance activities and building space assigned to a machine center in a simultaneous manner.

On top of this, a U.S. version of GCAM must include well-developed and disciplined practices in activity-based costing, the latest planning and forecasting techniques, and process management techniques to support Sarbanes-Oxley. Whatever happens, GCAM in the U.S. will become a work in progress, but it must be formalized with proper exposure processes and appropriate diligence.

Perhaps a caution is in order lest software companies and consulting firms become overly excited at the prospects of a new cash-spinning opportunity. A crucial aspect of energizing management accounting in the U.S. has to be the professional process with which proper standards of performance, exposure drafts, committees, and certification are achieved. The process isn't for the fainthearted. What is proposed is a continuation of the journey that was launched by *Relevance Lost*. To be successful, industry, academic, government, and professional organizations need to pull together to launch a disciplined, sustainable, strong management accounting profession that has integrity and authority.

The management accounting profession must determine the appropriate positioning of properly qualified practitioners in organizations. The profession needs to breathe life into its research programs and to drive the methods management accountants will learn and apply in pursuit of their critical organizational role and responsibilities. IFAC has given us a starting point with the new definition of management accounting. Now we must develop the implementation and certification programs to support it. Academics and practitioners should be willing to step away from a system of constructs defined by financial reporting and move to establish a new set that is specific for management accountants where it's recognized that regulatory compliance is necessary but insufficient.

NOW MORE THAN EVER

The gauntlet is down to everyone in the accounting profession, especially in the U.S., though professionals in other parts of the world will be affected and have a contribution to make. Never has the challenge been so stark and pertinent. The accounting profession in the U.S. and elsewhere has had to face itself in the mirror over the past few years in order to recognize itself as badly flawed. It's now clear that depending on regulatory, external reporting; financial reporting; and external audits and auditors is insufficient. It's time to bring accountability to where it belongs—to managers supported by a cadre of professional management accountants. The banking community is making headway with the Basel Accord. Examining and developing GCAM or something like it in North America is one initial step.

Ladies and Gentlemen, sign up and take up the challenge! Our management accounting profession is in disarray. Let's go to work. ■

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