

# Chapter Zero in Perspective

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**ALTHOUGH THE MANAGEMENT ACCOUNTING PROFESSION HAS UNDERGONE MAJOR TRANSFORMATIONS IN THE LAST 20 YEARS, MANY PRACTITIONERS AND ACADEMICS SAY GERMANY IS FAR AHEAD OF THE UNITED STATES IN DEVELOPING STANDARD PRACTICES. WHAT ARE THE NEXT STEPS THE PROFESSION NEEDS TO TAKE TO HAVE WORLDWIDE COHESIVENESS?**

**T**his article provides an overview of Chapter Zero, the introductory chapter to the latest edition of the preeminent cost accounting textbook on German Standard Costing, *Flexible Plankostenrechnung und Deckungsbeitragsrechnung*,<sup>1</sup> and looks at some developments that have had an impact on U.S. management accounting. Chapter Zero also describes how German management accounting should move forward. Aspects of this proposal that would work for U.S. management accounting also will be examined.

Although the textbook discusses the development of standard costing in Germany over the years, its primary focus is the most advanced form, which goes under various names: standard costing, flexible standard costing, marginal costing, contribution margin accounting, the latter two terms combined, and Grenzplankostenrechnung (generally abbreviated in U.S. literature as GPK). Each of these names highlights a certain aspect of a broad, sophisticated approach.

*Flexible Plankostenrechnung und Deckungsbeitragsrechnung* literally translates into “Flexible Plan Cost

Accounting and Contribution Margin Accounting.” In this article, I will use the term marginal costing, which is a literal translation of the predominant term used in the German text. Do not, however, read too much into the use of the term “marginal.” Although a sophisticated approach is used to determine marginal costs for every cost object, German standard costing is not a direct (variable) costing system. A good one-paragraph description of marginal costing is given at the outset in Chapter Zero (see Section 0.1).

## **THE RELEVANCE OF CHAPTER ZERO TO U.S. MANAGEMENT ACCOUNTING**

Why consider what is written in a German textbook? For the simple reason that a path well trodden is one easier traveled. As will be evident from Chapter Zero, management accounting in Germany is facing transformation pressures but seems positioned to come out stronger on the other side. U.S. management accounting can learn from the German experience in a number of areas:

◆ Gain more insight into what transpired over the last

two decades and why,

- ◆ Understand the current state of U.S. management accounting,
- ◆ Gain insight into a path forward, and
- ◆ Leverage established approaches.

Moreover, there is a distinct lack of critical debate and discussion in the U.S. management accounting profession from both academia and practitioners, which hinders progress and is unhealthy. Take, for example, the virtual absence of material on the weaknesses/pitfalls of activity-based costing (ABC).<sup>2</sup> Chapter Zero sheds significant light on the issues related to the developments over the last two decades, which marginal costing brought to the fore in Germany yet traditional standard costing (or its proponents) in the United States failed to highlight.<sup>3</sup> Chapter Zero, then, is relevant not only from the perspective of providing insight into the past and a glimpse into the future but also in identifying concrete levers that can be used to launch U.S. management accounting's own restoration process.

### BACKDROP TO CHAPTER ZERO

The last one-and-a-half decades of the 20th Century were marked by developments that challenged conventional management accounting theories and thinking. The authors added Chapter Zero to the 11th edition of the marginal costing textbook to address these developments from a German management accounting perspective. The developments can be divided into two broad categories:

- ◆ Economic and industrial structural changes (refer to Section 0.2), such as the decline in manufacturing significance and the rise in outsourcing, and
- ◆ Innovative ideas in management systems and tools from new thinkers (refer to Section 0.3.4), such as ABC and the balanced scorecard.

Although the United States served as the primary breeding ground for the new thinkers, their ideas spread quickly. Germany faces similar transformation pressures and recognizes the need to change (Section 0.3.3). In contrast to what happened in the United States, developments in Germany unfolded along different lines.

Early on, ABC took two aspects of the U.S. establishment to task: the “peanut butter” spreading of bulging

indirect costs and the relevance of the management information provided. The latter almost inexorably—because of the lack of an independent and robust management accounting discipline in the United States—led to battle lines being drawn between ABC and financial accounting (GAAP).

In Germany, on the other hand, with its well-entrenched management accounting discipline, the new thinkers faced something wholly different—marginal costing. This made their endeavors both less risky and more challenging. Less risky because financial rule makers, the might of the capital markets, and capital market regulators did not have to be confronted on the relevance issue.

On the other hand, their task was more challenging due to the entrenched nature of marginal costing. As it turned out, marginal costing was a totally different kettle of fish, and transplanting the arguments from the United States into Germany would prove less successful when measured against initial U.S. “victories” for ABC. For various reasons, such as a high level of sophistication and the decision relevance of the management information provided, marginal costing proved difficult to ridicule compared to traditional standard costing. The main thrust for change in Germany ended up arguing for simplification and questioning the benefits of a perceived overkill in precision (Section 0.3.2).

Today, particularly in the United States, a view of the management accounting solution that will integrate the best of the old and the new while supporting effective management of the 21st Century enterprise remains elusive. Such a solution requires a thorough understanding of the strengths and weaknesses of the old and the new concepts. As is evident from Chapter Zero, the clash between marginal costing and the new thinkers resulted in vigorous debate and active research in Germany that will serve as a sound foundation going forward. The results so far, the path forward, and a glimpse at the way the problems will be solved are also discussed in Chapter Zero (refer to Sections 0.5 and 0.6).

### WHAT IS LEFT STANDING, AND WHAT MUST STILL BE RESOLVED?

The authors of Chapter Zero liken the current transformation process to a similar event that occurred in

the 1960s and 1970s when Riebel's and Plaut's approaches were integrated into German management accounting (Section 0.4). To highlight progress and point to aspects that still need to be settled in the current transformation process, Chapter Zero identifies a number of areas where marginal costing and the new concepts are at odds with each other as well as areas where they are considered complementary (see Section 0.5).

It is significant that complementary areas generally are enhancements to the foundation laid by marginal costing. For example, see the discussion on indirect cost areas (Section 0.5.3) as well as leveraging the structures and information of marginal costing for value-based management and the balanced scorecard (Section 0.3.2). Some of the new concepts fall into the category of management methods and fulfill requirements not previously satisfied, such as target costing and process reengineering and optimization.

Areas where marginal costing and the new concepts are at odds tend to be more fundamental and center on ABC's proposed shifts in the principles to be applied. In particular, ABC's abandonment of the causality principle for "resource usage," its approach to cost categorization, and its view on variability are some of the aspects that remain to be resolved (Section 0.5). In this regard, Chapter Zero is particularly skeptical of the applicability of ABC information obtained by applying these principles in decision theory. Nevertheless, German management accounting is well poised to leverage learning and research over the last 15 to 20 years into a holistic solution for the 21st Century.

### WHAT CAN U.S. MANAGEMENT ACCOUNTING LEARN FROM THE GERMAN EXPERIENCE?

As indicated previously, there are at least four areas where U.S. management accounting can learn from the German experience.

#### *Insight into what transpired over the last two decades and why*

Here we are concerned primarily with insights relevant to Chapter Zero that are applicable to U.S. management accounting. They fall into several categories:

◆ **Grasp the smaller picture first.** The disastrous result of

taking on the U.S. financial accounting rule makers in an attempt to drive management accounting change is now a matter of documented history. If "problems are messages," as has been claimed, someone did not understand the message. More importantly, because traditional standard costing is still the dominant method in use and the relevance of management information is still an issue, do we understand the messages yet? The scenario and the consequences that played out in the United States never came up in Germany because the German management accountants recognized that the real enemy was not outside management accounting's city walls.

◆ **The fallout of a shunned profession.** Traditional standard costing was easily overrun, partly because its army was already weak. In Germany, the financial and management accounting professions remain equals.<sup>4</sup> What was needed in the mid-1980s in the United States—and still is—is a strong management accounting profession. What it will take to get there and the form it will take lie in the hands of the U.S. business community—management being the preferred patron of management accounting's place in the sun. Failing that, the Sarbanes-Oxley Act of 2002 seems to signal that it will be forced onto the business community.<sup>5</sup>

An approach that balances highly regulated financial accounting (with the weight of statutes and penal codes behind it) with unstructured management accounting is in place in Germany. For whatever reasons U.S. corporate decision makers neglected the pursuit of relevant information, it is hard to believe that long-term competitive advantage is served by the status quo. Moreover, the effectiveness with which the German model weathered the transformation storm points to an approach worth investigating, at the very least to prevent a reoccurrence of recent history the next time something new is introduced.

◆ **Understand the principles and their implications.** The lack of sound capacity management in ABC, the move to full absorption, its approach to cost categorization, the abandonment of the principles of causality, and variability (see Section 0.5) while applying ABC results in the realm of decision theory—wholly inappropriately—should be lessons learned. Particularly in the United States, where the view prevailed that all costs related to

a process/activity are variable (implying avoidable), this was disastrous.<sup>6</sup> For example, ABC information, typically based on historical G/L data, was applied regularly in outsourcing decisions, which conventional thinking suggests is entirely a discounted-cash-flow scenario. In Germany, skepticism and a healthy debate prevailed with regard to ABC information for decision making (see Section 0.5.5).

◆ **Keep the technology curve in sync.** Initially, simple ABC models were built on floppy disks, and money-spinner consultants proliferated them to great effect but with perilous consequences for consistent application, sound theory, and quality. In contrast, marginal costing's information technology base has its roots in the late 1960s.<sup>7</sup> Robust, integrated enterprise resource planning (ERP)-based management accounting systems (running parallel to the G/L) were in use by the mid-1980s to support marginal costing.

◆ **A misplaced emphasis on the KISS principle.** ABC's lack of sophistication made the concept attractive at first, but this was also one of the biggest contributors to its eventual problems. For whatever reasons, the 1990s saw a widespread knee-jerk reaction to social, economic, and technological complexity, particularly in the United States. "Keep it short and sweet" became the mantra in business, and complexity was enemy number one—never mind that reality is as complex as is mirroring business economic activity.

The resultant perils of oversimplification, particularly with regard to sound decision theory (see the outsourcing example above), should be bookmarked for future reference. It was Einstein who said: "Things should be as simple as possible but not simpler." The post-Enron and WorldCom world is not simple and never will be. The solutions to managing it effectively will also not be simple, but technology can be made to carry most of this burden as envisioned in Chapter Zero. In any case, a critical aspect of a future management accounting solution has to be that of coming to terms with the appropriate level of detail required. In Germany, gauging by the latest adoption rate of marginal costing, the KISS principle found few adopters.

◆ **Different costs for different purposes.** Some voices in U.S. management accounting argued for keeping ABC in the realm of strategic modeling—an area where

ABC's principles, such as resource usage, are far more relevant. But the general need for better decision support in U.S. businesses drew ABC into the operational fray and product costing. In this regard, and in retrospect, the resultant feeding frenzy that ensued among management consultants was the worst scenario anyone could wish on an enemy. ABC was applied as the product-costing engine on the back of more sophisticated client/server software, its overtly strategic principles and pitfalls in decision theory notwithstanding. In Germany, the debate still rages on this (see Section 0.5.5).

While critics of ABC might feel vindicated, given what happened over the last two decades, this is only half the story.

#### *Understanding the current state of U.S. management accounting*

The other half of the story is that U.S. management accounting is not nearly as poised to advance as its German counterparts. It is ironic to note that the measures of the new thinkers' initial success in the United States—how quickly they were able to overwhelm established management accounting thinking and the rate of adoption of ABC—turned out to be indicative of the degree of ultimate failure.

Survey after survey indicate that ABC has gone through significant decline in recent years and that U.S. organizations have retreated to familiar ground: traditional standard costing.<sup>8</sup> Yet traditional standard costing now has little, if any, credibility, which leaves U.S. management accounting with a weak foundation. The picture is one of a crushed resistance and a toothless victor, resulting in much disarray and signaling the need for major rebuilding and hard work ahead.<sup>9</sup> Add to this the lack of insight as to what transpired and why, the lack of knowledge as to how to prevent a reoccurrence, and a lack of vigorous debate. The road back to the top seems impassable.

In Germany, where initial success for the new thinkers was less spectacular, the picture is very different. Marginal costing has immense credibility, and ABC already has been adapted—to Prozesskostenrechnung (process costing)—to integrate better with marginal costing.

Finally, it is noteworthy that the theory of constraints

(TOC) gets no mention in Chapter Zero. This is understandable because TOC is not a management accounting approach per se but a production scheduling approach with limited monetary views of resources. Moreover, marginal costing provides superior decision-support information for the types of decisions that TOC purports to enable. This is particularly true with regard to insight into the operating expense (OE) cost pool—TOC's black box. The tug of war between ABC and TOC speaks volumes about the state of management accounting in the United States. Why the need to be at each other's throats? These are, after all, different management tools, and each has its rightful place in a holistic and integrated management accounting solution.

### *Point the way forward*

Yet Chapter Zero also points to a possible way forward. At a minimum—and as a possible first major milestone—U.S. management accounting must get to the point where its German counterparts find themselves today: on a well-grounded, solid foundation to integrate the new and the old. The resuscitation of traditional standard costing in the U.S. for this purpose seems both a monumental task and doomed to failure. Clearly the path forward is a matter of expediency over homegrown perfection, and it requires participation from all walks of the management accounting discipline.

Attempts to revive old fiefdoms are to the detriment of management accounting as a whole and should be met with stern resistance. Fully addressing the reasons for the status quo in U.S. management accounting and what is needed to get back on track should be the first priority. Current attempts to revive ABC should be subjected to rigorous scrutiny, particularly where and how a modified ABC would fit in a future integrated management accounting landscape.<sup>10</sup>

What is needed is a holistic solution that effectively integrates the best of the old and the new management accounting approaches, management methods, and tools. Only then will relevance truly be recovered as envisioned in the mid-1980s.

### *Potential to leverage established approaches*

Given the enormity of the task facing U.S. management accounting, it seems appropriate to tap into what is

available locally and elsewhere. Leveraging established approaches in closing the current gap is clearly the more expedient approach.

Despite a sophisticated attempt in Germany to dethrone marginal costing, it has survived the onslaught of the new thinkers. Research indicates (see Section 0.6) it is more entrenched now than ever. This is a testimony to its solid grounding in management accounting theory and its acceptance by practitioners. These characteristics are essential to any approach that would serve as the foundation of a future management accounting solution.

### **THE FUTURE**

The global management accounting environment is not dormant, nor is it waiting for U.S. management accounting to come to terms with its own problems before everything moves on. Instead, changes are occurring on multiple fronts that hold more implications for U.S. management accounting:

- ◆ International accounting standards convergence is under way;
- ◆ After serious corporate misdeeds in the United States, regulations are tighter, yet they now allude to topics closer to management accounting's home—an accurate reflection of economic activity and internal controls;
- ◆ Significant effort has been invested to establish international management accounting definitions and standards.

Management accountants are struggling to come to terms with the effects and significance of the events of the last two decades as well as with how to transform their work into something of substance and permanence that will deliver real value to enterprise managers and the stakeholders they represent. As is evident from Chapter Zero, U.S. and German management accounting—and probably others, too—are in the same boat. Why not all row with what we collectively possess while pointing the ship's bow in the direction of that common destination? ■

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ment in ERP systems and has published on the topic extensively. He holds a degree in mechanical engineering, a B. Comm degree in economics and transportation economics, and a master's in business leadership. The latter included a thesis on GPK and an international research project into 180 companies that had implemented the German cost management approach. Anton can be contacted via e-mail at [antonvdm@RCAinfo.com](mailto:antonvdm@RCAinfo.com).

- 1 Wolfgang Kilger, updated by Kurt Vikas and Sochen Pampel, *Flexible Plankostenrechnung und Deckungsbeitragsrechnung*, Gabler GmbH, Wiesbaden, Germany, 2002.
- 2 Philip Beaulieu and Anita Larka, *Coverage of Criticisms of Activity-based Costing in Canadian Text Books*, Haskayne School of Business, University of Calgary, Calgary, Alberta, Canada, October 2002.
- 3 In this article, "traditional standard costing" refers to standard costing as practiced in the United States, while the term "German standard costing" refers to GPK.
- 4 Paul Sharman, "Bring on German Cost Accounting," *Strategic Finance*, December 2003, pp. 30-38.
- 5 *The Sarbanes-Oxley Act*, Section 103 (a) (2) (A) (iii)(II)(aa), "including maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;" and Section 302 (a) (5) (A) refers to internal controls of such design and operation as to "...record, process, summarize and report financial data."
- 6 Anton van der Merwe and David Keys, "RCA Case 1: Excess and Idle Capacity," *The Journal of Cost Management*, Volume 15, Number 4, July/August 2001, pp. 21-32.
- 7 Hans-Georg Plaut, Heinrich Moeller, and Werner Medicke, *Grenzplankostenrechnung und Datenverarbeitung*. (Marginal Costing and Data Processing), Munich, 1968.
- 8 The CAM-I RCA Interest Group Survey into Marginal Analytics, an online study conducted in May-June 2003; Ashish Garg, Debashis Ghosh, James Hudick, and Chuen Nowacki, "Roles and Practices in Management Accounting Today," *Strategic Finance*, July 2003, pp. 30-35.
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- 10 Robert S. Kaplan, *Activity-Based Costing: Modified Approach*, Harvard Business School Press, Boston, Mass., July 2001, and "Easier than ABC: Will 'activity-based costing' make a comeback?" *Economist.com*, October 23, 2003.