

# Why Is Traditional Accounting Failing Managers?

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## Summary

Critics have claimed that traditional managerial accounting is at best useless and at worst dysfunctional and misleading. Today's general ledger and budgeted spending systems support departmental and "stovepipe" managerial philosophies. In contrast, activity-based costing (ABC) information supports project and process-based thinking.

Cross-functional processes are now recognized as the integrating theme for how work gets done, how outputs are produced, and how customers get served. Only ABC can bring true fact-based measures and visibility to costs, without the dreaded and often distorting cost allocations. Further, ABC both quantifies what all outputs cost, in addition to product costs, and more importantly why things have costs. These insights are gained by identifying and measuring the cause-and-effect related activity cost drivers. Cost drivers provide sound logic, which leads to orders-of-magnitude and better accuracy of the costs of outputs, products, services, and customers.

ABC then serves as the framework to associate these true costs with their value and waste, their strategic importance, their level of performance, and other "attributes" of work. All of this cost and trait data are further translated into which products, customers, or internal company-sustaining people cause and consume all of the resources . . . and in exactly what proportions.

Ultimately cost data is simply a means-to-ends where the ends are the decision-making of the organization. Today an emerging focus is to become a "learning organization." Unlike traditional accounting reports, which managers react to by being happy or sad, ABC data makes them smarter!

ABC is becoming successful because there is a structural problem resulting from deficiencies with the *existing*, traditional financial accounting methods. Traditional accounting relies on the general ledger (G/L), which is a collection of account balances where transactions are recorded. The G/L's focus is not on what is the work and conversion of raw materials into finished products; in contrast, ABC's focus is on the work.

As a solution, ABC acts as a translator for the G/L, not a replacement for it. The G/L's substantial payroll-related amounts give managers virtually no visibility to the *content of work* going on nor the interrelationships between that

work and other work or products or customer services. To further weaken the G/L's usefulness, it is organized around separate departments or cost-centers, whereas individuals within these artificial groupings are continuously commingling and multi-tasking within and among the numerous projects and core business processes.

ABC solves the G/L's structural deficiency by translating the G/L into a much differently organized and more flexible database. One key difference is that ABC describes the activities with an "action-verb-adjective-noun" grammar convention, such as "inspect defective products." People relate better to this cost-wording, and it also allows for linear relationships with variable costs and their activity costs rates. This information is essential for cost estimating.

How long will companies want to perpetuate making decisions with their traditional costing systems? How long can they remain competitive with them?

## Why Is Traditional Accounting Failing Managers?

The approach selected to describe this paper is by using an interview of myself, the author:

*Q 1.1: Some organizations would argue that they have gotten along for years without using activity-based costing or ABC. Why then would they need ABC today?*

A 1.1: In the past, organizations were profitable or, if they were in the not-for-profit sector, were well funded. Also, in the past, their organization was simpler relative to today, with less variety and diversity of products, services, and customers. Consequently their overhead costs were lower.

In the past, organizations could make mistakes, and their profitability would mask the impact of their wrong or poor decisions. They could carry unprofitable products and customers because the winners would more than offset the losers.

Back then, organizations could still survive with misleading cost allocations and the lack of visibility from their general ledger cost systems.

Today the margin for error is slimmer. Organizations can't make as many mistakes as they could in the past and remain competitive. Price quotations, capital investment decisions, and make versus buy decisions all require a sharper pencil today. Many of their competitors understand the cause-and-effect

connections which drive costs. The resulting price squeeze is making life more difficult relative to the past.

And today, the road is no longer long and straight, but it is windy with bends and hills, which doesn't give much visibility or certainty to the future. Organizations need to be agile and continuously transform their cost structures and work. This is difficult to do when organizations don't understand their cost structures and economics.

**Q 1.2: ABC seems to have a "schizophrenic" reputation. Some people claim that ABC is just a better way to more accurately allocate costs to products or customers. Others suggest that ABC is a better form of cost information used for continuous improvement and to manage business processes. Which is correct? Is ABC an accounting tool or a management tool?**

A 1.2: ABC is schizophrenic because it is both a better process management tool and a cost assignment-to-outputs tool.

Many organizations need the data strictly for *strategic purposes*. Complexity and increased proliferation of products and customers have increased their overhead costs, without an adequate way of tracing to who or what consumes it. Organizations can no longer intuitively guess where and with whom they are making profit. They need ABC to segment the diversities and properly trace the consumption of their resource costs.

Organizations also realize that regardless of the source of their profits, they must manage the process costs and remove waste and unused capacity. Their use of a ABC is for *operational purposes*. Since the structural inadequacies of their existing general ledger systems deny them a process-based view of workflow cost across their organizational boundaries, they need ABC to understand where those costs are, what drives them to occur, and which costs may be low-value-added or potentially impactable near term.

Up-front, these organizations use the ABC data to reengineer by defining the as-is state, which usually introduces some organizational shock since the real truth about costs comes out. They focus on activity management. Post reengineering organizations next link the same ABC data with their continuous improvement, TQM, and process management programs. Many will use ABC data as the inputs for their "balanced scorecard" performance measurements.

The ABC data is simply means to ends. That is why ABC should never be labeled as an improvement program or "fad of the month." ABC data simply makes visible the economics of the organization, which are occurring with or without ABC present.

**Q 1.3: Please describe the key issues and concerns that people and organizations have with activity-based costing, or ABC.**

A 1.3: The issues with ABC depend on where an organization is with regard to ABC, and there are three starting points:

- *Beginners*—the issue is how to get started. They know ABCs' value but not the path.
- *Pilots*—pilots have begun their discovery with ABC. They know there have been some implementation failures. They want to increase the likelihood of success.
- *Advanced and mature users*—these organizations have always been interested in two goals: (1) to institutionalize ABC into a permanent, repeatable, and reliable production system, and (2) to establish the ABC output data to serve as an enabler to their ongoing improvement programs, like TQM, change management, cycle-time compression, core competency, business process reengineering, and so on.

But there are new emerging issues for the *advanced and mature ABC users*:

- integrating the ABC output data with their decision-support systems, like capital investment justification
- integrating the ABC data with cost estimating and predictive planning, including activity-based budgeting (ABB)
- learning the skills and rules for re-sizing, reshaping, re-leveling, and otherwise readjusting the model's structure in response to solving new business problems with the ABC data
- collecting and automatically importing the data into the ABC system.

**Q 1.4: Perhaps you could give us a basic overview of what ABC is. More specifically, could you explain how ABC works, and how is it different from what is done today?**

A 1.4: It's easier to understand ABC if we start with what is done today. If you simply ask a sample of managers how happy they are with their existing financial data to make decisions in order to improve their organization's competitiveness, you can guess the answer. It's thumbs-down. We've already touched on some of the causes that stem from structural deficiencies of the general ledger. They simply can't relate to the data or find it wanting.

Many financial systems are used for command-and-control accounting police purposes when in fact the best uses for financial data is for predictive planning, cost estimating, and decision support. Again the traditional general ledger approaches fall short with rigid two or three step allocation structures, which still result in arbitrary allocations, not traced due to causality. And these cost allocation schemes do not capture the step-variable cost behavior that one gets from the cost assignment logic and cost drivers used in an ABC system.

Most organization's cost allocation schemes are at best useless, and at worst dysfunctional and misleading. There are plenty of "allocation food fights," which disturb people, including transfer-pricing.

ABC resolves and corrects these structural shortcomings of the general ledger by using an advanced cost re-assignment mechanism. ABC flows costs with the understanding that events trigger work to happen. Consequently, the costs, which measure the event's effect, then flow back towards from the event. Most events, called activity cost drivers, start with customers who effectively place the demands on work which then shows up as costs.

ABC does not use general ledger language like "payroll" or "maintenance" but instead uses phrases like "process international invoices." These phrases, which describe the work activities that people and equipment perform, are worded as an "action verb-adjective-noun" grammar convention; employees can relate much better to this language and sense they can favorably impact the work it describes.

Next, these defined activities, which have translated the organization chart into its elements (hence dissolving the chart and leaving it behind), can be directly traced to those suppliers, products, base-services, customers, or outputs that are causing the work to occur and fluctuate. Better yet, this tracing can recognize in what proportions the diversities of the cost receivers uniquely govern the consumption of the work costs.

If work is consumed by other work that is too far removed to recognize the diversity of the final cost receiver, that is fine with ABC. By default that work activity cost can be directly traced to other work that does drive it and which is intermediate to the final products. For example, when personnel spends more time recruiting with a high turnover area, the work of that area is effectively more expensive.

This power of ABC to reassign cost along an arterial flow network without regard to levels or "steps"—and at the element of work, not a department—gives it great accuracy. ABC is far superior to cost allocations computed on "columns-to-rows" spreadsheets, which only the accountants can understand.

To add to the power of ABC, the same activity cost data used to reassign costs to the cost receivers can also be assigned sequentially and additively to see and understand the costs of the end-to-end business processes. Again, the structural deficiency of the vertical cost-center structured general ledger prevents managers from seeing this horizontal view.

Finally, ABC allows "attributes" to be scored and graded against the activities. ABC attributes allow managers to differentiate activities from one another. Multiple activities can be simultaneously tagged with these grades, and of course the dollars trail along at the activity level.

***Q 1.5: You have been involved with ABC since the 1980s—some people refer to you as one of its "pioneers." By looking back on its history, what pet peeves do you have about how ABC has progressed?***

A 1.5: First, I'm not so sure I'm a pioneer as much as an archaeologist. Most managerial improvement methods have been written about and discussed for decades. I was fortunate to get involved when the tools and greater needs for them emerged.

The areas of ABC which have surprised me as the impediments to progress with the ABC movement are: (1) the slow recognition of ABC as a behavioral change management tool, (2) the excess amount of unnecessary detail and precision placed in the pilot ABC models, and (3) poor model designs and architecture of the cost flow assignment logic.

1. ABC project managers have been slow on the up-take to recognize the behavioral change management aspects of the ABC data. ABC is a socio-technical tool, and the emphasis should be on the socio. Many ABC project teams see ABC as simply a better measuring scheme or cost allocator. However, it's real value is introducing undebatable fact-based data, which can be used by employees to build business cases, to quickly recognize business problems or opportunities, and to test hypotheses. The last use is important so that good conclusions can be attained prior to taking actions.

2) Many accountants and engineers presume that "precise inputs equates to accurate outputs." With ABC's reassignment of cost logic, errors are not additive or compounding; they dampen out as the accumulating costs approach their ultimate cost receiver. As a consequence, the ABC flow model can tolerate reasonable input errors and still yield roughly right numbers. In the end, the level of accuracy depends on what decisions are made with the data.

Unfortunately, the ABC teams never start at the end decision and discuss the accuracy requirements of the data, but they presume tremendous levels of detail and precise inputs. This leads to oversized ABC models that are way past the diminishing returns on incremental accuracy. The ABC projects fail under the weight.

3) Poor model designs lead to poor results. It's that simple. Yet most ABC projects are first-time efforts, even if they are lead by very talented people. As a consequence, the models usually have odd shapes and sizes that are inconsistent with the degrees of variety or diversity of the products and customers and with the degree of complexities in the business processes.

***Q1.6: It appears as if the case for ABC data is pretty strong. What do you see as the future for ABC?***

It goes without saying that ABC will become the organization's permanent, repeatable, and reliable production system

for managerial accounting. The only issue is how quickly that will happen. And as institutionalization happens, the subsequent issues are: (a) how deep and granular will the levels of detail be for the ABC system, and (b) how frequently will the costs be updated. Today many organizations refresh their ABC data monthly, but with greater computing power coming, we'll head into the shorter time intervals of weekly, daily, and, ultimately, dynamic costing.

The future of ABC is in the areas of (1) tool convergence, (2) data visualization and animation, (3) uses of the data for predictive planning and unused capacity management, and (4) model design validation, industry standardization, and certification.

1) The output of ABC data is frequently the input to another system, such as a customer order quotation system. There will be a convergence as these now somewhat separate tools become part of a tool suite.

2) Someone once said to me, "If you can't draw a picture of it, you can't understand it." Data visualization is coming. With ABC, visualizing is a natural for better viewing the model's shape and assignment logic. Also, for viewing the business processes, ABC's end-to-end view of activities, it will be logical to move beyond racked-and-stacked numbers and move to viewing process flow charts.

3) ABC is not really an "accounting police" tool to punish people for their past behavior. ABC data is business intelligence used to either (a) see and assess things, through the lens of costs and work activities, much of which have never been seen before; or used to (b) estimate the cost consequences of future decision options.

For assessing the organization's behavior, ABC's data will give much more clear and accurate views of the costs of just about anything imaginable to place a cost on. Fact-based decision-making will replace today's reliance on people's intuition and assertions.

The big opportunities for ABC are in predictive planning, cost estimating, and managing unused or unnecessary capacity. Here the ABC model will have captured all the cost rates and traits of the current state. I like to think of it as the "inertia" or speed the organization is currently running at, and burning resource costs at that rate. That data is all calibrated to use for project future costs of various "what-if" scenarios. This is done by estimating new quantities of the cost drivers to "reverse-calculate" the ABC model to solve for the level of resources to be consumed in the "to-be" state.

4) The rash of poor model designs and construction will be resolved as the rules and properties of ABC models are documented and understood. Industry process templates and standard dictionaries, albeit a level or so above where employees uniquely define their work, are inevitable. They will speed an ABC start-up plus introduce consistency, which is

sorely needed by the benchmarking industry that suffers from an apples-and-Oreos syndrome.

***Q1.7: You have consistently stated that an impediment that has slowed widespread acceptance of ABC involves the "rate of learning" about ABC. Training courses and books exist on ABC. Why then do you see the ABC movement as slow-going?***

A1.7: There are three factors which seem to apply drag or friction to the ABC movement, which itself is actually picking up steam: (1) costs are outside most people's comfort zones, (2) the degree of organizational resistance to change, including ABC, is grossly underestimated, and (3) for some organizations, there is insufficient cost pressures, but these organizations are becoming a minority.

(1) Costs measure the effect of events much more than their root cause. And costs are not tangible or physical. You cannot go to a store and purchase a couple of costs. What would they look like? Costs really reside in an abstract information space somewhat like a shadow or echo. I like ABC costs to be thought of as a sonar-imaging system; here we "see" the effect of the cost drivers.

(2) Resistance to change is natural to people. They like the status quo. They usually will not try something new or different unless there is some combination of (a) dissatisfaction with their current situation, and (b) a vision of what a better condition looks like. With regard to managerial accounting, most people are unhappy with their current accounting data but cannot articulate why. When they are helped with understanding why, they then see ABC as a rescue line that resolves the structural deficiencies of their general ledger data.

(3) The more that organizations discover they are in a profit margin squeeze, that they are threatened with limited funding, or become anxious that they cannot comfortably gauge the cost consequences of their decisions, then the more they take interest in ABC.

***Q1.8: Traditional information systems are created with planning that emphasizes a substantial amount of up-front "requirements definition." Is this practice effective for designing ABC systems?***

A1.8: The step of requirements definition planning often taken with systems projects may be appropriate for most projects, but not necessarily for ABC. ABC has a tremendous "leveling problem"—it is difficult to determine in advance what levels of detail and where. There are many interdependencies within an ABC model that ultimately govern those levels plus the accuracy of the outputs. Hence, it is better to quickly construct a baseline ABC model and then iteratively make adjustments from that scale model.

A rapid ABC model design simulation also helps accelerate the organizational learning about how ABC really works, not just its concepts and benefits. The initial ABC model built

this way is basically a disposable, throwaway model, a place where you can make your mistakes and fix them in the next iteration. The ABC model design remains intact; it is just the data that can be discarded. However, surprising to the participants, the output data already begins to directionally reveal new facts or results counter to the organization's belief system that up until now were part intuition and part legacy.

The alternative to a rapid design followed by iterative adjusting is a potentially large-scale failure. I look at the up-front scale model design as an insurance plan; you pay a little premium, just a few days up-front, to prevent a later disaster, plus assure that everyone's learning about ABC is taking place.

If you teach people to fish, they can fish forever. Quickly learning what ABC is all about and what data is involved can allow fine-tuning via sensitivity analysis based on the initial ABC model.

***Q1.9: We frequently hear about the importance of cost drivers? What is so important about them, and are there any misconceptions about them?***

A 1.9: Cost drivers are the "pump and valve" of the ABC cost reassignment system. They are critical because not only do they segment and flow the costs to reflect the diversity of the products and customers, but they govern the accuracy of the output.

Resource drivers are the first out of the chute. They simply reflect how much various people do various work activities. Here, precision is not as important as simply having plenty of little estimates. Next, the activity cost drivers take over. They reassign the costs toward their target final cost objects. What is nice about these is that they truly have a linearly variable relationship between the activity cost and its driver quantity. A large misconception is that all activity cost drivers must be measurable and imported from a transaction-based data file. In reality, employees have tremendous insights in their brains and can estimate the quantities or proportions of the driver to their cost objects. There is a minor fall-off in accuracy, but at a tremendous cost-savings in data collection.

The largest misconception is that overall accuracy, or the flip-side error, of the final cost outputs (products, base-services, and customers) is governed by the precision and accuracy of the inputs. In reality, since ABC is a reassignment system, error does not snowball, it dampens out. And the assignment logic is really a "direct-costing" architecture. Hence, the real contributing source of accuracy is not the input data, but the cost assignment logic network itself!

***Q 1.10: You have said that ABC's future would be part of a "tool convergence." Can you expand on that?***

A 1.10: Cost data is only part of the equation. As is often mentioned, after senior management has set a vision and defined the strategies, the all important core business processes become the mechanism to deliver the value. Processes are key and time, quality, service, and cost, all "derivatives" of the process that are inextricably braided together. You really cannot measure one in isolation from the others.

Process modeling software tools are becoming important. When operations that are sorely in need of redesign are attempted to be fixed, the big decisions have been made by gut feel. Modeling removes relying on intuition. When process modeling and ABC are combined, you get synergy. By adding simulation software for what-if scenarios, and adding flow-charting software for visualization, and adding on-line analytical processing (OLAP) software tools for instant diagnosis, you develop a suite of tools. These software tools are converging into a suite of tools. A carpenter with only a hammer would be somewhat limited, but not so with a belt full of tools.

Management science can be operationalized out of the textbooks and into practice as the information revolution marries the methodologies revolution.