Why We Need a Conceptual Framework for Managerial Costing

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IMA® recently established a seven-member task force to draft a conceptual framework for managerial costing that will define practical principles and concepts to improve cost modeling and decision support inside organizations. Managerial costing, a central area of practice in management accounting, will gain credibility, wider application, and greater visibility when a clear framework exists. The framework will support the practices and techniques for internal cost and operational modeling that create critical business information for managerial insights, analysis, and decision making.

This article introduces the topic to IMA members and seeks to increase awareness of the need for such an endeavor. The task force believes multiple benefits will accrue to the management accounting profession as a result of this pursuit (see "Benefits of a Managerial Costing Framework," p. 38).

The Need for a Managerial Costing Framework Is Here

Managerial costing is a subset of management accounting that focuses on connecting operational resources and processes with their monetary value to generate the information required for effective decision support and value creation. Management accounting is much broader than managerial costing and includes cost accounting to support external financial reporting, behavioral issues, performance evaluation, and many other subject areas. Managerial costing satisfies what we believe to be the core purpose of management accounting—supporting decision making to achieve enterprise optimization. Managerial costing includes capacity costing, marginal and incremental costing, and costing for process optimization, to name a few areas of costing necessary to operationalize strategic cost management.

Working within this scope, the task force constructed a conceptual framework and carefully defined principles and concepts that focus on managers and employees throughout the company as the primary customer of the information. Our main objective was to satisfy the needs of those seeking to understand the interaction of operational resources, their values, and outputs. The fulfillment of this objective will be a significantly improved ability to identify optimal decision alternatives and create sustainable value. Given the growth of financial planning and analysis groups within CFO organizations, we believe this objective is of immediate interest.

A managerial costing framework will create a clearer path and minimize risk for decision makers as they evaluate the methods, practices, expertise, and technology tools needed to achieve their goals for decision-making information. Currently, no clear or accepted approach exists for differentiating the characteristics of a beneficial managerial costing approach from those that are deficient and potentially misleading to managers. A wide variety of managerial costing approaches, such as traditional standard costing, activity-based costing (ABC), throughput costing, lean accounting, German managerial costing (known as GPK), and resource consumption accounting (RCA), claim to provide superior information for cost modeling and decision making, but do they? All businesses would benefit from a clear benchmark that would help them evaluate the characteristics and effectiveness of cost modeling and decision support options. Selecting a costing and decision support approach is particularly challenging for smaller and midsize organizations because they have limited financial, IT, and personnel resources

Benefits of a Managerial Costing Framework

- Investment in expertise and systems will increase when decision makers see a clearer, more accepted, and less risky path to creating the cost-based decision support information they need.

- A framework and principles for costing information for internal decision support will allow midsize and smaller companies to more consistently achieve improved cost-based decision support information, thus improving their competitiveness and profitability. The framework will provide a structure for evaluating and generating requirements for costing, simplifying research.

- Transparency will improve as businesses and the public become more aware of the differences between financial information for internal decision making and external financial reporting. Many organizations, analysts, and accountants don't understand the limitations of financial-accounting-based cost information, particularly for internal decisions.

- The improvement in transparency will have beneficial effects for evaluating risk in the economy as it will facilitate deeper understanding of the boundaries of financial statement information for predicting the long-term value of companies. The framework concepts provide a guide for creating clear cause-and-effect relationships to model operations and costs at a level much deeper than is required for external financial reporting.

- Management accounting and its unique body of knowledge and skills will be better differentiated and defined within the broader accounting profession.

- A common and sound foundation will facilitate learning and communication and aid cost modelers in contributing significantly to achieving an organization's strategic objectives. The framework will provide clear definitions of principles and concepts that are often misunderstood and misapplied in practice, such as excess capacity, attributable cost, and cost responsiveness.

and expertise to invest in, implement, and operate a decision support system.

A conceptual framework for managerial costing also should more clearly differentiate the types, objectives, and purposes of costing (e.g., internal decision support from external financial reporting). Defining managerial costing principles and concepts clearly and concisely will increase the awareness of the significant differences and consequences of using costing information. For example, the concept of capacity has numerous definitions in management accounting literature, and many of them hide the impact of costs, opportunities, and management options associated with excess capacity. Costing approaches designed to satisfy one purpose, such as external regulatory compliance reporting, usually aren't adequate for a different purpose, such as internal decision support to optimize operations in the organization. In financial accounting, cost information is typically aggregated to more efficiently provide the more general information needed for external financial reporting and to simplify the audit process. Increased awareness of the limits of various types of cost information will clarify and refine management's information needs for evaluating economic risk and opportunity. Too often, managers believe external financial statements are the only correct view of financial information and don't realize they are only one financial model of the organization with specific benefits and limitations. One view or perspective on any important issue is inherently limiting and risky. We hope the result will be a better understanding of the specific contributions of the various forms of financial information in predicting the value of operations. The more information managers seek on their organization's operations, the better decisions they will have the opportunity to make. A commonly accepted conceptual framework for managerial costing will provide a useful foundation of principles and concepts that will facilitate learning and communication throughout the accounting profession and across professional boundaries. Barriers, often in terms of perceived unfairness, exist in the communication of cost information in organizations. For example, operations is typically held responsible for all manufacturing costs while marketing, even when not meeting sales targets, isn't viewed as responsible for excess capacity costs. If cost modelers better understand managerial costing, they will be more effective and efficient in supporting decision makers to achieve their organization's strategic objectives.

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The task force believes that the need for a managerial costing framework and principles is justified based on the expected benefits. Yet another perspective may be even more compelling. Consider the consequences of what could happen *without* an accepted conceptual framework and principles for managerial costing. "Without Managerial Costing Principles…" (p. 40) provides a possible list of undesirable outcomes. Many are already occurring. These realizations provide a persuasive call to action for the establishment of managerial costing principles and an accompanying framework for guidance in using those principles.

Purpose and Scope of the IMA Task Force

As mentioned, the purpose of our task force is to introduce a framework that defines, at a conceptual level, the creation and use of cost and related decision-making information that supports the processes and decisions of the primary value creators inside organizations—managers and employees. High-quality cost information is required for the creation of value within an organization. Financial accounting information is available in abundance, but is it an adequate tool for managerial costing? Or is it produced with principles that impair its usefulness for detailed internal decision support? The managerial costing framework focuses only on the decision-making needs of those working inside organizations to create long-term, sustainable value. This includes many smaller economic decisions where awareness of the practical economic impact at a detailed level will facilitate real alignment with operational decisions and enhance value creation. Common examples of problems created by the application of traditional financial accounting cost information are lean productivity initiatives that are stopped as a result of the short-term negative income statement impact of reducing inventories or production managers who face static product costs when excess capacity increases as the result of productivity improvements.

Financial information produced under generally accepted accounting principles (GAAP) is the most common form of information available in organizations. In their conceptual frameworks, financial accounting standards setters recognize that GAAP information has limitations for use by decision makers managing organizations and make the explicit assumption that internal managers can access or create whatever information they need to fulfill their decision-making needs. The problem is that GAAP-based information is often the only information available because of the low rate of implementation of advanced costing approaches, and it is often a challenging task to derive the relevant cost information needed for internal use when the methodology isn't in place to collect the necessary data. Additionally, the skill set, knowledge, and even language are often lacking to critically evaluate the limitations of cost information generated to comply with GAAP. The framework for managerial costing intends to eliminate this problem by providing and standardizing the language, principles, and concepts necessary to create cost information focused solely on internal managers' decision-making needs in areas such as resource capacity and marginal costing. The relevant cost information can be captured in most modern Enterprise Resource Planning (ERP) systems and made readily available. But the knowledge must exist, and the organization must understand the benefit of focusing effort and investment on managerial costing systems. Few ERP vendors or implementers are currently prepared to offer much beyond improved integration for external financial reporting unless specifically and repeatedly pressed by their customers.

Without Managerial Costing Principles...

- A core knowledge area of management accounting isn't grounded in accepted principles and concepts.
- There is currently no clear mechanism for determining the quality of managerial costing practices.
- Managerial costing's customers (i.e., information users) often lack a basis for confidence and trust in legitimate approaches that provide necessary decision support.
- Selection of a managerial costing approach is based on the comparison of specific methods, often based on advertising and salesmanship, since there is no recognized framework to assess the quality of a method's application of fundamental principles and concepts.
- Managerial costing will continue to unravel the cost information collected for standards-based compliance accounting, which is insufficient for rigorous decision support information since financial accounting information need only provide historical full cost of products and assets.
- Attempting to source managerial costing data from the general ledger (rather than directly from financial and nonfinancial transactional data) will remain the routine practice for decision-making purposes, and it will continue to produce dysfunctional results. Data for managerial costing for decision making must be a clear reflection of the underlying operations and resources. This means an effective managerial costing model must begin with a model of operations rather than with dollars in categorized general ledger accounts.
- Managerial costing, a key source of the superior decision support skills of management accountants, will continue to be discounted in comparison to financial-accounting-based skill sets. Without a well-structured body of knowledge for managerial costing, it will continue to diminish in practice and academia in comparison to financial accounting.
- Nonfinancial data that is vital to create the cause-and-effect relationships for decision support will continue to be overshadowed by a focus on the general ledger as the source of business intelligence data. General ledger data has been methodically stripped of nonfinancial data and must be laboriously reconnected to operational data to make it an analytically useful tool at most levels of the organization. This effort is complex, expensive, and results in untimely feedback for operations. For example, companies that have ABC models typically can run their models only monthly, quarterly, or semiannually because of the general ledger schedule and the massive effort to integrate operational data into the model.

The Role of Principles in a Profession

Foundational principles are critically important in shaping and enhancing the status of the profession of management accounting. In fact, a robust set of principles should be one of the cornerstones on which the profession is based. In the July 1957 issue of *Social Work*, Ernest Greenwood defined the most widely accepted attributes of a profession: (1) a common body of knowledge, (2) professional authority and credibility, (3) regulation and control of members, (4) a professional code of ethics, and (5) a culture of values, norms, and symbols. Continuous refreshment of the second attribute is vital for management accounting. We believe the credibility and authority of management accounting as a profession will be substantially enhanced by the acceptance of a conceptual framework and the promulgation of principles related to managerial costing since it's a core body of knowledge within the profession.

In August 2005, Jeff Thompson and Jim Gurowka wrote a *Strategic Finance* article titled "Sorting Out the Clutter," which opened with:

As management accountants and financial managers you've been besieged by three-letter acronyms touting the latest and greatest strategic costing methods to help manage your business operations. Do they really help? How would you know?

Clearly, there has been confusion around the practice of managerial costing because of the diversity of approaches, practices, methodologies, tools, and processes that exist in the marketplace—such as standard costing, ABC, throughput costing, lean accounting, and RCA, to name some of the major approaches. This usually happens in the absence of commonly accepted principles to assess a method's strengths and weaknesses in providing decision support information. Principles provide a fundamental anchoring effect and a touchstone to assess the validity and reliability of specific managerial costing approaches. Currently, there is no clear mechanism for assessing the quality, effective scope, and characteristics of managerial costing practices. Consumers have difficulty determining how to choose between approaches that claim to provide necessary decision support, and they experience even greater challenges assessing the knowledge and competence of providers and consultants. Contradictions and inconsistencies (e.g., a single product with two or more different reported costs) between different costing methods should be clearly traceable to differences in underlying fundamentals. In the absence of a conceptual framework outlining principles and concepts, managerial costing discussions center on comparisons of method-based practices driven, in part, by the quality of the advertising and salesmanship associated with the method. Managerial costing should be driven by logic and the scientific method as managers seek to model their processes, resources, and costs to optimize results. A conceptual framework is a step toward providing that structure.

Distinguishing Management Accounting from Financial Accounting

As you have gathered by now, a clear distinction needs to be made between the management accounting and financial accounting bodies of knowledge and skill sets. As pointed out by Angella Sutthiwan and B. Douglas Clinton in "The Conflicting Roles of Controllership and Compliance" (*Strategic Finance*, July 2008), controllership in many European countries is clearly a separate function from compliance accounting. "Yet accountants in the U.S. are so accustomed to mixing the tasks and responsibilities of controllership and compliance that they often don't even know they are doing it…and they're often conflicted and/or confused regarding the proper course of action to take….This often results from drawing on the wrong skill set to make decisions."

The fundamental—most important—purpose of management accounting is enterprise optimization, while compliance accounting (i.e., tax, regulatory, and other external reporting) is primarily concerned with satisfying the rules for reporting business and financial information to a variety of external constituencies. Over the past 50 years, the managerial costing decision support function in particular has been relegated to working from information produced using inadequate principles from compliance accounting. Historical financial reporting at full cost isn't the only perspective on costing, but it's the perspective that overwhelmingly dominates accounting curricula, particularly in the United States.

For example, systems designed mainly to value inventory for financial and tax statements fail to give managers the information they need to promote operating efficiencies. Statement of Federal Financial Accounting Concepts (SFFAC) No. 1, "Objectives of Federal Financial Reporting," paragraph 198, cautions: "Full assignment of all costs of a period, including general and administrative expenses and all other indirect costs, is an important basis for measuring cost of service. However, full cost is not necessarily the relevant cost for making all decisions." Statement of Federal Financial Accounting Standards (SFFAS) No. 4, "Managerial Cost Accounting," paragraph 40, states: "In defining the proper measurement, assignment, and allocation of cost for a given purpose, selecting the appropriate accounting method and whether to use full costing should be carefully considered."

Another fundamental limitation for managerial costing has been sourcing financial data from the general ledger (rather than sourcing directly from transactional data) for decision-making purposes, which often provides dysfunctional results because the general ledger is fundamentally a tool for financial accounting and external financial reporting. Sourcing financial data from the general ledger results in monetary abstractions that don't preserve important quantity-based information that managerial costing needs to provide cause-and-effect information on operations, such as insight into the resources to be managed and an understanding of capacity issues. Thus, quantitative, nonfinancial data vital to define cause and effect for decision support is often ignored or matched with financial data too infrequently or inaccurately to provide meaningful information. The typical example is overhead allocated by direct labor even when overhead equals or exceeds direct labor in size. Such practices hide any cause-and-effect relationship and give the impression all overhead costs are proportional to product output. When dollars are modeled as a proxy for the underlying operational activity, the resulting model normally loses the vast majority of its operational cause-and-effect relationships because dollars are highly divisible, but resources aren't and typically contain significant components of fixed costs.

Professional certification is impacted as well. Recognition is growing with the expansion of the CMA® (Certified Management Accountant) designation in the U.S. and internationally and with the announcement of the joint venture by the American Society of Certified Public Accountants (AICPA) and the Chartered Institute of Management Accountants (CIMA) that management accountants or professional accountants in business have a special set of skills and knowledge. Without principles and a common body of knowledge to distinguish managerial costing as a vital component of superior decision support skills, this rich area of practice will be discounted within the management accounting profession. The focus of support for strategic decision making will remain compliance-based accounting information rather than the deeper understanding of business operations that can be gained through effective managerial costing practices.

Do We Need Principles?

Again, the management accounting profession has never had managerial costing principles of practice or a conceptual framework. Then do we really need principles and a framework now? The task force thinks so, and we hope the discussion in this article will encourage management accountants to see a need—a dire need. Others might ask, "Do we really need regulation and standards for managerial costing?" In the traditional legal sense, managerial costing needs no regulations or standards. But we currently have little to no basis for objective evaluation or assessment of costing practices except for externally focused financial reporting standards. The excuse of "no legal requirement" is often used to argue that "anything goes." This erodes confidence in the legitimacy of managerial costing practices. Imposing regulations and standards isn't the objective of the framework. The goal is to build a strong, clearly articulated baseline that will enable managerial costing to add real value to organizations in their quest to meet their strategic objectives and to ensure managerial costing remains a growing, vital area of practice within an expanding management accounting profession. **SF**

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