
Book Review

Jack M. Ruhl

Cost & Effect: Using Integrated Cost Systems to Drive Profitability and Performance, by Robert S. Kaplan and Robin Cooper (Boston: Harvard Business School Press, 1998); hardcover 358 pages, \$29.95; 800-248-1878.

Managers with ten different products need to know the cost of each product. An overall average doesn't help, especially if the ten products consume vastly different levels of resources. In a competitive marketplace, managers need to know the effects of their improvement efforts, especially their efforts to measure performance and manage costs better.

Jack M. Ruhl is associate professor and chairman of the Department of Accountancy at Western Michigan University in Kalamazoo, Michigan.

Imagine that you and nine friends are all enthusiastic bowlers. The ten of you get into the car to go to a bowling alley that has just opened in your neighborhood. Because everyone in the car is a serious bowler, each of you is eager to improve his game.

But when you and your friends walk into the newly opened bowling alley, you are in for a surprise, because the bowling alley is constructed in such a way that the pins are hidden from view. When you throw the ball, you hear a crash of pins falling, but you don't know for sure how many you knocked down—or even if the crash came from your own lane. But the manager of the bowling alley tells you not to worry: At the end of the evening he will add up all the pins knocked down, divide by ten, and that will be the score for each bowler.

Sounds ridiculous, doesn't it? Yet this could be a modern parable about cost and performance measurement systems.

Managers with ten different products need to know the cost of each product. An overall average doesn't help, especially if the ten products consume vastly different levels of resources. In a competitive marketplace, managers need to know the effects of their improvement efforts, especially their efforts to measure performance and manage costs better.

The authors of *Cost and Effect: Using Integrated Cost Systems to Drive Profitability and Performance*, Professors Robert S. Kaplan and Robin Cooper, present further developments in the related fields of *activity-based costing* (ABC) and *activity-based management* (ABM). Most importantly, they succeed in linking ABC and ABM to other management approaches such as *total quality management*, *target costing*, *continuous improvement*, and *reengineering*.

The book presents the authors' vision of integrated cost and performance measurement systems—and of the expansion of management capabilities made possible by such an integration. The discus-

CCC 1098-9382/98/010059-05
© 1998 John Wiley & Sons, Inc.

sion begins with a categorization of four possible stages of cost and performance measurement systems.

FOUR-STAGE MODEL FOR COST AND PERFORMANCE MEASUREMENT

The authors assert that cost and performance measurement systems can be classified into one of four categories or stages. Few companies have either Stage I or Stage IV systems—most systems fall between the extremes.

Stage I Systems: Emerging Companies

Stage I systems exist in emerging companies that have not committed the time or resources required to develop an excellent financial reporting system. Stage I systems are inadequate even for financial reporting purposes. This inadequacy may be the result of having an internal control system so poor that transactions are recorded incorrectly—or not at all.

Stage I cost and performance measurement systems are difficult to audit. The companies that have such systems often have large writedowns of inventory after internal and external audits.

Stage II Systems: A Focus on Financial Reporting

Many companies never operate with Stage I systems. Instead, they develop Stage II systems from the start. Stage II systems are driven by financial reporting. As a result of this focus, however, they collect costs by responsibility centers rather than by activities or business processes—which means that they also report highly distorted product costs.

Stage II systems provide managers feedback that is too late, too aggregated, and too financial in nature. Such systems have been roundly criticized by proponents of ABC and ABM—most notably, perhaps, in books such as *Relevance Lost: The Rise and Fall of Management Accounting* (Johnson and Kaplan, 1987).

Stage III Systems: Beyond Financial Reporting

Three characteristics of Stage III systems enhance managers' abilities to measure cost and performance:

- The systems incorporate a traditional but well-functioning financial system that performs basic accounting functions and also enables the preparation of periodic financial statements.
- ABC systems take data from the financial system (and from other information and operating systems as well) to measure the costs of activities, processes, products, services, customers, organizational units, or other cost objects. These ABC systems run alongside the traditional systems.
- The system includes an operational feedback loop that provides front-line employees timely and accurate information (both financial and nonfinancial information) about efficiency, quality, and cycle times of business processes.

Stage II systems provide managers feedback that is too late, too aggregated, and too financial in nature. Such systems have been roundly criticized by proponents of ABC and ABM.

ABC systems take data from the financial system (and from other information and operating systems as well) to measure the costs of activities, processes, products, services, customers, organizational units, or other cost objects. These ABC systems run alongside the traditional systems.

One especially interesting aspect of Stage IV systems is that information relevant to managers is king. In other words, Stage IV systems are designed to maximize their benefit to managers and front-line employees who are intent on continuous improvement.

But in a working environment characterized by well-trained and empowered employees who are challenged daily to satisfy customers and to respond to competitors, control may be far less important than learning and improvement.

Stage IV Systems: Integrated Financial Systems

In Stage IV systems, operational systems are integrated with ABC systems. Together, they provide the basis for preparing external financial statements.

One especially interesting aspect of Stage IV systems is that information relevant to managers is king. In other words, Stage IV systems are designed to maximize their benefit to managers and front-line employees who are intent on continuous improvement.

The financial accountants also rely on information generated from Stage IV systems to prepare financial statements for external use. But Stage IV systems cater primarily to managers and operational employees rather than accountants—just the opposite of the financial-reporting emphasis of Stage II systems. In a Stage II system, in other words, financial reporting comes first; internal decision makers have to make do as best they can.

Few companies have implemented Stage IV systems. Far more have Stage III systems, which this book discusses extensively.

STAGE III SYSTEMS FOR LEARNING AND IMPROVEMENT

This book correctly points out that the point of view of most traditional costing systems is on *controlling*. Top management tries to predetermine standards, then measure actual performance against those standards.

But in a working environment characterized by well-trained and empowered employees who are challenged daily to satisfy customers and to respond to competitors, control may be far less important than learning and improvement.

KAIZEN COSTING

Costing that supports learning and improvement is referred to as *kaizen* costing. (*Kaizen* is the Japanese term for continuous improvement.) In the context of cost management, *kaizen* means reducing the cost of existing products by finding ways to increase the efficiency of the production process used in their manufacture. For *kaizen* costing to be effective, work teams must have detailed cost information on a continuous basis. Standard costs are continually updated as process improvements are made.

PSEUDO PROFIT CENTERS

Companies may also improve through the use of “pseudo profit centers”—that is, organizational groupings in which employees are made responsible for profit within their part of a company. In a pseudo profit center, employees focus not on reducing cost (a negative action), but on increasing profit (a positive action).

The book maintains that employees are more highly motivated by a positive goal. To illustrate, they give the example of a company that provided employees in a pseudo profit center a daily income statement. The center “sold” its product (within the company) at a price that was based on the quality of the product. Thus, higher-

quality products meant higher revenues and higher profits. Further, through the use of the pseudo profit center and a daily income statement, employees could determine which trade-offs between costs and revenues would lead to the highest profit. The employees were willing to incur greater cost if revenues rose even higher.

OPERATIONAL AND STRATEGIC ABM

The book provides a useful discussion of two applications of ABM—*operational* ABM and *strategic* ABM.

Operational ABM

Operational ABM includes actions to increase efficiency, decrease costs, and enhance the utilization of assets. Put differently, operational ABM is about the actions required to *do things right*. It is used along with continuous improvement programs such as *total quality management* (TQM) or with discontinuous improvement programs such as *reengineering*.

One way to employ ABM is as obvious as identifying the efficiency of activities performed. For example, an ABM assessment team might study an activity and ask questions such as the following:

- Is this activity fragmented?
- Do many different people perform various aspects of the activity?
- Does this activity require multiple handoffs?

If the answer to these questions is yes, the activity is probably performed inefficiently, which means that ABM may be useful.

Strategic ABM

In contrast to operational ABM, *strategic* ABM is about *doing the right things*. Managers who use strategic ABM attempt to increase profitability by altering the demand for activities. They assume that activity efficiency remains constant.

Strategic ABM works by shifting the mix of activities away from costly and unprofitable applications toward more profitable ones. For example, managers who use activity analysis may find that their low-volume specialty products are undercosted by traditional product costing systems. In response, they may redesign products to change to a less costly mix of activities.

NO TEN EASY STEPS

Given the huge task of integrating ABC and ABM with other important management ideas of the past fifteen years, this book sets forth an ambitious project. Nonetheless, the authors have come up with many new and interesting ideas. This book provides a conceptual foundation for better cost and performance measurement.

Readers who expect to get “the ten easy steps to ABC/ABM” from this book will be disappointed. As the authors note, their intent was

not to provide a step-by-step guide. Rather, the book gives a big-picture approach to cost management. Those who are responsible for actual implementation of a cost system will have to look elsewhere. There are many good sources, including *Activity-Based Cost Management: Making It Work* by Gary Cokins (Chicago: Richard D. Irwin, 1996) or Arthur Andersen's *Activity-Based Management: Lessons from the ABM Battlefield* by (editors) R. Steven Player and David Keys (New York: Master Media Limited, 1995).

In their inexhaustible willingness to link ABC and ABM to the rest of the management literature, Cooper and Kaplan remind me of Lewis Carroll's forty maids with forty mops, trying to clean everything up. The best writers and thinkers are like that. Not only do they succeed at articulating these links, but they also provide useful new applications for ABM methods.

REFERENCES

- Johnson, T. H., and Kaplan, R. S. *Relevance Lost: The Rise and Fall of Management Accounting*. Boston: Harvard Business School Press, 1987.