German Cost Accounting: how it developed, what it is, and when it works

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ABSTRACT

German Cost Accounting evolved in a debilitating atmosphere of hyperinflation. It includes cost centers for avoidable costs. Avoidable costs may be, but are not necessarily variable costs. Cost centers are a central theme to Responsibility Accounting, which have been shown to reduce costs and/or improve quality in developing economies. GCA is most effective in a repetitive but flexible system, and it is less effective in highly automated systems. That it is not effective in highly automated systems may explain why US manufacturing firms believe GCA is not cost effective, and why it is not used extensively in the United States.

INTRODUCTION

This paper will show that not only is managerial accounting relevant, but those cost accounting methods popular in German speaking countries can improve profits and quality. The goal is that the information be relevant and reliable. The problem is that no one system is both relevant and reliable to all decision makers at all times. For example, absorption costing will indicate a higher net income if inventories increase and a lower net income if inventories decrease, and such inventory change may only be the result of how the inventories are valued. Variable costing has its problems too; inventory may be valued differently depending upon how fixed costs are allocated [1]. Inherent to this inconsistency is an additional problem. Accounting information uses historical costs, or sometimes replacement costs. It typically reports what has already happened, and although we may try to extrapolate what already has happened into the future to make future decisions, we typically do not use the current accounting as part of the current decision making process. In contrast, “German cost accounting was designed with the explicit objective of supporting management decision making about which products or services to offer, how to price them, and how to plan and control operations” [2]. GCA provides the information concurrently as part of the manufacturing process. It is not used to determine the cost of inventory; it is used to control the cost of inventory.

The GCA system has costs. Workers may become so focused on their tasks that they fail to consider how they affect everything else. Sharman [2] noted that, “So intricate is the scoring process that some players become distracted and concentrate on keeping score rather than playing the game ([for example] Enron, WorldCom). In those instances, the analysts (unintentionally perhaps) created business performance criteria based on scorekeeping intricacies rather than actual playing ability.” This paper examines whether GCA is universally beneficial, or whether its usage is just a cultural preference of German Speaking countries, and why it is not extensively used in the US.

Literature Review

How History and Culture Affect Accounting

"Cultural factors are a part of the cost-benefit considerations that should underlie all management accounting choices" [3]. “[Germany’s] strong anti-inflation attitudes are the result of the ravages of two debilitating inflationary periods it went through in the 20th century” [4]. Following World War I (1914 to 1918) and until World War II (1939 to 1945) Germany experienced massive hyperinflation. In 1923, a person would have to pay 1,000,000,000,000 (1 trillion) Marks to buy the same things 1 (one) Mark would purchase in 1918 [5].

German companies have been very cautious, as have its investors. "Traditionally the primary source of finance for German companies [has been] bank loans, rather than equity raised through the capital market" [6]. Traditionally, German firms were financed more from borrowing whereas US firms were financed more from selling stock. In Germany the emphasis has been to protect the lenders. "Conservative balance sheet valuations were central to creditor protection. … [N]o distinction was made between financial statements prepared for tax purposes and those published in financial statements. … Before 1998 … legal requirements were absolutely supreme" [4]. "Creditor protection [was] a fundamental concern of German accounting as embodied in the Commercial Code. At [the end of World War II], business accounting emphasized national and sectional charts of account (as in France). The Commercial Code stipulated principles of 'orderly bookkeeping' [to protect creditors]." "Independent auditing barely survived the war." However, "The German accounting environment has changed continuously and remarkably since the end of World War II." "The new German accounting standard-setting system is broadly similar to the systems in the United Kingdom … and the United States. …, [but] Germany still is one of the world's staunches adherents to the historical cost principle" [4].

What is German Cost Accounting?

German controlling emphasizes a team effort between controllers and managers and includes: (a) a strong focus on strategy and planning, (b) detailed and specific accounting information, and (c) intensive academic research [9]. It includes Activity-based Management: (a) it assigns costs to the year the costs produce the associated benefits, (b) it assigns costs to activities, and (c) it assigns the costs of the activities to products or systems [10], and it includes – "the idea that managers should be held responsible for costs they have control over" [11]. This, it is believed, can be accomplished with cost centers.

The cost centers are most effective in manufacturing or service organizations that are highly routinized and repetitive [2]. Cost centers should be simple – not complex [12]. Cost centers do not monitor all costs, only marginal costs [13]. Cost centers should be designed so that each center is only monitoring a single activity which could be a cost or a quality aspect, but managers may be responsible for many different cost centers [2]. The cost centers should incorporate benchmarking, just-in-time inventory management, transfer pricing policies, strategic planning, activity-based costing (ABC), and target costing (German and Japanese) [14].

Mitigating Observations

"Many U.S. management accountants say their companies aren't interested in GPK [GCA] for a variety of reasons," including that costs exceed benefits [15]. Further, "German research and development have basically 2 problems: 1. German companies have not entered big new markets such as multimedia and genetic engineering because of risk aversion, farsightedness and political barriers. 2. In existing markets such as machinery and car industries, German companies have lost market share to competitors who were better able to meet customer needs in terms of product quality, functionality, and price"[16].

If we examine a typical managerial accounting textbook we will see that cost centers are part of Responsibility Accounting [17], and further examination shows that GCA and Responsibility Accounting are nearly indistinguishable. Lin and Yu [18] reported a longitudinal study of a Chinese manufacturing company before and after the introduction of responsibility accounting. The findings were that responsibility accounting (GCA) produced positive results in China and developing economies.

German Cost Accounting tries to use current accounting information to minimize costs. Managers are placed in charge of cost centers. The cost centers monitor only those costs over which management has control, and can potentially be avoided. Frequently avoidable costs are the same as variable costs, but not always. The cost center structure should be simple so that only one activity or cost is being monitored by a manager, but a manager may be responsible for several costs centers.

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