

CHAPTER 1

What Are ABC and ABM?

The brain is a wonderful organ. It starts working the moment you get up in the morning and does not stop until you get into the office.

—Robert Frost

WHAT IS ABC?

Activity-Based Costing (ABC) is an accurate method of assigning costs to work activities, processes, products/services, customers, and lines of business. It is based on the notion that efforts required to produce products and services can be quantified and, therefore, assigned to the product or service. Similar to a bill of materials, products have a bill of activities required to deliver the product or service. For simplicity's sake, "products or services" will be referred to as "products" from this point forward, understanding the concepts apply to both.

Background

After reducing direct material and labor costs in the mid-1970s, organizations recognized that antiquated information systems were not meeting their ever-changing management information needs. Many companies embarked on ABC initiatives to focus on indirect product and service costs. By assigning overhead costs, companies were able to

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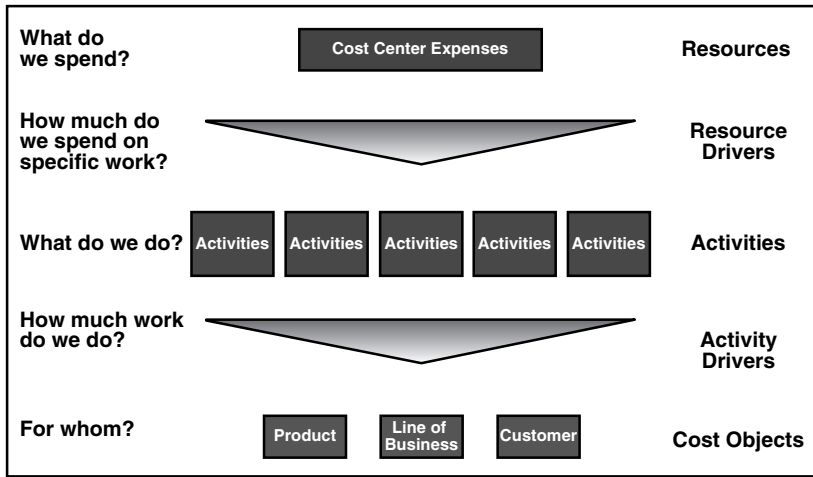


FIGURE 1.1 Basic ABC Flow and Terminology

clearly identify, improve, or divest unprofitable products, inefficient processes, and poorly performing regions.

The cornerstones of ABC are that cost is *consumed* and consumption can be managed. As such, ABC provides an excellent basis for cost accounting, chargeback, and performance management.

Figure 1.1 illustrates the flow of ABC information. The left column identifies the business questions addressed at each level. The middle column provides a visual representation of ABC implementation. The right column identifies the common ABC terminology used to describe the data.

ABC Terminology Definition

Figure 1.2 represents a simplified example of ABC cost flow for bank operations.

Using Figures 1.1 and 1.2 as references, let's further define some of the ABC terminology.

- **Resources** represent all the available means that work activities can use to provide products to Lines of Business (LOBs) and

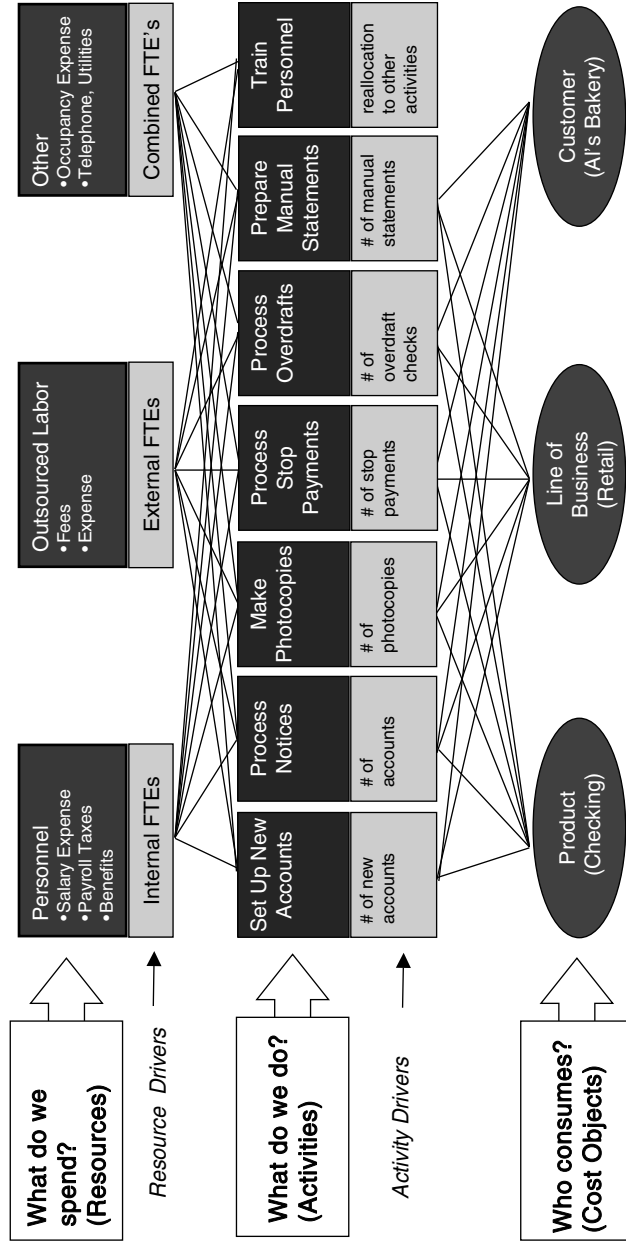


FIGURE 1.2 Simple ABC Example

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customers. Examples of resources include personnel, equipment, third-party contracts, and facilities.

- **Resource Cost Pools** are logical groupings of resources (quantified in General Ledger accounts) that are consumed in the performance of activities. The three resource cost pools shown in Figure 1.2 are Personnel, Outsourced Labor, and Other.
- **Resource Drivers** are measurements of the resources consumed by an activity. Notice that the resource drivers in Figure 1.2 are different for each of the resource cost pools. If the resource drivers for the resource cost pools are the same, there is an opportunity to consolidate resource cost pools. This will be discussed in more detail later in the book.
- **Processes** (not shown) are groups of related and interdependent activities performed to achieve a specific objective. Within a bank, a process called “Add Funds” includes all activities required to credit a customer’s deposit account.
- **Activities** are what people and systems do in an organization. Activities consume resources to produce an output. Activity names begin with a verb. Examples of activities include Set Up New Accounts, Process Notices, and Train Personnel.
- **Tasks** (not shown) are the components of an activity and tell us how activities are performed. Processes, activities, and tasks represent a logical business process model decomposition. Each process, activity, and task should start with a verb and collectively define the hierarchical level above it.
- **Activity Drivers** are measurements of the frequency and intensity of demand placed on an activity by cost objects. They are similar to resource drivers. Notice that the activity drivers in Figure 1.2 are different for each of the activities. If the activity drivers for multiple activities are the same, there is an opportunity to consolidate activities. This will be discussed in more detail later in the book.
- **Cost Objects** represent the persons or things that benefit from incurring work activities. Examples of cost objects include products, LOBs, and customers.

Company Income Statement

Loan Net Interest Income	\$1,000
Loan Application Expense	300
Payments Processing Expense	<u>400</u>
Net Income	\$ 300
Margin	30%

FIGURE 1.3 Consolidated Product Income Statement**ABC versus Traditional Costing**

So, how is ABC different from traditional costing? Let's compare. Figure 1.3 shows a consolidated net income statement from a two-product company. The company receives revenue (Net Interest Income) from the two loan products it offers. The loans require resources from Application and Payments Processing.

Using traditional costing, the costs of the products are allocated based on the revenues of the products. In the example shown in Figure 1.4, Loan Product E (easy) contributes 60% of the revenue while Loan Product D (difficult) contributes 40% of the revenue.

Figure 1.4 shows the 60/40 split of expenses, resulting in a 30% margin for both products. In reality, however, the loan products are very different. Loan Product E (easy) requires a web-based application and electronic payments. Loan Product D (difficult) is a traditional paper-based application with paper check payments. If Product D's applications took five times the effort of Product E and the payments took twice the effort of Product E, the ABC results would look like Figure 1.5.

	Product (E)	Product (D)	Total
Loan Net Interest Income	\$600	\$400	\$1,000
Loan Application Expense	180	120	300
Payments Processing Expense	<u>240</u>	<u>160</u>	<u>400</u>
Net Income	\$180	\$120	\$ 300
Margin	30%	30%	30%

FIGURE 1.4 Traditional Product Income Statement

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	Product E	Product D	Total
Loan Net Interest Income	\$600	\$400	\$1,000
Loan Application Expense	50	250	300
Payments Processing Expense	133	267	400
Net Income	\$417	(\$117)	\$ 300
Margin	70%	(29%)	30%

FIGURE 1.5 ABC Product Income Statement

Notice the dramatically different margins as a result of assigning costs based on consumption rather than allocating (spreading) costs based on traditional costing. Product D is actually destroying shareholder value.

ABC Results

Activity-Based Costing has been used for decades with mixed results. Let's make sure we are on the same page regarding the definition of success: sustained improvement of shareholder value through improved cash flow. As a proxy, it is often easy to use Net Income Before Taxes (NIBT) as a "success" scorecard, knowing full well that there may be circumstances that require the demonstration of improved cash flow.

As you will see, it is very important to define success early and often for any change. Many people get personal success—the implementation of a system or process, the accolades from peers—confused with the shareholder's definition of success. This book is intended to highlight key elements of successful implementations—and, just as importantly, to help the reader avoid the numerous pitfalls before, during, and after the implementations.

Many of the examples in the book are drawn from my past implementations in shared service environments within the financial services sector—banking and insurance. It is an incredibly complex arena with many options and opinions. Since the majority of the employees working in the financial services industry are financially oriented, many believe that they could easily create an Activity-Based Costing/Management model and culture. In fact, it takes years for a costing

novice to understand and incorporate all of the nuances required for a successful implementation. While a small library could be created to house ABC literature, very few of these books go into great depth regarding the methods to drive ABC to the bottom line.

WHAT IS ABM?

Activity-Based Management (ABM) is active process management undertaken to improve performance. The relationship between ABC and ABM is best depicted in Figure 1.6 and is commonly referred to as the CAM-I Cross. While ABC focuses on assigning resources to activities and activities to cost objects, ABM decomposes a business process model into activities and then to performance measures. The moniker ABC/M (Activity Based Costing/Management) is used to identify the full scope of both ABC and ABM.

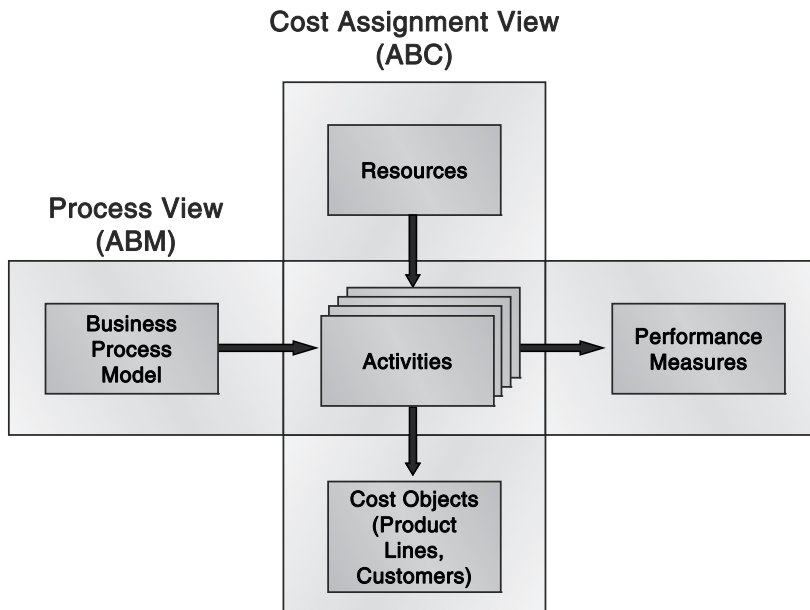


FIGURE 1.6 The CAM-I Cross

Source: The Consortium of Advanced Management—International (CAM-I), 1990, www.cam-i.org.

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It is important to note the intersection of Activities in the CAM-I Cross. Both ABC and ABM focus improvements on activities. Activity improvements drive business improvements. Activity costs can be improved a variety of ways including:

- **Reducing the activities drivers (requests for work).** This can be done by working with cost objects (consumers) such as customers and product managers to reduce the number of work requests. This will be discussed briefly in the next section and in depth in Chapter 4.
- **Improving the quality of the work through the use of a variety of quality improvement techniques such as Total Quality Management (TQM) or Six Sigma.** During an ABC implementation, you and your team will identify non-value-added (NVA) activities. Even more frequently, you will uncover NVA tasks “marbled” in activities, similar to fat being marbled into good meat. Identification and prioritization techniques will be discussed in Chapters 3 and 4, respectively.
- **Increasing the throughput of the activities to decrease the unit cost of the activities.** Once improvements are made, either (a) process more work for the same cost, or (b) reduce resources and costs to reflect the lower effort required to complete the work.
- **Reducing the resource costs.** Most commonly, this involves better supplier sourcing and may include outsourcing and offshoring. Resource cost reductions will not be discussed in this book.

The largest opportunity to reduce product and customer costs resides in activity (process) improvement. Without improving activities, why would you expect reduced costs? As Albert Einstein stated, “Insanity is defined as doing the same thing over and over again and expecting different results.”

Cost Object and Activity Driver Management

A lot of emphasis in cost and profitability improvement in ABC/M is appropriately placed on improving activities. However, many people

overlook the importance of cost object and activity driver management. In my experience, cost object and activity driver management remain a relatively large untapped opportunity in ABC/M implementations.

To demonstrate the value of cost object management, let's start with a concept called Cliff Charts (or Whale Curves). Cliff Charts are used at many manufacturing and financial institutions to rank the profitability of products and customers. For a commercial banking line of business, Cliff Charts plot the most profitable to least profitable customers in order and look like Figure 1.7.

Figure 1.7 demonstrates that the approximately median customer is the "breakeven" customer with a maximum cumulative profit of \$466 million; \$190 million of value is destroyed by relationships with customers to the right of the midpoint. The company would be 69% more profitable without customers to the right of the midpoint. Of course, this simple improvement to the profitability assumes all costs are variable costs, which is not realistic. However, if the Cliff Chart were shown as marginal profit/loss only, you'd get roughly the same order of customers—the losers are still the losers.

How realistic is the slope of the curve? Royal Bank of Canada found that 17% of its customers accounted for 93% of the bank's profits, so it is not uncommon for the slope to be high in the beginning.¹

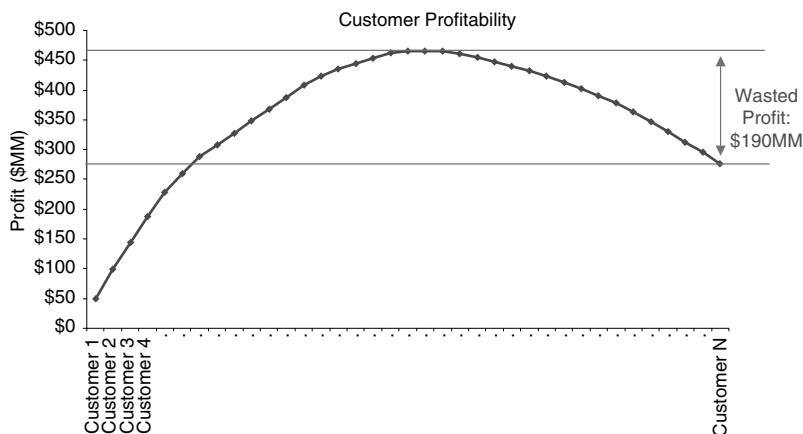


FIGURE 1.7 Customer Profitability Cliff Chart

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Typical heights of the curve are 200–300% of the final customer (or product) profitability. In other words, the worst relationships destroy 100–200% of the corporate value.

The key is not to immediately exit those relationships, but to make them more profitable. Focus on the least profitable customers and migrate them to profitability through increased volume, share of wallet, behavior changes, price increases, and so on. If you are unable to move them into a profitable relationship, then exit them—our shareholders are better off without them. This will be covered in more detail in Chapter 4.

Cliff Charts can be used throughout the organization to rank profitability. Common Cliff Charts include:

- **Customer segment profitability within Retail and Individual lines.** Due to the large numbers of Retail and Individual customers, customers should be grouped to determine meaningful patterns and insights. For large, homogeneous customer bases like those in Retail and Individual lines, customer segment profitability (or profitability broken into deciles) is most appropriate.
- **Customer relationship profitability within Commercial and Institutional lines.** For smaller, highly variable customer bases like those with Commercial and Institutional lines, customer relationship profitability is most appropriate.
- **Branch profitability ranking within Retail lines.** While the composition of underlying products and customers clearly drives this ranking, branch profitability can be effectively used as a motivational tool. Additionally, investigate any differences in unused capacity to improve underutilized branches.
- **Relationship Manager profitability ranking within Commercial and Institutional lines.** Similarly, the composition of underlying products and customers drives this ranking, but the Cliff Chart can be an effective motivational tool for the sales force. Similarly, look to identify and improve ineffective sales personnel.
- **Product profitability within all lines.**

There are a few limitations of Cliff Charts to keep in mind. Cliff Charts do not usually contain the expected future profitability of the

customer. Therefore, new customer relationships (less than six months) are often excluded from the analysis. Also, in the case of product Cliff Charts, they do not show product interdependence. However, even with its flaws, the Cliff Chart is a valuable and powerful tool for improving the corporate bottom line.

ABC without ABM

Over the years, I have heard no less than three consulting firms claim that they “invented” Activity-Based Costing. The date ranges were generally in the 1980s. One of the consultants had been around so long and claimed so many “inventions,” we often joked that he probably invented farming, too. In the end, who cares who invented ABC? An ABC solution without implemented actions to improve the bottom line is worthless. I often ask my teams, “What is the value of better information?” The answer is: “Nothing . . . unless you use the information to drive results.”

As a matter of fact, a great ABC implementation without ABM to improve the bottom line actually destroys shareholder value through the efforts and expenses required to implement ABC. One of the most common and damaging mistakes of ABC/M implementations is the overemphasis on ABC and the lack of emphasis on ABM. Never lose your focus on the end state. Drive improvements to the bottom line or the ABC/M implementation will be viewed (correctly) as a failure.

Remember to “begin with the end in mind.” The remaining chapters in this book are written to help structure and implement ABC and ongoing ABM to drive results.

NOTE

1. Larry Selden and Geoffrey Colvin. *Killer Customers: Tell the Good from the Bad and Crush Your Competitors* (New York: Portfolio/Penguin, 2004).

