

# Spring chicken or dead duck?

By *Belinda Johnson and Ernest Glad*



Belinda Johnson (email [belinda.johnson@cortellgroup.com](mailto:belinda.johnson@cortellgroup.com)) heads the activity-based costing team and is the Auckland manager of the Cortell Group of companies, an organisation specialising in business intelligence solutions, and Ernest Glad is the founder and CEO of the group (email [ernest.glad@cortellgroup.com](mailto:ernest.glad@cortellgroup.com)).

In the past twenty-odd years, we've had plenty of exposure to the concept of activity-based costing (ABC). Many organisations have evaluated, implemented, glorified or even dismissed ABC.

So where does this leave us? Will ABC die a slow death, to be replaced by a new flavour of the month; will there be a "new wave"; or will it just tick on in an evolutionary fashion?

We have noticed three distinct phases in the development of ABC.

## The experimentation phase

This was when organisations trialled ABC in a particular department or area. Calculations were typically done on spreadsheets and were mostly one-off exercises. Either some shocking revelations came out of this, or the results were treated indignantly and dismissed as inaccurate because the underlying data was wrong etc. This either led to rejection of the technique or created the desire to repeat and improve the process.

## The technology phase

During this phase ABC systems came on the market and many organisations started repeat costing exercises. Costing was mainly focused on operational areas such as factories. ABC systems were interfaced with both operational and financial systems to regularly produce costing information and trends.

Organisations that did not undergo a lot of change soon discontinued their periodic costing exercises as the incremental insights gained did not merit the ongoing expenditure. But in volatile organisations where new services were constantly added, organisation structures changed regularly or profitability was unstable, regular ABC exercises became vital.

## The extension phase

Businesses discovered that a large proportion of costs originated outside the factory gate and customer-driven activities were mainly concentrated in the latter parts of the value chain. This, together with a much stronger customer-centric focus, forced the ABC exercise to provide in-depth customer profitability and

supply chain analyses. Costing systems continued to become much more sophisticated and integrated.

## What does the future hold?

Has ABC become stagnant? What will drive it forward from here and what is new? We believe that the ABC era is far from over, but there are eight important strategic developments needed to move ABC into an exciting future.

### Supply chain costing

Extending the ABC exercise throughout an organisation's supply chain has become a major challenge. Management now demands to know the cost of the delivery of that product on that day, to that customer, using that truck and what the profit or loss on that delivery was. These questions pose some major technological challenges to ABC systems, but these challenges can be met. Costs of late deliveries, emergency orders, returns handling and after-sales service have all become important supply chain cost objects, and provide tremendous insight into operational inefficiencies. For example, the cost of a manual customer order against an electronic order will be clearly known, as well as its impacts.

Looking at supply chain costing holistically provides insights into profitable channels, routes, customers and products. The comparison between customer-driven activities and organisational activities provides only confusing insight into profitability analyses. Supply chain costing requires fresh thinking and use of the best technologies on the market. Supply chain collaboration between customers and suppliers is not really possible if the full supply chain costs are not known.

### Business process management (BPM)

BPM has had a key impact on improving business processes by way of increased productivity, elimination of non-value-added activities, modelling of cost behaviour and improving internal controls. BPM is very much the popular new management technique. It must be clearly distinguished from its older sibling, business process re-engineering, which was a much more technical approach to business improvement. In contrast BPM takes a holistic approach by integrating elements such as

workflow, process modelling, compliance and risk monitoring, performance improvement, business activity monitoring and several other techniques.

ABC is also an integral part of the BPM methodology, as it uses the process definitions, volumetric measurements and business intelligence components to provide before and after images of business processes. This in turn provides valuable insights into whether new processes deliver products and services at a reduced cost.

#### **Integrating ABC with economic value added (EVA) methods**

EVA is a performance measurement methodology that seeks to identify whether a business adds or destroys value for its shareholders. Obviously it is even more beneficial for an organisation to have this information at segment or division level. Sophisticated ABC techniques can assist in tracing an organisation's cost of capital into all its activities and can clearly show the impact on every product, service or customer. This encourages the use of EVA as a management technique at all levels of a business.

#### **Transfer pricing**

Transfer pricing has become increasingly important to corporations for the purposes of equitably costing shared services, proving economic independence between interlinked business entities, and in performance measurement schemes. Ideally, transfer pricing should be market-driven but as this is often not possible, cost will be a significant determinant of transfer pricing.

Cost can only be used as an indication of an equitable transfer price if charges are reasonable and do not include capacity or operational inefficiencies. They should also serve as a target to reduce overall costs. Accurate cost measurement as well as a form of benchmarking will be necessary to make effective transfer pricing a reality. ABC can also assist in finding a happy medium through a combination of fixed and variable pricing based on different capacity levels and performance benchmarks being reached.

#### **Business performance measurement**

Most organisations today seek dramatic improvement in business performance. This is measured in improved returns on capital, higher productivity ratios, better quality indicators and various other ratios, and requires new methods of measuring performance as well as new measuring techniques.

Wireless networks and other data-capture techniques have changed the way that productivity, quality and throughput are measured. More sophisticated and broader-based performance measurement can be rolled out across the enterprise. The lack of available measurement that was previously a problem for costing systems is no longer an impediment in rolling out advanced costing solutions.

Modern business performance measurement solutions encompass a multitude of factors rather than purely financial measures, enabling organisations to add value in a balanced format. Individual performance measurement (and the remuneration scheme) can be better aligned with that of the organisation as a whole. ABC can play a significant role in processing and providing appropriate performance measures.

#### **Activity-based budgeting (ABB)**

It has long been accepted that ABB is a logical extension of ABC. ABB provides the capability to use the relationship between cost drivers and resource consumption to prepare a much more reactive budget.

A budget that reacts dynamically to volume changes is more valuable than the older static budgets. For example, it is easy to say that next year a manager will spend \$20,000 on travel – a fixed budget irrespective of business volume. However, if this budget is measured in costs per trip (say \$700) and the trips are directly related to activity such as customer visits, the budget process is not only easier but re-forecasting also becomes a lot simpler.

#### **Integration into strategic management accounting**

Strategic management accounting requires a thorough understanding of an organisation to devise new product, customer, delivery and marketing strategies to dramatically improve an organisation's performance. It makes no sense for an organisation to change strategies that affect these areas of their business without performing a comprehensive ABC study. Equally so, the continuous evaluation of strategies should be dependent on regular cost measurement.

#### **Real-time costing**

Real-time or transactional costing must be an objective of any dynamic organisation. We consider real-time costing as the ability to provide a reasonably accurate interpretation of all costs, such as delivery, marketing and administrative costs before a transaction commences. It allows an organisation to determine the profitable outcome of a particular transaction and provides the opportunity for avoiding unprofitable business.

#### **Conclusion**

We believe better knowledge about costing as well as the availability of new technologies will provide a new impetus in delivering more advanced and sophisticated costing solutions.

ABC has a mixed history, including poor implementation, lack of costing knowledge, competition from various "fads", throughput accounting, standard costing and many other issues. But we believe it is here to stay as part of the armoury of the modern financial manager. Having been involved in a multitude of ABC implementations in many different industries it is our view that ABC has made such an impact on organisations' strategies and performance measurement that it will not fade away.

The future for ABC has arrived. ■

Copyright of Chartered Accountants Journal is the property of Institute of Chartered Accountants of New Zealand and its content may not be copied or emailed to multiple sites or posted to a listserv without the copyright holder's express written permission. However, users may print, download, or email articles for individual use.