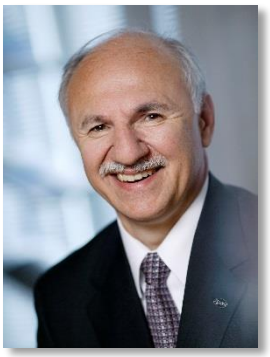
Activity-Based Costing (ABC) Expert Gary Cokins

MAKING ABC SUCCESSFUL



Gary Cokins is an internationally recognized expert, speaker, and author in enterprise performance management (EPM) systems and business analytics. After graduating in industrial engineering and operations research and with an MBA in 1974, he worked at FMC Corporation from roles in strategic planning and financial controlling to production management. In 1981, he moved to management consulting (Deloitte, KPMG, EDS) where he focused on activity-based costing, ABC, (trained by Harvard Business School Professor Robert S. Kaplan) and finally joined the software vendor ABC Technologies that was later acquired by SAS. In 2012, he founded an advisory firm, Analytics-Based Performance Management LLC (www.garycokins.com).

INTRODUCTION

Today, **entrepreneurs anticipate** their **market changes**, make **decisions** in that direction and **analyze** their **results**, within the **corporate strategy guidelines**.

In such an environment, **driving** a company business requires an effective **toolkit** which provides accurate information to facilitate analysis. This is because **understanding** what has to be changed is needed before **launching** any action plan. This is the reason why **ABC** (Activity-Based Costing) seemed to be a promising response to the enterprise **performance management** needs, in the early nineties.

How does this promise stand twenty five years later? Critics have reported customers who were dissatisfied with their results from ABC. They mainly claimed that the method itself is too complex, lacks from a really efficient toolkit, and results in never-ending implementation projects.

To answer this question, aXoma Consultants decided to interview Gary Cokins, an internationally recognized expert, speaker, and author in enterprise performance management (EPM) systems and business analytics. Trained in the eighties by Harvard Business School Professor Robert S. Kaplan himself, a leading ABC researcher, Gary Cokins implemented ABC for various customers, on the behalf of management consulting firms or specialized software vendors.

How did companies proceed, before ABC, for managing their products or services performance?

Companies simply used the flawed and misleading cost information that the accountants provided. Many managers knew the costs were inaccurate, but their companies enjoyed high profit margins so they were not overly concerned. That is not the case today.

Why was ABC considered as an innovative method, at its beginning?

In the 1980s and 1990s companies that investigated or even implemented ABC considered it to be "innovative" not only because it was different from their traditional costing practices but also because ABC's calculated costs for products or standard service-lines were substantially different from what had been reported. The changes were sometimes greater than 100% or more in both directions. That is, some products were dramatically over-costed and others under-costed.

Most of the time, ABC comes down to calculating costs. Nevertheless, managing a company is not only a question of reducing expenses but also deals with revenue for increasing profitability. How does ABC meet this requirement?

ABC does not provide answers. It generates needed questions. Its purpose is to provide focus and visibility as to where a company makes or loses profits. Pricing for revenues should always be determined by the market and on what customers are willing to pay – the "top" line of a financial income statement. ABC provides the "middle" line to subtract from the revenues' "top" line to report what the "bottom" line is – profits. Companies cannot reduce their costs to prosperity. At some point their quality and service levels will suffer adversely affecting their customers. They will need to not just grow revenues but grow "profitable" revenues. ABC provides information as to which products, standard-service lines, channels, and customers are more or less profitable. From the ABC information companies can take actions based on better decisions.

What kind of business or organization does fit with ABC?

ABC applies better for companies with repetitive processes, which is for most companies. For companies that produce make-to-order or one-of-a-kind products, such as a satellite, then project accounting is a superior direct costing method. ABC also applies to companies that have experienced an increasing proliferation of many diverse and varying products, such as with more colors, sizes or ranges. This increasing variation and diversity of products creates complexity which in turn requires more indirect expenses to manage the complexity. ABC's strength is tracing and assigning indirect and shared expenses by complying with cause-and-effect relationships that traditional "overhead cost allocations" violate that costing "causality principle". Traditional cost allocations "spread" expenses like butter on bread using cost allocation factors, such as revenue volume, which ignores how each product uniquely consumes the work activity costs belonging to the end-to-end processes. That is where the "activity" word in ABC comes from.

Today, at least in France, ABC is considered too complex for implementations. What are the main reasons for such a negative output?

The main reason that some ABC implementations fail is due to accountants or inexperienced consultants. They have misconceptions as to the primary source of cost accuracy. As a result they over-design their ABC cost model well beyond diminishing extra cost accuracy for the extra administrative effort to collect, validate, and report the information. They define a thousand or more detailed work activities when perhaps only seventy five activities would have been sufficient. They also

believe that each employee must complete a daily timesheet of where they spent time on their activities. Both have little impact on cost accuracy. The majority of the cost accuracy comes from modeling the relationships between cost objects, such as products and customers and work activity costs. ABC rapid prototyping with a few iterative models that are selectively more granular resolves this problem. This ABC implementation method assures a "right-sized" ABC model plus accelerates manager learning and buy-in for ABC information.

From the customer experience around ABC, the IT toolkit is mainly highlighted as the major a weakness. Yet, in the early years of ABC, most software vendors, such as ERP or accounting software vendors, invested in packaged applications for managing activities, setting up budgets or plans, and analyzing differences between actuals and forecasts. What more did this toolkit need for providing simpler ABC implementations? Is it still the case today despite the new IT innovations of the last ten years?

Most software vendors provide tools that are integrated with the general ledger accounting system with its responsibility cost centers and detailed expense account codes. Costing is basically modeling. It is not about T-accounts and debit and credit transaction postings. ABC "models" the consumption of resource expenses that are accumulated in a general ledger by causally tracing the expenses as costs to work activities. It then further traces the activity costs to products, standard service-lines, channels, and customers using "activity cost drivers". Today the superior software vendors either provide ABC functionality or they have partnered with dedicate ABC software vendors.

Some critics also highlight the uncontrolled duration of most ABC programs. They often state that ABC takes many months to implement and is a never-ending highway. What are the best practices for more efficient ABC implementations with quickly visible results?

As I mentioned in my answer to question number 5, ABC rapid prototyping is the best and proven way to "quickly" see results as well as "right size" an ABC system. The key is after peer managers and executives have viewed the preliminary results is to ask them, "When the more detailed and accurate ABC model is complete in a few weeks, what one type of decision or analysis will you use the information for?" With their replies, you effectively commit them to follow through. Using the information for decisions will sustain the ABC model as a permanent and repetitive production system. An additional step is to link the ABC information to the KPIs of the managers' incentive compensation program. That will assure that ABC reporting will be sustained because employee bonuses will depend on the ABC information.

Moreover, the same critics point out that ABC systems are difficult to maintain from both a management and an IT perspective.

This is a common misconception. As I previously mentioned, accountants over-design ABC models. They can be "right-sized" and also use estimates from managers except for only the few quantitative driver information that IT needs to import into the ABC model in addition to the general ledger source expense data. With ABC cost assignments, any cost must always normalize to 100% to fully reconcile the input expenses with output costs. This means that ABC can tolerate minor estimating errors relative to the extra effort of IT having to integrate ABC from source systems.

In 2004, the time-driven ABC (TDABC) method was introduced as a revolution in ABC. Why was TDABC supposed to better match the ABC customer's needs?

There are many misconceptions about TDABC. It is not a revolution. Industrial engineers have used TDABC concepts for decades for one-time studies

for portions on the company's expenses. TDABC applies when there are special conditions, primarily to calculate the cost of unused capacity. ABC is best when all the enterprise expenses are included. One can start with traditional rate-based ABC and convert it to a TDABC model if the extra effort is needed and justified.

Some analysts and software vendors recently questioned the TDABC supposed added-value. For instance, they state that TDABC is nothing more than a variant to the former ABC. Furthermore, they deny the general opinion that TDABC is easier to implement and simpler to maintain than the former ABC. What conclusion has come regarding TDABC versus ABC, after ten years?

There is little difference with data maintenance effort between rate-based ABC and TDABC. One could argue that TDABC requires greater effort, not less effort, than ABC since ABC can leverage estimates and its driver quantities using units rather than time measures, such as number of minutes. Managers relate better to units of output, such as the number of automobile loans processed in a bank, rather than the time incurred to perform an activity, such as the time to process a single automobile loan.

A general opinion states that ABC is mainly designed for large organizations, because they have access to numerous resources, during the implementation cycle and the maintenance phase. How can middle-size organizations deal with TDABC or ABC programs?

This is another misconception. ABC can apply to organizations with as few as 25 employees. As described in my answer to question number 4 as the diversity and variation of products expands this creates complexity and the need for more indirect expenses to manage the complexity. Small organizations increasingly offer more diverse products and services. So ABC also applies to them. Regarding resources today ABC software is user friendly where accountants and analysts can maintain the models with minimal assistance from IT resources.

Eventually, because it was formerly Professor Robert S. Kaplan's main topic when he researched and reported about ABC, what is the use of ABC in the EPM systems of today?

ABC is best used in two ways. First is for the strategic purpose of understanding profit margins to rationalize the more profitable products and services to promote and determine which types of customers to retain, grow, win back and acquire. Second is to calculate unit-level cost consumption rates needed for the "predictive" view of costs – driver-based rolling financial forecasts, cost estimating, and what-if scenario planning. ABC is less leveraged for operational process productivity analysis because the lean and six sigma quality management consultants promote their own methods. ABC can be useful for cost reduction, but those consultants believe that companies should just use their methods and that cost improvement will automatically be the result. This is short sighted because ABC reporting can validate if the alleged cost reductions are in reality being realized. In addition, the activity costs in ABC can be exported into value stream maps to provide focus on which activities are high value-adding or not.

What final advice would you give to companies considering implementing ABC?

My advice is to not under-estimate the magnitude of resistance to change requiring the need for behavioral change management techniques. An ABC communication plan is more important for success than the ABC software implementation plan.