

sorting out the clutter

AS MANAGEMENT ACCOUNTANTS AND FINANCIAL MANAGERS YOU'VE BEEN BESIEGED BY THREE-LETTER ACRONYMS TOUTING THE LATEST AND GREATEST STRATEGIC COSTING METHODS TO HELP MANAGE YOUR BUSINESS OPERATIONS.

DO THEY REALLY HELP?
HOW WOULD YOU KNOW?

BY JEFF THOMSON AND JIM GUROWKA

Can you guess the year of these magazine quotes: “Survey results: ABC is worth the investment”; “Nine steps to implementing ABC”; “Is ABC suitable for your company?”; “Managing your ABC system...not a panacea for what ails businesses”; “ABC: It doesn’t work all the time”? If you guessed 2005, try again. One more clue: At IMA’s 75th Anniversary Annual Conference in New York City, the eminent Prof. John K. Shank of Dartmouth College said, “Traditional accounting is at best useless and at worst dysfunctional and misleading.” Suffice it to say, the audience was stunned. Shank went on to describe the imminent “sea change” that would occur in management accounting, explaining how cost management would be to the current decade what total quality management was to the previous one.

By now, you know the decade is the 1990s, and, if you're really good, you know the year is 1994. That's the same year one of us documented the first successful telecommunications implementation of an Activity-Based Costing (ABC) process.

But this article isn't about guessing games, nor is it just another look at history or ABC. It's about strategic costing. Our definition of strategic costing is "an integral part of a broader *management accounting process* that converts usage quantities to monetary units utilizing a costing methodology for purposes of resource allocation, pricing, and profitability around products, customers, distribution channels, etc."

What exactly is the clutter that we say exists? It's the barrage of terms that purport to being the best way to help you run your business. We'll attempt to sort out the clutter and put forward an *initial* set of best practices that you should use when selecting and deploying a strategic costing process (notice we said process, not technology). This set of best practices is based on our years of practical experience in this area. Later this year, we intend to launch research (surveys and field studies) to refine the strategic costing best practices. Our strategic costing universe for this article includes: Standard Costing, Activity-Based Costing, Resource Consumption Accounting, Target Costing, and Theory of Constraints. We aren't covering other methods such as Lean Accounting and Kaizen.

YESTERDAY'S HOPE

ABC clearly was part of the sea change John Shank predicted. Using it as an example, over the past 10-15 years, there have been a dizzying number of case studies and articles touting ABC success stories, and even more have proclaimed that ABC is at best a disappointing failure. Thomas Johnson and Robert S. Kaplan at first hailed ABC as the answer to "relevance lost," but Johnson later called it "pure snake oil" as a tool to improve the competitiveness of a business.

To put ABC in perspective, let's examine a successful but ultimately unsustainable application and discuss reasons why it wasn't sustainable.

The focus of our attention was a \$30 million telecommunications billing center (annual expense—labor and nonlabor, management, and union) responsible for all functions associated with billing high-end business customers who were purchasing a bundle of telecommunications services. These billing functions included a billing control office (monitoring billing process records,

Table 1: Macro Financial and Operational Measures

Metric	1989	1990	1991	1992	1993
Customers	Base	10X	25X	35X	40X
Minutes	NA	NA	Base	48%	90%
Earnings	NM	NM	Base	+\$200M	+\$300M
Unit Costs	NM	NM	Base	-15%	-35%
Reject Rate	NM	NM	21%	8%	5%
ADO	NM	NM	45 days	36 days	34 days
NA=not applicable NM=not measured ADO=avg. days' outstanding (receivables)					

editing checks, validating data, and correcting service order and other errors) and a bill print center (printing, sorting, and dispatching invoices for the bundled service offerings). The center was experiencing severe customer dissatisfaction and financial problems related to inaccurate bills, late bills, lost bills, and spiraling costs. The CFO team brought in a consultant to help them deploy ABC in the billing center. The goals were simple: Understand the drivers of cost so that intelligent resource allocation decisions could be made to lower the cost of delivery and significantly improve customer satisfaction (as opposed to the death spiral—slash the "wrong" costs, which only adds to the customer satisfaction problems).

The technical aspects of the ABC approach are detailed in "Activity-Based Management at AT&T" in the April 1994 issue of *Management Accounting* magazine (the predecessor to *Strategic Finance*). In short, we met with billing center personnel and used a process approach that began with tracing costs directly to resources. Resources were traced to activities, and activities were traced to whatever entity consumed their physical output. Instead of the more limited two-stage driver model, we used a multistage analysis to identify operational and cost relationships. We defined drivers as activity, process, or resource related. Some of the activity drivers confirmed by team members (through traditional storyboarding and process flowcharting) were number of customers tested, change requests, service orders, bill groups (customer locations), bill resolution groups, printer hours, and pages printed.

Was the ABC billing center implementation a success? Yes. See Table 1 for macro financial and operational measures.

We created a passion for success by quoting Alexander Graham Bell, one of the founding fathers of the telecommunications industry: "Leave the beaten path occasionally and dive into the woods. You will be certain to find

something you have never seen before.” We used this planning model (i.e., process approach to strategic costing driven by ABC) to dive into the “woods” and turn around a major business operation in the throes of intense competition.

With all of the clear success and passion generated by this strategic costing implementation, *why wasn't the initiative sustainable?*

1. The ABC implementation was viewed as a stand-alone, one-off solution to a specific problem vs. one cog in an integrated performance management solution.
2. The ABC implementation not only was lacking an integration plan in terms of an overall performance management architecture, but it lacked any planning in terms of connectivity to the general ledger or enterprise resource planning (ERP) system from a technology perspective.
3. There were no standards, guiding principles, or best practices—cultural, organizational, methodology, technology. We all know this period in the evolution of strategic cost management was a feeding frenzy for consultants and software vendors alike. Pity the poor practitioner!
4. In a bit of Monday-morning quarterbacking, in many cases our ABC wasn't really ABC. We didn't capture idle capacity (after all, the A in ABC is for activity, not inactivity!), and, in many cases, we allocated costs instead

of using a true activity-driven approach (we mistook the A in ABC for allocation vs. activity!).

5. Because ABC wasn't put in place with the appropriate transformational change emanating from the very top, other “more pressing” business issues and initiatives supplanted strategic costing initiatives.

Those reasons for failure are common in many ABC initiatives, but the need for competent cost management tools is no different and, in many respects, is more pressing now than 10 years ago. This has led many cost management practitioners to search for a “better” strategic costing methodology within the context of a broader management accounting framework.

TODAY'S REALITY

We believe that ABC and other strategic costing approaches don't fail because of the underlying methodology alone but often because of poor implementation principles. Yet we aren't saying that “pure” ABC as defined over a decade ago is an analytical exemplar in terms of fixed vs. variable assignment, treatment of idle capacity, and quantity-based understanding of resource consumption at the source.

Table 2 summarizes several of the more prevalent strategic costing methodologies that exist today (some are actually *broader* management accounting processes)

Table 2: Types of Strategic Costing Methods or Processes

Strategic Costing Method	Characteristic/Application
Standard Costing	Total cost divided by total quantities for a particular resource, activity, or cost pool. Historical roots back to the early days of manufacturing. Problems well documented—poor implementations resulting in smearing of costs generally inappropriate for strategic costing. An advantage of standard costing is simplicity.
Allocation-Based ABC	Models too granular in terms of number of activities and cost pools. Too much allocation of cost (push ABC). No customer dimension. Little understanding of the complexity of an organization's activities. Terminology and standards inconsistent and/or nonexistent. Little or no focus on the resources that drive the activities.
Best-Practice ABC	Well-designed implementations; buy-in from the top and from process owners; deep focus on operational relationships and narrow focus on key activities; product, customer, geographic, and distribution channel dimensions captured; ABC viewed as part of an integrated, holistic performance management system capturing people, analytics, and technology; dual focus on activities and the resources that drive them.
Time-Driven ABC	Approach that complements traditional ABC by accounting for idle capacity and simplifying data collection.
Resource Consumption Accounting	New approach that combines resource intensity of GPK (German cost accounting) with activity intensity of ABC and adds in additional features.
Target Costing	More of a comprehensive system for profit planning than a specific type of strategic costing methodology.
Theory of Constraints	Systems management philosophy developed by E. M. Goldratt in the early 1980s—essentially, maximize throughput by identifying constraints. Often at odds with principles of ABC. More concerned with eliminating major bottlenecks and improving throughput than reducing variable costs.

along with their characteristics and application in use. You can find more detail about them in the IMA Centre of Excellence at www.imanet.org.

Let's take a look at a few.

Time-Driven Activity-Based Costing

Robert S. Kaplan and Steven R. Anderson say that some companies abandoned ABC because it didn't capture the complexity of their operations, took too long to implement, and was too expensive to build and maintain (see their article in the November 2004 issue of *Harvard Business Review*). They essentially argue that surveying employees for activity time estimates can't be scaled, and wasted time results from employees arguing about the accuracy of cost-driver rates that are derived from subjective beliefs. Kaplan and Anderson also indicate that traditional ABC models fail to capture the complexity of actual operations and argue that, in acquiring employee time estimates, idle capacity isn't captured and the estimated cost-driver rates are substantially overstated (will an employee actually report "idle" time!?).

Essentially, their revised approach to ABC is for managers to use the 80/20 rule to directly estimate the resource demands imposed by each transaction, product, or customer rather than assign resource costs to activities first and then to final products or customers. Instead of surveying employees on how they spend their time, managers would directly estimate the practical capacity of the resources supplied as a percentage of the theoretical capacity. Estimates of the cost per time unit of capacity lead to estimates of the unit times of activities, which lead to derived cost-driver rates. Idle capacity is highlighted for strategic discussion, and models are much easier to update by estimating the unit time required for a new activity vs. the tedious task of interviewing employees again.

Target Costing

Target Costing is a comprehensive system for profit planning that requires a significant investment in information and tools. Although there's an equation to define the target cost (Target Cost = Allowable amount of cost that can be incurred on a product and still earn the required profit from that product = Competitive Market Price minus Target Profit), Target Costing is more about a way of managing and a way of thinking driven by six key principles: price-led costing, customer focus, focus on design of products and processes, cross-functional teams, life-cycle cost reduction, and value chain involvement.

Strategic costing methodologies are a subset of the Tar-

get Costing profit planning process and "fit" in the following ways. First, a key step in the target costing process is to turn an allowable target cost into an achievable target cost that involves cost analysis and estimation, value engineering, and continuous improvement. For example, in developing cost targets for design teams and organizational units, ABC can help turn an allowable cost into an achievable cost. More broadly, the process-management orientation of ABM (Activity-Based Management) fits nicely with one of the six key principles of Target Costing, namely the emphasis on cross-functional teams to achieve success. An excellent reference that will give you more insight is *Target Costing: The Next Frontier in Strategic Management* by Shahid Ansari, Jan Bell, and the CAM-I Target Cost Interest Group (with which IMA is a strategic partner).

Theory of Constraints

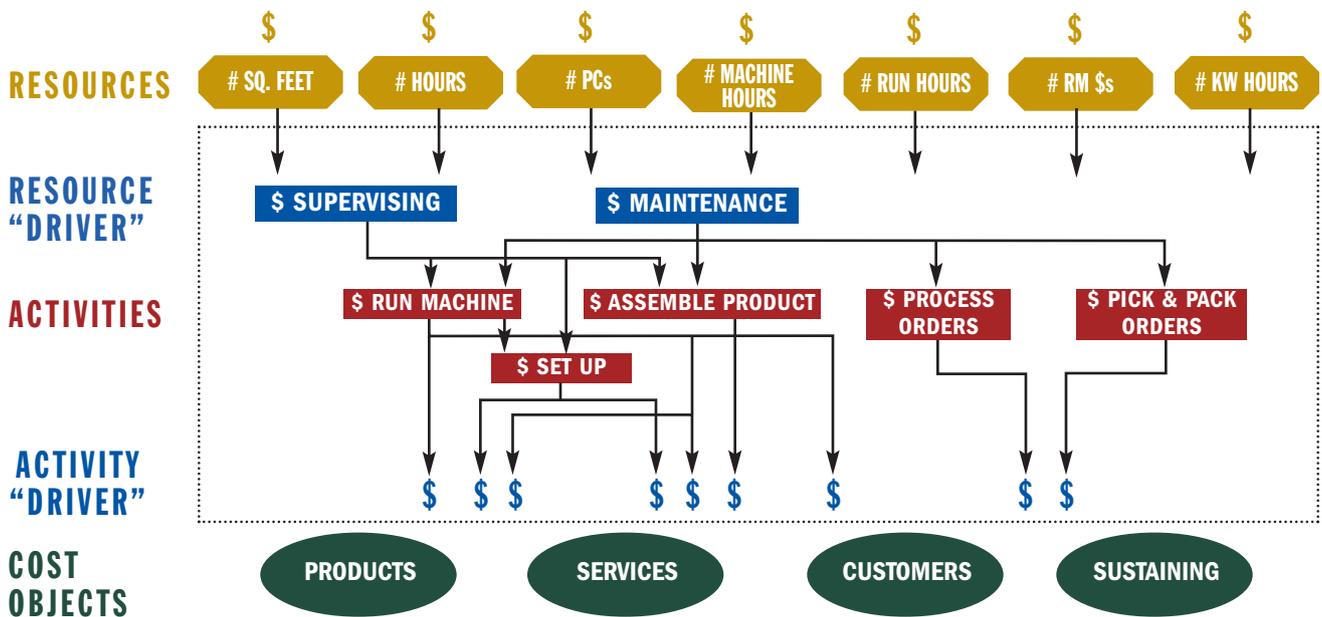
IMA Statement on Management Accounting No. 4HH, *Theory of Constraints (TOC) Management System Fundamentals*, explains TOC: "The Theory of Constraints (TOC) is a systems management philosophy developed by Eliyahu M. Goldratt in the early 1980s. The fundamental thesis of TOC is that constraints establish the limits of performance for any system. Most organizations contain only a few core constraints. TOC advocates suggest that managers should focus on effectively managing the capacity and capability of these constraints if they are to improve the performance of their organization."

TOC and ABC advocates have been somewhat "at odds" with each other because decisions resulting from use of the techniques on the same application could differ. For example, ABC has often considered all costs to be variable in the long run, the relevant time frame for many strategic decisions. TOC is oriented more toward short-run optimization studies where many costs are fixed. TOC also tends to have more information value for "hard" assets, such as machines, where the short-run emphasis is on eliminating wasted time on the constraints rather than on shedding costs. ABC tends to have more information value for the "soft" assets—people—who are flexible, redeployable, and salary based. In these cases, costs can be shed because ABC penalizes those jobs that consume excess amounts of employee time and effort.

TOMORROW'S PROMISE

We aren't articulating a vision for the future of strategic costing yet, but we hope to help clear a path for this vision with a set of benefits for Resource Consumption

Figure 1: Cost Tracing



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Accounting and a list of strategic costing best practices. We believe RCA has the potential to not only complement but transform ABC and strategic costing within the context of a broader, integrated management accounting process. The list of best practices is just a start, but we hope they will make you think about your own company's operations.

Is there still a call to action to transform strategic costing and management accounting? We think so, especially since recent surveys have found that 80% of corporations still use traditional cost allocation and aren't pleased with the results in terms of accuracy and the ability to take action.

Resource Consumption Accounting

Every ABC description, textbook, or case study will have a reference to resources as the starting point for an activity analysis and assignment of costs to their "final" destinations (e.g., products or customers) through a single-stage or multidriver process. Let's look at a figure (Figure 1) from Focused Management Inc. In its simplest form, ABC traces resources to activities and activities to outputs. And yet a disproportionate amount of analysis is focused on the activity side, not the resource consumption side of the cost flow.

RCA is an emerging strategic costing process that integrates German cost accounting's emphasis on marginal costs and resources with the activity/process view underlying ABC within the context of an integrated perfor-

mance management system (e.g., ERP). German cost accounting methods have had dozens of years of clear success and added value to the enterprises they serve in both the manufacturing and service sectors. IMA has been working with several RCA thought leaders (Anton van der Merwe, David Keys, Sally Webber, Douglas Clinton, Kip Krumwiede, and Gunther Friedl) to advance the approach through live case studies from manufacturing and service industries, a growing number of publications, and, ultimately, training and certifications. For a full set of resources on German cost accounting and RCA, visit IMA's Centre of Excellence or www.RCAinfo.com.

Some potential benefits of RCA relative to "traditional" strategic costing methodologies are shown in Table 3.

Strategic Costing Best Practices

Here's a list of a few strategic costing best practices:

1. ABC, RCA, or any other TLA (three-letter acronym) must be a subset (not a driver or a stand-alone one-off) of an *integrated, holistic performance management system* involving people, organization, and technology as captured in Figure 2.

2. Strategic costing functionality should be part of an integrated technology solution that includes the G/L and a data-centric vision. For example, in the U.S., many companies don't use the full functionality of their ERP systems.

Table 3: Potential Benefits of Resource Consumption Accounting

Strategic Cost Issue	“Traditional” Treatment	RCA Benefit
Fixed vs. variable/ resource-level analysis	Identifies/assigns cost as fixed or variable at an activity, process, or product level, obscuring the true cost consumption pattern at the source (resource level—people, machines, etc.). Cost consumption patterns virtually ignored at the resource level. ABC—All costs for a process are variable, obscuring decision making (e.g., outsourcing where hidden costs may still remain).	Identifies and assigns cost as inherently fixed or variable (proportional) at the <u>resource level</u> , highlighting more realistic cost consumption patterns. Recognizes that inherently proportional costs can be consumed in a fixed manner (e.g., training time—direct labor normally 100% variable, but time spent in training is fixed consumption).
Resource interrelationships	Explicit relationships not captured between resource pools.	Assignments are made from resources to resources and from resources to activities to resources, often in a reciprocal manner. This allows for resource optimization on the input side of the enterprise.
Treatment of idle or excess capacity for strategic resource management	Often allocated to product, obscuring product profitability and pricing analyses. <u>Budgeted</u> volumes used for unit costs. ABC—often smears idle capacity to every activity (“ABC done poorly”).	Attributes the cost of idle capacity to the resource level but does not smear it to product. Idle capacity highlighted for strategic discussion. <u>Theoretical</u> volume used in determining unit costs.
Assignment of costs/ model update complexity	<u>Pushes</u> cost of resources to cost object by spreading all costs incurred over final products. Model updates tedious and subjective (e.g., employee time surveys), resulting in an outdated model. Time- or Event-Driven ABC simplifies data collection and cost assignment, but does NOT get at the heart of resource consumption patterns.	<u>Pulls</u> cost of resources consumed to cost objects by using <u>quantified</u> output-consumption modeled rates (based on causality) that become standards. Because quantified rates are used, they are more objective and easier to update to keep pace with continual changes in economic reality.
Treatment of depreciation for product life-cycle management	G/L book depreciation (e.g., DDB, SYD) doesn’t reflect economic reality. For example, actual cost of maintenance on an older machine could result in a higher product life-cycle cost not reflected by traditional accounting. Selling products using older, fully depreciated machines creates a higher, distorted view of profitability.	Replacement cost depreciation better reflects economic reality over the product life cycle for make vs. buy and other types of decisions.
Tracking level to support multilevel decision making	Primary grouping of costs is at “final” level (product, customer, or distribution channel). Little or no detail available at the true cost source, the resource consumption level.	Resource, activity, process, and “final” cost levels of detail available with linked causal relationships supported by quantity-based modeled relationships.

3. Any strategic costing methodology must *identify and highlight idle or excess capacity* as a strategic resource management issue vs. smearing or ignoring idle capacity. (Smearing means inappropriately spreading costs across multiple products, services, or customers based on broad allocations and not true cost causality.)

4. Some degree of *resource-level analysis* is required to capture true cost consumption patterns at the source, where trade-offs and resource allocation decisions can be made effectively. Activity- and process-level analyses by

themselves are inadequate except in the simplest of operations. Cost assignment and analysis at the “final” level only (product, customer, or distribution channel) isn’t a best practice—it’s strategic costing *malpractice!*

5. The strategic costing *model update process* should be efficient, scalable, objective, and adaptable to change (examples are Time- or Event-Driven ABC and RCA quantity-based modeled relationships). One of the historical problems with traditional ABC is that the process relies on surveying managers on how they spend their time on

Figure 2: Performance Architecture



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myriad activities, which, when multiplied by the number of managers and operations, could become a very unwieldy process that isn't efficient or scalable. Time- or Event-Driven ABC and RCA quantity-based modeled relationships allow for activity and resource consumption inputs to be much more efficiently updated so the model doesn't "break down" because of an inability to update.

6. *Training and education* are critical enablers to the success of any strategic costing methodology, and training includes consistent and accurate use of costing language: All users of the information, including operations managers, must understand what the data means, how it can be used, and why it is different from what has been done before. They must also be involved in making sure the costing analysis reflects their reality.

7. Not only is tone at the top another important enabler of success, but *commitment and continuity from the top* are equally important. Incorporating anything new and potentially transformational requires ongoing commitment, or the initiative will fail.

8. The CFO team can incite change and a call to action, but *operations must lead and manage the change initiative*.

IT'S YOUR MOVE

We have made a first attempt to sort out the "strategic costing clutter" by stressing the need to move to a set of

best practices and evaluation criteria that aid practitioners in industry and away from simplistic debates around which methods are successful and which aren't. Which strategic costing method is "right" for you? It depends. Each organization needs to assess its own business issues, tolerance for data collection, and levels of required accuracy and then begin. Follow the best-practice implementation steps, and talk to others (even outside your industry) who have been successful. *How* you implement may be more important than *what* you implement. ■

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