

Technical Briefing

CIMA

DEVELOPING AND PROMOTING STRATEGY

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Activity-based Management – An Overview

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Activity-based management and activity-based costing (ABM/ABC) have brought about radical change in cost management systems. ABM has grown largely out of the work of the Texas-based Consortium for Advanced Manufacturing-International (CAM-I). No longer is ABM's applicability limited to manufacturing organisations. The principles and philosophies of activity-based thinking apply equally to service companies, government agencies and process industries. The acronym itself has evolved from ABC to ABCM (activity-based cost management) to ABM, and the application of ABC evolved from a manufacturing product costing orientation to a management philosophy of activity management applied in industries and organisations other than manufacturing.

Activity-based costing and activity-based management have been around for more than fifteen years. Most forward-thinking companies have implemented them, or are in the process of doing so.

ABC is not a method of costing, but a technique for managing the organisation better. It is a one-off exercise which measures the cost and performance of activities, resources and the objects which consume them in order to generate more accurate and meaningful information for decision-making. ABM draws on ABC to provide management reporting and decision making.

ABM supports business excellence by providing information to facilitate long-term strategic decisions about such things as product mix and sourcing. It allows product designers to understand the impact of different designs on cost and flexibility and then to modify their designs accordingly. ABM also supports the quest for continuous improvement by allowing management to gain new insights into activity performance by focusing attention on the sources of demand for activities and by permitting management to create behavioural incentives to improve one or more aspects of the business.

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- ABM is a fundamental shift in emphasis from traditional costing and performance measurement. People undertake activities which consume resources – so controlling activities allows you to control costs at their source.
- The real value and power of ABM comes from the knowledge and information that leads to better decisions and the leverage it provides to measure improvement.
- ABM enables management to make informed decisions about lines of business, product mix, process and product design, what services should be offered, capital investments, and pricing.
- ABM is more than an accounting tool; it's a system for continuous improvements. It is not a single answer but merely one of the many tools that can be used to enhance organisational performance management.
- ABM will not reduce costs, it will only help you understand costs better to know what to correct.
- The process of ABM does consume resources, and the manpower costs can be significant.
- Companies considering or already implementing ABM should realise that although certain product or market factors might make it potentially beneficial, those same factors might not lead to a successful implementation. ABM gives us a much better chance of establishing a useful costing for outputs. But there is a price to pay. It can be difficult to find out what costs apply in a particular activity, and those involved may be suspicious of others charged with finding out. Some areas of activity overlap and are difficult to separate. And, of course, ABM is a costly exercise in its own right.
- Other priorities, top management commitment, IT capabilities, and integration with financial and budgeting systems should be considered before implementation.
- Organisations have begun to look at ABM for a variety of reasons. Among the most commonly cited are:
 - top-down pressure to reduce costs;
 - competitive pressure/market conditions;
 - organisation-wide programme;
 - the introduction of benchmarking;
 - regulatory issues;
 - seeking world-class status through process management.
- ABC and ABM are a continuum of value. ABM is the application of ABC data to manage product portfolios and business processes better.

Part 1 – General FAQs

Why have organisations turned to activity-based techniques?

Management practices and methods have changed over the last decade and will continue to change.

Organisations are moving from managing vertically to managing horizontally. It is a move from a function orientation to a process orientation. Total quality management (TQM), just-in-time (JIT), benchmarking and business process reengineering (BPR) are all examples of horizontal management improvement initiatives. These initiatives are designed to improve an organisation's work processes and activities to effectively and efficiently meet or exceed changing customer requirements.

Management information systems to track and provide information about the horizontal aspects of a business have lagged significantly behind the needs of its managers.

Activity-based costing/activity-based management fills this information need by providing cost and operating information that mirrors the horizontal view. The focus of ABC is on accurate information about the true cost of products, services, processes, activities, distribution channels, customer segments, contracts, and projects. Activity-based management makes this cost and operating information useful by providing value analysis, cost drivers, and performance measures to initiate, drive or support improvement efforts and to improve decision-making.

What is the difference between activity-based costing and activity-based management?

ABC has been around for some time. It has promised companies a new way to understand costs and a new way to limit these costs to the products and customers driving them. It has been heralded as the cost accounting model that would help management improve profitability. And it is fair to say that it does do that if:

1. management gains a thorough understanding of its business processes and cost behaviour during the ABC analysis process; and
2. management applies the insights gained during ABC fact gathering and analysis to improve decision making at both operating and strategic levels. This is the essence of ABM.

Put simply ABM is ABC in action.

ABC prompts managers to ask the right questions. ABC becomes ABM (management) when it is used to:

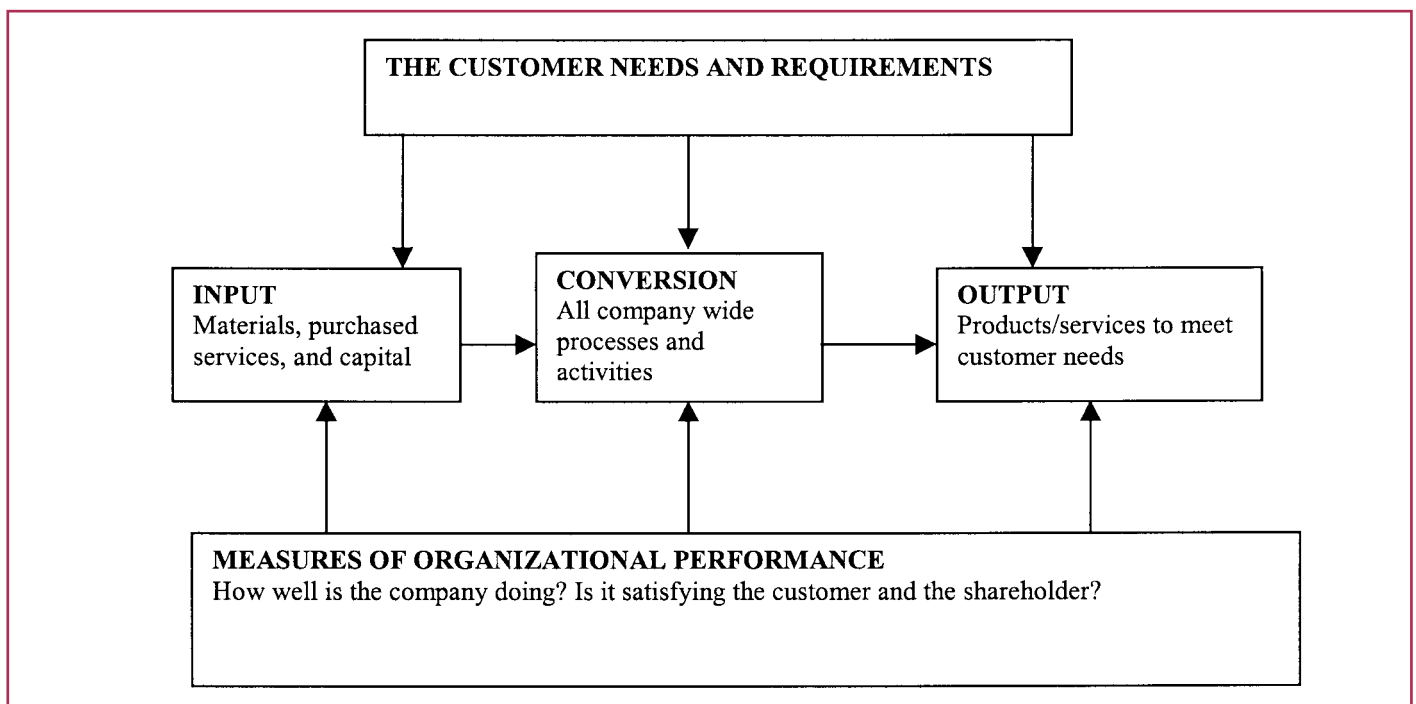
- design products and services that meet or exceed customers' expectations and can be produced and delivered at a profit;
- signal where either continuous or discontinuous (re-engineering) improvements in quality, efficiency and speed are needed;

- guide product mix and investment decisions;
- choose among alternative suppliers;
- negotiate about price, product features, quality, delivery and service with customers;
- employ efficient and effective distribution and service processes to target market and customer segments;
- improve the value of an organisation's products and services.

What are the basics of ABC?

Activities are the common denominator of the horizontal, processed-based view of the organisation.

The horizontal view of the organisation



Source: *Implementing Activity-based Management in Daily Operations*, John A Miller, 1996, Inc, p. 2, Exhibit 1-1. © John Wiley & Sons. This material is used by permission of John Wiley & Sons, Inc.

Placed at the top of the process-based organisation are the needs and requirements of customers. Every company exists to meet these needs and requirements, this is shown at the top of the model. Processes and activities are represented in the middle of the model. At the bottom of the model are the measures of organisational performance. Processes and activities are the central nervous system of the process-based organisation and represent the core of what the organisation does to create value for its customers and shareholders. How well the organisation competes at the activity and process level will ultimately determine its survival. Performance of activities is the cornerstone and common denominator of improvement initiatives. Management must focus on the process/horizontal view of their organisations to remain competitive. Activities represent the horizontal view. Activity-based management is a tool developed to support the process-based organisation by providing information and data needed to plan, manage, control,

and direct the activities of a business to improve processes, products and services, to eliminate waste and to executive business operations and strategies. This information takes the form of the outputs of an ABM information system.

What are the outputs of an ABM information system?

Organisations that are designing and implementing ABM will find there are five basic information outputs:

- the cost of activities and business processes;
- the cost of non-value-added activities;
- activity-based performance measures;
- accurate product/service cost (cost objects);
- cost drivers.

The cost of activities and business processes

Since activities form the very core of what a business does, the basic output of the ABM system must be to provide relevant cost information about what a business does. Instead of reporting what money is spent for and by whom, costs are assigned to activities.

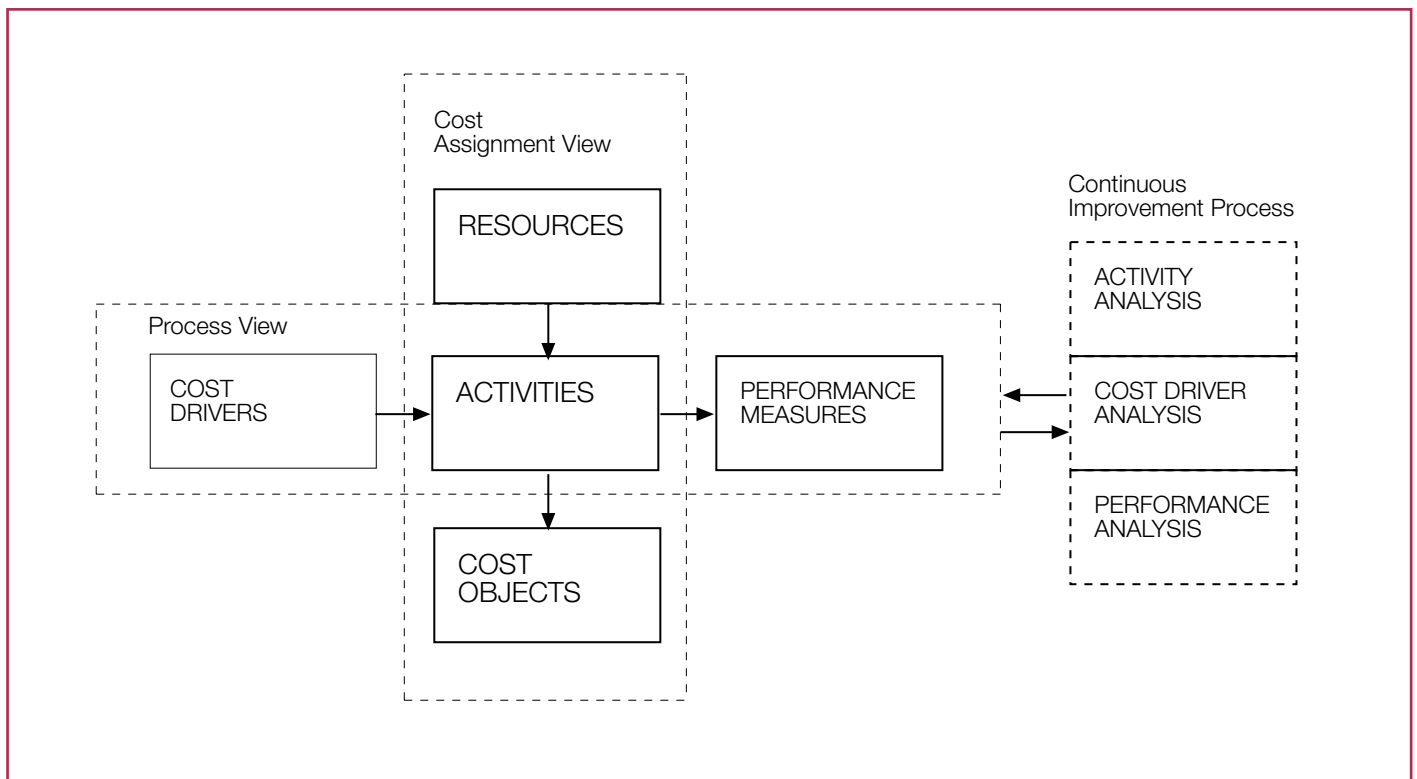
The cost of non-value-added activities

Some activities add value to a product or service, while some do not. A non-value added activity is an activity that is considered not to contribute to customer value or to the organisation's need. This is defined as waste. Identification of waste is valuable to management. This crucial information output provides a focal point for improvement efforts.

Activity-based performance measures

In addition to cost information for business processes and activities, the ABM system must report information and data on activity performance. Knowing the total cost of activity is insufficient to measure activity performance. Activity measures of quality, cycle time, productivity and customer service may also be required to judge activity performance. Measuring the performance of activities provides a scorecard to report how well improvement efforts are working and is an integral part of continuous improvement.

The CAM-I ABM Model



Activity-based management model, from *Implementing Activity Based Management in Daily Operations*, J A Miller, p.236, Chpt: The CAM-I glossary of activity-based management, © John Wiley & Sons, Inc. This material is used by permission of John Wiley & Sons, Inc.

Accurate product/service cost (cost objects)

Products and services are provided to markets and customers through various distribution channels or contractual relationships. Because products and services consume resources at different rates and require different levels of support, costs must be accurately determined. Accurate product and service cost information is vital for selecting the individual and segmented markets where an organisation competes and for pricing in those markets. Accurate product and service cost information is a key information output of the ABM systems.

Cost drivers

The final output of an ABM system is cost driver information. A cost driver is any factor that causes a change in the cost of an activity. For example, the quality of parts received by an activity, for example the percentage which are defective is a determining factor in the work required by that activity, because the quality of parts received affects the resources required to perform the activity. An activity may have multiple cost drivers associated with it.

Summary

The ABM outputs described above, all contribute to management improvement initiatives and improved decision-making by providing cost and operating information about the activities of the organisation.

The model above is a view of activity-based management. It depicts the key relationship between ABC, on the left, and the management analysis tools that are needed to bring full realisation of the benefits of ABC to the organisations. ABC is a methodology that can yield significant information about cost drivers, activities, resources and performance measures. However, ABM is a discipline that offers the organisation the opportunity to improve the value of its products and services.

Part 2 – Practical guidance on implementing ABM

- **Focus on critical needs**
Before implementing an expensive information system or a more sophisticated costing system, decide what are the organisation's most important issues or decisions and what types of information would help address those issues.
- **Get top management support**
If you think ABM might be a useful tool in your organisation, be sure to get top management's support first. With their help, identify critical information needs, and show how an activity-cost approach could provide valuable information. Seek approval for small, relatively quick projects, such as a single process or a pilot plant. If these are successful, management will drive further implementation and help make it a priority for other areas.
- **The main cost system**
If pilot projects are successful, try to incorporate ABC methods into your organisation's financial reporting process. Successful implementers of ABC systems are six times as likely to have integrated ABC into their primary financial system and almost twice as likely to use ABC for budgeting (KIP R. Krumwiede, CMA, CPA, *Management Accounting*, April 98).
- **Consider a separate model**
If integrating ABC into the main cost reporting system is not feasible, consider developing a separate PC-based ABC system that can be used on an infrequent basis for strategic decision-making. The model should be relatively simple and can be updated with data that already is available or easily collected. But even a relatively simple model can be far more accurate than many traditional cost allocation methods.
- **The existing information system**
If you implement an ABC costing system, make sure that the input requirements can be easily supported by the existing information system. If not, either change the model or install a more sophisticated integrated system.

- **Smaller companies**
Smaller companies need to be especially creative to find reasonable activity cost drivers from their often more limited data. For example, use material cost as a proxy for its weight. Look for available drivers that have some correlation with how resources are spent.
- **The implementation team**
Make sure the people who will be actual users of the ABM information are represented on the implementation team. A common mistake is putting managers on the team and not getting enough input from the cost accountants or other analysts.
- **Start simply**
The best advice is to start simply. Implement ABM at a high level in order to get concepts across. Once you have created an interest, there will be a "demand pull" for more information. Use spreadsheets until you identify exactly what your needs are, and then buy the software that meets your needs.
- **From manufacturing companies to all industries**
For a long time ABM was viewed as relevant to manufacturing. Experience has demonstrated that activities are universal to all organisations, including service companies, schools, government, and non-profit organisations. To varying degrees, every organisation has processes and activities in place to convert capital, materials and purchased services to products/services required by its customers and users. Regardless of industry, activities represent the core of what the organisation does to create value for its customers and shareholders.
- **Start with product costing**
Product/service costing is the dominant initial application of ABM in most organisations. Don't produce a list of activities which:
 - runs into the 1,000s, many with insignificant amounts of cost allocated to them;
 - does not identify the cost of wasted activity;
 - does not identify customer or product specific activity;
 - takes many hours for a PC to calculate each month; *and*
 - is so detailed that the benefits of ABM are lost.

Part 3 – Checklist

Implementations often fail because the business does not take the time to identify what it is trying to achieve and then to ensure the approach will deliver the required outputs. For an organisation to decide on the correct approach to ABM there are a number of questions it must ask first which would include:

- What are the objectives for the ABM implementation project (i.e. what are the uses you will put the information to when it is created)?
- What are the particular circumstances of your business in which the implementation will happen?
- How easy would it be to make a realistic allocation of costs directly to activity groups?
- How stable over time and between products/customers are the costs of resources consumed in completing activities?
- How stable over time and between products/customers is the amount of resources consumed in completing activities?
- How stable over time and between products/customers are the sub-processes that comprise the activity?
- How many distinctly different activities are there?
- How stable over time and between products/customers is the mix of activities completed?
- How consistent is the amount of capacity used over time and hence the amount of surplus capacity?
- Is the amount of surplus capacity a major concern for the business?
- Is the management of overheads within operating units a major concern for the business?
- Given these circumstances what is the most appropriate approach to achieve your objectives?

Part 4 – Further reading and bibliography

- <http://www.pitt.edu/~roztock/abc/abc.htm>
ABM Internet website guide, by Narcyz Roztock of the Pittsburgh University. Comprehensive internet web links covering all areas of ABM
- <http://www.cam-i.org>
The CAM-I web site, useful articles and further info.
- http://www.activitybasedmgmt.com/-ABM_ABC_Information.htm
Consultancy US website with articles database, definitions of terms and techniques, questions and answers, recommended reading and general info.
- <http://www.eiasm.be/MAR-2001.html>
CIMA sponsored research seminar, Italy, 2001 on ABC/ABM, call for papers.
- <http://www.icms.net/whatisabm.htm>
Consultancy site, books, articles, case studies, toolkits, software, ask the experts, definitions.
- <http://www.nan.shh.fi/raw/ima/imabc.htm>
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- <http://www.cfoeurope.com/199810f.html>
An article from the magazine for financial directors and treasurers, CFO Europe. 'Not as easy as ABC' by Christopher Watts.
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