

Activity-Based Costing/Management

Lessons from a Public Service Organization



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Transparency, accountability and performance continue to be a focus for governmental management and reporting. Increasingly scarce resources, and constituent demands for more efficient and effective services are two driving forces toward new methods of managing the business of government. The public sector, primarily on the federal level, recognized the advantages of internal costing systems that match the service production processes of an organization.¹ AGA's *Performance-Based Management* report identified activity-based costing as "an excellent means of understanding processes and their costs."² Most examples of activity-based costing/management (ABC/M) are found at the federal level.³ Nonetheless, all levels of government are advised to use it as an effective financial model as part of a broader performance-based management system.⁴

"Activity-Based Management for Service Industries, Government Entities, and Nonprofit Organizations" outline the benefits of activity-based management for service industries, government entities and nonprofit organizations.⁵ The use of an activity-based costing (ABC) system is only meaningful if government employees use the causal data to manage business processes toward the achievement of the organization's strategic objectives and service excellence.⁶ Increased use of quantifiable performance measures and performance-based budgeting in the public sector may lead to increased use of ABC systems.

Figure 1. CAISO History



CAISO was created in 1998 when the state restructured its electricity markets at the recommendation of the Federal Energy Regulatory Commission (FERC), following the passage of the federal Energy Policy Act of 1992, which removed barriers to competition in the wholesale generation of the electricity business.

While utilities still own transmission assets, the independent system operator (ISO) acts as a traffic controller by routing electrons, maximizing the use of the transmission system and its generation resources, and supervising line maintenance. As the nerve center for the power grid, the ISO matches buyers and sellers of electricity, facilitating more than 28,000 market transactions every day to ensure enough power is on hand to meet demand.⁷

This article utilizes the experience of a not-for-profit public benefit corporation chartered by the state of California, California Independent System Operator (CAISO), to highlight 10 best practices when adopting and using ABC/M. Figure 1 describes the establishment of CAISO and the nature of its operations. CAISO's service orientation, customer focus, and emphasis on transparency and accountability make CAISO an excellent model for governmental

units to pattern their own process frameworks.

Laying the Groundwork

1. Begin with strong messaging from top management — Full support and expectations from top management must be clearly articulated. As with any significant organizational change, communication from the executive level to all levels of the organization

provides a mandate for change and should relay a positive vision for the effect of the change.



In 2009, CAISO chief executive officer (CEO) and executive team piloted ABC, with full implementation occurring in 2010.⁸ CAISO's revenue requirement varied greatly between 1998 and 2007;⁹ and at one of his previous employers, the CEO had learned that ABC data could inform management decision-making. ABC was added to the five-year strategic plan in 2008. In the 2009 update to the five-year plan, ABC was more fully defined as a strategic initiative to help the organization excel in performing capabilities by defining, measuring and controlling sustainable business processes.¹⁰ In 2012, the new CAISO CEO reiterated executive commitment to the use of ABC. The goal in using ABC was to ensure all process owners responsibility — knowing their own processes, understanding interfacing processes, and identifying on which processes employees spend time.

2. Identify project leadership team — Key members of the organization who are enthusiastic about the project and are responsible for, as well as accountable for, the setup and/or future modifications of the ABC system must be identified. A team of individuals who understand the project and can field questions may prevent frustrations from occurring in the individual business units during the implementation phase and when inevitable glitches arise. An added benefit of a well-chosen team of experts is its ability to envision how the ABC financial system fits into a broader continuous improvement and management system.



CAISO formed an organizational effectiveness group that reported to the CEO.

The group was charged with implementing ABC, mapping key processes into a framework, approving the strategic-planning process and ensuring corporate compliance.

3. Utilize internal industry expertise — Trust your managers to know your business processes better than external consultants with little or no experience with your services could.



CAISO paid for consultants whose deliverables did not represent the true business process of CAISO.

The leadership used their own employees for better results. In addition, consultation with another company in the industry that has used ABC can result in valuable benchmarking. CAISO contacted another utility in the industry that was using ABC for comparative purposes, and by doing so, avoided common ABC pitfalls such as using too many codes, implementing new ABC tracking systems that duplicate some or all of current time- and project-tracking systems, and pushing the initiative without articulating a clear vision of how the resulting data would be used.

4. Establish employee buy-in — Spend considerable time planning for potential problems and to moderate cultural resistance and help gain employee support.



Because CAISO employees had previously undergone mapping exercises with external consultants that resulted in an unusable deliverable, they resisted new mapping. There was also a fear that ABC would result in headcount reduc-

tion. Setting up a pilot program at a strategic rather than a procedural level, reassuring employees that perfection was not expected, and asking them for input and feedback helped build demand from many managers for more detail about the activities in their business unit. Examples from the pilot were used to show how the information could be leveraged for continuous improvement, especially where employee time was spread across multiple processes.

Gathering the Data

5. Identify critical, strategic-level processes — The strategic-level processes guide the placement of the critical core business processes that serve as the roadmap of all procedural activities. Working from the top-down avoids becoming mired in unnecessary detail and avoids overwhelming personnel who need to record activities on time-cards but do not want to manage their time through ABC codes. An added benefit is obtaining executive- and manager-level agreement on a working process map before filling in detailed procedural activities.



By undertaking the aforementioned actions the CAISO team was able to

delineate process areas and identify activity contributions. CAISO's focus on the business process framework as the driver for the ABC system, without tying it to the organizational structure, ensures flexibility for the organization. When reorganization occurred, the activities and accompanying ABC codes were simply moved to another unit and/or performed by a different individual.

6. Acknowledge the political nature of identifying cost centers — Be willing to compromise with internal constituents when the result maintains the integrity of the costing system.



The CAISO team could have placed human resources (HR) business processes in the support services bucket of costs. When the vice president of HR requested recognition that HR activities are critical and distinct activities from other support business services, the team made this concession. The assignment of the HR costs was similar to other indirect costs, and the HR department was more motivated to participate in the collection of ABC data.

7. Refine the system — After strategic business processes are identified and the process mapping to the tactical and procedural levels

begins, the need for adjustments may become evident.



The CAISO team identified top business processes; and required every employee to put the business processes on their time sheets. Concurrently, the CAISO team worked with the operations team to develop a set of process maps. After arriving at a reasonably complete list of the activities under the business processes, managers were interviewed to estimate times associated with the activities. Implementation of the mapping also revealed the need for adjustments, leading to more useful costing data.

Implementing ABC/M

8. Leverage reporting requirements/mandates — Integrating the needs of any reporting requirements with the ABC financial

system serves to increase information system efficiencies and can eliminate duplicate work for employees.



CAISO is regulated under both the Federal Energy Regulatory Commission (FERC) and the North American Electric Reliability Corporation (NERC). FERC regulates the tariffs (rates) CAISO sets and requires performance metrics reporting. CAISO prepares cost of services studies using its ABC system to illustrate how rates are determined. In addition, the ABC system is leveraged to compile the information needed for the FERC performance metrics reporting, NERC compliance audits, internal control audits and enterprise risk management have leveraged the same business process framework as the ABC system as input for their activities.

The goal in using ABC was to ensure all process owners responsibility — knowing their own processes, understanding interfacing processes, and identifying on which processes employees spend time.



9. Simplify and promote transparency — Begin with set percentages based on manager input in the fewest possible cost buckets. Refining the system down to the penny becomes cumbersome and difficult for customers to understand.



The CAISO team created rates limited in scope but comprehensive enough to cover the company. CAISO utilized employee knowledge and industry comparisons to devise only 3 cost buckets. In contrast, the external consultant devised 17 cost buckets. CAISO's streamlining from 17 to 3 cost buckets simplified the process mapping into those cost buckets. The manager interviews and timesheets were used to set and/or adjust the allocation percentages. This simple process was easy to explain to customers and within regulatory guidelines.¹¹ Most customers were pleased with the simplicity and predictability of the rates. A few customers complained to CAISO when funding increase requests were denied. Those customers remained with CAISO after they were given a 10-year transition period. Three years later, the customer base was further reassured by the process when there was only a one-percent rate change from the initial rates set. The one-percent rate change was based on actual time sheets, and this stability in rates increased customers' acceptance of the process. Since ABC implementation, CAISO's headcount has remained very stable, while the organization continues to advance its technology and strategies.

10. Use ABC/M as a management tool to increase efficiency and effectiveness — ABC can highlight both the upstream and downstream interconnectivity of processes, and can help identify activities prime for improvement and/or automation. Avoiding unnecessary employee layoffs is a key component of this best practice. Instead, the data can be used to redistribute the workforce within the organization. Additionally, managers can use the data to develop performance plans for their employees.



CAISO accomplished changes in these three management areas:

- **Interconnectivity** — Before implementation of ABC, some employees considered their activities as independent of all other processes. The business-process mapping identified the interconnectivity of each activity and their connections to upstream and downstream processes. Managers had considered their units as separate and distinct cost centers, but ABC helped the managers realize they are merely process owners who are interconnected with the processes owned by other business units.
- **Automation** — CAISO identified activities that, while value-adding, took too much time to complete. Some of these processes were automated to save time, but the CEO assured employees their jobs were secure and that they would be trained to do other things within the organization.

- **Performance Plans** — Managers of business units integrated ABC activity reports into their planning processes. Performance plans were developed for employees, establishing expectations for time spent on work activities. Managers could manage their processes and work activities proactively rather than reactively. Assessments of employee work activity and whether the performance expectations needed to be adjusted became easier. Thus, valuable input toward further refinement of the ABC codes was made available.

Moving Beyond ABC/M

CAISO knew it needed a better rate system and kept that end goal in mind when developing its ABC system. CAISO also used its ABC data to move into the realm of activity-based management. The ABC financial system informed managers where their employees were spending most of their time, allowed them to decide if changes were necessary and informed the budgetary process. On a strategic planning level, once CAISO was prepared to operationalize a strategic goal, ABC was integral in comparing the costs between possible actions.

Similarly, governmental units may want to determine the true and actual cost of services to improve services, decide on outsourcing or privatization and/or align activities to the organization's mission and strategic plan.¹² Each governmental unit will have an identifiable service mission that should be executed through the goals and objectives of the strategic plan. While executing the strategic planning process, the desired outputs and outcomes can be incorporated into the budgeting



process by identifying available resources and assigning expenditures against those resources.¹³ ABC/M allows the costing of outputs and outcomes within the context of a broader performance management system to inform those decisions. █

Endnotes

1. Euske, K.J. (2003). "Public, private, not-for-profit: everybody is unique?", *Measuring Business Excellence*, Vol.7, No. 4, pp. 5-11.

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10. Accessed Nov. 1, 2016 from www.caiso.com/Documents/2008-2012StrategicPlanFinal.pdf

11. The annual budget and grid management charge effort is a public stakeholder process. The CAISO public website has the whole history including stakeholder commenting processes. The cost allocation sheets and rationale are posted back to 2009. Accessed Nov. 1, 2016 from www.caiso.com/informed/Pages/StakeholderProcesses/Budget-GridManagementCharge.aspx

12. See Endnotes 4 and 5.

13. Purcell, Melanie D. (2009). "A Balanced Budget: It's Not Just About Cuts," *Government Finance Review*, December, pp.30-33.



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