

Lessons From the ABM Battlefield: Getting Off to the Right Start

Feature Article

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There is a raging debate about the value of activity-based costing (ABC) and activity-based management (ABM). Some have called ABC a revolution in management thinking; others have called it warmed-over standard costing. Johnson and Kaplan at first hailed ABC as the answer to lost relevance [3], though Johnson later recanted and called ABC "pure snake oil" [4]. For the purpose of this article, the term ABC refers to the cause-and-effect assignment of costs to cost objects, such as activities, products, and customers, while the term ABM refers to the use of ABC information for decisions about activities, products, customers, and other cost objects.

The pitfalls of ABC and ABM discussed in this article were identified through some 50 interviews, including interviews with 30 members of the ABM experience interest group of the cost management system section of the Consortium for

Advanced Manufacturing-International (CAM-I). (In most cases, the names of the companies have not been disclosed.) Those interviewed included practitioners who were implementing ABM, users of ABM information, ABM consultants, and managers who had rejected ABM.

Note that the purpose here is not to argue against ABM but rather to expose and better understand the problems so that they can be avoided or minimized.

PITFALL 1—LACK OF TOP MANAGEMENT BUY-IN

The decision to begin any improvement effort usually takes time. The process that executives go through is illustrated by the continuum [2] depicted in figure 1. In this process, executives must move through an awareness phase, a buy-in

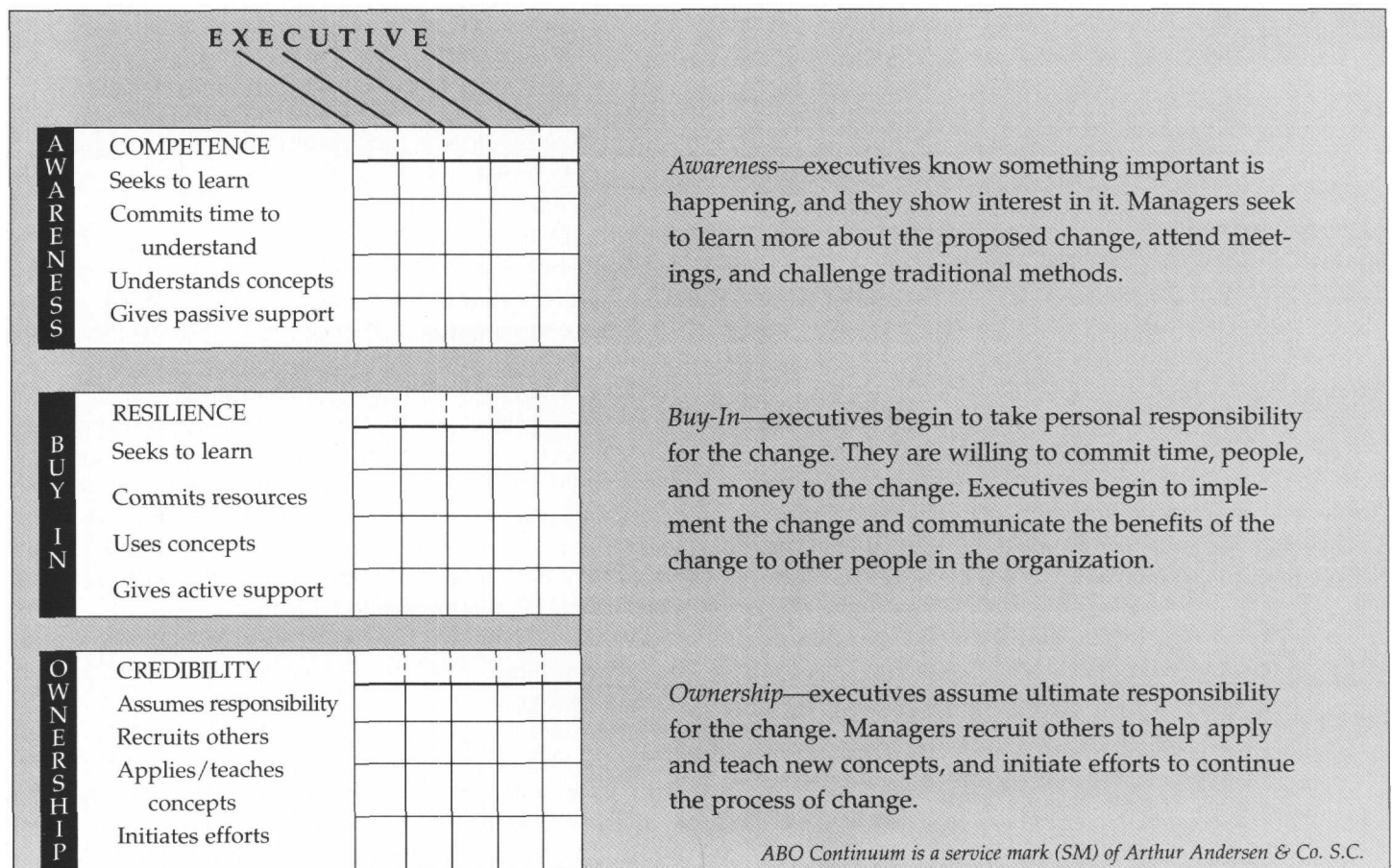


Figure 1—Awareness, Buy-In, Ownership (ABO) Continuum

Table 1—Three Views of Costs

	Financial	Operational	Strategic
Users of Information	<ul style="list-style-type: none"> • financial controllers • tax managers • external shareholders • shareholders • lenders • tax authorities 	<ul style="list-style-type: none"> • line managers • process improvement teams • quality teams 	<ul style="list-style-type: none"> • strategic planners • cost engineers • capital budgeters • product sourcing
Purposes	<ul style="list-style-type: none"> • financial accounting • inventory valuation 	<ul style="list-style-type: none"> • key performance indicators • value/nonvalue added indicators • activity analysis for process improvement 	<ul style="list-style-type: none"> • activity-based product costing • target costing • investment justification • life cycle costing • make/buy analysis
Level of Aggregation	<ul style="list-style-type: none"> • high aggregation • often company-wide data 	<ul style="list-style-type: none"> • very detailed • little aggregation 	<ul style="list-style-type: none"> • plant or product-line aggregation • detail based on what is needed for specific decision
Reporting Frequency	<ul style="list-style-type: none"> • periodic, usually monthly • probably could be quarterly or annually 	<ul style="list-style-type: none"> • immediate • sometimes hourly or daily 	<ul style="list-style-type: none"> • ad hoc, as needed • usually a one-time study
Type of Measures Needed	<ul style="list-style-type: none"> • financial 	<ul style="list-style-type: none"> • physical 	<ul style="list-style-type: none"> • both physical and financial

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Source: this concept was originally developed by Steve Hronec of Arthur Andersen for an internal training course entitled *Cost Accounting in the Reinvented Factory of the Future*, presented in December 1983. It was first used in this form by Steve Player on an engagement for Nordic Track in October 1993.

phase, and an ownership phase. They also have the right and ability to cease movement through these phases at any time—a right that is often exercised because other issues are perceived as more critical, more urgent, or more beneficial.

Understanding the awareness, buy-in, ownership continuum (ABO)SM helps explain the number-one pitfall to ABM projects: lack of top management buy-in, which was the most commonly-cited reason for ABM not achieving its full potential. When top management is not fully supportive of an ABM effort, the ownership phase of the ABM continuum is never reached—indeed, the company often never gets past the awareness phase.

Management Support

A lack of buy-in and ownership often manifests itself by the failure of top managers to supply their own time, the help of other dedicated people, or the funding needed to implement the project. Despite management's awareness of the potential benefits of ABM, they have insufficient buy-in and commitment to move toward owning the change.

Supportive top management includes not only the top management of a company, but also top management of plants or facilities where ABM is implemented. One company that has been using ABM since the mid-1980s has implemented ABM in only 60 percent of its plants, largely because of the reluctance of some plant managers to use ABM in their plants.

Ideally, top management support should be in place before ABM is started. ABM delivers valuable information for activity analysis and also more accurate information about cost objects (e.g., products, services, and customers).

If top management does not realize this up front, it is unlikely that ABM will be carried through to completion.

Examples in the Defense Industry

The defense industry provides a prime example of where lack of top management support can cripple attempts to implement ABM. While many defense companies have had successful pilots that showed the benefits of changing business practices, few have yet led to permanent ABM systems. Why not? Usually because top management has a different view of the business—a view that focuses on viewing costs as required by the Cost Accounting Standards Board and the government procurement regulations.

More than one ABM project has foundered after successful pilot projects out of fear of creating cost and pricing data subject to government disclosure. Top management teams have feared that the government would require cost reductions on contracts for which the ABC cost turns out to be less than the cost [of] using traditional methods, and, conversely, would not allow increases on those contracts for which the ABC cost proves to be higher.

While the [US] Defense Contract Audit Agency (DCAA) has encouraged ABC implementations and promised understanding and support, contractors have found it difficult to trust them. Many defense contractors have therefore shifted their focus away from ABC (i.e., for product costing, with all the inherent DCAA risks entailed) toward activity analysis. The goal is thus to reduce overall overhead costs, which is far more appealing to top management.

PITFALL 2—FAILURE TO UNDERSTAND THE THREE VIEWS OF COSTS

Cost-management systems can serve at least three distinct purposes:

1. financial;
2. operational; and
3. strategic [5, 1].

All these different views of costs entail different users, purposes, levels of aggregation, reporting frequency, and types of measures (see table 1). The simple truth is that it is difficult for a single system, even an activity-based system, to simultaneously meet the requirements of all three different views.

The hype over ABC/ABM comes from assertions that activity-based methods can serve all three purposes—in essence, that ABC/ABM can be all things to all people. In fact, an ABC/ABM system can serve all three purposes, but it cannot do them all simultaneously. The first step, therefore, is to understand how information from a new cost system will be used. After that, project design issues will fall into place.

Both Product Costing and Financial Reporting

Some companies, for example, try to develop an ABM system that will provide strategic product costing and also financial reporting. Costs for strategic decision-making and financial reporting differ, however, in the following ways.

- Strategic product costs normally include costs (e.g., selling and administrative costs) that do not qualify as product costs under generally-accepted accounting principles (GAAP).
- Strategic product costs may not include some factory overhead costs (e.g., plant security and the plant manager's salary) because they cannot be accurately assigned to individual products.
- Strategic product costing may defer some costs to future periods or recognize other costs currently, even though they will not be incurred until sometime in the future. (For example, environmental costs may be estimated and included in strategic product costs for the current year, even though GAAP would not recognize these costs until future years.)

Therefore, since strategic product costs may differ significantly from GAAP costs, strategic product costs must undergo a major revision at the end of each period before they can be used for financial reporting. To avoid this additional work, some companies follow GAAP rules when they calculate costs to be used for strategic purposes, but the result is costs that are not as accurate or relevant as they should be.

PITFALL 3—LACK OF CLEAR OBJECTIVES

Closely related to the lack of top management buy-in is the lack of clear objectives. For management to move through the ABO continuum swiftly, the company's business objectives must be understood. This is critical in sharpening the focus from awareness to buy-in.

There is a growing awareness of ABM, yet many people remain confused by the range covered by ABM. Many people in the awareness stage, for example, misunderstand what is meant by ABC terms such as *cost driver*, *cost object*, and even the word *activity*. Many believe that the use of ABC information for product costing and the use of that information for activity analysis are the same thing, but they are not. Companies may do either or both. In such a setting, the focus on clear business objectives is often lost. In searching and trying to understand what ABM is, people's focus often shifts (frequently with the help of "experts" who are selling products) to the specific features of various approaches. These features could be taken from packaged software, a particular consulting firm's methodology, an article, or a book. What gets lost in the details is a clear business objective of why ABM is being undertaken in the first place.

Examples

The controller of a petrochemical plant on the [US] Gulf Coast was reviewing three proposals to assist his implementation of ABC. He stated that he liked Arthur Andersen's approach to the project but wondered why no software program had been brought to demonstrate that approach. The Andersen representative offered to demonstrate any of three off-the-shelf ABC packages or two custom-developed packages. First, however, he wanted to clarify if the controller were interested in buying software or addressing a business problem. The controller thought for a moment, refocused on his business objective, declined the software reviews, and ultimately chose Andersen to help solve the business issue.

Similarly, a manufacturer in the Pacific Northwest requested help in conducting an ABM pilot in one of the company's development operations. When asked the company's business objective, the executives stated that they were doing it because it was in their individual management by objectives (MBO) memo for the year. Unfortunately, the engineering group that ran the development operation did not have it in their MBO, so the pilot project never happened. Why? There was no linkage to a clear business objective.

Ask Why

If no clear business objective exists for an ABM project, try asking the project team why they are doing the project, then—if necessary—ask "why" four more times [1]. For example:

1. Why is this project being performed?
"Because it will make us a better company."
2. Why will it make us a better company?
"Because we will better understand product costs."
3. Why do you need to understand product costs?
"Because we do not understand what causes costs."
4. Why do we need to understand what causes costs?
"Because we have to understand how we can reduce and avoid costs."
5. Why is reducing and avoiding costs important?
"To meet our strategic objective of being the low cost provider."

After asking "why" five times, the objective should be clear and clearly linked to critical business objectives. If it is still not clear, the project should be aborted. This clear business objective should be written down. If it is clearly defined, writing it down should be easy to do and everyone should agree on it.

PITFALL 4—A FINANCIAL PERSON HEADS THE ABM PROJECT

A financial person should not head an ABM project, nor should the ABM team be made up only of financial people. When this happens, the project is viewed as an accounting project. While number crunching is necessary, ABC numbers must accurately model the organization and must be used to make decisions. If both of these conditions are satisfied, an ABC system is transformed into an ABM system.

Putting someone from marketing, operations, or engineering in charge of the project helps ensure that activities and costs are viewed horizontally. Instead of being perceived as an accounting project, ABM will thus be perceived as a management tool needed for management decision-making. This ensures that key linkages between business processes receive visibility, which is often the most insightful benefit of the project.

Example

In a recent review of one Midwestern manufacturer, Arthur Andersen consultants analyzed the company's cost management practices and identified five separate cost management systems that were being used: a financial system, a purchased material system, an operating system for plant 1, an operating system for plant 2, and a quality cost system. This fact was a revelation to the cost accounting department, which had known only about its own system.

Had an ABM project been implemented using only financial personnel, four existing nonaccounting systems would have been overlooked. A more critical issue, however, is the fact that the needs of those users would have gone unknown. These additional systems often exist because users act to meet their information needs. When such systems exist, the opportunity exists to eliminate redundant tasks by implementing an ABM system that includes information to support some or all of these nonaccounting systems.

An ABM system must differ from the traditional cost accounting system it replaces. This is particularly true in companies in which the traditional cost accounting system focuses on financial accounting, on accountants rather than accounting customers, and on past information rather than estimated future information. An ABM system cannot have these characteristics and cannot be perceived to have these characteristics.

PITFALL 5—LACK OF EMPLOYEE INVOLVEMENT

Employees must be involved in creating, implementing, and continuously improving the ABM system. The identification of activities and cost drivers should be undertaken mainly by nonaccountants. Accountants or outside consultants may facilitate this process, but the identification of activities and related cost drivers must be done by those most knowledgeable about the work—those who do it. Accountants are not experts in knowing what work people are doing, nor are they experts in knowing what causes the work.

When nonaccountants are actively involved in creating an ABM system, they are more likely to use the information it generates and to make suggestions for improving the ABM system. Nonaccountants can spot errors and suggest changes to ensure that the ABM system accurately models operations and tracks operational behavior.

ABM should be viewed as a continuous process where improvements are normal rather than exceptional. Moreover, ABM must evolve to accurately model organizational changes over time. If ABM is viewed as a one-shot project, any benefits received may be temporary.

To ensure that the ABM model evolves, the following steps can be taken:

- integrate activity analysis with the annual planning cycle;
- link departmental performance measures with departmental activities; and
- include an evaluation of specific critical activities in employee performance appraisals.

PITFALL 6—LACK OF FUNDING

A successful ABM system often requires a significant investment for outside expertise and new permanent employees. Someone must be responsible for the intricacies of ABM. Whether packaged software is used or a custom system is developed, costs for ABM software can be substantial. A company that tries to economize on training, obtaining outside expertise, or finding appropriate software risks jeopardizing its ABM project.

Example

One Midwestern manufacturer concluded that, because of demands on existing employees, it would use a part-time

project team to implement ABM. To date, the company has spent over a year trying to launch its ABM effort. In reviewing the company's cumulative costs (which are still growing), it appears all but certain that a dedicated 60-day effort would have been far less expensive.

A company that believes that an ABM system will provide information that leads to making better decisions should estimate the value of those better decisions. Placing a value on making improved decisions may be critical to getting the resources needed to move forward on a rapid and focused basis.

PITFALL 7—LACK OF TRAINING

Many employees must be trained in ABM. The initial training is generally done by outside experts. A substantial cost savings will result if subsequent training can be conducted by company personnel. While inside training may not be as "slick" as outside training, inside trainers have more knowledge about the company and can integrate this knowledge into their ABM training.

Both the ABM implementation team and the people using ABM information must be trained. Much of the training should be done early in the implementation process, though some training must take place after implementation. In addition to training on the general concepts used in ABM, some managers need specialized training. For example, design engineers should be trained in how to use the ABM system to cost new products.

While training requires a significant expenditure, ABM may be easier to understand than the old cost system. At one company, for example, although the old cost system used only one overhead base and the ABM system ten, the old cost system failed to model the factory accurately. Top management wanted its managers to understand the cost system so that they could make better decisions. This goal was easier to achieve under ABM, because the managers had never understood the old cost system.

A periodic follow-up should be conducted to see if training has proved effective. This can be ascertained by asking questions such as the following.

- Are managers using the ABM system the way it was intended?
- Are managers using information about activities as well as product information?
- What difficulties are managers and accountants encountering?
- Do managers understand the ABM information?
- Are there mistakes in the ABM system?
- How can the system be improved?

ABM may be outside the "comfort zone" of nonaccountants, who may feel threatened by sophisticated accounting information, but extensive training in ABM may help. Also, getting these people to participate in developing ABM information will help overcome their fears.

PITFALL 8—"THE OUTSIDE CONSULTANTS DID IT TO US"

Another common problem in ABM projects is the misconception that "outside consultants can do it to us." A warning flag should go up if a consultant dictates answers rather than soliciting them. Some consultants try to impose the same answers they used in previous engagements rather than find answers appropriate to the current circumstances. A consultant's role is to help the company be successful, which should include a healthy dose of knowledge transfer.

ABM must reflect the goals of management and model the organization. An ABM system representing the consultant's perception of management's goals and of the organization may not be effective. Instead, consultants should facilitate management's taking ownership of the ABM system.

Many people purchase ABC software with the mindset that ABM is like a can of beans: you can walk into a store and buy it off the shelf. But ABM is not prepackaged software that can be applied regardless of a company's particular circumstance to achieve successful results. Software is only one tool used in a successful ABM application.

PITFALL 9—LACK OF COST MANAGEMENT EXPERTISE

At least one permanent employee in the company should be (or at least become) an ABM expert. This person may have implemented ABM for another company, served as an ABM consultant, or taken the time and effort to develop the necessary skills. In any case, someone must be permanently responsible for the functional and technical aspects of the ABM system. A company that lacks such an expert is subject to great frustration and many missteps.

Example

The finance organization of a coal company wanted to use ABM to streamline its accounting activities. Each of the department's 20 employees kept detailed time logs in 15-minute increments. Activities were captured for 2 weeks. Unfortunately, this effort resulted in a pile of useless data. Why? Because the company lacked experience in performing ABM analysis. It failed to establish and use a common activity dictionary and numbering scheme before data collection. Without this step, the activity logs could not be summarized or compared, because employees performing the same tasks described them differently. Since making sense of the data was impossible, the project was scrapped.

Cost management expertise can be acquired in the form of outside consultants or research groups such as CAM-I. When all the outsiders leave, however, someone inside the company must have the expertise. This expertise requirement applies to each operating unit as well as to companies as a whole. Someone at each location must understand and be able to operate the system. At one company that adopted ABM, for example, ABM was not implemented in some

operating units because the units did not have the necessary expertise in cost management.

PITFALL 10—NO LINK BETWEEN ABM AND JIT, TQM, BPR, OR OTHER MANAGEMENT INITIATIVES

Most companies that implement ABM have also adopted other initiatives such as just-in-time (JIT), total quality management (TQM), and business process reengineering (BPR). ABM cannot be implemented in isolation; it must be linked with these and similar management initiatives. Indeed, ABM provides valuable cost information for making decisions about JIT, TQM, and BPR. For example, ABM can support BPR by showing that if a standard part is used in a product design rather than a new part, \$1,000 will be saved. This cost information can be used to encourage actions that are consistent with the objectives of JIT, TQM, and BPR. Even if ABM cost information indicates that a decision to achieve these objectives will be costly, this is still valuable information, because all of these approaches are cost sensitive: actions to increase response time or quality should be taken only if the benefit exceeds the cost.

Example

One aircraft manufacturer had a "face-off" of improvement efforts—that is, it conducted an ABC project, a concurrent engineering project, and a theory of constraints project at the same time, the goal being to see which worked best. A better approach would have been to use all three projects together. Having improvement efforts work together instead of competing is like hitching several horses to a wagon: you go farther and faster if the horses are all pulling in the same direction.

A successful example of this is the ABM implementation at Johnson and Johnson [6]. Successful ABM pilot projects caught the eye of TQM process champions, who saw it as a better way to measure quality improvements. These TQM process champions thus became ABM champions as well, which meant that the ABM project team became part of the TQM group. This linkage was critical to the success of ABM.

Any one of these ten pitfalls can cause ABM to fail, but if these pitfalls are recognized and dealt with, ABM has a good chance of getting off the ground and succeeding.

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