



TenStep Supplemental Paper

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Focus Costs on What Counts - Use Activity-Based Costing

Activity-Based Costing (ABC) was developed by Professors Kaplan and Cooper to develop a meaningful approach towards allocation of overhead. But ABC is more than just a method of doing accounting - it is a tool for making strategic decisions and a method for focusing on operational inefficiencies. It is powerful because it is simple, and is based on identifying the drivers of cost and calculating the associated cost.

Compared to traditional accounting, ABC is simple. Occasionally, traditional accounting will provide information that is accurate, but also late, irrelevant and sometimes misleading.

For each process in ABC, the cost buckets are identified, their cost drivers are clearly understood and the cost per driver is calculated. Costs are found by counting the drivers. If it costs five dollars to invoice a customer, and one customer generates a hundred invoices, then the associated cost is 500 dollars. Another customer might generate ten thousand invoices, and therefore have a different cost structure.

The main work in setting up an ABC Program is identifying and calculating the cost buckets and cost drivers. This is the same groundwork required to re-engineer a business, including benchmarking (how do we compare?), activity analysis (how can we do better?), and service-level analysis (what will the customers pay for?).

ABC shows that if a product requires more labor, takes up more space, costs more to purchase or sits on the shelf longer, it generates higher costs. It also shows that some products and some customers are profitable and are unwittingly used to subsidize those that are making a loss.

The results of ABC analysis always capture the imagination of top management. It is a dramatic demonstration of the 80/20 rule, which states that "80% of the profit comes from just 20% of the customers." The same principle can apply to products and even to suppliers. Customers or products that are both important and profitable must be retained. Products and clients that are neither important nor profitable should be cut back. The most interesting products and customers are the large unprofitable ones. Often, there are creative ways of converting these products and customers to make them profitable.

ABC is now being used by several companies and is gradually gaining an advantage over traditional costing.