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In class, activity-based value looks like a great way to manage a company's limited resources. But many managers who have tried to implement the ABC in their organizations on any significant scale have abandoned this attempt in the face of rising costs and employee annoyance. They should try again, because the new approach we set out in the following pages bypasses the difficulties traditionally associated with the large-scale implementation of the ABC, relying on informed management assessments rather than employee surveys. It also provides managers with a much more flexible cost model to capture the complexity of their operations. ABC's Made Difficult Roots problems with THE ABC lie in the way people traditionally build ABC models. Suppose you analyze a customer service department that performs three things: processing orders, processing requests, and performing credit checks. The department's total costs (staff, management, IT, telecommunications and other fixed resources) are $560,000. Actual (or anticipated) quarterly volumes of work in these three events include 49,000 orders, 1,400 requests and 2,500 credit cheques. To create the traditional ABC model for this department, you can survey employees to estimate the percentage of time you're fading (or expecting to spend) on these three activities, and then assign department spending on resources according to the average percentages you get from the survey. Let's say employees report that they spend (or expect to spend) about 70% of their time on customer orders, 10% on requests or complaints, and 20% on credit checks. This means, according to the ABC, that each order consumes $8 resource costs, each request $40, and each credit check is $44.80, as shown on ABC's Doing The Traditional Way. Armed with these figures, known as driver's fares, managers can assign the department's resources to customers and products that use its services. Doing ABC The traditional way This approach works well in a limited environment in which it was originally applied is usually a single department, plant or location. Difficulties arise, however, when you try to roll out this approach on a large scale for use on an ongoing basis. In the course of brokering a major bank, the ABC's data collection process required 70,000 employees at more than 100 sites to submit time-allocation reports each month. The company hired 14 full-time people to manage data collection, processing and reporting. The time and cost required to create and maintain an ABC model of this magnitude is a major obstacle to widespread adoption in most companies. Because systems that infrequently updated (due to the cost of re-viewing and re-insurance), evaluating the process model, product and costs of customers in the near future Inaccurate. What's more, people spend their time arguing about the accuracy of cost rates and drivers that stem from people's subjective beliefs, rather than addressing the flaws that the model shows: inefficient processes, unprofitable products and customers, and excess capacity. Traditional ABC models are also often unable to capture the complexity of actual operations. Consider the actions of the ship ordering customer. Instead of taking on the constant cost of the order, the company may wish to recognize the difference in cost when the order is sent in a full truck, in a cargo smaller than a truck (LTL), using a night express, or a commercial carrier. In addition, the order can be entered into the system both manually and electronically, and it can be either a standard or expedited transaction. In order to achieve significant differences in the resources required by the various delivery mechanisms, new activities need to be added to the model, thereby increasing its complexity. As the activity dictionary expands, either to reflect the action in more detail, or to expand the scope of the model to the entire enterprise, the requirements for computer programs used to store and process data increase. Suppose a company has 150 activities in its ABC corporate model, applies costs in these events to approximately 600,000 cost objects (products and customers), and launches the model monthly for two years. This will require estimates, calculations and storage of more than 2 billion items. This expansion has resulted in ABC systems outperforming common spreadsheet tools such as Microsoft Excel, and even many ABC software packages. It can take several days for these systems to process data in one month. For example, the automated ABC model for Hendee Enterprises, a $12 million canopy manufacturer, took three days to calculate costs for 40 departments, 150 activities, 10,000 orders and 45,000 linear items. These problems have become apparent to most ABC performers. But a subtler and more serious problem arises from the poll itself and the survey itself. When people estimate how much time they spend on a list of activities transferred to them, they invariably report percentages that are up to 100. Few people report that much of their time is idle or unused. Thus, cost and driver rates are calculated provided that the resources are running at full capacity. But as we all know, operations often work much less than their capabilities. This means that the estimated rates for the driver's stakes are usually too high. (Technically, they will be overstated by the reciprocal percentage of capacity utilization: at 80% the use of the rate is too high; at 67% the stakes are too high.) The new ABC Solution Problems with ABC does not abandon this concept. ABC eventually helped many many identify important opportunities to increase costs and profits by restoring loss-making customer relationships, improving the processes in the shop, lower product costs and streamlining the product range. Its potential on a larger scale represents a huge opportunity for companies. Fortunately, simplification is now possible thanks to what we call the time-oriented ABC, which we have successfully helped implement to more than 100 client companies, including the one described in this article. In the revised approach, managers directly assess the resource needs of each transaction, product or customer, rather than assigning resource costs first to activities and then to products or customers. For each resource group, only two parameters are required: unit resource time costs and specific resource consumption time for products, services, and customers. At the same time, the new approach provides more accurate cost and cost rates, allowing you to estimate unit time even for complex, specialized transactions. In the revised approach, managers directly assess the resource needs of each transaction, product, or customer. Estimate the cost of a unit of power per unit of time. Rather than looking at staff as to how they spend their time, managers first directly assess the practical potential of the resources provided as a percentage of the theoretical capacity. There are different ways to do this. As a rule, we can simply assume that the practical full capacity is from 80% to 85% of the theoretical full power. So if an employee or machine is available to work 40 hours a week, its practical full capacity is 32 to 35 hours per week. Typically, managers will suck out a lower rate of, say, 80% for people, allowing 20% of their time for breaks, arrival and departure, communication and training. For machines, managers can give out a 15% differential between theoretical and practical capacity to ensure downtime due to maintenance, repairs and scheduling fluctuations. A more systematic approach might be to review past levels of activity and to identify the month with the highest number of orders processed without excessive delays, poor quality, overtime or strenuous staff. Whichever approach you prefer, it's important not to be too sensitive to small mistakes. The goal is to be roughly right, say, within 5% to 10% of the actual number, not accurately. If the practical capacity estimate is a gross error, the time-controlled ABC launch process will show an error over time. Going back to our example, let's assume that the customer service department 28 reps to work on the front lines, and that each puts in eight hours a day. Theoretically, each worker delivers about 10,560 minutes per month or 31,680 minutes per quarter. Quarter. practical capabilities are about 80% theoretical so about 25,000 minutes per quarter per employee, or 700,000 minutes in total. Since we already know the cost of supplying power - $560,000 in overhead, we can now calculate the cost per minute of power delivery ($0.80). Most resources are measured in terms of availability, but the ABC's new approach can also recognize resources that are measured in other units. For example, the capacity of a warehouse or vehicle will be measured by the space provided, while memory storage will be measured by megabytes. In such situations, the manager will calculate the cost of resources per unit based on the appropriate capacity measurement, such as the cost per cubic meter or cost per megabyte. Estimating the unit's operating time. Calculating the cost of a unit of time supplying resources for business activities, managers then determine the time it takes to perform one unit of each activity. These figures can be obtained through interviews with employees or through direct observation. There is no need to conduct surveys, although in large organizations, interviewing staff can help. It is important to emphasize, however, that the issue is not the percentage of time an employee spends on an action (say, processing orders), but how long it takes to complete one unit of this action (the time it takes to process a single order). Again, accuracy is not critical; rough precision is enough. In our example, let's say that managers determine that it takes 8 minutes to process an order, 44 minutes to process a request, and 50 minutes to process a credit check. Getting cost and driver rates. Cost driver rates can now be calculated by multiplying the two input variables that we have just estimated. For our customer service department, we get a driver's rate of $6.40 (8 multiplied by $0.80) to handle customer orders, $35.20 (44 to $0.80) to handle requests, and $40 (50 to $0.80) to perform credit checks. Once these standard rates are calculated, you can use them in real time to assign costs to individual customers as transactions arise. Standard tariffs can also be used in discussions with customers about prices for a new business. Note that these rates are lower than those rated using traditional ABC methods (see again the ABC's Doing Traditional Way). The reason for this difference becomes apparent when we recalculate the quarterly cost of customer service activities. In the exhibition Impact of Practical Capacity, a time-driven analysis by ABC shows that only 83% of practical capabilities (578,600 out of 700,000 minutes) of resources, during the quarter, were used for manufacturing work, and therefore only about 83% of the total expenses were assigned to customers or products during this period. This is about the technical flaw of the traditional ABC systems we mentioned earlier, that the employees interviewed react as if their practical capabilities were always being fully utilized. Impact of Practical Capacity In the case of our customer service department, the traditional ABC survey has generated a distribution of work 70%, 10%, and 20% of the time of employees performing three department activities. However, while this distribution reflects how workers spend their productive time, the fact that their total working hours are significantly less than their practical capacity of 32 hours per worker per week has been completely ignored. Calculating resource costs per unit of time forces the company to include estimates of the practical capabilities of its resources, allowing ABC cost drivers to provide more accurate cost signals and underlying process efficiency. Cost analysis and reporting. Time-driven ABC allows managers to report their costs on an ongoing basis in a way that identifies both the costs of the company and the time spent on them. In our example, the customer service department, the time-driven ABC report will look like an ABC show, Time-Driven Way. ABC,'s Time-Driven Way Note, the report highlights the difference between the power supplied (both quantity and cost) and the power used. Managers can review the cost of unused capacity and consider measures to determine whether and how to reduce the cost of supplying unused resources in subsequent periods; they can then control these actions over time. In some cases, this information may save companies that are considering expanding away from unnecessary new power investments. For example, vice president of operations at Lewis-Goetz, a hose and belt manufacturer based in Pittsburgh, saw from his time abc model that one of its plants runs at only 27% capacity. Instead of trying to cut the plant, he decided to save capacity for the big contract he expected to win in the same year for which he would otherwise have created new capacity. Model update. Managers can easily update their time-driven ABC models to reflect changes in operating conditions. To add more activities to the department, they do not need to re-examine staff; they can simply estimate the unit time required for each new action. Managers can also easily update rates on cost drivers. These bets can change by two factors. First, the change in the price of the supplied resources affects the cost of the unit of delivery time. For example, if employees receive an 8% increase in compensation, the cost of resources in our increases from $0.80 per minute to $0.864 per minute. If new machines are replaced or or to the process, the cost of resources changes to reflect changes in operating costs associated with the introduction of new equipment. The second factor that could lead to a change in the cost factor is a change in performance. High-quality programmes, continuous efforts to improve, reining or introducing new technologies can enable the same activities to be carried out in less time or with less resources. When continuous, sustained improvements have been made in the process, the ABC analyst recalculates estimates of unit time (and therefore resource requirements) to reflect the improvement in the process. For example, if a customer service team receives a new database system, representatives can perform a standard credit check in 20 minutes, not 50 minutes. To accommodate the improvement, just change the unit time estimate to 20 minutes, and the new cost-driver will automatically be $16 per credit check (down from $40). Of course, you should add back to the cost of the impact of buying a new database system by updating the cost per unit of time estimate, so that the final figure may be slightly higher than $16. By updating the ABC model based on events rather than on the calendar (once a quarter or a year), you get a much more accurate reflection of current conditions. Every time analysts learn of a significant change in the cost of the resources provided or the practical capabilities of those resources, or the changes in the resources needed to do so, they update resource costs per unit of time or resource cost, estimates. And every time they learn of the significant and constant shift in efficiency with which the activity is carried out, they update the unit time estimate. Time equations to capture complexity So far we have relied on the important simplification of the assumption that all orders or transactions of a certain type are the same and require the same amount of time to process. But time-driven ABC doesn't require that simplification. It can take into account the complexity of real operations by incorporating time equations, a new feature that allows the model to reflect how the order and characteristics of activity cause changes in processing time. Time equations greatly simplify the evaluation process and provide a much more accurate cost model than would be possible using traditional ABC methods. The key understanding is that while transactions can easily become more complex, managers can usually identify what makes them complex. Variables that affect most of these activities can often be accurately identified and are generally already registered in the company's information systems. For example, let's say that a manager is studying the process of packing a chemical for shipment. In this situation arises from the potential need for special packaging and additional air needs, as opposed to ground transport. Let's say that if a chemical is already packaged in such a way that it meets the standard requirements, it should be 0.5 minutes to prepare it for shipment. However, if the product requires a new package, the manager evaluates either by experience or by several observations that it will take an additional 6.5 minutes to deliver the new packaging. And if an item is to be submerged by air, he or she knows (or can quickly determine) that it will take about two minutes to put the package in an air-worthy container. This information allows the manager to estimate the time required for the packaging process: Packaging time: 0.5 - 6.5 (if special packaging is required) - 2.0 (if delivered by air) of the ERP system many companies already store data on order, packaging, distribution method and other characteristics. This order and transaction data allows you to quickly determine the specific time requirements for any particular order by a calculation similar to the above. With this expansion, a time-driven approach to THE ABC can capture the complexities of the business much easier than the traditional ABC system could, which might well be forced to take into account different transaction times, viewing each option of the process as a separate activity. Consider the case of Hunter Corporation (not his real name), a large, multinational distributor of scientific products whose 27 facilities process more than one million orders each month to distribute up to 300,000 different SKUs products to 25,000 customers. His old ABC model required employees in his sales department (sellers dealing with phone and internet orders rather than dealing with customers face-to-face) to envelop the percentage of time they spend on three activities each month: setting up a customer, ordering and speeding up an order. Using a time-driven approach, Hunter's ABC team was able to group three actions into a single departmental process called the insider's sales order. The team learned that you could enter basic order information for about 5 minutes, as well as 3 minutes for each line item and another 10 minutes if the order was to be expedited. If the customer was new, it would take another 15 minutes to set up the customer in the company's computer system. Following the approach described earlier, the previous three-action model was replaced by one time of the equation: Entry time to the internal order no. 5 (3 × number of linear elements) - 15 (if a new customer) - 10 (if an expedited order) It was easy to implement, as the ERP Hunter system was already tracking the number of linear elements for each order and included fields that determined whether it was a new peak. The model has multiplied the estimated sales time by cost per minute to come to the cost of processing each order. Hunter can now get a more accurate and accurate estimate of its costs in the block, while reducing the complexity of the data collection and analysis process. Hunter has since rolled out time-driven ABC throughout its operations. The results were dramatic: Hunter reduced the number of items tracked from 1,200 to 200 departments. Managers can add complexity to the model by simply adding new elements to the time equations, which puts less strain on Hunter's accounting system than the inclusion of new activities. The cost estimate is now based on actual characteristics of order and direct observations of processing time, rather than on subjective estimates of where and how people spend their time. The new model is easier to test. The hunter can agree on the total time of the process, i.e. the total absolute time spent on all activities tracked during the period, with other indicators of the resources supplied, such as the number of heads. For example, if the total process time is below the time implied by the main tally, managers know that some of their unit time estimates are too low or that people are not working on capacity. This check is difficult with the traditional ABC, which is based on the estimated proportions of time spent and rarely includes downtime or unused capacity time. The ABC model, based on Hunter's time, requires only two people working two days a month to download, calculate, verify and report the results, compared to the team of ten people and three weeks that were needed to maintain the previous model. Employees now spend time profiting from the information, not just updating and maintaining it. The kind of Hunter deployment conducted is not difficult to achieve. Time-driven ABC models can be easily applied and configured for other factories and companies in the industry because the processes they use are similar. Dave Deinzer, CEO of Denman and Davis and president of the North American Steel Alliance, commented, For the most part, we are all pretty much the same... cutting, sawing and finishing metal with the same equipment and the same procedures. You could probably apply the same time-based ABC model to all of us. The chief information officer of another steel distributor, TW Metals, said: We were able to roll out our time-based ABC template model in three months at all 36 of our businesses. The ability of time-driven ABC to simply identify and report complex processes also provides a powerful negotiating tool when it comes to dealing with customers. Wilson-Mohr, an industrial controlled company in Houston, worked as a for engineering contractors (EC) to build custom process management systems for refineries and chemical plants. His time-driven model showed for time, the high cost of engineering change orders issued by ECs to replace parts or reconfigure the design. In the past, Wilson-Moore has only charged the EU for projected changes in the cost of materials as a result of change orders. Now it can also clearly detail the cost of additional sales, design, design, and production of labor, which is eng centurion when implementing change orders, making it easy to recover those costs by restoring prices. (For a detailed example of how time-driven ABC helps companies manage customers, see the Strategic Change sidebar at Kemps LLC.) Kemps, headquartered in Minneapolis, is a full line of dairy products that produces milk, yogurt, sour cream, cottage cheese and ice cream products. Its customers are retailers and distributors, big ones like SuperValu and Target, and as small as the stores. Kemps sells its products under its own proprietary portfolio along with products sold through private labeling and digging contracts. Like most dairy plants, Kemps is experiencing consolidation in its customer base. She decided to move from her old customer relations strategy, ready to do what the customer asked for, to a strategy with lower overall costs. The new approach clearly requires an accurate understanding of the cost of the product and customer that Jim Green, CEO of Kemp, will use to instill a low overall cost culture across the organization. As a critical component of the cost-to-serve model, Kemps has introduced a time-based ABC system to track the cost of transitions in the production and packaging of all of its products, as well as the cost of collecting, loading and delivering products to a diverse customer base. The model documented differences in how the company entering orders from customers (customer phone call, call seller, fax, truck-driver entry, EDI, or Internet) as it packed orders (full stacks of six cases, individual cases, or partial break package cases for small orders), how it delivered orders (commercial carriers or its own fleet, including route miles), and time spent by the driver in each customer's location. The extra time for overflows to clean allergens (such as nuts, eggs, soy or wheat) used in some ice cream products can now be accurately assigned to these products. The model also captured the additional packaging costs for special promotions and specific customers labels and promotions. The company soon learned it was losing money with one of its customers, a chain of high-end specialty stores, due to the low volume and large variety of ordered products and small exactly-in-time delivery chains requested. Kemp's Vice President of Sales called explained the situation and offered three options: accept the price increase and the minimum order size; eliminate its private ice cream label by replacing it with a standard Kemp branded product that is already manufactured Effective, large volumes; or find another ice cream supplier. When the customer asked why Kemps was making the changes, the vice president replied that after 25 years, Kemps only now understood its true production costs and the impact of specialized production on its margins. The customer agreed to a 13% price increase, agreed to the liquidation of two low-ton products and agreed to accept full rather than partial orders for trucks, thus eliminating internal storage fees for Kemps. The changes gave an immediate benefit of $150,000 a year, turning this loss-making customer into a profitable one. Kemps also used its time-based ABC model to become a leading supplier of dairy products to a national customer. Kemps has demonstrated that it can determine the specific costs of producing, distributing, and processing orders associated with customer service based on the actual characteristics of the order: DSD (direct store delivery) or shipment to distribution centers, delivery of gallons against pints, and volume and combination of products. The time-based ABC model fostered an open, trusting relationship between supplier and customer that distinguished Kemps from competitors. Kemps also became aware that some of its small store customers were overordering and returning the product when the code expired. To avoid the high cost of these discounts and profits, Kemps offered these retailers a 2% discount if they would manage their own stock without a return option. Thus, Kemps eliminated 95% of the profit out of the code, creating a net savings of $120,000 per year. Over the past seven years, we and our colleagues at Acorn Systems have successfully helped more than 100 clients incorporate time-driven ABC into their processes. Most of them reported a significant improvement in profitability, which they attributed to information obtained as a result of the new approach. Take the case of Banta Foods, a Midwestern food distributor with revenue of $155 million from 17,000 SKUs and 5,000 customers. It worked on a razor-thin net margin of about 1%. Historically, its profit drivers have increased the number of orders taken per day, increasing total revenue and controlling total costs. The Banta-based ABC system, which was fully implemented within 16 weeks, has shown much greater detail in its cost structure, linking costs to products, orders, customers and territories. Managers learned that a $1000 order, previously considered the smallest break-even size, can be either quite profitable or unprofitable depending on the distance to the customer, the location of the product in stock, the size of the order, the frequency of delivery, the type of service and the customer's credit rating - all of which were included in the in the new time-controlled ABC system. Based on data from the The Banta model introduced an indefatigable minimum order size, reduced the list of unprofitable products, facilitated sales of high-quality products, negotiated with customers either to reduce the demand for high-price services, or to increase their prices, and offered incentives for their sellers to increase the net profit of their customers. It also negotiated with suppliers to recoup the cost of processing customer discounts. The General Sales Manager used this information to transform their sales representatives from customers to consultants, helping them create customers and territories that were more profitable for Banta. He reports: Sellers can now increase their gross margins not just by adding points to their margins, but by knowing which products to sell. Accurately forecasting the value and profit of the proposed business, Banta was able to take over a new business that increased revenues by 35% and generated an immediate improvement in profit of 43%, with another 25% still not coming through from future opportunities. (See Banta Foods.) Its performance led to the distinction of being named Innovator of the Year in an industry magazine, an institutional distributor. Profitable solutions at Banta Foods Over the past 15 years, costing activities have allowed managers to see that not all incomes are good income, and not all customers are profitable customers. Unfortunately, the difficulties involved in implementing and maintaining traditional FAA systems have prevented them from accepting them on any significant scale. Time-driven ABC has overcome these challenges by offering a transparent, scalable methodology that is easy to implement and update. It relies on existing databases to incorporate specific features for specific orders, processes, suppliers, and customers. Cost based on activities is no longer a complex, costly implementation of financial systems; ABC's time-driven innovations provide managers with meaningful cost and profitability information, quickly and inexpensively. A version of this article appeared in the November 2004 issue of Harvard Business Review. Reviews. time driven activity based costing kaplan pdf. time driven activity based costing kaplan book. time driven activity based costing robert kaplan and steven anderson

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