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Dear Executive:

As I mentioned in last quarter's executive letter, the article I co-authored with my old friend and colleague Gary Cokins "Where Does ABC Fit Amongst the Clutter of Management Accounting" appeared in the March/April issue of *Cost Management*. Leading off that issue was the first chapter of a new book by Harvard Business School Professor Robert Kaplan and Acorn Systems Chairman and founder Steven Anderson. As many of you know, Robert Kaplan and his former Harvard colleague Robin Cooper are credited by many with the introduction of ABC/M to the mainstream of management accounting. The title given their *Cost Management* article was "The Innovation of Time-Driven Activity-Based Costing

I want to make clear at the outset that I have a great deal of respect for Dr. Kaplan and his contributions to the body of knowledge that comprises modern management accounting. As a matter of fact, it was an article titled something like (I can no longer find my copy of the article) "Does Cost Accounting Undermine Production?" written by Dr. Kaplan for *Harvard Business Review* nearly a quarter century ago that set me on the path my career has taken ever since. Down deep, I am really a big fan of Dr. Kaplan and his work.

However, as many of you are aware, I have taken exception to the direction mainstream ABC/M has taken since its introduction in the late-1980s. In my view, activity-based costing is a "lens" an organization can use to develop a valid economic cost model of its operations. That valid model can then be incorporated into the organization's decision support system in whatever way it finds most appropriate and practical. For a vast majority of businesses this does not require the implementation of special software or major changes into its day-to-day cost accounting system.

Another problem I've had with the development of modern management accounting concepts is the implication – driven, I assume, by the desire to sell more software and consulting services – that every new technique developed to incorporate activity-based concepts in a specific area is an earth-shattering breakthrough requiring a major paradigm shift and the implementation of new software and the assistance of new "experts." Whether these techniques are called Value-Stream Accounting, Resource-Based Accounting, Throughput Costing, or Time-Driven Activity-Based Costing, I see them all fitting into this category.

It is from this perspective that I make the comments that follow regarding "The Innovation of Time-Driven Activity-Based Costing.

SHORTCOMINGS OF “CONVENTIONAL” ABC SYSTEMS

In introducing the subject, the article starts by describing the situations at Charles Schwab brokerage operations and Hendee Enterprises, a small Houston-based awning manufacturer, several years ago. In both cases, the maintenance of a “conventional” ABC system took a disproportionate number of man-hours to collect and process monthly time reports, too many days to process the information and prepare management reports, and generated data that was stale by the time it arrived in management’s hands. As a result, these and many other organizations implementing “conventional” ABC systems soon either abandoned them altogether or ceased updating the system.

The “conventional” ABC system the article alludes to is a fully-integrated, software driven, day-to-day costing system and the observations it makes are true. The cumbersome, time consuming efforts to maintain an integrated, software driven, day-to-day costing system are seldom worth the effort or, in other words, “the climb is not worth the view.”

The *fully-absorbed* cost information generated by activity-based costing is an extremely valuable strategic tool, but it loses its value as decisions move along the spectrum from strategic to tactical. The closer one gets to tactical, the more valuable the *incremental* cost information generated by a well-designed activity-based *economic model* becomes. Activity-based cost information generated each month based on one-month’s “actual” activity is usually unnecessary, seldom a true indication of a change in the organization’s fundamental economics, and often misleading. The ebb and flow of the activities performed by an organization over time – based on changes in the volume and mix of business, number of new products being launched, or stage in the organization’s business cycle – make the “actual” results during one moon orbit around the earth of questionable value. It is, however, the major focus of a “conventional” integrated, day-to-day ABC system.

Strategic cost information should be based on the fundamental economics of the business, not on the economics encountered during any individual (and short) period of its operation. A complete updating of the data in the system or “refreshing” of the model every month is seldom worth the effort. Constant updating is not the result of management’s need for the information; it is a requirement of the software.

The article lists the needs of management to “obtain accurate cost and profitability information to set priorities for process improvements, rationalize their product variety and mix, price customer orders, and manage customer relationships in ways that benefit both parties.” The list sounds good to me. I cannot, however, see how the monthly updating of that information adds any more value than the periodic (perhaps no more than annual) “refreshing” of an activity-based economic model with more current data and estimates.

Finally, decision support information should be based on *future* cost information, not the *historical* cost information generated by a system that simply “slices and dices” general ledger data in a sophisticated manner. We can learn to predict future costs effectively by studying history, but the absolute historical costs themselves are next to useless.

SIMPLIFICATION UNDER TIME-DRIVEN ACTIVITY-BASED COSTING

One of the benefits of TDABC described in the article is the simplification of the data collection process. Instead of constantly interviewing employees and collecting time sheets to feed the system, it suggests (in my words, not the article's) developing a *standard costing system for non-production activities*. In the article's words, the TDABC model 1) "calculates the cost of resource capacity" and then drives departmental costs to cost objects by 2) "estimating the demand for resource capacity (typically time, from which the name for the new approach was chosen) that each cost object requires." **That sure sounds like a standard costing system to me!** First, calculate the cost of operating an activity center at its capacity. For example it costs \$250,000 to operate a machining department at its 10,000 hour practical annual capacity - \$25 per resource hour. Second, estimate the demand for that resource by a cost object. For example, one product requires two hours of machining or \$50 (2 hours x \$25). After attributing \$25 per hour to all cost objects' demand for the activity, whatever is left represents unused capacity (or a temporary overuse of capacity).

TDABC simply applies that principle to non-production activities. Suppose our \$250,000 department can process 10,000 orders annually at its practical annual capacity. One customer (the cost object) orders twice per year. The annual cost of processing that customer's orders is \$50. After attributing the \$25 per order to all cost objects' demand for the activity, whatever is left represents unused capacity (or a temporary overuse of capacity). Does that sound familiar?

The article accurately points out that (in our example) all orders (or whatever the driver[s] of the activity centers might be) might not require the same amount of effort but that "conventional" ABC assumes that they are all the same. That may be true of "conventional" ABC. It suggests that first, a cost per time unit of activity, perhaps a cost per minute of order activity time, be calculated and second, that time estimates be made for the performance of each type of activity driver – in our example it might be for the processing of a new customer order, a domestic order, and an international order – be made. In that way a different cost can be attributed to each activity performed by the activity center's workers as can a measure of the over or under utilization of capacity be determined.

A similar result can come from the use of the very simple "weighted event" technique – a technique my firm first used (I don't believe we invented it, I'm sure we picked it up somewhere and it seemed like a pretty good idea) in the mid-1990s and that appears in my 1998 book *Activity-Based Costing: Making it Work for Small and Mid-Sized Businesses*. The "weighted event" technique involves estimating the "relative" effort required for each different activity performed in an activity center, using those weights to estimate the amount of the activity center's cost that relates to each activity, and then calculating the "cost per" of each occurrence of each activity.

Continuing our example, the 10,000 orders processed by the order processing activity represents 500 new customer orders, 7,500 domestic orders, and 2,000 international orders. In comparing the relative amount of time required of each type of order, the organization believes the least time is spent on domestic orders. As a result, domestic orders are "weighted" as 1.0. International orders are estimated to be three times more time consuming than domestic orders and new customer orders to be five times more time consuming. As a result, they are "weighted" as 3.0 and 5.0 respectively. The resulting calculations are shown in Figure 1.

Order Activity	Number of Orders	Effort Unit Weight	Effort Units	Effort %	Activity Cost	Cost per Activity
New Customer Orders	500	5.0	2,500	15.6%	\$39,063	\$78.13
Domestic Orders	7,500	1.0	7,500	46.9%	\$117,188	\$15.63
International Orders	<u>2,000</u>	3.0	<u>6,000</u>	<u>37.5%</u>	<u>\$93,750</u>	\$46.88
Totals	<u>10,000</u>		<u>16,000</u>	<u>100.0%</u>	<u>\$250,000</u>	

Figure 1 – Weighed Orders / Cost per Order

Taking the process one step further, the same calculation can be made to determine the time required for each type of activity. Let us suppose the activity had 5 employees with an average of 1750 hours available annually (after subtracting vacation, holidays, breaks, absences, etc.). By simply substituting the 10,500 available hours (5 employees x 1,750 hours) for the \$500,000 cost the hours required for each type of order can be determined as shown in Figure 2.

Order Activity	Number of Orders	Effort Unit Weight	Effort Units	Effort %	Annual Hours	Hours per Activity
New Customer Orders	500	5.0	2,500	15.6%	1,641	3.28
Domestic Orders	7,500	1.0	7,500	46.9%	4,922	0.66
International Orders	<u>2,000</u>	3.0	<u>6,000</u>	<u>37.5%</u>	<u>3,938</u>	1.97
Totals	<u>10,000</u>		<u>16,000</u>	<u>100.0%</u>	<u>10,500</u>	

Figure 2 – Weighed Orders / Hours per Order

The hours per order information resulting from this calculation can be used in projecting the demand for order processing personnel, measuring the improvements made in order processing processes and in supporting a variety of other decision support situations as well as in “bookkeeping” an order processing department – with absorption and variances if desired – the same way as standard costing accounts for a manufacturing department.

SUMMARY

The success of “conventional” ABC systems has been marginal at best for two primary reasons; 1) they have been poorly designed and 2) it has been assumed that they must be integrated into an organization’s day-to-day costing system and, as a result, updated continuously. The poor design has been driven by the technology focus of ABC implementations. They have been designed around the software’s capabilities, not around the decision support needs of management. This has resulted in their being both too complex and too simple. They are complex because of all the data that must be accumulated and the constant “number crunching” that must take place for the system to work. They are too simple for two reasons: 1) they are generally based on general ledger-driven, historical cost information, not future-oriented economic information, and 2) once costs are assigned to activities, they do not differentiate between different “kinds” of activities performed within an activity.

Time-Driven Activity-Based Costing addresses some of these weaknesses, but I wouldn’t categorize it as a revolutionary new idea. Our firm has been using its underlying concepts at organizations of all types and sizes for nearly fifteen years. Maybe the software developed to apply standard costing concepts to non-manufacturing activities is a step forward in the agonizingly slow maturity of activity-based concepts, but in my opinion, it is a welcome addition

to the “toolbox” of activity-based costing, not a breakthrough solution to the myriad of shortcomings inherent in “convention ABC” thinking.

UPDATE

I’ll be presenting a session titled “*Sorting Through ‘The Clutter’ in Management Accounting*” at the IMA’s Annual Conference in Phoenix on June 20th. My speaking schedule then slows down for the summer and will resume next fall when I will present “*Pricing for Profitability*” for the Brain Injury Association of America – Michigan Chapter on September 27th and “*Designing Cost Systems that Work*” at the MACPA’s Financial Management in Industry Conference on October 25th.

I apologize to those of you who requested a copy of the article I co-authored with Gary Cokins for the March/April 2007 issue of *Cost Management*, “Where Does ABC Fit Amongst the Clutter of Management Accounting.” The publisher has decided that allowing authors to have copies of the articles they have written for their journal in some way endangers their intellectual property rights and, as a result, had refused to provide me with a .pdf copy of the article. Guess who won’t be writing for *Cost Management* a third time.

Full-Day Seminar Part Deux

As I mentioned in the Winter 2007 letter, after a seven year hiatus, I’ve begun presenting an updated version of my one-day seminar for the Michigan Association of CPAs. The session’s new title is “*Decision Costing: Using Activity-Based Concepts to Improve ‘The Bottom Line’*.” This seminar’s predecessor was one of the most popular one-day sessions presented locally by the Michigan Association of CPAs and nationally by the Institute of Management Accountants during the 1990s. The first of two Metro Detroit area sessions took place on April 25th and a second will take place June 18th. As of this writing, no further sessions have been scheduled until a 6-CPE hour version will be sponsored by the Metro Detroit Chapter of the IMA in March 2008. Information on the seminar and how to register for the June 18th session is provided at the end of this letter.

I look forward to hearing from any of you who have questions or comments regarding this month’s letter. As always, please feel free to forward a copy of this letter to anyone you believe would be interested.

Very truly yours,

Doug

Douglas T. Hicks, CPA, CMC
President

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The Michigan Association of CPAs and D. T. Hicks & Co. Present...

**Decision Costing:
Using Activity-Based Concepts to Improve “The Bottom Line”**

Marriott at Centerport – Pontiac, Michigan
Monday – June 18, 2007

Developed and Presented by: Douglas T. Hicks, CPA, CMC

The second session of D. T. Hicks & Co.’s new one-day seminar *Decision Costing: Using Activity-Based Concepts to Improve “The Bottom Line”* is now open for registration on the Michigan Association of CPAs website.

This new seminar is an update of D. T. Hicks & Co.’s popular MACPA and Institute of Management Accountants seminars *Decision Costing: Activity-Based Costing in Action* and *Activity-Based Costing for Small and Mid-Sized Organizations* that were presented throughout the United States in the 1990s – sessions for which Doug Hicks was awarded the Institute of Management Accountants’ *Instructor of the Year Award* in 1998.

Decision Costing: Using Activity-Based Concepts to Improve “The Bottom Line” is not about cost accounting. It is about developing and using the accurate and relevant economic cost information decision makers need if their organizations are to thrive and grow in an ever more competitive world. It is designed for both accountants and non-accountants alike.

Simply use the link below for a description of the session, its objectives and major subjects, as well as information for registration and overnight accommodations.

<http://www.michcpa.org/Public/Catalog/CourseDetails.aspx?courseID=07HABC1>

Developer and presenter Doug Hicks is a practitioner and educator who has been helping organizations develop the fact-based economic information they need to succeed for over two decades. His two books have sold over 15,000 copies worldwide and his articles have appeared in a wide variety of professional and trade periodicals including *Journal of Accountancy*, *Cost Management*, *ActionLine*, *Plastic Technology*, *Modern Casting*, *Precision*, *Printing Manager*, *Manufacturing Engineering*, *Leadership Excellence*, and *Management Accounting*.

Don’t miss this opportunity to learn how you can develop the accurate and relevant economic cost information that will help your organization improve its “bottom line.”