

HOW ACTIVITY-BASED MANAGEMENT CONTRIBUTES TO SHAREHOLDER VALUE

A Methodology for Measuring the Return From Activity-Based Costing/Management Initiatives

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EXECUTIVE SUMMARY

With three of the world's major economies (in the United States, the United Kingdom, and Japan) teetering on the brink of recession, business leaders are probably wondering what they can do next to be successful and to improve organizational performance. Managers tend to shelve investments when payback is either too hard to quantify or too far in the future—however, they still need to take positive actions to improve their businesses now.

Analysts and the business community have long recognized that an activity-based costing and management (ABC/M) approach can contribute to shareholder value, and business analysts are encouraging companies to revisit it. Getting actionable information from ABC/M projects is a quick process—counted in weeks rather than months. But will you realize a quantifiable return from investing in ABC/M? We review the evidence, setting out a methodology for measuring return on investment (ROI) in an ABC/M initiative, and reviewing empirical research and reported cases. Evidence suggests positive returns that can be substantial and very quickly realized.

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Audience: CFOs, financial controllers, financial managers, and cost accountants.

INTRODUCTION

Increasingly, enterprises are moving towards value-based performance measures, which are designed to provide a better measure of business performance than potentially misleading ratios such as earning per share (EPS). Economic value-added (EVA) or shareholder value-added (SVA) measures are typical of the new measures being used. Both are based on the premise that all capital has a cost, and earning more than the cost of capital creates value for the shareholder.

Put simply, if you increase returns from existing assets—or make further investments that have a return above the cost of capital—you will create value for your shareholders. If this isn't possible, free up the cash and return it to the investors, who can then seek out profitable investments for themselves.

THE ROLE OF ACTIVITY-BASED MANAGEMENT

Activity-based management (ABM) has been around for more than a decade and has been adopted by enterprises with varying degrees of enthusiasm. Increasingly, business leaders and analysts are realizing that ABM is a critical piece in the decision-making framework of today's corporations. To quote leading U.S. business analyst firm AMR Research:

“Activity-based management is rapidly changing from a staid, annual manufacturing-oriented process into an essential real-time decision component used to assess profitability for new products, channels, and customers. With all the talk of revenue-optimization, ABM has been ignored as the other half of profit optimization.”¹

Unless an enterprise understands how customers and products drive activities within the business and how they consume costs and resources, it's unlikely to be able to make the informed decisions needed to improve margins and reduce costs.

Traditional costing tends to overlook the fixed costs of doing business with customers, and leads to a distorted view of customer profitability. Combining costing and management, ABC/M helps companies identify underperforming assets and nonvalue-added activities, so they can realign resources to improve profitability.

Many companies mistakenly believe they can forego ABC/M and instead enhance shareholder value by downsizing. However, this can lead to ill-informed decisions. To quote Edward Forrest, “ABC/M reveals the redundant and nonvalue-added activities and cost inefficiencies that impede shareholder value... if (these companies) had been using ABC/M, the information could have helped them make more informative hiring and firing decisions.”²

¹ The AMR Research Alert on Enterprise Management, June 12, 2001.

² Forrest, E. Activity-Based Management: A Comprehensive Implementation Guide, McGraw-Hill, 1996.

ABC/M IN PRACTICE

Other than coercion from above, managers undertake ABC/M projects for two main reasons—explicitly to save costs or, more generally, to support decision-making at both the strategic and operational level.

Initiatives to save costs are variously described as downsizing, rightsizing, business process review (BPR), reengineering, process improvement, shared services, or a host of other titles. Regardless of title, the cost-savings objective is to ensure the enterprise has a resource base that is both efficient and cost-effective. With the purpose of achieving a step-change in costs, these projects may be short-lived—or they may be ongoing, providing costing information to drive continual improvements across the enterprise.

But an increasing number of enterprises are deploying ABC/M to reliably identify true end-to-end product, customer, or channel profitability. Armed with ABC/M information, enterprises are able to make informed commercial decisions, such as:

- Pricing products and services more accurately
- Identifying the most profitable groups of customers as the focus of future customer relationship management (CRM) activity
- Identifying how to price sales coming from e-commerce against regular business
- Providing detailed costing information as the basis for negotiating discounts with key accounts

When front-line managers access ABC/M information to support business decisions, they often quickly appreciate the value of the insight it provides—acting more confidently and driving the enterprise to ever-higher levels of competitiveness.

No matter what drove the initiative in the first place, it's clear that well-planned ABC/M initiatives have a major impact on key financial drivers—such as maximizing sales, increasing margins, and optimizing investments—all of which affect shareholder value. The remaining question you might ask is, “Yes, but will an investment in ABC/M create value, too?”

APPRAISING THE POTENTIAL RETURN ON ABC/M INITIATIVES

Techniques for assessing return on IT investments are well-documented. It's widely recognized by management that companies receiving the best value from IT investments are those that adopt a rigorous approach to quantifying benefits prior to making a purchase decision.

However, compared to most other IT investments, ABC/M initiatives present unique differences:

- ABC/M applications aren't transactional systems and, in themselves, don't deliver any business benefits. The decisions that managers make as a result of having the information create the value.
- Information from ABC/M supports strategic decisions at the top of an organization as well as operational decisions further down the organization. Few other IT applications carry an impact so widely across an enterprise.

A typical prepurchase appraisal for an ABC/M initiative might proceed as follows:

Step 1: Identify Opportunities to Create Value

Identify opportunities to create value by increasing revenues, decreasing cost, or reducing capital requirements. Wide-ranging opportunities may include:

- Improvements in margin from more informed pricing and discounting
- More effective marketing from knowing what types of customer are profitable
- Cost savings from removing nonvalue-added activities and improving key processes
- Reductions in capital requirements due to removing unprofitable products, customer, or business channels

Step 2: Quantify the Benefits

In practice, assigning a monetary figure to the benefits of ABC/M investment may be the most difficult step. In parts of your business where the key benefit of an ABC/M investment is likely to be a reduction in cost, quantifying the benefits is easier—but even here, estimates are necessary.

You may need to quantify less obvious business benefits, as well. For example, using ABC/M to focus your company's process improvements may lead to better service for your customers. Better service is likely to lead to increased customer satisfaction, which may lead to less customer attrition—which in turn might lead to increased revenues. This is exactly the same logic used to justify many CRM applications, and it's more difficult to quantify than a simple cost saving.

However, if your managers believe there is a significant opportunity to reduce attrition, they should measure the levels of customer satisfaction and attrition, targeting realistic improvements and modeling the impact on revenue.

The adoption of ABC/M frequently allows more informed decisions on pricing and

discounting, and you can estimate the likely improvement in margins. You can then bring together all these different elements of cost savings, revenue gains, and margin improvements, and model them to show the value of your ABC/M initiative over time.

If this sounds highly speculative and you are still skeptical, rest assured this type of appraisal has much in common with those used to justify investments in enterprise resource planning (ERP) and CRM initiatives that cost considerably more than an investment in ABC/M. And, unlike investments in ERP and CRM, enterprises can approach ABC/M in bite-sized chunks, starting with a pilot study in a single business unit in order to understand the type of returns that can be enjoyed.

Step 3: Quantify the Cost

Your next step is to quantify the cost of the application, implementation, and ongoing support. To make your investment decision, compare the value created by the project with that of other possible investments available to your enterprise.

Step 4: Manage the Deliverables

Once you've made the decision, you must manage the project to make sure that the planned returns are delivered. Be prepared to modify the project according to the payoffs that are actually realized. This may even include abandoning a project midstream.


It's also important to ensure that once the implementation is complete, your managers are equipped with timely, accurate ABC/M results—and easy access to them so improved decision-making can begin. Therefore, to receive maximum benefits from the project, your plan must define management reporting requirements, enable buy-in, and allow for training executives on new management methods.

Step 5: Communicate Progress

Finally, don't forget to communicate the benefits of the investment across the organization. Sometimes these will be financial, but if you want the success to be understood at all levels of the organization, it's frequently better to use measures that are relevant to each department—such as local improvements in productivity or profitability.

REPORTED RETURNS FOR ABC/M INVESTMENTS

Despite the time and effort taken to produce the prepurchase justifications, post-implementation appraisals are rarely robust and documented results are not widespread. Many managers state that ABC/M-supported decisions are hard to distinguish from other methods that have led to improvements in their companies'



performances. Other managers may see adoption of ABC/M as a source of competitive advantage and be reluctant to share the results.

However, a growing body of evidence both from academic research and from enterprises themselves shows a positive return on investment (ROI) with ABC/M, and indicates it can make a substantial impact on business performance:

- In a U.S. study of a sample of 65 enterprises with ABM programs and a control group of 139 without, professors Gagwin and Bouwman found that if they controlled for other business improvements initiatives such as BPR and just-in-time that may be happening concurrently, there was still a positive relationship between ABM and improvements in the enterprise's performance, as measured by ROI.³
- In the United Kingdom, in a review of ABC initiatives in life insurance, Lancashire and Edwards found that ABC could deliver a 1,000% payback, comparing the total costs of implementation against the short-term cost savings identified within the first two years of implementation.⁴
- In a review of the potential of ABC, published in the Harvard Business Review, authors Ness and Cucuzza examined the experience of Chrysler in the US, and stated that the cost savings can be enormous—up to 50 to 100 times the cost of the ABC implementation at some of its sites.⁵

³ Gagwin D. and Bouwman M. "The Association Between Activity-Based Costing and Improvement in Financial Performance," University of Texas at Brownsville, School of Business Research Colloquium, April 2000.

⁴ Lancashire J. and Edwards D. Activity Based Costing in the Insurance Industry, Bacon & Woodrow.

⁵ Ness J. and Cucuzza, T. "The Full Potential of Activity Based Costing," Harvard Business Review, May 1995.

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- Pharmaceutical company GlaxoWellcome reduced 3 million rand from operating costs in its South African company, through savings implemented by applying Metify ABM—the Business Objects solution for ABM. ⁶
 - Prior to deploying software across its retail operation to measure product and customer profitability, Allied Irish Bank performed an ABM pilot study in its central leasing department. The bank reported achieving cost savings equivalent to the cost of the software license. ⁷
 - In 2001, Tech Data, a provider of IT products, logistics management, and value-added services, attributed a 33% increase in EPS—in part to the contribution ABC/M had made to its performance. Tech Data noted that profitability in areas using ABC/M was twice that of others. ⁸
 - Long an advocate of ABC/M, which it uses to support pricing decisions across 80% of the company, DHL Worldwide Express reported that each 1% profit margin improvement generated \$5 million in greater profits in 1999. ⁹
 - Warner Lambert used ABC/M to help rationalize its product portfolio, eliminating 50 unprofitable lines across 20 brands—while both sales and profits increased. ¹⁰

⁶ Computer Week, May 2001.

⁷ Business Objects Case Study, May 2001, On file.

⁸ Tampa Bay Business Journal, May 29, 2001.

⁹ Player, S. and Cobble, C. Cornerstones of Decision Making: Profiles of Enterprise ABM, Oakhill Press, 1999.

¹⁰ Business Objects Case Study, 1999, On file.

CONCLUSION

While not all ABC/M projects can be said to be successful, an increasing body of evidence from both empirical research and case studies indicates that investing in ABC/M delivers demonstrable returns—and the cost of the investment can be quickly recouped. These results are reassuring for managers, especially as they are encouraged to reappraise ABC/M at a time when investment in IT and business systems is under ever-greater scrutiny.

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