



ABC On Steroids  
Salient Management

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Draft - See Eric Frantz Salient

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## ABC On Steroids

### Management Accounting Irrelevance

Management Accounting necessarily serves three masters: (1) to support financial statements; (2) to provide process control information to the respective cost centers; and (3) to estimate the product costs for pricing, margin analyses, sourcing, etc.

During the 19th century, where a single product, simplified business was common, this was feasible as the overheads could be simply assigned to products based on the direct labor (typical 60% Direct Labor, 10% overhead, 30% material), and you could aggregate the throughput for the financial reporting.

However, as industry in the 20th century grew in complexity with multiple products, multiple business units, diverse sourcing and customers, and an increasingly indirect bureaucracy of support, a simplified approach to allocating overhead based on an easily measured direct labor was, at best, inappropriate, and, at worse it was extremely misleading. The need to fully absorb all costs to satisfy inventory rules and external financial reporting forced an allocation of variable, as well as relatively fixed costs, down to individual products, without regard to whether those products actually affected or drove those costs. Typically, a small percentage of the products that truly created margin were perceived to be heavily penalized by the large percentage of products that truly caused the complexity costs.

The worst-case scenarios were incorrect pricing, misguided outsourcing, and disastrous product segmentation. This was all exacerbated by the need to measure short term results, which further forced incorrect decisions on whether to invest for the long term. Management Accounting, even when augmented by more sophisticated systems, drove incorrect behavior, such as:

- Applying (absorbing) indirect overhead based on direct labor, even in cases where the overhead was inverse to direct labor (e.g. automation equipment)
- Continuing production of a product well beyond demand in order to “absorb” more labor, resulting in expensive inventory
- Outsourcing products predicated on perceived short-term internal costs without regard to the resultant impact on longer term capacities
- Slower turns of inventory, and greater complexity of mix due to inaccurate costing, driving up capital investments and ongoing carrying costs
- Lost margin due to under-estimating the costs, and due to over pricing (lost competitiveness)
- Misapplied management metrics and labor incentives, which resulted in short-term focus and heavy reliance on efficiencies, at the expense of long-term strategy and effectiveness
- And many more...

Through the 1980s, Management Accounting remained as a subordinate to Financial Accounting, while companies focused on the external reporting of short-term results, rather than providing operational insights for performance improvement. While the Management Accounting practices remained much unchanged from the early 20th century, industry evolved dramatically. It is as paradoxical as if a



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Model T assembly worker from 1920 attempted to supervise the final assembly of a late 20th century Lincoln Continental, let alone a 2020 Tesla. “*Wait a minute. You mean we sell more than one model and more than one color - black?*”

### Uneasy as ABC

A growing recognition that Management Accounting was inadequate for managing most businesses, including prominent writings such as the *Relevance Lost*<sup>1</sup>, stimulated a movement by the 1980s.

Activity Based Costing (ABC) and Activity Based Management (ABM) were

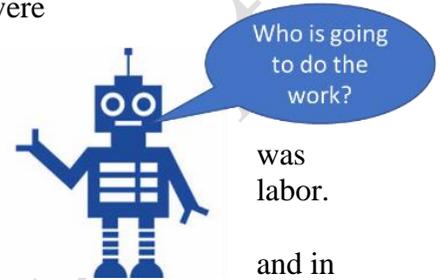
very significant approaches for recognizing the real costs of a product or service, and the respective drivers that could identify opportunities for improvement. ABC was responding to the inadequacies of

traditional standard costing approaches in which the indirect overhead allocated to a product, service, etc. based on an easily measured direct

The issue was that, while the indirect overhead was increasing as a proportion of total costs, it was becoming less related to direct labor,

some cases, inverse to direct labor. For example, robotics and automation are captured in indirect overhead (programming, maintenance, depreciation), but actually eliminate the direct labor! At

some point you have high indirect overhead but very little direct labor.



was labor.

and in

ABC assigns the cost of each activity in an organization to specific products and services according to the actual consumption by each based on cost drivers. For example, procurement process costs such as issuing purchase orders might be assigned based on the number of purchase orders related to each product. This is significantly different than using direct labor to spread the costs. ABC assigns more indirect costs (overhead) into direct costs compared to conventional standard costing.

This all sounds great, but ABC lost ground in the 1990s because it was an inefficient use of resources (expensive and difficult to implement for small gains) and could not easily be institutionalized. The following comments represent some of the challenges identified by two of the most prominent spokesmen for ABC, Robert Kaplan and Robin Cooper.

*“The time and cost demands of creating and maintaining an ABC model on this scale (pertaining to a subject company in this citation) is a major barrier to widespread adoption at most companies. Since the systems that are put in place are updated infrequently (because of the costs of re-interviewing and resurveying), the model’s estimates of process, product, and customer costs soon become inaccurate. What’s more, people waste their time arguing about the accuracy of cost-driver rates that are derived from individuals’ subjective beliefs rather than addressing the deficiencies the model reveals: inefficient processes, unprofitable products and customers, and excess capacity”* (Kaplan and Anderson, 2004)

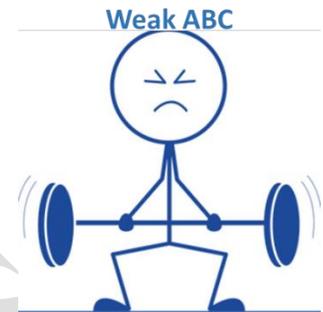
In a case study on Innovation, Robin Cooper noted that when a firm wants to actively drive value during the lifecycle of a product, “*the cost-reduction insights that activity-based costing provides might be redundant because of Olympus’ (case study company) use of general kaizen costing and functional group management. This limited role for product costing (ABC in this example) might seem surprising given the recent popularity of activity-based costing (as of 2004), but it reflects the way that Olympus Optical has designed its cost management program.*” (Cooper and Slagmulder, 2004).

<sup>1</sup> *Relevance Lost: The Rise and Fall of Management Accounting* by Thomas Johnson and Robert Kaplan (Johnson and Kaplan & Thomas H. Johnson and Robert S. Kaplan, 1987)

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Activity Based Costing alone did not improve competitiveness. It was an improved method of accounting for the real costs but was not organized to reflect the unused capacities nor customer requirements – two extremely critical elements of improving performance. ABC was a better way to account for a complex product and process but did not drive reduction of that complexity. In fact, it increased the complexity of the accounting process.

Despite of the downside, ABC was a great improvement over Standard Costing. Benefits such as cost reductions by 3-5% have been cited, as well as increased revenue due to improved pricing competitiveness and product/customer rationalization. ABC was beneficial for pricing, business segmentation, mergers & acquisitions, customer validation, sourcing strategy, investment strategy, product innovation, organizational development, benchmarking (selling costs, production costs, etc.), transfer pricing – if it can be sustained!



An enhancement to ABC, Time-Driven ABC was introduced during the 2000s with promise to simplify by requiring fewer interviews and less data collection and adding a benefit of recognizing unused capacity within the processes. With the advancement of tools for tracking time cycles, the overall process could be more automated, and likely would exceed the benefits of ABC.

However, it continued to be stymied by a still tedious need to collect and maintain data, and lack of ability to institutionalize due to the inevitable business factors changes. The current adoption of time-driven ABC seems limited, although there is some prevalence in healthcare.

### ABC - ✓ Pros and ✗ Cons

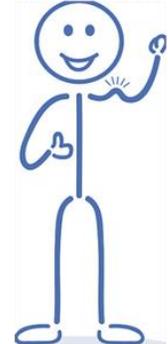
- ✓ Improved costing (vs. Standard Costing) for product pricing
- ✓ Indirectly assists in cost reduction, process improvement
- ✗ Is not a bottom-up operational improvement, nor driving customer responsiveness
- ✗ Time consuming and difficult to implement
- ✗ Difficult to institutionalize

### ABC on Steroids

Salient Performance Management provides the precise accounting of all value added, and thus recognizes the unique requirements for assigning supportive and/or indirect costs and cost drivers by product, service, customer, or other entity as appropriate. While supporting the simplification of accounting through Lean and Throughput Accounting, SPM is also able to take the best of Activity Based Costing and Time-Driven ABC. It will systematize and automate with continuous feedback on the relevancy of chosen methods for attributing those costs. Simply, you can track the actual “realization” of the chosen cost drivers, with the option of adjusting “on the fly”.

SPM enables ABC in a multi-step process, where an activity is initially allocated to varying families of products based on certain similarities (e.g., methods of

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production, configurations). This allocation may be based on volume, revenue, time, complexity, etc., and estimated based on a forecast. Or, perhaps the activity is allocated based on Reason Codes, Cost of Quality, or other methods of segmentation. As the year progresses, the initial allocation may need to change based on actual consumption, to have a real view of the costs for internal decisions (not necessarily external reporting).

Secondly, the same consideration is needed to allocate product family (or other segmentation) costs down to the individual item sold. The final net cost is the total of direct costs and allocated costs, including multiple activities (mapped to the sellable product with a Bill of Activities). Salient's approach is revolutionary in that, once you have primed the system, it continuously updates cost driver formulas in ABC based on actual performance. The inability to automatically update has been an Achilles heel for most ABC initiatives, which typically rely on initial cost driver assignments based on forecasts and must be updated manually to reflect actual business performance.

An example might be the assignment of Purchase Order (Procurement, Supply Chain personnel fully loaded compensation) expenses based on the cost driver of "# of Purchase Orders". Maybe you initially assigned the Purchase Order expenses (\$8000/week) to 4 families (Family A: \$3000, Family B: \$2000, Family C: \$1500, Family D: \$1500)<sup>2</sup>. For Family A, the cost driver is number of purchase orders, estimated at 100 P.O.s per week, which results in \$30/P.O. assigned to products<sup>3</sup>, customers (depending on how the P.O.s are proportioned to those products, customers). However, during the month, you will have visibility to the realized number of P.O.s, and if they are tracking to 120 or 80, you can adjust rate/P.O. accordingly. And, you have a continual accounting of the cost drivers, thus the ad-hoc maintenance is alleviated.

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<sup>2</sup> This initial assignment may be based on knowledge of complexity, people assigned specifically, etc.

<sup>3</sup> There may be further nuance based on complexity factors – thus each type of purchase order may have specific weightings

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The following illustration reflects Salient's ABC model:

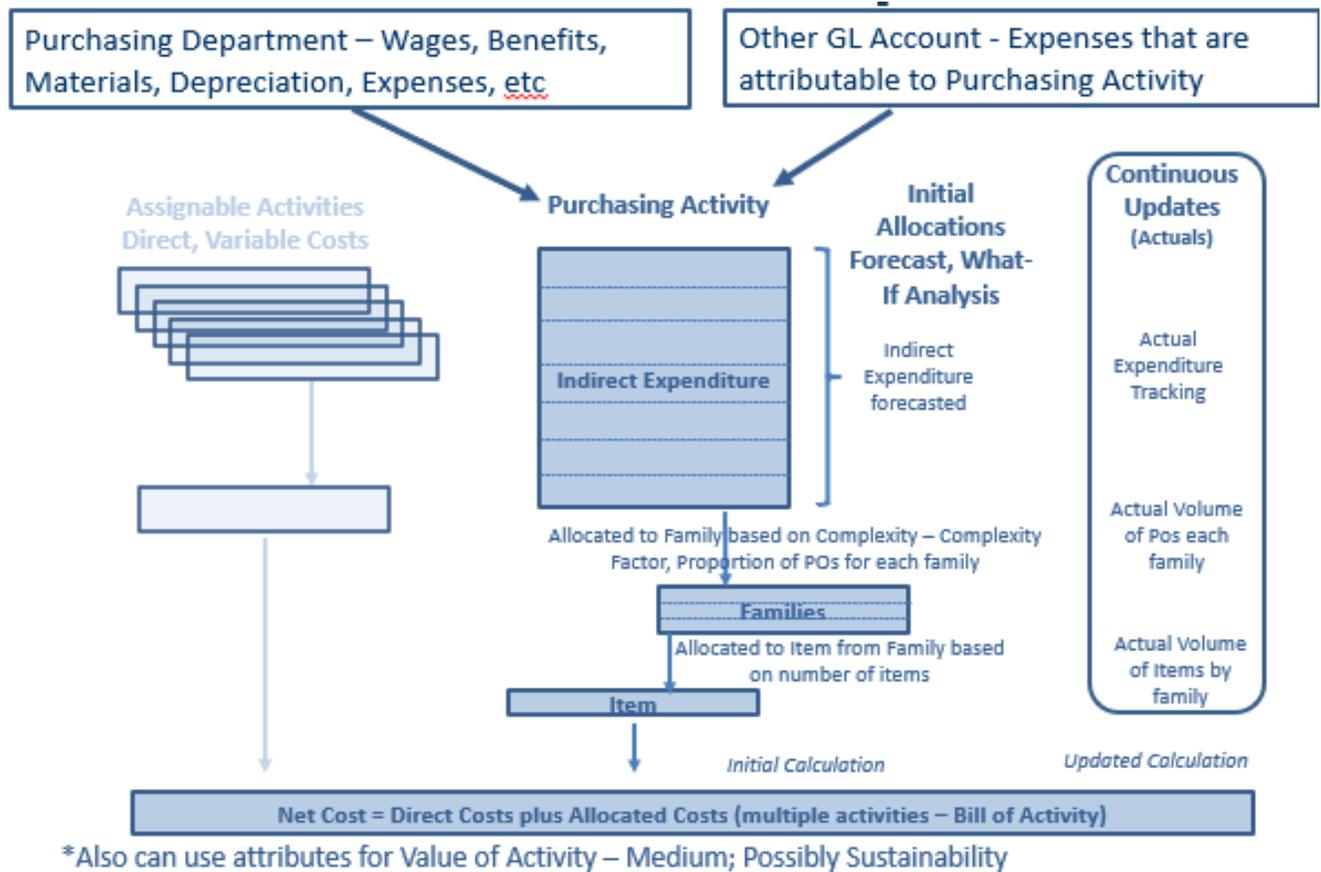


Figure 1 – Salient model for ABC

Click [here](#) to learn more about how Salient's Allocations Advanced enables a precise accounting

Simply, SPM leaps past the former challenges that reduced effectiveness of Standard Accounting and stymied the institutionalizing of ABC. At the same time, it supports the Lean initiatives to simplify through blanket orders, reduced suppliers, etc., with the recognition of reduced P.O.s per week AND the respective reduced personnel compensation that will be re-assigned to other value-add duties.

Salient Performance Management enhances ABC, BCS, EVA, Constraint-based Throughput Accounting, Lean, Six Sigma, and continuous improvement, and makes them all viable methods.

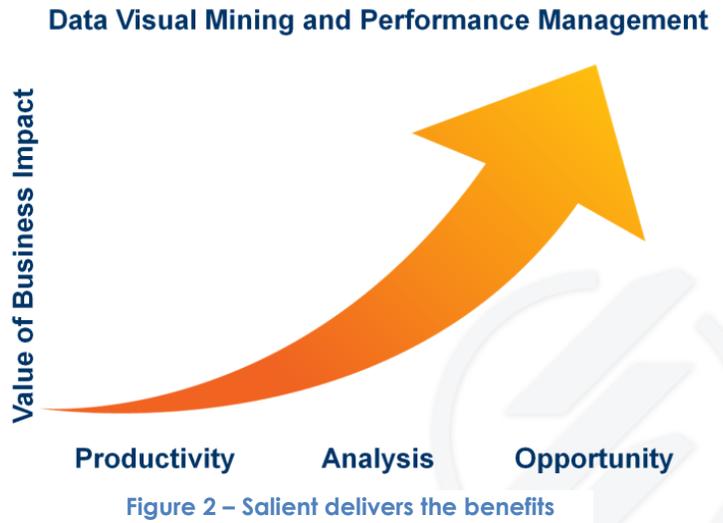
- SPM automates and institutionalizes ABC
- SPM provides the underlying operational improvement insight for BCS
- SPM enables the exact and transparent accounting of value, which is needed for EVA
- SPM provides the visibility and performance monitoring for Throughput Accounting
- SPM enables the valuation of waste reduction opportunities for Lean, Six Sigma
- SPM is fundamentally about enabling continuous improvement.

## Business impact

Continuous improvement techniques require investments in software/technology, process improvement, and organizational development. SPM provides the insights and practice for rapid realization of the improvement and institutionalization of best practices. Additionally, there are potential findings through discovery of business opportunities (not possible in more static analyses, reports, and less robust approaches in Lean) (Figure 2).

These are typical benefits:

- Revenue enhancement based on rationalized products and customer, insights for pricing, increased competitiveness
- Gross Margin enhancement based on the Revenue enhancement benefits, plus cost reduction through continuous improvement and mix management
- Indirect Costs reduction through insights on cost drivers, capacity optimization, inventory optimization, and continuous improvement
- Working capital optimization
- Fixed assets optimization



Additional benefits such as quality, customer service, etc. are results of the actions taken above.