

Cost-Cutting ABCs

A new approach to accounting - Activity-Based Cost Management - can reveal hidden assets and liabilities.

Lawrence M. Kohn

Cost cutting. It's the aerobics of the 90s for businesses large and small. More than just the latest buzzword or 90-second flash-in-the-panacea, it's a survival technique. Companies that aren't trimming the fat now may not be around in five years to regret that they didn't.

But cost cutting is a lot easier to talk about than to do. Some cuts, like key personnel, can be a false economy; much of the waste may be hidden; and maybe, as a manager, you feel you've cut costs to the bone already. So how to cut more, and where?

One technique for getting the crucial information you need to make *effective* cost cuts is a system called ABC - Activity-Based Cost Management. Corporations like Tektronix, IBM, Hewlett-Packard, and Weyerhaeuser are using this system to find the real costs of production.

ABC involves breaking down the entire production process into segments and then, through analyzing direct costs and through a process of allocation, discovering the costs and revenues that are associated with each step. The cycles of activity in each step and how those

change over time are also analyzed. The end result is some solid intelligence about what each step is costing on a per-unit basis.

"ABC means you have to understand your process in detail, not just labor and materials, but the particular thorny piece - the overhead and indirect costs. The goal is to understand all the things you have to do to produce a unit - what the costs are, both direct and indirect, for every step of the way," says Steve Duffy, Managing Director, Managing Consulting Services for Kenneth Leventhal & Co., an accounting firm with offices in 13 cities.

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Many of these indirect costs are overlooked by conventional cost management systems, which were developed at a time when direct labor was the main variable cost of production, and, hence, was the one most



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closely monitored. Now, according to *Business Week*, automation has cut hands-on labor costs to 15% of manufacturing costs, and overhead accounts for 55%. But these indirect costs are spread across all products using the same formula. As a result, managers seldom know a product's real costs, making it difficult, if not impossible, to trim them effectively.

ABC tracks the costs of overhead functions - everything from R&D to advertising - and attaches them to the products and services that use them. "What ABC gives you," says Duffy, "is a fully loaded profit and loss profile of a unit on a manufacturing basis." This profile, in turn, makes it easier for managers to pinpoint places where cost-cutting or improved efficiency are called for.

Successful implementation of ABC requires a de-

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tailed understanding of how a company works and how each product manufactured is brought to market, step by step. It requires the accountants to go out and visit the factory floor, and, even more important, according to Duffy, the entire production team to be really in touch with the actual numbers involved in manufacturing the product.

When a company decides to implement the ABC system, usually the first step is to gather a team, including the shop workers and the secretaries, to chart each step of the manufacturing process, from the beginning of design until the finished product is delivered to the customer. These charts reveal which steps add value to the product, and which ones don't. This knowledge then enables a company to go to work on reducing "hidden" costs.

Sounds good, but how much work - and expense - is involved in getting an ABC system up and running? That depends, says Duffy. "...on how far a company has already gone in terms of breaking down production and really allocating costs. Typically, the tighter a company has been because of low profit margins or keen competition, the easier it is."

And the difficulty of implementing the system? Not a lot if done properly. Careful planning is the key. Duffy suggests that creating a we/they situation between the accountants and the manufacturing team could be a serious mistake.

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"These initial steps can be a false start, even though the intentions are good," he says. "If you bring the numbers people in and set them up as a kind of separate organization, apart from the people involved in the productive process, you may just add to the overhead."

What is needed instead is a cohesive, joint team of accountants, management and shop floor personnel. "What you really want to do is give the numbers to the people in the process, who, when they change their behavior, can affect them," says Duffy.

This empowerment of the production staff is the secret to the success of ABC. "[This system]...requires the people operating it to really be in touch with the numbers. There are all sorts of views about not letting the workers really understand all of the costs because they might figure out what the profit is, and that might not motivate them," Duffy says. "But what you find at the best companies is that kind of information is power. You can't expect people to help your overall objective if you don't give them the information, if they're not allowed to see how their be-

havior in the production process is taking shape in terms of real numbers.

"Once you give individuals reliable information about the cost of their operation, and then track that information over time, then, when you state objectives about lowering costs, you can expect to see some results," he adds. "People will come up with ideas about how to improve performance. Basically you... [convert] your work force into men and women who are not just working at jobs, but who really understand the costs associated with every action."

This is not to belittle the accounting function. The basic numbers are an essential beginning, but, "The way to change behavior is to have people that are doing the work be sensitive to what happens to costs when they make changes...In effect you have given them real time power to be able to distinguish which of their actions are efficient and which are not," says Duffy.

But cost cutting is not the only advantage to ABC. The

ABC BEGINS WITH FORMING A TEAM THAT CHARTS EACH STEP OF THE MANUFACTURING PROCESS FROM THE BEGINNING OF DESIGN UNTIL THE FINISHED PRODUCT IS DELIVERED TO THE CUSTOMER.

same kind of analysis can give managers an effective tool to justify fresh investments. Many times managers know an investment should be made, but more traditional accounting systems can't deliver hard numbers to demonstrate why. For example, an ABC system can reveal the hidden costs in storing raw materials and moving them about the factory, thereby helping a manager to justify investment in a system to reduce quantities held in temporary storage.

ABC can also help make accurate bids for jobs. Some computer models using this system can predict which activities will be needed to complete a particular job, so management can predict more accurately what an acceptable profit margin should be.

While ABC is relatively new and unfamiliar to many, Steve Duffy sees it as becoming more common in the 1990s. "I think more companies will focus on this. Many economists are predicting relatively low growth in the 90s, which is really a function of the high debt levels we have in this country. When you have that kind of burden and relatively low margins and less money for investment, then companies are going to find that their bottom line improvement is going to come less from revenue growth and market share, and more from holding their costs down. I think these kinds of systems and the products that help implement them have a good future in the near term." ■

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