

Pharosinformatics

Case study

Using ABM to cost and assess the value of central support functions

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Using ABM to cost and assess the value of central support functions

A large services organisation had weathered many changes in the business climate. Business divisions expanded and contracted according to the whims of the market and the ability of the divisions to compete. In good times, central service functions such as Facilities, IT, Marketing, HR, Legal and Finance all staffed up to meet the increased demand. Yet in leaner times, these same functions always had immediate arguments against belt-tightening.

The business divisions determined their profitability after deductions of central service charges, so divisional directors took a keen interest and bargained hard to reduce their own share of the re-charged costs.

From their perspective, central services appeared to be able to levy a significant charge on the divisions, without any accountability for cost, quality or service levels. Some of the more entrepreneurial divisions retaliated by levying service charges on each other!

The turning point came when a new CEO was shocked to see the ingrained hostile behaviours that characterised the relationship between the central support functions and the business divisions.

What had been missing was:

- Information to allow the business divisions to assess the value-for-money obtained from central services
- Visibility of the costs of central services and an understanding of what drove the level of costs up or down
- An assessment of the effectiveness of central services provision

The new CEO introduced Activity Based Management (ABM) with aim of building a cost model and, from that, a pricing model. But this was not to be an academic exercise in costing; the CEO also expected solid improvements in central services' effectiveness.

Calculating output costs

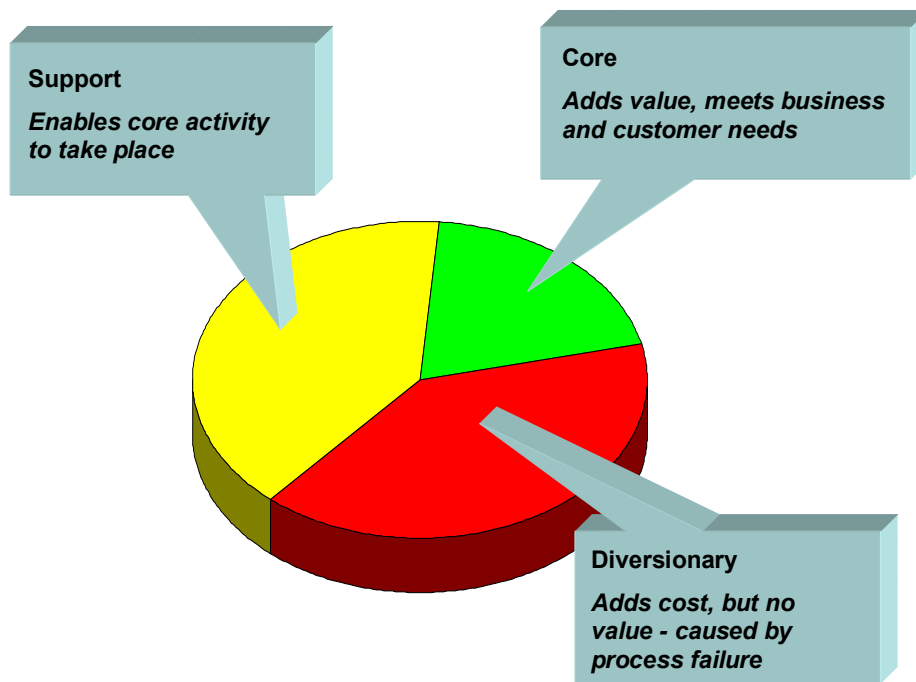
First the ABM team calculated the direct and indirect cost of central services. For each individual the costs included salary and employment costs, vehicles, travel and entertainment. Other overhead resources were then assigned to people on an appropriate basis. These costs included rent, power, heating, office furniture and equipment, accounting, training, personnel administration, reception, PCs, e-mail, printers and IT support.

As part of the data collection, each member of staff identified their activities and the amount of time typically spent on each. Activities were classified as either core, support or diversionary as shown on the figure below.

Core activities are those that directly meet a business need. For example the production of analyses and reports for the business.

Support activities are those that make it possible for core activities to take place, which include training and maintenance of records.

Diversionary activities, such as checking and chasing, highlight process failure and wasted time and effort.



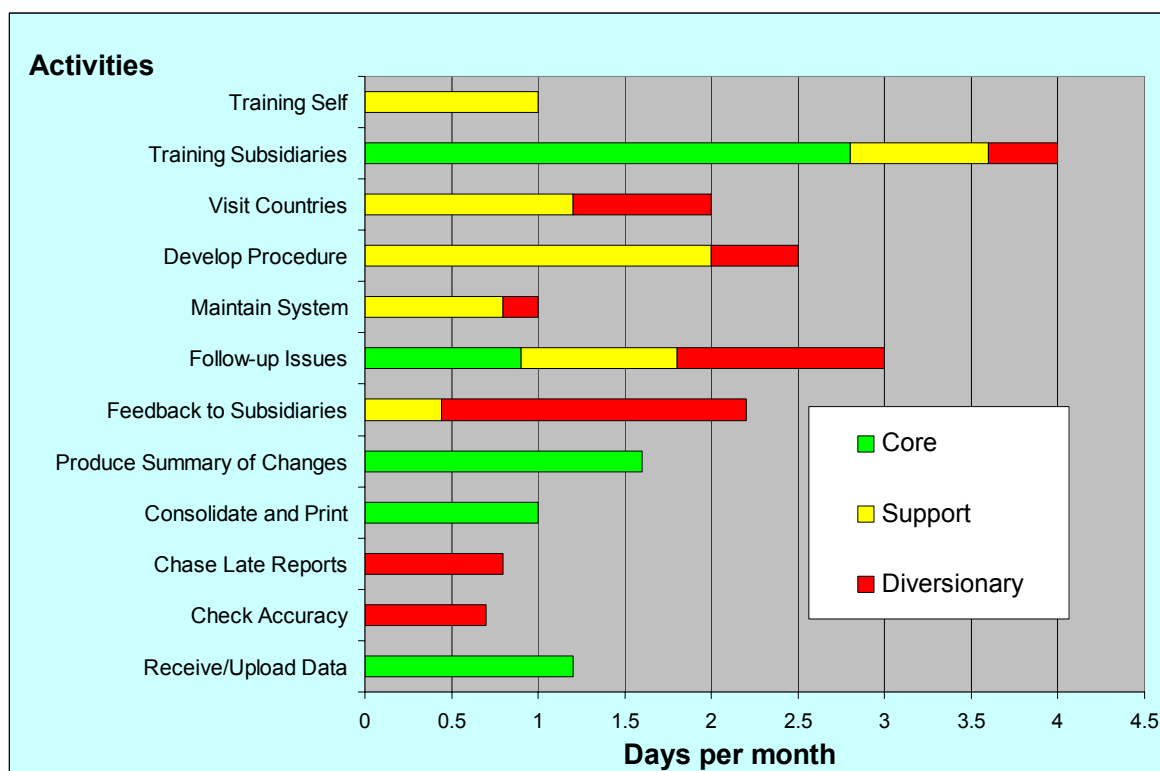
Staff were immediately surprised at how much of their time was spent on diversionary activities-almost 30 per cent across the whole of central services.

Checking and correcting errors in the monthly figures provided by the business divisions proved a particularly frustrating and time consuming diversionary activity - just one of many instances where process failures in the business divisions inflated costs in central services!

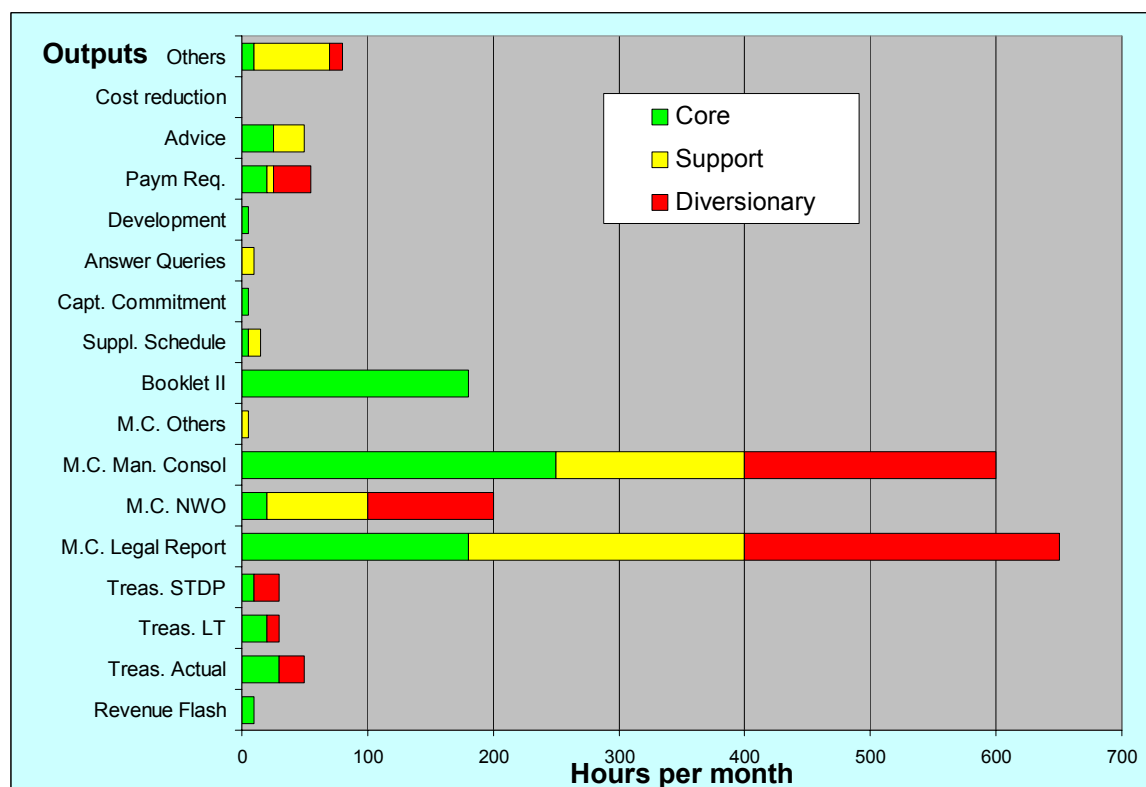
By concentrating on root causes and solutions, many opportunities for process improvements were found. This allowed central services to reduce the costs of the majority of services and offer enhanced service levels for a small number of outputs which the business divisions regarded as critical.

An example - Management Accounting

Management Accounting described Treasury Reports, Financial and Management Accounts and Advice among their core outputs. The costs of these activities and the proportions of different types of activity are shown in the figure below.



There were also support outputs such as policies and procedures, the reporting system and training, as well as diversionary outputs such as feedback, corrections and re-submissions as shown in the figure below.



In order to measure their value, the core outputs were judged by the business divisions on content (relevance, actionable), accuracy and timeliness - information being a perishable item.

The cost of producing each output was compared to the value perceived by the divisions. As a result, management accounting and divisions worked together to make value-for-money decisions to reduce the

frequency or eliminate reports that cost more than they were worth. In some critical areas, both sides agreed to an enhancement of service - an outcome that would never have been countenanced under the old regime.

Management Accounting dept were also able to make a number of cost-saving process improvements:

- Consolidation of the forecast quarterly at regional offices only, cutting out branches;
- Distributing checking software to the business divisions;
- Rationalising the chart of accounts and entity names to reduce complexity and coding errors;
- Dramatic reduction in number of cost centres;
- Reporting levels to be cut back to limited number of agreed indicators.

Six months after implementation the benefits were visible to all. Transfers of data to Head Office reduced from two days to two hours, there was a massive reduction in reporting errors, and deadlines were beaten by seven days at month end. Management accounting increased its productivity by over thirty percent overall. The high turnover in staff they had experienced previously was eliminated.

Cost drivers

Cost drivers are a critical outcome of an ABM study. They predict how resources will vary as a result of a change in any of the key cost drivers of the business - business volumes being just one of cost drivers in this organisation. The existence of cost drivers means that spare resources cannot be hidden or absorbed. In the past, if total demand for a service fell, costs stayed the same so unit costs rose.

Now, central services managers were made accountable for the cost of the spare resource. They could channel it into another service where demand was increasing, or eliminate it, usually through natural wastage. But they could now long hide its existence.

A year after the ABM study, service costs had fallen by over twenty percent, a considerable benefit. The cost debate continues each year, but now on a much sounder and less emotional footing. Despite the cost savings, service quality has actually increased as managers continue to concentrate on improving processes and further reducing unit costs. Given that such improvements in productivity and effectiveness in a central function had been rare in the past, ABM was subsequently introduced into the business divisions to provide a focus on product and customer profitability.

Since introducing the ABM approach a more subtle benefit has since emerged. As the visibility of service costs has improved and the mentality of cross-charging other divisions has subsided, business managers were able to focus their energies externally on customers, rather than internally on wrangling about costs.

Benefits demonstrated by this study

This review captures the key benefits of Activity Based Management and our approach to the effective utilisation of central services.

- Clear definition of services and outputs, their costs and the activities involved in their delivery
- Understanding the links between business volume, service quality and cost.
- Using output costing to compare costs with customer perceived value
- An equitable and highly visible charging structure based on resource consumption
- The ability to predict how resources will vary in response to changes in cost drivers
- The use of core, support and diversionary activity classifications to focus process improvement