

What's wrong with Activity-Based Costing?

Activity-based-costing is promulgated by DCLG as a useful technique for improving public services. It is anything but. This article explains why.

Activity-Based Costing (ABC) encourages managers to cost of all the activities involved in providing a product or service. In simple terms, the approach is to map the process as a series of activities and then calculate the costs of the activities which make up the product or service.

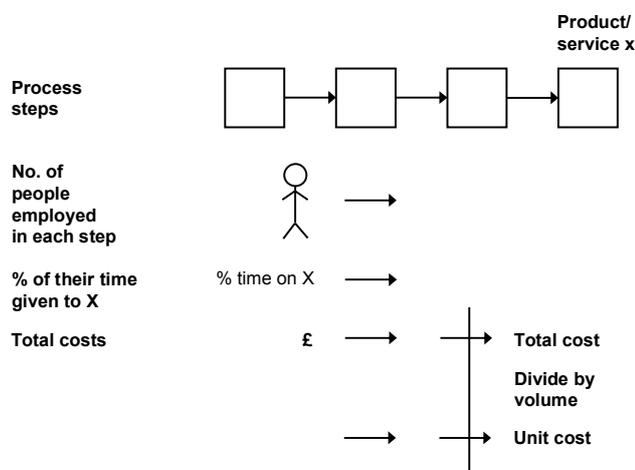


Figure 1: The logic of Activity-Based Costing

The method is to conduct interviews with workers involved in the process under scrutiny; the workers are asked to estimate how long each activity takes and work out the percentage of their time given to each activity. Each worker is also allocated a ‘backpack’ of costs relating to infrastructure costs (e.g. office rental, IT equipment). The result is that you know the costs of all of these activities.

Leaving aside the question of whether information gained by interview (rather than studying the work) is reliable, we should reflect for a moment on something Taiichi Ohno¹ taught. He showed it is wrong for manufacturers to maximise production from machines, as what matters is whether the machine is ready and able when the flow of work arrives. I also recall my physics teacher pointing out that a man resting on a shovel may be working at his most efficient rate. It is to make the mistake of thinking being active is being productive. Command and control thinkers assume people are busy all

¹ Taiichi Ohno was the ‘production genius’ behind the Toyota Production System (see Womack, Jones and Roos 1990 ‘The Machine That Changed the World’ Simon and Schuster: London)

day, can work at the same rates all day and won't be subject to other forms of variation. It is to treat people as machines, assets to be sweated.

Even if we take this view, we have to have doubts about the value of the information we get from using ABC. The means of improvement are always to be found in the work: Failure demand, dirty input, re-work, duplication of effort, errors, unnecessary bureaucracy – in short, waste. It is these work-based phenomena that help you understand the means for improvement. So if ABC does show high costs in part of a service you still ought to measure these things – and there is no guidance from government on the need for that – before you take action or you run the risk of making things worse. To attend to the parts of a process on the basis of costs is to know nothing of the value the parts have in respect of the purpose. It is easy to see how ABC might lead to cost-reduction targets with no knowledge of the consequences. But that's what the command and control thinkers want: cost-reduction. ABC is at best a redundant activity and at worst will mislead.

'A juggernaut out of control'

H Thomas Johnson was one of the people to first write about ABC but later described it as a 'juggernaut' which was out of control:

'As someone who helped put the activity-based concept in motion, I feel compelled to warn people that I believe it has gone too far. It should be redirected and slowed down, if not stopped altogether... Indeed, activity-based costing does nothing to change old remote control, top-down management behaviour. Simply because improved cost information becomes available, a company does not change its commitment to mass produce at high speed, to control costs by encouraging people to manipulate processes, and to persuade customers to buy output the company has produced to cover its costs'²

In manufacturing, many organisations who have adopted ABC have then attributed the setup costs of machines as a cost driver, which leads them to produce greater batch sizes (the opposite of Ohno's aim at Toyota of 'single-piece flow'). This has led them to get rid of all low volume products and concentrate on the larger volume products. Johnson had spent seven years studying the Toyota plant in Georgetown where he had learned the folly of cost-management. It is a lesson which the UK government's public sector reform regime has yet to learn.

The only real test of an improvement activity is its impact on the bottom line

John Darlington, lecturer at Cardiff University's Lean Enterprise Research Centre, has devised a 'Flow Accounting' methodology as an alternative. He helps manufacturers to devise measures which help them to understand their work in a systemic way. Darlington emphasises that accountants should actually only focus on what difference an

² Johnson, H.T. 1992b 'It's Time to Stop Over Selling Activity Based Concepts' Management Accounting September/October pp26-35

improvement activity is making to the organisation's bottom line. For Darlington, it is irrelevant how overheads are apportioned in the accounts: creating value for the customer should be the real goal of the organisation. The justification for having an HR or IT dept or improvement function must be self-evident, not because it can be justified through some internal management accounting practices. If any management activity is being decided on its impact on the cost per unit produced, then a company has been led down the path of taking an internal view of value instead of providing value to the customer. Therefore, for Darlington, the best measure of any improvement activity is ultimately whether it has an effect on the organisation's bottom line.

Purpose, Measures, Method

In services, the same logic applies. If an organisation can focus on doing the right thing for its customers, with measures derived from purpose, there will soon be a positive impact on the bottom line. Understanding the relationship between the purpose of a system, the measures that are being employed to see how the system is performing and the method by which the work is being done must be the starting point for any improvement. Managing value is critical, not managing activity.