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# Activity-Based Management for Financial Institutions

Driving Bottom-Line Results

**Brent Bahnub**

Foreword by **Gary Cokins**



# **Activity-Based Management for Financial Institutions**

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# Activity-Based Management for Financial Institutions

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*Driving Bottom Line Results*

**Brent Bahnub**



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*For Jordan, Taylor, and Logan*



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# Foreword

With this book Brent Bahnub has made an important contribution to the body of knowledge of managerial accounting by providing a comprehensive guide to the key aspects of activity-based costing—generating interest and buy-in for it, designing the system, avoiding implementation pitfalls, and applying its information for decision support and analysis to drive bottom line results. This book provides hope for those who recognize the deficiencies of their existing traditional costing methodology and system. It reveals what can now be accomplished by leveraging the progressive power of information technology that was only recently developed and mastered in the 1990s.

Have there been other books written about activity-based costing and management? Of course. I even authored a few. But the majority of material written about activity-based costing (ABC) described outcomes from before ABC software was advanced to the stage to accommodate much more flexible modeling including multi-stage cost assignments, multi-dimensional viewing, and scoring costs with attributes (like value-added versus nonvalue-added), to name a few.

Brent is proof of a hypothesis I have long held—that those who have actually experienced implementing a project or system are far more capable of explaining the concepts than those who simply research it.

## **THE NEED TO REPLACE TRADITIONAL COST MEASUREMENT METHODS**

To provide some background, before flexible modeling with ABC principles became possible, accountants were restricted to the traditional thinking of debits and credits and departmental step-down cost allocations of support departments succeeded by 1980s primitive two-step

cost allocation of work activities. With 1980s ABC thinking, accountants still continued routinely to violate the cause-and-effect principle's relationships (still using broad-brushed cost allocation factor averages, though less broad) that 21st century ABC technology enabled compliance with. Fortunately, that reluctance to adopt ABC has been gradually shifting and those who genuinely care about facilitating better decision making for their organization are embracing it.

Brent's employment in the 1990s with Ernst & Young's management consulting arm and with organizations that applied commercial ABC software gave him the opportunity to work with similarly talented professionals who were all simultaneously observing organizations that could finally discard the yoke of restrictive costing practices and truly model the transformation of resource expense inputs (e.g., salaries, supplies, travel, etc.) into their *calculated* costs, so that the costs realistically represented the economics of the organization. Costing is modeling. It was an experience for Brent similar in exhilaration to what junior architects enjoyed who worked at Frank Lloyd Wright's Talleyson, Wisconsin offices, or young scientists felt working at Thomas Edison's "idea factory." The knowledge of better ways to model costs accelerated as organizations that had purchased ABC software were applying it to their organization's real world problems.

## OVERCOMING THE SPEED BUMPS OF ABC

Along ABC's bright successes in the 1990s, there also came limited results and in some cases failures. And perhaps due to misguided lofty expectations that ABC would be some form of a magic pill that could solve all problems, rumors circulated that ABC was ineffective. People still periodically ask me, "Is ABC still going on?" as if it had passed on as another short-lived management fad. The implication was that either ABC system implementations were scaling down or being abandoned—or that those organizations that had not yet implemented ABC had examined it and chosen likely not to implement it near term.

The problem was not with the principles of ABC, but rather with how it was being implemented and with how its positive impact on improved decision making was not fully appreciated. It will be tough to stop the use of ABC-principled accounting because it correctly

answers eternal questions that managers will forever be asking. What do things cost? Where do we make or lose money? What will be the future impact on spending from possible planned changes?

ABC is indeed alive and well. This book provides evidence of real implementations with real significant results to prove it. Brent's book demonstrates the successful adoption of ABC.

I am honored that Brent invited me to write this Foreword for his book. The past few years I have had the privilege to present seminars all over the world on the broader topic of performance management that includes ABC, strategy maps, and balanced scorecards, and other components. As background, I was fortunate to have gotten involved with the ABC movement as a consultant with KPMG Peat Marwick in the mid-1980s and trained then by Professors Robert S. Kaplan and Robin Cooper of the Harvard Business School. Bob and Robin were pioneers in researching, documenting, and applying ABC.

Once I was exposed to the logic of and superior visibility from ABC, I wondered, "Why doesn't everybody use this practice?" But now that roughly twenty-five years have passed since ABC was formally introduced by Kaplan, I still wonder what accounts for the slower than expected adoption of ABC. In my travels I routinely ask this question of trusted practitioners in this field. The initial explanations include lack of good data or the complexity or inability for software to replicate the ABC principles. But, as I mentioned, those obstacles were resolved in the early 1990s when "end-to-end" integrated commercial ABC software had matured and ABC implementers learned to use quick ABC rapid prototyping with iterative remodeling methods to get quick results with sufficient accuracy. For example, the customers of my employer, SAS, the world's largest provider of business analytics software including an ABC offering, provide testimony that ABC is essential to their performance management and improvement.

A deeper explanation surfaced that the mentality of accountants, who often drive ABC implementation projects, may have done more damage than good for the ABC movement. That is, not only is the accountant's unnecessary concern for precision and exactness (in my experience, accountants do not actually harbor a fixation on precision and exactness for ABC) a hindrance because of the resulting oversized

and overengineered ABC models that retard learning and buy-in, but their concern that their accounting data reconcile with generally accepted accounting principles (GAAP) regulatory reporting may even have been a worse obstacle.

More recently I have heard opinions about ABC's slow adoption rate that support one of the unspoken laws of management: If your senior leadership cannot articulate the basic principles of an improvement initiative, then employees will never achieve or sustain the initiative. And if the leadership is weak, success may be low. I believe this may better explain why the adoption rate of ABC has been so gradual.

But as I attend various business conferences and continue to spend time with organizations that have been using ABC for several years, I am very impressed with the depth of problems it is being used to solve. Brent's book reveals how financial service firms, including banks, have applied ABC to their back-office operations and shared services to validly measure, report, and charge back costs to departments served. The book's lessons apply to all service sector organizations and arguably also to manufacturers and distributors as they increasingly add customer services to their commodity-like products for strategic competitive differentiation.

Perhaps even more important, Brent's book also reveals how organizations are moving beyond measuring product and standard service-line profitability further to measuring customer profitability and value—treating existing and future customers as if an investment in a portfolio—in order for their sales and marketing people to better deploy resources for differentiated customer treatments and segmented marketing campaigns with varying deals and offers in proportion to the value of the customer or sales prospect. Granular ABC data is integral in those calculations.

## **ABC PROVIDES LIGHT AT THE END OF THE TUNNEL**

So does ABC work? Sure it does. But implementers need to be prudent and economical. Any improvement initiative like ABC will always be judged by management based on a cost versus benefits test. If organizations keep the administrative effort to operate ABC low and the benefits from using the data for decision analysis high, then ABC systems

will be adopted and sustained. My sense is that in the next decade or two, ABC will be as widely accepted as standard cost accounting is today.

But some hurdles that must be overcome lie ahead. Brent's book not only sheds light on what the obstacles and implementation pitfalls for ABC are but is also prescriptive on how to resolve them. It is no wonder that managers and employee teams typically do not trust their cost accounting data and continue to wait for the day that they can have visibility and transparency to the hidden costs that comprise their outputs and insights to the external forces and cost drivers that cause their expense structure. Brent's book accelerates that future day to today.

This book inspires organizations to decide to get started (or restart) rather than postpone the inevitable.

Gary Cokins



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# Preface

Over the past fifteen years, I have had the unique experience of seeing Activity-Based Costing/Management (ABC/M) from nearly every perspective. First, as an MBA student at Columbia Business School, I learned the high-level theory of ABC. Of course, at a high level, ABC is extremely straightforward. I wondered why every company in the world had not already moved to ABC. ABC is clearly superior to traditional costing.

Next, as a consultant working for Ernst & Young and subsequently CapGemini, I designed and implemented ABC and chargeback solutions at several Fortune 100 financial services companies. In all cases, the ABC implementations were considered successful and the consulting engagements ended prior to establishing a sustained ABM process and realizing many ABM benefits. Sure, ABM benefits were identified and some were implemented prior to the completion of the consulting engagements, but the ABM benefits never seemed to reach their full potential after we left.

Then I decided to eat my own cooking and leave the consulting world to implement ABC at National City Bank. I was determined not only to implement ABC, but also to realize much greater returns by structuring the ABM portion of the solution. However, prior to the completion of the ABC journey, I was asked to become the Chief Financial Officer for the Operations and Information Services division of National City. The opportunity was too good to let it pass. So, for the next two years, I performed the duties of the divisional CFO and continued to be a vocal advocate of ABC/M within the bank. While there were pockets of multi-million dollar savings, I still felt that we could have done better.

My epiphany occurred at the next leg in the journey. I was requested to identify and lead focused improvement efforts on a

subset of assets within the bank. I was given full rein to design the opportunity identification and governance processes. I defined team member roles and selected my own team. I used the ABM and organizational change management techniques in this book to improve the business by more than \$40 million annually. That was the home run I was craving!

In mid-2008, I transitioned out of ABC/M and process improvement when I became the group manager for commercial deposit products at National City. My ABC/M experience was now complete. I had moved from being the designer and implementer of ABC/M solutions to being the primary customer of ABC/M solutions. As I made the transition, I thought it would be a waste of knowledge not to document the experiences and lessons learned over the past fifteen years.

So, what was the epiphany? It was very simple, actually. ABC without ABM does not matter. The focus needs to shift away from ABC towards ABM. Here is a shocker: There is no such thing as a perfect ABC model and there never will be. If you believe that you can assign individual costs—like everyone’s actual purchase price of their office personal computer—to multiple products across multiple lines of business with 100.0000% accuracy, you are sadly mistaken.

Does it matter that ABC models are not perfect? Of course not. Debates about whether ABC models are “right” or “wrong” are nonsensical. There are not “right” or “wrong” ABC models; there are just more accurate and less accurate ABC models. Across the board, ABC solutions are significantly more accurate than standard costing. Acceptable ABC models are probably more than 80% accurate. Good ABC models are probably more than 90% accurate. Business leaders should be comfortable making decisions on data that is more than 90% accurate.

Instead of saying goodbye to ABC/M forever, my passion for ABC/M was reignited while I wrote this book and I accepted a position driving ABM improvements at First Niagara Bank. Once again, I am excited at the opportunity to drive millions of dollars in value to the shareholders through ABM.

Many books have been written about Activity-Based Costing and Activity-Based Management over the past twenty years. In my

experience, I found Gary Cokins' and Robert Kaplan's books particularly useful.

This book expands on existing ABC/M work in five areas:

1. **More focus on how to drive ABC data to the bottom line using ABM and other organizational change management techniques.** ABC without ABM is a waste of shareholder value. This book is not intended to teach you how to make the best ABC model. It is intended to help you actually drive bottom line results. That does not happen without ABM and strong organizational change management.
2. **Stronger focus on the financial services industry.** Originally, manufacturing undertook and, in some cases, mastered ABC/M. Most financial services firms could still drive millions of dollars of improvements through better use of ABC/M.
3. **More emphasis on shared services.** A major component of financial services is the back office. At times, the shared services organization is the initiator of ABC/M projects as a method to clearly articulate and improve its cost structure. In all cases, the shared services organization was my starting point for ABC/M.
4. **Stronger emphasis on Organizational Change Management (OCM).** OCM is a tremendous enabling discipline for process improvement. Combined with the power of the ABC data, OCM makes driving ABM value a reality.
5. **Templates, tools, and techniques to improve the odds of a successful ABC/M implementation.** Through years of leading ABC/M implementations, I have seen and used what works and what does not. This knowledge, in and of itself, will save you months of headaches and possibly your career. The templates in this book are available on the companion website (see page xix).

This book is intended to be used by people with at least a basic knowledge of ABC/M. The book provides a basic ABC/M refresher in Chapter 1, but does not dwell on introductory generic examples of ABC calculations. Although the examples in the book are primarily

from the financial services industry, it should be particularly useful to any former or current ABC implementer trying to determine why the ABC/M project has not been as financially successful as it should have been. This elusive success requires a renewed focus and commitment to ABM.

While ABC/M can be a dry topic, I have tried to provide some levity throughout the book. My wit can be a bit caustic at times and although my wife frequently advised me to refrain from such comments, some still remain. To those of you easily offended, I apologize in advance. Also, like most people, I have a tendency to write the way I speak, so I apologize in advance to English majors everywhere.

As a lifelong advocate of knowledge sharing, I hope these lessons learned from driving bottom line results and leading ABC/M projects will make your life a bit easier. Best of luck in your endeavors!