



COMPUTERWIRE BUSINESS INTELLIGENCE MARKETWATCH SERIES

# Activity-Based Costing and Performance Management

Activity-Based Costing might have lost ground in the metrics world but that shouldn't diminish its importance in performance management.

Publication Date: April 2006

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## DATAMONITOR VIEW

### CATALYST

In the lexicon of business performance management, activity-based costing, ABC, a budgeting and analysis process that evaluates overhead and operating, is often the Cinderella that doesn't get invited to the ball.

### SUMMARY

- Overview: ABC;
- Vertical & Horizontal Spread;
- Market Dynamics;
- Conclusion

### METHODOLOGY

<b>Method/source</b>	In-depth interviews with industry executives.
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## ANALYSIS

### Overview

In the lexicon of business performance management, activity-based costing, ABC, a budgeting and analysis process that evaluates overhead and operating, is often the Cinderella that doesn't get invited to the ball.

But ABC software is worth a much closer look especially if you want to investigate the impact your activities have on your business plans. Understanding your "ABCs" can give you a better understanding of your company's business processes and underlying expenses.

ABC has traditionally been a niche sector, small in size, but it is growing in importance as evidenced by acquisitions of ABC specialists like ABC Technologies, Activa, and Sapling, and the merging of ABC capabilities into BPM and ERP suites.

ABC is no longer been sold or implemented as a standalone software application. It is becoming a foundation for more strategic, driver-based business measurement and analysis. The trend is for ABC modeling and analysis is to become a part of higher-level performance-focused applications like activity-based budgeting or customer/product profitability analysis.

ABC, also referred to as activity-based management or ABM, is meant to increase the accuracy of cost information by precisely assigning overheads and other indirect costs directly to specific business activities. ABC goes beyond traditional cost allocation. It involves identifying and modeling the complexity of cost drivers and linking them around product, service, or customer-creation activities.

From a business standpoint, ABC software lets managers to see which products or services are profitable or losing money. It does this by capturing the causal relationships that exist between costs and business activities. ABC proponents assert that many companies struggle to get a handle on the true profitability of their product and customer mixes because managers don't really have a clue of what resources (activities) went into producing their goods or winning and maintaining customers. Traditionally, businesses have measured profitability through generalized cost data, typically allocated across products and based on subjective decisions. ABC provides a more accurate and granular cost-mapping that can be traced back to discrete activities, which is useful for determining problems, guiding resource investment, or optimizing business processes.

Importantly, ABC software solutions support a methodological "best-practice" framework. Calculating cost allocations accurately requires a consistent, well-defined methodology to allocate costs and overheads.

But the acronym ABC has kept a low profile in executive circles. Until very recently ABC has been whispered as a back-office tool used almost exclusively by the office of finance. But make no mistake ABC is the de facto engine for profitability analysis in certain industries. Most, if not all, large banking and telecoms firms today are using classic ABC as a standard way of calculating cost and profitability. But they might not necessarily call it that - executives prefer to talk about profitability and scorecarding.

Now ABC's visibility seems to be rising once again - but this time in more mainstream business circles. According to a recent survey by BetterManagement.com, ABC/ABM is flourishing as a methodology for improving BPM results. Of the 520 companies surveyed, 87% said they are either doing ABC today or are seriously considering it to provide a more complete picture than traditional cost accounting.

At a recent Gartner conference, one analyst predicted that profitability modeling and optimization and budget planning enabled by ABC would be one of the top three BPM-focused initiatives for this year and next.

There are several reasons for this resurgence:

- **Economic downturn** - ABC is back in vogue, as companies operating in a depressed economy tend to focus their resources on existing customers, rather than seeking out new ones. ABC helps them to separate the profitable ones from the loss-making ones and also to figure out ways to raise profits without having to drastically raise prices of products and services.
- **Driver-based budgeting** - Traditional Excel-driven budgeting and planning, based largely on gut feel is now under attack for its lack of business-driven focus. ABC is now seen as a subset of driver-based budgeting, rather than a distinct software application.
- **Customer intelligence and valuation** - Customer-centric sectors like banking and telecoms increasingly realize that that growing their top-line (i.e. organically) also means growing their customer base or ensuring that their customers stay loyal. ABC helps by allowing companies to better understand the value their customers bring to your bottom-line.

## *Vertical & Horizontal Spread*

ABC started in the manufacturing sector in 1980s mainly to drive process improvement. But it's now used widely across many industries including financial services, retail, consumer packaged goods, and government agencies.

Industry-specific ABC solutions are rare, but starting to emerge in traditional ABC strongholds such as telecoms, manufacturing, and banking.

There are about a dozen or so specialist independent ABC software vendors left in the market. These include: ALG Software, Acorn Systems, Decimal Technologies, ICMS, Lead Software, Prodacapo, and Mavatec (now part of BAE Systems).

These ABC specialists - notably ALG and Acorn Systems - are now starting to position themselves more in the BPM space. The specialists target only a sub-set of the overall financial analysis market - they don't provide broader BPM capabilities like financial consolidation or statutory reporting. This is where the partnerships with BPM companies will come into play.

## *Market Dynamics*

ABC as a standalone application remains a substantial subset of the market and is still big enough to sustain growth - but only in the near term. The top three or four ABC providers - SAS, Oracle, ALG, and Acorn - command about 60% share of the ABC market today.

However, the days of small, independent ABC specialists look numbered as companies recognize ABC as part of a much broader performance management solution. Specialist ABC applications are restricted to companies looking for a best-of-breed solution.

Vendors like ALG and Acorn will increasingly find themselves squeezed by larger ERP and BPM vendors that are keen to bump up their solutions with costing. This means that ABC software vendors are being pressured to improve or change their products in order to retain market share.

Moreover, organizations today are demanding a solution that spans across the entire enterprise to handle all products, customers, distribution channels, as well as cost centers and activities. That capability is way beyond today's niche ABM vendors.

ABC analysis is becoming one piece of a larger BPM system. This means that ABC results must be easily portable to BPM applications and/or the ABC software must have many BPM features embedded within the core software. For many ABC specialists the latter will be a huge challenge. Hence the ability to seamlessly integrate the ABC results with large-scale enterprise BPM or ERP frameworks is the key to survival for smaller ABC software companies.

Consolidation is also on the cards, with niche vendors like ALG and Acorn ripe for acquisition by larger enterprise and BI software vendors. The value of ABC is unlocked when it's linked to BI and analysis tools, pointing to these vendors as potential acquirers. Cognos's recent alliance with Acorn could perhaps signal an acquisition down the road. Cognos clearly has to borrow ABC capabilities from Acorn to bump up the costing capabilities of its CPM suite.

## CONCLUSION

ABC is moving from a standalone application to a foundation for strategic business measurement and analysis. The trend is for ABC models to become a key building block for higher-level BPM applications, such as activity-based budgeting or customer/product profitability. These performance measures rely heavily on ABC cost, driver-quantity, cycle time, and profitability results coming out of an ABC model. ABC software is definitely worth investigating if you are interested in the synergy that exists between planning and activities.

After a slow start, ABC has now attracted interest from the likes of Oracle, SAP, Hyperion, and SAS. It will be very difficult for smaller ABC specialists to compete with these giants, even if their solutions are functionally richer. Vendors that continue to persist in selling small-scale ABC applications will not survive for much longer. For the remaining ABC software independents this means adapt, integrate, or simply die. They must decide whether to compete with the new competitors, affiliate with them, or withdraw from the competitive market and find a new niche.