Implementing ABC/ABM
Slow, but Steady…
While Driving Value Along the Way

Luv Lessons Learned

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Background

In a traditional, volume-based product-costing (VBC) system, only a single predetermined overhead rate is used. All manufacturing-overhead costs are combined into one cost pool, and they are applied to products on the basis of a single cost driver that is closely related to production volume. The most frequently used cost drivers in traditional product-costing systems are direct-labor hours, direct-labor dollars, machine hours, and units of production.

A common problem with traditional, volume-based product-costing systems is that high-volume product lines are overcosted and the low-volume product line are undercosted. High-volume products essentially subsidize low-volume lines. Traditional product-costing systems fails to show that low-volume products are driving more than their share of overhead costs. As a result of these misleading costs, company managers may misprice products (Hilton 2002).

Activity-based costing (ABC) differs from VBC by focusing attention on activities and resources used. ABC systems, which focus on batch-level, product-sustaining, and facility-sustaining costs, provide a higher level of cost-driver information when compared to traditional volume-based costing systems that typically provide only volume-related cost drivers. A cost driver is a characteristic of an event or activity that results in the incurrence of costs by that event or activity (Drake et al. 1999).

Due to the number of important initiatives competing for resources at Southwest Airlines, no full-scale implementation of ABC/ABM has yet been proposed. Rather, some of the benefits of such an implementation have been "cherry-picked" over the past few years.

Why Slow, But Steady?

With the U.S. economy's downturn that began in 2001, punctuated by the tragedy of September 11, 2001, Southwest, like airlines throughout the U.S. and around the world shifted from a growth strategy to a cash conservation strategy.

Administrative hiring was immediately frozen and has remained so.

So, we had choices….

Is it better to continue our ABC/M efforts at the current pace OR to commit a bright, energetic accountant/analyst to hedging aircraft fuel costs?

Is it better to continue our ABC/M efforts at the current pace OR to commit a resource to developing new gameplans for negotiating local fueling arrangements?

Is it better--at a time when other airlines, your competitors--are breaking their labor agreements, extracting dramatic wage rate cuts and other employee benefit givebacks--to commit resources to working closely with company and union Leaders and other Employees to drive out costly waste from work rules that no longer make sense for Employees or Shareholders?

Model and Learn from Subsegments (divisions, departments, etc.)

Before determining to undertake the development of an enterprisewide activity-based costing model, we chose to model subsegments of our business:

Frequent Flyer Program (initially The Company Club and now, Rapid Rewards) (1996)

Understanding activities necessary to support Rapid Rewards, Southwest's frequent flyer/Customer rewards program--widely-recognized as the most successful, simple, easy-to-use, and generous frequent-flyer program

Customer Relations

Cargo (1997)

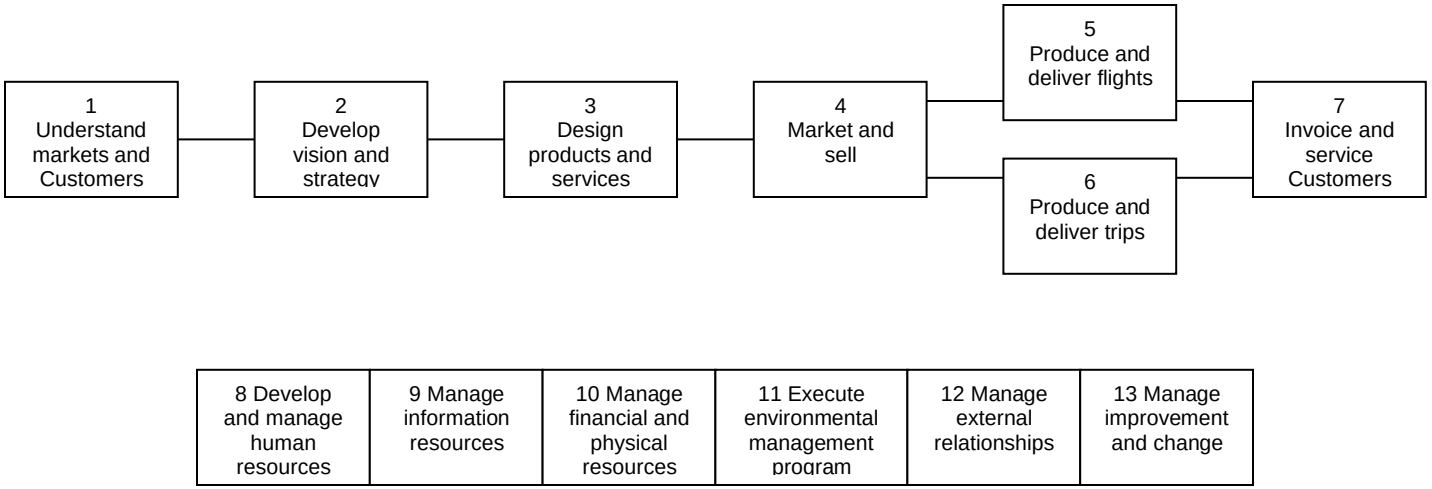
A relatively small, but important contributor to Southwest's profits. Presented us with two interesting capacity-costing questions--aircraft and bag handlers.

Develop and Communicate a Comprehensive, but not necessarily complete Framework Early

Arthur Andersen & Co. framework developed for Southwest's aircraft maintenance, repair, & overhaul function

And use it for organizing materials collected along the way
So much of what we learn is identified and developed while researching related things

We've adopted the American Productivity and Quality Center's (APQC's) International Benchmarking Clearinghouse:



Cost Pool Trend Totals Hold Valuable Information Themselves

The key objects of an ABC system hold valuable information, separately, as well as within the system. Harvest useful information from these key components:

- Overall process map and crossfunctional process maps with context diagrams (emphasizing the "critical few" strategically critical processes
- Resource Cost pools
- Resource-to-Activity Maps (starting at resources and identifying them with the activities that require them)

Resource-to-Activity Maps Hold Valuable Information, Too

Between-station comparisons--straightforward comparisons intended to identify exceptions for further review

Work content-based view of airport operations efficiency

We have six major labor classifications at airports, Customer Service, Operations, and Ramp--Agents and Supervisors. Customer Service sells you tickets, checks you in, accepts your bags, provides you documents needed to get through security checkpoints, and helps you to be ready to board. Operations meets flights coming in, helps Customers deplaning and boarding, while coordinating with Flight Attendants, Pilots, Aircraft Provisioners and Fuelers, Customer Service, Ramp (bag and cargo handling) and, of course, Customers. Ramp handles bags and cargo off and on flights as well as some of the aircraft servicing between flights.

In the past, we've studied and compared labor efficiency using workers-per-aircraft, workers-per-departing flight, etc.

By combining resource pool data and resource-to-activity maps with aircraft activity counts we developed a new metric for station worker efficiency--one based on work performed rather than work per unit-of-results (aircraft flight departures). With this new approach, we have been able to demonstrate the effects of technology insertions and enhancements on station workload and to see the relation between station worker resource quantity, workload, and idle time. (Note that human physiological recovery time following strenuous effort isn't "idle" time.)

Over a five year period, we identified, airport-by-airport, where technology and process changes had and had not resulted in reduced resource usage and lower total costs. This was not evident using conventional input-output measures.

Illustrative Example: Administrative Costs in Southwest's "Operating Departments"

Before the tragic events of September 11, 2001, Southwest began to notice a slowing in the U.S. economy and a reduction in the strength of demand for domestic air travel

Our Planning Department, under the Leadership of Mike Van de Ven and Gary Kelly made plans to rein in discretionary spending.

One of the targets considered was administrative costs within our "Operating Departments".

Without ABC information we would have had just general ledger data for our use. This would have provided us with the ability to select departments to consider and with objective cost elements categories: salaries for administrative assistants and clerical support

[see Case #2]

Epilogue: What are we missing?

Drake, Haka and Ravenscroft (1999, 324) provided empirical evidence that innovative activity can produce a higher or lower level of firm profit when workers have ABC information. The direction of the effect on profitability depends upon whether the incentive structure complements the cost system. It is not clear that we have a complementary performance/incentive structure to our ABC costing.

References

Drake, Andrea R., Haka, Susan F., and Sue P. Ravenscroft. 1999. "Cost System and Incentive Structure Effects on Innovation, Efficiency and Profitability in Teams." *The Accounting Review*. 74:323-345.

Global Best Practices. 2005. *Process Classification Framework*. World Wide Web: http://www.globalbestpractices.com/Home/ProcessFrameworks.aspx?Link=Process+frameworks/Process+classification+framework. Retrieved January 11, 2005. [This describes the framework devised in 1992 by Global Best Practices and other members of the APQC's International Benchmarking Clearinghouse.]

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