
You'd Better Know Your "ABC's"

Process Mapping and Activity Based Costing

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The Problem

Conventional wisdom is that at least 20 per cent of cost must be driven from health care products and services. This requires a new way of doing business. Distributors and manufacturers are challenged to make the best cost cutting decisions; bad ones may be fatal to the organization. Two management approaches will help, and you'll hear a lot more about them in coming months. They are *process mapping* and *activity based costing* -- "ABC" for short.

Many core processes used by distributors and manufacturers for supplying customers have evolved without critical examination. These processes are insidious legacies of cost-plus days. Unnoticed, bottlenecks and unnecessary steps have crept in, raising costs and lengthening the time to fill orders.

Methods of cost accounting, having evolved from the manufacturing industry practices of the 1920's, are useless in diagnosing problems and making management decisions. The reason: accounting systems don't link costs with the activities that produce them. For example, most companies budget by department. But customers pay for products that pass through several departments, and the actual costs of producing, distributing, and selling those products is lost.

For distributors, core activities include purchasing, transporting, storing, and selling the product. Numbers produced by accounting systems don't reflect differences in the cost of products delivered to different groups customers. The result is that the company overprices its products in one market and under prices in others. As competition mounts, the overpriced customers are "cherry-picked" by competitors while the company is stuck with money losers.

What To Do About It

Process mapping charts the "as-is" process across departments. It's the first step in improving the process and assigning activity based costs. A cross-department team is best for the mapping job. The team agrees on how the process *actually* works, as contrasted with how the team *thinks* it works. Involvement of suppliers and customers on the mapping team improves chances for success.

The most common form lists the process activities along the horizontal axis of the map. The map's vertical axis lists the departments or other functions performing the steps. Often the map reveals a convoluted process path filled with wasteful steps from start to finish.

While the map shows "how" things are done, the mapping team must add "how well." This evaluation points to competitive deficiencies where fixes are mandatory or to exploitable opportunities where the company is superior. It is critical that the *how well* incorporate the mapping team's understanding of what different customers want and are willing to pay for.

The mappers can now assign activity costs to the process steps. To do this, the mapping team should know the resources in employee time, materials, and other support needed for any activity. Estimates are okay and are certainly better than doing nothing or analysis by paralysis. Being approximately right is better than being absolutely wrong.

The Benefits

Putting activity costs to work will make the difficult job of change a little easier. Examples of the management tasks that will benefit are:

- Improving cost and service. Activity costs point out high cost steps. The “how well” assessment shows where customer service is weak.
- Understanding profit. ABC shows which products and customers make money for the company. Of course, this can and should be linked to price sheets and rep commissions.
- Budgeting and capitation. Budgets have to fit what customers will pay. Capitation models will set product prices for most health care goods and services, including medical supplies. ABC will show how far you are from "market" levels.
- Adding services. Upstream and downstream activities are candidates for new services, like opening a hospital supply room. ABC can help your customer evaluate the benefits of your service.
- Outsourcing. Likewise, mappers may find an internal activity could be better done outside. ABC enables the cost comparison.
- Menu pricing. Activity costs will help sharpen the pricing pencil. They are also essential to crafting menus of optional services.
- Reorganization. Mapping and activity costs can help divide the business into focused divisions specializing in specific markets. Each division will have a cost and operating structure appropriate for its customer segment.
- Investments in facilities and information systems. Good data will show the payoffs from investments.
- Assimilating acquisitions. Use the techniques in rationalizing multiple operations. If there are two or more ways of doing the same task, use ABC to find the best.

Decisions like these will come fast and furious. Managers need all the tools they can lay their hands on. Process mapping and activity based costing are in added advantage in making decisions faster, better, and with less risk of failure.

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