A REVIEW ON - ACTIVITY BASED COSTING (ABC), AS MANAGEMENT TOOL

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ABSTRACT
In most of the time the organizations and managers are interested in and worried for the costs. In this era of intense competition on price and quality, attention is shifting from standardization to customization of products and services. The traditional costing method has become obsolete because various costs especially overheads are incorrectly allocated to products or services. The goal of any cost system is to provide relevant and timely information to management. This information supports better management of corporate resources in production of products or provision of services, and improves competitiveness in terms of costs, quality and profitability. Amidst the changes, which the business world has witnessed during last few decades, traditional cost accounting systems have been found to be faltering. The criticism basically revolves around overhead allocation techniques used in traditional cost systems, thus Activity-Based Costing (ABC) is an alternative to the traditional way of accounting. The study covers a review of the concept and applicability of Activity Based Costing (ABC) and also examines its effectiveness in cost and output management.

Keywords: Activity Based Costing, Standardization, Customization. Overheads

INTRODUCTION
Activity Based Costing (ABC) is a system for assigning costs to products based on the activities they require. In this case, activities are those regular actions performed inside a company. Organizations may be moved to adopt ABC by a need to improve costing accuracy and to understand better the true costs and profitability of individual products, services, or initiatives. ABC gets closer to true costs in these areas by turning many costs that standard cost accounting views as indirect costs essentially into direct costs. By contrast, standard cost accounting typically determines so-called indirect and overhead costs simply as a percentage of certain direct costs, which may or may not reflect actual resource usage for individual items.

Under ABC, accountants assign 100% of each employee's time to the different activities performed inside a company. The accountant then can determine the total cost spent on each activity by summing up the percentage of each worker's salary spent on that activity. A company can use the resulting activity cost data to determine where to focus their operational improvements. Senior management can now decide how much focus or money to budget for resolving this process deficiency. Activity Based Management includes the use of Activity Based Costing to manage a business. Though the process of ABC is tedious, costly and subject to errors, it may be able to pinpoint the cost of each activity and resources into the ultimate product.

As it is a tool for a more accurate way of allocating fixed costs into product, these fixed costs do not vary according to each month's production volume. ABC identifies product costing in the long run, but may not be too helpful in day-to-day decision-making.
THE LITERATURE

In the 1980s, the renowned American management accounting scholars Cooper, Turney, Sharman et al. began advocating the merit of the ABC system. These scholars understood that the traditional cost system was unable to cope with changes in the industry environment, progress of corporate R&D and production technology, and changes in customers’ demand for products. Under the premise that the cost system must provide the correct information, the “ABC system” developed from practical case study is a more accurate tool for helping enterprises calculate the product costs (Cooper and Kaplan, 1988). The ABC system has a considerable number of examples in the academic or practice. There are also many domestic enterprises prepared to use this new system, thus improving the traditional cost system.

ABC system is a costing principle that relies on activities that have a cause – and – effect relationship with cost as a basis for allocating such cost to cost objects which jointly cause the cost (Dabor and Eragbhe, 2005). ABC provides management with a valuable new tool to assist in determining and allocating product costs more realistically. It also provides the means by which to isolate and account for costs in relation to the activities associated with those costs (Lowder, 2006). It is very critical we understand that ABC is not a quality improvement program like process reengineering, or statistical process control. This distinction is important so that we do not classify ABC as a fad or fashion (Cokins, 2002).

THE CONCEPT OF “ABC” SYSTEM

The “Activity Based Costing” (ABC) system refers to the accounting system for the calculation of the costs. Activity is used to conduct the production of products or render services as the center for the cost collection. The costs are attributed to each Activity, and then through Activity, the costs are attributed to the products or services. The ABC system emphasizes the “Activity” and uses the cost of these activities as the basis to assign costs to other cost objects (such as: products, services or customers). The ABC system can be traced back to the consideration of the structure standards-based “indirect cost” for the manufacturing processes. Many “indirect costs” are derived from the batch, production volume, and equipment. The ABC system can accurately estimate, especially in the enterprise for the provision of the individual, the Activity costs and resources cost aspect of the products.

Under ABC, product costs are not strictly isolated to manufacturing costs and are expanded to include non-manufacturing costs such as selling, marketing, distribution, and administrative that can be directly traced to the product through activities (Garrison et al, 2006). ABC charges products for the cost of capacity they actually use and not for idle capacity like the absorption method. In addition, ABC does not allow costs shifting of batch-level or unit-level costs from products produced in smaller volumes to products produced in larger volumes. These distinctions represented a tremendous improvement over the “lump-sum” allocation method used under the absorption costing methodology where there exists a strict application of manufacturing costs to product costs. However, the true worth of ABC from a managerial perspective is its ability to assign activity costs to cost objects. This enabling characteristic allows management accountants to reassign activity costs across business processes and identify relationships more accurately in decision-making processes. Identifying and allocating costs based upon an activity rate assist in making many types of decisions spanning across functional areas that involve not only products, but also distribution and customer related decisions (Compton, 1996; Gabram, 1997; Cokins, 2002; Friedl, 2005; Hoshower, 1996 in Lowder (2006).

THE ACTIVITY BASED COSTING PROCESS FLOW

Activity Based Costing is best explained by walking through its various steps. They are:

1. Identify costs: - The first step in ABC is to identify those costs that we want to allocate. This is the most critical step in the entire process, since we do not want to waste time with an excessively broad project scope. For example, if we want to determine the full cost of a
distribution channel, we will identify advertising and warehousing costs related to that channel, but will ignore research costs, since they are related to products, not channels.

2. Load secondary cost pools: - Create cost pools for those costs incurred to provide services to other parts of the company, rather than directly supporting a company’s products or services. The contents of secondary cost pools typically include computer services and administrative salaries, and similar costs. These costs are later allocated to other cost pools that more directly relate to products and services. There may be several of these secondary cost pools, depending upon the nature of the costs and how they will be allocated.

3. Load primary cost pools: - Create a set of cost pools for those costs more closely aligned with the production of goods or services. It is very common to have separate cost pools for each product line, since costs tend to occur at this level. Such costs can include research and development, advertising, procurement, and distribution. Similarly, you might consider creating cost pools for each distribution channel, or for each facility. If production batches are of greatly varying lengths, then consider creating cost pools at the batch level, so that you can adequately assign costs based on batch size.

4. Measure activity drivers: - Use a data collection system to collect information about the activity drivers that are used to allocate the costs in secondary cost pools to primary cost pools, as well as to allocate the costs in primary cost pools to cost objects. It can be expensive to accumulate activity driver information, so use activity drivers for which information is already being collected, where possible.

5. Allocate costs in secondary pools to primary pools: - Use activity drivers to apportion the costs in the secondary cost pools to the primary cost pools.

6. Charge costs to cost objects: - Use an activity driver to allocate the contents of each primary cost pool to cost objects. There will be a separate activity driver for each cost pool. To allocate the costs, divide the total cost in each cost pool by the total amount of activity in the activity driver, to establish the cost per unit of activity. Then allocate the cost per unit to the cost objects, based on their use of the activity driver.

7. Formulate reports: - Convert the results of the ABC system into reports for management consumption. For example, if the system was originally designed to accumulate overhead information by geographical sales region, then report on revenues earned in each region, all direct costs, and the overhead derived from the ABC system. This gives management a full cost view of the results generated by each region.

8. Act on the information: - The most common management reaction to an ABC report is to reduce the quantity of activity drivers used by each cost object. Doing so should reduce the amount of overhead cost being used.

We have now arrived at a complete ABC allocation of overhead costs to those cost objects that deserve to be charged with overhead costs. By doing so, managers can see which activity drivers need to be reduced in order to shrink a corresponding amount of overhead cost.

USES OF ACTIVITY BASED COSTING

The fundamental advantage of using an ABC system is to more precisely determine how overhead is used. Once you have an ABC system, you can obtain better information about the following issues:

1. Activity costs: - ABC is designed to track the cost of activities, so you can use it to see if activity costs are in line with industry standards. If not, ABC is an excellent feedback tool for measuring the ongoing cost of specific services as management focuses on cost reduction.

2. Customer profitability: - Though most of the costs incurred for individual customers are simply product costs, there is also an overhead component, such as unusually high customer
service levels, product return handling, and cooperative marketing agreements. An ABC system can sort through these additional overhead costs and help you determine which customers are actually earning you a reasonable profit. This analysis may result in some unprofitable customers being turned away, or more emphasis being placed on those customers who are earning the company its largest profits.

3. Distribution cost: - The typical company uses a variety of distribution channels to sell its products, such as retail, Internet, distributors, and mail order catalogs. Most of the structural cost of maintaining a distribution channel is overhead, so if you can make a reasonable determination of which distribution channels are using overhead, you can make decisions to alter how distribution channels are used, or even to drop unprofitable channels.

4. Make or buy: - ABC provides a comprehensive view of every cost associated with the in-house manufacture of a product, so that you can see precisely which costs will be eliminated if an item is outsourced, versus which costs will remain.

5. Margins: - With proper overhead allocation from an ABC system, you can determine the margins of various products, product lines, and entire subsidiaries. This can be quite useful for determining where to position company resources to earn the largest margins.

6. Minimum price: - Product pricing is really based on the price that the market will bear, but the marketing manager should know what the cost of the product is, in order to avoid selling a product that will lose a company money on every sale. ABC is very good for determining which overhead costs should be included in this minimum cost, depending upon the circumstances under which products are being sold.

7. Production facility cost: - It is usually quite easy to segregate overhead costs at the plant-wide level, so you can compare the costs of production between different facilities.

Clearly, there are many valuable uses for the information provided by an ABC system. However, this information will only be available if you design the system to provide the specific set of data needed for each decision. If you install a generic ABC system and then use it for the above decisions, you may find that it does not provide the information that you need. Ultimately, the design of the system is determined by a cost-benefit analysis of which decisions you want it to assist with, and whether the cost of the system is worth the benefit of the resulting information.

PROBLEMS WITH ACTIVITY BASED COSTING

Many companies initiate ABC projects with the best of intentions, only to see a very high proportion of the projects either fail, or eventually lapse into disuse. There are several reasons for these issues, which are:

1. Cost pool volume: - The advantage of an ABC system is the high quality of information that it produces, but this comes at the cost of using a large number of cost pools and the more cost pools there are, the greater the cost of managing the system. To reduce this cost, run an ongoing analysis of the cost to maintain each cost pool, in comparison to the utility of the resulting information. Doing so should keep the number of cost pools down to manageable proportions.

2. Installation time: - ABC systems are notoriously difficult to install, with multi-year installations being the norm when a company attempts to install it across all product lines and facilities. For such comprehensive installations, it is difficult to maintain a high level of management and budgetary support as the months roll by without installation being completed. Success rates are much higher for smaller, more targeted ABC installations.

3. Multi-department data sources: - An ABC system may require data input from multiple departments, and each of those departments may have greater priorities than the ABC system. Thus, the larger the number of departments involved in the system, the greater the risk that
data inputs will fail over time. This problem can be avoided by designing the system to only need information from the most supportive managers.

4. Project basis: - Many ABC projects are authorized on a project basis, so that information is only collected once; the information is useful for a company’s current operational situation, and it gradually declines in usefulness as the operational structure changes over time. Management may not authorize funding for additional ABC projects later on, so ABC tends to be “done” once and then discarded. To mitigate this issue, build as much of the ABC data collection structure into the existing accounting system, so that the cost of these projects is reduced; at a lower cost, it is more likely that additional ABC projects will be authorized in the future.

5. Reporting of unused time: - When a company asks its employees to report on the time spent on various activities, they have a strong tendency to make sure that the reported amounts equal 100% of their time. However, there is a large amount of slack time in anyone’s work day that may involve breaks, administrative meetings, playing games on the Internet, and so forth. Employees usually mask these activities by apportioning more time to other activities. These inflated numbers represent misallocations of costs in the ABC system, sometimes by quite substantial amounts.

6. Separate data set: - An ABC system rarely can be constructed to pull all of the information it needs directly from the general ledger. Instead, it requires a separate database that pulls in information from several sources, only one of which is existing general ledger accounts. It can be quite difficult to maintain this extra database, since it calls for significant extra staff time for which there may not be an adequate budget. The best work-around is to design the system to require the minimum amount of additional information other than that which is already available in the general ledger.

7. Targeted usage: - The benefits of ABC are most apparent when cost accounting information is difficult to discern, due to the presence of multiple product lines, machines being used for the production of many products, numerous machine setups, and so forth – in other words, in complex production environments. If a company does not operate in such an environment, then it may spend a great deal of money on an ABC installation, only to find that the resulting information is not overly valuable.

CONCLUSION

Competition demands that companies continually improve and innovate. New products and service must be developed to replace those that become obsolete. New processes must continually be developed to make production more efficient. But companies globally are realizing that product and service mix was wrongly priced because of the traditional accounting systems.

With these problems, Activity Based Costing offer planning and behavioural considerations that help make significant improvement over the traditional approaches. ABC has emerged as a tremendously useful guide to management action that can translate directly into higher profit. Activity Based Costing can help companies in answering the market needs of better quality products at competitive prices. Ascertaining the product profitability and customer profitability, this method can contribute effectively in top management's decision-making process. With ABC, enterprises can improve their efficiency and reduce the cost without sacrificing the value for the customer. The decision to install such a sophisticated cost system calls for firm-level suitability analysis taking into consideration the efficacy of existing cost system and proclivity for managerial action. In the time of change, which is inevitable in a business, it is imperative that the management decision makers must have an accurate, relevant, flexible, and comprehensive cost accounting system to aid them in their decision making processes. With ABC to its benefit, any enterprise will have a built in competitive cost advantage and can continuously add value to its stakeholders.
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