Impact of Activity Based Costing Technique and Abcm on Various Managerial Decisions (A Conceptual Study)

Ms. Sanjana *
Mr. Tushar Jindal**

*Assistant Professor, Department of Financial Studies, Shaheed Rajguru College of Applied Sciences for Women, University Of Delhi

** Assistant Professor, RICS SBE Amity University, Noida UP

ABSTRACT

Through this study, the objective is to study the effect of implementation of Activity Based Costing (ABC) and the information generated on various types of decisions made by managers. ABC system of costing, when implemented, gives visible benefits for any firm. First, for implementation, all the components of cost are thoroughly studied, that generally are not done when we follow traditional method of costing and we distribute certain overheads for cost calculations on absorption or apportionment basis. Secondly, the complete process is scrutinised in detail and analysis is done to check the efficiency against the predefined benchmarks. Use of information based on ABC can increase the efficiency, closing down of unprofitable segments and to utilise the available resources in more profitable operations, which ultimately leads in cost reduction and increase in revenue and in turn, better financial performance. However, initially the implementation of ABC technique for estimation of cost may involve a lot many challenges. An ABC analysis may not be popularised because of two key reasons. First, it may not reveal every time any new information to the management that it already know before the ABC analysis, and secondly, it may require the hiring of outside specialists/consultants for implementation and also the change in organisational structure which some time is resisted by the management, as management may not be willing to work on recommendations of an outsider’s data and analysis which may significantly be different from the earlier adopted traditional costing techniques. However, ABC system can be a more accurate way of costing and can go a long way in managing pricing, profit and revenue, taking decision relating to product mix etc. in both manufacturing and service sector.

Key words: Activity Based Costing, Supply Chain Management, Profit management

1. LITERATURE REVIEW

The ABC method was designed in the United-States during the 80’s (Cooper and Kaplan, 1988). Johnson and Kaplan suggested that for implementation of ABC technique, a manager need to do two things. First, to analyse more deeply the organization activities and processes and second, to link together the strategic and the operational management. These proposals
announce the development of the Balanced Scorecard (Kaplan and Norton, 1996) and of a strategically oriented ABC.

Robin Cooper and Robert S. Kaplan (Measure Costs Right: Make the Right Decisions, HARVARD BUSINESS REVIEW, September-October 1988) have explained that Activity Based Costing is not an automatic decision taker. It has been designed to assist the management in better decision taking by providing more accurate information about all the activities of production and related support activities and also the cost components so that management can pay more attentions on the activities that can lead to better utilisation of available resources and increase in profit. By implementing Activity Based Costing, it has been observed that it helps the management to take better decisions regarding their product design, product mix and continuously improving the operational aspects.

Shank & Govindarajan (1989) have developed an operational model with the definition of key success factors, determined in using a competitive analysis of the environment and an analysis of the internal processes of the company, with the help of the ABC method. It is integrated in a SMA (Strategic Management Accounting) system with Life-Cycle and Value Chain analyses processes. So the ABC applications clearly belong to the SMA stream.

Robin Cooper and Robert S. Kaplan (Profit Priorities from Activity-Based Costing, HARVARD BUSINESS REVIEW May-June 1991) also suggest that managers can increase profits by simultaneously boosting revenues and reducing spending on resources. The point is that management must take some action to capture the benefits from the signals ABC analysis sends. Activity-based cost management systems provide companies with management information and not just the traditional accounting information. ABC reveals often unexpected peaks of profitability and craters of losses in a company's operations. But managers should not use the information naively to close plants, drop customers, or eliminate products. They should use it as a guide to revise the prices of their products or to change customer transactions, to alter product and customer mix, or to perform activities more efficiently.

Lebas (1999) explains that ABC implies taking into account the value that the customers attribute to the products. This is a principle of the Target Costing method and it has a strong impact on the firm’s costs analytic structure.

Gregory Wegmann (Developments around the Activity-based Costing Method: A State-of-the Art Literature Review): In this study, the authors have analysed several ABC applications. In their meaning, these developments reveal the research of multidimensional accounting systems. Today, managers want specific applications with a high degree of
modularity: a process costing system for a standard production, combined with a customer-driven ABC and a time-driven ABC for very complex activities and practically it is quite possible by using modern soft wares.

V.G. Narayanan Ratna G. Sarkar (The Impact of Activity Based Costing on Managerial Decisions at Insteel Industries - A Field Study, Harvard Business School, 1999) have concluded that managers might have some understanding of the diversity across products in allocation of overheads but they probably did not have complete understanding of ABC cost intuitively before the ABC study was done. Their study has also supported the hypothesis that management has changed their decision with ABC analysis after their interviews with the managers and their statistical analysis, rationalising the product portfolio and better pricing decisions.

Robert S. Kaplan and Steven R. Anderson (Time-Driven Activity-Based Costing, November 2003): According to these authors, over the past 15 years, activity-based costing has enabled managers to see that not all revenue is good revenue, and not all customers are profitable customers. Unfortunately, the difficulties of implementing and maintaining traditional ABC systems have prevented activity-based cost systems from being an effective, timely, and up-to-date management tool. The time-driven ABC approach has overcome these difficulties. It offers managers a methodology that has several positive features like easy and fast implementation, simple integration with already installed ERP and CRM systems, inexpensive maintenance, more visibility to capability utilizations etc.

Manoj Anand, B. S. Sahay & Subhashish Saha, 2005 (Activity-Based Cost Management Practices in India: An Empirical Study) : Their survey shows an encouraging response of the Indian corporate sector to activity based costing with 49% (n = 26) of the respondents adopting it. The firms are successful in capturing accurate cost and profit information from their ABC cost systems for their value chain and supply chain analysis vis-à-vis non-ABC user firms. The need for activity-wise cost information in budgeting, product pricing decision and customer profitability analysis has urged the management of the Indian firms to adopt Activity Based Costing systems. No significant difference has been found in the motivation to adopt ABCM across the manufacturing as well as service sector and across the stages of activity-based cost system adoption (supplementary/offline). This implies that activity-based costing has equal opportunities in both the sectors and the motivations are uniform over the stages of adoption.

Kuchta and Troska (2007) explain that the ABC is a good method for profiling customer profitability. They believe that a Customer-driven ABC that can help in determining which
products and customers are the most profitable, which activities are customer-focused, whether processes are customer value-added or not, and where efforts toward customer-related improvements should be made.

Nitin Kumar & Dal gobind Mahto (2013) Activity-Based Management methods have a broad range of uses, permitting the empowering utilization of ABC information for a wide variety of company functions and operations such as process analysis, strategy support and time-based accounting, monitoring wastage, as well as quality and productivity management. ABC provides information for strategic decisions, such as product mix and sourcing decisions that is consistent with the long-run nature of these decisions. ABC allows product designers to understand the impact of different designs on cost and flexibility and modify their designs accordingly.

Mahal abd–check Hussain (2015) have concluded that Activity-based costing has already come up as a new generation concept in trade and commerce. It has changed the traditional view of cost and management accounting. It measures cost more accurately than other volume based cost system. As more accurate overhead cost allocations lead to fewer distortions, it acts as a performance evaluation tool. The system introduced some burning issues like ABM, balance score card, benchmarking, TQM as performance evaluation tool. By using segment reporting and relevant costing in conjunction with ABC system, unprofitable product line or department can be dropped.

2. OBJECTIVES

There are lot many teaching cases and studies to show the effect of implementation of ABC technique on managerial decisions. The aim of this study is to find the effect of applying activity based costing technique while taking various decisions for increasing the productivity and efficiency. This study particularly aims to study the effect of ABCM on the decisions like:

- Does Activity Based Costing provide accurate and complete information regarding various aspects of cost?
- Does ABC system of costing provide better technique to take pricing decisions?
- Is there any difference between management motivation in using ABCM from different sectors like production industry or service industry?
- Does management really give consideration to the results of ABC technique in their decision making process related to Product Mix and Market Mix?
Does implementation of ABC technique have any effect on ROI, Profits and Revenue?

3. METHODOLOGY
In this study, literature review has been done on relevant studies and articles related to Activity based Costing and Activity base Costing Management. Referred studies and source papers include reports, empirical research papers, scholar articles from various published and unpublished sources. Since the available literature related to Activity Based Costing Management is quite vast and voluminous, in this study, several conclusions and decisions taken using the ABC technique have been considered to relate this particular study objectives.

4. DISCUSSION AND FINDINGS
Activity-based costing is not designed to trigger automatic decisions. It is designed to provide more accurate information about production and support activities and product costs so that management can focus its attention on the products and processes with the most leverage for increasing profits. It helps managers make better decisions about product design, pricing, marketing, and mix, and encourages continual operating improvements.

Activity-based costing can change how managers evaluate new process technologies. Streamlining the manufacturing process to reduce setup times, rationalizing plant layout to lower material handling costs, and improving quality to reduce postproduction inspections can all have major impacts on product costs—impacts that become visible on a product-by-product basis with activity-based costing. A more accurate understanding of the costs of specialized products may also make computer-integrated manufacturing (CIM) look more attractive, since CIM is most efficient in high-variety, low-volume environments.

Many managers understand intuitively that their accounting systems distort product costs, so they make informal adjustments to compensate. But few can predict the magnitude and impact of the adjustments they should be making.

Consider the experience of a leading manufacturer of hydraulic valves whose product line included thousands of items. About 20% of the valves generated 80% of total revenues, a typical ratio for multiproduct organizations. Of even greater interest, 60% of the products generated 99% of the revenues. Nonetheless, management remained enthusiastic about the 40% of its products that generated only 1% of revenues. According to its cost system, these specialty items had the best gross margins.

An analysis using activity-based costing told a very different story. More than 75% of this company’s products (mostly the low-volume items) were losing money. The products that did
make money (less than one in four) generated more than 80% of sales and 300% of net profits.

ABC system have recognized that organizational resources are needed both for direct production of goods and services and for indirect or support activities. The goal of ABC is to measure and then price out all the resources used for activities that generate the production of goods and services for customers (Cook, Grove and Coburn, 2000). When analysing production expenses in service organizations, the demand for support resources arises from product volume and mixes. In a lot of service firms including financial institutions such as banks, some expenses are driven naturally by products, e.g. checking accounts, savings, mortgages, etc. A great deal of the expenses for service functions are caused by differences in customers’ preferences, even though they are using the same service. The analysis starts by examining the expense structure of each operating department and proceeds by determining the factors that create the demands for the functions performed by the department. The objective of analysis is, therefore, to discover the nature of the demand and quantify it. The basic goal of the analysis is to obtain the unit costs for processing transactions from products and customers (Hussain and Gunasekaran, 2001).

Application of ABC in the Service Sector As a technique, ABC has its roots in the manufacturing sector and most of the literature on ABC emphasizes its use in a manufacturing setting. Yet, it must be acknowledged that significant and growing economic activity takes place in the non-manufacturing sector. It is important to note that ABC principles apply to all types of business. For example, service companies face the same changing environment that has necessitated modifications in cost management practices in manufacturing companies in order for them to remain competitive. Strong competition for existing services together with customers requiring greater service choice will force a compression of profit margins. Since service companies are more people-intensive than manufacturing, there is greater need to focus on the myriad of activities that are performed in order to serve the customer. In a service arena, determining and lowering the “cost to serve” is a critical success factor. The challenge is to make the less expensive service also the preferred service among customers.

Managers need to take a conceptual shift from tradition costing technique to effectively use ABC as a guide to profitability. Under ABC technique the traditional way of allocating all expenses to individual units gets shifted towards matching them with level of activity that consumes the resources. ABC has been considered as a powerful tool that can guide management action in higher profitable direction. It teaches management to act in cost
reducing direction also by making them explore finding new ways to reduce the resources required for performing different activities and then guiding them in translating these resource savings into profits.

5. CONCLUSION

Indeed, activity-based costing is as much a tool of corporate strategy as it is a formal accounting system. Decisions about pricing, marketing, product design, and mix are among the most important ones managers make. None of them can be made effectively without accurate knowledge of product costs.

Activity-based costing is a new system of cost calculation absolutely necessary, a new way of thinking regarding costs. In most cases, the activity-based costing method must be implemented in addition to the traditional costing systems, which are essential for the purposes of management accounting.

The study shows that the activity-based costing and activity-based management system helps managers to properly manage indirect costs (by activities) and understand the profitability of products, distribution channels and customers. Therefore, it offers a powerful instrument for decision-making.

6. REFERENCES

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