The Role Of ABC in Management Decision-Making

Fatemeh Jafari
Department of Commerce, B.M.C.C, University of Pune, India

Dr. Mehdi Shariatmadari
Central Tehran Branch, Islamic Azad University, Tehran, Iran
mehdishariatmadari@yahoo.com

Abstract
Activity-Based Costing/Management (ABC/M) is an Information System developed and overcome some of the limitations of traditional cost accounting and to enhance its usefulness to strategic management decision-making. In this paper, we show how an ABC/M system can serve as a useful information system to support effective operations decision-making processes. By viewing an ABC/M system as an enabler to improve the operations decision-making, we demonstrate that these systems enable an operations manager to enhance the quality of the decision-making process.

Introduction
To support compliance with financial reporting requirements, a company’s traditional cost-accounting system is often articulated with its general ledger system. In essence, this linkage is grounded in cost allocation. Typically, costs are allocated for either valuation purposes (i.e., financial statements for external uses) or decision-making purposes (i.e., internal uses) or both. However, in certain instances costs also are allocated for cost-reimbursement purposes (e.g., hospitals and defence contractors).

The traditional approach to cost-allocation consists of three basic steps: accumulate costs within a production or nonproduction department; allocate nonproduction department costs to production departments; and allocate the resulting (revised) production department costs to various products, services, or customers. Costs derived from this traditional allocation approach suffer from several defects that can result in distorted costs for decision-making purposes. For example, the traditional approach allocates the cost of idle capacity to products. Accordingly, such products are charged for resources that they did not use. Seeking to remedy such distortions, many companies have adopted a different cost-allocation approach called activity-based costing (ABC). This paper focuses on the effect of ABC on management decision making and elaborates related features.

What Is Activity-Based Costing?
In contrast to traditional cost-accounting systems, ABC systems first accumulate overhead costs for each organizational activity, and then assign the costs of the activities to the products, services, or customers (cost objects) causing that activity. As one might expect, the most critical aspect of ABC is activity analysis. Activity analysis is the processes of identifying appropriate output measures of activities and resources (cost drivers) and their effects on the costs of making a product or providing a service. Activity analysis provides the foundation for remedying the distortions inherent in traditional cost-accounting systems.

Traditional Cost-Accounting Systems Versus Abc
Geared toward compliance with financial reporting requirements, traditional cost-accounting systems often allocate costs based on single-volume measures such as direct-labour hours, direct-labour costs, or machine hours. While using a single volume measure as an overall cost driver seldom meets the cause-
and-effect criterion desired in cost allocation, it provides a relatively cheap and convenient means of complying with financial reporting requirements. In contrast to traditional cost-accounting systems, ABC systems are not inherently constrained by the tenets of financial reporting requirements. Rather, ABC systems have the inherent flexibility to provide special reports to facilitate management decisions regarding the costs of activities undertaken to design, produce, sell, and deliver a company's products or services. At the heart of this flexibility is the fact that ABC systems focus on accumulating costs via several key activities, whereas traditional cost allocation focuses on accumulating costs via organizational units. By focusing on specific activities, ABC systems provide superior cost allocation information—especially when costs are caused by non-volume-based cost drivers. Even so, traditional cost-accounting systems will continue to be used to satisfy conventional financial reporting requirements. ABC systems will continue to supplement, rather than replace, traditional cost-accounting systems.

The Role Of Abc In Management
Management in all business areas and organizational activities are the acts of getting people together to accomplish desired goals and objectives efficiently and effectively. Management comprises planning, organizing, staffing, leading or directing, and controlling an organization (a group of one or more people or entities) or effort for the purpose of accomplishing a goal. Resourcing encompasses the deployment and manipulation of human resources, financial resources, technological resources, and natural resources.

Because organizations can be viewed as system, management can also be defined as human action, including design, to facilitate the production of useful outcomes from a system. This view opens the opportunity to 'manage' oneself, a pre-requisite to attempting to manage others.

ABC is a costing model that identifies activities in an organization and assigns the cost of each activity resource to all products and services according to the actual consumption by each: it assigns more indirect costs (overhead) into direct costs.

In this way an organization can precisely estimate the cost of its individual products and services for the purposes of identifying and eliminating those which are unprofitable and lowering the prices of those which are overpriced.

In a business organization, the ABC methodology assigns an organization’s resource costs through activities to the products and services provided to its customers. It is generally used as a tool for understanding product and customer cost and profitability. As such, ABC has predominantly been used to support strategic decisions such as pricing, outsourcing, identification and measurement of process improvement initiatives uses:

- It helps to identify inefficient products, departments and activities
- It helps to allocate more resources on profitable products, departments and activities
- It helps to control the costs at an individual level and on a departmental level
It helps to find unnecessary costs
It helps fixing price of product or service scientifically

Even in ABC, some overhead costs are difficult to assign to products and customers, such as the chief executive’s salary. These costs are termed ‘business sustaining’ and are not assigned to products and customers because there is no meaningful method. This lump of unallocated overhead costs must nevertheless be met by contributions from each of the products, but it is not as large as the overhead costs before ABC is employed.

Although some may argue that costs untraceable to activities should be “arbitrarily allocated” to products, it is important to realize that the only purpose of ABC is to provide information to management. Therefore, there is no reason to assign any cost in an arbitrary manner.

**Activity-Based Management**

In order to manage costs, a manager should focus on the activities that give rise to such costs. Accordingly, given the activity focus of ABC, managers should implement ABC systems in order to facilitate cost management. Using ABC systems to improve financial management is called activity-based management (ABM). The goal of ABM is to improve the value received by customers and, in doing so, to improve profits.

The key to ABM success is distinguishing between value-added costs and non-value-added costs. A value-added cost is the cost of an activity that cannot be eliminated without affecting a product’s value to the customer. In contrast, a non-value-added cost is the cost of an activity that can be eliminated without diminishing value. Some value-added costs are always necessary, as long as the activity that drives such costs is performed efficiently. However, non-value-added costs should always be minimized because they are assumed to be unnecessary. Examples of non-valued-added activities include storing and handling inventories; transporting raw materials or partly finished products, such as work-in-process inventory items, from one part of the plant to another; and redundancies in production-line configurations or other activities. Often times, such non-value activities can be reduced or eliminated by careful redesign of the plant layout and the production process.

By applying ABC, an organization can identify non-value-added activities, which consume resources without adding value to customer services. To closely monitor and eliminate these activities with ABC, an organization must develop non-financial measures. For example, an information system that keeps track of customers’ time waiting for goods or other services can focus administrator’s attention on the problem and help find a solution. While eliminating waste may not reduce product costs in every case, it can improve the quality of services provided.

**Activity Based Management**

Activity Based Management (ABM) enables managers to understand product and customer profitability, the cost of business processes, and how to improve them. Since conventional management accounts and standard costing systems do not provide this information, it is perhaps surprising that ABM is not more widely used. Unlike many management techniques, research shows that 80 per cent of companies that have employed activity-based techniques found them to be successful.

Why? Activities consume resources – people, materials and equipment – and this consumption can be measured. Activities are triggered by events, which can be counted, or decisions, which can be reviewed. Activities produce outputs – products and services, which can be counted and measured. Activities can be undertaken by different methods, which will vary the unit cost. Activities are linked together to form business processes. Understanding what activities are, what they cost, what drives them, what they produce, how they are done and how they are linked together is useful.

We have understood manufacturing activities in this way for years. We measure the consumption of direct labour and materials in making products. On average, however, direct labour, materials and components account for around two thirds of total costs in manufacturing businesses. The other, unmea-
sured, third is overhead activities and costs. Inservice industries, the ratio is the other way round – the unmeasured ‘overhead’ accounts for two-thirds or more of costs.

Overhead costs are the black hole in conventional management information systems. ABM shines light into the hole. Knowledge of a business at the level of activities is the basic building block upon which new understanding can be built of where profits are being made and where they are being eroded. By making visible what was previously invisible, ABM throws a spotlight on those aspects of a business where action can directly improve business performance. Because it deals with ‘financial numbers’, ABM is often seen as the preserve of the Finance function. In fact, its real strength lies in providing genuinely useful information for all functions in an organisation.

**Managers throughout the business need the right information to understand and address two key issues:**

- How the company can position itself better in the market – for which accurate product and customer profitability information is vital.
- How it can improve its internal capability and lower unit costs – for this, it needs to understand and change the procedures, systems and processes that create products and deliver services to customers.

Most organisations are complex. Building an ABM model of a business requires a structured approach and the dedication of a team to achieve a result in a reasonable timescale. But building a model is only the start. Embedding ABM into the business means giving managers not only a new understanding of what drives costs, but the means to measure and act on the drivers to reverse adverse trends.

Initially Activity Based Costing (ABC) was presented as a means of establishing product costs more accurately. The emergence of Activity Based Management (ABM) provided a means of enhancing profitability. ABM is underpinned by a theory of resource consumption with activities giving rise to costs, as in ABC, but taking the analysis further in a way that provides management with insights into managing the business overall. Essentially, these insights are focused on a process view of the business and a deeper understanding of product, channel and customer profitability.

**Cost Management System**

Several management analysis and decision processes involving value analysis, process analysis, quality management, all get integrated into a total cost management system. As a result the decisions arising out of such a system get integrated with business management decisions. That is how the modern Cost and Management Accountant today becomes not only a member of the management team but also strategic manager himself.

**Application Of Activity Based Costing**

ABC estimating is especially useful in instances where the number of activities is uncertain or may change during the estimate process. Referring back to the ABC estimate, if the number of samples changed, it would be fairly easy to recalculate the cost of the sampling. Activity-based management and activity-based costing (ABM/ABC) have brought about radical change in cost management systems. ABM has grown largely out of the work of the Texas-based Consortium for Advanced Manufacturing-International (CAM-I). No longer is ABM’s applicability limited to manufacturing organisations.

The principles and philosophies of activity-based thinking apply equally to service companies, government agencies and process industries. The acronym itself has evolved from ABC to ABCM (activity-based cost management) to ABM, and the application of ABEvolved from a manufacturing product costing orientation to a management philosophy of activity management applied in industries and organisations other than manufacturing.

ABC is not a method of costing, but a technique for managing the organisation better. It is a one-off exercise which measures the cost and performance of activities, resources and the objects which consume
them in order to generate more accurate and meaningful information for decision-making. ABM draws on ABC to provide management reporting and decision making.

ABM supports business excellence by providing information to facilitate long-term strategic decisions about such things as product mix and sourcing. It allows product designers to understand the impact of different designs on cost and flexibility and then to modify their designs accordingly. ABM also supports the quest for continuous improvement by allowing management to gain new insights into activity performance by focusing attention on the sources of demand for activities and by permitting management to create behavioural incentives to improve one or more aspects of the business.

Applying ABC in a department involves the following steps:

Step 1: Identify all significant activities of the department. Arrange with the director of the department to conduct interviews with staff members responsible for key activities;

Step 2: Create a flow chart of key activities to identify which activities provide value-added services. Non-value-added activities should be eliminated or at least significantly reduced. Develop non-financial measures as needed to monitor non-value-added activities;

Step 3: Determine cost categories for allocating activities identified in Step 1. Some costs are directly traceable to activities, while other costs are allocated using suitable bases. The resulting cost figures represent the cost of a department’s activities;

Step 4: Trace the costs of the department’s activities to product;

Step 5: Allocate the costs of activities not directly traceable to customers.

Conclusion

Today, companies produce a wide range of products. Overheads are of considerable importance. Simple methods of apportioning overheads based on direct labour are not justified. Intense global competition calls for correct costing of products to avoid errors in decision making. All activity like material handling, set up etc. are important and needs proper decision making, hence, the significant for emergence of activity based costing arises.

To conclude, familiarity with and adoption of ABC was found to be comparable across both the manufacturing and service sectors. Service firms that provide multiple services that use overhead at differing rates can benefit from the use of ABC, as can manufacturing firms with multiple products that place different demands on overhead.

However, ABC helps better identify the nature of the decisions that management is called upon to make. It also focuses management on two clear objectives.

1. To ensure that cost effective methods are used to produce current products to current customers at a price that generates the maximum positive ABM Product and Customer Contributions.

2. To ensure that the ABM Contributions are used effectively to generate new products and services to new markets such that the return on the investment in Sustaining costs is greater than that which would be achieved by shareholders investing elsewhere.

References


