

Activity Based Costing-As a Strategic Decision Making Tool

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Abstract: It is said 'If you can't measure it, you cannot manage it'. Costing, being at the core of performance measurement of an enterprise, requires a systematic and structured approach, with aim of providing a holistic framework to manage the costs. This initiative, called as Total Cost Management (TCM), involves the process of managing the financial outcome of activities- internal and external to the organization- to support efficient and effective decision-making. TCM uses various techniques and tools for achieving its objectives. It aims to improve the profitability without sacrificing the value for the customers. Activity Based costing is an important tool among them. It is in this context the present paper explains the tool of ABC with an illustration in banking sector

Key Word: Activity Based Costing, Traditional costing

Date of Submission: 25-04-2020

Date of Acceptance: 08-05-2020

I. INTRODUCTION

Cost refers to the expenditure incurred in manufacturing a product or in rendering a service. It is expressed from the producers'/manufacturers' view point. Costs to be incurred can be classified as direct costs and indirect costs. Direct costs are costs, which can be directly related, identified with or attributable to a cost centre or a cost unit. For e.g. cost of raw material used in the finished product, wages paid to site labour in a construction contract etc. Indirect costs are costs, which are not directly identified with a cost centre or a cost unit. As they are incurred over different heads, they are also called as overhead costs.

As direct costs can be identified with/attributable to a cost centre/cost unit, they are comparatively easy to control. Being that is not the case of overheads, they are difficult to control. They constitute a significant component of cost while manufacturing a product or rendering a service. Hence they are to be identified and analysed with effective and efficient means.

II. TRADITIONAL ABSORPTION COSTING SYSTEM

Under traditional absorption system the approach is as follows;

Firstly, overhead costs are collected. Then they are classified as fixed and variable overheads. Thirdly specific costs are allocated to particular cost centres and common costs are apportioned to various cost centres on appropriate basis. As a fourth step, service cost centres' expenses are reapportioned to production cost centres. Then overhead recovery rate is computed the basis of labour hours or machine hours.

The traditional absorption costing system of overheads suffers from the following limitations:

- It attributes costs to cost centres. However, costs are influenced by their driving factors; not by cost centres.
- This method seeks to measure the cost per unit of time, instead of cost per unit of the product
- It uses a denominator (like machine hours, labour hours etc.).These rates assume that products, which take longer time, involve more overheads.

This method does not facilitate s easy identification of idle capacity costs or abnormal overhead costs.

III. ACTIVITY BASED COSTING – BASICS

Activity based costing is a method that measures cost of a product/service, based on the activities performed to produce the product/service. The underlying assumption is that activities drive the cost, which are driven by the product or customer, this radically differs from the conventional costing systems, which is built on the assumption that product drives the cost directly.

In ABC, the following terms are used;

3.1. Activity

Activities comprise of units of works or tasks: For e.g. purchase of materials is an activity consisting a series of works like receiving purchase requisition, advertising quotation invitation, identifying suppliers, placing purchase order and so on. The activity may be unit level, batch level, product level or facility level. Unit level

activities are those activities for which the consumption of resources can be identified with the number of units produced. For e.g. inspection or varnishing. The number of batches of units produced drives costs of batch level activities. For example, machine setup, material ordering etc. Product level activities are those activities whose costs are driven by the creation of a new product line or its maintenance. For e.g. designing a product. Facility level activities are necessary for sustaining the manufacturing process. For e.g. ground maintenance, production manager's salary.

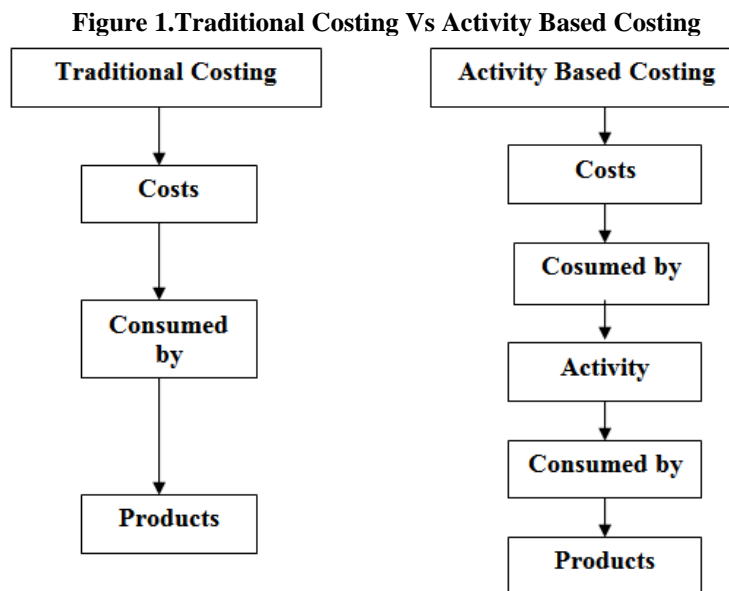
3.2. Cost object

It is an item for which cost measurement is required. For e.g. a customer, a job or a product.

3.3. Cost driver

It is the factor that causes a change in the cost of an activity. It may be Resource Cost Driver (RCD) or Activity Cost Driver (ACD).

- Resource cost driver – It is a measure of the quantity of resources consumed by an activity. It is used to assign the cost of a resource to an activity or cost pool.
- Activity cost driver: It is a measure of the frequency and intensity of demand, placed on activities by cost objects. It is used to assign activity costs to cost objects. For e.g. number of service calls, number of products serviced etc.



IV. ABC SYSTEM –STEPS IN INSTALLATION

The following are the steps involved in ABC System in order to recover overhead costs:

1. Identify the various activities within the organization.
2. Relate the overheads to activities using resource cost drivers (RCDs). Overheads will be related to support and primary activities. RCDs are used for this purpose. All costs will be identified under the activities, thus creating Activity cost pools/cost buckets.
3. Apportion the cost of support activities over the primary activities on suitable basis. It enables collect all costs under primary activities. The base is the cost driver, which is the measure of how the support activities are used.
4. Determine Activity Cost Drivers (ACDs) for reach Activity or cost pool. Activity Cost Drivers are used relate the overheads collected in the cost pools to cost objects. This is based on the factor that drives the consumption of the activity.
5. Calculate Activity Cost Driver (ACD) Rate

Activity Cost Driver Rate (ACDR) is computed by dividing total cost of the activity (cost pool) by its Activity Cost Driver. It is computed for each activity. In order to ascertain the cost, the rates will be multiplied by different amount of each activity that each product/other cost object consumes. This rate can be used to ascertain cost of products/rendering services.

V. ABC SYSTEM –INSTALLATION PROCESS

In order to install an ABC system the following systematic procedure is to be followed.

5.1 Specifying the objectives:

Firstly the motives for pursuing an ABC system must be established. It may be to improve product costing or to identify non-value adding activities in the production process/rendering services.

5.2. Identifying Costs

Costs are of two types viz., direct and indirect costs. Direct costs are easily assigned directly to products. Indirect costs, which are not product-specific, form the focus of ABC. They are assigned to the cost object i.e. product/service via cost buckets and activity drivers.

5.3. Specifying Process

Process specification involves identification of different stages of the production process, the commitment of resources to each process, processing times and bottlenecks. This provides a list transactions which may or may not be defined as activities at a subsequent stage.

5.4 Defining Activities

The list of transactions as identified in the previous stage is analysed to ensure aggregation or grouping of common activities and elimination of immaterial activities. Activities are categorised into primary activities and support activities.

5.5. Selecting Activity Driver

In this stage, determine the Activity Cost Drivers (ACDs) used to relate the overheads collected in cost pools to cost objects (products) this is based on the factor that drives the consumption of activity. Generally a single driver is selected for every activity even though multiple and inter-related drivers may exist

5.6. Costing

A single representative activity driver can be used to assign cost from the activity pools to cost objects. Such linking of total costs to cost objects is based on the ACD rate.

5.7. Training the Staff

The co-operation of the work force is essential for successful implementation of any method. Staff training should be oriented to create an awareness of the purpose of ABC. The team effort of employees should be ensured by convincing its mutual benefits.

5.8.Review and follow up

The actual operation of the ABC system should be clearly monitored. Periodic review and follow-up action makes the system effective and efficient in achieving the intended objects.

VI. MANAGERIAL APPLICATIONS OF ABC

The major managerial applications of ABC include the following:

6.1. Cost Control:

ABC enables to identify the activities and their the cost drivers. This is gives a clear indication as to the causal factors. This, in turn will help to save the total cost / cost per unit by effective cost control methods. Strict adherence to standards set will facilitate total cost control.

6.2. Cost Reduction

By identifying the cost drivers, permanent, real and genuine savings in cost is also possible. Scientific management techniques such as time and motion study, standardisation and simplification etc. will help the firm to achieve a long-term saving in cost per unit. As a result of long-run advantages, it will benefit the firm to achieve higher levels of efficiency. Thus, it will act as a strategic cost management tool.

6.3. Better Customer Satisfaction

Being price is one the key determinants of customer satisfaction, the firm can offer competitive rates for different types of customers. Even if a customer is charged at high, satisfactory justification can be given in terms of the volume of activities served to him. Thus the customer recognises the fact that he pays only for what he gets. This will indeed, improve customer satisfaction. As customer is the king of any business and the key for survival and growth, satisfied customer base will help the firm to ensure long-term survival and growth.

6.4. Activity/Process Management

Identification of activities, their classification and inclusion in determining the overhead absorption rate will cause to have an enhanced attention on the activities involved. Such an attention will help to think systematically and scientifically about the method in which they are done. ABC implementation will make the employees, across functions, to understand the various costs involved, which will in turn enable them to

- Analyse the Cost
- Identify the Value Added and Non Value Added Activities.

- ❑ Implement the improvements and realise the benefits.

This is a continuous improvement process in terms of analysing the cost, to reduce or eliminate the Non Value Added activities and to achieve an over all efficiency.

6.5. Customer analysis

Traditionally it is believed that:

- ❑ High volume customers are profitable customers
- ❑ Loyal customer is also a profitable one.
- ❑ Profits will follow a happy customer.

The ABC studies on customer profitability have unveiled that the above are often exceptions.

With the costing based on activities, the cost of serving a customer can be ascertained individually. Deducting the product cost and the cost to serve each customer one can arrive at customer's profitability. This method of dealing customer cost and product cost separately have lead to identifying the profitability of each customers and to position their products or services accordingly.

6.6. Innovative and Realistic product costing

Traditionally, costs have been allocated to products arbitrarily and have been averaged out across products. In a multi-product enterprise this leads to unreliable cost information resulting in either under-costing or over-costing of products. The management cannot take effective strategic decisions based on this information. ABC costs the products based on the activities that goes into it. This facilitates arriving at the accurate cost of the products and enhances effective strategic decisions to:

- Position their products better
- Facilitate better Product mix for the market
- Enhance the bargaining power with the customer

VII. INDUSTRIES BENEFITED THROUGH ABC

Industries benefited through ABC include, inter alia, the following;

A. Manufacturing Industries

1. Automobile Manufacturers & Distributors
2. Auto-Ancillary Manufacturers & Distributors
3. Casting & Foundry Industries
4. Engineering Industries
5. Processing Industries
7. Ceramic units

B. Service Industries

1. Hospitality industries
2. Banks
3. Financial Institution

Note: A case of applying ABC method is illustrated in appendix-I

VIII. CONCLUSION

Activity Based Costing has helped enterprises in answering the market need of quality products at competitive prices. Ascertaining the product profitability and customer profitability, this method has contributed effectively for the top management's decision-making process. With ABC, enterprises were able to improve their efficiency and reduce the cost without sacrificing the value for the customer. This has also enabled enterprises to model the impact of cost reduction and subsequently confirm the savings achieved.

In toto, this method is a dynamic tool for continuous improvement. With ABC to its benefit, any enterprise will have a built-in competitive cost advantage and can continuously add value to both its stakeholders and customers. However, top management's commitment, well-trained employees' team, appropriate software support are inevitable for its ultimate success.

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Dr.Shacheendran.V. “Activity Based Costing-As a Strategic Decision Making Tool.” *IOSR Journal of Humanities and Social Science (IOSR-JHSS)*, 25(5), 2020, pp. 18-22.