Activity Based Costing

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Introduction

The Traditional costing practices were pressurised by Cooper & Kaplan, (1984) due to the failure of providing detailed and quality information for decision making. The Activity Based Costing system was initiated in United States by Cooper & Kaplan in 1987, which amended the cost system by expanding the indirect cost pools and identifying cost drivers. The ABC system allocates the cost on the basis of cost drivers. Activity-based Management (ABM) represents a way of managing a firm with activities using the results of the ABC technique. Practically, there is a continuum between these two methods in a firm using them (Antos & Brimson, 1999).

Discussion

This paper is structured into three sections. The first section deals with the publication released on ABC costing since its inception to the present date. It also expands or criticises the theory provided by Kaplan and Johnson. The second section assesses the impact of ABC studies on the companies and consultants. It also discusses the perceived benefits provided by implementation of ABC system in organisations. The third section provides the conclusion. The section presents the literature and evaluation on the publications identifying the ABC techniques and its development. The relevant case study is also presented to provide the evidence of Researches.

The ABC method was considered in mid of 1980’s by Kaplan to amend the misleading allocation of overheads to the products or services. Initially, it was only a response by American scholars over incorrect standard costing methods. After the initial response, several scholars also provided their opinions. Lebas (1991) agreed that ABC has gained strategic and management
dimensions. The operational model was developed by Shank (1989) with the use of key success factors and analyses the company’s internal process with the help of ABC technique.

The formal management accounting approach provided by Kaplan & Johnson reveals the resistance from the management control, strategic management and operational control. According to Bhimani (2007), there is rising interest in strategic management accounting (SMA). Under a firm, a SMA tool has the ability to link the strategic & marketing goals with the operational goals. Roslander & Hart (2003) focused on the work of marketing aspects and Brimson (1988) focused over the work of strategic dimensions.

Different practitioners & scholars are of their opinion that ABC system has various pitfalls. These criticisms includes the costly implementation of ABC, greater time utilisation and difficult to define the cost drivers. Kaplan & Anderson (2007) illustrates that the ABC software of a Manufacturing company Hendee Enterprise took 3 days in calculating the overall the cost for the company’s activity which includes 45 thousand items, 10 thousand orders and 150 activities.

ABC has cost more accurately than the traditional system cost issues, it is capable of recognising in detail the causes of cost and helps us in better management of activities. Kuchta (2007) indicate that advantages or benefits of adoption of ABC include improving the accuracy and relevancy of product cost. It also provides cost information for making timely decisions and follows more closely the trail of the indirect costs and the cost object. On the one hand, the study of Malmi & Teemu (1999) states that for research costs management and results are needed to progress firsthand.
A recent study by Rodriguez (2010), review thoroughly the existing empirical evidence internationally, about the process of ABC system implementation. Its main findings were the following:

- The technical, organisational and cultural factors most affecting the implementation of ABC system are: cost level indirect manufacturing, complexity and diversity products, the existence of an internal leader, size and the complexity of the company and the values and beliefs that underlie a company measures such as innovation and customer service.

- The implementation of various international ABC models is examined through surveys, tablets or in-depth case study of the process implementation in different private companies & economic sectors whose information is analysed by multiple regression models.

- Analysis of ABC model errors, such as errors in the estimation of model time. ABC designs are based on experiments and statistical system of the results.

- The consequences of implementing the ABC system in the companies leads to improvements in cost, quality, in production cycle times and profitability. For example, the application of the processes of continual improvement to optimise the use of scarce resources of an organisation.

There are new uses of the ABC system in the value chain analysis methodology (VCA) in order to reduce costs in the chain of supplies. In a case study of a chain British supermarket with its suppliers presents this new application of the ABC system (Cooper & Kaplan, 1991). The following illustrates the application of the ABC costing on the basis of information of the Peruvian company based in Frenosa.
Frenosa is a manufacturing company, located in the industrial area, department of Lima Callao. The company operations includes the design, development and production of materials bearings, brake fluid and coolant, rivets tooling to install and auto friction materials parties. The company belongs to the metal industry mechanics and is classified within the ISIC 3430: manufacture of parts and accessories for vehicles and their engines. In July 2000 the company obtained the certified ISO 9002 by BVQI accredited AZ Austria, ANSI Arab, and DAR for manufacture processes of its different product lines. Certification has earned him and strengthen the recognition and confidence to their local customers and from outside.

To develop the case study selected and coasted production processes and supporting steps to generate the ABC system, taking into account each of the elements involved are:

- Gather all costs and expenses of the company under the concept of resource pool. Next, resources are typified into three categories: materials then, direct staff and other resources.
- Select the cost objects: production activities and product liners clutch.
- Then following question are asked: what are the costs of resources that make up the pool and are the resources directly attributable to product? If the answer is yes, then charged directly to the product. As an illustrative we can mention that the costs of materials are charged directly to the lining of clutch.
- If the answer to the question in third point is negative, then it is necessary to develop in-producers of resources to allocate the cost resources to activities.

**Development of Activity Based Budgeting and Management**
A Budget can be described as a standard or a plan in financial terms. The budgets are prepared in order to control and measure the actual performance with the planned. One of the Budget styles increasingly demanded is activity-based budget (ABB) which has the potential to link the cost with the activities which gives the management better assessment of resource allocation and full cost of product or service. ABB is derived from ABC and is related to zero-based budgeting. Once the total activity cost is determined than drivers can be assigned which connects the primary activities with the support activities of the organisation. The development of activity based budgets will help senior executives and managers in exercising control through several ways. Flexibility can be introduced in the labour force such as labour deployed according to the need, hidden cost and waste can be eliminated, considering the least and most expensive activities, places can be identified where spending can be reduced and cost baseline could be established through the introduction of technology and process which limits the efforts requirements in the activity (Vercio, 2011).

In today’s Business environment, the recent automation and technology have affected the cost structure of product & services and the production processes.

Strategic control and planning have become essential requirement due to the rising completion and variation in consumer demands. The classical budgeting techniques are unable to meet the needs of modern companies and hence there is a need for advanced budgeting methods such as activity based costing which has become popular among the company’s managers. Under this system, the costs are apportioned to the products depending on the activities which are required for the production of these products. This system provides information regarding product costs to the manager and this management style is known as activity based management. The purpose of
this activity based management is to fulfil the customer demands through creating value and to control the interaction and relationship between product performance and production processes (Miller, 2010). ABB as a part of ABM is a method that determines the forecasted activity cost needed for a specified product or service production. The usage of ABC in budgeting process helps the managers to convert the fixed costs into variable costs and to determine cost in objective manner (Swenson, 2009). ABB is a strong cost controlling and planning tool which eliminates the activities that does not add value and thereby raising the cost efficiency.

Accordingly, ABB is a part of ABC and ABM which ensures to assess the profitability and costs measure more accurately and easily. It further provides information regarding enhancement of production process, customer profitability analyses and pricing decision.

The ABC has generated enormous enthusiasm in and around its basic ideas. Moreover, researchers are studying the actual cost accounting practices of companies. The Research of Dr. Michiharu Sakurai conducted in 1998 of the School of Business Senshu University in Japan conducted an investigation in which he describes how most companies in the United States and Europe were working or implementing ABC systems and in Asia almost 30% were inclined towards this costing method.

The ABC system is the most developed and expensive attempt done so far to identify and correlation that causes (cost drivers) and activities. It extends the literature that there are many authors that who have argued that in our area we usually determine costs items to the difficulty of finding distribution bases to ensure accurate costing.
The ABC has correctly allocated cost by the use of multiple cost allocation bases. The ABC has criticised the abuse of labour based direct cost allocation, especially when used as a base only to apply indirect costs to products. Therefore, we can say that this new costing method have based their criticism of the traditional costing that they were always using labour as a basis for application apportionments.

The ABC has stressed the idea that executives manage the costs to monitor activities instead of products. Accounting costs highlights the interdependent activities and trends between activities in many departments or functional areas.

The ABC has stressed that the costs of production are affected by all functions in the value chain, not only by the manufacturing cost. Inventory costs provide incomplete production costs while taking decisions.

The ABC has alerted the directions of the existing cross-subsidisation between the production cost when there are a wide range of operational activities and a wide range of products. That is, the case studies have shown that existing systems costs using large load averages.

**Affects of ABC for Companies and Consultants**

Indeed, proponents of the method of traditional cost accounting have insisted that the statement of the ABC has already been addressed previously by several authors and that there are intelligent administrations application databases using indirect charges. The Activity-Based Management is not the excellent way to respond to the cost-generating activity, which is true;
similarly, an appropriate direction needs not to have an accurate assessment of each functional area and through the resources required to implement it.

Many scholars and consultants have never tended to explore the history of thought. However, if they do, avoid leaning their versions of the history. If they do, should be especially careful to avoid claiming that their ideas are new.

Influence in decisions relating to the fixed term pricing, product diversification and sale and manufacture thereof. Such simplified ignores other sources of information; other factors influence the pricing and numerous interdependencies and points between products and costs.

The activity-based costing (ABC) consultants, practitioners and managers observe the questioning process at the soul and heart of ABC execution. Apart from a dependable data collection technique, it also trains the employees regarding ABC and activity-based management. More importantly, it also assures the achievement of the project by supporting in constructing a feeling of possession among the employees. Therefore, it is essential that the interviewer who might be a consultant from outside the company or is a member of the project team. It should be well educated and trained over handling various activities of departments including the areas of ABM and ABC.

As an example we have the book: Strategic Cost Analysis by Shank (1989) falling in all pointing errors, as attributed characteristics not possessed by ABC shows as a panacea when it is only an instrument further simplifies the job of address-unresolved see all problems and be the great innovation awarded him their eulogies. At the same time some scholars ignore the difficulties
presented by such a method, which are neither few nor simple to solve. It is therefore inevitable
to refer to the confusion causing the fact that a book with such misunderstanding of what are the
costs has dissemination has been achieved e.g. even claims that the traditional methods "as all
they do is give distorted information nothing wrong late and cannot thus making decisions. This
author goes on to say, From indeed, if top management is unaware of his obsolescence, then it
runs a serious risk of wrong decisions and follow product strategies that can be wrong fatal
consequences.

In addition, this book has several failures of conceptualisation in terms of which is a method, for
instance, is intended to pre establish the back-flush accounting as a method cost when in reality
the change represents over the traditional method is only in eliminating the charge that would
normally be production makes the process of labour and indirect charges. The same is true in the
case of throughput accounting in which only the raw material is considered as Cost, and labor
and charges indirect and overhead costs that take results (Zimmerman, 1997). Apart from that
already given in the previous note, this change from the traditional method does not involve talk
of a new method.

Furthermore, it is also arguable that labour is always considered a fixed cost, as their
organisations in which the item is still functional of manufacture and, therefore, it is clearly
Variable mind, the typical case would be the. As regards the mathematical model invented by the
author of the text, it is only a suggestion to reduce costs, which does not mean, either, which is a
cost method. With regard to the concepts Chain value and product life cycle, although interesting
topics to include methods costing should not be considered as such because not imply a change
in assignments or new application databases, or that there are elements different cost, etc.,
features that do includes the ABC. It is important to elucidate this issue because in the School of Accounting and Administration of the UNAM some teachers have adopted proposals which are considered as costing methods.

**Conclusion**

The Traditional accounting and costing systems developed by Johnson and Kaplan were criticised for not focusing externally, lacking strategic aim, adopted short term approach and focus towards minimum variances. One of the most common criticisms of Johnson and Kaplan was the apportionment of indirect labour and overhead cost in the similar way to the direct labour cost. In 1980’s the direct labour cost comprises major part of product cost. Today, by the adoption of advanced manufacturing technology, the direct labour cost only comprises of 10 to 20% of the product cost while the overhead cost consist of 40-50% of the product cost. The introduction of ABC method overcomes various traditional criticisms of management accounting. By summarising the ideas of ABC developed over a period of 20 years it becomes apparent that ABC is a better technique of assigning overheads into products. The ABM makes use of this information for decision making and ABB is used to determine the future allocation of resources (Gen & Ronen, 2009). In this paper, we evaluate various applications of ABC system. In today’s environment, the manager’s demands particular information with high degree of reliability, such as the time driven and customer driven ABC system. Today, less than 20% of the companies have implemented ABC system. A question raised that whether all the ABC publications are fully justified or new developments in ABC system will be introduced that will replace the previous management tools.
References


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