

Activity Based Costing (abc) Systems And Implementation Issues

Introduction

Increasing cost of living is the major issues in Sri Lanka as well as globally. The reasons for such are explained by the government and business leaders that are increasing price of commodity in world market and also increasing the price for Oil globally. Therefore, the total burden is passed it to the public who consume the goods and services.

In setting the price, understanding and managing the cost elements are most important; in between that managing the overheads is the vital role of business leaders/Management Accountant. In an organization, even in public or private organization, they fail to manage the overheads and also fail to follow appropriate method to absorb fair overhead into the product and services due to the traditional cost accounting systems. This leads to increasing the price of commodity and also passing burden to customer/consumer.

The cost of living issues is not only related with material consumption, but also related with managing/absorbing the overhead into the product and services. In order to overcome the issues and effective cost management, Activity Based Costing/Management (ABC/M) is the effective method to manage the cost and cost drivers in the organization. The designing and implementation part is much more difficult but the benefit is more to the organization as well as to the public.

This article explains the needs of cost information for decision making, comparison of traditional costing with ABC costing methods and the stages in designing and implementing the ABC at the

organizational level and also focuses on its implementation issues as well as the solution to overcome the problems.

Eventually, it is explained the further development of cost management and cost accounting certification methods which needs to be implemented by the government in Sri Lanka like financial accounting, and auditing certification by the Chartered Accountant.

Cost Information for Decision Making

The goal of the organization is to maximize the profit and shareholders wealth. The return for the investment should be certain and the Managers are responsible for that. In order to achieve the objective, it is the responsibility of the management to pay more attention on two variables: one is that revenue and the second one is the cost. Managing the overhead is the challenging role of the management and the timely cost information is most important for decision making. In fact, there are three main reasons why a cost accumulation system is required to generate relevant cost information for decision making. The first one, many indirect costs are relevant for decision making, and the second is that an attention - directing information system is required that periodically identifies those potentially unprofitable products that require more detailed special studies, and finally product decisions are not independent.

In the production process, all costs are classified as direct and indirect cost in which the direct cost is easily observable and identifiable. The direct cost is the cost which directly attributed with the product and services. These costs are direct material cost,

and direct labor cost. In contrast, indirect cost is the cost which is not directly attributed with the product and also it is very difficult to identify product to product basis. These costs are indirect material cost, indirect labor cost and also factory overheads cost.

In such a case, paying more attention to the indirect cost and allocating to each product based on the resource consumption is most important in setting price and also to maximize profit for the organization.

In the process of selecting profitable product combination among the wide range of products, cost identification and analysis based on product basis is most important, when it comes to service organization, there may be a chance to analyze the cost by customer basis. The reason is to make sure that each product/service is still profitable? Or to be discontinued? Kaplan (1990) considers a situation where a company has 100 products and outlines the difficulties of determining which product, or product combinations, should be selected for understanding special studies. Kaplan states: First how do you think about which product you should even think about making a decision on? There are 100 different products to consider. But think about all the combinations of these products: which two products, three product or groupings of 10 or 20 products should be analyzed? It is a simple exercise to calculate that there are 2 different combinations of the 100 products, so there is no way to do an incremental revenue/incremental analysis on all relevant combination.

The resource consumption is different from product to product as the activities & process are varied. All range of product consumes joint resources but the usage is different. The identification of the resources consumption is critical, therefore the cost accumulation systems is most important. Cooper (1990b)

also argues that decisions should not be viewed independently. He states: The decision to drop one product will typically not change fixed overhead spending. In contrast, dropping 50 products might allow considerable changes to be made. Stated somewhat tritely, the sum of the parts (the decision to drop individual product) is not equal to the sum of whole (the realizable saving from having dropped 50 products). To help them make effective decisions, managers require cost systems that provide insight into the whole, not just isolated individual parts.

Designing ABC Systems and Implementation Issues

Understanding the cost & its allocation systems are vital to cost accountant, the cost allocation systems differ from traditional cost accounting systems to ABC/M systems. Traditional cost systems allocates overhead to production and service department and then reallocates service department costs to the production departments. An ABC system assigns overheads to each major activity (rather than department). With ABC systems, many-activity based cost centers (alternatively known as activity cost pools) are established, where with traditional systems overheads tend to be pooled by departments, although they are normally described as cost centers. During the 1980s the limitations of traditional product costing systems began to be widely publicized. In order to overcome the traditional cost accounting limitation, Cooper and Kaplan conceptualized the ideas underpinning these systems and coined the term ABC. This idea has now become firmly embedded in the management accounting literature and educational courses and many practitioners have attended courses and conferences on the topic of ABC.

Designing ABC Systems

Designing ABC system is the critical & challenge able task of management or cost accountant in the organizational level. The complexity of the operations will make problem and create issues in the implementation of ABC system.

There are mainly four steps involved with the designing process such as identifying the major activities that take place in an organization, assigning costs to cost pools/cost centers for each activity, determining the cost driver for each major activities, and assigning the cost of activities to products according to the product's demand for activities.

Activities are composed of the aggregation of units of work or task and are described by verb associated with task. For example, purchasing of material might be identified as a separate activity. This activity consists of the aggregation of many different tasks, such as receiving a purchase request, identifying supplier, receiving quotation & assessing quotation, preparing purchase order, mailing purchase order, and performing follow up. At the initial steps, analyzing the activity is most important, the starting point is to study about the physical plan and structure of the organization and start to do the job analysis to understand how the time is spent. Having interview the managers and employee questions such as what staff works at the location and what tasks are performed by the persons employed at the location. At the first stage, many detailed task are identified.

After the activities have been identified the cost of resources consumed over a specified period must be assigned to each activity. The aim of the allocation is to determine how much the organization is spending on each of its activities. The cost to activity may be classified direct and indirect cost. The indirect cost and jointly sharing cost should

be assigned to activities on the basis of cause-and-effect cost drivers or interview with staff who can provide reasonable estimates of the resources consumed by different activities.

In order to assign the costs attached to each activity cost center to products a cost driver must be selected for each activity center. There are several factors to be considered when selecting the activity cost drivers. First, it should provide a good explanation of costs in each activity cost pool. Second, a cost driver should be easily measurable, the data should be relatively easy to obtain and be identifiable with products. The activity cost drivers are mainly three such as transaction driver, duration cost driver, and intensity driver.

The last stage is that assigning the cost of the activities to product which involves applying the cost driver rate to product. Therefore, the cost driver must be measurable in a way that enables it to be identified with individual products. The ease and cost of obtaining data on cost driver consumption by products is therefore a factor that must be considered during the third stage when an appropriate cost driver is being selected.

ABC Implementation Issues

ABC systems is not a new systems in the business industry, many other businesses have already adopted with activity based approach to their management process. Even though having such systems, there are number of considerations and issues must be faced. The latter part of the article focuses on those issue with concluding remarks.

Complexity of the operations and difficulties faced to identify the activities and its drivers are the major issue faced by the organization. The primary reasons of having complexity of the operations is that top managements are not having clear idea of the importance of the cost management through activity and also lack of support given to the accountant.

There are practical problems faced by the accountant faced with modeling too many activities - calculating the model takes longer, maintaining the activity list is an administrative night mare, and classifying activities to identify wasted activity becomes a more onerous job.

Lack of support from the operational level staff and the divisional manager due to lack of knowledge on costing and maintaining the activities are another issue faced by the organization. The objective was not clearly communicated with the managers and poor training & development program was the main reasons to fail in the ABC systems implementation. Information & information systems are the major strength in ABC systems, example - customer sales order process, the identification of all relevant activities, cost drivers, and maintaining & recording the information on timely basis, but lack of understanding and contribution lead to have misinterpret the information to management

Business process improvements and changes in the operational activities will lead to the changes in the activities and cost drivers. It is the challenges to the management to re-design the whole process and examine the business process; again it will be the problem of selecting the suitable drivers and finding the data for driver may not be easily available.

Resistance to a new cost accounting system is one of a source of ABC failure. It is the challenge and issue faced by the accountant as the factory workers are willing to work day to day operations without having any difficulties through implementing new systems. Implementing ABC systems will lead to have operational changes and re-engineering, this was not agreed by the workers and resistance for a new changes and systems.

The dominate culture at the organization is another reasons to face issues in ABC implantation, workers at the organization thinks that the accounting function and role will have an influence on the workers and the organizational activities. Due to such attitude & behaviors (internal politics), the systems goes wrong in place.

Conclusion

It is important that the firm corporate strategy should carry the term "providing value to customer through low cost & high quality of product & services". The corporate strategy should be communicated properly among the organizational worker and changing their behavior & attitude is most important in ABC systems implementation and its success.

Proper training & development, preparation and understanding the operational activities well before the designing and development stage are most important enough. The enlarger vision and operational knowledge in the stable environment will make success of the ABC systems in the organization. Eventually, the best practice of ABC systems will lead to create value to customer and contribute to economic development of the country.

References

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By: **M.S.A. Riyad Rooly**
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 ACMA, ACPM

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