Activity-based Cost Management — Implications for Business Process Improvement

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Abstract

The compulsion to gain competitive advantage in both domestic and international markets is fast changing the complexion of many business organisations. Management Accounting has largely continued to make use of the techniques of the 1950s and the 1960s, which largely ignore the factors like variety, complexity and change that are increasingly driving costs. In this backdrop, an attempt has been made to focus on Activity-based Cost Management (ABCM) that very much addresses the aforesaid issues. In this connection, a business organisation has to undertake a vital exercise vis-à-vis its growth, i.e., Business Process Improvement. The ABCM approach requires categorisation of all activities in a business process as Core, Support and Diversionary and helps management concentrate on vital core activities and avoidable diversionary activities.

Key-Words : Cost management; Activity-based Cost Management (ABCM); Business Process Improvement; Core activities; Diversionary activities; Activity-based Costing.

Background

The compulsion to gain competitive advantage in both domestic and international markets is fast changing the complexion of many business organisations. The direct costs of products/ services are in the process of being cut, new technologies and automation are being adopted on a massive scale, life cycles of products/services are getting shortened and so on. These changes, taken together, have certainly resulted in a definite shift in the cost structure of many business organisations, e.g., in the manufacturing sector, direct costs are fast giving way to an increasing burden of overhead costs; in the service sector, massive expansion of systems, support and control functions is taking place vis-à-vis the growing complexity and variety of even more demanding markets.

Management Accounting has, to a very large extent, continued to make use of the techniques of the 1950s and the 1960s for providing top management teams with the basic cost information for the purpose of making key product/ service and investment decisions, which largely ignore the factors like variety, complexity and change that are increasingly driving costs. For example, organisations continue to recover the overhead costs using indices like direct labour hours or machine hours, reflecting production volume alone. In recent times, there is an increasing awareness and recognition among the management accountants that traditional management accounting techniques can, in fact, distort vital cost information and can adversely affect strategic as well as tactical decisions.

Against this backdrop, an attempt has been made to focus on Activity-based Cost Management (ABCM), an approach that very much addresses the aforesaid issues. ABCM is much wider, in its scope, than the original concept of Activity-based Costing (ABC) in the sense that it considers different crucial aspects of a business organisation rather than just product costing. ABCM has relevance not only in manufacturing but also in other functional areas.

Due to certain inadequacies of conventional Management Accounting as a discipline, many business organisations remain unaware of the fact that a sizeable proportion of their products/ services/ customers contribute very little/nothing to profits and sometimes even help erode them. ABCM sensitises top management teams and, in the process, contributes to profitability-improvement. ABCM also helps identify the factors that drive operating costs (both direct and overhead) in order to reduce such costs, and at the same time, ensures that the important organisational and customer needs are well taken care of.

Cost Management

Cost management helps identify the factors that drive costs. It also requires measurement and analysis of costs in a way that helps managers appreciate and explain better the factors that influence their business. In the process, it helps managers operationalise effective control in achieving their objectives.

Organisations incur some costs, which are not scanned by the top management though the magnitude of such costs demands that. Management accountants very often do not report costs in a manner to help top managers make decisions. Though the extent of such problems varies across the functional areas, all functions (and not just manufacturing) suffer from them.

The Key Problem Areas

(A) Significant Increase in Overhead Costs — Competitive forces are fast driving the business organisations to become more responsive to customer needs. This era is characterised by more rapid product obsolescence/ supercessions, improved product/ service features, wide range of choice, shorter lead times, lower real prices, etc. The compulsion to face this challenge has inevitably created an unprecedented and massive growth in the cost of support functions like planning, engineering, product development, purchasing, materials handling, stock control, marketing, training and management services. Consequently, while the direct labour content of products/ services has reduced much over a period of time, overhead costs have increased significantly.

(B) Time Lag — The link between the cost drivers and the costs themselves are most often not easily understood because of time lag and the involvement of several different functions. As a new product moves progressively from idea generation to production, the cumulative costs incurred, which are relatively low at the initial stage, accelerate as the manufacturing facility gears up for production with required stock and equipment. Though the finance and the other functional areas focus considerable attention on the very expensive production phase, much of the unit product costs are actually determined in the early stages. Only a closer relationship among suppliers, the purchasing and manufacturing functions, and the design and engineering teams will help ensure that the significance of the decisions at the initial stage are clearly understood. Otherwise, the product cost estimation for decision making may be largely unreliable.

(C) Meaningful Control — Cost management demands effective cost control. In the long run, almost all costs are controllable, but fixed costs cannot often be controlled in the short run. Even the variable costs are not very often controllable in the short run. Though much time and effort are spent to locate and measure such costs, in many cases, the efforts do not yield the desired result. The reality is that the leverage to control costs in the short run to medium run is much greater in the overhead areas than in the direct cost areas in a typical manufacturing organisation. Management accountants, very often, have the tendency to gather information that is easy to collect and measure and which appear to be important to the business organisation. Very often the value of such information is limited and does not help managers exercise meaningful control. Therefore, identification and measurement of the cost items that often remain unnoticed but build up costs significantly is a crucial step from control point of view.

(D) Product Cost Ascertainment — Most business organisations recover their manufacturing overheads on the basis of direct labour hours, machine hours, etc. Apart from the fact that this approach is easy to understand and implement, it is useful when direct labour content is high and overhead cost content is low. However, in recent times, overhead costs have grown significantly mainly at the expense of direct labour. Consequently, product costs computed by using the conventional methods are increasingly becoming unreliable for the purpose of resource allocation and profit determination. Where prices are market-determined, incorrect product cost estimation may lead a firm to continue with unprofitable products or discontinue profitable products, and result in huge losses. On the other hand, when prices are determined on a cost-plus basis, incorrect cost estimates will lead to loss of profitable business through over pricing or accumulation of losses through under pricing.

(E) Inadequacy of Traditional Cost Management — The structure of a typical business organisation is hierarchical and the type of departmentation is functional. This functional approach is reflected also in the cost reporting and cost control exercises. Departmental performance is monitored by using a system of budgetary control. Though this approach is simple and largely used, it has been found to be inadequate for the following reasons:

- Though top management gives much time and effort in developing corporate strategies, a faulty system of communication of such strategies down the line is often responsible for failure to get the desired results. Most of the time, on grounds of confidentiality, only a fragmented part of the total strategy is communicated to each department in the form of departmental budget. Consequently, departmental managers often lose their initiative to respond to the wider corporate opportunities.
- Business organisations try to meet their corporate objectives and customer needs. In this respect, each department has a role and is given a cost budget. However, very often, the departmental budgetary targets become sacrosanct and the departments' contribution to meeting overall corporate objectives and customer needs decreases.

  Traditional management accounting focuses only on departmental costs but often ignores the quality and/or importance of the service provided by such department. The adverse variance is obviously highlighted when a department's costs exceed its budget but the traditional system does not provide for identification of the root cause and/ or suggest remedial course of action. An importance service will certainly be adversely affected if a resource is cut indiscriminately to somehow adhere to budgetary limits.

- Traditional management accounting largely fails to appreciate that effectiveness of key business processes (which are usually cross-functional in nature) underlie corporate success. Inadequacies in any department (which contributes to a business process) can certainly affect the entire business process. Traditional Management Accounting, which is tuned to a typical hierarchical and functional organisation structure, largely fails to appreciate the relevance of business processes. Also traditional management control systems seem to be inadequate and ineffective.

(F) Profitability of Customer/ Customer Group — Different customers and customer groups have varying needs. In order to retain existing customers and attract new customers, business organisations need to provide widely different levels of services vis-à-vis a number of service elements (e.g., frequency of delivery, number of order lines, quantity per order line and customer location, discounts offered and after-sales service). Each of these service elements has associated costs but the conventional Management Accounting techniques largely fail to appreciate this. Thus, business organisations often fail to understand the true cost of rendering service and, therefore, the true profitability of individual customer/ customer group. Some customers whom the business organisation regards as most important may not at all contribute to profitability while some potentially valuable customers may remain neglected.

The Possible Responses

A different approach is required to take care of the aforesaid limitations of traditional cost management. Such an approach must be able to:

1. consider the important cost drivers like variety, complexity and change, apart from volume, in order to determine reliable product costs;
2. determine true customer profitability by rationally relating the costs of providing different service elements to individual customers/ customer groups;
3. measure the failure costs, more so with respect to the overhead areas, in order to sensitise top management vis-à-vis potential areas for improvement;
4. locate the cost drivers to enable managers to channelise their efforts for cost control in the right direction; and
5. identify and appreciate the importance of crucial business processes.

ABCM -The Tasks Involved

ABCM involves the following important tasks:

(A) Collection of Relevant Data — Collection of relevant data makes it possible to build an activity database necessary for various types of analyses. The activity database is a quantified record documenting all the activities of all the people working in the business organisation. Activity data differ from the traditional management accounting data in the sense that such data, quickly collected, are not precise but only a reasonable estimate for making effective decisions. However, analysis and interpretation of activity data requires appreciation of corporate and customer needs.

(B) Survey of Customer Needs — A business organisation will have to always meet customers' needs and sometimes go beyond that. It is necessary to undertake surveys on external customers' needs in order to appreciate the factors perceived vital by the customers vis-à-vis the service level they expect. Then such factors must be prioritised and both customers' and top managers' assessment regarding business performance must be obtained. The gap between the perceptions of managers and customers requires serious analysis in order to identify the areas requiring improvement in service levels and also the areas where service levels can be reduced.

(C) Identification of Critical Success Factors (CSFs) — ABCM, inter alia, is expected to make available the required resources for meeting the current and potential customers' demands. This, in turn, requires knowledge regarding the strategic direction of the organisation and the major requirements of the external customers. Interactions with the senior managerial people will help appreciate the strategic direction of the organisation and survey of external customers' needs will help understand their real requirements. These two types of inputs taken together will help develop the CSFs which reflect the vital issues to be carefully handled in order to be effective. Clear understanding of CSFs facilitates management of necessary changes.
Accomplishment of these three tasks enables a business organisation to undertake a vital exercise vis-à-vis its growth, i.e., Business Process Improvement (BPI), which, inter alia, helps remedy the inadequacies of traditional cost management.

Business Process Improvement

A business process is really a meaningful combination of the activities performed logically and in a sequential manner in an organisation. Ultimately, it is the effective performance of the business processes as a whole that actually matters. A business process will not be effective unless each individual activity within it is performed well and is fully integrated into the overall business process. However, effective co-ordination of a number of managerial groups (in charge of different parts of a business process) is really a difficult job due to the existence of different types of organisational barriers, e.g., those arising out of too rigid a hierarchical structure and functional departmentation in case of a typical business organisation.

Any ABCM exercise requires grouping of related activities into a business process. All such activities in a business process need to be reviewed regularly more so because they are not at par in terms of value addition vis-à-vis business process improvement. The ABCM approach requires categorisation of all such activities in a business process as core, support and diversionary.

Core activities are those that add value to the business and thus provide a service to the internal and/ or external customers and definitely call for particular type (s) of expertise. Core activities can be enhanced or reduced. The top management can make decisions regarding enhancement/ reduction of the service levels provided by the core activities in the major/ less important business processes. This can be done by analysing the business processes keeping the customers' needs and CSFs in mind.

Support activities are those necessary to make core activities happen. Support activities must be performed effectively with the help of appropriate systems.

Diversionary activities are those which are necessary to take care of failures/ inadequacies anywhere in the organisation. Diversionary activities can certainly be minimised, though not altogether eliminated. This can be done through a root cause analysis of problems.

Diversionary activities increase in number and scope as a result of frequent occurrence of failures throughout the organisation arising out of the chain effect of failures taking place in one or more segments of the business processes. This is more so because business processes in an organisation are, in a sense, interrelated. In the long run, the cost of eliminating the cause of a failure is less than the cost of the diversionary activity (ies) to be undertaken to take care of that failure.

The analysis of all the activities of an organisation in terms of the abovementioned activity-categories will certainly help the top management work out an effective balance among such activity-categories.

Any effective ABCM exercise will, in the process, lead to a desirable change in the mix of core, support and diversionary activities in a business organisation. Such exercise, in the long run, will help develop a totally different way of looking at business costs. ABCM generates costs and identifies the relevant cost drivers in a process-wise manner rather than in a department-/cost centre-wise manner. In the wider context of corporate and customer needs, ABCM is instrumental in enabling the top management to focus on and evaluate the opportunities for business process improvement.

In identification of attractive investment opportunities and their evaluation, ABCM plays a major role. It helps management concentrate on vital core activities and avoidable diversionary activities. On the whole, ABCM facilitates quantification of improvements resulting from investments particularly in terms of better service provided by core activities, more effective support activities and minimisation (if not elimination) of diversionary activities.

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