



ACCOUNTICA

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Content :

1. Activity- based costing (ABC) and activity- based management (ABM) – Katarzyna Gierusz
The article outlines the nature of ABC and ABM and discusses the extent to which they are better than conventional management accounting as an aid to decision making.



Activity- based costing (ABC) and activity- based management (ABM)

In twenty century many factors such as strong competition, development of technology and increase of customers' needs determined company's activities. To meet environment's requirements firms had to diversify their services, start to produce products in small batches and implement new production and management systems. Those changes caused the substantial increased of overhead costs. Since they had no obvious connection with products volume the traditional way of cost allocation became useless. The need of more accurate costs allocation system, as a basis of economic decisions, was indicated especially by manufacturing companies. Activity- based costing (ABC) was a response for this requirement. ABC is not a radically different method of cost allocation. It is just more developed than conventional costing. However, in contrast to traditional allocation, ABC could have been easily adopted by managers. The ABC's conception of treating firms' activities as the causes of costs was the foundation of activity-based management (ABM or ABC/M). This method facilitated the decision making process and monitoring in companies. Nowadays, despite the common roots, ABC and ABC/M are set against the conventional management accounting. Those systems are believed to provide more real and accurate figures, which guarantee better management. On the other hand, the methods based

on companies' activities have the limitations and disadvantages which in some situations might eclipse the benefits.

The nature of activity- based accounting and management can be discussed from two points of views. They can be set against the conventional accounting or against each other. The first approach emphasize that, in contrast to traditional costing, ABC is focused on process of product's manufacture rather than on product itself. This perspective imposes two- stage method of cost allocation which is more complex than conventional one. The approach taken by ABC assumes that *'costs are pooled to activities according to each activity's consumption of resources. The second stage assigns costs to costs objects (such as products, services and customers) based on their use of activities'* (Hopper, D. Northcott, R. Scapens, 2007, p. 160). In other words, costs objects generate activities that in turn consume costly resources (W. Seal, R. H. Garrison, E. W. Noreen, 2006, p. 325). In practise it means that product are charged only for the costs of capacity they really used and even non-manufacturing which do not change proportional to the volume or direct labour can be assigned to it. Thanks to this model the allocation of overhead costs is more accurate, better reflect the reality and guarantee more stable unit costs. The



traditional allocation of costs as a simple and one-stage method is helpless towards non-volume related costs.

Activity-based management seems to be the natural consequence of ABC. However they seem to have different nature. ABC method is based on static analysis of company, while ABM system is more dynamic, related to changes. This feature is connected with objectives appointed to those models. ABC is concentrated on providing information about costs, their reasons, products, processes and markets. In contrast, ABM tries to find the ways of changing the level of costs and improving products, processes and markets. This is why activity-based costing is focused *ex post* and activity-based management *ex ante*. Moreover, ABC method provides results of operational management, while ABM system is a tool of strategic management. Despite different natures, ABC complements ABM and harmonizes with it. However, they are not inseparable, *'ABM implementation is possible even if organization does not allocate overhead costs according to ABC'* (A. Szychta, 2007, p. 266).

The possibility of assigning overheads which are unrelated to volume seems to be the original advantage of activity-based method. However, it is not the only one. The literatures (M. Reyhanoglu, 2004; T. Hopper, D. Northcott, R. Scapens, 2007;

A. Szychta, 2007) present more positive aspects of this tool. Almost all are connected with the facilitation of decision-making process. As it has been already mentioned, ABC has an application to management. This extension enabled to take issues such customers profitability into consideration. In other words *'ABC/M facilitates customer profitability analysis by identifying the activities needed to sell products to each customer'* (T. Hooper et al., 2007, p.165). Moreover, it can be used to create the relationship with clients. Secondly, not only do those systems (ABC and ABC/M) help to identify non-value-added activities such as store, but they also diagnose costly or ineffective activities. This identification encourages companies to redesign manufacturing process which in practise means that organisation resign the activity or reduce time spend on it. Moreover, ABC helps managers to understand costs drivers. Thanks to this they are better prepared to plan, control and reduce costs. Such knowledge is also used when they make pricing decisions, design new products or services, chose new distribution channels or suppliers and construct the activity-based budget. Those decisions have direct impact on company's profit. Finally, ABC/M can be also useful in estimating cash flow. *'By separating costs into activity pools and identifying a cost driver into each pool, the analyst can more accurately determine the level of various costs that will be*



incurred' (M. Reyhanoglu, 2004, p. 8). Because of above advantages all comparisons between conventional management accounting and activity-based accounting are in ABC's favour. The leading writers (R. Cooper, R. S. Kaplan and M. T. Johnson) are unanimous that in such variable environment it is really hard to use traditional management methods in decision-making process. The justification of this opinion is simple. Conventional costs allocation is oriented too much toward financial accounting and does not provide information improving management. But does it really mean that traditional management accounting is useless nowadays?

In my opinion short-term decisions can still be based on conventional management accounting, especially on variable costing and cost-volume-profit analysis. However, it is possible only in companies where ABC system do not have to be implemented. I mean organisations with low overhead costs, small numbers of customers and homogeneous products which are produced in big batches. For such enterprises the contribution approach is not only sufficient to make decisions but it is also cheaper and easier to implement. Moreover, in many situations it gives the results as good as activity-based approach. Managers can use traditional methods to decide whether make or buy elements of their product, how to deal with limiting factors, whether accept an extra order or how

optimize production (C. Drury, 1996, chapter 11). Unfortunately, variable costing and cost-volume-profit analysis cannot assist strategic management. In long-term approach the figures of each parameter are too uncertain.

ABC/M system has also the disadvantages and limitations. First of all data gathering is complicated, time-consuming and costly (E. Nowak, R. Piechota, M. Wierzbiński, 2004, p. 189). Sometimes ABC modal requires changing company's organisation or process of production. Moreover, all employees should be involved in this system so employee education at every level is necessary. However, this might cause the staff resistance. The biggest problem related to ABC/M is the time. Probably this is the only issue which was not solved by this system. The information provided by this system are often based on monthly data while managers, nowadays, need daily or even hourly ones (M. Reyhanoglu, 2004, p. 10). Those implementations problems can be overcome, however, even then company still have to use the conventional method of cost allocation for external financial reports (W. Seal et al., 2006, p. 298).

Activity-based accounting has a complex nature. On the one hand is more developed than conventional management accounting, but on the other hand is static and focused ex post. No matter which approach is taken into consideration ABC's



contribution to decision-making process is unquestionable. However, both ABC and ABC/M systems are criticized for being only a refinement of conventional management accounting. It is also believed that companies implement those tools only because it is trendy not because it is helpful (T. Hooper et al., 2007, p.172). Regardless of true reasons, ABC/M was a chance for some big, manufacturing firms such as General Electric to improve their competitiveness and quality of management. However, the ABC's success should

not settle that traditional management accounting is obsolete and inadequate. Although it is less complex and not so sophisticated as ABC/M model, for many organisations it is sufficient to make decisions. It can be a solid base for operational management. No matter which model will be chosen by company, it must be sure that this system is suitable for it. Because even the best management accounting approach will not work if it is not tailor to firm's needs.



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