



## ACTIVITY BASED COSTING AND ITS IMPACT ON THE PROFITABILITY OF THE ORGANIZATION

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### ABSTRACT

Activity based costing (ABC) systems claimed conventional managing accounting systems created confusing costs in a modern-day, turbulent, frequently altering business surroundings and implementing Activity based costing system would help the organization to get rid from difficulties, therefore

activity-based costing (ABC) shows the sign of enhanced competitiveness and efficiency in every organization. The purpose of this article – after analyzing the existing literature in the field – is to emphasize those new cost systems such as ABC could be a strong that assures competitiveness and efficiency for each company. Another objective is to present that, besides its disadvantages, firms implement the ABC system because it allows superior tracking of costs to objects, superior allocation of expenses to cost objects, financial and non-financial analysis and measures valuable to managers and management accountants in the decision making process.

**KEYWORDS** :ABC, profitability, Organization.



### INTRODUCTION :

Changes in the business environment, suppressed by worldwide rivalry in the field of business and hi-tech modernism, have led to innovations in the use of both monetary and non-monetary information in organizations. The latest atmosphere makes demands of an important information and data about costs and performance of the organizational activities, processes, products, services and customers. A country of an economy in huge lies on industries particularly manufacturing sectors such as attire and textiles companies, leather, medication, cement, electronics, etc. As more corporate sectors venturing into manufacturing industries create competition, they are required to give a quality

customer service at reasonable cost. Several firms have gone into insolvency as consequences of deprived control over getting higher overhead cost. Thus, the sustainability of a firm in manufacturing industry is largely depending on the ability to keep the operation cost at marginal level and thus make it as competitive advantage to take it to even greater profitability.

Both cost and management accounting concepts and techniques are used in manufacturing sectors to offer cost information for decision-making process. A study by Horngren (1995) found that the focus of cost management should be on decisions and the various cost management techniques, systems and measurements that encourage and help managers to make superior economic decisions.

Modern-day management accounting text and textbooks usually makes the talk that ABC systems are “enhanced” than time-honored systems. However, Foster and Young (1997, 68) note “What is strikingly ab-sent from the research literature is any systematic analysis of what better means, how better should be measured, and what challenges are seen in making these measurements”. Foster and Swenson (1997) called for more replication, extension and refinement of ABC success measures.

ABC looks after each overhead costs, which in most organizations constitute the main operating costs, and addresses marketing, general and administrative costs, as well. Whereas traditional cost systems frequently understate profits on high-volume products and overstate profits on specialty items [6], ABC reveals the cost of complexity arising from the range of products and variations by allocating all costs to the products or services that consume them. ABC implementation leads to a better understanding of the cost drivers that generate these costs, thereby focusing management attention on the way resources are consumed by activities and supporting effective management of these activities.

### ABC EXECUTION CHARGE

While ABC execution charge generally augmented during the early 1990’s, Innes et al. (2000) reported a slight fall between 1994 and 1999 in ABC execution by large UK corporations (from 21 percent to 17.5 percent). A replication of this study in 2001 of New Zealand corporate sector Chartered Accountants, reported an adoption rate of 20.3 percent (Cotton et al. 2003). A large scale US survey (in the food and beverage industry) revealed an 18 percent implementation rate (APQC/CAM-I 1995), while a study of Canadian businesses indicated 14 percent had implemented ABC (Armitage and Nicholson 1993).

There have been few studies of ABC implementation rates in Australia. Booth and Giacobbe (1997, 1999) surveyed 213 manufacturing firms and reported a 12 percent rate of active implementation decisions. This was reasonably consistent with Clarke and Mia (1995) who found an ABC implementation rate of 13 percent in Australia’s largest manufacturing firms. These rates were relatively low when compared with those indicated above for the UK, USA and New Zealand, but closer to that reported for Canada.

### HOW ABC CONCEPT OBTAINED THE SUCCESS

Thinking that some variable defines success depends on the individual value placed on the ABC system. There can be a diverse number of variables that may be used to measure ABC success. Examples of ABC success measures tested in prior research include - decision use, decision actions taken, dollar improvements and manager evaluation (Foster and Swenson 1997); user attitude, technical characters-tics, supposed helpfulness in humanizing job performance and organizational process impact (McGowan 1998); management evaluation and dollar improvements (Shields 1995); employee fulfillment (McGowan and Klammer 1997); overall use and accuracy (Anderson and Young

1999); and increase in firm value (Kennedy and Affleck-Graves 2001).

While measures of ABC success such as “dollar improvements” or “increase in firm value” are empirically appealing they are full with possible confounding variables that are tremendously complicated to have power over. Kennedy and Affleck-Graves (2001, 20) admit “despite the strong and robust proof in this paper, it is not possible to prove there is a contributory connection between ABC implementation and subsequent increases in shareholder value”.

Shields (1995, 153) states that “Providing a definition, however, was challenging as the literature is vague about what constitutes success, and discussions with ABC experts during building of the survey did not result in consensus about a tangible definition.” The approach that Shields (1995) adopted was to allow the user to rate the degree of success with whatever definition they deemed relevant. It has been argued, for example, that if a user perceives satisfaction with an information system per se, then the system is successful, consequently user satisfaction can be a proxy for system success (McGowan and Klammer 1997; McGowan 1998).

### **ABC IMPLEMENTATION INVOLVES BEHAVIORAL CHANGE MANAGEMENT TO OBTAIN THE PROFITABLE STAGE IN THE ORGANIZATION**

As with any innovative management method or instrument, a successful change management process has to be in place before implementing an ABC system. An idea of this process should be to ensure that there is support for the system at all levels of an organization. This includes having a top level manager to champion the initiative, as well as acceptance by lower-level managers. The acceptance by these later managers often can be obtained by demonstrating that in most cases the existing cost accounting system produces distorted, and thus misleading, information. This distortion often arises because an existing costing system does not reflect the increasing complexity of an organization and the products and services it offers. By implementing a costing system that reflects that complexity—and provides the operational information necessary for managing a company’s operations—managers can see the increased relevance of the information provided for managerial decision making and enhanced performance management.

The change management process needs to specifically address the “people” issues that will arise in the implementation of the new costing system. This includes addressing commitment to the existing system that various managers may have, and their reluctance to change. It is also important to address the effect of the new system on performance measurement and compensation systems.

One ABC implementation technique developed in the 1990s that radically paced the time to implement ABC, enhanced the ABC model design, and reduced the risk that a project may run into problems caused by excessive detail and complexity is called ABC rapid prototyping with iterative remodeling. This technique confirms that the denominator in the benefits to cost ratio is kept small. It also raises the numerator by more unrecognized benefits. ABC rapid prototyping can lead to a production ABC system being created in weeks, not years, and with minimal support which can surely increase the profitability of the organization.

### **CONCLUSION**

ABC is an influential management tool that has been introduced in response to the hopelessness of conventional cost accounting and cost management principles. Advocates of ABC have been won over following their understanding that the general ledger’s cost center and chart of account expense data is structurally deficient in calculating costs and providing cost visibility and driver understanding. They recognize that broad-based cost allocations create grotesquely distorted and

misleading costs compared to tracing costs with ABC principles. The adoption rate of ABC is propelled by increasing proliferation of all businesses outputs (including types of suppliers, products, services, channels, and customers) that cause increased complexity and increased indirect expenses to manage the complexity. Appeals by quality and Lean management to their sales colleagues to “standardize” cannot overcome customers’ demand for customization. Implementation of ABC in any manufacturing organization helps a lot to manage the emerging needs of the time and to obtain a good position in this competitive environment of competition in this scenario of marketing environment.

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