

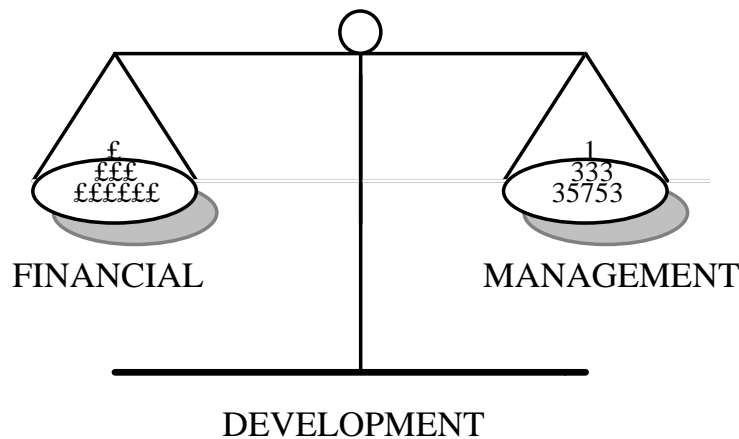
# FINANCIAL MANAGEMENT DEVELOPMENT

## Decision Making

## Management Accounting

NO 313

## ACTIVITY BASED COSTING



ONE OF A SERIES OF GUIDES FOR  
FINANCIAL MANAGEMENT DEVELOPMENT

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This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

# ACTIVITY BASED COSTING

## ABC - WHY DO IT?

Activity Based Costing is a management tool to assist decisions. In some industries it is also used as a basis to allocate fixed costs or indirect costs across products or services with a view to justifying prices. However, it is primarily a management accounting technique rather than a financial accounting requirement.

The desire for cost allocation stems from the existence of costs in an organisation which are not Directly related to Products. These may be service departments (finance, personnel etc.) or fixed overheads (factory rent, office heating etc.).

In many organisations these costs are sizeable portions of the total revenue and unless management takes care to control them they can outweigh the Contribution from products sold, thereby causing a loss.

However, in many instances it is difficult to identify one single basis on which to allocate costs. Headcount is fine for personnel costs but may be inappropriate for research. Sales value is fine for banking costs but can penalise high value items. In addition, too many organisations have found that instead of using the cost data sensibly, managers of productive departments have tended to manipulate the basis used e.g. by hiring contract labour, who do not carry the "overhead allocation".

Activity Based Costing was designed as a way of analysing costs incurred by seeking to identify the factors that cause them. These are called Cost Drivers. The emphasis in ABC is to identify the causes of costs to establish whether they can be changed to result in lower costs, resulting in greater efficiency without reducing value. ABC is best used as a management investigative and modelling technique. Although some organisations have used it as a cost allocation method within their costing systems in all too many cases this has resulted in a loss of control as managers have no basis for challenging and changing allocation methods which are hard wired into the accounting system.

## ABC - HOW TO DO IT

The normal approach is to identify all costs. These are then broken down into Direct Costs and Indirect Costs at a level which is appropriate for the decisions being considered.

This might be Stock Keeping Units, Pallets, Customers or whole product lines. The key issue is to identify the objectives of the exercise first. If it is to reconsider pricing of different pack sizes then the unit is the pack and direct costs will be those associated with the pack. It is important all costs are considered - including hidden costs such as sunk costs, opportunity costs and discounts - but not all need be used in the calculation. In ABC it is the Journey that is important; not the End Result.

## CHARGE THE DIRECT COSTS

Once true direct costs have been identified they can be respectively identified as part of the cost of the product. This does not mean that the investigation is completed for those items. The customer - whether specifically, or by implication through paying the price - must be convinced that the value added by the activity causing the cost is worth the extra cost. In some cases it is not. Self service cafeteria's avoid the staff cost because customers carry their own food to the tables. The customers have decided to carry out the activity themselves. Direct does not mean necessary, or value adding.

## IDENTIFY THE COST DRIVERS

Costs are caused by activities. In some cases these add value, in some case they do not. In many cases the value added does not justify the cost. A key benefit of ABC is that it helps identify low value adding activities.

Accounting systems rarely reveal the true cost drivers. For example the cost of processing invoices depends on the number of invoices not their value and the time spent per invoice may be more directly related to the number of key strokes in the customers name and address, than any other factor.

Once key cost drivers are identified it may be useful to consider them. A motor manufacturer's stated intention to reduce the number of its suppliers by 90%, is in part due to the realisation that ordering, purchasing, receiving, negotiating etc. type costs are driven by the number of suppliers and thus a reduction in number can result in a reduction in cost. The key questions are "What causes this cost? Is it worth it? and Can we reduce it without reducing value?"

## ALLOCATE THE INDIRECT COSTS

Once the indirect costs are known and the Cost Drivers have been identified, the costs can be allocated across the Units of Production specified. This enables a fairer allocation of costs than many of the more conventional allocations based on headcount, revenue or space occupied. In particular it highlights the cost of complexity. Every effort should be made to identify items where the cost of complexity is high and remove them.

## CONSIDER THE RESULTS

ABC can cause organisations to remove low value adding activities; it enables them to identify Cost Drivers with a view to reducing them; it can lead to decisions on delisting products where the income generated does not match the cost, or encourage the expansion of a product previously considered a loss maker.

Of itself it achieves nothing. Only by careful use, can it be an aid to decision making. This includes pricing decisions but care always needs to be taken when using cost as a basis for pricing.

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David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development.

He has worked as a Financial Controller and Company Secretary in the Finance Industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over thirty major organisations including Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, The Post Office, Rothmans and Zeneca. International training experience includes work in Denmark, Kenya and the Czech Republic for Unilever, in Dubai for Al Atheer, in Holland and the U.S. for Avecia and Zeneca and in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. A key output from the training is demonstrable use of the knowledge and skills acquired to enhance corporate profitability. In addition he has run courses in acquisition evaluation (The Economist, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). He has also developed material for delivery by in house personnel (Royal Mail, Lloyds Bowmaker and Conoco) and computer based training packages (The Post Office, Unilever and BP).

He is a prolific writer of case studies, role plays and course material, he has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants and the need for taxation awareness training for general managers.

He is married with one grown up daughter and his outside interests include being The Treasurer of the Hospice of St. Francis (Berkhamsted), and a member of the Catholic Alpha Training Team (Promoting the Alpha course on Basic Christianity). He was a Governor of Luton University for nine years and a school Governor for four years.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).