

An Empirical Study on How Activity Based Costing is relevant to Enabling Managers take better Business Decisions

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ABSTRACT:

*The intent of this research paper is to reveal the important parameters that Manufacturing Organisations in India should take into consideration to remain competitive. Due to the changing dynamics of business environment, organizations need to rethink their business models and strategies in order to **achieve competitive edge**. The reality remains that successful organizations are able to improve quality, lower their costs and take quick corrective actions around products, customers and services that incur them losses. The challenge lies in getting accurate and timely information about the parameters that define and sustain profitability – thus enabling long term competitiveness. The study intends to reveal the parameters that the Manufacturing Organisations feel they need to monitor consistently; and how shifting from Traditional costing systems to Activity Based Costing systems can help them get information on those parameters more accurately and timely.*

INTRODUCTION

Today's business environment has become very complex. Most Emerging Indian Manufacturing Organizations are recently facing the challenge to remain competitive in this dynamic and ever changing market scenario. There is a rising pressure on pricing and profitability. In such fast changing environments, speed of decision can become a crucial factor for better competitiveness.

The intent of this research was to understand the parameters which the management of such Emerging Manufacturing Organizations felt necessary for building strategies for remaining "competitive". A questionnaire was given to 25 CEO's of Emerging Manufacturing Organizations in the region of Mumbai & Thane in the State of Maharashtra. The questionnaire asked them to give their preference around the parameters that are critical for "**building competitiveness**" in

their businesses and what were the challenges they felt their organisations had in getting the information for the same.

The questionnaire placed 15 global parameters for building competitiveness and the CEO's were supposed to rank 10 out of them in ascending order of importance. The 15 globally known parameters for competitive advantage were as under :

1. Accurate Product Costing,
2. Target Costing of competitive products,
3. Supplier selection decisions,
4. Pricing decisions,
5. Quality Costs,
6. Learning & Continuous Improvement initiatives,
7. Distribution services effectivity,
8. Customer profitability,
9. Customer selection / elimination,
10. Resource Capacity costs,
11. Asset utilization,
12. Vendor sustaining costs,
13. Productivity understanding,
14. Transfer pricing,
15. Product mix decisions.

The 10 parameters which came out in the order of importance are the following :

1. Pricing Decisions
2. Productivity Understanding
3. Product mix Decisions
4. Asset Utilization
5. Customer Profitability
6. Accurate Product Costing
7. Target Costing of Competitive Products
8. Customer Selection/Elimination
9. Learning & Continuous Improvement initiatives
10. Supplier selection Decisions

This analysis gave us the insight about the 10 most critical parameters for building competitive advantage to the CEO's of Emerging Manufacturing Organisations in Mumbai & Thane region of Maharashtra. Tracking these consistently would assist the managers take strategic decisions to build competitiveness for their organisations.

The challenge most CEO's (around 85% of the respondents) voiced was, the inability of their existing accounting systems to deliver the data on such parameters – accurately, consistently and timely. Managing these parameters need them to be measured and monitored on a consistent basis – wherein the CEO's felt the inadequacy of the existing financial oriented management information systems. They suggested that as the information systems around these parameters was inaccurate, many organisations decisions had a heavy reliance on instincts of Top Management people and the gut-feel experience of the senior members of the organisations; for taking such strategic decisions.

REALITIES

In today's competitive business environment, it is imperative that the management of such growing organisations receive timely information on the parameters mentioned above. This calls for a system of management accounting and better MIS (Management Information System) for accurate and timely strategic decision enabling data.

The fact is that many Indian organizations have still not evolved themselves to gather and collate strategic decision oriented data, as they have not yet adapted to enhanced management cost systems. They still depend on organizational information which comes from traditional costing systems, which were essentially designed for simpler technological age when competition was less, organizations produced standard products and services and when speed, quality and performance were lesser important factors of success. Due to heavy reliance on traditional costing systems, managers of growing manufacturing organizations, don't have relevant information to guide their improvement activities. Managers many a times don't even have valid information to shape their strategic decisions about processes, products, services and customers.

To remain competitive, managers need to rethink their managerial practices and thus in close relation to this, they need to quickly reshape their existing accounting systems, especially the cost accounting systems. Traditional managerial accounting techniques such as absorption costing, budgeting and profit-based performance measures need to be replaced with strategic management accounting oriented costing techniques. Current business environment demands relevant information and data about costs and performance within the organization's activities, processes, products, services and customers. In order to survive, companies need to be agile in key strategic decision making parameters. Agility demands features like flexibility, robustness, adaptability and speed in the organisations.

The recommended solution to build agility in organisations, is the active use of Activity Based Costing (Fricke E, Shulcz AP (2005) Design for changeability (DfC): Principles to enable changes

in systems throughout their entire lifecycle, in *Systems Engineering*, Vol.8, pp. 342-359. Wiley Periodicals).

Activity Based Costing has slowly but surely emerged to meet the need for business and performance information – which is much beyond the traditional “financial oriented” information. Managers of competitive organisations can get accurate information about the cost of resource demanded by individual products, services and customers by using Activity Based Costing. The robustness of this technique is that, it enables indirect and support expenses to be driven first to activities and processes; and then to products, services and customers. This helps the managers in getting a clear picture of economics of their operations, and in turn, improve their decisions.

Information received from Activity based Costing can play a pivotal role in assisting decisions that determine the mix of the product line, pricing of the products, identifying the location of sourcing components and assessing new technology and many more strategic decisions (Beyond Governance: Creating Corporate Value through Performance, Conformance and Responsibility, Martin Fahy, Anastasia Weiner, Jeremy Roche).

Many leading companies across the globe use Activity Based Costing systems to:

- Design products and services that both meet customers’ expectations and can be produced and delivered at a profit;
- Signal where either continuous or discontinuous improvements in quality, efficiency and speed are needed;
- Assist employees in their learning and continuous improvement activities;
- Guide product mix and investment decisions;
- Negotiate about price, product features, quality, delivery and service with customers;
- Efficient and effective distribution and service processes to targeted market and customer segments.

All of the above are essential ingredients to build competitive advantage for any Manufacturing firm operating in a dynamic and evolving environment.

CONCLUSION

In today’s competitive environment, there is pressure on the companies to stay competitive in the market. All the necessary information regarding the costs is not available by using traditional costing techniques. Activity based costing (ABC) assigns manufacturing overhead costs to products in a more logical manner than the traditional approach; essentially by assigning the cost of those activities only to the products that are actually demanding the activities (Kaplan & Cooper).

This research focuses empirically on investigating the influences of Activity Based Costing information and its effectiveness on measuring the parameters that help organisations become competitive. Traditional Costing Systems are not only inadequate but irrelevant in giving such strategic oriented information. CEO's of Emerging Indian Manufacturing Organisations need Activity Based Costing Information's to assist them take meaningful decisions to stay competitive. These data can help the managers build cost and performance management measurables, which can assist managers build strategies for increasing the profitability and thus competitiveness.

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