

Cost Control to Result Control—The New Business Challenge for the 21st Century

The tasks, responsibilities and practices of management are being guided not by traditional cost control but by the pressing need of the hour—result control or managing for results. This concept is likely to underlie the enterprise that executives will have to manage tomorrow. We have to redesign both our enterprises as well as the accounting system to provide adequate relevant information to the leaders of the businesses to manage these new challenges.

We live in a period of profound transition where every thing is going under rapid and tremendous transformation. National boundaries of trade and commerce are being increasingly extended to international arena. Cross-border flow of technology, fund and services has become the rule rather than an exception in today's business. Globalisation has taken a deep root in every sphere of our economy. Management of enterprise, earlier considered to be the exclusive domain of Managerial Economics, has developed into a new subject of its own with its own theories, principles and postulates to be practised as a separate and distinct subject—'Management'. Consolidation, competition, creation and innovation have become the new management challenges.

Peter F. Drucker, the eminent management thinker of our time, has rightly pointed out that *"The centre of a modern society, economy and community is not technology. It is not information. It is not productivity. It is the managed institution as the organ of society to produce results."*

This is the new paradigm on which modern management should re-orient its role and practice. Drucker has emphasised the purpose of management as;

"Management exists for the sake of institution's results. It has to start with the intended results and has to organize the resources of the institution to attain these results. It is the organ to make the institution, whether Business, Church, University, Hospital or a Battered women's shelter, capable of producing results outside of itself."

To make things happen, management has to learn to organise its information systems to provide the desired information to be used as its key resource.

Traditional Costing vis-à-vis ABC System

One of the required changes in the system that demands attention most is the area of system of costing. Traditional cost accounting determines the cost of a product. What it costs to do something and the costs of not doing are excluded. But costs of not doing are very much important in today's business because it also affects the ultimate result of the business and its position. Activity Based Costing (ABC) records both the costs of doing and costs of not doing something and as such provides full information to the management of the economic activity for taking a considered view as a whole not only to control cost but also to control the result.

So it is high time that we adopt Activity Based Costing (ABC) in place of traditional cost accounting. Some businesses have already completed this exercise and others are in the process of doing so.



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Activity Based Costing (ABC) was first developed to cater to the needs of manufacturing industries but gradually it finds its application suitable in service sectors and in other non-business sectors as well. It takes a different concept of not only the business process but also measures such processes in different ways.

Costing is basically the system of determining or ascertaining costs of product or service. And for this purpose, both traditional costing system and activity based costing are the same as far as this objective of determination of cost is concerned. ABC is also a product cost method. But there are some differences in approach between the two. As far as the direct costs are concerned they can be easily and conveniently related to the products or services under consideration, the treatments in both the system of costing will not pose any problem. The controversial area is the allocation and apportionment of overheads and its ultimate absorption in the product or service. For distribution of overheads in traditional costing system mostly volume related cost drivers are used wherein in activity based costing more appropriate and pin-pointed cost drivers are used in the distribution of overheads to the key activities as determined by the management in installing the ABC system.

Activity Based Costing (ABC) is basically “an approach to the costing and monitoring of activities, which involves tracing resource consumption and costing final outputs. Resources are assigned to activities and activities to cost objects based on consumption estimates. The latter utilizes cost drivers to attach activities costs to outputs.” In ABC an activity are focused upon as fundamental cost objects and the cost of these activities are used as building blocks for computing the cost of other objects. This technique can be gainfully utilised as a means of cost management in general and cost reduction in particular, and can be applied to the existing or new products at any stage of the product life cycle.

In traditional costing system total manufacturing cost of a product is taken as the sum total of the cost of all operations that go into

the product while manufacturing. But for the performance and profitability of a business costs of the total process have to be managed which is the essence of this new Activity Based Costing (ABC). Activity Based Costing (ABC) postulates that business is an integrated economic chain that starts when the raw materials arrive at the F.O.B./F.O.R destination and continues even after the finished product reaches the end users till the completion of the service period either in the form of warranty or after sales service free or on chargeable basis. Service or installation is still a cost of the product, even if the customer pays.

ABC encompasses the whole gamut of activities starting from product design, value addition in every stage of manufacture, process efficiency, cost of machine down time both for planned maintenance and breakdown maintenance, waiting time for a needed part or tool, cost of rework, defective and spoilage, cost of quality control, cost of inventory management and other such areas comprising both cost of doing and cost of not doing of certain activities. All these areas are very important for the performance and position of an enterprise. In traditional costing system some of the above costs are treated as period costs or abnormal costs and directly charged to Profit and Loss Account and in many cases fail to draw the proper attention of the management. Thus ABC integrates several procedures and areas of management control earlier considered to be the separate functions of value analysis, process analysis, quality control and costing - into one comprehensive system - Activity Based Costing (ABC). In this way ABC not only helps the management in controlling costs but also in achieving the results by bringing into focus the areas that require attention of the management under one umbrella—the result control.

Another important area where ABC can make a great impact is the service sector. In most manufacturing companies traditional costing system has proved to be inadequate but many service industries like hospitals, banks, schools, newspaper etc. have practically no appropriate cost information to control. Cost of individual

operation in service sector cannot be precisely determined as manufacturing companies are doing for traditional cost accounting. Because in service sector there is practically one cost; that of the Total System. The distinction between fixed cost and variable cost is totally irrelevant in service sector which is very vital in traditional costing system. One very important assumption on which the whole edifice of ABC is based is that all costs are fixed over a given period and such costs can be related to various activities being carried on by the enterprise. By applying this principle, service sector can ascertain cost of its different activities and exercise proper control. Now the service sector can determine which activity is at the centre of cost and result? Which activity is most profitable? Which activity is fetching the maximum yield per limiting factor of resources deployed? On the basis of such information they can formulate their strategies and concentrate on high yielding segment of business. Thus ABC has added new insights into the cost of getting and retaining customers in business of all kinds.

Serious cost disadvantage affects the competitiveness of an enterprise to a great extent. So cost control should be an important objective of management to remain competitive in the market. For controlling cost the first prerequisite is to determine the cost effectively and to this end ABC offers a better technique compared to the traditional costing system. Poorly conceived costing often depletes the competitiveness and weakens a company's market share, profitability and financial position and ultimately hampers business result. So the corporates have to move from cost control to result control through better tools and techniques to effectively face the competitive environment. ABC is definitely a better option to pursue such an end. It can substantially lower manufacturing costs. According to an estimate it may go up to a reduction of twenty five per cent to thirty per cent.

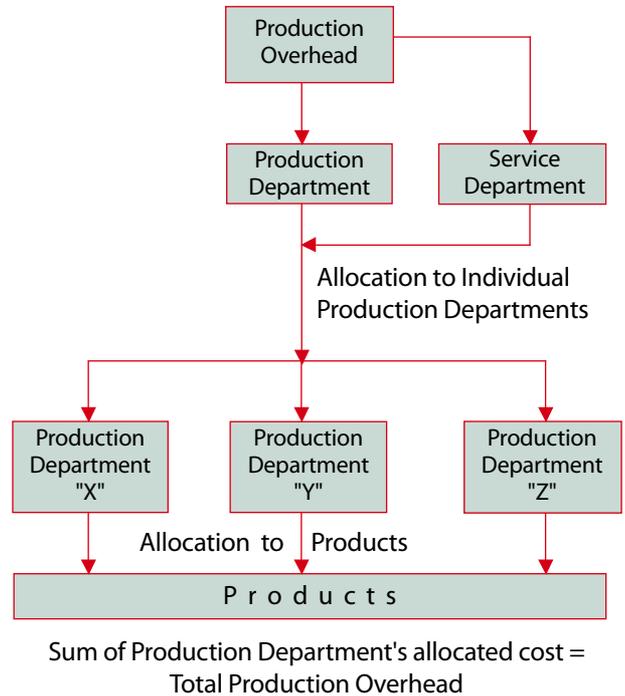
Implementing ABC System

PART I

Before describing the steps to be taken for implementation of the Activity Based Costing

(ABC) system, the mechanism used for allocation and absorption of overhead costs under both the systems of costing are presented below so that the readers can have a general idea as to the difference between these two systems.

Fig –1 Traditional Product Costing System



From Figure 1 and Figure 2, it transpires that under traditional product costing overhead costs are grouped together under the heading of cost centres and then absorbed into product costs on some agreed basis such as direct labour hours, machine hours etc. But in Activity Based Costing (ABC) system activities are considered as fundamental cost objects and these activity costs are absorbed into the products through appropriate cost drivers.

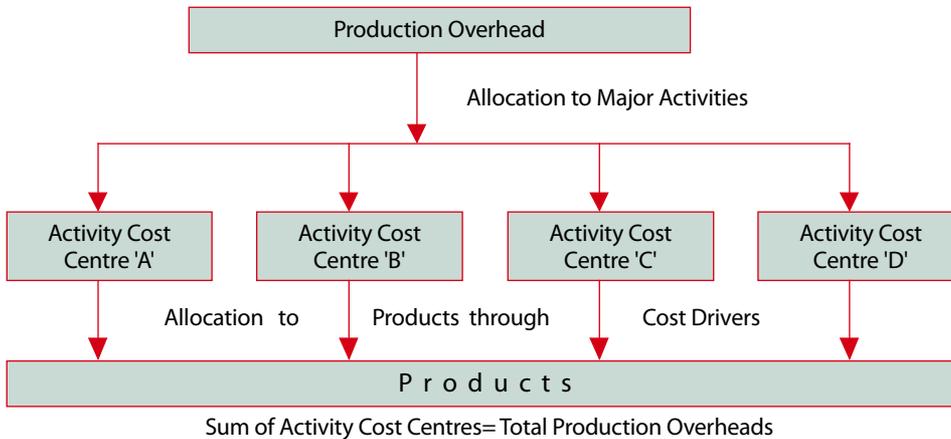
Part II

If a company decides to establish an Activity Based Costing (ABC) system, the following four major steps are to be taken:-

(1) Identification of Activities

The major activities that take place in the organization should be identified in respect to which costs are to be collected. Activities

Fig – 2 Activity Based Costing System



comprise the aggregation of units of work or task that can conveniently be summed up as an activity. As for example tasks relating to receiving a purchase indent, identifying suppliers, calling quotations, evaluation of offers, preparing purchase orders, mailing purchase orders, performing follow up, receiving and inspecting materials may be aggregated as purchasing and receiving activities and all expenses relating to these tasks can be collected under this activity cost centre. Activities are identified with the help of activity analysis and are to be selected at a reasonable level of aggregation based on cost versus benefits criteria and must be significant to justify separate identification with the ability of a single driver to provide a satisfactory determinant of the cost of activity.

(2) Assignment of Costs to Activity Cost Centres

The resources consumed over a specified period by different identified activities should be assigned to each activity. Some of the cost of the resources may be directly attributable to the specific activity centre but some other resources may be shared by several activities. These costs should be allocated to the concerned activities on the basis of cause and effect cost drivers called resource cost drivers or on the basis of reasonable estimates of the resources consumed by different activities.

(3) Selection of Cost Drivers

To allocate the cost of each activity as collected

through step 2 above to different products (Cost objects), an appropriate cost driver is to be selected for each activity cost centre. These cost drivers are called activity cost drivers and mainly consist of transaction drivers, duration drivers and intensity drivers. In selecting a particular cost driver

several factors are to be kept in mind such as its capacity to provide a good explanation of costs

One of the required changes in the system that demands attention most is the area of system of costing. Traditional cost accounting determines the cost of a product what it costs to do something and the costs of not doing are excluded. But costs of not doing are very much important in today's business because it also affects the ultimate result of the business and its position.

in each activity cost centre; it should be easily measurable; data should be relatively easy to obtain and be identified with products; and the cost of measurement should be reasonable.

(4) Assignment of Cost of Activities to Products

In the final stage of the operation of ABC, cost drivers rates are charged to the products. Therefore, the cost drivers should be measurable in a way that enables it to be identified with each individual product. As for example, if set up hour is selected as cost driver, there must be a mechanism for measuring the set up hours consumed by each product. Product will be charged as per set up hours consumed multiplied by rate per hour.

Case Study on Cost Determination as per Traditional Product Costing vis-à-vis Activity Based Costing

Let us assume that a company engaged in the manufacture of three products A, B and C determines its product cost on the basis of traditional product costing. The figures for the month of April 2006 were as follows:-

Now the company is willing to establish ABC system and after analyzing the activities has identified two major activity cost centres as (1) Purchase and Receiving materials and (2) Production scheduling and Set ups and selected Purchase Requisition and Number of Batches as cost drivers for Activity (1) and Activity (2) respectively. The details of the activities and their related costs are given below :

Activity Cost Centre	Cost Drivers	Cost (in Rs)
(1) Receiving purchase indent, Identifying suppliers, Calling quotations, Evaluation of offers, Placing orders, Purchase orders, Receiving and Inspecting materials	Purchase Requisition	36,400
(2) Production Scheduling, Machine Set Ups	Number of Batches	15,600
Total Production Overheads		52,000

Additional information received is as in Table 3 on next page :

By processing the information in Table 1, 2 and 3 we can calculate the cost driver's rate as;

1st Activity Rs. 36,400 ÷ 364 = Rs. 100 per purchase Requisition

2nd Activity Rs. 15,600 ÷ 60 = Rs. 260 per set up

Product	A	B	C
Units produced	1000	2000	3000
Cost in Rs			
Direct Material per unit	5	4	3
Direct Labour @ Rs 2 per hour	3	4	5
Production overhead allocated			
On the basis of direct labour cost	6	8	10
Total cost per unit	14	16	18

Applying these particulars if production costs are calculated on the basis of ABC, the position would have been as given in Table 4.

Observation

The above exercise reveals that products A and B have been significantly under costed and product C has been significantly over costed by the traditional costing system (Refer Table- 1)

relative to the ABC system (Refer Table-4). Based on lower costs products A and B are likely to be priced low and based on higher cost of C, its price will be fixed at a higher level. In view of the competition in the market and offering by other manufacturers of item C at a lower price based on their cost estimates (which is true), product C of this company will gradually lose

its market due to high price and the company will lose its market share heavily and incur huge loss. C being a high volume item the financial position of the company will be very alarming in the long run. On the contrary, the company may be tempted to increase the production of A and B which will be sold in the market due to their lower prices based on lower cost estimate (Which is basically wrong), the company will be losing heavily.

Products	A	B	C	Total
Number of Purchase Requisition	120	180	64	364
Number of Set Ups	15	30	15	60

Particulars /Products	A	B	C
Units produced	1000	2000	3000
Costs in Rs per unit			
Direct Materials	5	4	3
Direct Labour @ Rs 2 per hour	3	4	5
Production Overhead			
(1) Purchase/Receiving/Ins	12	9	2.13
(2) Scheduling/Set Ups	3.90	3.90	1.30
Total costs	23.90	20.90	11.43

The essence of the problem lies in the fact that in this illustration, the activities are both Batch related, not unit related. ABC reflects this reality in its allocation of production overhead costs to the products. So in this age of tough competition and where proportion of indirect costs are increasing compared to the direct costs, ABC is the most suitable system of costing to address such change.

Economic Chain and Price led Costing

When the business is going global and the availability of goods and services are flowing from one corner of the globe to the other, a company cannot remain satisfied with its own cost of operations but it has to know the costs of its entire economic chain and has to work with a view to managing costs and maximising yields. The days are gone, when companies producing goods and services were starting with costs, put a desired profit margin and arrived at a price. That was the age of cost led pricing when costs were determining price. But now the rule of the game has been changed altogether. Now market sentiments will determine the price.

Now you cannot shift your inefficiencies and idle costs to your customers in the form of price. Now they are better informed and better placed for bargaining. The producers and marketing companies have to pay proper attention to the price the customers are willing to pay. Now this is the target price and will determine the allowable costs. This is price-led costing which is becoming the rule of the game. If you want to be in business you have to follow this rule. What matters in the market place is the economic reality, the cost of the entire value chain - starting from initial design of the product to the point of after sales service. So costing system should provide adequate feed-back to establish the cause and effect relationship not only in the cost chain but in every thing else - especially corporate strategy and product planning. Costing system is not only to ascertain costs, not only to control it but to control result. This movement from cost control to result control is very much important; otherwise even the most efficient company will suffer from an increasing cost disadvantage in the days to come. The history of last twenty-five to thirty years would only confirm this. Japanese automobile companies like Toyota, Nissan and Honda used a form of Activity Based Costing (ABC) and were better placed in the market in terms of profitability and market share compared to General Motors, Ford and Chrysler in the United States who based their pricing on traditional costing system and even after allowing spectacular discounts and hefty cash rewards could not retain their customer base. This is due to the fact that the cost of such special deals and their negative yield had not appeared in their traditional method of costing. □