



TenStep Supplemental Paper

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Activity-Based Costing - Implementation

Activity-Based Costing (ABC) is an accounting system that allocates costs to products based on the resources they consume. The costs of all activities are traced to the product for which these activities are performed. Overhead costs are also traced to a particular product rather than spread arbitrarily across all product lines. The true cost of a product can be determined more accurately with ABC when compared to costs calculated using conventional accounting.

The ABC system can be used for determining the competitive price for a product, developing budgets, estimating future costs and measuring performance. It allows management to understand what increases costs and how to manage them. ABC is a cost accounting system that provides a matrix to accurately calculate the resources consumed by activities and the activities generated for products and processes. This helps assess the efficiency of the company in converting resources into value.

ABC enables a company to identify the activities with excessive cost and little value added so that they can be eliminated. It can help employees make cost-conscious decisions at all levels of the company and promotes proactive cost reduction rather than reactive performance/problem investigation. ABC is used as a powerful tool for improving products, services, processes and market strategies.

When overhead costs are allocated directly to products, managers may find that a particular product is not profitable, which could lead to a change in business strategy. ABC provides several ways to enable a company to decide if resource consumption for a particular product is consistent with its business objectives.

Background

There are various methods for designing and implementing an ABC system. Primarily, the size of the company and the desired outcome should be considered. Larger firms should consider a pilot program prior to implementing the system in the whole organization. Moreover, it must be integrated with the older accounting system.

Software can be bought to integrate the conventional accounting system with a detailed ABC configuration. The conventional accounting system is still used, and the ABC structure is an add-on to be used when specific information is needed for a decision. An off-line system can allow an organization to improve its cost information without disrupting its current information and financial systems.

Every cost-related aspect of the accounting system should be reported to the ABC structure. In order to effectively introduce major organizational changes, all employees must fully include ABC in their work practices and use it as their primary source of business information. Cost and performance measurement systems and all incentive systems have to be integrated with ABC. The advantage of using ABC as the sole accounting system is that it will be used consistently for daily decision-making.



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A conventional accounting system usually cannot report costs by processes because the purpose is to help the accounting department keep the books. ABC helps operations do their job by making cost information available at a level that everyone can use for day-to-day decision-making. The biggest obstacle to implementing ABC is resistance from managers and employees.

Unit managers may misinterpret ABC as a tool for upper management to discover detailed information about a department or to reveal inefficient practices previously hidden by the conventional accounting system. The corporate culture must be such that new information is not used against a business unit. Instead, everyone should be encouraged to identify problems and inefficiencies so those practices can be changed. Everyone must understand and agree that a cost-conscious approach is the company's priority and ABC is the tool to make that possible.

Implementation

Both lower-level managers and representatives from manufacturing, engineering and information systems should be part of the ABC system implementation team because all of them use the system. A diversified group also helps achieve a higher level of acceptance and ownership throughout the company. Information about the progress of the new system should be available to everyone.

Once the ABC system is installed, employees will witness the advantages and usability of the system. To obtain continuous support from the employees, they should be made aware that the ABC system is being used to make decisions and track performance. When the new ABC system produces changes that reduce cost and eliminate inefficiencies, employees should be made aware of how their efforts are contributing to the increased profitability of the company.

Employees must be oriented to the principles and mechanics of ABC. Depending on the level of involvement, employees may be trained in the basic concepts of ABC, problem solving, information analysis and how to build a new ABC system. Implementation of ABC can take three to fifteen months, depending on the size of the organization.

ABC produces significant results because it changes the culture of the organization. If a company's priority is to make cost-conscious decisions and eliminate inefficiencies and unprofitable activities, then all employees must be given the tools to work towards that goal. ABC provides visibility to information previously hidden in a conventional accounting system. With the right data and corporate culture, employees will have the means and the incentive to work towards eliminating excess costs and work towards producing the most affordable products.