

Convergence of ABC and ABM Principles – Guarantee of a Performant Management

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Abstract. *This article describes the principles of Activity-Based Costing and Activity-Based Management. By its analysis it has been deduced that ABC method becomes the main instrument of providing information for the ABM method. So, the ABM method becomes an important instrument for obtaining performances in business and the warranty for a performing management.*

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1. The principles of Activity-Based Costing method (ABC)

The principles of Activity-Based Costing method represent a management analysis that is reflecting with accuracy the production costs of products, works, offered services to customers in report of resource consume of enterprise and, also, allows to identify causes to improve performance and profitability through reporting insufficiencies of classical used management accounting methods.

One of the reasons, maybe the most important one, relates to allocation of indirect costs with arbitrary keys which lead to an inaccurate and incorrect allocation of its on costs carriers. Also, it can be identified as cause and the simple methods character of elaboration of charges, estimations and internal transferring prices. So, because the traditional methods do not take into account of the expenditure incurred over several years (conception costs of a new product, research and development cost etc.), and so the information from enterprise's administration does not take into account the strategic segments, this leading to absence of precise analysis of profitability of different categories of customers which makes impossible to determine an image as a real economical-financial performances obtained by the enterprise itself.

Starting from these causes which underlie the improvements in profitability, the ABC (Activity-Based Costing) has proposed to undertake and carry to achieve more cost effective, by eliminating the arbitrary criteria for the allocation of indirect costs, an improved ways substantially separating the direct costs of indirect and precise delimitation of actions included in operation's composition of the activities.

Technical literature presents arguments underlying relevance of the production costs obtained using the method ABC (Activity-Based Costing), focusing mainly on the fact that costs are variable depending on the multiple causes and that the fixed costs are only on a very short time. So, we conclude that the use of "activity" concept allows consideration of non-use of some functional department from the enterprise and also the opportunity to determine multiple ways of costs calculation (on products, on customers, on distribution networks, etc.).

If managers will take into count in their decisions the principles of ABC (Activity-Based Costing) method, then it will be observed profitability improvement of the enterprise from the first stages of its application. Over time, managers will find some effects that will benefit them against the competition, namely: cost reduction, product loss reduction. All these are based on knowledge of all causes which are leading to increase the production volume, sub-activity diminution and finally reduction of products selling prices. The well known "subsidized" effect and used in the classic methods is completely

eliminated in the ABC method and so is a correct imputation of effective consumed resources costs (salaries, raw materials, equipments, etc.) per products and customers. As result of this aspect, the enterprise can make an election of customers, choosing the most profitable ones (from point of view of sales volume) and giving up to the less profitable ones.

One of the most important contributions of the ABC method is that it remedies weaknesses of traditionally approaches of production calculation costs. To meet the needs and requirements of users of accounting information, it has been made a very careful analysis of the main causes that led to choosing ABC (Activity-Based Costing) method in comparison with traditionally cost methods and that are the base of profitability improvement of the enterprise, as follows:

A. Sharing analysis of allocated indirect costs with arbitrary cost drivers

Traditional methods used for the distribution of indirect expenses only one key for the assignment or criteria. This meant that, in fact, certain products or certain customers actually bear a percentage of 10-15% of indirect costs, while other customers supported by up to 40% of indirect costs. Share of indirect costs and the total fixed cost of production was very low. All these proportions resulting from the use of allocation bases that were unsuitable type of expenditure choice. The number too small of keys distribution used for indirect costs allocation has lead to a decrease in their reliability, giving rise to much higher costs for certain products and spending too little for others. Just this situation has generated appearance of the phenomenon of *subsidization* between products (customers). In other words, some products, according to its technological process requiring many operations were imputed much bigger structural costs, taking into account the actual consumption of resources made to achieve them.

B. Coherency analysis between provided administrative information and strategically segmentation of the enterprise

To extend the services offered to the customers and also to be still competitive, many small and midsized enterprises agree to divide the enterprise on strategic segments. This phenomenon often met in the most majority of the developed countries in economic terms does not represent a monopoly of large enterprises. Benefits offered by the enterprise in each chosen strategic segment are approximately the same, but the degree of customs complexity is variable. So, in the honor of some customs, the administrative service can be much more important for a strategic segment than to another. An activity costs analysis inside of the administrative service allows to fix a way of determination and much more correct allocation, and also to obtain profitability at the level of each strategic segment⁽¹⁾. According to traditionally methods, the analytical

result (not delimited on customers and customs segments) were determined like this:

$$\text{Analytical result} = M - (\text{IPCRA} + \text{MC} + \text{DC})$$

Where:

M = margin of direct costs, based on the relation: $M = (\text{Sales} - \text{Direct Costs})$;

IPCRA = indirect production costs rationally allocated;

MC = management costs; DC = distribution costs.

Starting from this calculation relation of analytical result, this allows us to take only an overall decision for the whole enterprise. In opposition with this, the Activity-Based Costing method, which makes delimitation on customers segments, allows visualization and decision much more extensive on activities. Thus the relationship for calculating the operating result, according to ABC method, is as follows:

$$\text{Result} = M_s - \sum_{a=1}^n (A_c)_s,$$

where:

$$M_s = (S - DM)_s$$

And M_s = margin of the strategic segment; S = Sales (turnover); DM = direct materials;

A_c = activity costs; a = activity type; n = number of activities; s = strategic segment.

Lack of identification of strategic sectors, which consume the resources of a heterogeneous manner, do not allow to the manager to perceive the real profitability of each segment. In this way it is realizing an improvement of the informative system through the ABC method demarche. This type of demarche allows to the manager to react fast, to choose revaluation of the selling prices before launching of products in one strategic segment or another.

C. Analysis of customer's profitability

To adapt at customer's needs in continuous growth, the small and midsized enterprises are tempted to differentiate commercial approaches by setting their coordinates on competition market in terms of purpose. Commercial service can aim bigger or smaller customers, or business to seek the same level, interested in providing the same range of benefits. These aspects

have a very important impact on enterprise profitability because each strategic segment “will use” resources of commercial service in a specific manner.

Trade costs of approaching various categories of customers are different and are reflected in the costing and pricing offer benefits. These arguments militate in favor of surrender to apportion indirect costs related to commercial service based on turnover, an arbitrary criterion, often used in traditional methods of computer costs. Contrary, Activity-Based Costing method (ABC) is recording a much more correct allocation because the used allocation criteria is a well chosen one and also is considered a more accurate identification of the customers.

A carefully effectuated analysis allow enterprises to identify and evaluate all new actions which have been elaborated for penetrating new market segments, and on the other hand, to retain the fidelity of the customer’s segments precedent obtained. Such activities are not destined to all enterprise customers. The ABC (Activity-Based Costing) method allows analyzing with accuracy the impact which has the activities on real profitability, according to a specific purpose, as well as very precise identification of costs, generating effects of new activities and their way of allocation on customers.

D. Transparency analysis of selling prices

The customers don’t know the production costs of the enterprise; they do know only the final selling price. As is known, the production cost represents the starting base for establishing the selling prices. For example, the repair made for equipment was provided in the case of traditionally methods by specialized firms or by persons especially trained in equipment repairs, meanwhile, in the Activity-Based Costing (ABC) method, these repairs are made by workers which work and maintain that equipment. In other words, in the case of the ABC method, it appears the “overqualified workers⁽²⁾” specific to Japanese method J.I.T. (Just-In-Time). This is a first aspect at what occurs internally, which aims the justification of lower costs. A second aspect is connected to “protection” and attraction of new customers through assurance of supplementary services. For example, in the selling price of a product is included transportation, installation or even guarantee and post-guarantee services. This success has led to appearances of the following three phenomenons:

- Industrial organization of technical services that is based on costs;
- Constitution of a dense network for emphasizing proximity toward customers;
- Development of advantages for customers according to services.

In conclusion, the proposed method of the ABC (Activity-Based Costing) constitutes the reconfiguration way to establish the selling price and solution to profitability improvement of traditionally cost calculation methods. The ABC method allows to operate either on the methods by which a “sell” in production costs or benefits to which sells the selling price is displayed and transparent and/or cost benefit crash risk is not borne by the customer, but the provider. This new method of determining the selling price has been drafted having regard to the two main directions: the identification of customer benefits and low cost of production calculated from the activities.

E. Analysis of price transparency for internal transfer

The approach proposed by the ABC (Activity-Based Costing) method allows calculation of transfer prices which are integrated in addition to other activities “bought” by another service or another subsidiary of the group. Therefore, resources of the commercial nature are not participating in the internal transfer price. This argument is applied to commercial activities, but it can be extrapolated to all activities connected to products and/or all management activities. This debate on calculation of more pertinent production cost has established the difference by setting of the margin. This thing depends on the policy chosen by the enterprise’s manager or group of enterprises.

F. Integration analysis of plural-annual costs

The research and development costs, design of new products, manufacture of moulds, equipments, creation and brands launching are engaged costs during an exercise, are the relevant costs incurred during the year, but whose cost can be justified only in the years ahead. The model of general accounting insists to record costs in the engagement year for allowing fiscal deduction of them. Indeed, they depend on the intangible costs, like expenses for education and wages, when those who have conceived are part of the staff.

In the case of traditionally methods, these costs were not taken into account, or if they were, they had a very small volume, almost insignificant. The ABC (Activity-Based Costing) method considers that these costs can be integrated in the planned production during all administrative period and updated every year. So, the customers will no longer pay the product’s manufacturing costs from the last year. This type of re-treating allows intervention in the management accounting. All these costs can be identified in time to achieve them, but not always they match to the allocated resources.

The enterprises should undertake studies in design and sale of products which present the lowest degree of risk in case of failure. This can be done by establishing certain typology, after conducting some studies on marketing, on

which to draw conclusions on their merchantability. If the production cost of products reflects the real cost of conception activity of them, then the selling price is determined as consequence of taking efficient decisions to offer the opportunity that those products compete with similarly once, but with a higher profitability degree.

2. The principles of ABM (Activity-Based Management)

The basic principles of ABM and ABC methods have been developed based on a research project sponsored by fifty organizations through the world under direct guidance of CAM-I director, Tom Pryor, the current chairman of Integrated Cost Management Systems (ICMS) during the course of three years (1986-1988). The result of his research was made public in 1988 by publishing an article in “Business magazine” which announced the launch of software, some books and providing training in the ABM quality field for all organizations regardless of their sizes.

A. The principle of identification of activities causes

According to this principle, the “*root*” of activities causes is found very rarely under control of staff and elimination of a part of the employees can not resolve the problem of costs generated by those activities. ABM is based on principle that “*activities consume costs, products and services and they are consumed by the customers*”.

B. The principle of identification of customer related to activity/process

According to this principle, it is proceeding to evaluation of customer satisfaction degree about costs, quality, and services level and product delivery time. After identification of satisfied customers, they pass on to identification of specific value activities. To carry out improvement activities and to meet the requirements of customers it can be used the ABM method closely connected with TQM (Total Quality Management), BRP (Business Process Reengineering) or benchmarking.

C. The principle of jointly management

According to this principle, it is proceeding to establishing of manager responsibilities by creating managerial teams (communities) which will lead functional activities synchronized through functional connections. These will create simple, efficient and flexible managerial processes whose purpose is to satisfy multiple requests of the customers.

D. The principle of culmination performances

According to this principle, the benchmarking activities related to best appropriate methods in the area may contribute to obtaining of high performances and the limit (culmination) of performances can be reached by using the methods from previous year in the recent year, and even improve of the actual performances.

E. The principle of elimination of non-value

According to this principle, it is proceeding to minimize and even eliminate of those non-value activities. As a result, it will proceed to reallocation of resources for increasing and improving performances (profit) of activities.

F. The principle of cooperation and disciplinary liability

According to this principle, it is proceeding to cooperation between departments in order to detect deviations (errors) and the roots of activity causes and establishing of disciplinary liability. To avoid the reiteration of negative deviations or variable planning it will be considered: defining the causes and settlement of negative deviations related to non-value activities, excessive costs and low quality.

G. The principle of permanent improvement of activities

According to this principle, the competitiveness is maintained through permanent activity improvement of an enterprise. This is a continuous analysis of the process, action and counting of all obtained results during the conduct of activities and search for those ways to improve the performances of an enterprise.

H. The principle of updating information

According to this principle, all information must be updated and avoided any irrelevant statistical data, any unfounded comparisons. Performances measurement should be based on updated data to enable effective decision making.

I. The principle of objectives identity

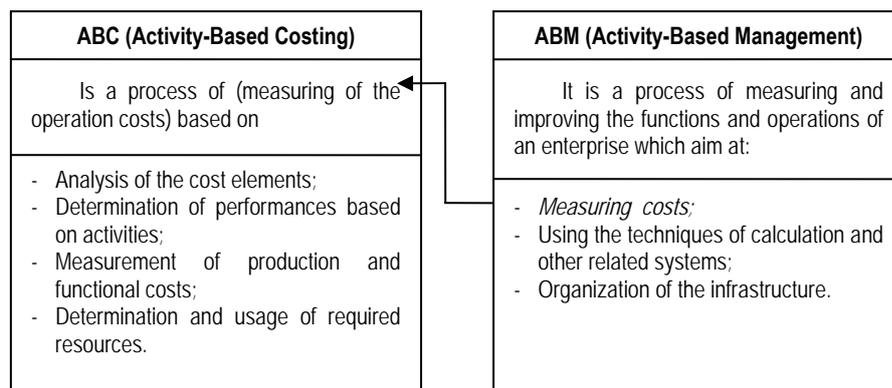
According to this principle, it refers to keeping check those activities that enhance the performances and correspond to the established objectives of the enterprise. It is defined as the measurement units of activities necessary to achieve a strategic plan and budget activities.

J. The principle of professional satisfaction

According to this principle, the staff of an enterprise will make an effective activity as long as their work will be rewarded and awarded properly to obtained results. They will provide to the employees all the tools necessary to obtain the desired results to increase effective the add-value activities. All these will lead to keep a favourable climate and will contribute to increase performances of the enterprise.

3. ABM method – tool of ABC method

Is the Activity-Based Management (ABM) a tool of Activity-Based Costing method (ABC)? The opinions are divided. Some specialists consider that the base of extension of the ABC method relies in the ABM method, meanwhile another part of the specialists consider that ABC method has undergone a separate evolution of ABM. Starting from the definitions of those two concepts we are submitting to your attention the next scheme meant to facilitate the proper understanding of them:



As it can be seen on the scheme above, the ABC method (Activity-Based Costing) represents in fact *an instrumental extension* of the ABM method (Activity-Based Management). The Activity-Based Management method (ABM) is an excellent way to improve the quality of managerial decisions mostly based on information provided by the ABC method. The ABM method permits the proper allocation of the resources to activities, helping to improve production and reduce their costs, based on analysis done through ABC method.

The objective of ABC method is not to influence the level of costs (as with the method of cost centre costs, for example), but rather the allocation of effective action on activities that determine the cost: “*People can not manage*

costs; they can only manage activities that determine costs". So, the ABC method acquires a new dimension: Activity-Based Management (ABM). The calculation aspect doesn't constitute the main element of the method but, by adding a strategic and managerial dimension, it is increased.

The ABC method consists in providing some informational costs more relevant, obtained with accuracy far greater than through traditional approaches. In this new approach, cost calculation is still considered a significant tool of the management, but doesn't constitute an end in itself. Once again, we must perform an activity analysis of the enterprise.

Taking actions over activities, the ABM method enables possible direction of the actions concerning the long term objectives. All costs that present the characteristic of being variable become useful in the process of making decisions. This is the terminology origin of the Activity-Based Management. These statements call for a definition of the movement of the circulation process of the resources through activities and variety products of the enterprise, which is very close to the reality. So, it becomes possible to measure the resource consumption for each activity and its value determination.

Notes

- (1) Strategic segment – target market segment chosen by the enterprise.
- (2) Overqualified workers – trained workers for execution of an extensive number of work tasks.

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