Role of Effective Cost Management in the Global Economy

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ABSTRACT

Interdependence of Global Economy has posed several challenges. One of them is an acute and urgent challenge of Cost Management. Time has come when countries, and particularly developing countries, have shifted their focus from 'price' to 'cost'. We have several examples. China is a cost competitive nation. Korea is also is an excellent example of cost competitiveness. For India there is a need to become aware of this trend and take immediate steps to overcome this phenomenon. One of the reasons identified and discussed in this exploratory study is the use of traditional costing system in India. This has lead to erroneous decisions my several large and small companies that are trying to make their mark in the global landscape. This paper further discusses the role of effective cost management through the use of modern costing approaches like 'Value Chain Analysis' and 'Activity Based Costing'.These approaches have been adopted my large companies all across the globe but there remains a substantial gap in their use with companies in India. This paper brings-out their contribution in making strategic decisions and their effective implementation. This is a concept review paper which can be further extended to empirical data analysis based on information collected from manufacturing and service based companies in India.

Keywords: Cost Management, Activity Based Costing, Decision Making and Strategy.

Introduction:

The domain knowledge of Costing Systems has helped us gain insight into practices of thecorporate sector for measuring and reporting performance of cost related data. Despite of advances in information technology and the emergence of decision support systems, Indian firms predominantly use traditional costing systems like Absorption Costing and Standard Costing for performance management. This has resulted into inaccurate reporting of costs to management and thereby has resulted in lacunas in managerial control especially with respect to financial aspects. As alternative, modern costing techniques such as 'Activity Based Costing (ABC)' provides a definite solution to this problem of inaccurate cost management. ABC has been successfully adopted by many multinational companies across the world. Unfortunately in the last 20 years there has been a very slow progress in the adoption of ABC in India.

The rationale of this study is to identify reasons for barriers to adoption of ABC. This research will explore areas of concerns for Indian firms in their approach towards ABC as an organizational performance management tool. This study attempts to identify the problems and prospects of adopting ABC in the Indian context. This should help industry in gaining knowledge about key factors that enable success of the new costing system and the contributions it can make to the value of the company.

Literature Review

This study will draw most of its basis from a similar study conducted in India in 2005 by Manoj Anand, B. S. Sahay and Subhaisish Saha using empirical data through a survey of 53 CEOs of India. The sample size of this survey was 500 companies in private sector and 75 PSUs. This research tested the hypothesis whether companies adopting ABC actually performed better than those that did not adopt ABC. The findings of this research suggest that companies that adopt Activity Based Costing generate accurate results of cost and information for planning. Johnson and Kaplan (1987)*s publication of the book 'Relevance Lost' brought a revolution in the history of management accounting. The management accounting systems of that time failed to provide relevant information for product costing and performance evaluation at the time of 'rapid technological change', 'fierce competition', and 'information processing revolution'. Drucker (1992) argued that accounting systems should provide answers about their businesses, markets, customers, and environment to 'information literate' managers. Thus, the role of a management accountant extended to incorporate multiple dimensions. The focus was not restricted to collection of cost information accurately. The scope of cost related data to support vital managerial decisions was also emphasized. . In the mid 1980s, the approach led to a churning of the whole cost accounting system, its methodology and even its philosophy. The most prominent feature that emerged out of the whole brain storming process was activity-based cost management system. Cooper (1988a) illustrated the need for activity-based costing systems. Consistent with this research, Cooper (1988b) found that the firms facing a high level of competition and having a diverse product mix are more likely to benefit from precise cost information and introduction of activity-based cost systems, with an added caution that the activity-based costing system introduction initiative itself should be cost effective. Meanwhile, Kaplan (1988) observed that many companies used single cost systems to meet three diverse needs, namely, inventory valuation and financial reporting, product/ service/customer costing and providing 'operational feedback to frontline employees' in the plant. However, he apprehended that, in a complex manufacturing environment with 'product and process diversities' and 'concern for excellence', the single cost system might not suffice for all the three needs.

Cost as a Competitive Advantage

One of the core accounting activities is the recording and analysis of costs. Costing systems first compile costs by broad classifications such as material, labour, power, etc., and then further analyze them by assigning them to cost objects. A cost object is defined as anything for which a separate measure of costs is desired. Thus the range of possible cost objects is considerable and includes products, customers, services, brands, departments, etc.An organisation's cost accounting system will routinely collect information about some, but by no means all, possible cost objects.

The value chain looks at all the activities through which products pass in an organisation and considers the value added by the process. If the chain is operating effectively, the products gain a greater added value than the sum of the individual activities and competitive advantage is gained.
The concept can be extended beyond the organisation itself and apply to whole supply chains and distribution systems, by synchronising the activities of all those involved in the value chain (from the supplier's suppliers to the final end customer).

Activity Based Cost Management

In traditional absorption costing, overheads are first allocated to cost centres and then to cost objects, that is, products. In ABC, overheads are related to activities or grouped into cost pools (depending on the terminology preferred). Then they are related to the cost objects, for example, products. (Unlike traditional absorption costing, ABC has other cost objects such as customers.)The two processes are, therefore, very similar, but the first stage is different as ABC uses activities instead of functional departments (cost centres).
Initially companies switched from traditional absorption costing to ABC in order to produce more accurate cost information for products. Managers in some of these companies were surprised by the information revealed, because it gave them a different perspective of the build-up of costs. This led them to adjust their pricing policies and to develop different product strategies, as they found that previously high volume, long production run products had been over-costed and low volume, short production run products under-costed.(Total absorption costing averages batch costs, such as set-up, over all products rather than relating them to the batch.)

ABC is particularly useful for product costing where:
production overheads are high in relation to direct costs.
• there is a great diversity in the product range.
products use very different amounts of the overhead resources.
consumption of overhead resources is not primarily driven by volume.
Organisations that have switched to ABC have found other benefits that fall under the heading of activity-based management (ABM), and it is in this area that the real benefit of ABC often lies. It produces another way of viewing the organisation and is like looking at the organisation from another perspective. ABM measures the effectiveness of key activities by identifying how activity costs can be reduced and value to customers can be increased. It also focuses management's attention on key value-adding activities, key customers and key products in order to maintain or increase competitive advantage.

Effectiveness of Costing Data for Coping with Global Challenges

ABM is a 'system of management which uses activity-based cost information for a variety of purposes including cost reduction, cost modeling and customer profitability analysis'. ABM uses the basic information provided by an ABC analysis to help managers to ensure that customer needs are satisfied with the minimum use of organisational resources.
Empirical studies of ABC implementation have frequently shown that the greatest benefit derived from its adoption is in cost management, rather than in the provision of more accurate product costs. When companies use ABC information for cost management it can be said that they have moved beyond ABC to ABM.

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In carrying out the analysis necessary to establish an ABC product cost it may become clear, for example, that the current organisation of activities leads to duplication and hence waste. The organisation and flow of processes can therefore be changed to eliminate duplication and achieve cost savings.

ABC also provides information that can be used to regularly monitor activities and so it aids continuous cost management or cost control. In order to appreciate the cost management insights which ABC can routinely provide it is important to understand the meaning of'activity or resource consumption'.

An activity may be viewed as being a collection of resources, which provide an organisation with service potential. When that potential is used, resource consumption takes place. For example, raw material is a resource that may be incorporated into products; consumption takes place when it is incorporated into the product.

Cooper and Kaplan (1988) insist that cost drivers must be based on **possible** activity measures. This is because the standard activity cost drivers that the system uses must reflect the underlying efficiency of the activities, as measured by the cost and quantity of resources supplied to perform each activity. This must be how much work can be done rather than how much work the organisation expects to do or has done in the past for a particular activity.
In the short-term, the costs of many support activities are fixed, yet the overall level of resource usage is still the result of decisions being taken within the firm.

ABC considers the amount of resource used, rather than how much has been spent. So although, in the short run changes in consumption do not lead to changes in spending (and it has limited use as a short-run tool), in the long run, ABC can lead to real cost savings.

Managers, able to see the results of their decisions reflected in their product or departmental costings, can put into motion plans to reduce costs. For example, payroll costs in one local authority were allocated to departments based on whether employees were paid weekly or monthly. The impact on the managers' budgets incentivised them to switch to monthly payment systems where possible.

Note that these plans can rarely be implemented immediately as they often involve fundamental changes. However, as a long-term planning tool, ABC plays an invaluable role in strategic decisionmaking.

Strategic Role of Cost

Strategic activity management recognizes that individual activities are part of a wider process. Activities are grouped to form a total process or service. For example, serving a particular customer involves a number of discrete activities that form the total service. Strategic activity management attempts to classify each activity within the whole as a value-added or non value-added activity. Non-value-added activities are unnecessary and should be eliminated.

Bellis-Jones (1992) noted that typically prior to the introduction of ABM 35% of staff time was spent on diversionary (non-value-added) activities. After the introduction of ABM, total staff time declined and the percentage of time spent on diversionary activities fell to 20% of the reduced time.

Non-value-added activities are often caused by inefficiencies or short sighted view within the existing processes and cannot be eliminated until it is explicitly recognized. For example, dealing with customer complaints is a diversionary activity, but it cannot be eliminated unless the source of the complaints is eliminated. Another example is machine set-up time. Better product design so that fewer components or more standard components are used will reduce the set-up time between component runs. So management must concentrate on eliminating non-value-added activities.

Conclusion

Activity Based Cost Management (ABCM) explained in the paper has several practical implications for companies in India with respect to enhancing its competitive position in the world. Its adoption and continuous improvement will enable Indian players to create their own brands and sustain them in long-run. Cost is not just information; it is a strategy in itself.

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