For the past 15 years activity-based techniques (ABTs) have been at the forefront of management accounting developments. Their advent has been associated with changes in production technology and organisational practices.

In the early 1980s many organisations became aware that their traditional cost accounting systems were generating information that was either misleading or irrelevant. Organisations and manufacturing processes were becoming increasingly complex, products were becoming more customised and product life cycles were getting shorter. Calculating product costs using traditional volume-based absorption methods (such as direct labour hours or machine hours) no longer produced meaningful results.

Consider, for instance, a business manufacturing a number of products including X and Y. Ten units of these products are produced every hour and total production is 500 units of each over the period in question. Overheads during this period are £100,000 and a total of 20,000 direct labour hours are worked on all products. If the business uses a traditional overhead absorption rate of £5 per labour hour, the overhead cost of both X and Y will be £0.50 per unit.

An inquiry reveals that the manufacture of X takes place in two production runs per period and the manufacture of Y takes place in 10 production runs per period. It also reveals that overhead costs relate mainly to “batch-level activities” associated with machine set-ups and materials handling for production runs.

If there are a total of 1,000 production runs in the period, overheads may be attributed to products at a rate of £100 per run. On that basis the overhead cost of X will be £0.40 (two runs x £100 ÷ 500 units) and the overhead cost of Y will be £2 (10 runs x £100 ÷ 500 units).

The reported unit costs of £0.40 (X) and £2 (Y) are activity-based, recognising that overhead costs are incurred through batch-level activities. It is likely that this statement offers a more meaningful version of product costs than the traditional unit volume-based version of £0.50 for both X and Y. Activity-based costing (ABC) gives more meaningful results because it attributes costs to products in a more sensitive manner, recognising the way in which overhead costs are actually incurred.

In the case described, the production of Y is a more complex operation than the production of X. The fact that Y has to be made up in frequent small batches (perhaps because it is perishable) means that it uses more resources than X. ABC recognises this, but traditional product costing does not.

This is particularly critical in the modern manufacturing environment. Continuous mass production of simple, homogeneous products is becoming increasingly rare. Production now typically takes place in short, discontinuous runs and a high proportion of product costs are determined at the design phase. Because of this, an increasing proportion of overhead costs are incurred at batch or product level. ABC can provide a statement of product costs that may be used for both performance management and decision-making.

The activity-based budget (ABB) has been developed to provide useful financial insights into the operations of an organisation. Traditional accounting tended to emphasise the nature of the costs being incurred (the input side) and budgeting tends to adopt the same pattern. ABB, on the other hand, emphasises the activities that are being achieved (the output side).

The power of ABB may be seen by comparing two statements of a local authority department’s budget (see figure 1, above). The ABB view provides a clear framework for understanding the link between costs and the level of activity. No such framework exists under the chart of accounts view, where many costs are deemed irrelevant for decision-making purposes because they are “fixed”.

In fact, few costs really are fixed in the long run or over a significantly wide range of activity levels. The problem lies in understanding how costs vary with the level and structure of output. The ABB view gives a clear impression of what it costs to produce certain outputs. For example, if you are considering the possibility of increasing the number of times the streets are cleaned by 25 per cent, the ABB view clearly indicates what impact this will have on costs.

It is important to note that neither ABC nor ABB replaces traditional general ledger accounting. Rather, they translate information from the ledger into a format that aids managers. Data presented in activity-based format may be less satisfactory for some of the traditional cost control and audit functions. An ABC report may be of little use to...
an auditor who is reconciling payroll costs with payments to staff. In this case, the auditor is more concerned with the inputs rather than what those inputs achieved.

The acronyms ABC and ABM (activity-based management) are sometimes used interchangeably. This is inappropriate, because ABC refers only to the actual technique used to determine the cost of activities and the cost of the outputs that those activities achieve. The aim of ABC is to provide improved cost data to help manage the activities of a business.

ABM is a broader concept. It refers to the management philosophy that views the planning, execution and measurement of activities as the key to competitive advantage. ABC and ABM are likely to be elements of ABM. A business that uses ABC and ABM is likely to understand its own cost structures and is, therefore, able to apply that appreciation for a variety of management purposes ranging from product design to departmental efficiency measurement.

Many people are disappointed about the effects of ABC and ABM on profitability and performance. A recent study in America by the Institute of Management Accountants disclosed that 80 per cent of ABC users reported that the approach had not yet resulted in a profit increase. Why is this?

One problem identified by researchers is that the data generated by ABC and ABM systems must be used effectively to achieve the desired results. “An ABC implementation failure could be defined as the inability of a company to move from simply generating ABC information towards actually using the information.” (Roberts and Silvester, “Why ABC failed and why it may yet succeed”, Journal of Cost Management, Winter 1996.)

These authors suggest that organisations sometimes contain structural barriers to change that make it difficult to progress from ABC to ABM. The design and installation of sophisticated accounting systems is pointless if the information from those systems isn’t used.

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Lessons from history

Grahame Steven
Why management accounting should stop following the lead of financial accounting and concentrate on modern requirements

Which came first: management accounting or financial accounting? The answer is, of course, management accounting, because even the most basic business requires information for planning, control and decision-making. There was little need for external reporting until the mid 19th century, since people ran the businesses they owned. The development that created a need for financial accounting was capital markets.

Before the 20th century the need to provide information to shareholders was not a significant issue for many limited companies since, in many instances, senior managers held large numbers of their firms’ shares. While information was provided to external shareholders, there were little or no legal requirement about what should be provided and when it should be issued. Some firms – for example, railway companies in the US – issued financial statements that had been audited by board members.

The need to provide information to shareholders changed as companies raised more and more money from capital markets. Ownership consequently became increasingly divorced from managership. External shareholders became more concerned about the quality of corporate financial information, because they relied on it to make investment decisions. Then, as now, financial scandals also created pressure for change.

In the UK the Joint Stock Companies Act 1844 required directors to provide an annual balance sheet to shareholders and to give an auditor (often a shareholder) access to the firm’s records, the statutory provision for compulsory audits was repealed in 1856. It was the Companies Act 1900 that sowed the seeds of modern financial accounting, since it re-established the need for compulsory audits and set out a standard audit report.

Financial accounting has a totally different perspective on the question of information provision from management accounting, as its principal aim is to meet the shareholders’ needs. Shareholders must have confidence in published accounts to make investment decisions, because they have no other access to company data.

The main way of creating this confidence is to have the accounts of limited companies approved by an independent party – ie, the auditor. But this approach has important implications for the preparation of accounts, since auditors can be legally liable for their opinions. Auditors prefer conservative accounting practices based on objective, verifiable, historical transactions, because this reduces the probability of being sued.

It is important to recognise that the practices adopted for financial accounting are not always appropriate for management accounting, because they may produce accounts that do not accurately reflect economic worth. Financial accounting, for example, treats much discretionary expenditure – R&D, preventive maintenance, marketing, training etc – as period expenses, although they will benefit future periods. So key investments for the future will not appear in the balance sheet.

Thomas Johnson and Robert Kaplan observed that managers under pressure to achieve short-term profit targets may cut back on discretionary expenditure (Relevance Lost: The Rise and Fall of Management Accounting, Harvard Business School Press, 1987). While this would put the company’s medium- or long-term prospects at risk, accounts prepared using generally accepted accounting principles (Gaap) will report increased profits. As Private Eye might put it: “Surely shome mistakes!”

It seems that the audit profession believes in the matching concept except when it is hard to apply it to significant business activities. In such cases the profession prefers to protect itself rather than provide data that may be more useful to shareholders.

While financial accounting does recognise economic worth built up by a company via intangibles, this is recognised only after it has crystallised in the form of goodwill. Even then, financial accounting is keen to get rid of goodwill because it is considered difficult to account for. How long can a multi-billion-dollar profession that underestimates business values by significant amounts be