

The Essence of ABC - The OffTech Approach

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ABC is a management tool.

Above all else, **ACTIVITY BASED COSTING** is a management **tool**. In itself, ABC can do nothing.

ABC can, however, help your managers with their decision-making processes. The **real value** of ABC depends on the use made of it by managers.

Resources necessarily involve costs because everything (including human beings) eventually wears out. Costs can include:

- Cash spent on running an operation;
- The maintenance of a resource base.

The costs of maintaining plant, buildings, personnel and other assets are often expressed by accountants as *depreciation*.

Accounting techniques attempt to quantify costs by including many subjective opinions, such as the bases of depreciation and/or inventory valuation. Accounting methods are often based on legal or Tax Office requirements rather than the **actual** costs of running a business. As well, some costs might be expended as investment for the future and are generally not included in an accounting approach to cost estimates.

Many **real** costs are of a 'direct' nature, for example, materials and some specific overhead expenses. In the past, methods adopted for allocating **other** costs, which might include Manufacturing, Distribution, Marketing and Administration costs, have created controversy and argument.

ACTIVITY BASED COSTING attempts to ensure that **every cent** spent by an organisation, including direct and overhead costs, is allocated to the products or services in the most equitable way in order to **realistically** identify the cost to the organisation of delivering those products or services.

In essence, ABC works like this:

- The ABC method identifies a group of 'cost pools' or 'activities' within your organisation through which a product or service must pass before it is delivered to the customer.
- The total cost of operating each of the 'activities' for a year must be estimated.
- The total number of hours that will be spent on each of the 'activities' in a year must be estimated.
- Based on these two estimates, a 'cost driver' for each of the 'activities' can be calculated.

For example, if it is estimated that a press will cost \$250,000 to operate over a year, including the direct and overhead costs allocated to that press, and it is estimated that 25,000 products will pass through that press during the year, an appropriate 'cost driver' would be \$10/product.

Alternatively, if it is estimated that each product will take 10 minutes to pass through the press activity, an alternative 'cost driver' for the press would be \$10/product x 6 products/hr, that is, \$60/hr to run the press.

Each of these 'cost drivers' is equally valid in this case.

- Assign a suitable 'cost driver' to each of the 'activities' identified in your organisation and thus calculate an estimate cost for each 'cost driver' unit.

The number of cost collectors used for determining the 'cost drivers' must be determined for each particular business. Problems can arise when the approach becomes unduly complicated and detailed. The degree of analysis that is realistic for an organisation must be clarified at the outset. Unnecessary resources may be used and a cost incurred through 'over analysis', thus defeating the whole purpose of the ABC exercise. The business could then suffer from 'paralysis through analysis'.

ABC must be tailored for each organisation in the light of its intentions and particular requirements, using a degree of analysis that is affordable and realistic.

Once an ABC exercise has been carried out, you should be able to predict the real costs of production, at least quite closely. The problems of planned margins and profit must then be considered. Does the market place dictate your margin or can you apply a selling price that will deliver a planned profit? Should you apply a planned mark-up on ABC costs uniformly across all 'activities' or can some 'activities' provide more profit than others? How does the final selling price compare with the ABC costs? By using the ABC costing method, you will be able to see **immediately** the amount of profit you can reasonably expect to make from any product or service you offer to your customers.

**If your initial cost estimates are correct, your profit
(before taxes) will be the selling price less the ABC cost.
It's that simple!**

You will also be able to know **immediately** those products or services that are being delivered at a loss because their selling price is less than their ABC cost.

By monitoring the costs - by comparing actuals with targets - you will be able to see whether your plans and targets are being achieved. Corrective action can be taken relatively quickly. This might involve rethinking your business goals and strategies for the foreseeable period.

Effective and timely monitoring is a good test for all managers - it is a good manager's quality control process.

ABC will quickly give you some guidance on how your sales revenue is likely to compare with the cost of delivering your products or services. Ultimately, however, it is up to you and your management skills to optimise the use of the resources at your disposal and to achieve your planned objectives.

The OffTech approach to ABC focuses on identifying the direct costs (including materials in the case of manufacturing organisations) associated with delivering your products or services and seeks to assist you with finding the best way of attaching the balance of your business's costs (ie. manufacturing, marketing, administration, selling overhead) to each of your products or services through the 'activity cost drivers'.

OffTech's 'recipe' for ABC implementation is broadly as follows:

1. Define your business objectives;
2. Clarify your organisational structure;
3. Identify your resources;
4. Estimate the utilisation of these resources;
5. Define your production, distribution, marketing and administration policies, goals and strategies;
6. Estimate the planned costs of all your business overheads;
7. Estimate your direct costs;
8. Calculate your 'activity cost drivers'.

OffTech have designed and built ABC Manufacturing© so that it is suitable for many different business situations. The program does not attempt to offer a 'cure-all' approach to production management - some customisation is required for each business application. However, sufficient flexibility has been integrated into its design to ensure that the customisation does not compromise the basic principles of ABC.

If you would like more information on OffTech's implementation of ABC, you can contact them on enquiries@offtech.com.au.

Possibly, your own staff will have the skills to do some of the preliminary design and installation work associated with an ABC system. OffTech is available to monitor and supervise their efforts in a **mentoring** role. Alternatively, OffTech can take a more direct role in organising your whole approach to ABC if you wish.

We suggest that you might want to complete the [Self-Survey Questionnaire](#). It should help you to take a realistic look at your organisation and assist you with deciding whether you want to go further with implementing ABC at this stage.

Please do not be surprised if:

- The questionnaire shows you problems that are other than cost-related ones;
- No miracle answer comes along.

ABC can only *help* good managers to 'manage better'. It is unlikely to transform an ordinary manager into a great manager by itself. ABC will *never* be a panacea for inefficiency or incompetence.

ABC SELF SURVEY QUESTIONNAIRE

ACTIVITY BASED COSTING

Requirements for the OffTech Approach

1. Briefly, describe your business.
 - What do you do? What are your objectives?
2. What category is it?
 - Manufacturing, Distribution, Service, Transport...
3. What is its size?
 - Turnover and staff.
4. What is its organisational structure?
 - Show a current organisational chart with responsibilities.
5. What is its legal structure?
 - Public Company, Private Company, Government Department, Non-Profit...
6. Do you have any costing system?
 - If so, briefly describe it.
7. How do you prepare Quotations and/or fix selling prices?
8. How many products and/or services do you provide?
 - Give a brief description of each.
9. List your major resources.
10. What reliable output counts (goods and/or services) are available at each stage in the chain from resources to product or services delivered to customer?
11. If manufacturing or Distribution:
 - Do you have a stock control system? (Materials, Work-in-Progress and Finished Goods).
12. If Services or Transport:
 - What capacity control techniques do you use?
13. If you have a manufacturing business, list your main raw materials - with the percentage of each to total material consumption (in \$).
14. What degree of computerisation do you have?
 - Briefly, describe hardware, software and staff computer literacy (if any of these apply).

If you prepare realistic and comprehensive answers to as many as possible of the above questions and would like to progress with the OffTech Approach to Activity Based Costing then please contact one of OffTech's consultants. (See below for contact details.)

To find out if Activity Based Costing is for your organisation, or to discuss implementation plans that are relevant, appropriate and specific to your business, please Email or Fax your ABC Self-Survey to us and we can assist you with professional consulting.

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Please feel free to [contact us](#) for any more information, about our consultancy and consultancy fees, that you require.