

Activity-Based Costing: The First Decade

The basic concepts and mechanics of activity-based costing (ABC) have been around for decades. For a variety of reasons, however, they were seldom used. Although cost accounting and transaction recording were the two key driving forces in the development of accounting ideas prior to the twentieth century, several key events during this century placed cost accounting squarely in the “back seat” of accounting theory and practice.

PRE-ABC ERA

As the century began, specialized branches of accounting were not necessary. When the first decade introduced a federal income tax, a new specialized area began—tax accounting. In the 1930s, when the Security and Exchange Acts placed a greater emphasis on financial accounting, cost accounting was split off as a separate discipline, with financial accounting surviving as the mainstream of accounting. Because tax and financial accounting practices are mandated by law or regulation, compliance with them is not optional. As a result, organizations spent most of their accounting resources on these two areas. Cost accounting was made a stepchild and relegated to a role of supporting its two law- and regulation-backed siblings.

As the century continued, events such as the compilation of the Internal Revenue Code (IRC) in 1954 and the creation of the Financial Accounting Standards Board (FASB) in the early 1970s, placed even greater emphasis on the compliance aspects of accounting, aspects served

by financial and tax accounting. Cost accounting developed somewhat during this period but, in keeping with its second-class citizen status, was severely limited in its ability to keep up with changing times.

Perhaps the complacency of a United States growing into an industrial giant while other countries' economies were being decimated by two world wars also suppressed any interest in the development of cost accounting. U.S. companies did not need to know their costs very well because the United States was the only nation that still had companies capable of mass-producing quality products for use within the country as well as worldwide. Fortunately, as the country's grip on industrial supremacy began to slip in the 1970s and early 1980s, knowledgeable individuals began to question the relevance of traditional cost accounting practices. They noted that, unlike financial and tax accounting, which serve to keep an organization in compliance with laws and regulations, *an organization's cost accounting information can actually make or break an otherwise sound business.*

PRIMARY PURPOSE OF COST INFORMATION

The reason faulty cost information can have such a devastating impact on an organization can be seen from a listing of uses and users of cost accounting information:

<i>Use</i>	<i>User</i>
Overall inventory valuation	Outsiders
Overall cost of goods sold	Outsiders
Strategic planning	Management
Capital budgeting	Management
Operational planning	Management
Operational budgeting	Management
Product cost control	Management
Process cost control	Management
Product costing/pricing	Management
Decision modeling	Management
Financial analysis	Management

It is easy to see from this listing who ranks as the major user of cost information. Management uses cost information regularly in its strategic and tactical decision making. Outsiders care only that the organization's overall cost of goods sold and inventory valuation are correct.

Why was it, then, that most cost accounting systems were (and in most cases still are) based on laws, regulations, and pronouncements of tax and financial accounting authorities? A major reason was that many accountants in industry came from financial or public accounting backgrounds. They carried the outside reporting orientation of their prior positions with them to their roles in industry. The possibility that something may be wrong with using financial reporting-oriented cost data in making management decisions simply never occurred to them.

Another reason was the misconception that maintaining two cost systems is too expensive and the benefits of having the second system cannot outweigh its additional expense. Because the tax and financial rules carry the weight of law, there is no option but to have a system that keeps the organization in compliance. A cost system that reflects reality is optional. The decision on a second system was easy if management believed such a system would be too costly.

A third reason was that the simple, extremely generalized costing practices, such as those allowed to comply with financial and tax requirements, were within the computational limitations of manual and pre-1980 computer systems. It was difficult enough to install a system that could simply track direct labor or machine hours. Developing one any more complex was out of the question.

For these and other reasons, day-to-day cost accounting systems were developed to support financial and tax accounting. Throughout the development of accounting during the first eight decades of this century, this practice held until it evolved into an accepted law of nature: An organization's cost accounting system exists to support its financial and tax accounting systems. This was the "first philosophical error" in the establishment of most cost systems. Some rudimentary system must exist that will enable a company to comply with financial and tax requirements, but an organization's cost system should be designed to provide management with the cost information it needs to make sound business decisions.

DAWN OF THE ABC ERA

In the early 1980s, challenges began to the ways in which cost information was calculated and used. Individuals such as Robert Kaplan, Robin Cooper, H. Thomas Johnson, Peter Turney, and Eli Goldratt began challenging the relevance of traditional costing practices in articles, books, and speeches. Goldratt's now famous statement that "cost accounting is the number one enemy of productivity" was a particularly effective "call to arms." As a result, academics, practitioners, and associations began to develop new approaches to cost information. These included Drs. Kaplan, Cooper, Johnson, and

Turney, as well as organizations like the Consortium for Advanced Manufacturing International (CAM-I), Institute of Management Accountants (IMA), and the Society of Management Accountants of Canada (SMAC). The efforts of these and many other individuals and groups developed a body of knowledge that came to be known as *Activity-Based Costing*, or simply *ABC*, in the late 1980s.

As often happens, the development of a catchy title that can be represented by a TLA (three-letter acronym) kicked off the establishment of a new industry: "The ABC Industry." Software packages were developed to assist in the implementation of ABC. Expensive seminars were offered to educate potential users in the theory and use of ABC. Academics sought to "outdo" each other with new and better ways to describe, define, and design ABC systems. Large accounting and consulting firms established their own "ABC Consulting Groups" to perform six-figure consulting projects. Smaller firms sent their accountants and industrial engineers to seminars to become instant "ABC Experts" and begin their ABC practices. To add more prestige to the subject, some began calling it activity-based management (ABM) or activity-based budgeting (ABB), both of which can basically be defined as using activity-based costing information to better manage the business. Some consultants in related areas began calling their services ABC to attract more clients. Like many other concepts, proponents of ABC/ABM/ABB began placing its position at the center of the universe with all other disciplines revolving around it.

As all this activity has taken place, the complexity of ABC has grown. It has begun to develop its own nomenclature. Instead of being a concept to adopt, it has become a system to implement. To many, the software, not the concept, has become activity-based costing. The perception that ABC is a complex set of mechanics that must be integrated into an organization's day-to-day reporting systems has become widespread. Attempts have been made to codify the procedures for implementing ABC, almost as if they were a tax code or body of financial pronouncements. Activity-based costing has begun to become an end in itself, not a means to an end. So much focus has been placed on the various implementation tools that have been developed to accommodate ABC's growing complexity that the tools themselves have become mistaken for the concept.

ABC AT SMALL AND MID-SIZED BUSINESSES

It is suggested that the high cost and complexity of ABC has discouraged most small and mid-sized organizations from improving their cost information. In both its 1996 and 1997 Activity-Based Costing Surveys, the Cost Management Group of the IMA found that size was a significant factor in

whether an organization adopted ABC. Whereas sales of firms adopting ABC averaged \$101 to \$500 million, nonadopters' sales were in the \$11 to \$100 million range. No mention was made of organizations with sales below \$11 million, which would lead to the conclusion that adoption in that group was almost nil. The report stated that "several companies cited the lack of resources (people and dollars) as a reason for not adopting ABC," and "this issue is probably most prevalent in smaller companies."

As will be discussed in Chapter 17, it is not the lack of resources that keeps small firms from adopting ABC, it is the *perceived* lack of resources that does so. Word gets around about six-figure consulting fees, hundreds of person-days of work, massive data collection efforts, new software, and expensive system conversions. No wonder smaller organizations believe they do not have the resources to undertake a project to adopt ABC! Fortunately, this perception is incorrect. Activity-based costing is a beautifully simple concept that can be adopted in a wide variety of ways. The complex, integrated systems devised by consultants and software companies are not usually required. The goal of ABC is to develop usable cost information that accurately reflects the cause-and-effect relationships between costs, activities, and products or services. Sometimes, all that is required is that managers change the way they think. At other times, modifications must be made in how an existing cost system works. Personal computer spreadsheets often can be developed to provide accurate and relevant cost information "offline."

To be universally useful, particularly to be useful to small and mid-sized organizations, ABC must be understood at its basic conceptual level. Systems and software are secondary issues that present only one approach to adopting the concept. Trying to adopt ABC by applying detailed, step-by-step instructions for its implementation or by trying to "fill in the blanks" of a software package is like trying to paint a self-portrait using someone else as a model. Although the resulting painting will probably qualify as a portrait, it will come out looking a lot more like the other person than it will looking like you.

After a decade of development and promotion, ABC seems to have fallen far short of the acceptance levels that the soundness of the concept should have led it to attain. It has probably done more to improve the profitability of software developers, conference coordinators, and consulting firms than it has the profitability of users. The responses I receive to a question I ask whenever I address a group of nonaccountants reinforces this view. When presenting the concept of ABC to such groups, I begin with the question, "How many people here have heard about activity-based costing?" Usually, 60 to 70% of the individuals in the audience will raise their hands. When I ask the follow-up question, "How many people here have heard anything good about activity-based costing?," only about half of those hands are raised. Obviously, something is preventing the message from getting through.

The biggest obstacle to the universal acceptance and use of ABC has been, in my view, the emphasis placed on its “computational virtuosity” instead of its “business utility” by the industrial engineers, software developers, and accountants who promote and implement the concept. The backgrounds from which these individuals come are detail oriented, so it is only natural that they are impressed with the theoretical correctness and precision of ABC’s calculations. The tendency of such practitioners is to develop solutions that are more detailed and complex than the problem deserves or requires. Owners and managers of businesses, however, do not care about “computational virtuosity.” They are impressed with ideas that have “business utility,” the ability to help them make more money and earn a better return on their (or their owner’s) investment. They want practical solutions to the problems at hand, not “overengineered” solutions that seem more complicated than the problems they are designed to solve.

If ABC is to gain the universal acceptance it deserves, it needs to be understood as the simple, yet valuable, business tool it really is. The chapters that follow describe this simple concept and how it can be used to create a powerful business tool that can improve the financial performance of any business, regardless of its industry, size, or complexity.