Profit accuracy

Business, Management

Compare the uses of both variable and activity based costing as managerial decision making tools in business providing both examples and applications. Be specific on how service products must have good cost measures to access both profit accuracy and process adjustments to remain competitive. Review of subject Both variable and activity based costing are valuable management tools in business. In this paper, we will discuss how variable and activity based costing used in an organization and explain how these two methods differ.

Variable costing is method of determining unit product cost and it is used internally for planning and control purposes only. Whereas, activity based costing (ABC) is a costing method based on activities that is designed to provide managers with cost information for strategic and other decisions that potentially affect capacity. We will also be looking to find the answer how service products must have good cost measures to access both profit accuracy and process adjustments to remain competitive.

Discussion Variable and activity based costing are managerial decision making tools. Variable costing identifies contribution margins of individual products, helps managers make decisions on what products to develop and what product to improve while ABC identifies profitability of individual products and from individual customers, helps managers make decisions on what products or customers' relationship to develop and what products or customers' relationship to improve.

Managers can apply TOC to make improvement for both variable and activity based costing approaches. In terms of cost measurement, profit accuracy,

pricing decisions, products' variable costs are based on volumes that are relevant. In addition, flexibility of managers makes pricing and other critical decisions for variable costing approach. In contrast, for ABC approach, costs assigned to products, customers and other cost objects are only potentially relevant.

Fully allocates all costs (including costs of idle capacity and organization-sustaining costs) to products, customers and other cost objects. This overstates costs and understates margins and causes mistakes in pricing and other critical decisions. It is really interesting that variable costing method is easy to make CVP analysis from income statement because variable and fixed costs are clearly identified but not easy to make CVP analysis from income statement to ABC method because variable and fixed costs are mixed.

That is also one of the reasons why ABC much more complexity, much more costly and time consuming than variable costing method. Compared with absorption costing, variable costing is less popular whereas ABC much less popular. Both variable costing and ABC are none conformity to GAAPs. Under variable costing, variable product costs are assigned to the units produced and expensed when the units are sold and fixed product costs are treated as period costs and expensed when incurred.

Under variable costing revenues are first reduced by all variable costs to arrive at an intermediate figure called contribution margin and then reduced by all fixed costs to arrive at a final net income figure. Variable costing is a more effective tool for short-run decision making such as whether to make or

buy a component, and pricing - especially when variable selling and administrative costs are included since it focuses on revenues and variable costs.

Variable costing is used for internal management only. Its uses include: (1) inventory valuation and income determination; (2) relevant cost analysis; (3) break even analysis and Cost volume profit (CVP) analysis and (4) short-term decision-making. Variable costing is, however, not acceptable for external reporting or income tax reporting. Companies that use variable costing for internal reporting must convert to absorption costing for external reporting.

Activity Based Costing (ABC -- also called transaction cost analysis) starts by apportioning an organization's expenses to a set of cost pools, usually classified by activity rather than by organizational unit or department. Cost analysts then use statistics to determine which transactions cause these pools to vary in size. These are called activity drivers, resource drivers, or cost drivers. Examples of cost drivers in a manufacturingenvironmentinclude the number of inspections, raw materials receipts, the number of components in inventory, machine setups, or change orders.

In many organizations, ABC is a by-product of quality management. Under quality management, ABC is used to distinguish between activities that add value (to final products) and those that do not -- like inspection, rework, and scrap, which arise out of defects in the service delivery process. Because quality management pushes significant operating decisions down to the lowest levels of the organization, cost measures and cost estimates are

needed at the lowest levels, as are measures of rework, activity cycle time, customer satisfaction, etc.

Standards are also needed for cost/performance measures. Standards can be based on the best an organization has achieved over time (base lining), the best practice currently being achieved somewhere (benchmarking), or an engineering standard -- in target costing, for example, price targets are set by the market (price less planned markup equals allowable cost) and evaluated for feasibility by computer simulation (drifting cost) (Tani, 1995). ABC is being used in the telecommunication market (http://www. trp. hku. hk/papers/2002/abc_telecom_text. pdf).

One of the better known estimates of the total cost of government regulation in the US uses the logic of ABC, although it applies it at an extremely aggregate level. Based on the presumption that firm level compliance costs are driven by new regulations and federal enforcement efforts, the Center for the Study of American Business at Washington University bases its estimates of regulatory compliance costs on the total number of pages in the Federal Register and the budgets of federal regulatory agencies.

The Fraser Institute has a study underway using this approach to estimating the cost of regulation in Canada. Activity based costing has also recently been applied to the problem of estimating the costs of the Federal Acquisitions Process in the United States. However, this approach still has deficiencies. It entails the cost-benefit trade-offs, since the more activity cost pools are identified in ABC system, the greater will be the accuracy of the

cost assignments, which also results in greater costs of implementing and maintaining the system.

In addition, the relevant period inconsistency with each cost per driver per period and activity costs per period can have an impact on the cost analysis accuracy as well. The usual distinction made in the literature is between decision facilitating and decision influencing (Demski and Feltham, 1976). Because time only runs one way, both uses of cost information are problematic. In the first instance, a cost description (measurement or estimate) is provided to decision makers before a decision is made.

Unfortunately, costs can only be measured after the fact. This means that cost analysts must estimate the costs of the alternatives under consideration. In some cases, measured cost is a reliable predictor of future costs; in other cases it is not. Regardless of its reliability, however, it is all we have or can have. In the second instance, cost is measured after decisions have been made and implemented. Only the measurement method and its consequences are conveyed prior to the decision.

In this second case, measured costs are used to evaluate managerial performance, with the purpose of influencing management choices. Consequently, managers must be informed as to how their performance will be measured and how performance measured will affect outcomes they care about -- promotion pay, esteem, etc. Conclusion Planned costs must take account of cost behavior if they are to provide a reliable basis for control. In addition, the link between sales and profit performance, under variable costing, ensures a performance measure that managers understand easily.

With the need to identify fixed and variable cost, and their importance to the production or service, as well being needed for managerial decisions these all interlink and are useful in identifying the needs of methods of use. The purpose of the various costing classification are dependent upon what type of project is being undertaken and what the intended outcome is. However, I feel that ABC fits in to the uses of various different.

This method can be a more appropriate way of classification of costs as it recognizes that in the long run most costs are not fixed, and it seeks to understand the forces that cause overhead costs to change overtime, and what activities cause costs and create demand.

References

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