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Activity Based Costing (ABC): is it a tool for company to achieve competitive advantage?

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Abstract

Most of the companies today have no idea what their products cost them to make. Usually companies think they do know but unfortunately they are not correct. This misunderstanding has led many business organizations to make decisions that are bad to the business. They might abandon profitable products in favour of products that are losing money. However, the companies' cost information just does not help! Generally managers receive cost information that is misleading and harmful, and make them do the wrong things in their work place.

This damaging information comes from full absorption costing (both fixed and variable costs) of calculating total product costs. The costing system calculates product costs by allocating a portion of the overhead or indirect costs to each products being manufactured. The amount of the overhead cost allocated is based on the amount of direct hours or direct labor costs required to make the product. This method of allocating is a good approach of allocating overheads many years ago when direct labor was the largest portion of cost required to make a product and when overheads were small.

The problems associated with this allocation methods were highlighted in the late 1980s with the publication of the influential book "Relevance Lost; the Rise and Fall of Management Accounting" by Tom Johnson and Bob Kaplan. Johnson and Kaplan showed that the historical development of cost and management accounting has given rise to inappropriate methods of allocating overhead costs. These methods of allocation lead to cost distortion. This resulted in managers making the wrong strategic decision. The overall objective of this study is to investigate and assess how ABC

provides the company with additional competitive edge to compete in the globalization environment.

The principle of activity-based costing has been a much talked about tools in the 1980s and 1990s. But is ABC really the strategic tool to achieve competitive advantage as expected? How the companies should approach the implementation of ABC in order to achieve the required results. What the companies should expect from the ABC? What is the future of ABC?

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