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## Activity-Based Costing – A Strategic Cost Management Tool for Effective Managerial Decision Making

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### Abstract

In this modern world, the managers are in need of Most Basic, consistent and reliable information on allocation as Allocation is the Prime Factor in Cost Accounting Systems. This information support the management on effective management of Resources and improving the competitiveness in the market on Cost, quality and efficiency and Profitability. Its evident that the Managers should have the Clear Understanding of Cost Factors, Cost behaviors during the cost allocation process. Studies on Cost Allocation till recent past was done on a Single Cost Driver and Cost Pool (Traditional Method). The primary failures of traditional costing systems are their inability to provide useful feedback about the costs and indeed most of them allocate overhead costs i.e., in the context of decision making, imprecise costs may lead to inaccurate decisions. To reduce the irrelevances experienced by traditional costing systems, Activity-Based Costing (ABC) has become more popular in cost accounting. The New Study on Activity Based Costing (ABC) attribute to the relationship between multiple Cost Drivers and Cost Pools. ABC identifies and assigns the cost of each activity resource to all products and services according to the actual consumption of each.

### Scope of the Study

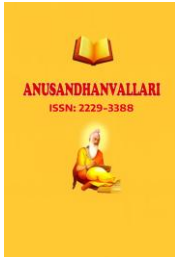
Changes in the business environment, caused by global competition and technological innovation, have led to innovations in the use of financial and nonfinancial information in organizations. The new environment demands appropriate information and data concerning costs and performance within the organization's activities, processes, products, services and customers.

Purpose is to examine Activity-Based Costing (ABC) as a strategic cost management tool for effective managerial decision-making.

Design a Methodology/Approach for A conceptual and literature-based analysis supported by industry case studies.

ABC enhances cost accuracy, supports strategic alignment, and improves decision-making in pricing, product mix, and resource allocation on the Findings

Practical Implications are that the Managers can leverage ABC to identify inefficiencies, optimize resources, and strengthen competitive advantage.



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This paper integrates theoretical perspectives with practical applications, situating ABC within the broader discourse of strategic cost management.

**Keywords:** Activity-Based Costing; Strategic Cost Management; Managerial Decision Making; Cost Drivers; Profitability Analysis

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## 1. Introduction

Cost management is integral to organizational success in competitive markets. Traditional costing systems often distort product costs due to arbitrary overhead allocations, leading to poor decisions in pricing, product mix, and resource allocation. Activity-Based Costing (ABC) emerged as a response to these shortcomings, offering a more accurate and strategic approach. This paper examines ABC's role in strategic cost management and its impact on managerial decision-making, situating it within the broader discourse of management accounting innovation.

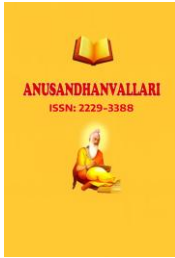
## 2. Objectives of the Study

- ❖ To Identify the Most Accurate Method of Product/Service Costing
- ❖ For Accurate Pricing Decision
- ❖ To Improve the Understanding of the Overheads and Cost Drivers
- ❖ To Help the Management in Taking Quality and Timely Decisions.

## 3. Literature Review

The literature on ABC highlights its superiority in complex business environments. Kaplan and Cooper (1998) pioneered ABC as a response to the limitations of traditional systems. Drury (2018) emphasized its role in improving cost accuracy, while Quesado and Silva (2021) identified ABC as a critical tool for aligning cost structures with organizational strategy. In the 1980's much criticisms were raised regarding the ability of traditional cost accounting to offer relevant and accurate information for managers. In that period, ABC has emerged as one of the powerful management accounting tools that recognizes such concern (Maelah and Ibrahim 2007). Since then Activity Based Costing has gained its recognition and has received substantial attention from different departments including the industries and academicians. ABC was initially developed due to the evident increase in overhead costs in Manufacturing Firms, sourcing many of the traditional costing inaccuracies; (Hussain and Gunasekaran 2001, Swenson and Barney 2001). Numerous studies have noted that the use of the applicability of ABC to all organizations in general is attributed to the universal existence of activities (Kennedy and Affleck-Graves 2001). At last, the utilization of ABC has been obvious in areas such as database marketing (Doyle 2002), the financial industry (Innes and Mitchell 1995, Dodd, Lavelle et al. 2002) the healthcare industry (Lee and Nefcy 1997, West and West 1997) telecommunications, transport, wholesale and distribution and information services sectors (Kennedy and Affleck-Graves 2001). Empirical studies across manufacturing, healthcare, and services confirm its effectiveness in enhancing profitability analysis and resource optimization. Horngren et al. (2015) further argue that ABC provides a foundation for strategic decision-making by linking cost information to organizational objectives.

Activity Based Costing in manufacturing sector is still predominant ;( Clarke and Mullins 2001);(Johnson 2002). The trouble with research into information systems in general, and the complexity of costing systems in particular is that in the context of information economics, system users are unaffected by sophistication (see Blackwell 1953; Marschak and Radner 1972; McGuire 1972). (Drury and Tayles 2005) identified a product costing system with high level of sophistication as consisting of many cost pools and many cost drivers including volume- and non-



volume-based cost drivers' transaction, duration, and intensity cost drivers. They argued that sophistication of costing system will be affected by the extent to which different cost drivers are used, such as volume-level, batch-level, and product sustaining cost drivers, with sophistication rising with the use of non-volume-level cost drivers. In addition, they insisted that sophistication is also dependent relative on whether transaction, intensity or duration of cost drivers is used. (Drury and Tayles 2005) consequently measured sophistication using a mixture of the number of cost pools and cost drivers used to allocate and assign the overhead costs into product costs so as to produce a subjective 15-points sophistication scale, from a slightest sophisticated system score of 2 to a most sophisticated system score of 16. (Abernethy, Lillis et al. 2001) distinct sophistication in a similar way to (Drury and Tayles 2005) with this discriminate that they made a distinction between the type and nature of cost pools. (Kaplan and Anderson 2007) proposes a more relevant and efficient cost modelling principles called the Time-Driven Activity Based Costing (TD-ABC) that assigns resources (e.g. all types of costs of a customer service department) directly to cost objects (e.g. order handling).

#### 4. Conceptual Framework of Activity-Based Costing

ABC operates on the principle that activities consume resources, and products or services consume activities. The process involves identifying organizational activities, assigning costs to activity cost pools, determining cost drivers for each activity, and allocating costs to products or services based on activity usage. This framework eliminates arbitrary allocations and provides transparency in cost structures, enabling managers to understand the true cost of products and services.

Usually, foremost companies are using their ABC Systems to (Kaplan & Cooper, 1998:5):

- Design the products and services that both meet customers' expectations and wants and can be produced and delivered at a profit.
- Signal where either continuous or discontinuous improvements in quality, efficiency and speed are needed
- Support employees in their learning and constant improvement activities.
- Guide product mix and investment decisions
- Negotiate about price, product features, quality, delivery and service with customers
- Efficient and effective distribution and service processes to targeted market and customer segments.

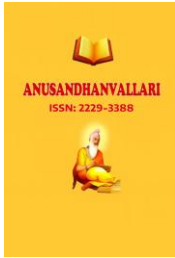
#### 5. Strategic Cost Management and ABC

Strategic cost management involves aligning cost structures with organizational goals. ABC supports this by identifying non-value-added activities for elimination, providing insights into customer and product profitability, supporting competitive pricing strategies, and facilitating lean management and continuous improvement. ABC thus becomes a tool not only for cost allocation but also for strategic alignment, ensuring that resources are directed toward value-creating activities.

#### 6. Applications in Managerial Decision Making

Managers need cost systems to perform three primary functions (Kaplan & Cooper, 1998):

- Valuation of stocks and measurement of the cost of goods sold for financial reporting – because of external circumstances with investors, regulators, creditors and authorities.



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- Estimation of the costs of operations, products, customers and services – because of the internal managers needs to recognize and improve the economics of their operations;
  - Provide the accurate and well-timed cost information and economic feedback to managers and operators about process efficiency to make both strategic decisions and operational improvements.

Managers leverage ABC for pricing decisions, product mix optimization, process improvement, customer profitability analysis, and budgeting. Accurate cost data ensures competitive yet profitable pricing. ABC helps identify high-margin products and discontinue unprofitable ones. It highlights inefficiencies and guides resource reallocation, while also distinguishing between profitable and resource-draining customers.

### **7. Case Studies**

In manufacturing, a multi-product company discovered one product consumed disproportionate overhead, leading to revised pricing and improved profitability. In the service industry, a bank applied ABC to analyze transaction costs, restructuring services to improve efficiency. Hospitals used ABC to allocate costs to patient services, enabling better budgeting and resource allocation. Retailers applied ABC to understand customer profitability, leading to targeted marketing and improved customer retention.

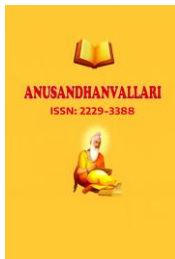
### **8. Advantages of ABC**

ABC offers greater accuracy in cost allocation, enhanced decision-making capability, identification of inefficiencies, strategic support for competitive advantage, and improved transparency in resource consumption. In a business concern, the ABC methodology allocates an organizations' inventory costs through activities to the products and services provided to its customers. It is generally used as an effective tool for understanding product and customer costs and profitability. As such, ABC has largely been used to support strategic decisions such as pricing, outsourcing, identification and measurement of process improvement initiatives uses:

- It helps to categorize inefficient products, departments and activities
- To apportion more resources on profitable products, departments and activities
- It helps to control the costs at an individual level and General Management
- It helps to find unnecessary costs
- It helps to fix the price of product or service scientifically.

### **9. Research Methodology**

Research Methodology is Important and systematic method of Finding solutions from different Alternatives to the problems especially an Investigation process, a recording and an analysis of situations for the purpose of Gaining Knowledge from the society. Research Design is the conceptual Structure in which the research is conducted:It considered the Blue Print of the Measurement and analysis of Data Required. The researcher collected only the secondary data for this study



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## 10. Limitations of ABC

Despite its benefits, ABC has limitations such as high implementation cost, complexity in data collection, resistance to organizational change, limited applicability in small organizations, and the need for continuous updating of activity data.

## 11. Future Directions

ABC is evolving with technological advancements such as ERP systems, AI-driven analytics, and big data integration. Future research should explore how ABC can be integrated with sustainability accounting, digital transformation, and global supply chain management to further enhance its strategic relevance.

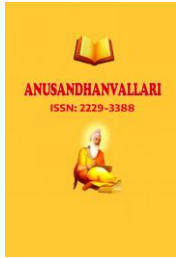
## 12. Conclusion

Activity-Based Costing transcends traditional cost allocation methods, serving as a strategic management tool that empowers managers to make informed decisions. By linking costs to activities and activities to products, ABC provides transparency, accuracy, and actionable insights. Despite challenges in implementation, its role in strategic cost management makes it indispensable in modern organizations.

This study is a theoretical analysis of the Effect of Activity based Costing in the Managerial decision making. With so many Qualitative and quantitative studies and research are happened and happening globally, even though It contribute to enhance our knowledge, still the area of real understanding, application and the positive impact of ABC wide open and can be expanded.

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