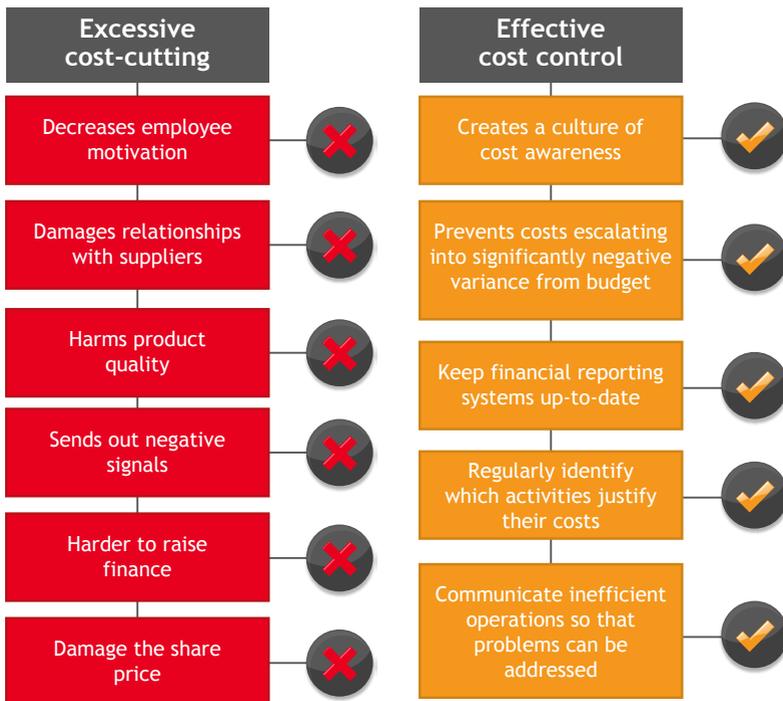


Chapter 17

Controlling Costs –
including Activity-Based Costing

How do I control costs to ensure resources are used efficiently?

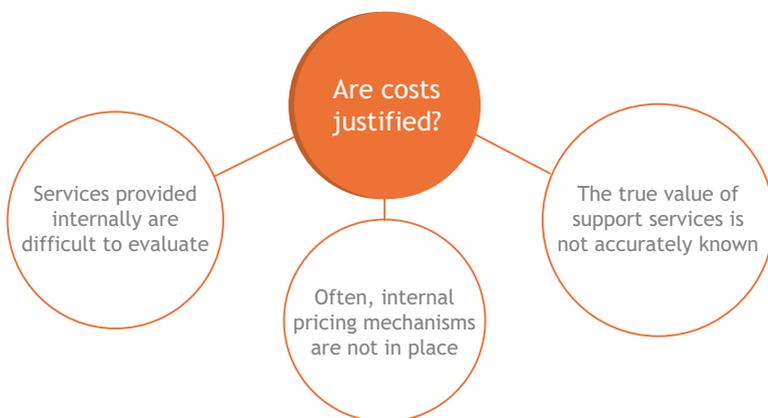
A central challenge for management is to extract maximum value from resources whilst keeping costs under control. Effective cost control recognises the negative impact that a singular focus on cutting costs could have on employee motivation, relationships with suppliers, and ultimately product quality. In addition, excessive cost-cutting can send out negative signals about the financial health of a business, which could affect its ability to raise new finance, or even damage its current share price. So, rather than focusing solely on cutting costs, effective cost control looks to create a culture of cost awareness throughout the organisation, that serves to prevent costs escalating into significantly negative variances from budget.



Key elements of a successful strategy to control costs are: keeping financial reporting systems up-to-date; regularly analysing them to identify which activities justify their costs; and communicating inefficient operations to staff so that problems can be addressed.

A good starting point is to take a fresh look at an organisation's costs through zero-based budgeting. Whereas incremental budgeting may perpetuate inefficiencies by using the previous year's costs as a baseline, zero-based budgeting requires each item to be newly evaluated. Does each activity justify its cost by adding value to the organisation? This may be a difficult question to answer where services are provided internally, by one department to another, where there is no internal pricing mechanism in place. Since these cost centres are not required to pay other departments for the support services they receive, the true value of these activities is not accurately known, and so their costs cannot be rigorously justified.

Incremental budgeting may perpetuate inefficiencies by using the previous year's costs as a baseline zero-based budgeting requires each item's cost to be newly justified.



In order to control costs, managers must first know the full costs of their departments' operations. How overheads are allocated or apportioned to each product becomes key.

Traditional methods apportion total overheads to each product as one item, based on the best overall measure of how much each product uses “overheads”.

For example, overheads may be allocated based on production time. So if the production of washing machines accounts for 20% of the total production time for all products, they would have 20% of the £1m total overhead cost allocated to them. This equals £200,000 of overhead costs which are apportioned to washing machines.

*Washing machines use 20% of total production time.
Total overheads = £1m. 20% of £1m = £200 000
Overhead costs apportioned to washing machines = £200 000*

One way of more-accurately allocating indirect costs to each product, is through activity-based costing, or ABC. Activity-based costing allocates each element of overhead separately, based on the most relevant measure of how each element is used. For example, maintenance costs may be allocated based on production time. Because the production of washing machines accounts for 20% of the total production time, they would have 20% of the £500 000 maintenance costs allocated to them, which equals £100 000. Design costs, on the other hand, may be allocated based on designer hours. Because the production of washing machines accounts for 50% of the total designer hours, they would have 50% of the £500 000 design costs allocated to them, which equals £250 000. So the

overhead costs apportioned to washing machines are now £350 000, rather than £200 000, making their true cost greater, and, more dependent on design costs. The implications for controlling costs are clear. If design costs are forecast to increase, the business must increase the price of washing machines by more than the price of other products, in order to maintain its margins. And if customers are not prepared to pay these higher prices, then the increased design costs cannot be justified and should be removed from the budget.

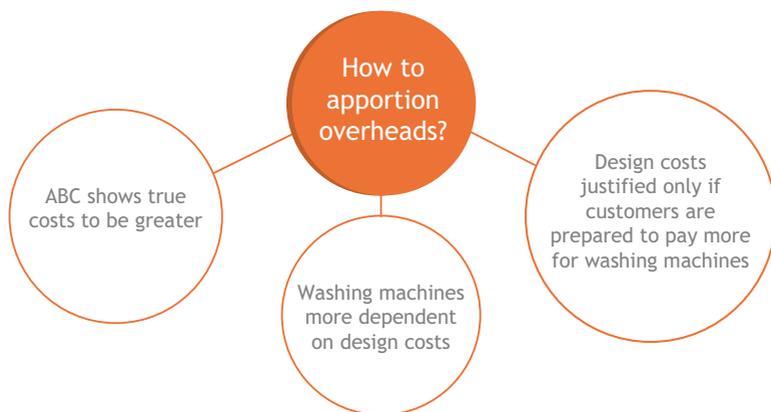
Washing machines use 20% of total production time.

Maintenance costs = £500 000. 20% of £500 000 = £100 000

Washing machines use 50% of total designer hours.

Design costs = £500 000. 50% of £500 000 = £250 000

Overhead costs apportioned to washing machines = £350 000



Sometimes, costs simply need to be cut. Overhead value analysis is a methodical approach used to reduce overhead costs whilst avoiding indiscriminate cost reductions. The business simply scrutinises all of the thousands of activities that make up each overhead cost, and identifies the areas where cuts can be made without affecting quality. The central mechanism is that both the managers of the support departments that supply the overhead services, and the managers of the departments that use the overhead services, are jointly responsible for identifying which costs to cut. This means that key activities are protected, and managers feel freer to recommend cuts because they no longer fear potential knock-on effects on other departments, about whose work they know little.

