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Subject Area - Accounting

Critically discuss the difference between activity based costing and throughput accounting.

Introduction

Changing external business environment has resulted in further developments in the tools and techniques used for management accounting. Traditional management accounting techniques had certain limitations associated with them, for instance, absorption costing methods have been found to be inappropriate in the modern environment. Similarly, standard costing' suitability with respect to its general philosophy and detailed operations has come under severe criticism. It is believed that traditional management accounting performance measures can produce the wrong type of response. As a response to the limitations of traditional accounting techniques, activity based approaches has gained significant repute.

The following paper will evaluate the activity based costing approach and attempt to highlight the inherent differences between activity based costing and throughput accounting approach.

In the case of activity based approaches, the focus is on the activities that the business carries out as opposed to how the activities have traditionally been organised into separate functions. Activity based costing was thus developed because it was realised that older methods like absorption costing, which used labour hours as the basis for absorbing overheads, did not provide useful information about the cost drivers, in other words it did not answer for the question what was causing the overheads to be incurred in the first place.

Generally, Activity Based Costing (ABC) is defined as an accounting technique that allows an organization to determine the actual cost associated with each product and service produced by the organization without regard to the organizational structure. Amongst various benefits associated with the ABC approach one of the major ones is that it helps to define the activities of the organisation in terms of value adding activities. In other words, as a result of ABC it is easy to identify which activities add value to the organisation. Identification of non-value adding activities helps in identifying where time, effort and money are being wasted and unnecessary costs being incurred.

Advantages associated with activity-based approach are many. More generally it is said that activity based costing recognises the inherent complexities faced by many businesses in the present day, which results in the businesses having multiple cost drivers, many of them are transaction based rather than volume based.. These complexities arise due to businesses now having a broader product range and the business environment in general is more volatile and unpredictable. It is further argued that activity based analysis provides a more meaningful analysis of costs which provide a better basis for pricing decisions, product mix decisions, design decisions and production decisions. Besides activity based analysis is concerned with all overhead costs, including the costs of the non-factory floor functions (product design, quality control, production planning, sales order planning and customer service) and not just factory-floor overheads; thus it takes cost accounting beyond the traditional factory floor boundaries. In addition activity based costing helps in identifying the causes of increases in costs and thus it further helps in reducing costs. ABC can be used in conducting customer profitability analysis.

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Despite the advantages associated with activity based costing a number of criticisms have been identified. Theorists have argued that the costs of obtaining and interpreting the new information may be time consuming activity, thus it has been suggested that activity based analysis must only be introduced when there are provisions in the organisation to manage information to use in planning and/or control decisions. Secondly, it has been criticised on the grounds that many overheads do not relate either to volume or to complexity and diversity. Severe criticisms were also raised with the underlying principle of ABC, which is that activity causes cost. Proponents of this viewpoint argue that decisions cause cost or the passage of time causes costs or that there may not be any one clear cause of cost.

Throughput accounting is an alternative to cost accounting based on Standard or Activity Based Costing (ABC) proposed by Eliyahu M. Goldratt. Throughput accounting claims to improve management decisions by using measurements that more closely reflect the effect of decisions on three critical monetary variables. It has originated from the Theory of constraints.

Throughput accounting is an approach to accounting, which is largely in sympathy with the Just-In-Time philosophy. In essence, Throughput Accounting assumes that a manager has a given set of resources available. These comprise of existing buildings, capital equipment and labour force. Using these resources, purchased materials and parts must be processed to generate sales revenue. Thus, according to Goldratt and Cox (1984), given the above scenario, the most appropriate financial objective to set for doing this is the maximisation of throughput, which is defined as, sales revenue less direct material cost.

According to Noreen et. al (1995), there are three building blocks in Goldratt's theory namely, throughput¹, operating expenses² and assets³ (Goldratt 1990). and Profit is measured by throughput minus operating expenses and profitability by profits divided by assets. (Goldratt & Cox 1992.)

Managers are thus motivated to apply the theory of constraints (TOC) because it presents them with a new dimension of focusing their energies on cost reduction rather than on profit enhancement. From this perspective TOC is considered simple.

The official definition of throughput is revenue minus total variable costs. However, some companies exclude all the other expenses, such as the variable selling and shipping costs, considering direct material the most significant factor. Thus, a simplified version of throughput accounting is also used. The visible difference between conventional and throughput accounting is the handling of direct labour, which is considered as a fixed cost. The variable cost nature of direct labour seems to be more a historical reminder than contemporary reality. In many companies, labour cost is, in practise, treated as a fixed cost. (Noreen et al. 1995.)

Noreen et.al (1995) cited the example where Throughput Accounting has been successfully applied also with ABC. Southwestern Ohio Steel has implemented a pricing model based on ABC and Throughput Accounting. This model has been used to analyse and justify manufacturing cycle-time improvements. (Campbell 1995).

Fritsch (1997) argues that the essential difference between throughput accounting and ABC lies in the time horizon. ABC is recommended for strategic planning whilst, throughput accounting works better to meet short-term purposes.

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As the time horizons increase, the solutions produced by throughput accounting begin to look more and more like those produced by conventional cost accounting techniques. Applications of ABC in strategic planning appear to be well documented.

It must be noted that ABC and Throughput Accounting are based on differing sets of assumptions that have an implicitly different time horizon thus claims of superiority of one approach over the other should be abandoned. It is however, possible to use both approaches together to achieve appropriate results.

Some researchers claim that Throughput Accounting approach requires less data and effort than ABC. It is further argued that Throughput Accounting is easier to implement and operate; it sometimes provides insufficient information to guide management decisions. A frequent question is whether ABC is worth the cost or whether the TOC approach will be sufficient

According to Etienne du Plooy⁴, Throughput Accounting is differentiated from all other types of costing systems because only the costs that are truly variable and identifiable to products, are allocated to the products or services produced. These costs are called Totally Variable Costs (TVC). All other costs that are not clearly variable with the quantity of products or services produced are pooled into Operating Expenses (OE). These costs which must also be recovered are not allocated to products. As Throughput is the rate at which the system generates money, and is calculated by subtracting the TVC from the selling price of products, Throughput Accounting puts the performance measures required to maximise business opportunity in place and thus enables management to take immediate corrective action when necessary.

It has been further argued by Noreen et.al (1995) by that the ABC approach yields the same activity for the unused capacity information that Throughput Accounting yields. As a result of tracing operating expenses to products and to unused capacity, an ABC income statement provides additional information concerning the per unit profitability of each product that a Throughput Accounting income statement alone would not provide.

Throughput Accounting has been considered as a perfect complement for many approaches such as the Theory Of Constraints and Total Quality Management (TQM). It is strongly believed that both labour and capital productivity are increased when Throughput Accounting is applied in organisations. It does not lead to inventory build-ups. It is considered more useful for management decision-making. It is closer to a cash flow concept of income and in its purest form it is based on the cash flows of transactions. It is applicable to any enterprise that has constraints. It is relatively inexpensive yet extremely effective. It consistently provides the right information for effective decision-making. It brings the organisation closer to its goal.

To explain the difference between activity based costing and throughput accounting an example has been provided: ABC takes the information used in throughput accounting and adds monetary values. ABC differs from Throughput Accounting in that it traces resource costs to activities. After resource costs have been traced to activities, one divides the activity cost (required by ABC) by the activity capacity (required by Throughput Accounting and ABC) to arrive at the activity-charging rate (required by ABC). Next, that activity-charging rate is multiplied by the quantity of the activity costs driver demanded by each product from each activity (required by Throughput Accounting and ABC). Based on the budgeted number of units produced, each activity's budgeted production cost is compared to that activity's budgeted capacity costs to arrive at the costs of unused capacity for that activity (expressed in financial amounts by ABC and in

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non-financial amounts by TOC). 5

Conclusion

From the preceding paragraphs it can be concluded that Activity based costing and throughput accounting approaches can be used together to achieve the best possible results for the organisation. Despite the inherent differences in the two approaches, they are both essential management accounting techniques, which will help the managers to make sound decisions regarding the future growth of the organisation. Thus in conclusion it can be said ABC and throughput accounting are both required to achieve the long term corporate objectives and for management accountants to arrive at sound managerial decisions relating to profitability of the business.

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