

The Impact of the Activity-Based Costing on SMEs' Financial Performance in Lusaka, Zambia

- Part I -

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Abstract

While several studies have been conducted regarding the impact of Activity-based costing (ABC) system on the financial performance of a firm, to a larger extent they were focused on large enterprises who are mainly established in developed economies. There have been very few studies focused on small and medium sized enterprises and specifically those in the developing/emerging economies. This project therefore sought to explore the impact of Activity-based costing on the financial performance of small and medium sized enterprises based in Lusaka, Zambia, being a developing economy. The specific objectives of the study were to investigate the relationship between Activity-based costing and financial performance in SMEs based in Lusaka, the impact of the implementation of ABC in SMEs on cost control and cost reduction, and the reasons why the majority of SMEs have not adopted the use of the ABC system.

An analysis of the responses from 20 participants in the survey revealed that only seven respondents (35%) had implemented the ABC system, while the other 13 (65%) were still using a traditional costing system. The study further revealed that all the SMEs who had adopted the ABC system had reported a positive impact on their financial performance, as well as on cost control and cost reduction. Furthermore, the study showed that there were three major reasons that the respondents indicated for not adopting the system, namely being satisfied with the traditional costing system (53.85% of the respondents), the high cost of implementing the ABC system (30.77% of the respondents), and lack of expertise to implement the ABC system (15.38% of the respondents). The contribution of this study to the body of knowledge is that the findings will contribute to the understanding of the impact that the adoption and implementation of the ABC system has on the financial performance of SMEs particularly those based in Lusaka, this being the first study on this topic. In addition, the findings of the study will contribute to the understanding of the reasons for low implementation of the ABC system among SMEs in Lusaka.

Key terms: Activity-based costing (ABC), costing systems, small and medium enterprises, overhead costs, traditional costing system

JEL Classification: M10, M41, M49, D24

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1. Introduction

Product costing has been identified as one of the critical factors in the performance and success of the company. This has been enhanced by the competitive environment created by globalisation. The changes in

the competitive environment as well as the structural changes to organisations have resulted in the need for organisations to have accurate information on product/services costs so they could set prices that are not only competitive, but also result in superior financial performance (Al-Dhubaibi, 2021; Pham *et al.*, 2021). The need for accurate product cost estimates therefore has resulted in the need for organisations to implement costing systems that will be able to provide such information.

Strategic management accounting plays a critical role in the development and implementation of costing systems that provide costing information needed for an organisation to remain competitive. Different costing systems may produce different cost information, therefore adopting and implementing a costing system that provides accurate costing information is critical to the success of any organisation in the competitive environment. The Activity-based costing (ABC) system is the type of system that not only provides accurate costing information to organisations, but also enables them to achieve and maintain a competitive advantage in a highly competitive global marketplace (Kocakulah *et al.*, 2017). The adoption of the ABC system, however, has not been widespread especially among SMEs in developing economies such as Zambia. This study therefore aims at investigating the level of adoption of ABC system among SMEs in Lusaka, Zambia, and the effect of the ABC system on the financial performance of the SMEs.

The study has the following structure: Chapter 1 comprises the introduction and rationale for the study, as well as the research questions and specific objectives of the study, Chapter 2 which consists of the literature review of previous studies on the topic, Chapter 3 deals with research methodology, Chapter 4 presents at the research findings and discussions and finally Chapter 5 provides details at the research limitations, future studies and conclusion.

1.1. Rationale for the study

The goal of any organization is to maximise the profit for its shareholders. In order to meet this goal organisations need to adopt strategies that will ensure they remain competitive in the provision of goods and services to their customers. One of the strategies that organisations must adopt is cost reduction and control. This may be achieved through the implementation of appropriate and effective management accounting systems such as the Activity-based costing system. It is due to the need for cost control that management accounting systems such as Activity-based costing were developed.

Unlike the traditional costing system which defines and categorises costs into direct and indirect expenses, Activity-based costing defines costs in relation to the activities or processes an entity undertakes and determines costs in accordance with the activities or events associated with such costs (Canby, 1995). The ABC system does not only focus on costs which are associated with the entity's processes and activities, it also evaluates whether or not such activities and/or processes add value to the organisation and by doing so it provides an understanding of how an entity can manage and reduce cost in a most effective manner (Maiga and Jacobs, 2003).

Therefore, the ABC system is an effective tool in analysing and controlling costs as it focuses on activities and processes that are cost drivers and by linking activities to events that generate costs, it provides a more accurate financial performance measurement (Canby, 1995).

While a number of studies have been conducted on the effect of Activity-based costing on the firm's financial performance, these studies have mainly concentrated on large enterprises in developed economies (Vetchagool *et al.*, 2020). Generally, there has been a lack of studies that cover the small and medium enterprises especially in the developing economies. There is therefore the knowledge gap that exists regarding the effect of the ABC system on the financial performance of the SMEs especially those established in developing economies such as Zambia. Equally there are no studies showing the level of implementation of the ABC system in SMEs in Lusaka, Zambia. This study therefore will seek to contribute to the body of knowledge by seeking to determine the level

of implementation of the ABC system by SMEs based in Lusaka and its impact on the financial performance of these SMEs.

1.2. Conceptual framework

The conceptual framework of this study is based on the fact that while small and medium enterprises have been key players in the economic activities of many countries, especially the developing nations, they are facing stiff and increasing competition in the global market environment (Rundora *et al.*, 2013).

Therefore, in order for them to stay competitive in an ever-increasing competitive global marketplace, they need to offer high quality goods and services that meet the expectations of consumers and customers at competitive prices. However, in order for these enterprises to make right decisions regarding the costs and pricing of their products and services, they require accurate and up to date costing information which can only be obtained through the use of proper costing systems such as the Activity-based costing. Failure to have a proper costing system in place may result in having inaccurate costing information which may lead to making wrong pricing decisions and failure to properly control cost. Failure to control costs may affect company competitiveness which may result in poor financial performance which ultimately may lead to company failure.

1.3. Significance of the study

Literature has left a gap in the impact of the Activity-based costing system on the financial performance of small and medium enterprises as almost all the studies are focused on large enterprises. The significance of this study therefore is that it will highlight the effects that the ABC system implementation has on the financial performance of the SMEs. This will add to the body of knowledge regarding the effects that the ABC system has on financial performance of SMEs and will help practitioners in making informed decisions on whether to adopt the ABC system as they make decisions on which costing systems to use.

1.4. Research questions

The general objective of this study is to investigate the impact of Activity-based costing on financial performance of small and medium sized enterprises in Lusaka. In order to achieve this objective, the following questions were formulated in order to be answered through a survey.

1. What impact does Activity-based costing has on financial performance of SMEs?
2. Does Activity-based costing help to control and reduce cost in small and medium sized enterprises?
3. What is the level of the ABC system adoption among SMEs in Lusaka and what are the major reasons for non-adoption of the system?

1.5. Aim of the study (specific objectives)

The specific objectives of the study were:

- (i) To investigate the relationship between Activity-based costing and financial performance in SMEs based in Lusaka.
- (ii) To investigate whether or not the implementation of the ABC system in SMEs helps to control and reduce cost.
- (iii) To investigate the level of the ABC system adoption among SMEs in Lusaka and the reasons for non-adoption of the ABC system.

2. Literature review

2.1. Introduction

Organisations require costing information regardless of their size or the industry they are in. Costing information serves a wide range of purposes for each individual organization which include decision making,

valuing inventory, product pricing, evaluating financial performance, as well as managing costs (Labro, 2019). The need for costing information, however, is largely determined by organizational characteristics and changes among the business environment and as uncertainty increases, decision makers seeking more costing information to help them in planning and control (Hill, 2000). Changes in the business environment such as increased competition as well as regulatory changes impact businesses in their operations which affects their cost structures and ultimately has an effect on their financial performance. As changes in cost structure of the business occur there is a need for more accurate costing systems which will give management more accurate cost information to help it make informed decisions concerning product pricing, cost control, as well as product mix (Labro, 2019).

Management needs more accurate cost information which will help it identify more profitable product mixes besides making decisions on pricing of products.

The need for more accurate costing information therefore has resulted in management accountants developing various costing systems which are more accurate in establishing the costs of products and services. The increase in competition both at national and global level has resulted in organisations trying to look for ways of producing their goods and services at lower costs in order to achieve competitive advantage (Al-Omiri and Drury, 2007). However, producing goods and services at lower costs entails that organisations need to have a deeper understanding of their cost structures and what are the cost drivers, and hence the need to have more accurate costing information. In order for them to have accurate costing information, the adoption and implementation of relevant and most appropriate costing system becomes critical. Over the years, management accountants have devoted much effort to the development of costing systems that may help organisations in obtaining more accurate costing information. Among such systems there are the traditional costing systems such as absorption costing and the newer and more robust system such as the Activity-based costing. No two costing systems, however, could produce the same costing information as each system produces different information (Labro, 2019). Therefore, choosing the most appropriate costing system which aligns with the organization's characteristics and its strategic objectives is critical to its competitiveness and for creating a competitive advantage. Activity-based costing is the type of method that researchers have identified as helpful to organisations in identifying costs incurred in producing goods and services and therefore making decisions that improve profitability as well as maintaining a competitive edge in the global marketplace (Kocakulah *et al.*, 2017).

2.2. Traditional costing systems

Traditional costing systems are methods of allocating manufacturing overheads (factory indirect costs) to the cost of a product or service, usually using direct labour hours or machine hours as the basis for allocation of overheads. Zaman (2009) argued that while, for many decades, traditional costing systems have worked well in ascertaining the cost of goods sold as well as the valuation of inventory and are likely to continue being useful for a foreseeable period of time, they pose a number of challenges to practitioners in today's competitive environment.

Traditional costing systems considers costs to be either variable with volume or fixed and groups costs in few cost pools with direct labor costs or machine hours being the major cost allocation basis for many organisations especially those in the manufacturing sector (Labro, 2019). However, several management accounting researchers have argued that traditional costing systems distort the product costs in a systematic way as the use of direct labor hours or direct costs as the basis of allocating indirect costs to products were not appropriate considering the automation of manufacturing processes as well as other business processes (Labro, 2019).

Apart from the distortion of product costs, traditional costing systems are not able to help organisations identify activities that do not add value as it is the case with the Activity-based costing system (Vetchagool *et al.*, 2020).

2.3. Activity-based costing

The Activity-based costing system is defined by the American Consortium for Advanced Management – International (CAM-I) as “a methodology that measures the cost and performance of activities, resources, and cost objects. Resources are assigned to activities, then activities are assigned to costs objects based on their use. The ABC system recognizes the causal relationships between cost drivers and activities.” (Pokorná, 2016). Unlike traditional costing system which allocates overhead costs to products using predetermined rates, the Activity-based costing is a system that assigns resource costs to cost objects based on the activities performed for the cost objects. Cost objects refers to such things as a product or service, cost center or department. Under the Activity-based costing an organization is able to identify activities that give rise to costs, i.e., the ABC system helps organisations identify activities and their cost drivers and the way these activities that include business processes should be managed and controlled resulting in management making good decisions relating to product expenses and profitability (Kocakulah *et al.*, 2017). Apart from the identification of cost drivers, the ABC system is used as a support tool for making critical decisions both medium and long-term decisions such as the product mix decisions, pricing decisions as well as make or buy decisions (Rundora *et al.*, 2013). Joseph *et al.* (2019) stated that although the Activity-based costing system is a management accounting system that gives accurate costing information its focus goes beyond that of determining product costs as well as financial control as it focuses on efficient deployment of resources which results in creating value for the firm.

Activity-based costing as a costing system was developed in response to challenges posed by traditional costing systems and in pursuit of a costing system that accurately reflected the true costs organizations incurred in producing their products and services. It was developed with the view that it will capture the economics of operational processes more accurately than the traditional costing systems (Vetchagool *et al.*, 2020). Vetchagool *et al.* (2020) argue that the ABC system is a better alternative to traditional costing systems due to its ability to overcome a number of challenges that traditional costing systems posed. This is due to the fact that the ABC system is capable of identifying cost drivers, thereby enabling organisations to gain quality information which allows them to understand the behavior of activities. Understanding the behavior of activities leads to identification of the root causes of overhead costs and subsequently enabling management to control costs through implementation of appropriate strategies and actions aimed at cost reduction. This argument is also supported by Kocakulah *et al.* (2017) who argued that the ABC system had the ability to provide accurate costing information as it was able to help organisations identify the true costs of their products and business processes and hence help them to create and maintain a competitive edge in the global marketplace. Creating and maintaining a competitive edge is achieved by making use of the information provided through the use of ABC system to make sound strategic decisions such as those that involve product planning and pricing, as well as managing costs. Pham *et al.* (2021) also stated that the ABC system was a better costing system than the traditional costing systems as it can be used to analyse the operations of a business that ultimately lead to the identification of both direct and indirect costs and classification of such costs based on the activities. Ultimately, ABC system deals with the distortions that traditional costing system inherently had and not only does it help eliminate distortions in costing information but also provides managers with a holistic view of managing costs (Rundora *et al.*, 2013).

Although several studies and literature have indicated the advantages and benefits of ABC as well as the effect of the ABC system on financial performance of organisations, such studies have mainly been conducted in developed economies and concentrated on large organisations. There have been very few studies specially undertaken to show the effects of the adoption and use of the ABC system on the operational and financial performance of small and medium sized enterprises in developing economies such as Zambia. One recent study was the one undertaken by Joseph *et al.* (2019) who looked at the extent of adoption of the ABC system by small and medium enterprises in the State of Tamil Nadu in India. Joseph *et al.* (2019) highlighted the fact that

there was very little research on the use of the ABC system in developing countries and especially in small and medium sized enterprises.

2.4. Activity-based costing and operational performance

Literature and several empirical studies have indicated that there is a positive correlation between the use of the ABC system and operational performance of the firm (Al-Dhubaibi, 2021; Pham *et al.*, 2021; Cagwin and Bouwman, 2002, as quoted in Pokorná, 2016; Zaman, 2009). Kocakulah *et al.* (2017) and Pokorná (2016) stated that the ABC system had a positive impact on operational performance of an organization as organisations were able to identify the causes of overheads and therefore they were able to control the costs and improve performance. Vetchagool *et al.* (2020) stated that the use of the ABC system had the capability to improve operational effectiveness. They supported their argument with an empirical finding of the study undertaken in Thailand. In their study they found a correlation between the use of the ABC system and improved operational performance. The study conducted by Vetchagool *et al.* (2020) was confirmed by the studies undertaken by Pham *et al.* (2021), who in their empirical studies established a relationship between the use of the ABC system and strong performance. They demonstrated that the implementation of the ABC system had a significant and favourable influence on the positive performance of firms (Pham *et al.*, 2021). Furthermore, Pham *et al.* (2021) stated that the adoption and implementation of the ABC system had the capability to help companies, especially manufacturing companies, to continually and sustainably improve their firm performance. Several other researchers have also supported the assumption that there is a positive correlation between the adoption and use of the ABC system and improved operational performance, although there have been some conflicting results on the impact of the use of ABC system on the organizational financial performance (e.g., Labro, 2019; Maiga and Jacobs, 2003; AlGammal *et al.*, 2016). However, all these highlighted studies have been targeted on large enterprises that trade on stock markets in their respective countries.

2.5. Impact of the ABC system on financial performance of small and medium sized enterprises

Small and medium enterprises play a critical role in a national economy as they greatly contribute to the creation of employment opportunities as well as to production output of goods and services and significantly contribute to the development of new technology (Kocakulah *et al.*, 2017; Gunasekaran *et al.*, 1999). Further, SMEs act as the bridging gap between the rich and the poor through provision of employment and they also act as innovation incubators and exhibit flexibility in their operations and thus they have the potential to improve their performance and ultimately their competitiveness in the competitive global market (Kocakulah *et al.*, 2017; Gunasekaran *et al.*, 1999). In Zambia, small and medium enterprises constitute 97% of businesses in the country and represent approximately 70% of GDP and 88% of employment (International Trade Center, 2019). Although SMEs are major players in the economic development of any nation, they are faced with a number of challenges among which is the ever-increasing competition due to globalization of markets, and the volatility of the global markets (Kocakulah *et al.*, 2017). The increased competition entails that in order for SMEs to remain competitive they need to adopt strategic initiatives that will enable them to improve their operational efficiency and subsequently their financial performance. The Activity-based costing system is one of those strategic initiatives which has been proved to help several organisations in making strategic decisions aimed at improving financial performance. The ABC system has been considered one of the most effective tools that had a positive impact on economic performance/financial performance of several firms that have successfully implemented it (Al-Dhubaibi, 2021; Alsayegh, 2020; Lu *et al.*, 2013, as quoted in Pham *et al.*, 2021). Pham *et al.* (2021) reported in their empirical research that the successful implementation of the ABC system had a positive impact on the firm's financial performance. This was also supported by research undertaken by Al-Dhubaibi (2021) who stated that there was a positive relationship between the successful implementation of the ABC system and the financial

performance of the firm. Both researchers reported that among the companies they surveyed those who had successfully implemented the ABC system had reported significant improvements in their financial performance as measured by their increased profitability. Vetchagool *et al.* (2018) also noted that there was a positive relationship between adoption of the ABC system and financial performance of the organization. However, they noted that this relationship became stronger when an organization implemented other systems such as the ISO 9000 system.

Although the ABC system has proved to have many benefits once it is successfully implemented, its adoption and implementation among SMEs has not been wide as it has received little attention from SMEs (Pham *et al.*, 2021; Alsayegh, 2020; Gunasekaran *et al.*, 1999). Apart from receiving little attention from SMEs, there are very few studies that are focused on the adoption and implementation of the ABC system in SMEs and its impact on their financial performance (Mohammed, 2019; Rundora *et al.*, 2013). Particularly in Zambia, there has been no empirical research that shows the impact of the adoption and implementation of the ABC system by SMEs on their financial performance. The closest studies found within the Southern African region are those undertaken by Rundora *et al.* (2013) in which they investigated the level of adoption and implementation of the ABC system in small manufacturing firms in Southern Gauteng region, South Africa. Nonetheless, the study was limited to small manufacturing firms in Southern Gauteng region and did not cover the entire South Africa and only investigated the extent to which the ABC system was adopted, the benefits that arises from the use of ABC and the perceived barriers to the adoption of ABC system in small manufacturing firms. This study will therefore fill up the gap of missing knowledge as a result of lack of empirical research on the ABC system adoption and implementation in Zambia's SMEs and its impact on their financial performance.

2.6. The ABC system and cost reduction and control in SMEs

Extant research has established several benefits of the adoption and implementation of the Activity-based costing system which include cost reduction and cost control. Vetchagool *et al.* (2020) reported in their research that the use of the ABC system by firms as a tool for cost strategy, analysis of costs, as well as evaluating the costs enables organizations to identify activities and cost drivers that do not add value and hence, eliminate them and by doing so the system enables organisations to reduce costs. This argument is also supported by Al-Dhubaibi (2021) who argued that the adoption and implementation of the ABC offered many benefits to those firms who successfully implemented it. He further reported that several firms who were surveyed in his research had indicated that the use of ABC system had enabled them not only to reduce costs but also to control costs by identifying non-value adding activities and eliminating them. Mohammed (2019) reported in his study of the impact of the ABC system on the performance of SMEs in Lagos State, Nigeria, that there was a relationship between the adoption and implementation of the ABC system and cost reduction and control as evidenced by the firms surveyed who reported reduction in costs due to the implementation of the ABC system.

While these studies have shown the benefits that organisations gain from the adoption and implementation of the ABC system, the majority of the research has been undertaken in developed nations, while very few research (e.g., Mohammed, 2019) has been undertaken in developing nations and specifically targeting SMEs. As Al-Dhubaibi (2021) argues, the extent to which users of the ABC system benefit from its implementation may vary from user to user depending on the level of implementation and other factors such as the expertise of personnel and other technical and behavioral factors of the organization.

2.7. Challenges in implementing the ABC system in SMEs

Despite the many studies conducted, mainly targeting large organisations, showing several benefits that have been obtained by organizations who adopted and implemented the ABC system, the level of adoption of the system has not been widespread even though in the recent past there has been an upward increase in the adoption of the ABC system by large organisations (Pham *et al.*, 2021; Lueg and Storgaard, 2017). While there

are several benefits of the adoption and implementation of ABC systems there are several challenges that organisations face, especially the SMEs, resulting in the low adoption of the system (Al-Dhubaibi, 2021; Pham *et al.*, 2021). Al-Dhubaibi (2021) noted that one of the challenges/barriers in implementing the ABC system was the costs associated with the implementation of the system which included the cost of the ABC software, as well as time commitment of both management and staff. In addition to cost challenges Pham *et al.* (2021) noted that organizational factors such as training of personnel in Activity-based costing, managerial support, organizational behavior and structure were some of the challenges faced by organisations in the adoption of the ABC system. Nair and Tan (2018) also identified several factors as being challenges faced by SMEs in implementing ABC system, and included such factors as competitive environment, company size, costing saving as well as user attitudes.

To be continued...

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