

CHAPTER 6

Activity Based Costing

A DEFINITION OF ACTIVITY BASED COSTING

The activity-based costing (ABC) system is a method of accounting you can use to find the total cost of activities necessary to make a product. The ABC system assigns costs to each activity that goes into production. It is a costing method that identifies activities in an organization and assigns the cost of each activity to all products and services according to the actual consumption by each. The Institute of Cost & Management Accountants of Bangladesh (ICMAB) defines activity-based costing as an accounting method which identifies the activities which a firm performs and then assigns indirect costs to cost objects.

OBJECTIVES OF ACTIVITY BASED COSTING

- To identify value added activities in transactions.
- To focus high cost activities.
- To distribute overheads on the basis of activities.
- To identify the opportunities for improvements and reduction of costs.
- To validate the success of the quality drive with ABC.
- To ensure accurate product costing for decision making.
- To use information to improve product mix and pricing decisions.

STEPS IN ABC SYSTEM

1. Identifying Activities
2. Assigning Costs to Activity Cost Centres
3. Selecting Appropriate Cost Drivers
4. Assigning the Cost of the Activities to Products

COST DRIVER

Activity based information may be non-financial but concerns activities across the entire chain of value adding process and focuses the attention of managers on activities that cause rather than the costs themselves. These activities are known as cost drivers.

Cost drivers are used to describe the events or forces that are the significant determination of the cost activities, e.g., production scheduling cost is generated by the number of productions runs that each product generates. Thus, cost drivers are factors that drive consumption of resources. Therefore, management of cost drivers is essential to manage costs.

COST POOLS/CENTRES

A cost pool is a grouping of individual costs, typically by department or service centre. Cost allocations are then made from the cost pool. For example, the cost of the maintenance department is accumulated in a cost pool and then allocated to those departments using its services.

IN BRIEF FOLLOWING ARE MAIN BENEFITS OF USING ABC TECHNIQUE:

1. ABC helps to reduce costs by providing meaningful information for cost-management. It helps in making the right decision.
2. ABC technique provides due importance to non-manufacturing cost which constitute a substantial portion of total cost. Traditionally non-manufacturing costs have been allocated under volume basis and thus, high volume products have been overvalued.
3. ABC technique provides accurate and reliable cost information. This cost information is essential for recent approaches in productivity improvement like Total Quality Management (TQM) and Business Process Reengineering.
4. ABC enables the management in formulating an effective pricing policy while fixing prices.
5. Cost of each activity is determined with the help of ABC. There is accuracy in indirect cost-allocation to products. This technique is helpful in make or buys decisions and transfer pricing.

WEAKNESS OF ABC SYSTEM

1. It is based on historical costs; while for planning decisions future costs are more relevant.
2. For many short-term decisions, identification of variable costs is very important. But ABC system does not partition variable and fixed elements of overhead costs.
3. The accuracy of ABC system fully depends upon the quality of cost drivers. The allocation and absorption of costs may become an arbitrary allocation process, if the cost drivers are not associated with the factors causing costs.
4. ABC system tends to be more costly than the traditional methods of applying costs to products.

DIFFERENCE BETWEEN ACTIVITY BASED COSTING AND TRADITIONAL COSTING

Basis of distinction	Activity Based Costing	Traditional Costing
Primary Focus	Uses multiple cost drivers for multiple activities.	Uses identical cost driver for different activities.
Application	Is difficult to implement and requires time and effort.	Is straightforward and easy to implement.
Scope	Cover product cost only.	Can cover both product as well as period costs.
Management Use	The values can be used in external financial statements.	The values cannot be used in reports of external reporting.
Effectiveness of operations	Enhances management knowledge about activities related to production process.	Does not provide opportunity to identify any specific reasons for costs incurred.

QUESTIONS

1. What is Activity Based Costing?
2. What benefits does ABC provide?
3. Distinguish between Activity Based Costing and Traditional Costing.

REFERENCE

- Gupta, R. Strategic Cost Accounting.
https://www.lkouniv.ac.in/site/writereaddata/siteContent/202004131501352277rajani_com_Activity_based_Costing.pdf