

COST MANAGEMENT

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UNIT 5 : ACTIVITY BASED COSTING

CONVENTIONAL COSTING SYSTEM

- In conventional costing system the costs are charged to a department or plant and later on charged to the product.
- Traditional system of accounting is called Volume based cost accounting where by the direct costs are charged to the products and overheads on the basis of some arbitrary selected criteria.



WEAKNESS OF CONVENTIONAL SYSTEM

- The basis used for valuing stock for the purpose of financial reporting is not acceptable for decision making.
- The classification of cost and variable cost is often unrealistic as the business becomes more complex when it grows.
- It is limited to provide information at the product level on completion of the production. The present management needs the feedback on performance while the product is still in progress.



MEANING AND DEFINITION OF ABC

- An accounting method that identifies the activities that a firm performs and then assigns indirect costs to products is called activity based costing.
- An activity based costing system recognizes the relationship between costs, activities and products.
- CIMA defines ABC as, ‘cost attribution to cost units on the basis of benefit received from indirect activities e.g. ordering, setting up, assuring quality’.



OBJECTIVES OF ABC

- To identify significant activities and assign overhead costs to each activity in proportion to resources used.
- Identify cost drivers appropriate to each activity and allocate overhead to the products.
- To remove nonmanufacturing costs from product costing.
- Fully cost products for external reporting purposes.
- To provide accurate cost information that is going to be used in managerial decisions.

FEATURES OF ABC

- ABC is a two stage product costing method that first assigns costs to activities and then allocates them to products based on each product's usage of activities.
- The cost pools accumulate the activity consists of different functions that are associated with cost objects.
- The overhead costs can be traced easily making cost data more reliable and accurate.
- It is based on activities that are consists of different functions that are associated with cost objects.

STEPS IN IMPLEMENTATION OF ABC

- Identify functional areas involved.
- Identify the relative activities involved in each functional area.
- Allocate the common expenditure to activities in each functional areas.
- Prepare a statement of expenditure function wise or account head wise.
- Identify the most suitable cost driver for each activity under functional areas.
- Determine the rate of cost driver for a particular activity.
- Absorb overhead on the basis of rate of cost driver.

BENEFITS FROM ADAPTATION OF ABC

- ABC is accurate and reliable in product cost determination as it focuses on cause and effect relationship in cost incurrence.
- ABC identifies the real nature of cost behavior and helps in reducing costs and identifying activities which do not add value to the products.
- ABC uses multiple cost drivers, many of which are activities based rather than volume based.
- ABC can be used to identify non-valued added activities and can help to better allocate resources to efficient and profitable activities.

DIFFICULTIES FACED BY THE INDUSTRIES IN THE SUCCESSFUL IMPLEMENTATION OF ABC

- Identifying activities and estimating costs of activity pools is difficult and expensive.
- It is difficult to identify and measure cost drivers for chosen activity pools.
- When the number of cost pools is large, it is natural that measurement errors will be large. In such a scenario, activity based cost information may be misleading.
- It is time consuming and expensive.

TERMS USED IN ABC

- **Activity** : A task or unit of work with a specific purpose.
- **Cost object** : it is an item for which cost measurement is required. E.g a product, a service, a job.
- **Cost driver** : it is a factor that causes a change in the cost of an activity.
- **Activity cost driver** : it is a measure of the frequency and intensity of demand placed on the activities by cost object.

KAPLAN AND COOPER'S APPROACH TO ABC

- Kaplan and Cooper of Harvard Business School, who have developed this new approach in costing to calculate product cost, claim that the cost should be classified as long term variable and short term variable cost.
- Traditionally short term variable cost are known as variable costs and long term are known as fixed costs.
- Short term variable cost are volume related and change proportionately with the volume of production. Long term variable vary in long term but not instantaneously.

DIFFERENCE BETWEEN TRADITIONAL COSTING AND ABC

TRADITIONAL COSTING	ABC
This was developed during 1870-1920.	ABC system began in 1982
Its is simple.	It is complex.
Less preferred	Accurate and more preferred
Focuses on structure rather than on process.	Focuses more on the activities than on structure.
The cost objects and used up resOurces are required to evaluate the cost.	The cost is independent upon the activities used up by the cost objects.