Sub: COST & MANAGEMENT ACCOUNTING - II

Sem: IV

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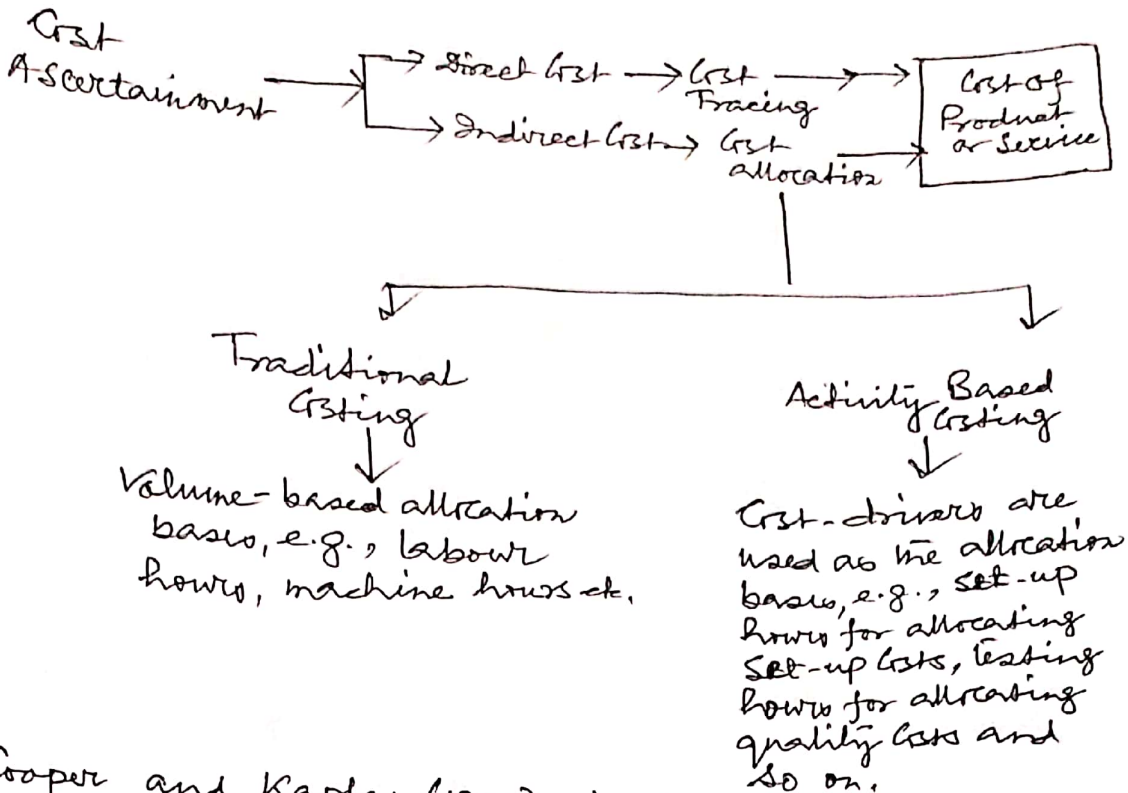
LEC. NO: 1

ACTIVITY BASED COSTING (ABC)



Cooper and Kaplan (1988) developed a more defined approach for assigning overheads to product and computing product costs. It is called ABC approach (Activity Based Costing). It was first applied by Dell Computer.

Problems of Traditional Costing:

Traditional costing can lead to undercosting or overcosting of Products or Services.

Undercosting results when a product or service consumes a relatively high level of resources but is allocated a relatively low cost.

Overcosting results when a product or service consumes a relatively low level of resources but is allocated a relatively high cost.

Over or Undercosting of Products distorts cost information and it causes management to make poor, inappropriate decisions for pricing, make or buy decisions etc.

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Over & Under Costing occurs because of overhead & indirect costs are recovered based on volume only i.e., MHR, LHR. It is popularly known as volume based cost allocation.

(Repeat -)

Cooper and Kaplan (1988) developed a more defined approach for assigning overheads to product and computing product costs. It is called ABC approach (Activity Based Costing) and used by Del Computer Organisation first.

Activities drive costs. Costs are, therefore, allocated based on appropriate cost drivers.

Cost drivers are the factors or transactions that are significant determinants of costs.

Activities and the relevant cost drivers are given below: (few examples) -

Activities	Cost driver
Purchasing materials	No. of orders placed
Inspection	Inspection per item
Packing	No. of Packing orders
Quality testing	Testing hours
Machine Set-up	No. of Production run

Advantages and Limitations of ABC

* Under ABC overheads or indirect costs are identified on the basis of activities rather than products. As costs are incurred for the activities involved in the manufacture of products/services, ABC helps in ascertaining more accurate costs of the products/services.
* Under ABC costs are ascertained for activities. As a result, costs can be easily obtained for different activities of the organisation that helps controlling costs.

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* ABC helps to ascertain costs of the products more accurately, thereby, identify the unprofitable products.
* Management may take appropriate action Paying attention to the problem areas and increase the Profitability of the organization.

Limitations

* ABC System involves more costs than the Traditional System.
* ABC emphasizes on the cost reduction.
* ABC does not conform to generally accepted accounting principles in some areas.

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