

Intro: this Study Guide discusses a more advanced costing technique: **ABC** (Activity-Based Costing). It explains **cost drivers**, cost per driver, cost per unit under ABC & also compares ABC with **traditional methods of overhead absorption**. It focuses on the implications of switching to **ABC for pricing, sales strategy, performance management & decision making**.

Appropriate cost drivers under ABC

Activity-based costing – focuses on individual activities as fundamental cost objects and uses costs of these activities to assign costs to products or services

Commonly-used terms in ABC

Allocation base is a **factor** used for **allocation of overhead costs to the products or services**

Cost object: Anything for which a measurement of cost is necessary

Example

Number of machine hours, number of direct labour hours

A product, a service, a department or an activity

Activity Based Costing

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Specialist Cost & Management Accounting Techniques

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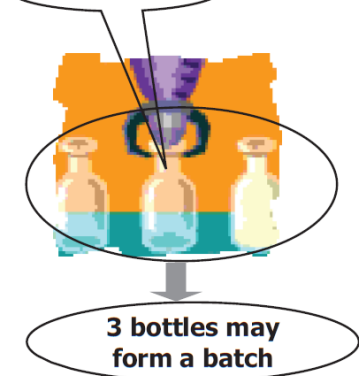
Cost pool: **collective cost** of manufacturing / service department or activity

Set-up cost, depreciation, supervisor's salary may be pooled in machine shop

Cost driver

A variable, which has a 'cause & effect' relationship with costs in a given time span. Instead of 'allocation bases' or 'overhead allocation rates', the term 'cost driver' is used by the ABC system.

Per unit



Volume-based

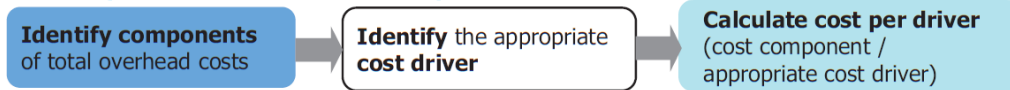
Refers to activities which have a high **correlation with** number of **units** produced

Non volume-based

Refers to activities which have a high **correlation with** number of **batches** of production, number of purchases

Costs	Cost drivers
Depreciation	Machine hour
Indirect labour cost	Direct labour hours
Machine set-up cost	No. of set-ups
Order placing cost	No. of purchases
Inspection cost	No. of inspections
Design cost	No. of product designs

Steps for the calculation of cost per driver



Calculation of overhead costs per units

Total costs are allocated

'Cost per driver x Number of units of relevant activity required per unit of a product'

Overhead cost per unit

'Total overhead cost allocated to a product per number of units produced'

Contrast between traditional system of costing & ABC system

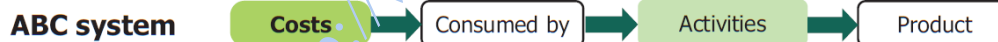


Activity Based Costing

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Traditional system	ABC system
<ul style="list-style-type: none"> First assigns costs to the major activities Then reallocates these costs to products / services 	<ul style="list-style-type: none"> First allocation to the departments Then departmental costs reallocated to the products / services
<ul style="list-style-type: none"> Overheads tend to be pooled by activity-based cost centres 	<ul style="list-style-type: none"> Overheads tend to be pooled by departments (no activities)
<ul style="list-style-type: none"> Production process activities and support activities are recognised as cost centres 	<ul style="list-style-type: none"> Activities are not recognised as cost centres
<ul style="list-style-type: none"> Both volume-based as well as non volume-based cost drivers are used 	<ul style="list-style-type: none"> Only volume-based overhead allocation bases are used
<ul style="list-style-type: none"> Costs are not merged. Service department costs are not allocated to production cost centres. They are allocated directly to the cost objects. 	<ul style="list-style-type: none"> Costs are merged. Allocates service department costs to production cost centres and not to the cost objects.