

ACTIVITY BASED COSTING *ABC*

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Introduction

There are a number of costing models used in the domain of business and Activity-Based Costing is one of them. In activity-based costing, various activities in the organization are identified and assigned with a cost.

When it comes to pricing of products and services produced by the company, activity cost is calculated for activities that have been performed in the process of producing the products and services. In other words, activity-based costing assigns indirect costs to direct costs. These indirect costs are also known as overheads in the business world.

Let us take an example. There are a number of activities performed in a business organization and these activities belong to many departments and phases such as planning, manufacturing, or engineering. All these activities eventually contribute to producing products or offering services to the end clients.

Quality Control activity of a garment manufacturing company is one of the fine examples for such an activity. By identifying the cost for the Quality Control function, the management can recognize the costing for each product, service, or resource. This understanding helps the executive management to run the business organization smoothly.

Activity-based costing is more effective when used in long-term rather than in short-term.

Implementation in an Organization

When it comes to implementing activity-based costing in an organization, commitment of senior management is a must. Activity-based costing requires visionary leadership that should sustain long-term. Therefore, it is required that the senior management has comprehensive awareness of how activity-based costing works and management's interaction points with the process.

Before implementing activity-based costing for the entire organization, it is always a great idea to do a pilot run. The best candidate for this pilot run is the department that suffers from profit making deficiencies.

Although one might take it as risky, such departments may stand an opportunity to succeed when managed with activity-based costing. Lastly, this would give the organization a measurable illustration of activity-based costing and its success. In case, if no cost saving occurs after the pilot study is implemented, it is most likely that the model has not been properly implemented or the model does not suit the department or company as a whole.

Having a Core Team is Important

If an organization is planning to implement activity-based costing, commissioning a core team is of great advantage. If the organization is small in scale, a team can be commissioned with the help of volunteers, who will contribute their time on part-time basis. This team is responsible for identifying and assessing the activities that should be revised in order to optimize the product or service.

The team should ideally consist of professionals from all practices in the organization. However, hiring an external consultant could also become a plus.

The Software

When implementing activity-based costing, it is advantageous for an organization to use computer software for calculations and data storage. The computer software can be a simple database that will store the information such as customized ABC software for the organization or a general-purpose off-the-shelf software.

The Procedure

The procedure for successful implementation of activity-based costing in an organization is as follows:

- Identification of a team that is responsible for implementing activity-based costing.
- The team identifies and assesses the activities that involve in products and services in question.
- The team selects a subset of activities that should be taken for activity-based costing.
- The team identifies the elements of selected activities that cost too much money for the organization. The team should pay attention to detail in this step as many activities may shield their cost and may look innocent from the outside.
- The fixed costs and variable costs related to activities are identified.
- The cost information gathered will be entered to the ABC software.
- The software then performs calculations and produces reports to support management decisions.
- Based on the reports, management can identify the steps that should be taken to increase profit margins in order to make the activities more efficient.

The management steps and decisions taken after an activity-based costing experience is generally known as Activity-Based Management. In this process, the management makes business decisions to optimize certain activities and let some activities go.

Things to be Aware of

Sometimes, organizations face the risk of spending too much time, money and resources on gathering and analysing data required for activity-based costing model. This can eventually lead to frustration and the organization may give up on ABC eventually.

Failure to connect the outcomes from the activity-based costing usually hinders the success of the implementation. This usually happens when the decision makers are not aware of the "big picture" of how activity-based costing can be used throughout the organization. Understanding the concepts and getting actively involved in the ABC implementation process can easily eliminate this.

If the business organization requires quick fixes, activity-based costing will not be the correct answer. Therefore, ABC should not be implemented for situations where quick wins are required.

Conclusion

Activity-based costing is a different way of looking at an organization's costs in order to optimize profit margins.

If ABC is implemented with the correct understanding for the correct purpose, it can return a great long-term value to the organization.

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