ABC

Session 9

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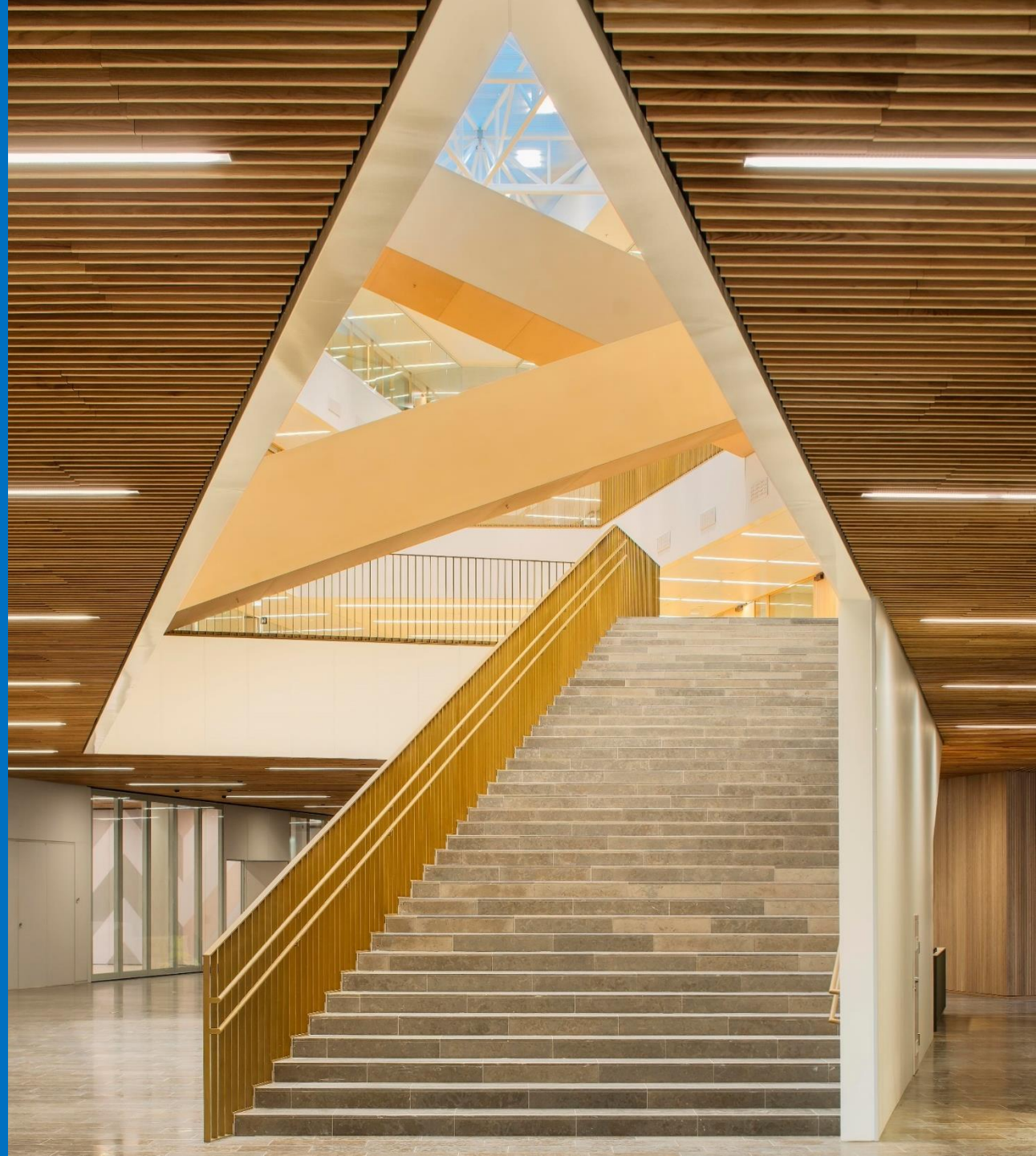
Aalto University
School of Business



Glossary

ABC Activity Based Costing

ABM Activity Based Management

Activity Based Costing (ABC) and Activity Based Management (ABM)

Agenda:
Learning Objectives for this session

5.1 Explain how broad averaging undercosts and overcosts products or services

5.2 Present three guidelines for refining a costing system

5.3 Distinguish between simple and activity-based costing systems

5.4 Describe a four-part cost hierarchy

5.5 Cost products or services using activity-based costing

5.6 Evaluate the benefits and costs of implementing activity-based costing systems

5.7 Explain how managers use activity-based costing systems in activity-based management

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Background

- Recall that **plant overhead is applied to production in a rational systematic manner, using some type of averaging**.
- There are a variety of methods to accomplish this goal.
- These methods often involve trade-offs between simplicity and realism.

Simple Methods
Can be inaccurate

Complex Methods
Usually more accurate

Source: Datar/Rajan (2021)

Plantwide and Department Overhead Calculations

Plantwide Overhead Rate *(Budgeted Manufacturing Overhead Rate)*:

Department Overhead Rate

Similar concept except overhead cost pools and selected base are obtained by department rather than plantwide.

Total Estimated Overhead ** / Total Estimated Allocation Base ***

** Obtain total of all overhead costs to be allocated.
*** Determine the best “base” – direct labor hours, machine hours, etc.

This rate is used to allocate overhead costs to all products

Source: Datar/Rajan (2021)

Example of Plantwide and Department Overhead Calculations

Let's say we have two departments: A and B with overhead costs of €300,000 and €450,000, respectively.

Let's also assume that the best allocation base (the most likely cost driver) in Department A is **Direct Labor Hours** and in Department B is **Machine Hours**.

The calculation of overhead allocation rates would be as follows:

	Dept A	Dept B	Plantwide
Overhead	**€300,000**	**€450,000**	€750,000
Direct Labor Hrs	**8,000**	7,000	15,000
Machine Hours	750	**1,200**	1,950
Allocation Rate-DLH	€37.50	n/a	€50.00
Allocation Rate-MH	n/a	€375.00	€384.62

Source: Datar/Rajan (2021)

For what companies does the old system work for which doesn’t it work?

Broad Averaging

- Historically, **firms produced a limited variety of goods and at the same time, their indirect costs were relatively small**.
- Allocating overhead costs was simple: **Use broad averages to allocate costs uniformly regardless of how they are actually incurred**.
  - Generally known as “Peanut-butter costing” (perhaps because it is spread evenly?)
- The end-result:
  - Products using fewer resources are overcosted, and products using more resources are undercosted.

Source: Datar/Rajan (2021)

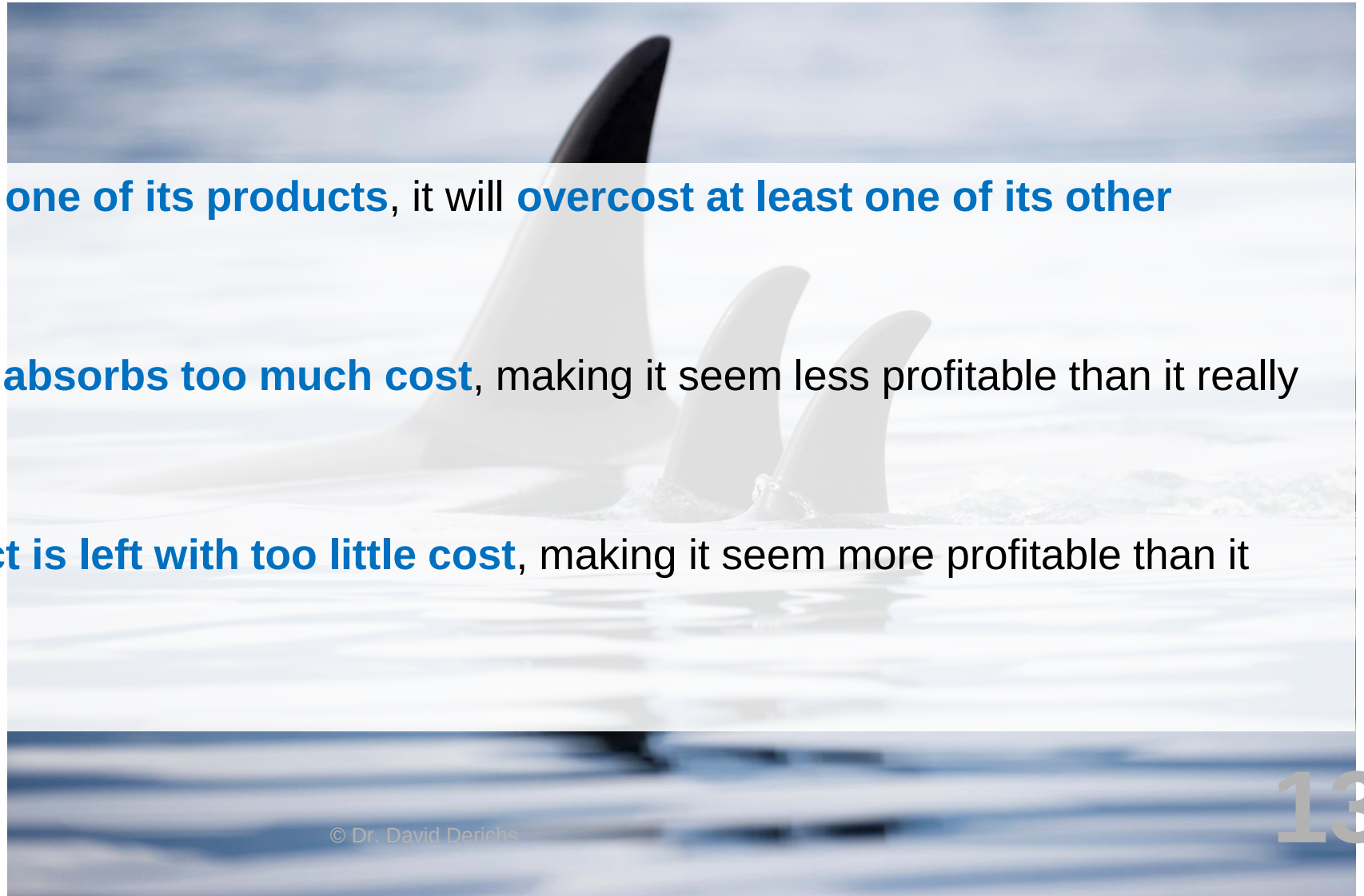
Over and Undercosting—Defined

- **OVERCOSTING** occurs when the cost measurement system reports a cost for a product that is above the cost of the resources the product consumes.

- **UNDERCOSTING** occurs when the cost measurement system reports a cost for a product that is below the cost of the resources the product consumes.

Source: Datar/Rajan (2021)

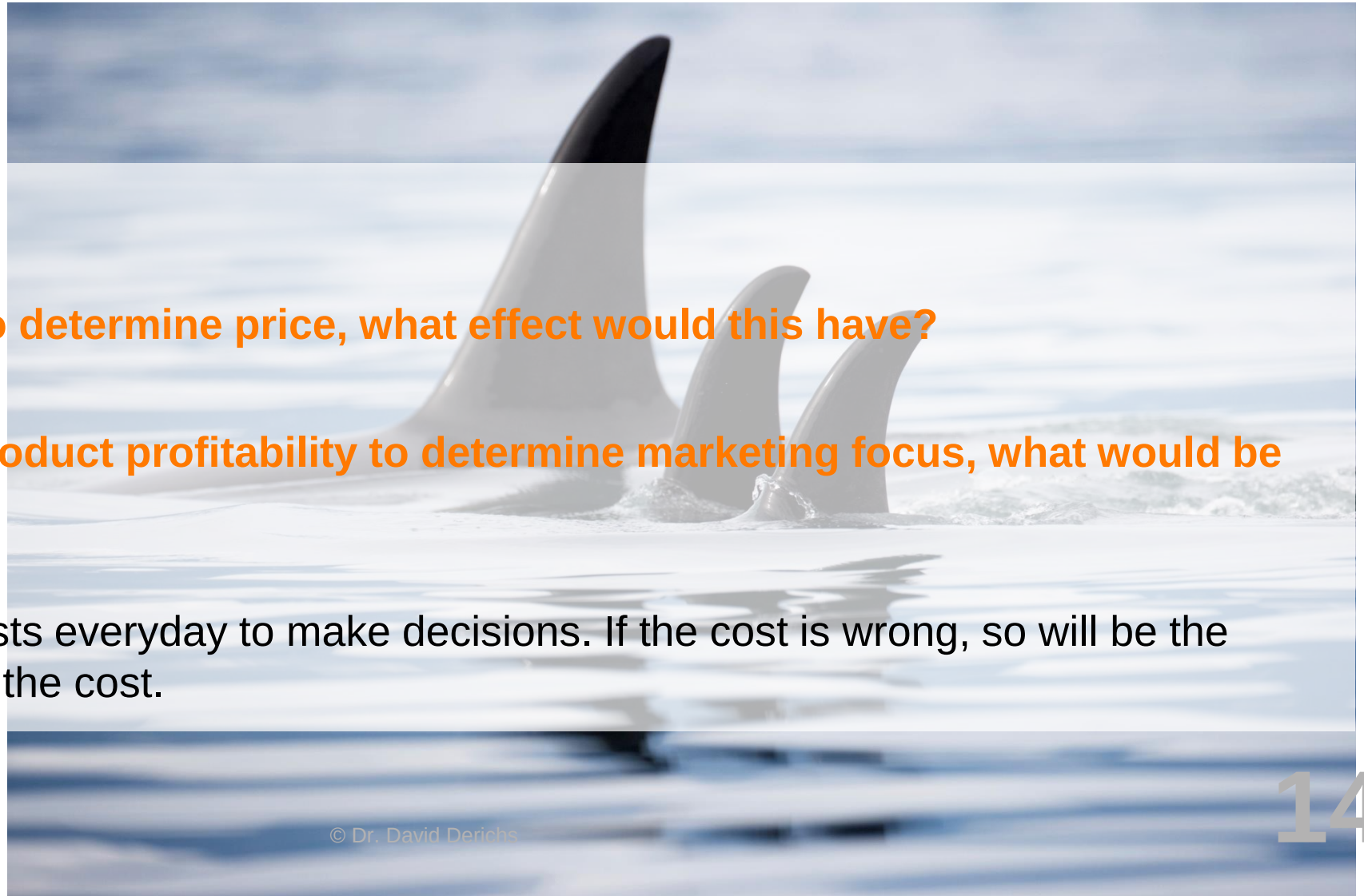
Product Cost Cross-Subsidization (1 of 3)



- If a company **undercosts one of its products**, it will **overcost at least one of its other products**.
- The **overcosted product absorbs too much cost**, making it seem less profitable than it really is.
- The **undercosted product is left with too little cost**, making it seem more profitable than it really is.

Source: Datar/Rajan (2021)

Product Cost Cross-Subsidization (2 of 3)



Consider the Following:

- **If you were using cost to determine price, what effect would this have?**
- **If you were looking at product profitability to determine marketing focus, what would be the result?**
- Managers use product costs everyday to make decisions. If the cost is wrong, so will be the decisions made based on the cost.

Source: Datar/Rajan (2021)
Managerial Accounting I

Example of Plantwide and Department Overhead Calculations

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Machine Hours	750	**1,200**	1,950
Allocation Rate-DLH	€37.50	n/a	€50.00
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Source: Datar/Rajan (2021)

Product Cost Cross-Subsidization (3 of 3)

How much overhead should be allocated to Job 457?

- Let's look again at our example:
- **Dept A** has €300,000 Overhead and uses DLH (8,000).
- **Dept B** has €450,000 Overhead and uses MH (1,200).
- **Job 457** incurs 1,000 DLH in Dept A and 1,000 DLH in Dept B; 50 M H in Dept A and 75 MH in Dept B.

Source: Datar/Rajan (2021)

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Activity Based Costing (ABC) and Activity Based Management (ABM)

5.2 Present three guidelines for refining a costing system

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Reasons for Refining a Costing System

Three principal reasons have **accelerated the demand for refinements to the costing system**:

1. Increase in **product diversity**
2. Increase in **indirect costs with different cost drivers**
3. Competition in **product markets**

Source: Datar/Rajan (2021)

Guidelines for Refining a Costing System

There are three main guidelines for refining a costing system:

1. Direct-cost tracing
2. Indirect-cost pools
3. Cost-allocation bases

Source: Datar/Rajan (2021)

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Types of costing systems

Direct costing systems

- Only assign direct costs to cost objects.
- Report contributions to indirect costs.
- No system in place to measure and assign indirect costs.

Traditional costing systems

- Use unsophisticated methods to allocate indirect costs to cost objects.

ABC systems

- Use sophisticated methods to allocate indirect costs to cost objects.

A Comparison of Traditional and ABC Systems

- Both systems use the **two-stage allocation process**.
- In the **first stage**, traditional systems tend to allocate costs to departments whereas **ABC systems allocate costs to activities**
- In the **second stage**, traditional systems rely on a small number of volume-based cost drivers (typically direct labour or machine hours) **whereas ABC systems use many second stage cost drivers.**
- **ABC systems seek to use only cause-and-effect cost drivers** whereas traditional systems often rely on arbitrary allocation bases.
- **ABC systems tend to establish separate cost driver rates** for support departments whereas traditional systems merge support and production centre costs.

Two stage allocation: a traditional system

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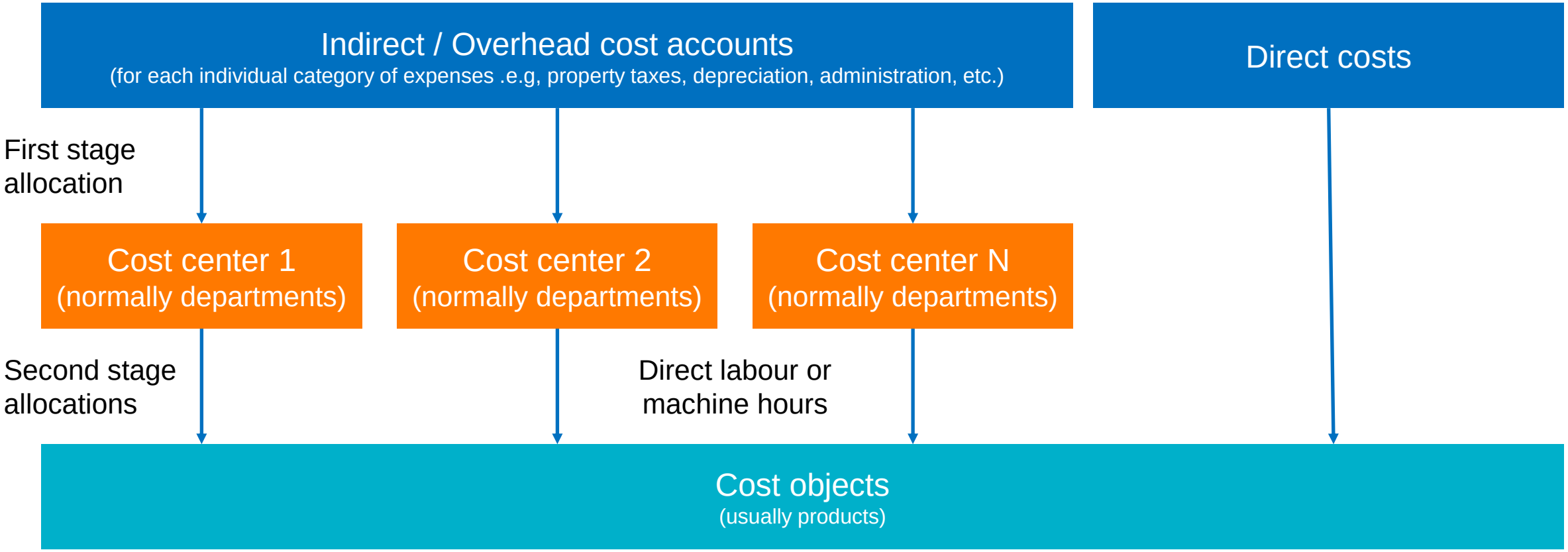

Two stage allocation: a ABC system

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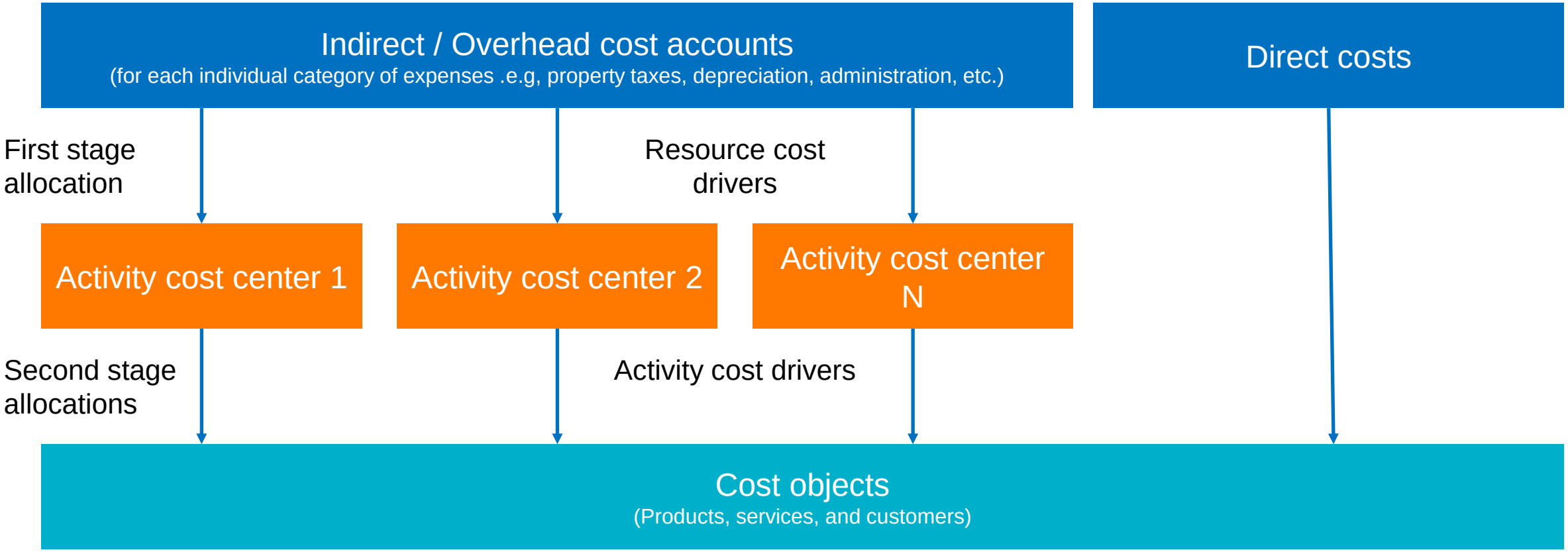
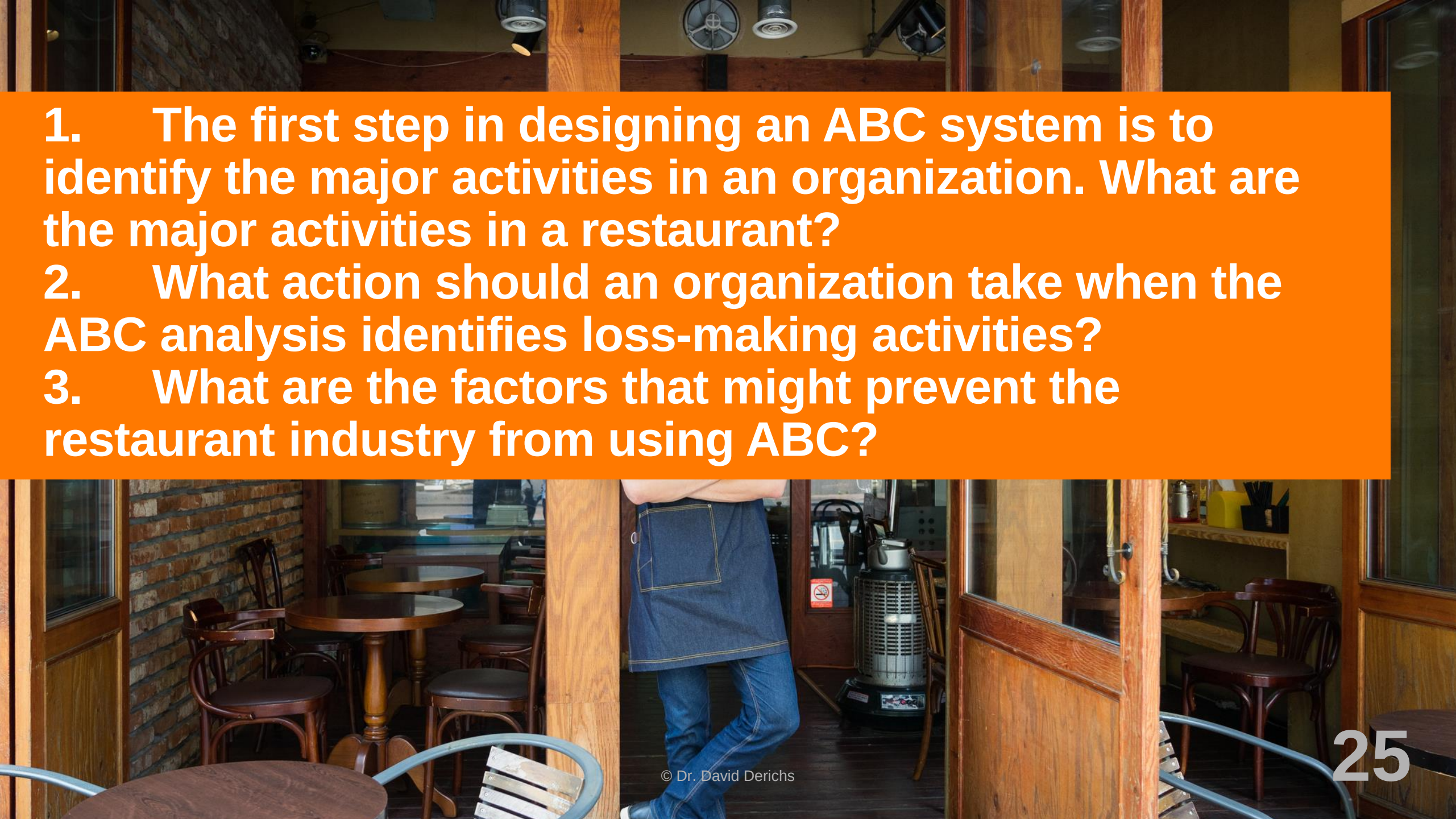




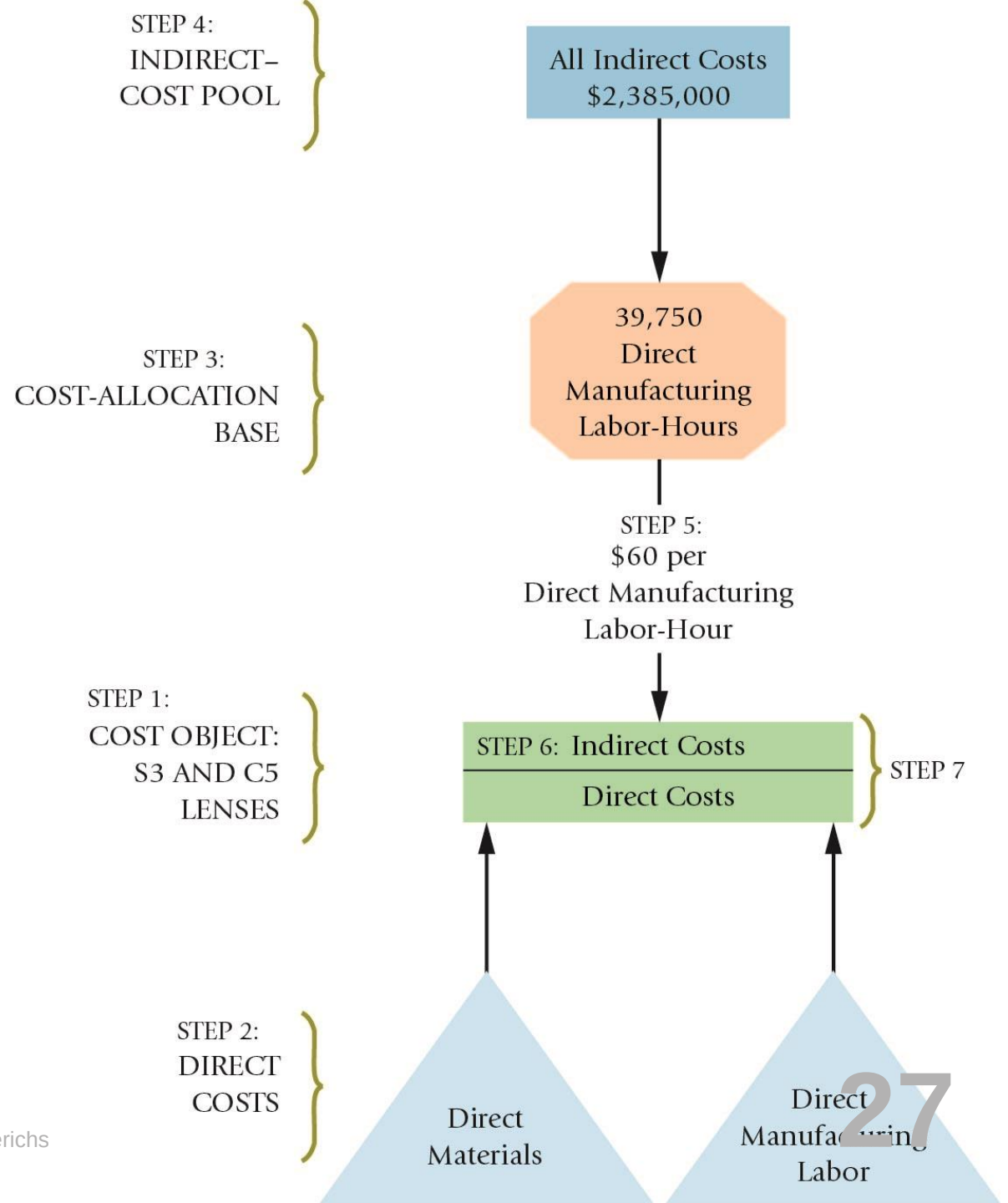
1. The first step in designing an ABC system is to identify the major activities in an organization. What are the major activities in a restaurant?
2. What action should an organization take when the ABC analysis identifies loss-making activities?
3. What are the factors that might prevent the restaurant industry from using ABC?

Volume-Based and Non-Volume-Based Cost Drivers

- Traditional systems use only volume-based cost drivers.
- **Assumption that overheads are directly related to units produced**.
- This can lead to the reporting of distorted product costs.
- Whereas, non-volume-based cost drivers consider activities other than units produced, e.g. number of setups.

An Example: Simple Costing System

Overview of Plastim's Simple Costing System



Source: Datar/Rajan (2021)
Managerial Accounting I

An Example: Simple Costing System

	A	B	C	D	E	F	G
1		60,000			15,000		
2		Simple Lenses (S3)			Complex Lenses (C5)		
3		Total	per Unit		Total	per Unit	Total
4		(1)	(2) = (1) ÷ 60,000		(3)	(4) = (3) ÷ 15,000	(5) = (1) + (3)
5	Direct materials	$1,125,000	$18.75		$ 675,000	$45.00	$1,800,000
6	Direct manufacturing labor	600,000	10.00		195,000	13.00	795,000
7	Total direct costs (Step 2)	1,725,000	28.75		870,000	58.00	2,595,000
8	Indirect costs allocated (Step 6)	1,800,000	30.00		585,000	39.00	2,385,000
9	Total costs (Step 7)	$3,525,000	$58.75		$1,455,000	$97.00	$4,980,000
10							

Source: Datar/Rajan (2021)

The Five-Step Decision-Making Process—Plastim

1. Identify the problems and uncertainties (**possible loss of a large S3 customer**).
2. Obtain information (**analyze and evaluate the design, manufacturing, and distribution operations for the S3 lens**).
3. Make predictions about the future (**obtain a better cost estimate for the S3**).
4. Make decisions by choosing among alternatives (**should they bid and if yes, at what price?**).
5. Implement the decision, evaluate performance, and learn.

Source: Datar/Rajan (2021)

Brief Intro to: Time-Driven ABC → More during the MSc course

- Not all businesses are suited to ABC.
- Costly design, implementation and operation of ABC have hindered adoption.
- Time-driven ABC developed to overcome such problems.
- Requires an estimation of:
  - cost per time unit of supplying resource capacity;
  - the unit times of consumption of resource capacity by products.

Example of TDABC

Calculation of cost driver rates using the traditional ABC approach

Activity	*% of time spent*	*Assigned cost (£)*	*Cost driver quantity*	*Cost driver rate (£)*
Process customer orders	70	392,000	49,000	8 per order
Handle customer enquiries	10	56,000	1,400	40 per enquiry
Perform credit checks	20	112,000	2,500	44.80 per credit check
		560,000		

Time-driven ABC reporting

Activity	*Cost driver quantity*	*Unit time (minutes)*	*Total time used (minutes)*	*Cost driver rate (£)*	*Total cost assigned (£)*
Process customer orders	49,000	8	392,000	6.40	313,600
Handle customer enquiries	1,400	44	61,600	35.20	49,280
Perform credit checks	2,500	50	125,000	40.00	100,000
Total used			578,600		462,880
Total supplied			700,000		560,000
Unused capacity			121,400		97,120

Adapted from Kaplan and Anderson (2004).

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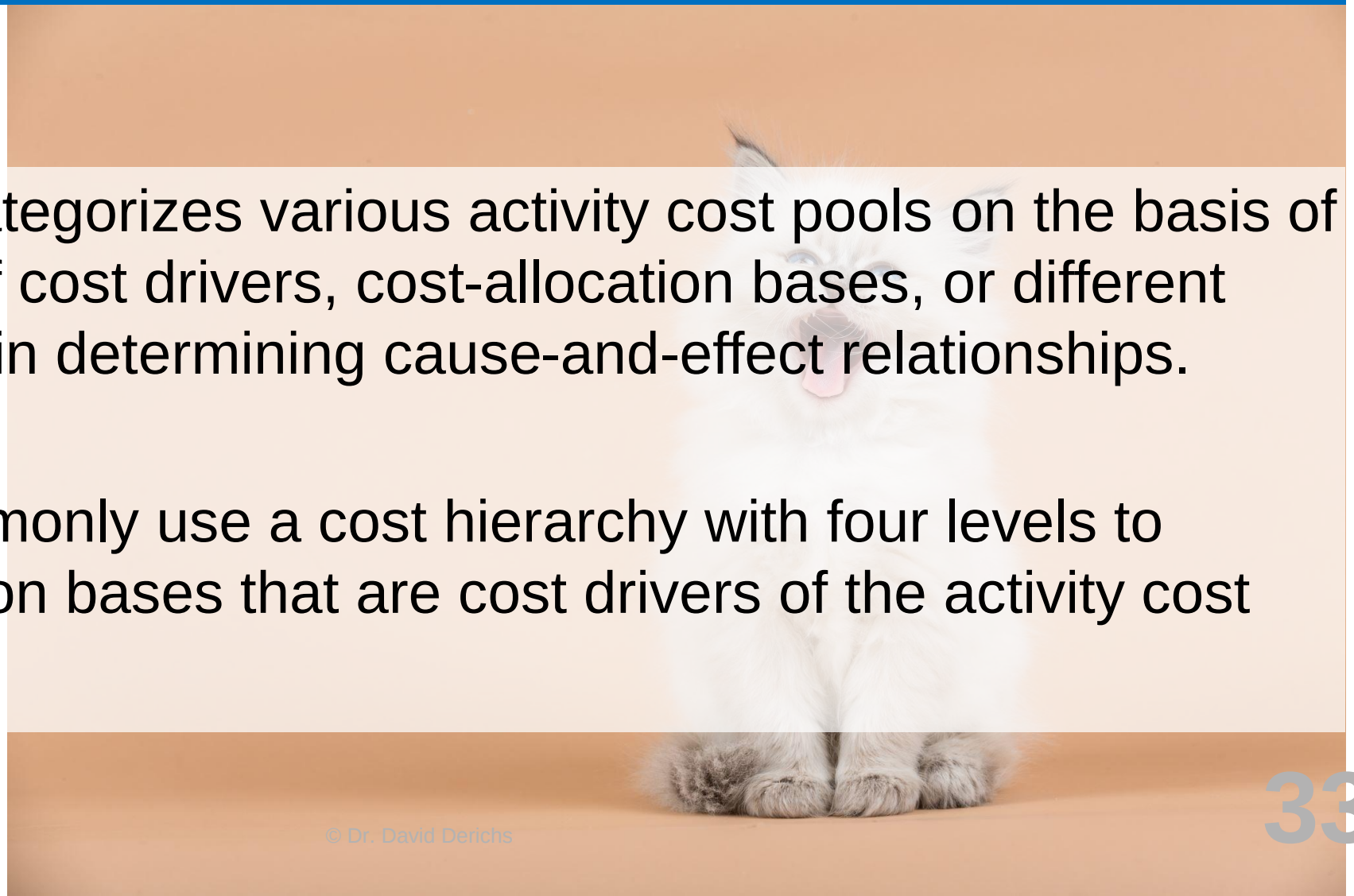
Cost Hierarchies (1 of 4)



A **cost hierarchy** categorizes various activity cost pools on the basis of the different types of cost drivers, cost-allocation bases, or different degrees of difficulty in determining cause-and-effect relationships.

ABC systems commonly use a cost hierarchy with four levels to identify cost-allocation bases that are cost drivers of the activity cost pools.

Source: Datar/Rajan (2021)
Managerial Accounting I

Cost Hierarchies (2 of 4)

There are four levels of the cost hierarchy:

1. **Output unit-level costs** (related to the individual units of a product or service)
2. **Batch-level costs** (related to a group of units)
3. **Product (or service)-sustaining costs** (related to support a particular product or service without regard to the number of units or batches)
4. **Facility-sustaining costs** (related to costs of activities that cannot be traced to individual products or services)

Source: Datar/Rajan (2021)

Cost Hierarchies (3 of 4)

1. Unit-level activities

- Performed each time a unit of the product or service is produced.
- Resources are consumed in proportion to the number of units produced or sold.
- Examples — Direct materials and labour, energy costs and expenses consumed in proportion to machine processing time.

2. Batch-related activities

- Performed each time a batch of goods is produced.
- Costs vary with the number of batches made.
- Examples include set-ups, purchase ordering and first-item inspection activities.

Cost Hierarchies (4 of 4)

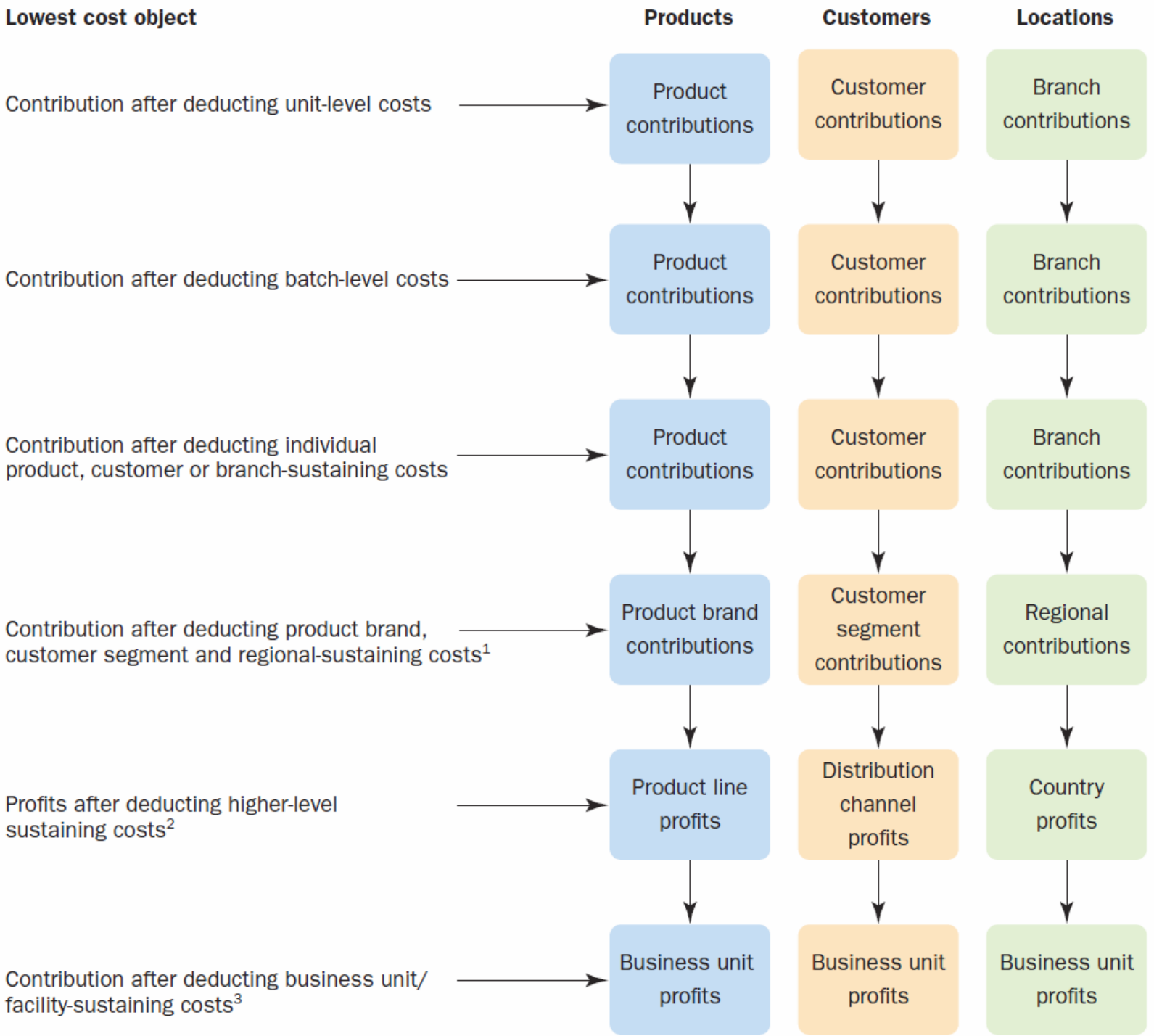
3. Product/service sustaining activities

- Performed to enable the production of individual products or services.
- Examples include activities related to maintaining an accurate bill of materials, preparing engineering change notices.

4. Facility-sustaining (or business-sustaining) activities

- Performed to support the organization as a whole.
- Examples include plant management, property costs and salaries of general administrative staff.
- Common to all products and services – not allocated to products/services.

Illustration of a cost hierarchy



Exercise Time – E1 Questions 1 & 2

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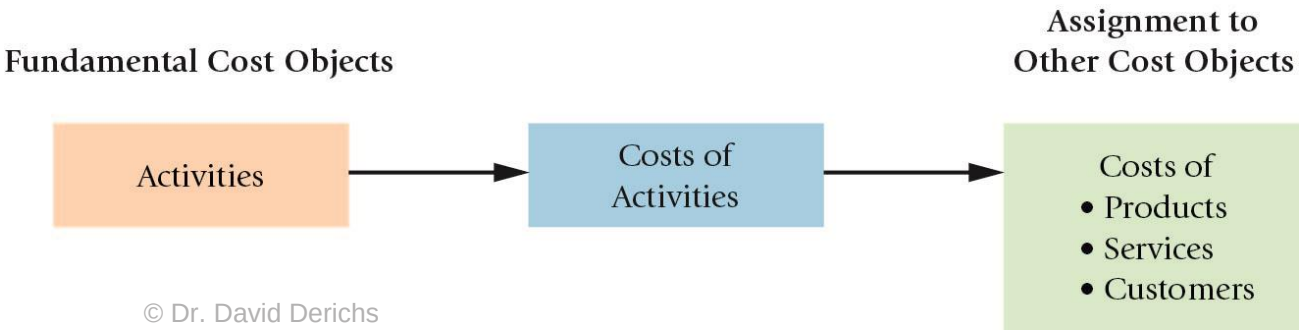
Activity-Based Costing (ABC)

Refines a costing system by **identifying individual activities as the fundamental source of indirect costs**.

An **activity** is an event, task, or unit of work with a specified purpose—for example, designing products, setting up machines, operating machines, or distributing products. These are often referred to as **cost drivers**.



Source: Datar/Rajan (2021)

4 Steps of designing an ABC system 1/3

1. identifying the major activities that take place in an organization;
2. assigning costs to activity cost centres;
3. selecting appropriate costs drivers
4. assigning the cost of activities to products according to the product's demand for activities.

Exercise Time – E1 Questions 3

4 Steps of designing an ABC system 2/3

1. Identifying activities

- The activities chosen should be at a reasonable level of aggregation based on cost/benefit criteria.
- Choice of activities influenced by the total cost of the activity centre and the ability of a single cost driver to provide a satisfactory determinant of the cost of the activity.

2. Assigning costs to activity cost centres

- Costs assigned to activity cost pools will include direct and indirect costs.
- Resource cost drivers used to assign indirect costs.
- Reliability of cost information will be reduced if arbitrary allocations are used to assign a significant proportion of costs to activities.

4 Steps of designing an ABC system 3/3

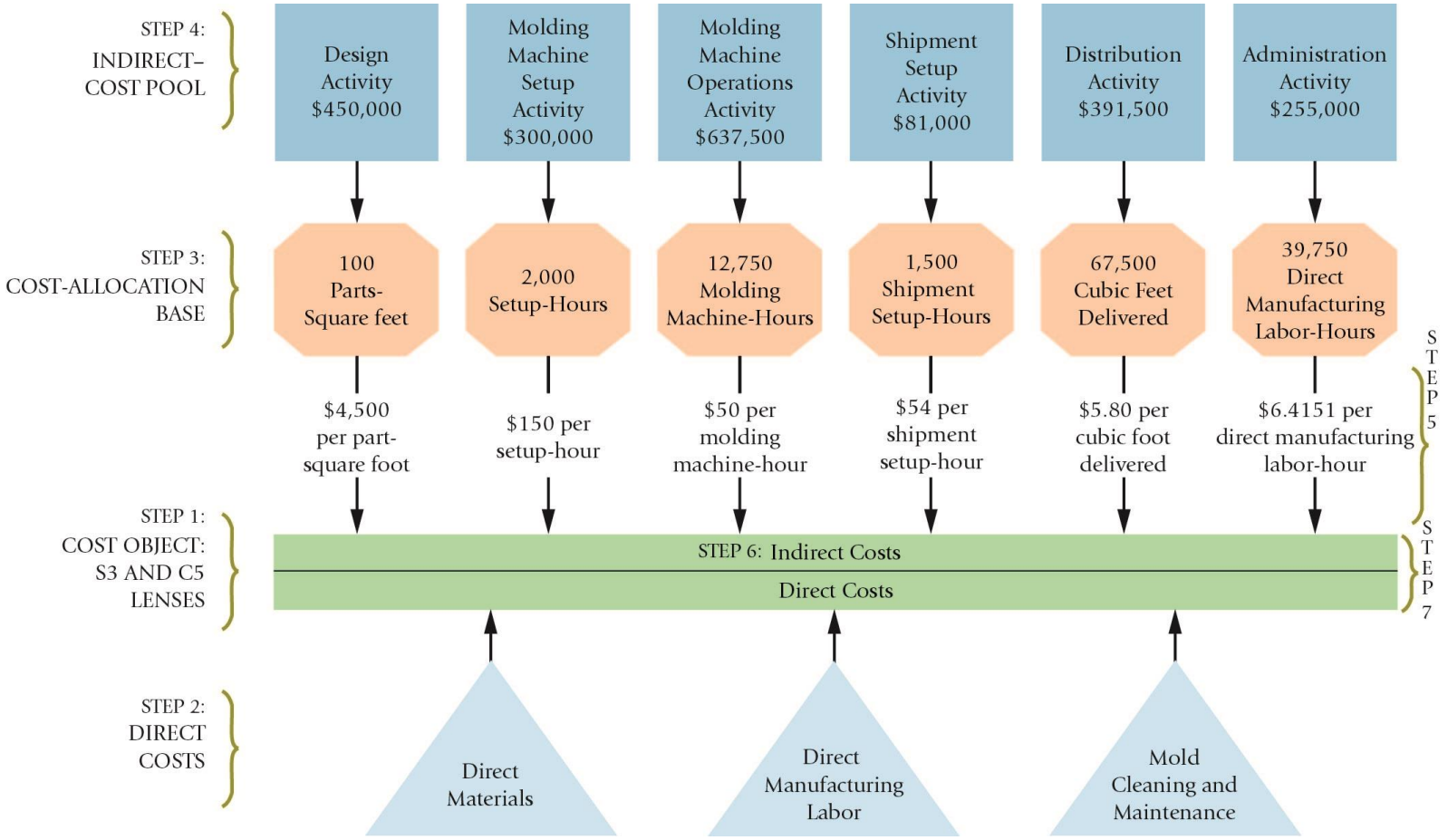
3. Selecting appropriate cost drivers for assigning the cost of activities to cost objects

- Drivers at this stage called activity drivers. They should:
  - provide a good explanation of costs of each activity pool;
  - be easily measurable;
  - the data should be easy to obtain and identifiable with the product.
- Activity cost drivers consist of transaction and duration drivers.

4. Assigning the cost of activities to products

- The cost driver must be measurable so that it can be identified with individual products.

Plastim and ABC Illustrated



Source: Datar/Rajan (2021)

Plastim: ABC Rate Calculation

	A	B	C	D	E	F	G	H
1			(Step 4)	(Step 3)		(Step 5)		
2	Activity	Cost Hierarchy Category	Total Budgeted Indirect Costs	Budgeted Quantity of Cost-Allocation Base		Budgeted Indirect Cost Rate		Cause-and-Effect Relationship Between Allocation Base and Activity Cost
3	(1)	(2)	(3)	(4)		(5) = (3) ÷ (4)		(6)
4	Design	Product-sustaining	$450,000	100	parts-square feet	$ 4,500	per part-square foot	Design Department indirect costs increase with more complex molds (more parts, larger surface area).
5	Molding machine setup	Batch-level	$300,000	2,000	setup-hours	$ 150	per setup-hour	Indirect setup costs increase with setup-hours.
6	Machine operations	Output unit-level	$637,500	12,750	molding machine-hours	$ 50	per molding machine-hour	Indirect costs of operating molding machines increases with molding machine-hours.
7	Shipment setup	Batch-level	$ 81,000	1,500	shipment setup-hours	$ 54	per shipment setup-hour	Shipping costs incurred to prepare batches for shipment increase with the number of shipment setup-hours.
8	Distribution	Output-unit-level	$391,500	67,500	cubic feet delivered	$ 5.80	per cubic foot delivered	Distribution costs increase with the cubic feet of packages delivered.
9	Administration	Facility sustaining	$255,000	39,750	direct manuf. labor-hours	$6.4151	per direct manuf. labor-hour	The demand for administrative resources increases with direct manufacturing labor-hours.

Plastim: ABC Product Costs

	A	B	C	D	E	F	G
1		60,000			15,000		
2		Simple Lenses (S3)			Complex Lenses (C5)		
3		Total	per Unit		Total	per Unit	Total
4	**Cost Description**	(1)	(2) = (1) ÷ 60,000		(3)	(4) = (3) ÷ 15,000	(5) = (1) + (3)
5	Direct costs						
6	Direct materials	$1,125,000	$18.75		$ 675,000	$ 45.00	$1,800,000
7	Direct manufacturing labor	600,000	10.00		195,000	13.00	795,000
8	Direct mold cleaning and maintenance costs	120,000	2.00		150,000	10.00	270,000
9	Total direct costs (Step 2)	1,845,000	30.75		1,020,000	68.00	2,865,000
10	Indirect Costs of Activities						
11	Design						
12	S3, 30 parts-sq.ft. × $4,500	135,000	2.25				} 450,000
13	C5, 70 parts-sq.ft. × $4,500				315,000	21.00	
14	Setup of molding machines						
15	S3, 500 setup-hours × $150	75,000	1.25				} 300,000
16	C5, 1,500 setup-hours × $150				225,000	15.00	
17	Machine operations						
18	S3, 9,000 molding machine-hours × $50	450,000	7.50				} 637,500
19	C5, 3,750 molding machine-hours × $50				187,500	12.50	
20	Shipment setup						
21	S3, 750 shipment setup hours × $54	40,500	0.67				} 81,000
22	C5, 750 shipment setup hours × $54				40,500	2.70	
23	Distribution						
24	S3, 45,000 cubic feet delivered × $5.80	261,000	4.35				} 391,500
25	C5, 22,500 cubic feet delivered × $5.80				130,500	8.70	
26	Administration						
27	S3, 30,000 dir. manuf. labor-hours × $6.4151	192,453	3.21				} 255,000
28	C5, 9,750 dir. manuf. labor-hours × $6.4151				62,547	4.17	
29	Total indirect costs allocated (Step 6)	1,153,953	19.23		961,047	64.07	2,115,000
30	Total Costs (Step 7)	$2,998,953	$49.98		$1,981,047	$132.07	$4,980,000
31							

Source: Datar/Rajan (2021)
Managerial Accounting I

Exercise Time – E1 Questions 4

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Plastim: Simple and ABC Compared

	Simple Costing System Using a Single Indirect-Cost Pool (1)	ABC System (2)	Difference (3) = (2) − (1)
Direct-cost categories	2 Direct materials Direct manufacturing labor	3 Direct materials Direct manufacturing labor Direct mold cleaning and maintenance labor	1
Total direct costs	$2,595,000	$2,865,000	$270,000
Indirect-cost pools	1 Single indirect-cost pool allocated using direct manufacturing labor-hours	6 Design (parts-square feet)[1] Molding machine setup (setup-hours) Machine operations (molding machine-hours) Shipment setup (shipment setup-hours) Distribution (cubic feet delivered) Administration (direct manufacturing labor-hours)	5
Total indirect costs	$2,385,000	$2,115,000	($270,000)
Total costs assigned to simple (S3) lens	$3,525,000	$2,998,953	($526,047)
Cost per unit of simple (S3) lens	$58.75	$49.98	($8.77)
Total costs assigned to complex (C5) lens	$1,455,000	$1,981,047	$526,047
Cost per unit of complex (C5) lens	$97.00	$132.07	$[illegible]

[1]Cost drivers for the various indirect-cost pools are shown in parentheses.

Source: Datar/Rajan (2021)

ABC Versus Simple Costing (1 of 2)

- ABC is generally perceived to produce **superior costing figures** due to the use of multiple drivers across multiple levels.
- ABC is **only as good as the drivers selected** and their actual relationship to costs. Poorly chosen drivers will produce inaccurate costs, even with ABC.
- Using **ABC does not guarantee more accurate costs**!
- ABC is an **alternate way to allocate costs**. It is generally considered to be more accurate and more costly to implement.

Source: Datar/Rajan (2021)

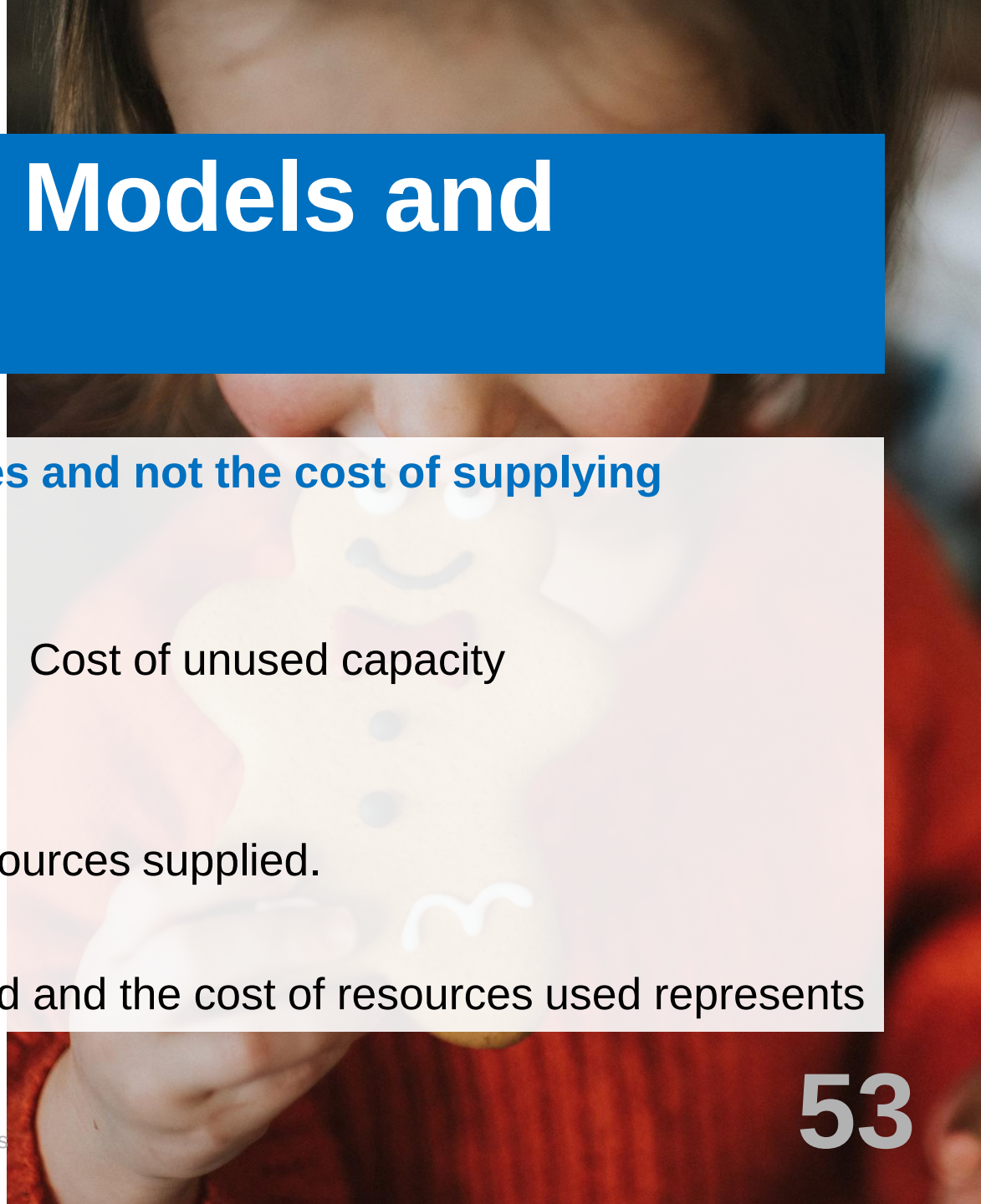
ABC Versus Simple Costing (2 of 2)

- **A company should consider refining its cost system when evidence begins to suggest that the existing system is flawed.**

- **A number of critical decisions**, such as pricing, whether or not one product should be "pushed" over another, whether or not a product should be dropped, etc. **will be made using cost information**.
- Therefore, best efforts should be used to arrive at a cost that is fair and reasonable for each product.
- **This is an imprecise science, and differences of opinion are likely to occur.**

Source: Datar/Rajan (2021)
Managerial Accounting I

Resource Consumption Models and Unused Capacity (1 of 2)

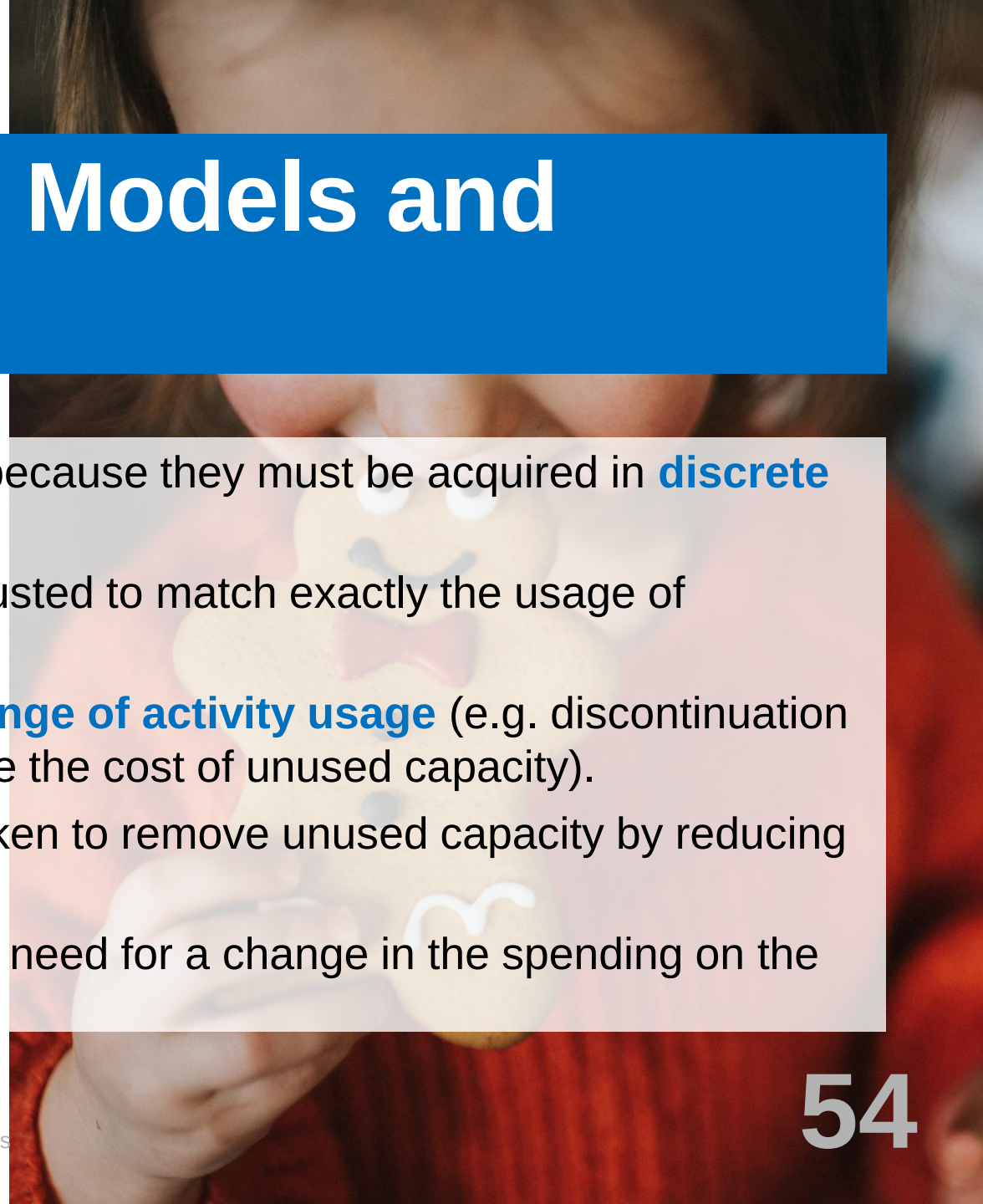


- **ABC systems measure the cost of using resources and not the cost of supplying resources:**

Cost of resources supplied	=	Cost of resources used	+	Cost of unused capacity

- Periodic financial statements measure the cost of resources supplied.
- ABC systems measure the cost of resources used.
- The difference between the cost of resources supplied and the cost of resources used represents the cost of unused capacity.

Resource Consumption Models and Unused Capacity (2 of 2)



- **Unused capacity arises** with committed resources because they must be acquired in **discrete amounts in advance of usage**.
- With flexible resources supply can be continually adjusted to match exactly the usage of resources.
- **Managers make decisions that will result in a change of activity usage** (e.g. discontinuation decisions reduce cost of resources used and increase the cost of unused capacity).
- Cash flow consequences will only arise if action is taken to remove unused capacity by reducing spending on the supply of resources.
- The periodic reporting of unused capacity signals the need for a change in the spending on the supply of resources.

Signals That Suggest That ABC Implementation May Be Helpful

1. **Significant amounts of indirect costs** are allocated using **only one or two cost pools**.
2. All or most **indirect costs are identified as output unit-level costs**.
3. **Products make diverse demands on resources** because of volume, process steps, batch size, or complexity.
4. **Products that a company is well-suited to make show small profits** whereas products that a company is less suited to make show large profits.
5. **Operations staff has substantial disagreement with the reported costs** of manufacturing and marketing products or services.

Source: Datar/Rajan (2021)

Aalto University
School of Business

Activity Based Costing (ABC) and Activity Based Management (ABM)

5.7 Explain how managers use activity-based costing systems in activity-based management

5.1 Explain how broad averaging undercosts and overcosts products or services

5.2 Present three guidelines for refining a costing system

5.3 Distinguish between simple and activity-based costing systems

5.4 Describe a four-part cost hierarchy

5.5 Cost products or services using activity-based costing

5.6 Evaluate the benefits and costs of implementing activity-based costing systems

5.7 Explain how managers use activity-based costing systems in activity-based management

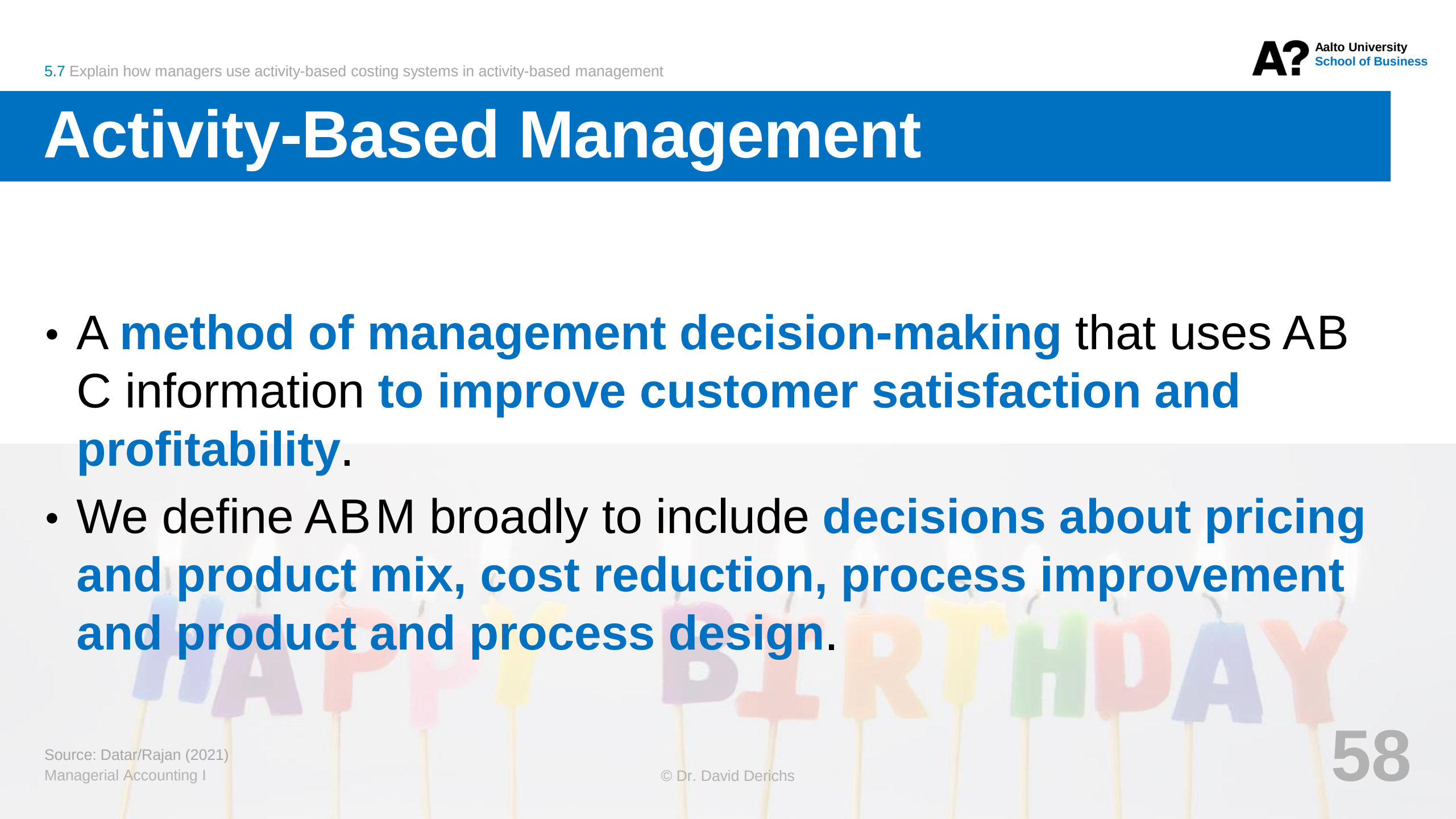
Behavioral Issue to Consider When Implementing ABC

- Gain the **support of top management** and create a sense of **urgency**.
- **Create a guiding coalition of managers** throughout the value chain for the ABC effort.
- **Educate and train employees** in ABC as a basis for employee empowerment.
- **Seek small short-run success as proof** that the ABC implementation is yielding results.
- **Recognize that ABC is not perfect** (better costs but complex system).

Source: Datar/Rajan (2021)

Activity-Based Management

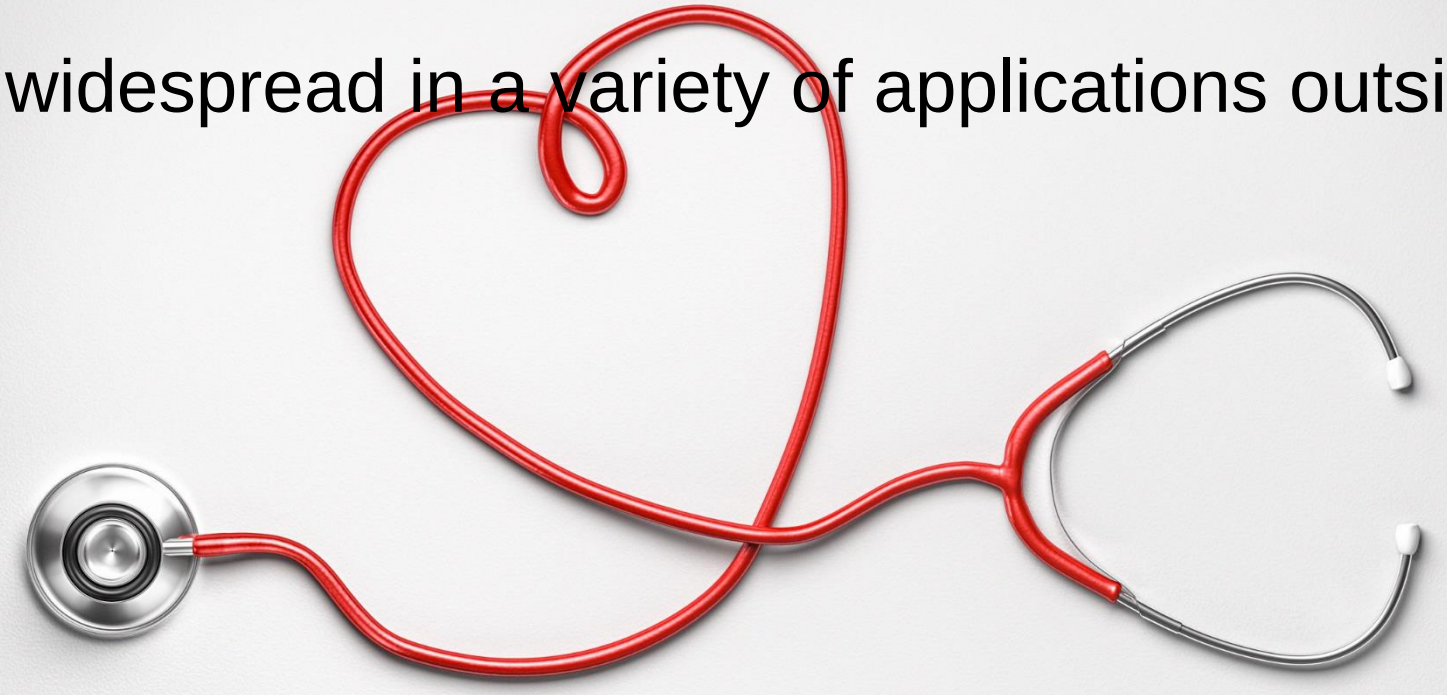
- A **method of management decision-making** that uses AB C information **to improve customer satisfaction and profitability**.
- We define AB M broadly to include **decisions about pricing and product mix, cost reduction, process improvement and product and process design**.



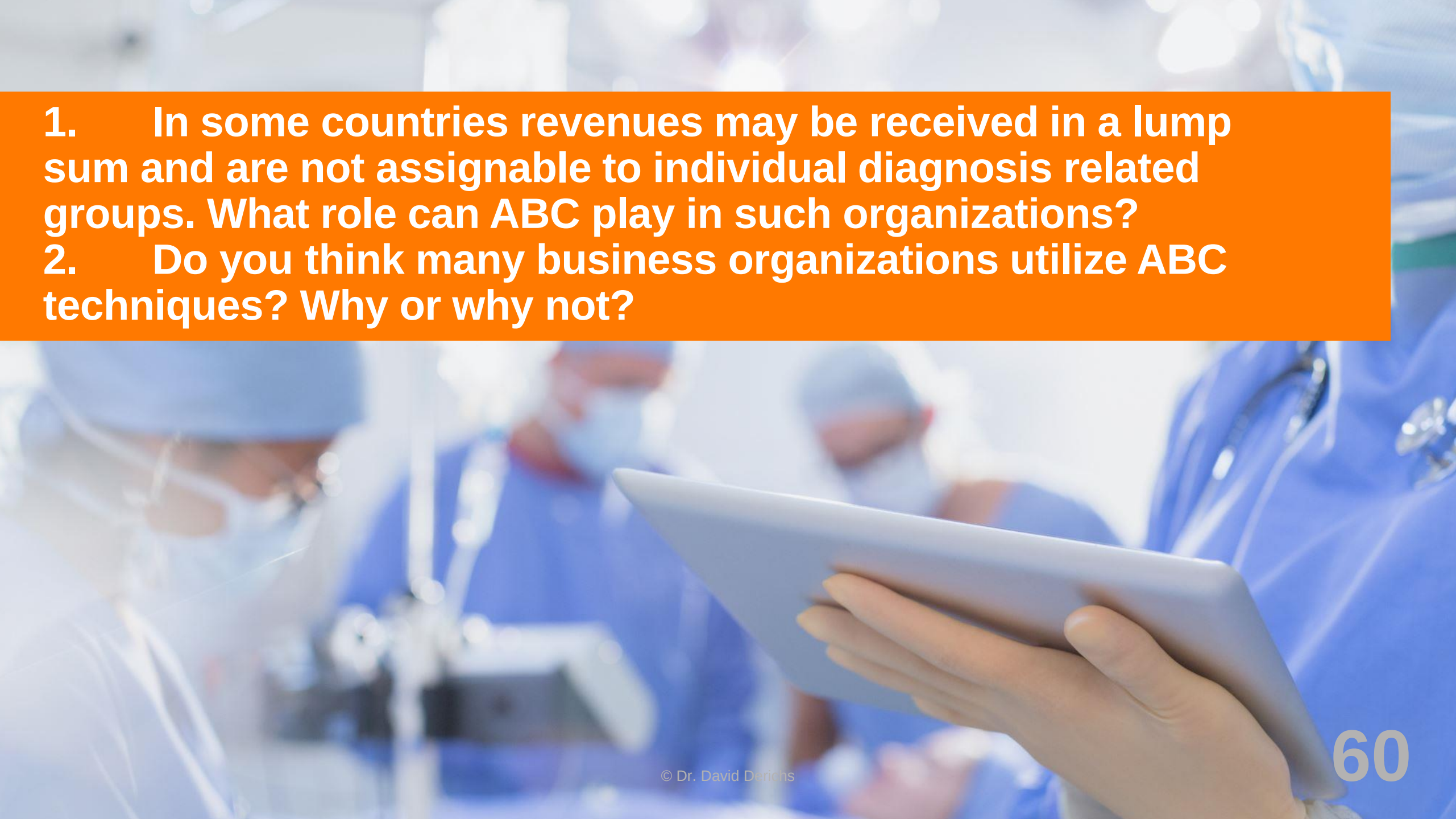
ABC and Service/Merchandising Firms

ABC implementation is widespread in a variety of applications outside manufacturing:

- Health Care
- Banking
- Telecommunications
- Retailing
- Transportation



Source: Datar/Rajan (2021)



1. In some countries revenues may be received in a lump sum and are not assignable to individual diagnosis related groups. What role can ABC play in such organizations?
2. Do you think many business organizations utilize ABC techniques? Why or why not?

Terms to Learn

Activity	Product cost cross-subsidization
Activity-Based Costing (ABC)	Product overcosting
Activity-Based Management (ABM)	Product undercosting
Batch-level costs	Product-sustaining costs
Cost hierarchy	Refined costing system
Facility-sustaining costs	Service-sustaining costs
Output unit-level costs	