COST MANAGEMENT LECTURE 5 SUMMARY – ACTIVITY-BASED COSTING

1) **Issues with simple/convention costing approach**
- Inappropriate pooling of indirect costs and poor choices for cost drivers can lead to incorrect costs of products/ services => Possible for ANY allocation system
- Main problems include
    - <u>Few direct cost</u> categories
    - <u>Limited number of cost pools</u> -> 1 single cost pool -> inappropriate pooling of indirect costs
    - <u>1 cost driver for all indirect costs</u> -> poor choices for cost drivers (not causal relationship with all costs). Cost drivers & allocation bases often centred around volume (especially in complex operating environments e.g. multiple products or services, frequent production in small lot sizes, complex customer demands/ environments)
- Assume all indirect costs behave the same way & have the same relationship with the cost driver (cause-effect)

    E.g. companies produce more simple products and thus simple product incurs more direct labour hours. Complex product requires more set-up cost; but if using direct labour hours to assign indirect cost, simple product may have higher set-up cost due to its larger direct labour hours.

- Cost-smoothing therefore causes issues with: product-cost cross-subsidisation

    + <mark>Over-costing</mark>: a cost object consumes low level of resources but is reported to have high total cost -> set price higher than needed -> lose competitive advantage & lose market share

    + <mark>Under-costing</mark>: a cost object consumes high level of resources but is reported to have low total cost -> set price lower than required -> unprofitable

    ⇨ Cost does not reflect consumption

    ⇨ **Cost of a product MUST reflect its consumption of resources**

    ⇨ **<mark>More likely to produce distorted cost data</mark> => lead to unreliable decision making e.g. pricing, product mix, resource allocation**

FIGURE 3.4

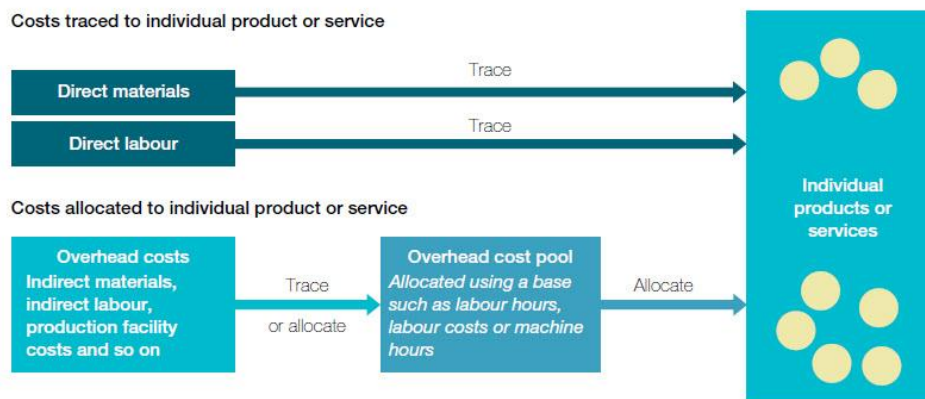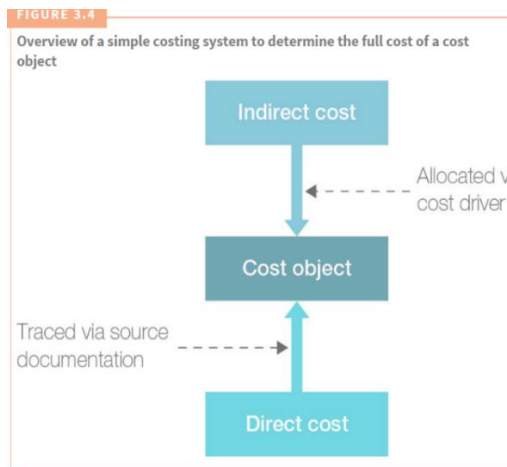Overview of a simple costing system to determine the full cost of a cost object

FIGURE 10.1   Conventional overhead cost allocation system

- Cost accounting systems have adapted over time to suit changes in
    + Operational environments (more complex => required to record and process more information)
    + Technology -> trace more direct costs
    + Cost structures
    + Management reporting requirements (decision making and forecasting)
    + Organisational structures (particularly those focusing on the value chain)

2) Activity-based costing
- Focus on the underlying activities involved with the product/service
- Cost object is the product & its cost pools are the activities involved with it
- Activity: type of task/function performed in an organisation for a specified purpose. E.g. design products, operate machines, distribute goods, set up machines, maintain & clean machines.
- ABC is a system that
    + seek to identify more costs as direct -> eliminate subjectivity & increase reliability (implement tracking mechanisms)
    + view costs through an activity lens (not just single cost lines, but identify where each cost belongs to what tasks)
    + use more cost pools (homogenous cost pools (activity-related) with suitable cost driver – cause-effect relationship) e.g. set-up cost pools – set-up hours driver
    => multiple cost pools used to reflect various activities performed
- ABC focuses on fundamental characteristic driving cost pool identification & cost pool selection
    ⇨ **ABC is less likely to have distorted cost data, BUT still possible to be unreliable if the selection of cost pools and cost drivers are poorly executed.**
- 2 steps
    + assign overhead cost to specific activities (cost pools)
    + compile cost of activities for total cost of each individual product/service
- Typical procedures
    + Identify relevant cost object (product/ service)
    + Identify activities => cost pools
    + Assign total indirect (overhead) cost to each activity-based cost pool
    + For each ABC cost pool, choose a cost driver/allocation basis (allocation base will reflect cost driver)
    + For each ABC cost pool, calculate allocation rate
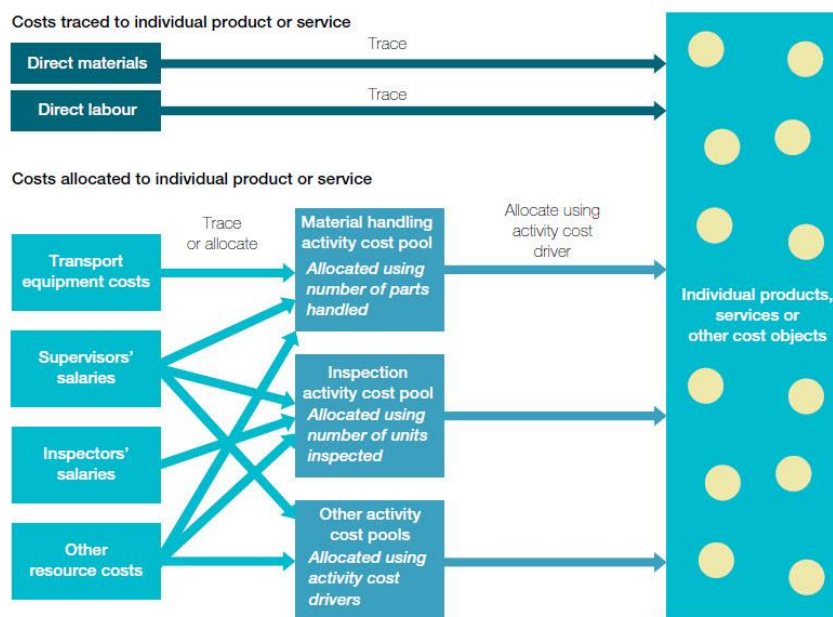   + For each ABC cost pool, allocate activity costs to the cost object (consumption of allocation base)

FIGURE 10.2 ABC cost allocation system