

ACTIVITY BASED COSTING

The activity-based costing (ABC) system is a method of accounting you can use to find the total cost of activities necessary to make a product. The ABC system assigns costs to each activity that goes into production, such as workers testing a product.

Many businesses use the cost of goods sold (COGS) to determine how much it costs to create a product. But, COGS focuses on direct costs and does not include indirect expenses like overhead.

Some businesses take their overhead expenses and allocate them evenly among all products. But because some products use more overhead expenses than others, the cost of making each product is inaccurate under this method.

With activity-based costing, we take into consideration both the direct and [overhead costs](#) of creating each product. You recognize that different products require different indirect expenses. By assigning both direct and overhead expenses to each product, you can more accurately set prices. And, the activity-based costing process shows you which overhead costs you might be able to cut back on.

Steps to be followed in ABC Analysis

The Activity Based Costing Process Flow

Activity-based costing is best explained by walking through its various steps. They are:

1. *Identify costs.* The first step in ABC is to identify those costs that we want to [allocate](#). This is the most critical step in the entire process, since we do not want to waste time with an excessively broad project scope. For example, if we want to determine the full cost of a [distribution channel](#), we will identify advertising and warehousing costs related to that channel, but will ignore research costs, since they are related to products, not channels.
2. *Load secondary cost pools.* Create [cost pools](#) for those costs incurred to provide services to other parts of the company, rather than directly supporting a company's products or services. The contents of secondary cost pools typically include computer services and administrative salaries, and similar costs. These costs are later allocated to other cost pools that more directly relate to products and services. There may be several of these secondary cost pools, depending upon the nature of the costs and how they will be allocated.
3. *Load primary cost pools.* Create a set of cost pools for those costs more closely aligned with the production of goods or services. It is very common to have separate cost pools for each [product line](#), since costs tend to occur at this level. Such costs can include research and development, advertising, procurement, and distribution. Similarly, you might consider creating cost pools for each distribution channel, or for each facility. If production batches are of greatly varying lengths, then consider creating cost pools at the [batch level](#), so that you can adequately assign costs based on batch size.
4. *Measure activity drivers.* Use a data collection system to collect information about the [activity drivers](#) that are used to allocate the costs in secondary cost pools to primary

cost pools, as well as to allocate the costs in primary cost pools to [cost objects](#). It can be expensive to accumulate activity driver information, so use activity drivers for which information is already being collected, where possible.

5. *Allocate costs in secondary pools to primary pools.* Use activity drivers to apportion the costs in the secondary cost pools to the primary cost pools.
6. *Charge costs to cost objects.* Use an activity driver to allocate the contents of each primary cost pool to cost objects. There will be a separate activity driver for each cost pool. To allocate the costs, divide the total cost in each cost pool by the total amount of activity in the activity driver, to establish the cost per unit of activity. Then allocate the cost per unit to the cost objects, based on their use of the activity driver.
7. *Formulate reports.* Convert the results of the ABC system into reports for management consumption. For example, if the system was originally designed to accumulate overhead information by geographical sales region, then report on [revenues](#) earned in each region, all [direct costs](#), and the overhead derived from the ABC system. This gives management a [full cost](#) view of the results generated by each region.
8. *Act on the information.* The most common management reaction to an ABC report is to reduce the quantity of activity drivers used by each cost object. Doing so should reduce the amount of overhead cost being used.

We have now arrived at a complete ABC allocation of overhead costs to those cost objects that deserve to be charged with overhead costs. By doing so, managers can see which activity drivers need to be reduced in order to shrink a corresponding amount of overhead cost. For example, if the cost of a single purchase order is \$100, managers can focus on letting the production system automatically place [purchase orders](#), or on using procurement cards as a way to avoid purchase orders. Either solution results in fewer purchase orders and therefore lower purchasing department costs.

Uses of ABC Analysis

Overhead decisions

The ABC system shows you how overhead is used, which helps you determine whether certain activities are necessary for production.

If you find that some activities cost more than they should, you can find new methods to do something. Or, you can cut out steps entirely.

Product pricing

The specific allocation of costs also helps you set prices that produce a healthy [small business profit margin](#). If you only know which direct costs go into your products, you are ignoring the other costs, which could lessen your profit margins.

With an ABC system, you can assign costs to each activity in the production process, allowing you to more accurately set a price that accounts for how much it costs you to create a product.