Activity-based costing (ABC) is an accounting method that identifies the activities that a firm performs and then assigns indirect costs to products. An activity-based costing (ABC) system recognizes the relationship between costs, activities, and products, and through this relationship, it assigns indirect costs to products less arbitrarily than traditional methods. Some costs are difficult to assign through this method of cost accounting. Indirect costs, such as management and office staff salaries are sometimes difficult to assign to a particular product produced. For this reason, this method has found its niche in the manufacturing sector.

1. INTRODUCTION

Activity-Based Costing (ABC) is that costing in which costs begin with tracing of activities and then to producing the product. In other words, it is the process of costing system which focuses on activities performed to produce products. This system assumes that activities are responsible for the incurrence of costs and products create the demand for activities. Costs are charged to products based on individual product's use of each activity. ABC aims at identifying as many costs as possible to be subsequently accounted as direct cost of production. Any cost that is traced to a particular product via its consumption of activity becomes direct of the product. For instance, in conventional costing system, cost of setup and adjustment time is considered as factory overhead and subsequently assigned to different products on the basis of direct labour hours. But in Activity-Based Costing, setup and adjustment time is determined for each product and its costs are directly charged to each product. Thus by emphasizing activities, ABC tries to ascertain the factors that cause each major activity, cost of such activities and the relationship between activities and products produced. Thus it is defined as: ‘An approach to the costing and monitoring of activities which involves tracing resource consumption...
and costing final outputs. Resources are assigned to activities, and activities to cost objects based on consumption estimates. The latter utilize cost drivers to attach activity costs to outputs.’

2. OBJECTIVES OF THE STUDY

- To understand the role of Activity-Based Costing (ABC) as a new costing technique
- To understand the different cost drivers to allocate the overhead
- To know the Difference Between Activity-Based Costing and Conventional Costing

3. RESEARCH METHODOLOGY

The research is exploratory in nature. It focuses on Literature review, News Papers, Journals, websites and the other reliable sources.

4. THE ACTIVITY BASED COSTING PROCESS FLOW

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

i.) 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.

ii.) 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.

iii.) 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.

iv.) 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.
v.) 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.

vi.) 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.

vii.) 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.

viii.) 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.

5. ABC & COST DRIVERS

In Activity-Based Costing, activities are identified and classified into different categories that have relationship with the different stages or parts of the production process. The factors that influence the cost of a particular activity are known as "Cost Drivers." A Cost Driver is literally the factors, forces or events that determine the cost of activities. The process of activity-based costing is based on the assumption that cost behaviour is influenced by cost drives. It should be understood that direct costs do not need cost drivers because direct costs are themselves cost drivers. They can be traced by direct relationship with the different parts of product. However, all other factory, office and administrative overheads need cost drives.

**Examples of Cost Drivers**

In order to trace overhead costs to manufacturing a product, suitable Cost Drivers should be identified. The following are the few examples of Cost Drivers in Activity-Based Costing:

<table>
<thead>
<tr>
<th>Cost Drivers</th>
<th>Activity</th>
</tr>
</thead>
<tbody>
<tr>
<td>i. Number of receiving order</td>
<td>Ordering</td>
</tr>
<tr>
<td>ii. Number of deliveries</td>
<td>Delivery</td>
</tr>
<tr>
<td>iii. Number of Purchase orders</td>
<td>Order Taking</td>
</tr>
<tr>
<td>iv. Kilometers travelled per delivery</td>
<td>Deliveries</td>
</tr>
<tr>
<td>v. Number of customers' visits</td>
<td>Customer Visit</td>
</tr>
<tr>
<td>vi. Number placing orders for purchase</td>
<td>Placing Orders</td>
</tr>
<tr>
<td>vii. Number of returning or empty bottles</td>
<td>Bottles Returns</td>
</tr>
<tr>
<td>viii. Number Material handling hours</td>
<td>Product Handling</td>
</tr>
</tbody>
</table>

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6. CLASSIFICATION OF ACTIVITIES

In the first stage of the Activity-Based Costing activities are identified and classified into different categories or segments of the production process. The grouping of activities is preferably done using the different levels at which activities are performed. Broadly, activities are classified into:

i.) Unit Level Activities
ii.) Batch Level Activities
iii.) Product Level Activities
iv.) Facility Level Activities

(1) Unit Level Activities: Unit Level Activities are those activities which are performed each time a single product or unit is produced. These activities are repetitive in nature. For example, direct labour hours, machine hours, powers etc. are the activities used for each time for producing a single unit. Direct materials and direct labour activities are also unit level activities, although they do not overhead costs. Cost of unit level activity vary with the number of units produced.

(2) Batch Level Activity: These activities which are performed each time a batch of products or group of identical products are produced. All the units of a particular batch are uniform in nature and in size. The cost of batch level activities vary with the number of batches are ascertained. Machine setups, inspections, production scheduling, materials handling are examples of batch level activities which are related to batches.

(3) Product Level Activities: These activities which are performed to support the production of each different type of product. Maintenance of equipment, engineering charges, testing routines, maintaining bills of materials etc. are the few examples of product level activities.

(4) Facility Level Activities: Facility Level Activities are those which are needed to sustain a factory's general manufacturing process. These activities are common to a variety of products and are most difficult to link to product specific activities. Factory management, maintenance, security, plant depreciation are the few examples of facility level activities.

<table>
<thead>
<tr>
<th>Activity-Based Costing</th>
<th>Conventional Costing (or) Traditional Costing</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) It begins with identifying activities and then to producing the products</td>
<td>(1) It begins with identifying cost and then to producing the products</td>
</tr>
<tr>
<td>(2) It mainly focuses on activities performed to produce products</td>
<td>(2) It emphasises mainly on ascertainment of costs after they have been incurred</td>
</tr>
<tr>
<td>(3) Cost Drivers used for identifying the factors that influence the cost of</td>
<td>(3) Cost unit is used for allocation and accumulation of costs</td>
</tr>
</tbody>
</table>

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Table 2: Difference between Activity-Based Costing and Conventional Costing
particular activity

(4) Overhead costs are assigned to Cost Centre or Cost Pools
(5) Overhead costs are assigned to products using Cost Drivers Rates
(6) Variable overhead is appropriately identified to individual products
(7) In ABC many activity based on Cost Pools or Cost Centers are created
(8) There is no need to allocate and redistribution of overhead of service departments to production departments
(9) It assumes that fixed overhead costs vary in proportion to changes in the volume of output.

(4) Overhead costs are assigned to production departments or service departments
(5) Overheads allocated on the basis of departmental overhead allocation rate
(6) Costs may be allocated or assigned either on actual cost incurred or on standard cost basis
(7) Overheads are pooled and collected department wise
(8) The process of allocation and re-distribution of the costs of the service departments to production department is essential to find out total cost of production
(9) It assumes that fixed overheads do not vary with changes in the volume of output.

7. CONCLUSION

ABC is a powerful management tool that has evolved in response to the ineffectiveness of traditional cost accounting and cost management practices. Advocates of ABC have been won over following their realization that the general ledger’s cost center and chart of account expense data is structurally deficient in calculating costs and providing cost visibility and driver understanding. They realize that broad-based cost allocations create grotesquely distorted and misleading costs compared to tracing costs with ABC principles. The adoption rate of ABC is propelled by increasing proliferation of all businesses outputs (including types of suppliers, products, services, channels, and customers) that cause increased complexity and increased indirect expenses to manage the complexity. As important as it is, however, ABC is not a panacea. As mentioned earlier, cost management should always be done in the broader context of performance management that integrates time, quality, service levels, risk, capacity planning, and costs. Given that, it is critical that an organization understands its cost structure. Having a management accounting system that supports that understanding, such as ABC, is critical for all of its stakeholders—its employees, its community, its loyal customers, and its shareholders.

8. REFERENCES

Jenica Stanislaus is a Master Commerce student at Fatima Mata National College, Kollam affiliated to University of Kerala in 2015. Her post graduate research focuses on study of the influence of psychology on the behaviour of financial practitioners and the subsequent effect on markets. She recently published an article relating to leadership in International Journal.