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## **Seminar on Costs & Tariffs**

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# **Activity Based Costing Methodology**

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*Note: The views expressed in this presentation are those of the author and do not necessarily reflect the opinions of the ITU or its membership.*



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## **Cost Types**

A product/service has usually three types of cost:

- *The direct costs, the*
- *Indirect costs, and the*
- *Common costs*



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## **Direct Costs**

- Are traceable directly to the product,
- The resources to which the costs are associated are usually totally assigned to the product,
- There is neither ambiguity nor difficulty to assign the costs to the product



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## **Indirect Costs**

- Are identified for the product,
- The resources to which the costs are associated are usually shared with at least one other product,
- The allocation of the cost require some calculations,
- I.E : billing costs



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## **Common Costs**

- Are not traceable to a given product
- The resources to which the costs are associated are usually shared by several products,
- There is no simple mechanism to allocate the costs to those products,
- I.E : overhead costs



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- Activity based costing
- “ABC” is a cost allocation method (not a cost concept);
- It can allocate indirect and common costs to given products when those costs are related to consumed resources



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## **Activities and business processes**

- Activities are the work that employees do
- to understand that work, identify the output that each group produces and the resources that the group is assigned
- linking the flow of outputs between groups helps an organisation understand its business processes





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## **Activity analysis**

- Is the identification and description of activities in an organisation
- helps an organisation to plan desired outcome
- forces an organisation to identify any gap between current performance and desired outcome and adapt the resources (cost saving)



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## **Major components of an activity**

- The definition of the activity-what is actually being done;
- the output - what is actually produced;
- the work load measure - what drives the work load;
- the customer or customers of the activity - i.e., who receives the output
- the inputs - i.e., what triggers the activity;
- the resources consumed to produce the specified output - i.e., what is the cost.



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## **Types of activities**

- Primary activities are the reason a group or employees team is formed;
- Secondary activities are activities that support primary activities; they are often of an administrative nature and may not have measurable outputs;
- Project activities are one-time activities and have defined start and end.



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## **“ABC” Basic Concept**

- A cost object (i.e: a product) is activity demanding,
- An activity is resource demanding
- A resource (mainly man or machine) is costly



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## **The Drivers**

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- Activity drivers: a measure of the frequency and intensity of the demands placed on ACTIVITIES by COST OBJECTS;
- Resource drivers: a measure of the frequency and intensity of the demands placed on RESOURCES by ACTIVITIES
- Cost drivers: any factor(s) that change the cost of an activity



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## **The Processes**

- A cost object results from the execution of several activities,
- Those activities are usually interrelated
- They are sequenced with a view to make the work flow as linear as possible
- The so called processes are subject to performance measurements



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## **Modern Management Trends**

- Process versus procedure
- Multidisciplinary teams versus hierarchy driven activity
- Understanding the process versus measuring the results



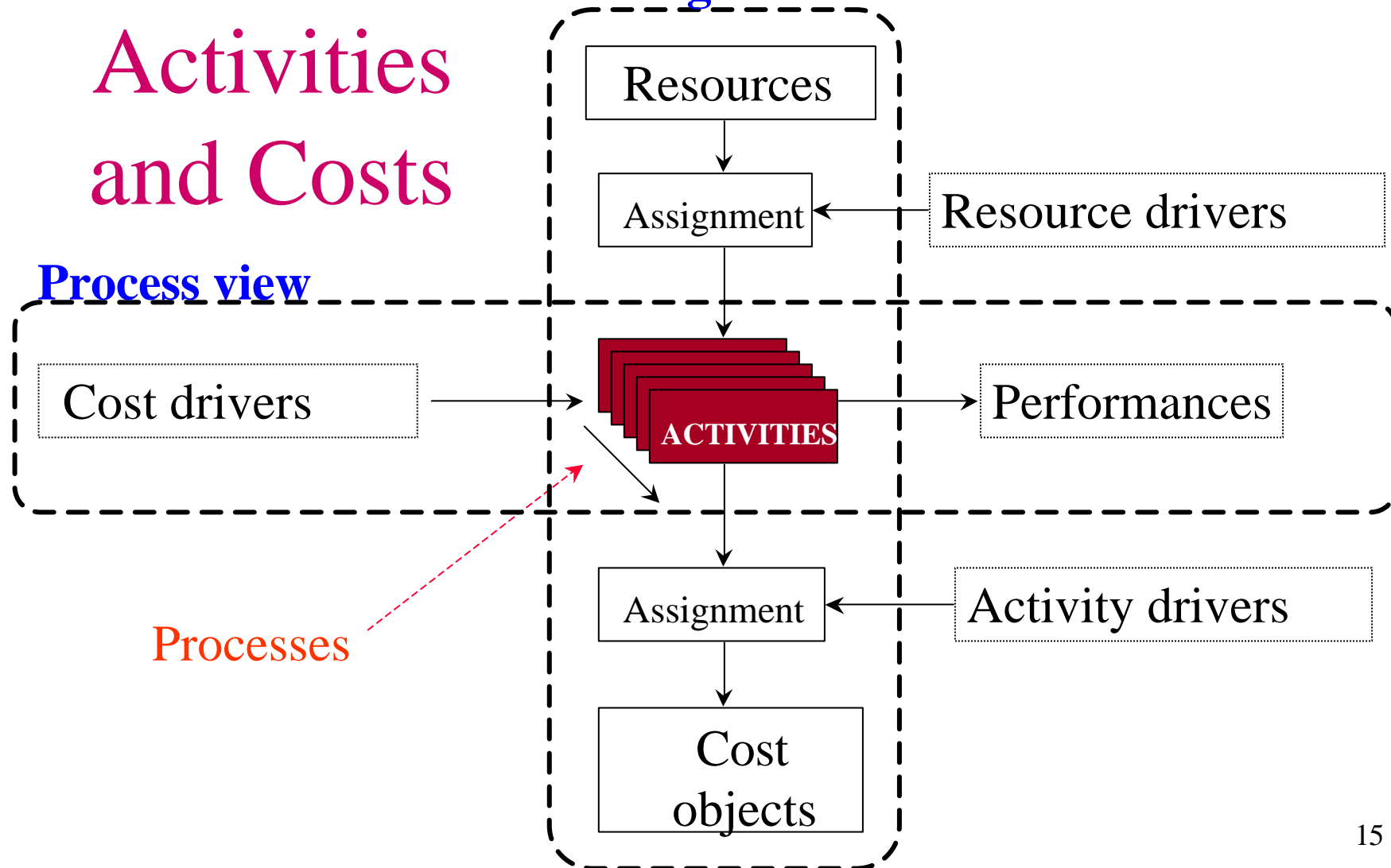
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# Activities and Costs

## Cost assignment view

## Process view







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## The Link

- The real concern of a manager is to minimise the volume of activity for a given cost object value,
- Consequently, the *activity drivers* are very often used *as performance measurement indicators*,
- The manager controls the system by focusing on the cost drivers



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## **Cost Allocation but ...**

That double dimension of “ABC” (cost assignment and process views) makes it a real cost management tool,

“ABC” provides “ABM” with the data needed for continuous-improvement which encompasses initiatives like

- *Business process reengineering, and*
- *Total quality management*

**END**



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**EXAMPLE**