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.
Cost Types

A product/service has usually three types of cost:

– *The direct costs, the*
– *Indirect costs, and the*
– *Common costs*
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
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
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
"ABC"

• 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
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
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)
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.
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.
“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
The Drivers

• **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
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
Modern Management Trends

• Process versus procedure
• Multidisciplinary teams versus hierarchy driven activity
• Understanding the process versus measuring the results
Activities and Costs

Process view

Cost drivers → ACTIVITIES → Assignment → Cost objects

Activity drivers

Cost assignment view

Resources → Assignment → Resource drivers

Performances
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
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
EXAMPLE