Understanding Activity-Based Costing

Checklist Description

This checklist provides an overview of activity-based costing, outlines some of its main applications, and considers the strengths and weaknesses of using this analysis.

Definition

Activity-based costing (ABC) is a means of analyzing costs according to particular activities performed by individuals, teams, divisions, or other components of a company. These activities can be analyzed on many levels, for example, looking at a process to determine the cost of the overall process, or breaking down a process into activities to determine more precisely how resources are consumed by each identified activity of that process. Therefore ABC is a means to identify the activities that drive overall costs in a company. At an individual employee level, an ABC analysis would measure how much time an employee spends on a particular task related to providing a product or service, as part of a process to attribute employee overhead costs to that particular activity. When applied throughout an organization, ABC models can analyze and cost the activities of all processes in a company, providing a range of information to support decisions in areas such as operations, marketing, and customer support. Information derived from ABC can also help companies to quote more accurately when bidding for new business, as improved knowledge about how much each activity involved in the new business costs to provide can help companies to price jobs more efficiently.

ABC is extensively used in the manufacturing industry, but it has also proved its worth in other sectors where a sound understanding of the costs of activities required to provide a product or service is needed, such as banks and finance companies, airlines, and logistics companies. ABC has also found favor in the public sector given the increasing pressure to provide accountability for funds spent and to provide services on a cost-efficient basis.

Advantages

- Understanding your costs better helps to support better management decisions.
- ABC is relatively easy for everyone involved to understand.
- ABC can help to challenge assumptions about which activities consume most resources.
- The methodology can also support more efficient setting of quotes for new business, given the improved knowledge about the costs of all activities necessary to fulfill the requirements.

Disadvantages

- Data collection and analysis can be a protracted and time-consuming process.
- The focus on cost—as opposed to value—could fail to recognize that some seemingly costly activities may act as a “loss leader” that supports other highly profitable business from the same clients.
- Maintaining an ongoing ABC system can be expensive.

Action Checklist

- Decide the scope of the ABC program, including the areas to be included and the level of depth of the study.
- Identify the relevant processes and activities that are to be examined as part of the ABC analysis.
- Consider whether your ABC study is to be a one-off or is to be undertaken at regular intervals.
- Determine the scope of distribution of the results within the organization.
Dos and Don’ts

Do

Use ABC to help identify areas of inefficiency, such as services that are being provided for unattractive margins.
Assess whether the cost of the ABC study could be offset by providing information on which customers are most profitable and whether some customers have actually detracted from profits.

Don’t

Do not expect the adoption of an ABC study to be universally popular in your company—some managers may be concerned that their pet projects could be exposed as less profitable than previously assumed.
Don’t share ABC information with employees who may subsequently be attracted by a competitor. ABC studies require the evaluation of a wealth of operational and financial data; these data may be proprietary to the firm and therefore commercially sensitive.

More Info

Books:

Article:
- Leahy, Tad. “Where are you on the ABC learning curve?” Business Finance (December 1, 2004). Online at: tinyurl.com/yeqm96y

Report:

See Also

Best Practice
- The Missing Metrics: Managing the Cost of Complexity
- Profitability Analysis Using Activity-Based Costing

Checklists
- Business Process Reengineering

Calculations
- Activity-Based Costing
- Cost and Effect: Using Integrated Cost Systems to Drive Profitability and Performance

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