Briefing Document on Activity-Based Costing

Activity-Based Costing (ABC) is a costing methodology that more accurately traces indirect overhead costs to products and services by putting a spotlight on the activities involved in the procurement and delivery of products and services. Traditional cost allocation methods, while much simpler to calculate and apply, often distort the true costs by applying an allocation base that does not relate to cost consumption (an example will follow). By providing more accurate costs by using a cause-and-effect approach, ABC can assist in more effective decision-making such as pricing, promotion and mix.

ABC appreciates that organizational behavior must be driven around achievement of strategic objectives and many improvements will involve the accurate knowledge of where costs are being driven in the organization. This enhanced cost knowledge can assist the organization in achieving strategic objectives, including improved profits in the private sector.

ABC can yield many benefits, including:

1. Improved pricing decisions;
2. Higher visibility of non-value-adding activities;
3. Better decisions around product mix and which (higher-profit) products and services to promote;
4. Improved customer satisfaction; and,
5. Higher profits.

ABC is related to the movement toward activity-based management (ABM). It often has a relationship with other initiatives such as business process reengineering (BPR) and lean management (LM). While sophisticated software systems are available and can be purchased, ABC can be effectively applied using a spreadsheet application and a knowledgeable programmer.

Implementing Activity-Based Costing

There is no one correct approach to implementing ABC. Normally, organizations will employ the following sequence:

1. Identify activities that use resources;
2. Identify the cost driver that uses (drives up) an activity's costs;
3. Calculate the cost rate per driver unit or transaction;
4. Assign costs based on the information above.

Example

A publishing company allocates all indirect overhead to its' three divisions based on net revenue (that is, gross revenues less returns). The belief was, there must be a direct link between revenues and the costs incurred in bringing in those revenues. One of the overhead costs allocated based on the net revenue is order entry. As orders were called in or e-mailed, order entry clerks entered the order into the company system. Order entry (OE) costs for 2018 were $1.2M. In terms of how the $1.2M was allocated, here is what 2018 looked like (all numbers in $000's):

Divisions

	A	B	C	Total
Net revenue	50,000	40,000	10,000	100,000
OE costs allocated	600	480	120	1,200
Allocation %	50%	40%	10%	

In 2019, the company undertook an ABC initiative and, following the ABC implementation steps, found the following:

1. Not surprisingly, entering orders was the sole activity responsible for the costs of the OE department;
2. There was a direct cause-and-effect linkage between the number of orders entered and the costs of the OE department (i.e. an order was the primary driver of the costs of OE – the more orders, the more work there was in OE);
3. In that there were 24,000 orders processed, the cost per order was computed at $50 ($1.2M / 24,000).

The ABC implementation team then turned their attention to the orders entered for each of the three divisions. They were astonished at what they discovered – the breakdown of orders by division (and the ABC-based order entry costs, calculated as # orders * $50) were as follows:

Divisions

	A	B	C	Total
Number of orders:	4,000	6,000	14,000	24,000
ABC-based costs ($000's)	200	300	700	1,200

The team had to double-check their results. How could Division C, a division that amounted to just 10% of corporate revenues, be responsible for over 58% of the costs associated with the OE department?! Then it started to make sense: Divisions A and B sold books to universities, colleges and schools – the orders were often very large (for example, Queen's University might make one simple order that approached a quarter of a million dollars). The average Division A order was $12,500; Division B's was $6,667. In contrast, Division C sold books to small stores and individuals – the average order was less than $250. As a result, it took many more orders to build the Division C revenue. Bottom line: the ABC initiative showed the company the following:

1. Some overhead costs may seem to be related to revenue, but in fact are driven by activities that do not directly tie to revenue;
2. It is import to investigate the actual drivers of cost (purchase orders in this case), to get a more accurate look at where costs are being consumed; and
3. The findings can be very useful in making informed decisions that can benefit the company. For example, they could consider higher prices for very small orders. Or, they could consider online ordering (even mandate it for small customers) to reduce the costs involved with OE.

Practical Tips and Guidelines

In implementing ABC, great care should be taken to adhere to a small yet important set of tips and guidelines. First, it is important that management communicate the ABC initiative, explaining the rationale for decisions that may have not been made in the past (such as price changes). Second, staff should be held accountable for using ABC results as appropriate (based on clearly

communicated objectives), and rewarded or penalized as necessary. Third, it is recommended that the organization choose a pilot ABC project. This pilot is usually one that would be smaller in scale (thus quicker to implement), yet important at the same time.