



## **Activity-Based Costing: Improving Cost and Expense Analyses**

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Activity-Based Costing (ABC) is a special costing model that manages business costs or expenses by identifying activities used for the production of products or services. The costs of associated activities are assigned to all products or services in order to ascertain the actual value of the output. This model assigns indirect costs, such as overhead, to products or services so as to better distinguish which products are profitable and which are actually inefficient.

Originally emerging in the 1980s, activity-based costing was an output of an increasingly competitive global market, in which technological improvements in production processes required less manual labor and greater oversight of costs associated with production. While it fell out of fashion in the late 1990s and early years of the 21<sup>st</sup> century, activity-based costing can be a valuable means of accurately assessing corporate costs and expenses.

Activity-based costing is best suited to companies containing various outputs with differing levels of complexity and operational intensity. It is also well suited to those businesses that provide customers with varying levels of products or services. ABC permits such companies to correctly ascertain the amount of total funds and resources being dedicated to each particular project.

With an ABC system, companies may develop a comprehensive picture of which products or services are most worthwhile, and which outputs need to be either amended or eliminated.

### **Methods of Conducting Activity-Based Costing**

There are four principal steps involved in the performance of activity-based costing. First and foremost, businesses must compile a master list of activities. While originally this stage had to be conducted from scratch, innovations in technology and experience have allowed today's companies to use digital methods and past precedent to compile lists. Activities can be identified by first considering a business' products or services, and then compiling lists of all the activities necessary to deliver the outcome.

Secondly, it is important to determine costs associated with carrying out each of the identified activities. The ABC model requires that costs be allocated to each activity performed. For example, when considering a machinery repair activity, a business would have to consider the cost of paying a maintenance person, as well as any associated hardware costs.

Next, corporations utilizing activity-based costing ought to compile a list of all the products or services provided by the business. This stage also entails associating activities with the particular products or services they help develop. This stage permits the business to identify whether resources are being expended wisely. Businesses can examine the total cost of creating a particular product or service and determine whether a profit is being made. These conclusions can then be connected with the revenue generated from customers and sales, in order to create a comprehensive picture of company costs.

Finally, businesses ought to identify sources of costs associated with various activities. Commonly referred to as “cost drivers,” these sources of expense generally fall into three categories: transaction drivers, duration drivers, and intensity drivers. These drivers identify the chief categories into which activities fall, thereby permitting businesses to determine their most expensive types of tasks. Businesses can then adjust their practices accordingly.

### **Benefits of Activity-Based Costing**

This method of cost accounting is widely applicable to numerous business financing, costing, and accounting needs. The ABC modelling process is applicable not only to partial views of company practices, but also to assessing the full scope of business expenditures. ABC is particularly helpful for identifying inefficient products, departments and activities across the whole spectrum of business practices. In addition, ABC can assist in determining the allocation of resources. With this method, more resources may be designated to profitable products and services, while resources may be directed away from those areas that are unprofitable.

Through activity-based costing, businesses can increase efficiencies by finding and eliminating extraneous costs and controlling resource distribution at any per-product level, as well as at any departmental level. ABC is an excellent means of identifying places where the business might be hemorrhaging money in support of unprofitable enterprises.

Another major benefit of activity-based costing is its ability to respond to increases in overhead costs by determining exactly where that money is going. It also is an efficient means of responding to any increased pressure from regulators, by more directly controlling the flow of company funds.

### **In Conclusion**

Activity-based costing is an efficient means of developing a comprehensive picture of a business' costs and expenditures, as they relate to products and services. ABC is simple to implement and can provide a host of benefits including the following:

- Activity-based costing is applicable to a wide range of business needs. It may be used to look at a small portion of production or at the full scope of business operations.
- With ABC, businesses can respond to inefficiencies. By identifying areas that are absorbing too many resources, managers can reallocate funds to more profitable areas.
- Activity-based costing provides a more direct means of controlling company funds. With ABC, businesses can manage exactly where funds are going and how resources are being used.

With activity-based costing, businesses can respond quickly and efficiently to demands for greater regulation. Companies that do not have internal expertise or capacity to conduct this kind of analysis should consider hiring an outside service provider with expertise in activity-based costing.

### **References and Further Reading**

Activity-Based Costing (ABC); David M. Katz; CFO.com; December 31, 2002;  
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