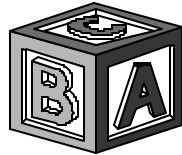


**Activity-Based Costing and Activity-Based Management**

**Introduction**

ABC systems help companies make better pricing and product mix decisions.

ABC assists in cost management decisions by improving processes and product designs.

*Activities generate transactions.*

*Transactions generate costs.*

*ABC traces costs to activities.*

**Undercosting and Overcosting**

	<b>Consumption Level of resources</b>	<b>Total cost reported</b>
Product undercosting:	High	Low
Product overcosting:	Low	High

**Undercosting and Overcosting**
**Production-cost cross subsidization:**

broad averages - costs assigned uniformly when multiple users consume resources differently

At least one product or job overcosted and at least one other product or job is undercosted

Cost smoothing effects can occur on both direct and indirect costs

**Refining a Costing System**

Guidelines for refining a costing system:

Direct-cost tracing – Classify as many of the total costs as direct costs as is economically feasible.

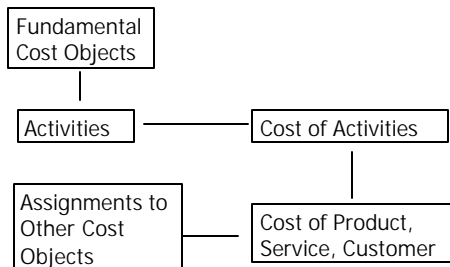
Indirect-cost pools – Expand the number of cost pools until each of these pools is homogeneous.

Cost-allocation basis – Identify the preferred cost-allocation base for each indirect-cost pool.

**Activity-Based Costing System**

ABC systems refine costing systems by focusing on individual activities as the fundamental cost object.

ABC calculates the costs of individual activities and assigns costs to cost objects such as products and services on the basis of the activities undertaken to produce each product or service.

**Activity-Based Costing System**

**Smaller, Less Affluent Investors Find Wall Street Less Receptive**

October 5, 1999 THE WALL STREET JOURNAL.  
 Memo to small investors who think financial-services giants are treating them like second-class citizens. Vanguard Group and Fidelity Investments and big brokerage firms like Merrill Lynch - have sought to appeal to a growing class of well-heeled investors with products and services not available to the less affluent. e-mail to brokers from Merrill: "If we are going to be Financial Consultants to wealthy and successful individuals and businesses, then we don't have time to provide personal services to the poor."

**Smaller, Less Affluent Investors Find Wall Street Less Receptive**

Merrill has sought to herd all accounts with less than \$100,000 in assets to a telephone-based customer-service center  
 Merrill says the memo was in jest.  
 Accounts of less than \$100,000 often don't generate profit for the firms. Sometimes, small investors can take up an inordinate amount of a broker's time and attention. The cost of correspondence and mailing often is the same for accounts of \$10,000 and \$10 million.

**Cost Hierarchies**

A cost hierarchy is a categorization of costs into different cost pools based on

- different degrees of difficulty in determining cause-and-effect relationships.
- the basis of the different types of cost drivers (cost-allocation bases)

**Cost Hierarchies**

ABC systems commonly use a four-part cost hierarchy to identify cost-allocation bases:

- Output unit-level cost
- Batch level costs
- Product-sustaining costs
- Facility-sustaining costs

**Output Unit-Level and Batch-Level Costs.**

**Output Unit-Level Costs**  
 are resources sacrificed on activities performed on each individual unit of product or service.  
 e.g. Energy, Machine depreciation, Repairs.

**Batch-Level Costs...**  
 are resources sacrificed on activities that are related to a group of units of product(s) or service(s) rather than to each individual unit.  
 e.g. Setup hours, Procurement costs.

**Product-Sustaining and Facility-Sustaining Costs.**

**Product-Sustaining** or service-sustaining costs are resources sacrificed on activities undertaken to support individual products or services.

e.g Design costs, Engineering costs

**Facility-Sustaining Costs**

are resources sacrificed on activities that cannot be traced to individual products or services but support the organization as a whole.

e.g. General administration, Rent, Building security

**Activity-Based Management**

ABM describes management decisions that use activity-based costing information to satisfy customers and improve profits.

- ❑ Product pricing and mix decisions
- ❑ Cost reduction & process improvement decisions
- ❑ Design decisions

**Product Pricing and Mix Decisions**

ABC

≈ gives management insight into the cost structures for making and selling diverse products.

≈ provides more accurate product cost information

≈ provides more detailed information on costs of activities and the drivers of those costs.

**Cost Reduction and Process Improvement Decisions**

Manufacturing and distribution personnel use ABC systems to focus on cost reduction efforts.

Managers set cost-reduction targets in terms of reducing the cost per unit of the cost-allocation base

or

usage of cost drivers per unit of the output.

**ABC and Department Indirect-Cost Rates**

Many companies have evolved their costing system from using a single cost pool to using separate indirect-cost rates for each department:

- Design
- Manufacturing
- Distribution

**ABC and Department Indirect-Cost Rates**

Why?

≈ Because the cost drivers of resources in each department or sub-department differ from the single, company-wide, cost-allocation base.

≈ ABC systems are a further refinement of department costing systems.

**ABC Systems Are Most Beneficial When...**

- ⌘ significant amounts of indirect costs are allocated using only one or two cost pools.
- ⌘ all or most costs are identified as output unit-level costs.
- ⌘ products make diverse demands on resources because of differences in volume, process steps, batch size, or complexity.

**Limitations of ABC Systems**

- Measurements necessary to implement the system.
- ABC systems require management to estimate costs of activity pools and to identify and measure cost drivers for these pools.
- Activity-cost rates also need to be updated regularly.
- Very detailed ABC systems are costly to operate and difficult to understand.

**ABC In Service And Merchandising Companies**

- very similar to the approach in manufacturing.

Costs are divided into homogeneous cost pools and classified as output unit-level, batch level, product, or service-sustaining and facility sustaining costs.

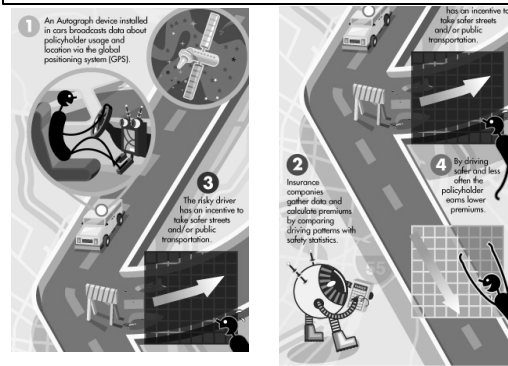
**ABC In Service And Merchandising Companies**

The cost pools correspond to key activities. Costs are allocated to products or customers using activity drivers or cost-allocation bases that have a cause-and-effect relationship with the cost in the cost pool.

**Costs of customers  
– Customer profitability**
**Delta Adds Fee for Seats Not Bought on Its Web Site**

NYT January 15, 1999

Citing the rising cost of conventional booking methods, Delta is imposing a surcharge -- \$1 one way, \$2 round trip -- on domestic tickets purchased anywhere but on the airline's own Internet site.

**ABC In Insurance**


**ARE FLAT RATES GOOD BUSINESS?****All-You-Can-Eat Pricing: A Mixed Picture**

ONLINE SERVICES: America Online can't meet demand after offering unlimited usage for \$19.95 a month

NATURAL GAS: Equitable Resources sells natural gas for a fixed monthly sum

LONG DISTANCE: AT&T is offering a One Rate plan--15 cents a minute, anywhere in the U.S., any time of day

PACKAGE DELIVERY: After years of flat rates, United Parcel Service and Federal Express have begun offering prices based on distance