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Activity based costing articles pdf

If you don't know how your company spends its money, you can't budget it effectively. Absorption costing and activity-based costing, or ABC, show you how much these functions and products cost your company. One difference between ABC and cost absorption is that businesses rely on the absorption-costing formula to keep books accurate and ABC on management decision-making. Absorption costing is a tool for calculating the manufacturing costs of products, including overheads. Its main use is to calculate the cost of goods sold for your income statement. Activity-based costing is much more effective at determining the exact costs associated with which products. It is a better tool for making management decisions. Companies that use generally accepted accounting principles, or GAAP, use the absorption-costing formula to calculate how much they spend on production processes and individual products. These items become the basis of the cost of the goods sold, a substantial amount for calculating your net income. You can meet gaap requirements with activity based on costing, but most companies find that approach way too cumbersome to be practical. Absorption-based costing is based on materials and work that contribute directly to a product plus fixed overheads and variable overheads. Fixed overheads include things like rent and insurance in a factory, which don't vary by production. The variable charge is affected by the output — for example, the electricity and maintenance required by the assembly line. The first step in the formula is to assign the various costs to cost sets, such as maintenance. Then calculate the usage information that you use to assign overheads. A typical usage number can be the hours a particular piece of equipment runs in a month or the direct working hours used in production. Divide the usage amount into the assigned cost. For an example of absorption costing, assume you have \$50,000 in cost and 500 hours of work. Each hour of work then absorbs \$100 in cost. If an item takes half an hour to build, that item will absorb \$50. When you prepare the income statement, you use the absorbent cost data to calculate the cost of the goods sold, which you deduct from net sales revenue. Activity-based costing allows you to distribute your general expenses more accurately than assigning them to working hours. Under absorption costing, two products take the same amount of time to do to absorb the same cost but not with ABC. That's the difference between ABC and cost absorption. For example, suppose you have two products that both take 90 minutes to manufacture. One, however, is a type of specialty made in small batches, so the production line requires additional installation time and product testing. Absorption costing based on working hours will assign overheads equally to both products, but the ABC assigns more of them to the item. The steps to assign activity-based costing are longer and more demanding than the absorption-costing type: Determining costs is the first step. Since you're not assigning them to your products evenly, you'll need research, thought and crunch number to get it right. Create the relevant cost totals. Primary cost groups are directly related to product lines, such as advertising and research and development. Administrative and IT services go to secondary spending groups. Identify the activity drivers that press the sub-cost sets. For example, the square length used for production affects the amount of rent and utilities that the production process costs. Use activity drivers to assign costs to sub pools in primary pools. Assign costs to specific objects or processes. Unlike absorption costing, you can use it for things other than manufacturing — for example, by assessing the cost of distribution channels or retail stores. Another difference between ABC and absorbing costing is how you can use them in your business. They're different tools that are good for different jobs. The most important job of cost accounting based on absorption is to calculate the cost of goods sold. Calculating how much you spent on the inventory you sold this quarter or this year is a necessary step in calculating your earnings for the period. You can use the cost of goods sold on the basis of absorption costing to prepare your financial statements or to evaluate the shares. Knowing the cost can help you set the price for your products. However, absorption costing has drawbacks as a tool for making management decisions: Unlike ABC, the absorption-costing formula does not get into the details of how much each product costs produce. If you compare the cost of different product lines and decide which one to drop, absorption costing can't tell you that. If the products are not sold, the relevant fixed overheads shall not be deducted from the profits. By assigning a little more overheads to products that sit in the warehouse, a company can keep overheads out of the income account statement, making the business look more profitable than it is. Absorption costing is important for accurate financial statements. Activity-based costing is a best tool for management decisions. As the ABC assigns costs and overheads to specific products and processes, it's much more useful to show you where to cut costs or maybe even cut your product line. Using ABC, you can compare your activity costs with industry standards. If your expenses are welcome, you know you have to reduce the cost somewhere. If you have a significant customer that requires additional costs, such as multiple refunds or special attention, the ABC allows you to assign these costs to the customer and assess whether the customer is profitable. Whether you're selling through your website, a store or through sales calls, the ABC can assess overheads each sales channel, so you can compare it with the revenue generated. ABC's data on manufacturing products can show you that it's more cost-effective to assign them to third parties. If you know the exact cost assigned to a particular product, you know the absolute minimum for which you can sell it and convert a profit. You can compare the cost of various production facilities, see which is the most efficient and use it to make decisions about the others. Like cost-based absorption, the ABC method has drawbacks. To assign costs efficiently, you need multiple individual cost groups. The more cost groups, the more complex the system, and the more work and expense it will take to collect data. Small, targeted ABC systems work well. Large, corporate systems can take years to install. It is also difficult to maintain the management and financial support a large ABC system requires. ABC requires input from many departments. Some of them may decide that they have higher priorities and be left behind in providing you with the necessary data. Companies can create an ABC system for a specific purpose and then decide not to update it or keep it up to date after that, rendering it useless. The working hours gathered for ABC may not be accurate. Employees usually don't admit they were surfing the internet or chatting with colleagues about company time and can assign these hours to something more acceptable. This can distort how many hours of work you assign to projects and processes. Unlike absorption-based costing, the ABC usually requires its own database instead of drawing data from the general ledger. If you only have one or two product lines and a fairly simple manufacturing system, you may be able to collect decision-making information without establishing an ABC. Cost accounting began as a way to track the actual cost of an item or service by calculating the direct and indirect costs required to produce that item or complete that service. Activity-based cost accounting (also called ABC for activity-based costing) is an accounting method that aggregates overheads for each activity performed by a company and then assigns the cost to anyone or whoever causes that activity. ABC is a more accurate way to attribute costs to activities and products than using costing methods. Before there was ABC, there was cost accounting. Costing worked well for businesses that rely on item or service to generate the actual cost of producing an item or completing a service. Direct costs for completing a project were added with the indirect cost of overheads to achieve actual costs. Over the years, many costing methods have been developed due to the inadequacies of the simple cost method. If a painting company uses cost accounting, direct costs would include labor costs and material costs. Indirect costs will include administrative work and the use of depreciating items such as brushes, ladders or vehicles. These direct and indirect costs are deducted from the income earned at work to reach the profits made. Consistency becomes an issue in basic cost accounting because some companies can arbitrarily outser indirect costs based on something easy to follow (direct working hours). Others may assign indirect costs based on the quantity of materials used. Processing and processing companies found it difficult to use cost accounting because monitoring of the processes used became very difficult. For example, a paper mill buys timber to create a number of different products using different techniques. A tree can produce a ream of paper and some salable by-products. Tracking the actual cost of the tree used for each individual product that was done or completed was almost impossible. These companies then created what they called process costing. Process costing records the cost for each process or department and not for each project or unit. The cost of production of the paper is attributed to this process, as well as the cost for the by-products. Indirect costs shall also be charged to the procedure. Cost accounting and process accounting are difficult for companies with complex production processes and practices, such as a company where many raw goods are used to create many different kinds. The ABC was created by the need to overcome these difficulties by dividing production into its core activities. After this segment, the costs for these activities are calculated and distributed to products based on the percentage of a specific activity required to produce a product. Traditional costing methods do not take into account some of the costs associated with a product or service, which limits management's ability to accurately invoice products and measure production levels. The ABC takes into account the production and non-production activities involved in the creation of a product. Separates production costs from management costs, allowing a more accurate picture of the actual cost of creating a product based on actual cost of production. While the information obtained through ABC is extremely valuable, the IRS and shareholders require the use of traditional methods to create the necessary tax reports. ABC is not what is called Generally Accepted Accounting Principles (GAAP) and therefore cannot be used for official observance This means that companies wishing to have the advantage of ABC techniques should use two different costing methods. Depending on the company, using two different costing methods may prove more costly than beneficial. However, many companies endure the extra work and believe the process is worth the extra time and expense. Expense. Expense.

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