

Activity-based costing

Activity-based costing (ABC) is a method of assigning costs to products or services based on the resources that they consume. Its aim, The Economist once wrote, is “to change the way in which costs are counted”.

ABC is an alternative to traditional accounting in which a business's overheads (indirect costs such as lighting, heating and marketing) are allocated in proportion to an activity's direct costs. This is unsatisfactory because two activities that absorb the same direct costs can use very different amounts of overhead. A mass-produced industrial robot, for instance, can use the same amount of labour and materials as a customised robot. But the customised robot uses far more of the company engineers' time (an overhead) than does the mass-produced one.

This difference would not be reflected in traditional costing systems. Hence a company that makes more and more customised products (and bases its pricing on historic costings) can soon find itself making large losses. As new technologies make it easier for firms to customise products, the importance of allocating indirect costs accurately increases.

Introducing activity-based costing is not a simple task—it is by no means as easy as ABC. For a start, all business activities must be broken down into their discrete components. As part of its ABC programme, for example, ABB, a Swiss-Swedish power company, divided its purchasing activity into things like negotiating with suppliers, updating the database, issuing purchase orders and handling complaints.

Large firms should try a pilot scheme before implementing the system throughout their organisation. The information essential for ABC may not be readily available and may have to be calculated specially for the purpose. This involves making many new measurements. Larger companies often hire consultants who are specialists in the area to help them get a system up and running.

The easy approach is to use ABC software in conjunction with a company's existing accounting system. The traditional system continues to be used as before, with the ABC structure an extra to be called upon when specific cost information is required to help make a particular decision. The development of business accounting software programs has made the introduction of activity-based costing more feasible.

Setting up an activity-based costing system is a prerequisite for improving business processes and for any re-engineering programme (see article). Many firms also use ABC data for the measures required for a balanced scorecard (see article).

Activity-based costing became popular in the early 1980s largely because of growing dissatisfaction with traditional ways of allocating costs. After a strong start, however, it fell into a period of disrepute. Even Robert Kaplan (see article), a Harvard Business School professor sometimes credited with being its founding father, has admitted that it stagnated in the 1990s. The difficulty lay in translating the theory into action. Many companies were not prepared to give up their traditional cost-control mechanisms in favour of ABC.

In 2007 Kaplan brought out a new book that tried to make activity-based costing easier. Called TDABC (time-driven activity-based costing), it attempted to relate the measurement of cost to time. As Kaplan put it, only two questions need to be answered in TDABC:

- How much does it cost per time unit to supply resources for each business process?

- How much time is required to perform the work needed for a company's products, transactions and customers?

Nevertheless, ABC has many satisfied customers. Chrysler, an American car manufacturer, claims that it saved hundreds of millions of dollars through a programme that it introduced in the early 1990s. ABC showed that the true cost of certain parts that Chrysler made was 30 times what had originally been estimated, a discovery that persuaded the company to outsource (see article) the manufacture of many of those parts.

Further reading

Kaplan, R.S. and Cooper, R., "Make Cost Right: Make the Right Decisions", Harvard Business Review, September–October 1988

Kaplan, R.S. and Cooper, R., "Cost and Effect: Using Integrated Cost Systems to Drive Profitability and Performance", Harvard Business School Press, 1997

Kaplan, R.S. and Anderson, S., "Time-Driven Activity Based Costing", Harvard Business School Press, 2007

Ness, J.A. and Cucuzza, T.G., "Tapping the Full Potential of ABC", Harvard Business Review, July–August 1995

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