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COST AND WORKS ACCOUNTING
(Overheads and Methods of Costing-II)
T.Y.B.COM

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- Purposes and Benefits of Activity Based Costing
ACTIVITY BASED COSTING:

Definitions:

1. Cooper and Kalpan:

“Activity Based Costing systems calculate the costs of individual activities and assign costs to cost objects such as products and services on the basis of activities undertaken to produce each product or service”.
2. CIMA, London:

“Cost attribution to cost units on the basis of benefits received from indirect activities, i.e., ordering, setting up, assuring quality etc.”.

3. Activity Based Costing is a technique of charging overheads to cost objects.

4. Activity Based Costing is a modern methodology of accounting, in which costs are first traced to activities and then to products.
PURPOSES OF ACTIVITY BASED COSTING:

Activity Based Costing aims at identifying as many costs as possible to be subsequently accounted as direct costs of production. Any cost that traced to a particular product via its computation of activity becomes direct cost of the product.

For example- In conventional costing system, cost of set up and adjustment time is considered as factory overhead and subsequently assigned to different products on the basis of direct labour hours. But, in Activity Based Costing, set up and adjustment time determined for each product and its costs are directly charged to each product. Thus, by emphasizing on activities, it tries to ascertain the factors that cause each major activity, its cost and the relationship between activities and products produced.
The philosophy more effectively and efficiently of Activity Based Costing is, that costs can be controlled directly on managing the forces that cause the activities rather than the cost.

Activity Based Costing system is used very well by the manufacturing industries for product costing where,
1. Production overheads are very high as compared to direct costs.
2. There is a tremendous diversity in the product range.
3. Consumption of overhead resources is not primarily driven by volume.
BENEFITS OF ACTIVITY BASED COSTING:

1. Activity Based Costing brings accountability and reliability in products, determination of costs by focusing on cause and effect relationship in the cost incurred.
2. It improves greatly the manager’s decision making and enables managers to control many fixed overhead costs.
3. It helps in fixing selling price of products.
4. It provides not only a base for calculating more accurate costs, but also a mechanism for managing costs. An Activity Based Costing system focuses managements attention on the underlying causes of costs.
5. It that resources consuming activities cause cost and that products incur costs.
6. With an effective activity based costing system costs are managed in the long run by controlling the activities that drive them.

7. Activity Based Costing systems may have the greatest potential for controlling to cost management, budgeting, control and performance evaluation.

8. The availability of cost driver rates can also have significant impact on the design of new products or can result in the design of existing products. Designers are made aware of the product characteristic that cause overhead costs through the cost drivers rates that are applied in costing the product.

9. It helps in adjusting pricing policies according to changing circumstances and to develop various product strategies for maximisation of profits.

10. It helps to identify unnecessary activities which may be eliminated in future to achieve greater cost efficiency.
Thank You