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

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Traditional Costing and Activity Based Costing System
TRADITIONAL COSTING:

Introduction:

In traditional costing method, overhead is usually applied based on either the amount of direct labour hours consumed or machine hours used. The problem with traditional costing is that, factory overhead may be much higher than the basis of allocation, so that a small change in the volume of resources consumed triggers a massive change in the amount of overhead applied. The traditional costing method is also called the conventional method.
Definitions: (Traditional Costing)

1. Traditional Costing is the allocation of factory overhead to products based on the volume of production resources consumed.

2. The traditional method of costing refers to the allocation of manufacturing overhead costs to the products manufactured.

This method assigns or allocates the factory indirect costs to the items manufactured on the basis of volume such as the number of units produced, the direct labour hours or the production machine hours.
ACTIVITY BASED COSTING:

Introduction:

Activity based costing is an upcoming and more polished approach for charging of overheads to products and ascertaining the product costs more accurately and scientifically. Activity based costing is a system which focuses on activities performed to produce products. In activity based costing activities become the focal points for cost accumulation. In activity based costing, overheads are first calculated separately for each activity and then are charged to various cost objects on the basis of activities consumed by these cost objects.
Definitions: (Activity Based Costing)

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.”.
Traditional Costing and Activity Based Costing System:

A fundamental difference between Traditional Costing and Activity Based Costing is that, ABC method expand the number of indirect cost pools that can be allocated to specific products whereas the traditional method takes one pool of a company’s total overhead costs to allocate universally to all products.

In traditional costing system, overhead costs are assumed to be influenced only by units produced. It means, costs of batch level, product level and
facility level activities are fixed costs, i.e. costs of these do not vary as production volume changes. Unit-based cost systems apportion fixed overhead to individual products and variable overhead are directly assigned to products using the base of number units produced.

In Activity Based Costing, variable overhead is appropriately traced to individual products. The costs incurred as the units are produced have been traditionally traced as variable overhead. But when fixed overheads are apportioned on the basis of units manufactured, as in traditional costing, such apportionment is likely to be arbitrary and also may not reflect activities and cost actually consumed by the products.
Activity Based Costing improves product costing procedure (as compared to traditional costing) because it recognises that many so called fixed overhead costs varying in proportion to changes other than production units. It means, under Activity Based Costing the other two level activities, batch level and product level are assumed to influence fixed overhead costs and batch level and product level, thus are accepted as non unit based cost drivers. By establishing the link between these cost drivers and fixed overhead costs, they are finally traced to individual products.
It is clear that, both the costing systems follow two stage allocation procedure. In traditional costing, in the first stage, overhead costs are allocated to production departments. But in Activity Based Costing, in the first stage, overhead costs are assigned to each major activity and not to departments.

In traditional costing, overheads are pooled or collected departmentwise. But in Activity Based Costing, many activity-based cost pools or cost centres are created. In traditional costing, overhead costs of service departments are allocated/reapportioned to production departments and therefore in this...
costing system finally only fewer cost pools exists. But Activity Based Costing creates separate cost pools for service activities as well and overhead costs of these service activities (service departments) assigned directly to specific products through applying cost driver rates. Thus, in Activity Based Costing, there is no need to allocate or re-apportion overheads of service departments.
Thank You