



Notes – Chapter 5

Activity-Based Costing

- I. Overview
 - a. The goal is to more accurately apply indirect costs.
 - b. There's a potential for "very bad accounting" when using a single overhead rate.
 - c. Traditional systems are inadequate
 - i. A single cost-driver doesn't accurately reflect incurrence of overhead.
 - ii. Distortion is caused because (among other reasons) not all costs are associated with the production of a single unit.
 - iii. If you have some jobs that are labor-intensive and some that are machine-intensive, a single rate just won't quite work.
- II. Cost Levels
 - a. Facility Level
 - i. Entire production process
 - ii. Building, etc
 - b. Product Sustaining Level
 - i. Needs to be done, but not all the time.
 - ii. Engineering, design changes, etc.
 - c. Batch Level
 - i. Incurred for each batch.
 - ii. Setup, inspection, etc. Not per unit!
 - d. Unit Level
 - i. Costs actually incurred for every unit produced.
 - ii. Machine time
- III. Solution
 - a. Recognize differences in the nature of costs.
 - b. Multiple cost drivers may be appropriate.
 - c. Ultimately try to treat indirect costs as direct costs – "forge the link" that allows them to be tied to particular products.
 - d. Stage I
 - i. Identify cost pools
 - ii. Apportion costs to those pools
 - e. Stage 2
 - i. Pick drivers for each cost pool.
 - ii. Apply costs from each pool based on its specific rate.
- IV. Activity Cost Pools
 - a. Understand the nature of costs (volume, levels, drivers)
 - b. Understand the nature of the process
 - c. Typical Examples
 - i. Machine Setup
 - ii. Receiving / Inspection
 - iii. Purchasing
 - iv. Equipment Maintenance
 - v. Facility Maintenance
 - d. Pick Cost Drivers
 - i. Examples
 1. Inspection: Inspection Labor Hours
 2. Machine Costs: Machine Hours
 - ii. Find a correlation between the activity and some driver
 - iii. Pick drivers that aren't expensive to measure
 - iv. How will the company react? Will use of a particular driver get skewed for the wrong reasons?