Activity Based Costing
and
Lean Accounting
Outline

- What is Activity Based Costing?
- Cost Accounting Systems
- Traditional Cost Systems
- Activity Based Costing
- Implementing ABC
- Benefits & Limitations of ABC
- Lean Accounting
What is Cost Accounting?

- Cost Accounting involves the measuring, recording, and reporting of product costs
- Both the total cost and the unit cost of products are determined
Traditional Cost Systems

- Although it may be impossible to determine the exact cost of a product or service, every effort is made to provide the best possible cost estimate.
- The most difficult part of computing accurate unit costs is determining the proper amount of overhead cost to assign to each product, service, or job.
Overhead Costs

- A single predetermined overhead rate is used throughout the year for the entire factory operation for the assignment of overhead costs.
- In job order costing, direct labor hours or costs are commonly used as the relevant activity base.
- In process costing, machine hours are commonly used as the relevant activity base.
Activity-Based Costing

- Allocates overhead to multiple activity cost pools and assigns the activity cost pools to products by means of cost drivers
- An activity is any event, action, transaction, or work sequence that causes the incurrence of cost in producing a product or providing a service
- A cost driver is any factor or activity that has a direct cause-effect relationship with the resources consumed
Activity-Based Costing

- Allocates costs to activities first, and then to the products, based on the product’s use of those activities
- Activities consume resources
- Products consume activities
Activity-Based Costing

- Not all products or services share equally in activities.
- The more complex a product’s manufacturing operation, the more activities and cost drivers it is likely to have.
Unit Costs under ABC

**Activity-based costing involves the following steps:**

1. Identify the major activities that pertain to the manufacture of specific products and allocate manufacturing overhead costs to activity cost pools.
2. Identify the cost drivers that accurately measure each activity’s contributions to the finished product and compute the activity-based overhead rate.
3. Assign manufacturing overhead costs for each activity cost pool to products using the activity-based overhead rates (cost per driver).
Benefits of Activity-Based Costing

- ABC leads to more activity cost pools with more relevant cost drivers
- ABC leads to enhanced control of overhead costs since overhead costs can be more often traced directly to activities
- ABC leads to better management decisions by providing more accurate product costs, which contributes to setting selling prices that will achieve desired product profitability levels
**Benefits of ABC**

- **ABC leads to better management decisions.** More accurate product costing helps in setting selling prices and in deciding to whether make or buy components.
- Activity-based costing does not, in and of itself, change the amount of overhead costs.
Limitations of ABC

- ABC can be expensive to use, as a result of the higher cost of identifying multiple activities and applying numerous cost drivers
- Some arbitrary overhead costs will continue, even though more overhead costs can be assigned directly to products through multiple activity cost pools
When to Use ABC

- Product lines differ greatly in volume and manufacturing complexity
- Product lines are numerous, diverse, and require differing degrees of support services
- Overhead costs constitute a significant portion of total costs
- The manufacturing process or the number of products has changed significantly
- Production or marketing managers are ignoring data provided by traditional cost systems and are using bootleg cost information to make pricing decisions
Activity-Based Management

- ABM is an extension of ABC, from a product costing system to a management function, that focuses on reducing costs and improving processes and decision making.
Lean Accounting

- Lean Accounting is intended to replace traditional accounting and measurement systems; it is **not** intended to be an additional analysis. Lean Accounting is right for companies that are well on the path toward lean manufacturing.
- Lean Accounting is more than a set of tools relating to measurement, capacity usage, value, and continuous improvement. Together these tools become a lean business management system that is radically different from traditional management.
Lean Accounting – The Lean Transition

- An important role for finance and accounting people in the lean organization is to actively support and participate in the transition to a lean enterprise.
Lean Accounting – Management Accounting

- A cornerstone of the lean business is performance measurement. We have few measurements that are focused on the creation of customer value and the achievement of business strategy.
- Measurements are primarily non-financial and are established for cells, value streams, plants, and corporations. Simplified costing and financial planning methods support these measurements.
Lean Accounting – Business Management

- To manage the business we need timely and valid information. Decisions are made using lean principles, not the traditional mass production mentality.
- Replace the department-focused structure with an organization that is focused on customer value and the value streams. Drive the business from value to the customer.
The problems of standard costing need to be addressed. Standard costing is an excellent costing method for traditional mass production; but standard costing is actively harmful to lean organizations.

Replace standard costing with value stream costing. Value stream costing eliminates most transactions and does not rely on allocation and full absorption of costs.
Lean Accounting – Financial Accounting

- While the majority of Lean Accounting affects internal processes, Lean principles are applied equally to the company’s financial accounting. There is much waste to be eliminated.
- Finance and accounting people in the average American company spend more than 70% of their time on bookkeeping and very little time on analysis and improvement.