STARTEGIC ANALYSIS OF OPERATING INCOME (ABC)

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Introduction:

> ABC is method of OH absorption.
> Here Costs are grouped based on Cost drivers rather than Cost Centers which drives Cost of an Activity.
> It provide an opportunity for Cost reduction.
> It ~~ensures~~ makes difference of Cost mgt info from external financial reporting.
> It helps in managing Costs & allocation of resources.

Traditional methods for OH absorption:

Single Rate method or Blanket Rate method

&

Departmental Rate method

<u>Steps:</u>

1. Allocation of OH
2. Apportionment of OH
3. Reapp. of OH
4. OH Recovery Rate
5. Absorption of OH

Disadvantages of Trad. Cost mgt

1. Focus on Cost Centres rather than Cost drivers for allocation of Costs.
2. This method Seeks to measure the Cost per unit of time instead of Cost per product.
3. This method may sometimes goes defective which assume product which takes longer time consumes higher OH.
4. This method does not identify idle/abnormal OH

Modern Method of Cost Mgt - ABC

Terms

- Cost of object
- Cost of Driver
  - Resource Cost driver → Qty of resource Consumed by a activity/Costpool
    - Eg: Distribution Costs.
  - Activity Cost driver → Frequency of usage of particular Cost driver in a activity
    - Eg: Research & Development
- Cost of Activity
  - Costpool

Types of Activity (Manufacturing Cost hierarchy)

Unit level → Batch level → product level → Facility level

Activity Cost driver rate = $\frac{\text{Cost pool / Cost of Activity}}{\text{Activity Cost Driver}}$

Difference b/w Traditional & ABC :-

OH allocation Traditional	ABC
1. Based on Cost Centres. Not realistic.	1. Based on Cost drivers.
2. Only: unit level & Facility level activities.	2. All: unit, batch, product & Facility level.
3. OH rate can be used to ascertain Cost of product only.	3. OH rate can be used to ascertain cost of particular Segment & channel.
4. Cost of object may is approximate	4. Cost of object is reliable & accurate
5. Cost of maintaining the System is low.	5. Cost of implementing ABC ↑ & Complex.

Steps in Implementing ABC:

1. Objective Specification. – a) Improve product costing b) Remove Non-Value added items
2. Identification of Costs for ABC.
   a) Direct costs
   b) Indirect costs for specify activity
   c) Indirect costs which are not product specific require ABC.
3. Process Specification / Identifying Activities
4. Selection of activity drivers.
5. Allocation of Costs using Cost drivers to Cost pools
6. Staff Training
7. Review & Followup.

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