



An Exemplary Analysis of Importance of Activity Based Costing Method

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ABSTRACT

The objective of this paper is to know the various shortcomings of the conventional costing system and to know the various advantages of implementing the activity based costing system. In this paper the importance of the ABC system is presented through the illustration and it shows that how the adoption of ABC system can change the decision making process.

Key words: Activity based costing system; Traditional based costing system, costing system.

INTRODUCTION:

As we all know very well that the need of human being leads to the invention and innovations. The drawbacks/Limitations of the financial accounting give birth to the cost accounting. The oldest method of accounting is financial accounting. It involves identifying and recording business transactions which are of financial nature and summarizing and interpreting the results thereof. The basic objective of financial accounting is to determine net profit or net loss incurred during a year. It is generally concerned with the preparation of income statement (profit and loss account) and positional statement (Balance sheet). This information is helpful for the outsiders only (i.e. creditors, customers, suppliers, and regulatory commissions, etc.) but it doesn't provide any information which is useful for the management point of view. It provides only the past data and is unable to exercise to control over the resources. In financial accounting we are unable to calculate per unit cost of the product/s. It also unable to provides the detailed report on each element of cost. Without the knowledge of per unit cost of the product any organization would be unable to scientifically determine the selling price of their product/s. In the present era of cut-throat competition, it has now become imperative for the manufacturers to make regular efforts for improving the quality of their products and controlling cost.

RESEARCH OBJECTIVES

- To investigate the impact of ABC implementation through illustration on the decision making process of the organization.

ACTIVITY BASED COSTING: EXPLANATION THROUGH THE EXAMPLE:

Let there are three production departments A,B & C and one service departments X. Sale during the year was Rs. 20,00,000, 4,00,000 & 8,00,000 respectively. The total cost incurred (Direct + Indirect) for service department was Rs. 20,00,000. The gross margin ratio is 10%. The services of X Department were utilized by production departments (A, B & C) 2 times, 3 times & 5 times respectively. What will be the difference on decision making while using traditional cost system using volume as the basis for allocation and by using Activity based costing system.

Solution:

Table:1-Computation of Net profit on the basis of Traditional Costing System

	A	B	C
Sales	20,00,000	4,00,000	8,00,000
Gross Profit (10%)	2,00,000	40,000	80,000
Less: Distribution of Overheads of X Deptt. (5:1:2)	12,50,000	2,50,000	5,00,000
Net Profit	5,50,000	1,10,000	2,20,000
Ranking of the products	1 st	3 rd	2 nd

Note: The distribution of the overheads of X Department is done on the basis of volume as generally considered by the traditional costing system. So the ratio is 10,00,000:2,00,000:4,00,000 or 5:1:2.

Table:2-Computation of Net profit on the basis of Traditional Costing System

	A	B	C
Sales	20,00,000	4,00,000	8,00,000
Gross Profit (10%)	2,00,000	40,000	80,000
Less: Distribution of Overheads of X Deptt. (in the ratio of services utilized) (2:3:5)	4,00,000	6,00,000	10,00,000
Net Profit	14,00,000	(2,40,000)	(2,80,000)
Ranking of the products	1 st	—	—

Note: The distribution of overheads of X department is done on the basis of services utilized by the various department as generally used by the ABC system. So the ratio is 2:3:5.

ANALYSIS:

From the above table 1 we can conclude that all products are profitable and advised to continue production of all the products. The total profit will be Rs. 8,80,000.

While observing the table 2 we can say that only product A is profitable and other both (B & C) are in loss. It is advisable to discontinue the production of product B & C. The profit of the firm will be 14,00,000 which is 5,20,000 higher as compare to the table 1.

CONCLUSION:

Thus from the above we can concludes that why we need an appropriate system for costing for taking correct decisions. ABC system help the management to take more correct decisions as compare to traditional cost system. In the above we have seen that due to incorrect system of apportionment of overheads the company will operated with all the three products as it seems to be profitable and by using ABC system we are able to see the correct picture. We can see the loss making products which will help to the management for taking the corrective actions.

So from the above study it is recommended that companies should focus on the implementation of Activity based costing system to get the benefits associated with the above system.