

Abc systems essay



**ASSIGN
BUSTER**

Measurement of cost by traditional costing method and ABC costing method are greatly different.

ABC allocates the activity costs into products by cost drivers, while traditional costing method uses quantity drivers (direct labor cost) to allocate costs. Since the use of the traditional costing method was not avoided of products loss, we may as well say then that its continual use would be a wrong economic decision. It is impossible to get correct activity information of each activity and the activity channeled towards production by using traditional costing method, while this can be achieved easily and accurately by ABC method. With the use of ABC, E Lab could now analyze which activity is tends towards loss of products, in order to discuss the possibility of reduction of such activities. 3. The product loss, measured by traditional costing method, was not encountered by ABC method since ABC could accurately allocate cost information.

Through the calculation of ABC, we are able to know the production of which good consumes activity most, which cost of activity is highest, helping us knows how to decrease cost and enhance efficiency. For example in E Lab's plant, the unit activity cost is the highest no of batches, its total cost is also the highest, and then the second highest cost is maintaining activity. It is necessary we look for alternative ways of carrying out these activities such as decreasing electricity consumption per hour, in order to decrease the activity cost per hour of operating machine activity. In that case, ABC method brought a great advantage for E Lab. If it used absorption costing systems normally calculate their product costs to on direct labor cost which

is not according to the activities. This gives the impression of a high degree of accuracy but it is really an example of mathematical precision.

Because of the arbitrary correlations used by this traditional approach, it is quite possible that the two products have the same over head, i. e. Badchlor and Adchlor. If this is so, the calculation shows that it is a waste of resources, giving a misleading answer.

A traditional absorption costing system may be cheaper to operate than an activity-based costing system but the cost of the errors resulting from its inaccuracies can be far greater. One important factor affecting the cost effectiveness of ABC systems is the continuous fall in the price of information technology. The rapid revolution in information systems is greatly reducing their operating costs whilst, at the same time, greatly increasing their effectiveness (Proctor R. 2000, p72). ABC overcomes all these disadvantages which absorption costing system has, as we can see, the reason of adopting ABC method is not only for costing calculation purpose, but also focus on customer service, management decision etc. , everything in a company will be considered into costing, activities will be the core for costing calculation, these will make ABC system more accurate for the modern style manufacturing definitely.

After the above discussion now we are going to analyze that why the product cost and the profitability is different in two approaches. As we have discussed that the traditional costing is based on direct labor costs i. e. 15600000 for Adchlor 15600000 for Badchlor and 4680000 dollars and if we allocate the over head costs but the above base the first two products have

the same cost but in actually the two products are manufactured in different batches and the number of batches for the two products is different so this problem is resolved by using activity based costing. In the traditional costing income statement the product Adchlor has a loss because of the wrong base for allocation of overheads.

Actually the costs associated with the product Cifchlor is allocated to the Adchlor which will raise the product cost and thus results in the loss for those products. This point is very important to the company as the management has cash flows problem so they have to make decision that which product is loss generating products so to reduce or ends up the production fir that product. But that problem is solved by using the activity based costing and this reveals the product Adchlor is generating good profits. By using the traditional costing income statement the overheads allocated to the three products line costs are 2147934, 2147934, and 644379 for Adchlor, Badchlor and Cifchlor respectively and using activity based costing the product line costs are 1917459, 2838000 and 829170 which shows that the product costs are allocated arbitrary and have the huge differences in the overheads costs. The overheads are allocated to the production on the basis of labor costs in traditional costing and in ABC method the base is used is the no of batches and the lots in which the products are produced.

The ABC method completely change the picture of the profitability of the three products as initially the Adchlor is in loss but actually that product is generating profit. Conclusion: The above discussion reveals the fact that the traditional based costing is not so realistic than activity based costing. E Lab can make decisions about the pricing and how to reduce the costs

associated with the product line and run with the current market situation. The profitability of the company can be increased by producing greater no. of batches and lots.

The ABC method opens the new doors for the profitability for the E Lab Inc. as the method is very significant for the pharmaceutical companies because the pharmaceutical products are made according to the no. batches or lots so the overhead is allocated to the products on more realistic bases and the pricing mechanism will work effectively. References: Mats and Usry.

Costing: Activity Based Costing. 2004