

Definition of activity-based cost accounting

[Business](#), [Accounting](#)



The matching principle of accounting dictates that for every revenue generated, a corresponding cost should be attributed to it. In order to determine the resulting profit properly, these components should be matched against each other.

This has been the guiding convention of financial reporting since the practice of accounting became an integral part of the economy to evaluate properly a firm in a somewhat standardized format.

Business firms, particularly, those engaged in production, adheres to the standards promulgated by their respective accounting standard-setting bodies. However, as far as internal users are concerned for purposes of making business strategies, financial accounting is too narrow.

As such, the management of a business firm can easily suspend this principle and adopt different methods of deriving cost information, as long as it would fit their specification. This practice has different effects in the evaluation of the firm's own performance.

Through the years, several efforts were exerted to improve revenue and cost matching that provides relevant information for evaluation purposes, and one of these is Activity Accounting. Activity Accounting has two phases: activity-based costing (ABC) and activity-based management (ABM).

Whereas the first phase provides useful insights and feedback in improving competitiveness through effective resource management, the second one emphasizes continuous improvement of processes. ABC is defined as a costing system in which numerous overhead cost pools are allocated using one or several non-volume related factors as bases.

Even though ABC likewise traces direct materials and direct labor the same way as TCA, it traces indirect costs, not on the number of output, but on the activities involved in the production process. As such, ABC is considered a more detailed and useful cost-tracing tool.

To illustrate, assume a company producing two distinct products, Product A and Product B, has accumulated manufacturing overhead cost amounting to \$1, 000, 000. 00. Assume further that it would take two direct labor hours (DLH) to produce Product A and five DLH for Product B, and total DLH for the whole period is 5, 000.

At the end of the period, there were 500 units of Product A and 1, 000 units of Product B. Finally, assume that direct cost per unit for Product A is \$250. 00 while that of Product B is \$350. 00.