The limitations of activity based costing accounting essay

ABC Costing is a modern costing technique that is used to determine the cost of the product for the management reporting purposes. ABC Costing System is a tool that is used in decision-making process. However, it has some certain limitations.

ABC Costing System is very costly to implement and maintain in a manufacturing and serving departments. Data concerning numerous activity measures must be collected, checked, and entered into the system. Which raise the labor requirement and need to be scrutinized on activity basis?

ABC costing systems produces the reports that are different from the profit and loss reports produced through traditional costing systems.

As most of the companies are using traditional costing systems, so because of the difference in the costing basis the costing and financial reports of the two companies of the same industry could not be compared for performance evaluation purposes.

Adaptability of ABC Costing System is not suitable for all kind of companies because small companies have not many resources to adapt it and have too many activities but size of transactions is too low.

Data Produced through ABC Costing System can easily misinterpret and can lead towards wrong decisions. So manager should use the data produced through ABC Costing System with extreme care and should assign the costs that are relevant to the products, customers and should not consider the other cost objects that are irrelevant.

ABC costing system does not comply with the GAAP and a company has to produce its reports for internal and external purposes by using traditional and ABC costing system both at a time.

In ABC costing system costs are allocated on the base of cost drivers and activities undertaken to manufacture the product, definitely, it provides the accurate and proper allocation of the costs to the products but there is a danger of over or under costing of the products when irrelevant cost drivers or activities are assigned to the products or services produced.

Q2) Please explain the differences between FIFO and Weighted Average Method in the process industry. How are units accounted for? How are costs accounted for? In periods of low inflation what method would make a difference? From a TAX point of view, does it make a difference?

Differences in Weighted Average and FIFO Costing Systems:

The main difference between FIFO and Weighted Average Costing systems is the method of calculation of the inventory and cost of goods sold in process costing system.

Valuation Method:

In FIFO costing method, costing department assumes that the goods that are sold earlier are the goods that are brought earlier and so on. The cost of goods sold is calculated on the base of the sequence of goods brought and sold.

In Weighted Average costing method, goods are valued on the base of total goods available for sale and ignore the sequence of their arrival in inventory and sales to the customer. Formula of the cost of goods available for sale or cost of sale is as follows:

Cost of total available for Sales ($)

Per Unit Cost of Goods Sold =

Total No. Of Units available for Sales

Suitability:

FIFO method can only be used where inventory can be separated easily and the cost of the inventory can be determined like computer, vehicles and other industries of the same nature.

Weighted Average Method is the most commonly used method and can be applicable in all industries but the organizations engaged in those products that could not be separated like oil; Natural Gas and LPG etc use particularly weighted average costing method.

In calculation of units accounted for FIFO method consider the units started and completed in the current period only and the beginning work in process units and its cost remain separate and it is considered that the opening work in process units are completed first and then new units started and completed in the same time period and units costs are calculated separately for beginning work in process units and units started in current period.

While in average costing method, equivalent production is calculated and based on equivalent production the cost of unit is determined and allocated to the production.

Q3) Can you explain the advantages and disadvantages of the Standard Cost system?

Advantages / Benefits of Standard Costing System:

Standards are the key factors that are used in management by exception approach. If costs remain within the standards, managers would be satisfied and would concentrate at routine activities but if it across the standards then it would be an alarming situation for the managers and they would try to analyze the reasons of inefficiency.

Standards are the targets that have been set by the management to achieve and they compare the actual performance of the employees with the standards.

Standard costs simplify the book keeping process as well by charging the standard cost to the job or product and by making the adjusting entry of the variance at the end of the period.

Standard costs fit naturally in an integrated system of responsibility accounting. The standards establish what costs should be, who should be responsible for them, and what actual costs are under control.

Disadvantages / Problems / Limitations of Standard Costing System:

Frequency of reporting the variance is too low that make the précised and useful data useless due to its release too late when it became out of date.

Labour variances consists mainly on labour quantity standards and labour efficiency variances and in both variances it is assumed that the production is highly labour intensive and the factor of machines performance is ignored.

There are some cases where a " favourable" variance can be as bad as or worse than an " unfavourable" variance i. e McDonald's has a standard for hamburger meat that should be in a Big Mac. A " favourable" variance would mean that less meat was used than standard specifies. The result is a substandard Big Mac and possibly a unsatisfied customer.

In standards costing system, meeting the standards of production and cost efficiency has more importance and other factors like quality of the products and satisfaction of the customer have been ignored.

In standard costing approach, the standards are considered the final destination and improvement process become very slow or stopped.

Q4) Please explain the following: NET PRESENT VALUE CONCEPT. If the NET Present Value is … Then the PROJECT ISPositive …. Acceptable since it promises a return greater than the required rate of return!

Net Present Value Approach:

NPV is a technique used in the management accounting for the decision-making and covered under the head of capital budgeting. In NPV approach the present value of the net inflow and outflows are compared by taking the effect of inflation and other factors influencing the value of money.

The present value of the cash outflow is adjusted against the present value of the inflows resulting from the investment and multiplying with the discount factor to equate it to the present value of this future inflow. Then the results are compared with the following table.

If the net present value is

Then the project is

Positive

Acceptable since it promises a return greater than the required rate of return

Zero

Acceptable, since it promises a return equal to the required rate of return.

Negative

Not acceptable, since it promises a return less than the required rate of return

Q5) Please explain a comparison of the Net Present Value and the Internal Rate of Return Methods. Which method do you like? What are the strengths of each.

Comparison between NPV and IRR Method:

In most of the conditions, Net Present Value Approach and Internal Rate of Return Method provide the same results. However, some times these present opposite results.

When we compare both methods, we consider the mechanism working behind both techniques. In internal rate of return, a rate of return is calculated based on the future net income arising from the investment by using given formula:

IRR = Initial Investment

Net Income

Then this required rate of return is compared with the required rate of return from investment, if IRR of the investment is greater than the required rate of return then the project is accepted otherwise the project is rejected. This method is much better than payback period and other old methods, because it considers the income of the projects to evaluate the project and also take account the inflows after the completion of payback period.

In NPV method the present value cash outflow is matched with the present value of the cash inflows arising from the projects and if the NPV is positive then the project is accepted otherwise rejected. NPV Approach is better approach then IRR because IRR completely ignores the time value of the money and just consider the net income arising from the project whereas NPV is based on the time value of the money by considering the inflation factors.

Q6) Managerial Accounting can work in many fields – manufacturing and in the service industry. Provide some examples of how Managerial Accounting can work in your industry using some of the tools you learned in this course? If in the Health Field, Could Relevant Costs be of use?

Application of Managerial Accounting:

Managerial Accounting has equal application in the service and manufacturing industry as well. There are three major an aspect for which managerial accounting is widely used.

Decision Making

Products Pricing

Performance Evaluation

Decision Making:

One of the most important functions of the management is to make the right and timely decisions for the development and security of the going concern status of an organization. This function is required in all kind of industries whether services or manufacturing. Managerial Accounting tools are used to provide the basis for comparison and making the accurate decisions.

Product /Services Pricing:

Every business has been established in order to earn some financial benefit and every business whether it deals in goods or services have to charge a price from its customers for the use of products or clients against the services provided. So managerial accounting tools and techniques would be used in order to determine the price of the goods or services to achieve the targeted profit.

Performance Evaluation:

Performance evaluation is required in all business areas and managerial accounting techniques would be used to evaluate the performance of a particular organization by comparing it with the same kind of industry or performance of the departments and businesses could be compared but all of these tasks are accomplished by the effective use of managerial accounting.

Relevant costing techniques are used in all industries and have application in the health field as well. The price charged to the patients should be formulated by keeping the factors of relevance in mind and historical costs should be eliminated when there are surplus capacity is available.