

# Absorption costing: advantages and disadvantages



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BUSTER**

There are two main costing methods that this company can use, absorption costing and Activity based costing. Absorption costing and Activity based costing (ABC) are two similar systems that are used to assign indirect costs to cost objects. Absorption costing is also called 'traditional costing'; it is more simplistic and uses arbitrary allocation. On the other hand, ABC is more sophisticated and uses cause-and-effect allocation. This report will deal with the different definitions, the history, the advantages and disadvantages of absorption and ABC systems. Then final a recommendation on which system is better suited for this company.

This company needs either of the two costing system because they are useful during planning and budgeting. Furthermore having the systems in place will allow overheads to be charged to services.

## **ABSORPTION COSTING**

" Absorption costing is a method of costing that, in addition to direct costs, assigns all, or a proportion of product overhead costs units by means of one or a number of overhead absorption rates." Cima (2005)

" Absorption costing systems is a costing system where manufacturing costs are allocated to products and non manufacturing costs are not allocated to the product but charged directly to the profit statement and excluded from the inventory." Drury (2008)

" Absorption costing is a system in which all the fixed manufacturing overheads are allocated to the products." Drury

From all these definitions the CIMA definition is the better definition because it mentions most of the key processes that are involved in absorption costing which straight away gives you an idea of what absorption costing is. The other definitions are also good as they state some processes involved in absorption but CIMA puts the definition in a more understandable way.

## **History**

This costing system was developed decades ago when companies were much smaller and had less overhead costs. During the time this system was developed there were mostly industrial companies which made this system suitable to assign costs to cost objects.

### How it works

This company currently operates under absorption costing system for working out overheads for their services. Working out absorption costing involves a two stage process. Stage one considering the allocation and apportionment of indirect costs to service and production cost centres and then apportionment of the service department to production department. Allocation is the process of estimating the cost of resources consumed by a product that does not use direct measures. This process deals with overheads that can be directly assigned to cost centres without the need to be apportioned. Cost apportionment is a process of charging indirect costs to cost centres that can't be directly allocated. Service department overheads are transferred to the production department so they can be covered.

Stage two works out the absorption rates that are then used to charge overheads to cost objects. The absorption rate worked out is used to calculate the total overheads of a product.

From all these three stages only allocation is used in ABC.

There are advantages and disadvantages of absorption costing:

### **Advantages**

Inexpensive and simple to operate. Absorption costing is simple to operate which makes it less expensive to operate. This is good for the company as it allows them to reduce their costs and understand what they are doing.

### **Disadvantages**

Less accurate. It's good that the system is simple, but this makes it less accurate when charging costs to cost objects because of the intensive use of arbitrary allocation. Arbitrary allocation is when an allocation base used is not a considerable determinant of its cost. Not knowing all the exact causes of certain costs will make it difficult during planning and budgeting.

Absorption costing emphasises on variable and fixed costs. This makes it difficult for the company to use information from this system for decision making; it's not detailed enough to help the business make predictions or budgets.

## **ACTIVITY BASED COSTING**

Different sources define ABC in different ways:

“ An approach to the costing and monitoring of activities which involves tracing resource consumption and costing final outputs. Resources are assigned to activities, and activities to cost objects based on consumption estimates. The latter utilise cost drivers to attach activity costs to outputs.”

Cima terminology

“ Activity based costing is a refinement of absorption costing that aims to charge overhead costs in much more detail so that the overhead cost can be charged on the basis of a cost driver.” Drury (2005)

Between these two definitions Cima definition clearly states what ABC is all about and mentions cost drivers which are a key area of this system. While the other definition does not specifically state what is involved in ABC e. g. cost drivers though it does point out that it's similar to absorption costing. Overall, the Cima definition is better as it is a more detail explanation.

## **History**

ABC system was developed when the current system then (absorption costing) was becoming less useful for assigning costs to products in the changing business environment. In the 1980s companies begun to increase in size and producing wider product ranges and services. Information processing costs were high, which made it difficult for sophisticated overhead allocation methods to be justified. There was an increasing demand for more accurate product costs; this led to the introduction of the ABC system. Cooper and Kaplan conceptualised the ideas behind this system as a way of trying to improve the accuracy of the charge made to cost objects in complex business environments.

## How it works

ABC system is worked out differently compared to absorption costing. They both use the two stage allocation process to assign overheads to cost objects. First stage overheads are assigned to cost centres and in the second stage the cost accumulated in the cost centres are allocated to cost objects. ABC differs from absorption costing by having more cost centres in the first stage and a greater variety of cost drivers in the second stage.

Exhibit 1 shows an example of a company's annual overhead costs which it will use to show how ABC works. Similarly to absorption costing, an overhead analysis sheet is produced where overheads are allocated to cost centres. This is shown in exhibit 2. Then activities are identified for each cost. From exhibit 3 column A, you can see that there are lots of activities that have been identified from major activities e. g. General factory support. The costs created over a specific period have to be assigned to the activities. When costs are accumulated by activities they are called activity cost drivers. Activity cost drivers have to be selected for each activity centre in order to assign the cost attached to products. In exhibit 3-column C and D you can see the activity cost drivers and the cost they each accumulate. Cost driver rates are worked out for each activity. Finally, the cost driver rates are applied to products. In exhibit 4 there is an example of Product G that is produced and uses various activity cost drivers and cost driver rates are applied.

There are advantages and disadvantages of having ABC in place, these are:

## **Advantages**

Helps identify unprofitable items from the product line. This will allow the company to make changes to their production, and improve their efficiency. Removing these unprofitable items reduces unnecessary costs the company may be encountering. Also it enables the company to increase its profit without the need to increase prices.

Provides quantifiable figures for planning and estimates. ABC identifies all the different cost drivers that contribute to the total overheads of producing a product or service. This will help when giving quotes to customers as well as for the business to see if taking up a certain project will be profitable to them.

ABC uses a large number of cost centres in the first stage and a greater variety of allocation bases in the second stage. This makes the system accurate at charging overheads to products. Accurate cost charges to products or a service reduces the risk of making a loss if the right amount is not charged.

## **Disadvantages**

Expensive to operate. The complexity of this costing system makes it expensive to operate compared to other alternatives. The business will have to invest time and resources in order for them to identify the cost drivers. E.g. one of the steps needed to identify cost drivers is to interview staff and have them fill in time sheets. This process will reduce the production time available to the company.

Time consuming. Using ABC is a very long process and requires a lot of information to implement; this is time consuming for the company and its staff.

There is too much attention to detail and control. Sometimes paying close attention to detail might make it difficult for the company to see the bigger picture or make the firm lose sight of strategic objectives just to seek for small savings.

It may be difficult to implement. In service companies there are costs that are difficult to allocate to specific service units and service department, staff often get involved in many non informal activities which may be challenging to record cost data.

## **Recommendations**

Given that the company supplies services to government bodies and operates under absorption costing, I recommend that we should change the costing system to ABC as it will be more suitable for the company. This costing system may be difficult to implement in service companies but it shows the company more detail of the various costs involved in each service they provide which is essential during decision making and planning.

To implement ABC there certain things the business will have to do:

Proper planning and commitment from staff, carrying out a pilot study first may be vital. This will provide information about whether having ABC will be a benefit to the company.



A team will have to be set-up that will be responsible for determining which activities are necessary for the services. The team should be made up of experts from different departments of the company and a consultant from outside can be used. Having individuals from different allows accurate identification of overheads involved. 5

When a team has been assembled, elements of each activity that cost money are determined. Attention to detail is vital as some costs are hidden.

Once all the costs have been identified and recorded, they have to be put in a computer system.

After the business has had enough time to analyze the data they can use the information in various ways e. g. working out total overheads for each service.

## **Conclusion**

Absorption costing has been around for a long time, ABC was developed as an improvement of absorption costing. ABC is a more accurate costing system compared to absorption costing as it looks at individual activities that contribute to the total overheads, while absorption costing looks at departments. Having looked at both advantages and disadvantage of the two costing systems it is clear that even though they are similar they have significant differences. I have recommended that we introduce ABC, it will be a huge benefit for the company as it will decrease the number of errors made during costing.