

What are the differences between absorption costing and abc?



Introduction

Absorption costing is the process which charges fixed and variable overheads to individual cost units. This means that it takes into account all costs incurred in the production of the product; they are absorbed.

Activity based costing (ABC) however, assigns manufacturing overhead costs to activities and processes in the business. It therefore gives a more accurate costing to individual cost units (products) but it is more timely and therefore more expensive. Therefore it depends on the company as to which method they would implement. Expenses such as salaries, rent and other indirect costs are therefore able to be taken into account when costing a product. An activity is a task that occurs over a period that consumes resources (e. g. raw materials and electricity) in a bid to transform inputs (e. g. labour) into outputs (the final product).

There is also another widely used costing method: Marginal costing. This method treats fixed costs as period costs.

Costing is important to a company as it helps with budgeting, but mainly so that they can 'cost' up the price to make a product or a batch of products. Without costing, a company would not be able to give an accurate cost price and therefore final retail price as they wouldn't know much it costs them to make the product.

What are the differences between Absorption costing and ABC?

There are two main methods of costing, absorption and activity based costing. There are some vital differences between the two and so the pros and cons of each must be taken into account to assess the suitability of each method.

The main difference is that ABC takes more than one cost driver into account, meaning that the final costing figure is more accurate than when using the standard absorption method, for example if a company made two similar products; product 1, which is a low volume item that requires many machine setups, more testing, and special engineering tasks and product 2, which is a high volume item that requires minimal setups and special operations, and is running continuously. If we were to apply the traditional absorption costing method, it would use the machine hours as the cost driver, and so product 2 would incur massively higher costs, due to it using the most machine hours, even though product one required far more additional activities, setups, and testing. This shows how the traditional method is not appropriate when a company produces multiple products/services that require very different inputs.

ABC is a more accurate system for assigning costs to products, as it traces all activities and assigns them to products by using multiple cost drivers. It also allocates the usage of common business resources to each product, again by the use of cost drivers such as labour hours. It is also useful for identifying products/services that are too costly to be profitable; although

they may seem to be generating a profit, they actually use up far too many resources to be profitable.

However, there are disadvantages to this method; high volumes of specific data must be accurately collected, which could prove to be extremely time consuming. It can also itself incur costs, as it would be fairly costly to implement.

Absorption costing also has its advantages over ABC; it is far easier to implement and run as it requires less volume of data and only takes a few cost drivers into account, normally machine/labour hours.

However, disadvantages include the fact that it doesn't take into account any indirect costs such as administration and distribution costs; it focuses on the fixed and variable costs. Also, it does not differentiate between fixed and variable costs, therefore the final costing can sometimes be inaccurate. It is also very difficult for management to make decisions based on the costing figures as they may not be accurate enough for the managers to make an informed, concise decision.

What steps would the company need to take if it was to introduce an ABC

For the company to introduce an ABC system, some careful planning and procedures must be put into place for it to be implemented correctly. The company must identify all the main activities in the business. An activity is the grouping of small units of work or tasks. An example of an activity would be the purchasing of materials and the tasks involved would be preparing the purchase orders, identifying supplier etc. The activities can be identified

using activity analysis. Such analysis would identify how the work space is being used and the payroll listings. These two would give the company an initial idea of the activities involved. Also, interviews with employees would be undertaken establishing questions like how they use their time. These all would help establish different activities. They can be grouped into larger generalised activities as it would prove costly and time consuming to have each individual activity as opposed to a general one. This is called an activity cost centre. An activity cost centre is normally a department.

Costs must then be assigned to activity cost centres. The costs of resources consumed such as labour hours must be established; the overhead costs such as lighting would be shared by other activities. The apportionment of these overhead costs must be undertaken to 'split' the indirect costs and assign them to activity cost centres.

Appropriate cost drivers would then need to be chosen for assigning the cost of activities to each of the cost objects. A cost object in the case of this company would be the services that it provides. The three main cost drivers would be transaction, duration and intensity drivers.

The final stage in implementing an ABC would be to assign the cost of activities to the services the company provides. This involves applying the cost driver rates to the services it provides. This is why the cost drivers must be measurable, or else there wouldn't be a way of quantifying the data. The direct costs must also be factored into each of the services. This will then give final costs for each of the services the company provides.

Describe and explain the differences between:

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an allocation

an apportionment

Absorption rates.

Allocation is the process of assigning overheads that are directly linked to the activity cost centre whereas apportionment is used where the overheads cannot be directly linked to the activity cost centre and have to be shared between several of them. An example of a cost that would be allocated would be raw materials and an overhead that would be apportioned would be lighting costs for the offices. The absorption rate however, predetermines the fixed and variable costs to each of the activity cost centres.

I would suggest that the company uses the ABC costing method as opposed to the absorption method. I have come to this conclusion as a result of the following research undertaken below. Because the company provides various services to government bodies, each one is different and is tailored to suit each job. Therefore, the company doesn't produce a generic service, and so ABC would be more suitable. If they were to implement an absorption costing method, costs would not be charged to each job accurately; it would only be based upon one cost driver, which I would assume would be the time it takes to produce and provide the service. This however would not be the case, as they would have to take into consideration other cost drivers such as hours of research undertaken and amount of data needed to be collected.

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