



SNS COLLEGE OF TECHNOLOGY

An Autonomous Institution

Coimbatore-35



Accredited by NBA – AICTE and Accredited by NAAC – UGC with ‘A+’ Grade
Approved by AICTE, New Delhi & Affiliated to Anna University, Chennai

Department of Automobile Engineering

III YEAR/ VI SEMESTER

19MEE301 / Engineering Economics and cost Analysis

UNIT-5

Traditional costing approach

The traditional method of cost accounting refers to the allocation of manufacturing overhead costs to the products manufactured. The traditional method (also known as the conventional method) assigns or allocates the factory's indirect costs to the items manufactured on the basis of volume such as the number of units produced, the direct labor hours, or the production machine hours. We will use machine hours in our discussion.

By using only machine hours to allocate the manufacturing overhead to products, it is implying that the machine hours are the underlying cause of the factory overhead. Traditionally, that may have been reasonable or at least sufficient for the company's external financial statements. However, in recent decades the manufacturing overhead has been driven or caused by many other factors. For example, some customers are likely to demand additional manufacturing operations for their diverse products. Other customers simply want great quantities of uniform products.

If a manufacturer wants to know the true cost to produce specific products for specific customers, the traditional method of cost accounting is inadequate. Activity based costing (ABC) was developed to overcome the shortcomings of the traditional method. Instead of just one cost driver such as machine hours, ABC will use many cost drivers to allocate a manufacturer's indirect costs. A few of the cost drivers that would be used under ABC include the number of machine setups, the pounds of material purchased or used, the number of engineering change orders, the number of machine hours, and so on.

Activity Based Costing

Activity-based costing (ABC) is a methodology for more precisely allocating overhead to those items that actually use it. The system can be used for the targeted reduction of overhead costs. ABC works best in complex environments, where there are many machines and products, and tangled processes that are not easy to sort out. Conversely, it is of less use in a streamlined environment where production processes are abbreviated.

The Activity Based Costing Process Flow

Activity-based costing is best explained by walking through its various steps. They are:

Identify costs

The first step in ABC is to identify those costs that we want to allocate. This is the most critical step in the entire process, since we do not want to waste time with an excessively broad project scope. For example, if we want to determine the full cost of a distribution channel, we will identify advertising and warehousing costs related to that channel, but will ignore research costs, since they are related to products, not channels.

Load secondary cost pools

Create cost pools for those costs incurred to provide services to other parts of the company, rather than directly supporting a company's products or services. The contents of secondary cost pools typically include computer services and administrative salaries, and similar costs. These costs are

later allocated to other cost pools that more directly relate to products and services. There may be several of these secondary cost pools, depending upon the nature of the costs and how they will be allocated.

Load primary cost pools

Create a set of cost pools for those costs more closely aligned with the production of goods or services. It is very common to have separate cost pools for each product line, since costs tend to occur at this level. Such costs can include research and development, advertising, procurement, and distribution. Similarly, you might consider creating cost pools for each distribution channel, or for each facility. If production batches are of greatly varying lengths, then consider creating cost pools at the batch level, so that you can adequately assign costs based on batch size.

Measure activity drivers

Use a data collection system to collect information about the activity drivers that are used to allocate the costs in secondary cost pools to primary cost pools, as well as to allocate the costs in primary cost pools to cost objects. It can be expensive to accumulate activity driver information, so use activity drivers for which information is already being collected, where possible