

ACTIVITY BASED COSTING IN SERVICE INDUSTRY



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ABC FUNDAMENTALS



ABC: Four Questions



- ❧ What activities are being performed by the organisational resources?
- ❧ How much does it cost to perform organisational activities and business processes?

ABC: Four Questions (Contd.)



- ❧ Why does the organisation need to perform activities and business processes?
- ❧ How much of each activity is required for the organisation's products, services and customers?

Traditional Method: Limitations



- ❧ Focuses on manufacturing costs
- ❧ Inappropriate when **variety of products** passes through the same cost centre and do not create **uniform demand** on all the resources in the cost centre.

ABC: Fundamental Principle



- ❧ ABC is based on the principle that products (services), customers and markets create demand on activities and activities create demand on resources.
- ❧ Cost should be collected against activities and then, those should be assigned to products (services), customers and markets.

Activity Categories



- ✧ Unit level activities
- ✧ Batch level activities
- ✧ Product (customer) sustaining activities
- ✧ Facility level activities

Product (Customer) Sustaining Activities

- ❧ Those activities are independent of the production or sales volume.
- ❧ They are independent of the quantity of production batches and customer orders.

Stages of ABC



- ❧ Identify different activities and create activity pools.
- ❧ Similar activities should be clubbed together to create activity pools.

Stages of ABC (Contd.)



- ❧ Relate overheads to activities, both support and primary, using resource cost drivers.
- ❧ This creates 'cost pools' or 'cost buckets'.

Stages of ABC (Contd.)



- ❧ Spread support activities across the primary activities on some suitable bases.
- ❧ The base should reflect the use of support activities by primary activities.
- ❧ The base is the cost driver.

Stages of ABC (Contd.)



Assign costs of activities to products or services or customers using **activity cost driver** rates.

Activity Cost Driver: Examples

<i>Activity</i>	<i>Activity cost driver</i>	<i>Batch/Product level</i>
Run machines	Number of machine hours	Batch level
Set up machines	Number of set ups or set up hours	Batch level
Schedule production jobs	Number of production runs	Batch level
Receive material	Number of material receipts	Batch level
Support existing products	Number of products	Product level
Introduce new products	Number of new products introduced	Product level
Modify product characteristics	Number of engineering change notices	Product level

ABC: IT Architecture



- ✧ Assigning activity costs to each product/service/customer requires information on the quantity of activity cost driver for each individual product/service/customer.
- ✧ This requires collection of a large amount of information.
- ✧ Therefore, ABC cannot be implemented without adequate IT infrastructure.

ABC IN SERVICE INDUSTRY



Service Organisations: Unique Features



- ❧ Insignificant direct costs (marginal costs)
- ❧ Prior commitment of resources
- ❧ No linkage between costs and revenue
- ❧ Significant product and customer-sustaining costs

Demand For Cost Information



- ❧ Managing products and customers
- ❧ Configuring the customer service delivery chain
- ❧ Budgeting the organisation's supply of resources

Managing Products and Customers



- ❧ In a manufacturing company, 'manufacturing costs' are customer independent.
- ❧ For service companies, the basic operating costs are determined by customer behaviour.

Configuring The Customer Service Delivery Chain

- ❧ Preferences of customer segments differ
- ❧ Companies can tailor their offerings and methods of delivery to satisfy the preferences.

Budgeting The Organisations Supply of Resources

ABC helps linking budgeting decisions that authorize the supply of resources for individual responsibility centres to the demands of products and customers, for the activities and services provided by these responsibility centres.

CASE STUDY



HOSPITAL



- ❧ In-patient departments are similar to shop floor manufacturing.
- ❧ Example is standard procedures and protocols in an operation theatre.
- ❧ However, the legacy system fails to assign support service costs to responsibility centres.

HOSPITAL (Contd.)



- ❧ Assigning costs to OPD offerings and customers is extremely difficult under the legacy system.
- ❧ Hospitals offer variety of services and customers' behaviour differ significantly.

Bank Wealth Management



- ❧ Variety of offerings
- ❧ Profile of customers and their demand on resources vary significantly
- ❧ Legacy system fails to correctly ascertain the cost of offerings and servicing customers.



THANKS