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| A R T I C L E | |
| Activity-Based Costing represents more than the ABCs of accurate  product cost calculations.  It’s a direct line to higher profits.  *New sections to guide you through*  *the article:* *The Idea in Brief*  * *The Idea at Work* * *Exploring Further. . .* | Profit Priorities from Activity-Based Costing by Robin Cooper and Robert S. Kaplan  P R O D U C T N U M B E R 3 5 8 8 |

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## T H E I D E A

I N B R I E F

Any way you slice it—by product, customer, distribution channel, or region—activity-based costing (ABC) helps you *really* follow the money. Focusing on any slice enables you to see

how an activity generates revenue and con- sumes resources. Once you understand these relationships, you’re better positioned to take the actions that will increase your selling mar- gins and reduce operating expenses.

*Profit Priorities from Activity-Based Costing*

Achieving these gains, however, requires that you look at expenses in a fundamentally new way. Instead of allocating expenses according to the number of widgets that roll off the line, you aggregate expenses according to activity, and then assign those expenses based on the drivers of the activities.

## T H E I D E A A T W O R K

Tra ditio na l cost accounting systems allocate indirect and support costs to products by using such measures as direct labor hours, machine hours, or materials costs. By contrast,

ABC recognizes that different products, cus- tomers, brands, and distribution channels make very different demands on a company’s resources. Accordingly, ABC starts by creating a hierarchy of activities and then assigns costs according to the activity involved.

Unit activity—machining a surface, for exam- ple—is performed on an individual unit. Set- ups are an example of batch activity—they’re performed on a number of units. Process engi- neering represents product activity, work that provides the overall capability for producing

a product. Facility activity comprises plant management, heating, and lighting—anything that sustains the whole facility.

Since costs cannot be adequately controlled at the macro level—the level of the balance sheet or income statement—ABC concentrates on

EXAMPLE:

To make a drive shaft, one manufacturer allocated

$13.38 of factory overhead to every 100 units. Accordingly, for the 8,000 units actually produced, the allocated overhead costs were $1,070. But an ABC analysis revealed that producing the shaft was actually much more expensive, consuming

$1,700 of support resources at the unit, batch, and product-sustaining levels. This information led management to alter its pricing, product mix, and process improvement decisions.

controlling batch- and product-level expenses, which can constitute up to 50% of a facility’s total costs. By modifying what goes on with batch- and product-level activities, ABC helps identify opportunities for substantial profit improvement.

Once you’ve completed the ABC analysis, two types of action are in order:

ucts that make heavy demands on support resources and lowering prices for high-vol- ume products that have been subsidizing the others.

2. Reducing resource consumption. This involves either decreasing the number of times activities are performed for the same output, or else reducing the resources con- sumed to produce and serve the existing mix of products and customers.

Can products be made with fewer parts? Can information technology be used to decrease the person-hours required for pro- cessing orders? If you have a large and especially unprofitable account, can you have the salespeople make fewer routine calls on it? These are the kinds of questions that will help you identify opportunities for conserving resources. But once you’ve iden- tified them, remember that you won’t actu- ally see profit improvement until you’ve eliminated or redeployed the freed-up resources.

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