

CHAPTER 5: ACTIVITY-BASED COSTING AND ACTIVITY-BASED MANAGEMENT

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Learning Objective 1 : Explain How Broad Averaging Undercosts and Overcosts Products or Services

As product diversity and indirect costs increased, broad averaging led to inaccurate product costs. That's because simple peanut-butter costing broadly averages or spreads the cost of resources uniformly to cost objects when, in fact, the individual products or services use those resources in nonuniform ways.

Broad averaging often leads to undercosting or overcosting of products or services. This can lead to certain strategic consequences, as follows. Suppose a manager uses cost information about products to guide pricing decisions. Undercosted products will be underpriced and may even lead to sales that actually result in losses because the sales may bring in less revenue than the cost of resources they use. Overcosted products will lead to overpricing, causing those products to lose market share to competitors producing similar products. But what if prices are determined by the market based on consumer demand and competition among companies? In this case, product undercosting and overcosting cause managers to focus on the wrong products. Managers give greater attention to overcosted products that show low profits when in fact costs and profits from these products are perfectly reasonable. They give less attention to undercosted products thinking they are highly profitable, when in fact these products consume large amounts of resources and are far less profitable than they appear.

Learning Objective 2 : Present Three Guidelines for Refining a Costing System

There are three main guidelines for refining a costing system:

- **Direct-cost tracing** - Identify as many direct costs as is economically feasible;
- **Indirect-cost pools** - Expand the number of indirect-cost pools until each pool is more homogeneous;
- **Cost-allocation bases** - Whenever possible, managers should use the cost driver as the cost-allocation base for each homogeneous indirect-cost pool.