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# Theory Q&A

## Chp5 Activity Based Costing

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# Chp5. Activity Based Costing

## Theory Q&A

(c) *Describe the various levels of activities under 'ABC' methodology.*

**(4 Marks)**

**(c) Various Level of Activities under ABC Methodology**

Level of Activities	Meaning
<b>1. Unit level activities</b>	These are those activities for which the consumption of resources can be identified with the number of units produced.
<b>2. Batch level activities</b>	The activities such as setting up of a machine or processing a purchase order are performed each time a batch of goods is produced. The cost of batch related

	activities varies with number of batches made, but is common (or fixed) for all units within the batch.
<b>3. Product level activities</b>	These are the activities which are performed to support different products in product line.
<b>4. Facilities level activities</b>	These are the activities which cannot be directly attributed to individual products. These activities are necessary to sustain the manufacturing process and are common and joint to all products manufactured.

(c) *PP Limited is in the process of implementation of Activity Based Costing System in the organisation. For this purpose, it has identified the following Business Functions in its organisation:*

- (i) *Research and Development*
- (ii) *Design of Products, Services and Procedures*
- (iii) *Customer Service*
- (iv) *Marketing*
- (v) *Distribution*

*You are required to specify two cost drivers for each Business Function Identified above.*

(c)

Business functions	Cost Driver
Research and Development	<ul style="list-style-type: none"><li>• Number of research projects</li><li>• Personnel hours on a project</li><li>• Technical complexities of the project</li></ul>
Design of products, services and procedures	<ul style="list-style-type: none"><li>• Number of products in design</li><li>• Number of parts per product</li><li>• Number of engineering hours</li></ul>
Customer Service	<ul style="list-style-type: none"><li>• Number of service calls</li><li>• Number of products serviced</li><li>• Hours spent on servicing products</li></ul>
Marketing	<ul style="list-style-type: none"><li>• Number of advertisements</li><li>• Number of sales personnel</li><li>• Sales revenue</li></ul>
Distribution	<ul style="list-style-type: none"><li>• Number of units distributed</li><li>• Number of customers</li><li>• Weight of items distributed</li></ul>

*(Any two cost drivers of each business function)*

*(c) What is meant by Activity Based Management (ABM) and discuss how Activity Based Management can be used in the business?*

**(c) Meaning of Activity Based Management (ABM)**

The term Activity based management (ABM) is used to describe the cost management application of ABC. The use of ABC as a costing tool to manage costs at activity level is known as Activity Based Cost Management (ABM). ABM is a discipline that focuses on the efficient and effective management of activities as the route to continuously improving the value received by customers. ABM utilizes cost information gathered through ABC.



## Activity based management can be used in the following ways:

- (i) **Cost Reduction:** ABM helps the organisation to identify costs against activities and to find opportunities to streamline or reduce the costs or eliminate the entire activity, especially if there is no value added.
- (ii) **Business Process Re-engineering:** Business process re-engineering involves examining business processes and making substantial changes to how organisation currently operates. ABM is a powerful tool for measuring business performance, determining the cost of business output and is used as a means of identifying opportunities to improve process efficiency and effectiveness.
- (iii) **Benchmarking:** Benchmarking is a process of comparing of ABC-derived activity costs of one segment of company with those of other segments. It requires uniformity in the definition of activities and measurement of their costs.
- (iv) **Performance Measurement:** Many organisations are now focusing on activity performance as a means of facing competitors and managing costs by monitoring the efficiency and effectiveness of activities.



(e) *What is meant by cost driver? Give its different categories. Suggest suitable cost drivers (at least two) in the following business functions:*

(i) *Distribution*

(ii) *Research and Development*

(iii) *Customer services*

**(5 Marks)**

**(e) Meaning of Cost Driver:** A Cost driver is a factor or variable which effect level of cost. Generally, it is an activity which is responsible for cost incurrence. Level of activity or volume of production is the example of a cost driver. An activity may be an event, task, or unit of work etc.

There are two categories of cost driver.

- **Resource Cost Driver** - It is a measure of the quantity of resources consumed by an activity. It is used to assign the cost of a resource to an activity or cost pool.

- **Activity Cost Driver** - It is a measure of the frequency and intensity of demand, placed on activities by cost objects. It is used to assign activity costs to cost objects.

Business Function	Cost drivers
Distribution	Number of units distributed, Number of customers
Research and Development	Number of research projects, personnel hours on a project, technical complexities of the projects.
Customer service	Number of service calls, number of products serviced, hours spent in servicing of products.