

What is Activity-Based Costing (ABC)?

Worksheet

ABC assigns overhead costs to cost pools tied to activities (like machine setups or inspections), then allocates each pool to products using an activity rate: $\text{Cost Pool} \div \text{Driver Volume}$, multiplied by each product's actual driver usage.

$$\text{Activity Rate} = \frac{\text{Total Cost}}{\text{Total Activity}}$$

Questions

1. What does Activity-Based Costing primarily improve?

- A) Cash flow timing
- B) Overhead cost accuracy by activity
- C) Employee scheduling
- D) Tax filing deadlines

2. An activity rate is calculated as:

- A) Cost pool driver units
- B) Cost pool / driver units
- C) Driver units / cost pool
- D) Cost pool + driver units

3. Which of these is an example of a cost driver?

- A) Company's tax rate
- B) Machine setup hours
- C) CEO's salary
- D) Fiscal year end date

4. Compared with traditional costing, ABC tends to reveal that low-volume, complex products were previously:

- A) Overcosted
- B) Undercosted
- C) Unaffected
- D) Always the cheapest to make

5. A factory's 'Machine Setup' cost pool is \$90,000 with 1,500 total setup hours as the driver. Find the activity rate.

6. Using the \$60/hour rate above, Product A uses 25 setup hours. How much setup cost is allocated to Product A?

7. A 'Quality Inspection' pool costs \$40,000 with 800 total inspection hours. Product B uses 200 of those hours. Find its allocated cost.

8. Define: What is Activity-Based Costing?

9. Define: Why use ABC instead of traditional costing?

10. Define: What is a cost pool?

Answer Key

1. B) Overhead cost accuracy by activity - ABC improves accuracy by tying overhead to the activities that actually cause it, rather than one volume-based rate.
2. B) Cost pool / driver units - Activity Rate = Overhead Cost Pool / Total Driver Units.
3. B) Machine setup hours - Machine setup hours is a measurable activity driver; the others don't cause activity costs to change.
4. B) Undercosted - Volume-based traditional costing spreads overhead evenly by volume, so complex low-volume products that consume more activities were undercosted.
5. Activity Rate = Cost Pool / Driver Units Activity Rate = $90,000 / 1,500 = \$60$ per setup hour
6. Allocated Cost = Activity Rate Driver Usage Allocated Cost = $60 \times 25 = \$1,500$
7. Activity Rate = $40,000 / 800 = \$50$ per hour Allocated Cost = $50 \times 200 = \$10,000$
8. A costing method that assigns overhead to products based on the activities that actually drive those costs, using multiple cost drivers instead of one blanket rate.
9. Traditional costing uses one volume-based rate (like direct labor hours) that can distort costs; ABC ties overhead to the actual activities that cause it.
10. A grouping of overhead costs associated with a specific activity, such as all costs of machine setups.

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