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Traditional Costing System Vs Activity-Based Costing System

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The business environment has changed dramatically over the last two decades as the result of intense global competition. Businesses that had previously used the traditional costing system were forced to switch to the activity-based costing (ABC) system, a more recent cost system. ABC and traditional costing are two competing approaches for allocating overhead costs to products and services. The ABC technique was developed in the 1980s for assisting firms to improve their cost management and competitive positioning, and it has since become extensively used due to its broad industry applicability (Quesado et.al., 2021; Mahesha, 2022).

Both approaches estimate overhead costs related to production and then assign these costs to products based on a cost-driver rate. The traditional costing system uses a single cost driver, whereas the ABC system uses numerous cost drivers, making it more complex than the traditional approach (Quesado, 2021). The traditional allocation system assigns manufacturing overhead based on a single cost driver, such as direct labour hours, direct labour cost, or machine hours, and is optimal when there is a relationship between the activity base and overhead. There is only one overhead cost pool and a single measure of activity, such as direct labour hours, which makes the traditional method simple and less costly to maintain (Mahesha, 2022). The predetermined overhead rate is based on estimated costs at the budgeted level of activity. Therefore, the overhead rate is consistent across products, but overhead may be over or under applied.



Since the traditional costing system uses a single cost driver, it becomes impractical when technology contributes to a large amount of the product cost (Wahidi et. al., 2021). Overhead costs are typically determined by many drivers, so integrating multiple cost drivers in the ABC system allows for a more precise allocation of overhead. Using multiple activities as cost drivers reduces the risk of distortion and provides accurate cost information (Mahesha, 2022). The ABC method first assigns indirect costs to activities, which subsequently assigns the costs to products based on the products' usage of the activities. ABC system identifies resources in each department's activities to provide information about a product's cost. It collects indirect costs and allocates them to various products in proportion to the product volume. Therefore, ABC system can estimate the product costs and individual activity costs used in the production well. The first step is classifying activities, associating various costs with various activities, determining homogeneous cost groups, and determining group rates. The second step of this stage is the determination of overhead prices selected from each cost group.

ABC system is generally considered more complex than traditional costing due to its detailed analysis of activities and multiple cost drivers. However, this complexity often results in a more accurate allocation of costs, particularly in environments with diverse product lines or complex production processes (Jalalabadi et. al., 2018; Suresh, 2015; Altawati, et. al., 2018). Thus, it reflected that ABC system is a better system compared to the traditional costing systems. In industries with complex and diverse operations, traditional costing methods may oversimplify cost allocation and fail to capture the true drivers of overhead costs (Zamrud et. al., 2020). ABC system is particularly well-suited for such environments as it can accommodate

varying production processes, product lines, and customer requirements. It provides a more granular view of costs, allowing businesses to better understand their cost structures and make strategic decisions accordingly. ABC system also enhances the decision making of the interested user with its better adaptable costing features to support the new business environment and global business competition. It thus creates a more sustainable source of competitive advantage. In addition, it identifies the under-cost and over-cost of the products of a firm (Altawati et. al.,2018).

While ABC system provides benefits in terms of accuracy and better distribution of overhead costs, it is critical to consider the organization's individual goals and circumstances before choosing between traditional costing and ABC. In many circumstances, a hybrid approach that incorporates features of both costing approaches may be the most feasible option. ABC system may not be appropriate for industries with simple manufacturing processes or homogeneous products when traditional costing methods may be sufficient. Industries with low overhead costs relative to direct costs may find ABC's benefits less desirable. Furthermore, for industries with straightforward production processes and relatively homogeneous products, traditional costing may provide appropriate and accurate cost information without the need complexity of an ABC system. Agriculture, mining, and basic manufacturing are examples of industries with simple cost structures that benefit from traditional costing methods. It's essential for businesses to carefully assess their needs, resources, and readiness for change before embarking on a switch to ABC system.

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