Activity-Based Budgeting



Organizations are often tempted to allocate most of their resources to operational activities that boost revenue and profitability. However, focusing on revenue-generation activities is not the only way to increase profits.

An organization can squeeze out higher profits from revenue by keeping a tab on costs and optimizing them wherever possible.

But here's a catch—unnecessary reduction in costs may force a company to compromise on the integrity and quality of business operations.

Hence, the company should carefully evaluate every possible way to reduce costs and then make an informed decision.

Here a budget comes in handy!

As John Maxwell, the No. 1 New York Times bestselling author, coach, and speaker, says, "A budget is telling your money where to go, instead of wondering where it went."

A budget helps a company allocate resources, calculate variances at the end of the period, and discover possible opportunities for efficiencies. A well-known and highly recognized budgeting method is activity-based budgeting, commonly known as the ABB method.

This article will discuss everything about activity-based budgeting and how it can help an organization keep steady control of costs.

What is Activity-Based Budgeting?

Activity-based budgeting is a management accounting budgeting method that identifies, analyses, records, and forecasts activities leading to costs for an organization.

Every activity that incurs a cost is scrutinized for potential ways to create efficiencies and enhance profitability—by reducing activity levels, eliminating unnecessary activities, or reducing costs for relevant cost drivers for the activity.

This method follows a no-nonsense approach and implies that a budget should be created only for necessary activities. If a cost can’t be traced to an activity, it’s not considered and accounted for in the budget.

Activity-based budgeting doesn’t consider historical data when preparing the budget. Hence, it is a prudent budgeting method for new companies and startups that don’t have historical data.

How does activity-based budgeting differ from the traditional method of budgeting?

Activity-based budgeting and traditional budgeting are the two of most prominent budgeting methods.

Traditional budgeting is a more straightforward way of creating a budget. It adjusts the prior period’s budget for inflation or changes in business activities.

In comparison, activity-based budgeting identifies critical activities and links them to their cost driver to calculate the required activity levels.

For example, a company incurred sales order processing expenses of $10 million last year.

This year, it expects its sales to grow by 10%. If the company opts for traditional budgeting, its current year’s budget for sales order processing will be $11 million.

Now, let’s suppose the company expects to process 1,00,000 sales orders this

year. For sales order processing activity, the company has identified labor hours as the cost driver. Each sales order requires 1 hour of processing labor hours and costs $20 per hour. So, each sales order will cost $20 to process.

If the company opts for activity based budgeting, the budget for sales order processing for this year will be $20 million.

This budget is just less than double the budget calculated as per the traditional budgeting method, but it gives the company a more realistic picture of forecasted costs.

Remember, a good business budget always helps forecast cash inflows and outflows and plan thoughtful allocation of resources.

What is the Difference Between Zero-Based Budgeting and Activity-Based Budgeting?

Both zero-based budgeting and activity-based budgeting methods have a few similarities and differences.

If we discuss similarities, both methods don’t consider the previous year’s budget for calculating the current period’s budget. Also, both don’t automatically include items from the last budget.

All expenses are justified for each new period, and only then are resources allocated.

However, the significant difference between the two budgeting methods is the basis of calculation.

Zero-based budgeting starts from zero every year and allocates resources based on the needs and costs of the department. Activity-based budgeting focuses on identifying specific activities and their cost drivers and then reaching the required activity levels.

Zero-based budgeting is function-oriented, whereas activity-based budgeting is activity-oriented.

What Type of Organization Should Use Activity-Based Budgeting?

Mature companies that don't experience significant changes in their business activity every year may opt for traditional budgeting since it requires less time, money, and effort and is often simpler to calculate.

However, new companies and startups can't choose traditional budgeting due to a lack of historical data.

> *Activity-based budgeting can be a savior, particularly for new companies and startups, as it helps the company analyze each cost driver and the corresponding activity levels to make an accurate budget without considering the past year's budget.*

Apart from new companies, activity-based budgeting is also suitable for companies undergoing material operational changes such as a change in the customer base, business lines, a significant shift in the geographical locations of prominent exporters and importers, or expansion in a new business line.

Even while establishing a subsidiary company, the management may adopt activity-based budgeting to allocate required resources.

How is Activity Based-Budgeting (ABB) Different from Activity-Based Costing (ABC)?

Activity Based Budgeting is a budgeting method, whereas Activity Based Costing is a costing method.

Activity Based Costing is used by organizations to allocate the current period's overhead to products and services based on various activities and their cost drivers.

Whereas, Activity Based Budgeting focuses on allocating the upcoming period's overhead based on activities and then measuring the actuals against budgeted

figures to calculate the variance.

They usually work hand in hand.

Details derived from Activity Based Costing method are used as an input when calculating base rates of cost drivers under Activity Based Budgeting.

What are the Advantages of Activity-Based Budgeting?

Activity-based budgeting is a more realistic way to create a budget and offers the following main advantages to an organization:

- **Increased control**: Each activity that incurs a cost or boosts revenue is scrutinized in activity-based budgeting. It allows the management to exercise better control to find potential efficiencies and cost reduction methods. Also, this strategy creates a cause-and-effect relationship between costs and activities, providing critical insights to decision-makers.
- **Competitive edge**: Once the overall production cost is significantly reduced, an organization can sell products and services at a lower price than its competitors, thereby creating a competitive edge.
- **Effective allocation of resources:** Every company has limited resources. By adopting activity-based budgeting, management can allocate resources to main activities (those that boost revenue) and eliminate or reduce nonprofitabile activities.
- **Elimination of bottlenecks:** By mapping the relationship between various activities and determining their cost drivers, management can avoid all possible bottlenecks that hamper smooth cross-division cooperation.

- **Focus on process efficiencies:** Instead of relying on past data to calculate variances, activity-based budgeting focuses on locating potential ways to create efficiencies and boost profitability.

What are the Disadvantages of Activity-Based Budgeting?

Like any budgeting strategy, activity-based budgeting also contains a few drawbacks which means it may not fit for all companies:

- **More expensive:** Activity-based budgeting is more expensive to implement and maintain than traditional budgeting since it's executed on a macro level and involves collecting information from various facets of a business.
- **Time-consuming:** Since management has to analyze activities with higher precision and detail down each activity's impact on overall profitability, activity-based budgeting often consumes more time than other budgeting methods.
- **Complex:** Here, management requires a deeper understanding of various functional areas of a business before determining which activity boosts revenue or incurs cost. Also, trained employees have to execute this strategy, or else it may lead to inaccuracy in budget calculation.

How are Fixed Costs Dealt with Under Activity-Based Budgeting?

While fixing the price of a product or service, we always consider two factors: cost of the product and profit margin.

Further, the cost of a product includes two components – fixed costs and variable costs.

Fixed costs such as factory rent & lease, utility bills, etc., always remain the same, whereas, variable costs will vary based on activity.

By adopting the Activity Based Budgeting method, an organization focuses on reducing or eliminating those unnecessary activities that increase the variable costs.

It can't reduce the fixed costs, which is why, fixed costs are not accounted for

under Activity Based Budgeting.

How to Implement Activity-Based Budgeting?

Activity-based budgeting comprises three main steps:

Identify Activities and Their Cost Drivers

The first step includes identifying key activities that incur costs for an organization and boost or deteriorate profitability.

Next, these activities should be ranked based on their importance so that optimum resources can be allocated to essential activities, followed by secondary activities that add value to customers and eventually benefit the organization.

After segregating activities into main and secondary activities, their cost drivers should be identified.

A cost driver triggers the cost of the activity. It is the root cause behind why an organization incurs a particular cost.

Examples of activity cost drivers are machine setups, maintenance requests, consumed power, purchase orders, productions orders, etc.

For instance, the production of a product requires 5 hours of machine time. Since machine time is an activity, its cost driver will be the number of machine-hours.

Higher machine hours will result in higher overheads for the company.

Let’s suppose, during a month; machines were used for a total of 5,000 hours. Here machine hours are the cost driver, and machine time overhead should be allocated to the product based on machine hours.

By adopting budget reporting and forecasting best practices, an organization can identify the right business and cost drivers.

Project the Number of Units Required Within Each Cost Driver for the Level of Activity Needed

The next step in calculating activity-based budgeting is identifying the number of units required to reach the desired activity level and achieve efficiency.

For instance, in the above example, this month, the company expects a total of 8,000 machine hours.

Calculate the Cost Per Unit of Activity Related to That Cost Driver

Here the cost per unit of activity is calculated based on the cost driver. The result is multiplied by the required number of units to reach the budget.

For instance, in the above example, the company incurred an overhead of $30,000. Since the actual machine hours were 5,000, the cost per unit will be $6 per hour.

Budget = Required activity levels x cost per unit

In our case, since the company expects a total of 8,000 machine hours this month, the total budgeted cost for this month will be 8,000*$6 = $48,000.

Bottom Line

Activity-based budgeting is a time-and-tested method for performance forecasting and measuring for those companies where production overhead costs are significantly higher.

It provides an organization a cushion against an unforeseen future due to added flexibility and innovative approach compared to the traditional budgeting system.

However, by adopting the activity-based budgeting method, an organization may shift its focus to immediate and short-term results and ignore the bigger picture.

Hence, the management should adopt a prudent decision-making approach and choose a budgeting method that meets the company goals accordingly.

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