

Activity-Based Budgeting

While a traditional budgeting approach adjusts previous costs based on inflation or changes in business activity, activity-based budgeting is a more accurate way of looking at costs.

Every cost acquired by a business will be looked at closely to figure out if efficiencies can be created and costs reduced. It can be as a reduction in activity levels or complete elimination of worthless activities. Ultimately, Activity-Based Budgeting aims to analyze business cost drivers and facilitate the business to become more profitable.

Activity-Based Budgeting Definition

Activity-based budgeting is often used in cost accounting. Managers make budgets and spending recommendations based on past production activities. Management examines the costs of performing particular activities, like bending a fender for a car, to budget the overall costs of manufacturing a product.

or

Activity-Based Budgeting is a management accounting tool that does not look at the past year's budget to arrive at the current year's budget. Instead, the activities that acquire the cost are deeply studied and analyzed. Based on the study, the resources are allocated to an activity.

Examples of Activity-Based Budgeting

Particulars	Unit	Cost per unit (\$)	No. of units	Total
Travel	Per person	30	300	9,000
Accommodation	Per person	20	300	6,000
Cost of Materials	Per item	3	40,000	120,000
Storage	Per product	1	35,000	35,000
Delivery	Per item	1	20,000	20,000
Process 1	Per item	3	35,000	105,000
process 2	Per item	2	35,000	70,000

Process 3	Per item	5	30,000	150,000
Total				515,000

Steps of Activity-Based Budgeting

There are 4 steps in Activity-Based Budgeting:

- **Identifying various activities.**
- **Identifying the costs of various activities.**
- **Project the number and the costs of units:**
- **Calculate the total cost.**

1. Identifying the Various Activities:

Activity-Based Budgeting starts with identifying activities that revolve around resource consumption. These activities are mainly classified as major activities and secondary activities that denote involvement and importance of an activity to the organization as per their priority.

Therefore, major activities are activities that are directly related to the objectives and are essential.

Activities that create added value to the customer and change its preference in the organization's favor may involve many resources that are considered secondary activities.

2. Identifying the Costs of Various Activities:

The 2nd step in Activity-Based Budgeting is to identify the cost drivers of various previously identified activities, that are the cost drivers for a manufacturing facility can be the total labor hours and wages paid to employees.

3. Project the number and the costs of units

After identifying the various activities and their costs, the next step is to identify the type and the number of the units (as shown in the table: **Type of the units**; per person, per item, per product, per service. **Number of the units**; 300, 40,000, 35,000, 20,000).

After identifying the type and number of units, we have to evaluate the cost of the total units. For example, the cost for the accommodation of every person: \$20.

4. Calculate Total Cost:

After identifying and projecting the activities and the costs, the next step is to calculate all the values and the costs to complete the budget.

These are the steps or the processes of activity-based budgeting.

Advantages of Activity-Based Budgeting

Activity-based budgeting (ABB) systems support more control over the budgeting process. Revenue and expense planning takes place at a definite level that provides necessary details regarding projections. It allows management to have more control over the budgeting process and align the budget with company objectives.

Here are some advantages of ABB:

Evaluation

Activity-Based Budgeting promotes a forward-looking view rather than looking at previous activities, which is a common feature of traditional budgeting that is it asks queries like 'what should be performed' and 'where can we make some improvement' rather than 'what was done earlier' and sort of just allocation of costs according to that.

Competitive Edge

Activity-Based Budgeting system eliminates many unnecessary activities, which facilitates the business to save its costs. The saved cost results in the production of goods and services at a lower cost than other available competitors. It also helps a business to achieve a competitive edge in the market.

Business as a Unit

This budgeting system helps in viewing the business as a unit and not as a department. The managers or the top management prepare the budget for the business unit as a whole and not keeping in mind any single department as done with other methods of budgeting.

Improves Relationships

The Activity-Based Budgeting technique helps to improve the relationship between the organization and its customers. The primary aim of this budgeting method is to wipe out irrelevant activities and serve the customers with the best quality and price. This enforces indirectly the employees of the company to provide the customers in the best way possible and secure customer satisfaction. In this way, the relationship between the organization and the customer enhances.

Disadvantages of Activity-Based Budgeting

Activity-based budgeting (ABB) is more cost-sufficient to implement and maintain than traditional budgeting approaches and more time-consuming as well. ABB systems need additional inferences and insight from management, which can, occasionally, result in potential budgeting inaccuracies.

Now let's have a look at the disadvantages of Activity-Based Budgeting:

It is Complex

Activity-Based Budgeting system requires research and analysis of various factors. This budgeting process comprises an estimation of demand and based on that, it does the estimation of resources to be employed in various activities.

It Requires Understanding

ABB requires a deep understanding of various functional sections of the business. If the manager preparing the budget is unable to understand and evaluate the areas of business, it would lead to imperfect budget preparation.

Cost-Sufficient

Implementation of ABB needs trained employees. An employee who is not trained enough cannot handle the budgeting process effectively. So the organization needs to spend extra money to train their employees. Otherwise, top management involves there, and this is more costly.

Resource Consuming

Budgeting in this method consumes a lot of resources for an organization. It requires top officials for conducting many analyzes. It is also a very time-consuming task. These resources can give better returns if they are employed in other operations.

Short Term

It focuses on the short-term objectives of the business. Sometimes focusing on short-term goals rather than long-term goals can prove very fatal for the organization.

Implementation of Activity-Based Budgeting

When to use: Businesses must evaluate their goals and requirements to determine whether an Activity-Based Budgeting system will make sense to implement. It is better to fit for new businesses that lack historical costing data than more established businesses have.

On the other side, a new start-up doesn't have years of historical financial record at its disposal. It may be beneficial for the newer start-up to go through each cost driver and their corresponding activity levels to make more specific financial projections.

What to do & what to don't:

Actions to take

Only use Activity-Based Budgeting if the overhead costs are a significant proportion of total operating costs.

ABB is useful in a [Total Quality Management](#) environment, to help identify the cost-effectiveness of activities.

Actions to avoid

Don't implement Activity-Based Budgeting unless you are using [Activity-Based Costing](#) as it is only suited to organizations that are also using Activity-Based Costing.

Don't ignore engaging with operation managers, or they may struggle with the conception of ABB, which makes the process more time-consuming.

Implementation of Activity-Based Budgeting

Activity-Based Budgeting Vs. Traditional Budgeting

Activity-Based Budgeting is an alternative budgeting process. Traditional approaches are more simplistic, adjusting prior period budgets to account for inflation or revenue increase. Rather than using previous budgets to calculate how much a firm will spend in the ongoing year, ABB digs deeper.

ABB is unnecessary for all companies. For example, established firms that experience minimal change often find that applying a flat rate to data from the previous year to project business growth and inflation is acceptable.

In comparison, new companies without access to past budgeting information cannot consider this an option. Activity-based budgeting is also expected to be implemented by firms experiencing material changes, such as those with new subsidiaries, business locations, important customers, or products. In these cases, past information may no longer be a proper basis for future budgeting.

Activity-Based Budgeting Vs. Zero-Based Budgeting

Both [Zero-Based Budgeting \(ZBB\)](#) and Activity-Based Budgeting differ from traditional budgeting methods. With traditional budgeting, a firm typically bases its budget for one financial year on the budget for the past year. It makes minor adjustments based on things like inflation or changes in revenue that is called **Cost-Based Budgeting**.

Zero-Based Budgeting goes about the budgeting process separately. ZBB, as its name signifies, starts from zero. Instead of giving each department or each function of the firm a budget based on the previous year, it reexamines all the firm's activities and functions. Starting from zero, it figures out them to see how much of a budget they actually need. This stops the firm from just putting money towards various

activities out of habit or inertia. It makes each function of the firm maintain its existence and its budget every year.

Activity-Based Budgeting is similar because it is not cost-based and it requires each function to justify itself each year. In the Activity-Based Budgeting process, each function of the firm is evaluated to see how it fits with the other functions and how it furthers the firm's objectives. This favors the firm to figure out which of its functions are most important.