

Traditional Costing vs. Activity-Based Costing: A Comparative Review of Literature

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Abstract: Costing systems play a critical role in managerial decision-making, pricing, and performance evaluation in organizations. Traditional Costing (TC), which allocates overheads using volume-based measures such as direct labour or machine hours, has been widely adopted due to its simplicity and ease of implementation. However, its relevance has been increasingly questioned in modern business environments characterized by automation, product diversity, and rising indirect costs. In response to these limitations, Activity-Based Costing (ABC) emerged as an alternative approach that assigns costs based on activities and cost drivers, thereby improving cost accuracy and transparency. This study presents a comparative review of literature on Traditional Costing and Activity-Based Costing with the objective of synthesizing conceptual, empirical, and practical insights. The study is based on secondary data and reviews published research articles, textbooks, and scholarly studies in the field of management accounting. Content analysis is employed to examine key themes such as cost allocation accuracy, decision-making relevance, implementation challenges, and strategic applicability of both costing systems. The review reveals that Traditional Costing remains suitable for organizations with homogeneous products, stable processes, and relatively low overhead intensity. However, it often results in distorted cost information in complex operational settings. Activity-Based Costing, on the other hand, provides more accurate and detailed cost information, supports strategic decisions related to pricing and product mix, and enhances cost control, although its adoption is constrained by higher implementation costs and resistance. The study concludes that costing system choice should be guided by organizational context, cost structure, and managerial objectives for effectiveness.

Key Words: Traditional Costing; Activity-Based Costing; Cost Allocation; Management Accounting; Cost Management; Managerial Decision-Making.

1. INTRODUCTION:

Cost accounting systems play a crucial role in providing information for managerial planning, control, and decision-making. Traditionally, organizations have relied on Traditional Costing systems, which allocate overhead costs based on simple volume-related measures such as direct labor hours or machine hours. While this approach is easy to implement and widely accepted for financial reporting, its relevance has been questioned in modern business environments characterized by product diversity, automation, and increasing overhead costs. In response to these limitations, Activity-Based Costing (ABC) emerged as an alternative approach that assigns costs to products and services based on the activities that consume organizational resources. By focusing on cause-and-effect relationships, ABC aims to provide more accurate cost information and support strategic decisions related to pricing, product mix, and process improvement. Given the coexistence of both costing systems in practice, a comparative examination of Traditional Costing and Activity-Based Costing is essential. This article reviews and synthesizes existing literature to highlight their conceptual differences, advantages, limitations, and contextual applicability, thereby contributing to a clearer understanding of their relevance in contemporary cost management.

2. LITERATURE REVIEW:

Johnson and Kaplan (1987): Johnson and Kaplan critically examined traditional management accounting practices and argued that traditional costing systems were designed for earlier industrial settings characterized by labor-intensive and standardized production. Their study highlighted that traditional costing relies heavily on volume-based allocation methods, which fail to capture the complexity of modern manufacturing environments. The authors emphasized that such systems often produce distorted product costs when overheads form a significant portion of total costs. Their work

laid the foundation for questioning the continued relevance of traditional costing in contemporary organizations and strongly influenced the development of alternative costing approaches such as Activity-Based Costing.

Cooper and Kaplan (1991): Cooper and Kaplan introduced Activity-Based Costing as a response to the shortcomings of traditional costing systems. They argued that ABC provides more accurate cost information by identifying activities as cost drivers and tracing overheads based on actual resource consumption. Their study demonstrated how ABC improves visibility into indirect costs and highlights non-value-adding activities. The authors concluded that ABC supports better managerial decision-making, particularly in pricing, product mix, and cost control, making it a strategically relevant costing system.

Hilton (2008): Hilton emphasized the practicality and simplicity of traditional costing systems, especially in organizations with homogeneous products and low overhead intensity. According to Hilton, traditional costing remains relevant for financial reporting and routine cost control purposes. However, he also acknowledged that the growing complexity of business operations reduces the effectiveness of volume-based allocation methods. His work provides a balanced view, recognizing the continued use of traditional costing while acknowledging the need for more refined systems like ABC in complex environments.

Innes and Mitchell (1995): Innes and Mitchell conducted empirical research on the adoption of Activity-Based Costing in organizations. Their findings revealed that firms implementing ABC experienced improved understanding of cost behavior and enhanced control over overhead costs. The study also identified that ABC adoption was more prevalent in organizations facing intense competition and cost pressures. However, the authors noted that successful implementation depends on organizational commitment and adequate training, highlighting practical challenges associated with ABC.

Drury (2000): Drury provided a comprehensive comparison of traditional costing and ABC, emphasizing their relevance in managerial decision-making. He argued that traditional costing systems are less effective in environments where indirect costs dominate total costs. In contrast, ABC offers superior cost accuracy by linking costs to activities. Drury concluded that ABC is particularly useful for strategic decisions such as outsourcing, product discontinuation, and process improvement, reinforcing its role as a strategic cost management tool.

Shields (1995): Shields examined the behavioral and organizational factors influencing the success of Activity-Based Costing systems. His study found that ABC implementation alone does not guarantee performance improvement unless supported by top management commitment and employee involvement. The research highlighted that resistance to change and lack of understanding often hinder the effective use of ABC. This study contributes to the literature by emphasizing that costing systems must be aligned with organizational culture to deliver intended benefits.

Gosselin (1997): Gosselin explored the relationship between organizational strategy and the adoption of Activity-Based Costing. The study revealed that firms pursuing differentiation strategies were more likely to adopt ABC than those focusing on cost leadership. Gosselin also observed that many organizations adopt ABC partially rather than fully, due to implementation complexity. The findings suggest that strategic orientation significantly influences the choice of costing systems.

Bhimani (1996): Bhimani analyzed the role of costing systems in supporting strategic management decisions. He argued that traditional costing systems are primarily operational and backward-looking, whereas ABC enables forward-looking strategic analysis. The study emphasized that ABC facilitates better alignment between accounting information and strategic objectives. Bhimani's work strengthened the argument that ABC is not merely a costing technique but a strategic management tool.

Kaplan and Anderson (2004): Kaplan and Anderson introduced Time-Driven Activity-Based Costing (TDABC) as a simplified version of traditional ABC. Their study addressed criticisms related to the complexity and cost of ABC implementation. TDABC uses time equations to allocate costs, reducing data requirements while maintaining accuracy. This contribution extended the ABC literature by offering a more practical and scalable alternative to traditional ABC systems.

Turner and Guilding (1997): Turner and Guilding examined the use of Activity-Based Costing in practice and found that organizations adopting ABC reported improved cost control and decision-making capabilities. However, the study also revealed that many firms struggled to sustain ABC systems over time due to maintenance challenges. Their findings highlight the gap between theoretical benefits and practical implementation of ABC.

Sarokolaei et al. (2012): Sarokolaei and colleagues conducted a comparative study of traditional costing and ABC in the banking sector. Their findings demonstrated that ABC provided more accurate service cost information than traditional costing. The study emphasized that service organizations, where indirect costs dominate, benefit significantly from ABC adoption. This research extended ABC literature beyond manufacturing into service industries.

Mahesha (2022): Mahesha compared traditional costing and ABC in a manufacturing context and found that traditional costing resulted in product cost distortions due to inappropriate overhead allocation. ABC, on the other hand, identified hidden costs and unprofitable products more effectively. The study concluded that ABC enhances managerial insight and supports better cost management decisions, especially in competitive environments.

Nitin Kumar (2013): Nitin Kumar examined the implementation of ABC in an automobile parts manufacturing firm and compared it with traditional costing outcomes. The study revealed significant differences in product profitability under the two systems. ABC provided more realistic cost estimates, leading to improved pricing decisions. The research highlighted the practical relevance of ABC in industries with complex production processes.

Stefano and Casarotto Filho (2013): Stefano and Casarotto Filho conducted a bibliometric review of ABC literature, particularly focusing on service sector applications. Their study identified growing academic interest in ABC due to its relevance in modern service-oriented economies. The authors concluded that ABC is increasingly viewed as a strategic tool rather than a purely accounting technique, reflecting its evolving role in management accounting research.

Waruwu (2024): Waruwu provided a recent comparative analysis of traditional costing and ABC through a literature-based approach. The study reaffirmed that ABC produces more accurate cost information by reflecting actual resource consumption. However, the author also emphasized that traditional costing remains relevant for small and medium-sized enterprises due to its simplicity. The study concluded that the choice of costing system should be context-specific rather than universal.

3. STATEMENT OF PROBLEM:

Accurate cost information is critical for effective managerial decision-making. Traditional Costing systems, though widely used for their simplicity, often distort product and service costs in environments characterized by high overheads and operational complexity. Activity-Based Costing has been introduced as an alternative to address these limitations by linking costs to activities and resource consumption. However, its adoption remains uneven due to implementation challenges and organizational constraints. Existing studies largely examine these systems independently, offering limited comparative insight. Hence, a systematic review comparing Traditional Costing and Activity-Based Costing is necessary to clarify their relevance, effectiveness, and contextual applicability in contemporary cost management.

4. SCOPE OF THE STUDY:

The present study is limited to a comparative review of literature on Traditional Costing and Activity-Based Costing systems. It focuses on conceptual frameworks, empirical findings, and implementation issues discussed in prior academic studies across manufacturing and service sectors. The study relies exclusively on secondary data sourced from journals, books, and scholarly publications. It examines cost allocation accuracy, decision-making relevance, and strategic applicability of both costing systems. The review does not involve primary data collection or sector-specific empirical testing.

5. CONCEPTUAL FRAMEWORK:

The conceptual framework of the present study is designed to explain the relationship between costing systems and managerial decision-making outcomes by comparing Traditional Costing and Activity-Based Costing. Costing systems serve as mechanisms for collecting, classifying, and allocating costs to products and services, thereby influencing the quality of information available to managers. Traditional Costing systems allocate overhead costs using volume-based cost drivers such as direct labor hours or machine hours. This approach assumes a linear relationship between production volume and overhead consumption, which is suitable for organizations with standardized products, stable processes, and relatively low indirect costs. In contrast, Activity-Based Costing is grounded in the activity-based view of organizations, where activities consume resources and products consume activities. ABC identifies multiple activities involved in production or service delivery and assigns costs based on appropriate cost drivers that reflect actual resource usage. By establishing cause-and-effect relationships between activities and cost objects, ABC provides more accurate and transparent cost information, particularly in environments characterized by high overhead intensity, product diversity, and complex operations.

The framework further recognizes that the effectiveness of a costing system is influenced by organizational context variables such as firm size, industry type, level of automation, competitive intensity, and managerial expertise. These contextual factors moderate the relationship between the chosen costing system and managerial outcomes. Accurate cost information derived from an appropriate costing system enhances key managerial decisions related to pricing, product mix, cost control, profitability analysis, and strategic planning. Ultimately, the framework suggests that alignment between organizational characteristics and the chosen costing system determines the usefulness of cost information and contributes to improved managerial effectiveness and organizational performance.

6. RESEARCH METHODOLOGY :

The present study adopts a descriptive and analytical research design based on secondary data to examine and compare Traditional Costing and Activity-Based Costing systems. The study relies exclusively on published academic

literature, including peer-reviewed journal articles, textbooks, conference papers, and authoritative reports in the field of management accounting. Relevant studies were identified through a systematic review of accounting and management journals using keywords such as Traditional Costing, Activity-Based Costing, cost allocation, and management accounting systems. The selected literature spans conceptual, empirical, and comparative studies across manufacturing and service sectors to ensure comprehensive coverage. The collected studies were analyzed using content analysis, focusing on themes such as cost allocation accuracy, decision-making relevance, implementation challenges, and strategic applicability. Findings from prior research were synthesized to identify patterns, similarities, and differences between the two costing systems. As the study is based solely on secondary data, no primary data collection or statistical testing was undertaken.

8. DISCUSSION:

The review of literature reveals significant differences between Traditional Costing and Activity-Based Costing in terms of cost allocation accuracy, decision-making relevance, and strategic usefulness. Traditional Costing systems, which rely on volume-based allocation measures, are found to be effective in organizations with standardized products and low overhead complexity. However, the literature consistently indicates that these systems tend to distort product and service costs in environments characterized by automation, product diversity, and high indirect costs. In contrast, Activity-Based Costing provides more accurate and transparent cost information by linking overhead costs to activities and appropriate cost drivers. Studies highlight that ABC enhances managerial understanding of cost behavior and supports strategic decisions related to pricing, product mix, and process improvement. Despite these advantages, the findings also reveal that ABC adoption is constrained by high implementation costs, data intensity, and resistance to organizational change. Overall, the literature suggests that neither system is universally superior; rather, their effectiveness depends on organizational context and managerial objectives.

9. CONCLUSION:

This study concludes that Traditional Costing and Activity-Based Costing serve distinct managerial purposes and remain relevant under different organizational conditions. Traditional Costing continues to be suitable for organizations seeking simplicity and compliance with financial reporting requirements, particularly where operations are stable and overhead costs are minimal. Activity-Based Costing, on the other hand, offers superior cost accuracy and strategic insight in complex and competitive environments. From a managerial perspective, the findings emphasize the importance of aligning the costing system with organizational structure, cost behavior, and strategic goals. Managers should evaluate the cost-benefit trade-off before adopting ABC and ensure adequate organizational readiness through training and change management. The study also suggests that hybrid or simplified costing approaches may help organizations balance accuracy with practicality. Overall, informed selection of an appropriate costing system can significantly enhance cost control, decision-making quality, and organizational performance.

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