Management Accounting

PRACTICAL CLASS 3

Illustration by Ana Seixas

Exercise

7 – DOCE AROMA COMPANY

(In) Direct Costs

DIRECT VS INDIRECT COSTS

So far, we have worked with very **simple** but *unrealistic* companies that **produce only one good**.

In real life, companies produce **hundreds** of different products in a **single plant**.

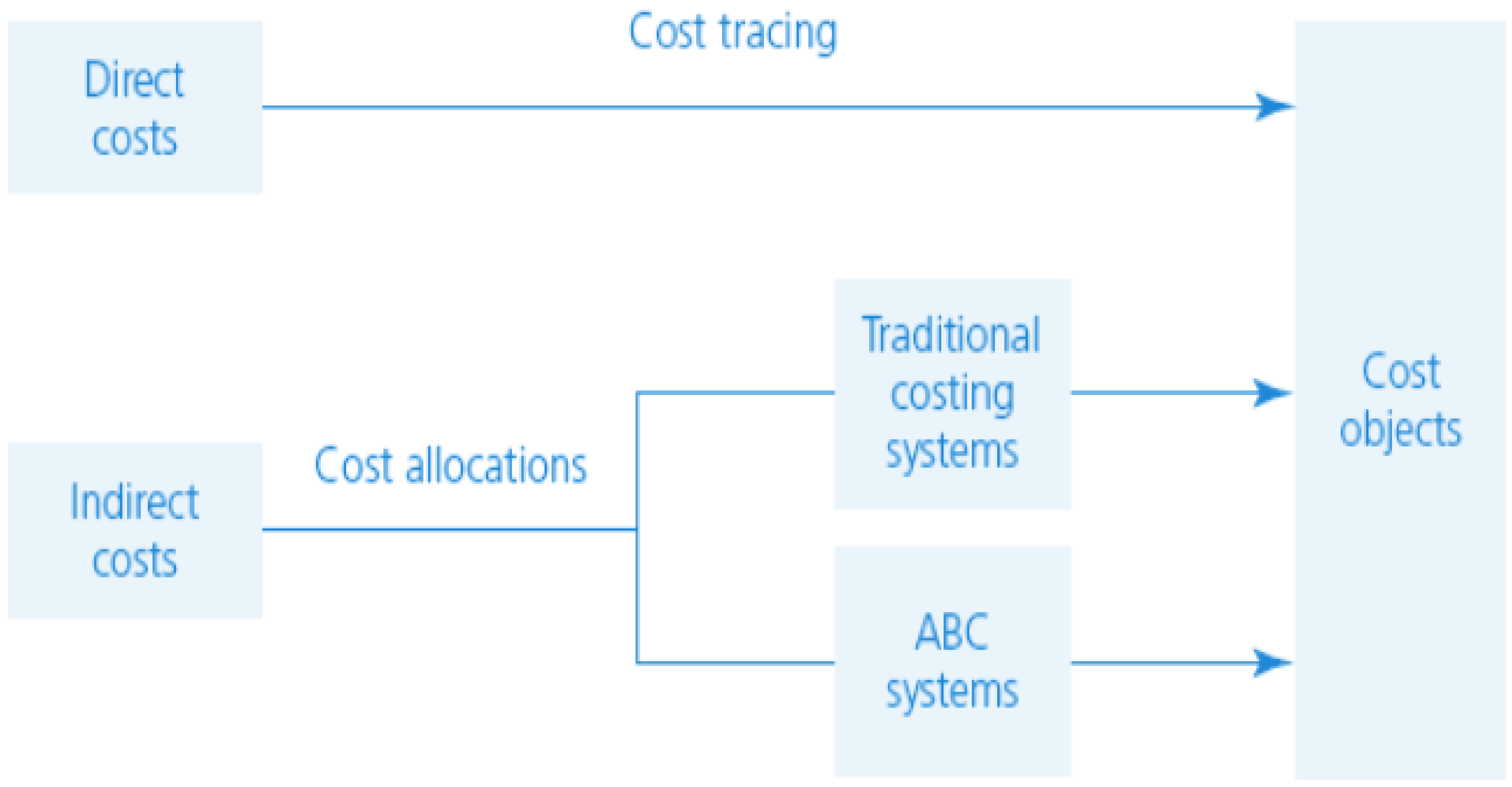
While Direct Costs are easy to trace, how should we assign Indirect Costs?

Note: *Remember that the precision of costing is a business decision. There's a trade-off between costs and benefit.*

Direct Costs	**Can** be **traced** easily and accurately to a cost object. *e.g. DM and DL*
Indirect Costs	**Cannot** be traced to cost objects and should be **allocated** based on estimates *e.g. MOH*

(In) Direct Costs

COST TRACING VS COST ALLOCATION



How do we know how much indirect products go for each product?

Cost tracing	**Where a cost can be directly assigned to a cost object** (direct costs are traced to the cost object).
Cost allocation	**Where a cost cannot be directly assigned to a cost object** (indirect costs cannot be directly traced to a cost object therefore are assigned to cost objects using cost allocations).

Traditional Costing

SINGLE OVERHEAD RATE & MULTIPLE OVERHEAD RATE

The easiest way is the **simple overhead rate**, which acts as an average. It is a blanket rate used by the organization to assign every indirect costs.

However, it might make sense to be more precise and have **multiple overhead rates** when resources' utilization varies much.

e.g. Clothes manufacturer with a Premium (hand-made) and a Regular (machine-made) line of products

Single Overhead Rate (SOR)

May make sense when resources are consumed **proportionally** across the organization

$$SOR = \frac{Total\ Overheads}{Total\ Allocation\ Base}$$

Multiple Overhead Rate

Suitable for resources consumed **differently** across the organization

$$MOR_i = \frac{Overheads\ i}{Total\ Allocation\ Base}$$

Exercise

8 – BETA COMPANY

Recovery of Overheads

SPENDING TOO LITTLE OR TOO MUCH

In practice, companies put on their **budgets** an **expected overhead rate** for the year, based on past data and intuition.

However, **overhead costs tend to fluctuate.**

How to proceed?

1) Compute **COGM** with the **budgeted rate ALWAYS**
2) Recognize **the difference** as a **period expense or revenue**

Over-Recovery of Overheads (OHO)

Spent **less** than budgeted

Actual MOH < Budgeted MOH

Period Revenue

Under-Recovery of Overheads (URO)

Spent **more** than budgeted

Actual MOH > Budgeted MOH

Period Expense