

Management Accounting

PRACTICAL CLASS 4



(In) Direct Costs

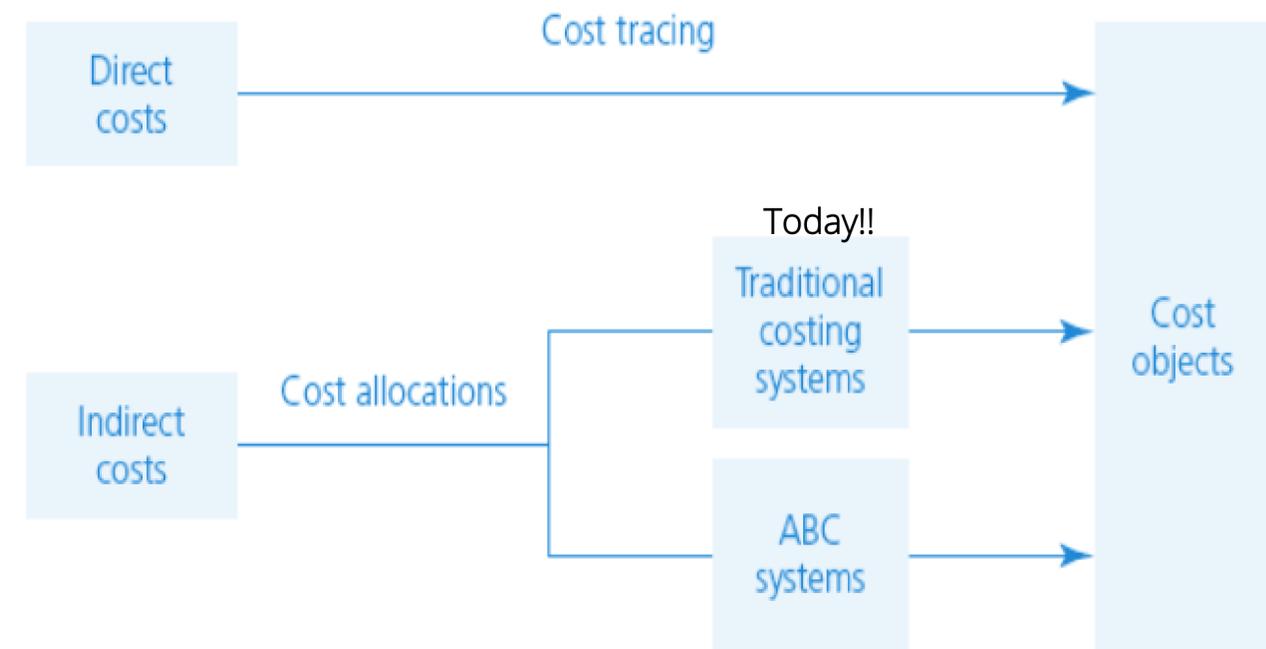
ADDING SOME ~~COMPLEXITY~~ REALISM

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

In real life, companies produce **hundreds** of **SKU's** (*Stock Keeping Units*) 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

Traditional Costing

GOOD OLD CHEAPER WAY

The easiest way is the **simple overhead rate**, which acts as an average rate across all overheads.

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. What would happen if

**Single
Overhead
Rate
(SOR)**

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

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

**Multiple
Overhead
Rate**

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

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

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**

Exercise

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