# Management Accounting

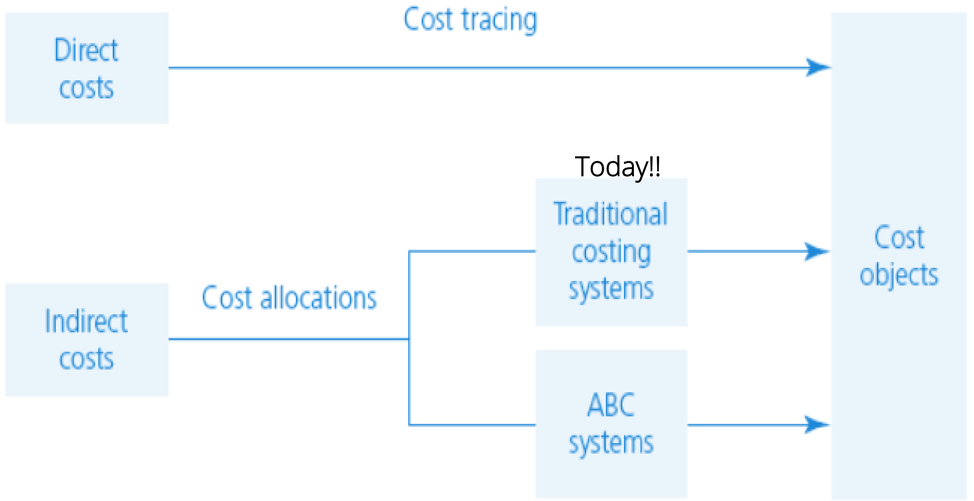
PRACTICAL CLASS 5



Illustration by Ana Seixas

# (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*

# Product vs Period costs

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| | |
|---|---|
| **Product Costs** | Attached to the products and included in the stock (inventory valuation). Treated as an expense (COGS) when products are sold<br>*e.g. Manufacturing Costs* |
| **Period Costs** | Not included in inventory valuation. Treated as an expense of the period in which they ocurred<br>*e.g. Non-Manufacturing Costs* |

# 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*

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

**Multiple Overhead Rate**

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

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

# MOH's & Departments

IN PRACTICE

Companies link MOH to Cost Centres, which are usually departments/production stages.

Inside the factory, there are 2 Types of Departments ➡️

We must link Services Departments Costs to the Production Departments which we can link to Products

***How?*** Compute Overhead Rates on Service Departments and Allocate them to Production Departments based on usage. ✅

***But there's a problem... What if Cleaning needs Maintenance?***

🤯 (*Interactions between Service Departments*)

**Production Departments**

Departments that are **Directly Involved** in the production of the finished goods

e.g. *Sewing, Cutting, Painting*

**Service Departments**

Departments that **Support** the functioning of other departments

*e.g. Maintenance, Factory Administration, Cleaning...*

# Homogenous Cost Pool

3 METHODS

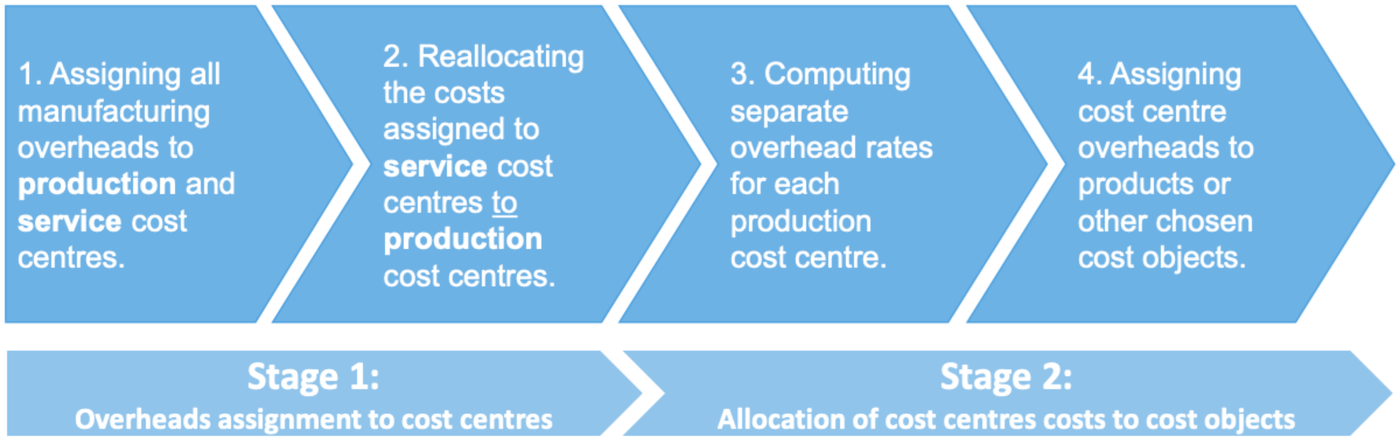
Which is to say:

- **Direct Method:** Just pretend interactions don't exist 🙈
- **Step-Down Method:** Just pretend (small) interactions don't exist 😮
- **Simultaneous Equation Method:** Flex your Math Skills to be as precise as possible 🤓

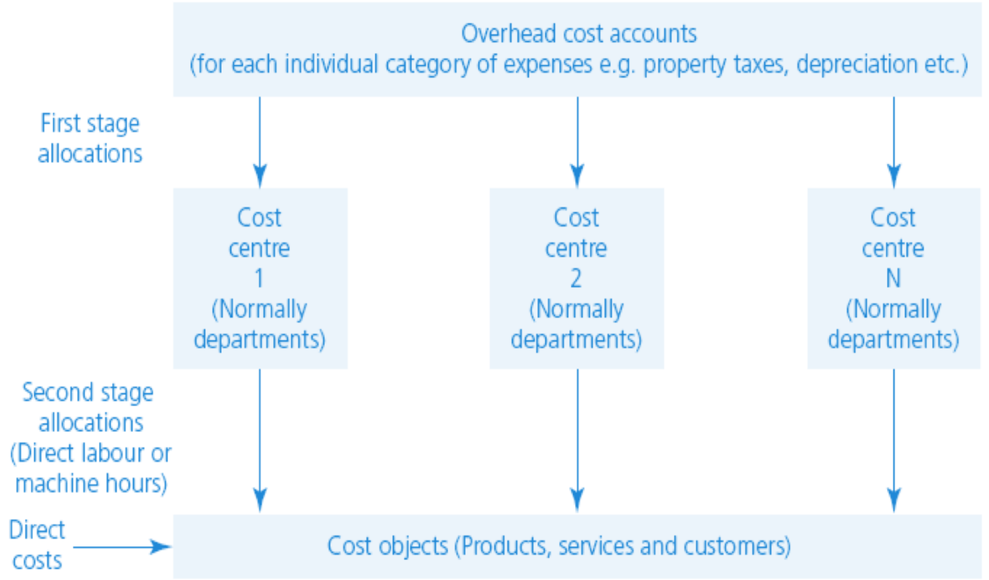
| | |
|---|---|
| **Direct Method** | **Disregard** interactions between **Service Departments** |
| **Sequential or Step-Down Method** | **Disregard** the smallest interactions (% of usage) |
| **Simultaneous Equation Method** | **Includes all** the mutual services provided by cost |

# Homogenous Cost Pool

IN PRACTICE




***Mateus Rodrigues, 2022***




***Drury, 2008***

# Exercise

11 – FINISHING MANUFACTURING CO