

# Management Accounting

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Practical Class #5

## Agenda

### **01** THEORETICAL RECAP

Homogeneous Cost Pool Method 02 EXERCISE 11 The Finish Manufacturing Co.

#### Homogeneous Cost Pool Method- Relevant Concepts

**Production Departments**- are part of the manufacturing process, such as cutting, assembly, machining, etc.

Service Departments- serve as support to the production departments, such as cleaning, maintenance, factory administration, etc.

**GOAL:** Reallocate the overheads of the Service Departments to Production Departments!

For that we need to take into account the interactions between Service Departments to Production Departments, and among Service Department themselves!

## Homogeneous Cost Pool Method

The 2-stage allocation process:

1<sup>st</sup> Assign OH initially to cost centre/cost pools (usually departments)

**2**<sup>nd</sup> Allocating the cost centre OHs to cost objects (products) using these second stage allocation bases/cost drivers



#### Homogeneous Cost Pool Method – Steps



There are 3 different ways of doing step 2, which one entailing a <u>different</u> <u>level of accuracy</u>

## Homogeneous Cost Pool Method

Methods to reallocate the costs assigned to service cost centres to production cost centres:

1. <u>Direct Allocation Method</u>: costs of the service cost centres reallocated only to production cost centres (no services to services)

2. <u>Sequential or Step-Down Allocation Method</u>: The service cost centre that renders the highest percentage of its total services to other service cost centres is closed first, then the second. (only the highest percentage)

3. <u>Simultaneous Equation Method</u>: Allocates costs by explicitly including the mutual services provided among all service cost centres (all is considered)

## O2 Exercise 11

Finish Manufacturing Company

#### When computing the rate of Service Cost Centres:

 Direct allocation method: disregards services provided between service cost centres <u>Rate of service cost centres</u>: divide only by the cost driver allocated to production centres <u>Exercise 11</u>: FA divide by 10 +60 employees; Maintenance divide by 7000 +1000 maintenance hours

2. Sequential allocation method: only the service that represents that highest percentage of the total work of the service cost centre is considered; the other one we will consider that only allocates their costs to the production centres

<u>Rate of services cost centres</u>: the service cost centre with highest percentage is divided by the total cost driver, the other only the cost driver corresponding to production centres <u>Exercise 11</u>: Maintenance has the highest percentage, so for the rate divide by total allocation base (2000 + 7000 + 1000 Maintenance Hours); we consider that FA only allocates costs to production centres, so for the rate divide by the corresponding 10 +60 employees allocated to the production centres

3. Simultaneous equation method: all services are considered, even services between services cost centres

<u>Rate of service cost centres</u>: divide by the total cost drivers

Exercise 11: Maintenance rate divide by 2000 + 7000 + 1000 Maintenance Hours; FA rate divide by the 10 + 10 + 60 employees