

To ensure an accurate allocation of indirect costs:

Steps:

Actual Costing	Normal Costing
1. Accumulate the actual indirect cost.	Predict indirect costs & allocation base quantity.
2. Determine the allocation bases for the indirect costs: Needs to be quantifiable and should be a good representation of the cost driver . That is, changes in the measured quantity of the allocation base should correspond to changes in the amount of OH costs that are incurred by the firm in order to produce the cost object. This ensures that IC are allocated based on a cause-and-effect relationship with the cost driver and the cost object. Resulting in accurate cost allocation.	
3. Measure the actual units of the allocation base	Measure the actual units of the allocation base
4. Allocation rate = actual total indirect cost / actual total allocation base quantity	Predetermined MOH rate = Budgeted indirect mfg cost / Budgeted allocation base quantity
5. Indirect cost allocated = actual quantity of allocation base incurred by the cost object x actual allocation rate.	Actual quantity of allocation case incurred by the cost object X Predetermined MOHR
	Adjust at the end of the period

Which indirect costs should be allocated to the cost objects?

To ensure that ALL costs are taken into consideration when doing a profitability assessment of the cost object & when making decisions on its selling price etc **all indirect costs** incurred by Payroll, HR, Marketing and Distribution should be allocated to the cost object.

However sometimes some costs (cost of PR, company website) cannot be allocated on a 'cause-and-effect' basis to the cost object. Therefore, firms **may** exclude allocating some of these costs to the cost objects.

– Cause-and effect problem: cannot allocate some costs to an cost object using an allocation base that would result in each product being allocated the amount of IC that they actually 'caused'.

How to determine the number of cost pools?

- Costs pools should be homogeneous (individual costs in the pool should have the same cost driver), this ensures a more accurate allocation of IC.
- Multiple cost pools will be required if IC have diverse cost drivers
- Need to consider cost vs benefit of having an additional cost pool.

Support department costs: Departments are interdependent of each other; they provide support to operating departments as well as each other, cost cannot be traced to operating depts. In an economically feasible way.

To allocate support dept costs to operating dept:

Allocate support costs to operating depts > accumulated to operating dept's OH > allocated to lines of products/services > allocated to each unit of product/service

- Direct method (Ignore interdependence)
- Partial method (Recognise some interdependence)
- Reciprocal (Recognise all interdependence)

Traditional/conventional costing system:

Single plant wide indirect cost pool with single volume based allocation base & single allocation rate. The chosen allocation rate may not be a good rep of the cost driver of all the different indirect costs (machine set up costs, material ordering costs – not driven by volume production).

- Under cost specialty/ complex, low volume products.
- Over cost standard/simple, high volume products

From which prices will be set too high/low, resulting in lower/higher volumes of sale.

ABC Costing

- Costly
- Used by firms that produce diverse products which do not consume resources in proportion to volume produced; has large proportion of IC; Operates in highly competitive markets (need to price things correctly); has a system that can capture all info required.
- Indirect costs split into multiple pools with different allocation bases.
- Focuses on individual activities as cost objects
- First allocate IC to activity cost pools > individual product based on their usage of each activity (recognise difference in usage of activities by diff products)
- Unit level > Batch level > Product/service sustaining > facility sustaining.

To be accurate: Homogenous cost pools; Total cost assigned to each pool is accurate; allocation base representative of cost drivers.

Uses:

- Come up with cost reduction initiatives (due to better understanding of which are the activities that drive IC)
- Better planning & budgeting (better predict/plan IC if we know the output volume; shows why actual differs from budgeted.); Better understanding of the causes of

indirect cost, especially fixed cost can provide the basis for better long-term planning.

- Control and profitability analysis, including pricing.
- Process improvement, reduce costs and increase efficiency through better activity selection and product design.
- Deciding which products to push (if there are production constraints)