Cost allocation method essay sample

KAI uses an inappropriate volume- based cost allocation method that causes inefficient resource allocation, disincentive among employees and weaker financial performance. To improve the existing method, Senior Management should consider reviewing the current situation to identify the problems, followed by adopting an alternative cost allocation method. The current revenue-based cost allocation method causes inefficient resource allocation, resulting in excess overhead costs. It lacks consideration of each branch's difference in cost structure and the irrelevant relationship between costs and revenues. The actual needs of different teams are not addressed. For example, the Operating Support Team's traffic accident handling costs are not related to revenue. Instead, the number of accidents should be used as cost driver. Although the number of accidents decreased by approximately 43% from 54 cases in 2007 to 31 cases in 2008, the traffic accident handling costs increased by approximately 40% from $11. 7 to $16. 4 million. Apart from inappropriate cost drivers, the method allocated unnecessary resource to branch activities that are not related to operation. For example, the headquarters building's maintenance costs are not related to Taejon branch's operating activities; it should not be allocated to the General Administrative Team.

The same applies to the Investment Team since its activities are independent of branch's operation. Use of revenues as the only cost allocation basis leads to excess overhead costs, which lowers the net income of branches. Allocation of excess overhead costs provides disincentives among employees. Their effort paid on reducing costs is not rewarded with lower overhead costs and their earning targets are harder to be reached.

From 2007 to 2008, Taejon branch’s total revenues increased by approximately 40% from $23. 6 million to $33. 2 million and its proportion of direct costs over total revenues decreased from 72% to 67. 5%. These reflect employees contributed to cost reduction and revenue increase. They were yet penalized with an approximately 22% increase in total overhead costs from $73 million to $89. 4 million. Particularly, Taejon branch decreased the number of employees by approximately 45% from 82 in 2007 to 45 in 2008. Yet, overhead costs of the IT team increased by approximately 32% from $18. 4 million in 2007 to $24. 3 million in 2008. The GA Team was also penalized by an approximately 13% increase in education and training cost from $4. 5 million to $5. 1 million. The two teams’ intention to reduce costs is not recognized by the headquarters.

Employees are discouraged by the allocation of excess overhead costs, which weakens their productivity. The overall financial performance in terms of net income is weakened by insufficient cost allocation. From 2007 to 2008, total revenues of the whole company increased by approximately 12% from $203. 5 million in 2007 to $227. 8 million in 2008. However, the total overhead costs increased by approximately 22% from $73 million to $89. 4 million. Increases in total revenues and overhead costs are disproportional. Rise in revenues cannot compensate for the excess overhead costs allocation. Thus, the net income declined. Reduced net income undermines our firm value, which may affect our company’s development in long term. Under the current volume-based cost allocation method, problems including inefficient resource allocation, disincentive among employees and weakened financial performance exist. It is important for the Senior Management to

consider adopting an alternative cost allocation method to improve the current situation. If not, our firm value may continue to lower and we may even lose our market share in the severely competitive market.