

Free essay on product costing issues at fabricator inc

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Last decades have seen substantial changes in the business world including deregulation, increasing competition and growing expectation of consumers (Atrill and McLaney, 2009, p. 134). These changes have brought about more competitive and dynamic environment across all industries. This paper examines how the changes affected the costing practices used by the company and recommends the ways to tackle the problems posed by the new environment.

Rising overheads

Two or three decades ago manufacturing enterprises like Fabricator inc. featured (Atrill and McLaney, 2009, p. 134) the following:

- Direct labor was one of the dominating elements of total manufacturing costs.
- The level of overhead costs was quite low.

Such economics justified traditional costing approach which charged overhead to the products based on direct labor hours as is still appears to be the case at Fabricator Inc. However, better transportation infrastructure, dramatic improvements in communication technologies and removal of trade barriers have led to a new business landscape characterized by the following developments:

- Machinery now plays more important role as many enterprises deployed advanced manufacturing technologies (CIMA, 2004, p. 92).
- Product variety widened. With increased competition and improved communications between countries, consumers have become more demanding leading to more pressure on manufacturers to re-design their products.

- The above factors led to substantial rise in overhead costs such as equipment depreciation, maintenance, scheduling and set up costs. One of the reasons behind this change was the widening diversity in products and services (Cokins, 2001, p. 5).
- The quantity of direct labor decreased substantially as a result of automation. This is clearly the case at Fabricator Inc. with only 5% of costs pertaining to this category.

The above explains the inexorable growth of overhead rate per hour to as high as \$ 3000/hour mentioned by the engineer as the rising overhead costs are divided by diminishing direct labor hours resulting in the soaring overhead rate. The question arises in respect of the relevance of the traditional costing still being applied in a new environment.

Deficient costing provides misleading information

Correct overhead allocation to the products is very important as it is included in the full cost of the products and as a consequence affects business decisions regarding quotations in bids and tenders. This is especially critical for modern manufacturing environments, as overhead is relatively large and the product variety is usually wide. The traditional costing addresses the issue by charging overheads to products based on direct labor hours.

However, as explained by the engineer, the direct labor is used less and less, while the application of technology (and related overhead) grows up and up. The question is whether the traditional costing is relevant in modern environment. A closer look at the overhead reveals that major part of those costs is support activities such as equipment set up, maintenance,

dispatching (CIMA, 2004, p. 141), i. e. activities not related to volume or direct hours. The conclusion is that allocating overhead based on direct hours produces irrelevant information for costing decisions. In case overhead is overcharged to the jobs as a consequence of the traditional costing method, it is very likely that Fabricator Inc. may price itself out during bidding process because it uses cost plus or mark up process to arrive at quotation.

Activity-based costing as a possible solution

The issues with conventional costing systems have come to the attention of academics and practitioners in 1980s. As a response to these problems, the concept of Activity-based costing (ABC) was developed in the late 1980s (Hicks, 1999). ABC aims to solve the existing problem by charging overhead costs to products through the intermediary of activities (Atrill and McLaney, 2009, p. 138). This can be described as follows:

- Various support activities necessary for manufacturing the products such as equipment set up, dispatching, scheduling, maintenance are identified.
- Overhead costs are allocated to the activities through the use of resource drivers such as sales orders. The resource drivers measure the intensity of resources use by the activities.
- The activity drivers, i. e. factors that cause the activities to be performed are identified. An example could be a number of production runs or a number of set ups.
- Activity cost is allocated to the products based on the intensity of use of the activity as demonstrated by the related cost driver.

The following scheme depicts the process:

Resources used => allocation through resource drivers => activities => allocation through activity drivers => products.

The ABC concept, as opposed to the traditional costing, takes into account more relevant, non-volume related factors that drive overheads (CIMA, 2004, p. 142). The result is that overhead is more accurately allocated to different products based on more relevant factors. However, care should be exercised in implementing ABC as it is not always easy to identify the correct resource and activity factors.

Conclusion

The advent of advanced manufacturing technologies and increase in variety of products has led to rise in overhead and diminishing of direct labor. This in turn has cast some doubts upon the relevance of the conventional costing system as demonstrated by the case of Fabricator Inc. The main problem revealed by the analysis is that overhead costs are not driven by direct labor but by a number of other, non-volume factors, such as set ups, number of production runs etc. One concept which takes account of those factors is Activity-based costing and it is arguably more relevant for modern manufacturing. However, implementation of ABC should be done only after a careful analysis by comparing its benefits and drawbacks. While the benefits have been essentially outlined above, the possible drawbacks include difficulty in identification and tracking cost drivers, and the system may become too complex and costly to operate.

References

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