

# Regarding methods of cost allocation



## Executive Summary

This report discusses the advantages and disadvantages of activity based costing.

In this report, a section introducing the purpose, scope, method used , limitations and background of this report was highlighted.

The findings of the meaning of activity-based costing, and the focus of activity-based costing as a means of managing the business on the basis of the activities that make up the organisation was defined.

A critical analysis of the advantages and disadvantages to meta calf furniture corporation was then enumerated.

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### Introduction

#### Purpose.

The purpose of this report is to critically analyse and discuss the advantages and disadvantages of Metcalf using an activity-based costing system.

#### Scope.

The report discuss the advantages and disadvantages of Metcalf using an activity-based costing system.

#### Method

The advantages and disadvantages were enumerated and a comparative analysis was done in terms of the cost driver rates, cost of resources used by individual products, services, or customers, cost of errors, overheads, units

cost, non-volume related activity cost, physical resources and cost of operation .

Limitations.

This report is only limited to the advantages and disadvantages of activity-based costing. There was no comparison to other methods of cost allocation because of lack of relevant data.

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Background

Metcalf furniture corporation produces sofas, recliners, and lounge chairs. Metacalf is located in a medium-size community in the north-western part of the united states. it is a major employer in the community. in fact, the economic well-being of the community is tied very strongly to metacalf operates a sawmill, a fabric plant, and a furniture plant in the same community.

The sawmill buys logs from independent producers. The sawmill then processes the log in to four grades of lumber: firsts and seconds, No. 2 common, and No. 3 common. All cost incurred in the mill are common to the four grades of lumber. All four grades of lumber are used by the furniture plant. The mill transfers everything it produces to the furniture plant, and the grades are transferred at cost. Trucks are used to transfer the

lumber from the mill to the furniture plant. Although no out side sale exist, the mill could sell to external customers, and the selling prices of the four grades are known.

The fabric plant is responsible for producing the fabric that is used by the furniture plant. To produce three totally different fabrics (identified by fabric ID codes: FB60, FB70, and FB80, respectively), the plant has three separate production operations- one for each fabric. Thus, production of all three fabrics occurs at the same time in different locations in the plant. Each fabric's production operation has two processes: in the weaving and pattern process and the coloring and bolting process. In the weaving and pattern process,

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yarn is used to create yards of fabric with different designs. In the next process, the fabric is dyed, cut in to 25-yard sections, and wrapped around card board rods to form 25-yards bolts. The bolts are transported by forklift to the furniture plant's Receiving department. All of the output of the fabric plant is used by the furniture plant (to produce the sofas and chairs). For accounting purposes, the fabric is transferred at cost to the furniture plant.

The furniture plant produces orders for customers on a special- order basis. The customers specify the quantity, style, fabric, lumber grade, and pattern. Typically, jobs are large (involving at least 500 units). The plant has two production departments: cutting and assembly. In the cutting department, the fabric and wooden frame components are sized and cut. Other components are purchased from external suppliers and are removed from stores as needed for assembly. After the fabric and wooden components are finished for the entire job, they are moved to the assembly department. The Assembly Department takes the individual components and assembles the sofas (or chair).

## Findings

### Meaning of activity-based costing (ABC)

This is a method of charging over heads to cost units on the basis of benefits received from the particular indirect activity e. g. ordering, planning, setting, etc. activity-based costing seeks not only to attribute overheads to product cost on a more realistic basis than

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simply production volume but also attempts to show the relationship between overhead cost and the activities that cause them.

Activity Based costing is regarded to as an accounting system that is sophisticated i. e expensive to operate, extensive use of cause -and- effect cost allocation, high level of accuracy and low cost of errors.

### Focus of Activity based Costing

It focus on managing the business on the basis of the activities that make up the organization. It is based on the premises that activities consume costs. Therefore, by managing activities, costs will be managed in the long term.

It analysis costs by activities and thus provides management with information why costs are incurred and the output from the activity (in terms of cost drivers)

### Discussion

Advantages of Activity- Based Costing System to Metcalf Furniture Corporation:

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1. ABC Systems establish separate cost driver rates for support centres, and assign the cost of support activities directly to cost objects without any reallocation to production centres
2. By using a greater number of cost centres and different types of cost drivers that cause activity resource consumption and assigning activity costs to cost objective

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on the basis of cost drivers usage, ABC systems can more accurately measure the resources consumed by cost objective.

3. Report product, service or customer costs represented estimated of the cost of resources used. The periodic reporting of both the predicted quantity and cost of unused capacity for each activity signals the need for management activity resources supplied.
4. ABC System use many different types of second stage cost drivers including non-volume-based drivers, such as the number of production runs for production scheduling and the number of purchase orders for the purchasing activity.
5. ABC Systems use both volume-based and non-volumed-based cost drivers. Volumed- based cost drivers assume that a product's Consumption of overhead resources is directly related to units produced. Non-volume-based cost drivers include se-ups and engineering orders.
6. ABC System measure the cost of resources used by individually, products, services or customers. During any particular period the number of orders processed will vary.

7. ABC System minimize the cost of errors.
8. Overheads are assigned to each major activity rather than departments

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#### Disadvantages

1. Where units cost are calculated, ABC systems can suggest an inappropriate degree of variability for example to calculate unit product costs batch levels activity costs are divided by the number of units in the batch and product sustaining costs are divided by the number of products produced.
2. In the area of decision making there is a danger that what started out as a non-volume related activity cost will be translated into a cost which varies with production volume.
3. The concept of managing unused capacity is fine for human resources but it does not have the same impactt for physical resources such as the acquisition of plant and equipment Human resources are more flexible and can be adjusted to the usage of resources.
4. ABC System is more expensive to operate.

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#### Conclusion

ABC must meet the cost/ benefit criterion and improvement should be made in the level of sophistication of the costing system up to the point where the

marginal cost of improvement equals the marginal benefit from improvement.

## References

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