

# **Topic 5. COSTING OF PRODUCTS AND SERVICES**

**Vera Butkouskaya**



## Topic 5. Part 1.

- 5.1. Costing systems
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  - ▷ Average costs vs. individualized costs
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- 5.2. Job costing
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## 5.3. Indirect cost pools and cost allocation

## Basic Terminology

Cost object

Direct cost of a cost object

Indirect cost of a cost object

***Cost-allocation base***

**Cost pool**

## Allocation Base

An **allocation base** is the basis upon which an company allocates its overhead costs.

It takes the form of a quantity, such as

- machine hours used,
- kilowatt hours consumed, or
- square footage occupied.

## Cost-allocation base

**Cost-allocation base** - a factor that is the common denominator for systematically linking an indirect cost or a group of indirect cost to a cost object.

*Financial - direct labor costs*

*Non-financial - the number of car kilometres travelled to allocate motor vehicle operating costs among different sales districts*

## Cost pool

- **Cost pool** - a grouping of individual cost items.

*Broad: A company-wide total-cost pool for telephones and fax machines*

*Narrow: Cost of operating car used by a travelling salesperson, or*

*Printing costs at the university*

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## 5.1. Costing systems



## Costing systems

**Costing systems** aim to report cost numbers that indicate the manner in which particular cost objects - such as products, services and customers - use the resources of the organization.

1. Cost-benefit-context (*designing and choosing*)
2. Made-to-order operations not vs. (*useful*)
3. Not only one source of information for managers (*non-financial metrics*)

# Job Costing vs. Process Costing

Costs are assigned to



*Audit by an accounting firm or  
A gearbox system for a particular car system.*

*Teddy bear or  
Soda ash*

Most companies combine 2 systems...

### Exhibit 3.2

### Examples of job costing and process costing in the service, merchandising and manufacturing sectors

	Service sector	Merchandising sector	Manufacturing sector
<b>Job costing used</b>	<ul style="list-style-type: none"><li>● Accounting firm audits</li><li>● Advertising agency campaigns</li></ul>	<ul style="list-style-type: none"><li>● Sending a catalogue to a mailing list</li><li>● Special promotion of a new store product</li></ul>	<ul style="list-style-type: none"><li>● Aircraft assembly</li><li>● House construction</li></ul>
<b>Process costing</b>	<ul style="list-style-type: none"><li>● Deposit processing</li><li>● Postal delivery (standard items)</li></ul>	<ul style="list-style-type: none"><li>● Grain dealing</li><li>● Processing new magazine subscriptions</li></ul>	<ul style="list-style-type: none"><li>● Oil refining</li><li>● Beverages production</li></ul>

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## 5.2 Job costing

## Six-step approach

Step 1. Identify the job that is the chosen cost object

Step 2. Identify the direct costs for the job.

Step 3. Identify the indirect-cost pools associated with the job.

Step 4. Select the cost allocation base to use in allocating each indirect-cost pool to the job.

Step 5. Develop the rate per unit of each cost-allocation base used to allocate indirect costs to the job.

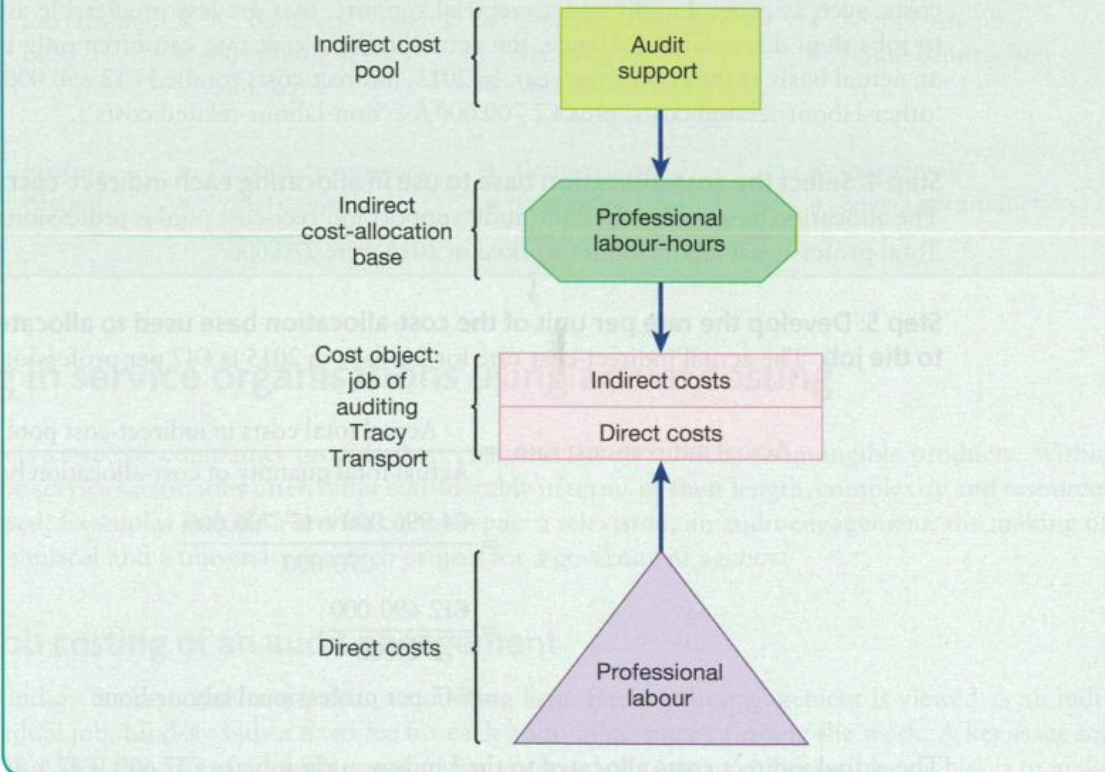
Step 6. Assign the costs to the cost object by adding all direct costs and all indirect costs.

## Actual indirect-cost rate

$$\text{Actual indirect-cost rate} = \frac{\text{Actual total costs in indirect-cost pool}}{\text{Actual total quantity of cost-allocation base}}$$

### Exhibit 3.3

### Job-costing overview at Lindsay & Associates



## Source documents

Managers and accountants gather information that goes into their cost systems through **source documents**, which are the original records that support journal entries in an accounting system.



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## 5.4. Cost accumulation; actual costs and budgeted costs

## Actual vs. Normal costing

Differ in their use of actual and budgeted indirect-costs rates.

	Actual costing	Normal costing
Direct-cost rates	Actual rates	Actual rates
Indirect-cost rates	Actual rates	Budgeted rates

## Budgeted indirect-cost rate

$$\text{Budgeted indirect-cost rate} = \frac{\text{Budgeted total costs in indirect-cost pool}}{\text{Budgeted total quantity of cost-allocation base}}$$



*Bhimani A, Horngren CT, Datar SM and  
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Accounting, 5/E. Financial Times Press  
2012.*

*Chapter 3.*