Recall that accounting information is a subset of all information managers use to handle the two prime economic tasks they face: coordinating actions (decision-making) and control (decision-control). Let’s see what accounting information can and cannot do.

**Chapter 7 ... Allocation Theory**

Why allocate costs?
- External reporting and taxes
- Contracts
- Managerial decisions

Incentive issues
1. When the allocation base is “taxed” - people will reduce usage of that factor.
2. Taxing people makes them pay attention to costs being recovered.
3. Non-insulating allocations promote mutual monitoring.

Study recommendations
Everyone should read Case 7-2 and discuss in groups.

**Chapter 8 ... Allocation Practice**

Cost allocations should be based on factors which cause variation in cost. However all cost allocations have some common problems. The most important is the death spiral.

What is the death spiral? If managers can reduce the usage of the factor used as an allocation base, they can shift costs on to other depts. By using less of the base ... however for the firm as whole the overhead costs do not go away (in fact because of inefficient factor substitution, they probably go up). Thus fewer and fewer activities have to be taxed more and more heavily making these activities appear unprofitable. In the limit this can lead to firms giving up potentially lucrative markets and products simply because the cost system is being gamed.

Two important cases of cost allocation are allocation of service dept costs and allocation of joint costs.

To allocate svc dept costs, we can use either direct method or step-down method or use the more complex reciprocal method. We ignore the reciprocal method as it is computationally complex and not often used. In the direct method each svc dept cost is allocated only to production depts. In the step-down method each svc dept is closed down in order and costs allocated to all remaining depts. Then the revised cost of the next svc dept is allocated to all departments remaining and so on till the last svc dept is closed.

Allocation of joint costs is meaningless for assessing profitability. We may have to allocate joint costs for inventory valuation or for pricing purposes. If so use physical units, sales price or NRV (i.e. final sales price minus all post-split off costs).
Chapter 9 ... Absorption Costing
Job and process costs systems are the two “canonical” cost accumulation systems.

Job Costing
Job cost systems accumulate costs by job or batch. Then cost of each unit of output is simply the batch average cost.

Tracing the cost flow is key. Revisit that.

Overhead is allocated using std. Rates. Why? Comparability, actual rates can vary from period to period and that noise makes it harder to evaluate managerial performance.

OAR (overhead allocation rate) = Budgeted Overhead/Budgeted Output expressed in standard units of input used as the allocation base.

Overhead absorbed = Units of output actually produced X OAR per unit of output.

Under or over-absorbed overhead = Actual overhead - overhead absorbed.

This can be closed to COGS or allocated to COGS and EI or we can re-estimate the overhead allocation rate at the end of the year and use the actual rate (very rarely done ... too costly and not useful for decision control purposes).

Another important thing to note is the role of expected volume in determining product costs. If expected volume is much lower than normal volume, generally using expected volume is incorrect as it causes too high an overhead allocation rate for the operation. If normal volume is much higher than expected volume, the correct thing to do is to use normal volume to cost products but then ask separately why one has excess capacity. Then whoever has decision rights over capacity choice should “eat” the loss due to lower volume.

One may have plant wide OARs or have multiple rates for departments and processes. Which one is chosen depends on cost benefit. If some departments really have very dissimilar cost consumption patterns, then multiple rates may be better. However one then has comparability and “fairness” problems to deal with.

Process Costing
In process costing the key trick is to compute equivalent units of output for each input separately and then divide the period cost for that input by the period output of that input. This gives you the unit cost of that input per unit of finished output. The unit costs can be computed using wtd. Avg or FIFO.
Chapter 10 ... Criticisms of Absorption costing

In allocating overhead to EI, we shift FOH from one year to another. However FOH really has many of the characteristics of period costs. So if by producing more or less in one year we can affect profits, just because more FOH gets shifted out to the next year via inventory, we give incentives to managers to overproduce.

We can use variable costing in which inventory is valued only at VC. This cures the overproduction incentive caused by valuing inventory at full cost and profits are not sensitive to changes in production volume.

However using variable costing causes two sets of problems: managers can play games and convert or reclassify FC as VC. The former can be done by outsourcing activities and can be very costly to the organization. The latter can be done by reclassifying costs and top management cannot check this since lower level managers have better information. Second, by ignoring FC, we give managers incentives to ignore the resources consumed by FOH ... these can be substantial and by the “what you don’t have to eat, you don’t care about” principle, we can see that a firm can get into serious trouble using variable costing.

Finally, just to repeat: beware of unit costs. Fixed costs are lumpy so when we think of unit costs, we are in effect “converting” fixed costs into variable costs. This can lead to serious mistakes in decision-making.

More in part II of the review....