COST AND REVENUE ANALYSIS

How to produce partial profitability information

EFFICIENCY

1. **OPERATIONAL PRODUCTIVITY**

$$\frac{O_{PHYSICAL}}{I_{PHYSICAL}}$$

   a) **Partial**

   b) **Total**

2. **FINANCIAL PRODUCTIVITY**

$$\frac{O_{REVENUES}}{I_{EXPENSES}}$$

   a) **Partial**

   b) **Total**

JUST THE OPPOSITE

EFFICIENCY

1. **OPERATIONAL PRODUCTIVITY**
   - a) **Partial** ✔
   - b) **Total** ✘
2. **FINANCIAL PRODUCTIVITY**
   - a) **Partial** ✘
   - b) **Total** ✔

DIFFERENT POSSIBLE PROFIT MARGINS

+ Sales revenues	**€**	**265.780**	**100,00%**
- Cost of goods sold (@manufacturing variable cost)	-€	85.330	-32,11%
= Manufacturing variable margin	**€**	**180.450**	**67,89%**
- Sales variable costs	-€	24.550	-9,24%
= Contribution margin	**€**	**155.900**	**58,66%**
- Fixed costs (excluding depreciation and amortization costs)	-€	83.009	-31,23%
= EBITDA	**€**	**72.891**	**27,43%**
- Depreciation and amortization costs	-€	38.126	-14,34%
= EBIT	**€**	**34.765**	**13,08%**
- Interst expenses	-€	12.500	-4,70%
= EBT	**€**	**22.265**	**8,38%**
- Income taxes	-€	6.680	-2,51%
= EAT	**€**	**15.586**	**5,86%**

SOME IMPORTANT RELATIONSHIPS

+ Sales Revenues

– Cost of Goods Sold

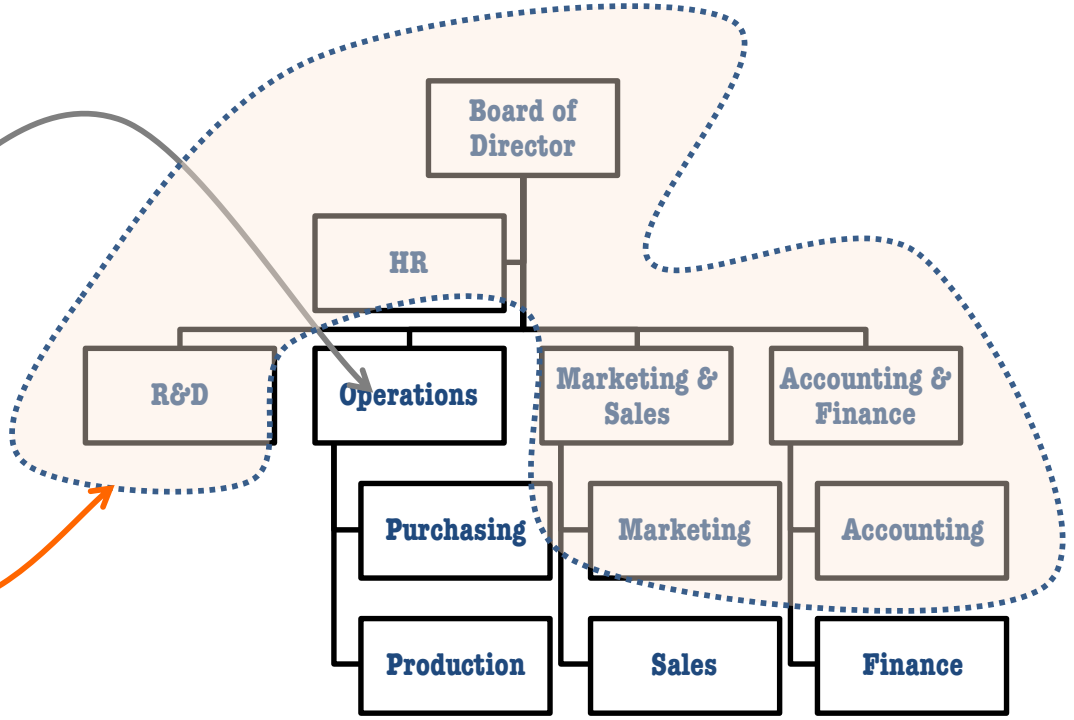
= Gross Margin

– S,G&A Expenses

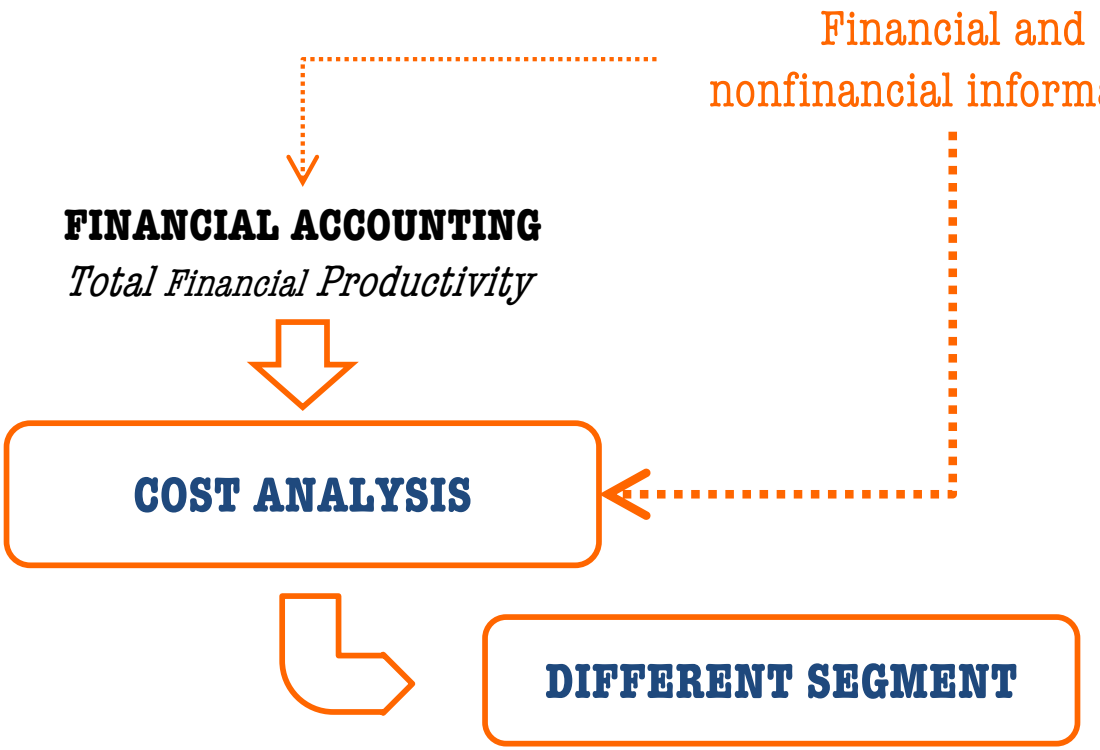
= EBIT

– Interest Expenses

= EBT



FROM TOTAL TO PARTIAL FINANCIAL PRODUCTIVITY



+ Operating revenues	€	4.207.565
- Operating costs	-€	3.705.816
= Operating profit	**€**	**501.749**

MANAGERIAL ACCOUNTING and MANAGERIAL COSTING

Partial Financial Productivity

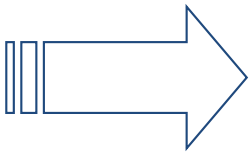
Product "A"	€	657.235
Product "B"	€	546.763
Product "C"	€	432.267
.....	.....	
Product "N"	-€	138.758
Operating profit	**€**	**501.749**

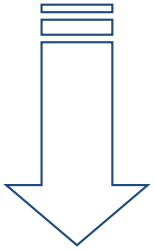
Customer "X"	€	432.001
Customer "Y"	€	367.455
Customer "W"	€	312.826
.....	.....	
Customer "K"	-€	25.789
Operating profit	**€**	**501.749**

Responsability center "1"	€	2.433.015
Responsability center "2"	€	1.774.550
Responsability center "3"	-€	64.520
.....	.....	
Responsability center "12"	-€	835.519
Operating profit	**€**	**501.749**

DIFFERENT COST OBJECTS

COST OBJECTS





"Internal"

Resources (Means of Production)
Responsibility Centers (Departments)
Activities or Processes
Projects
WIPs
Products or Product Lines

"External"

Customers or clusters of Customers
Distribution Channels
Geographical Areas
Suppliers

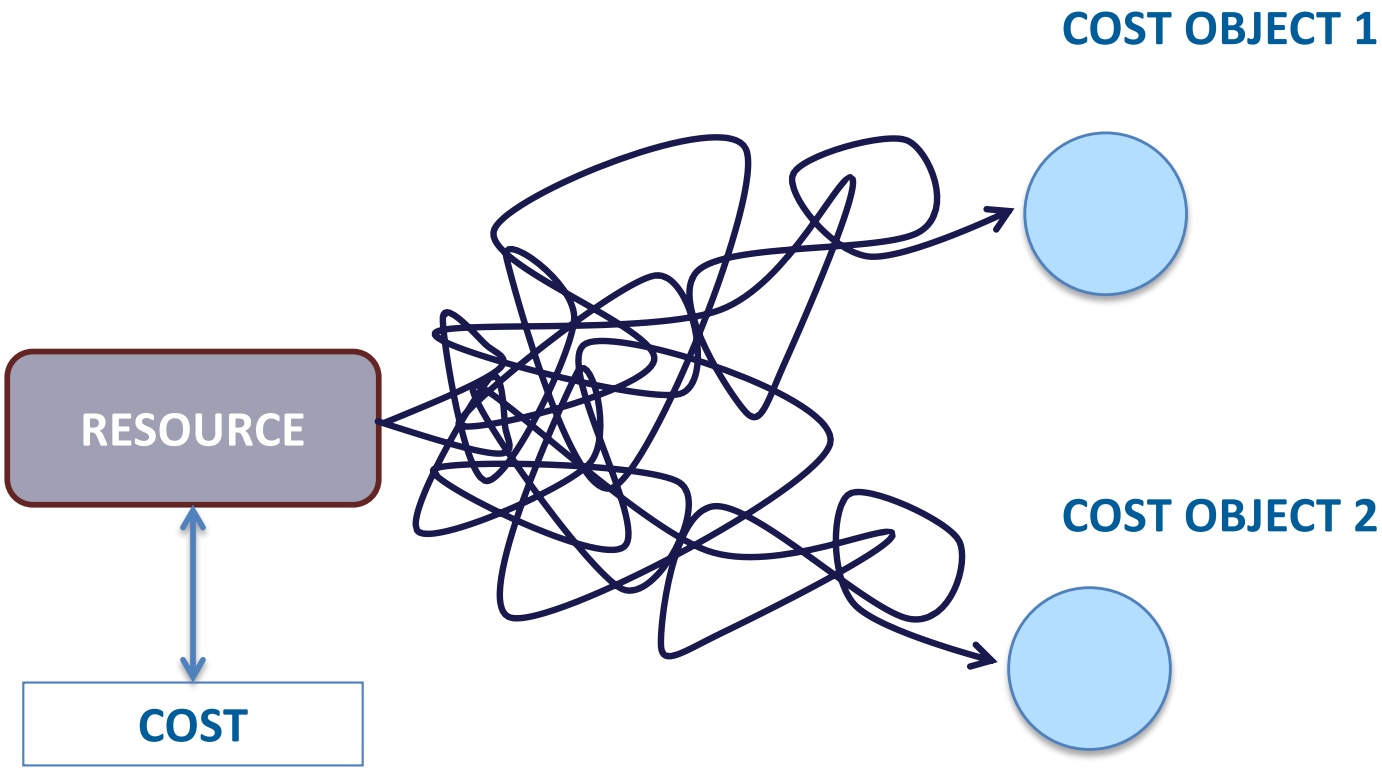
These cost objects are the most innovative: they denote the adoption of a more modern management control. The focus is on the outside world.
Those who adopt this perspective seek to obtain the information necessary to manage market competition more effectively

A SEGMENT INCOME STATEMENT

	JOB 1	JOB 2	JOB 3	JOB ...	JOB N	Total
+ Sales Revenues	xxx	xxx	xxx	xxx	xxx	∑
- Sales Commissions	xxx	xxx	xxx	xxx	xxx	∑
= Net Revenues	**= xxx**	**= xxx**	**= xxx**	**= xxx**	**= xxx**	**= ∑**
- Direct Materials	- xxx	- xxx	- xxx	- xxx	- xxx	∑
= First Margin	**= xxx**	**= xxx**	**= xxx**	**= xxx**	**= xxx**	**= ∑**
- Outsourced Work	- xxx	- xxx	- xxx	- xxx	- xxx	∑
= Second Margin	**= xxx**	**= xxx**	**= xxx**	**= xxx**	**= xxx**	**= ∑**
- Other Direct Costs	- xxx	- xxx	- xxx	- xxx	- xxx	- ∑
- Direct Labor	- xxx	- xxx	- xxx	- xxx	- xxx	- ∑
= **Job Orders Direct Margin**	**= xxx**	**= xxx**	**= xxx**	**= xxx**	**= xxx**	**= ∑**
- Manufacturing Overhead						- xxx
- Selling Overhead Expenses						- xxx
- Administrative Expenses						- xxx
- General Expenses						- xxx
= Ebit						**= xxx**

WHY IT IS DIFFICULT TO COMPUTE....

Partial financial productivity measure:



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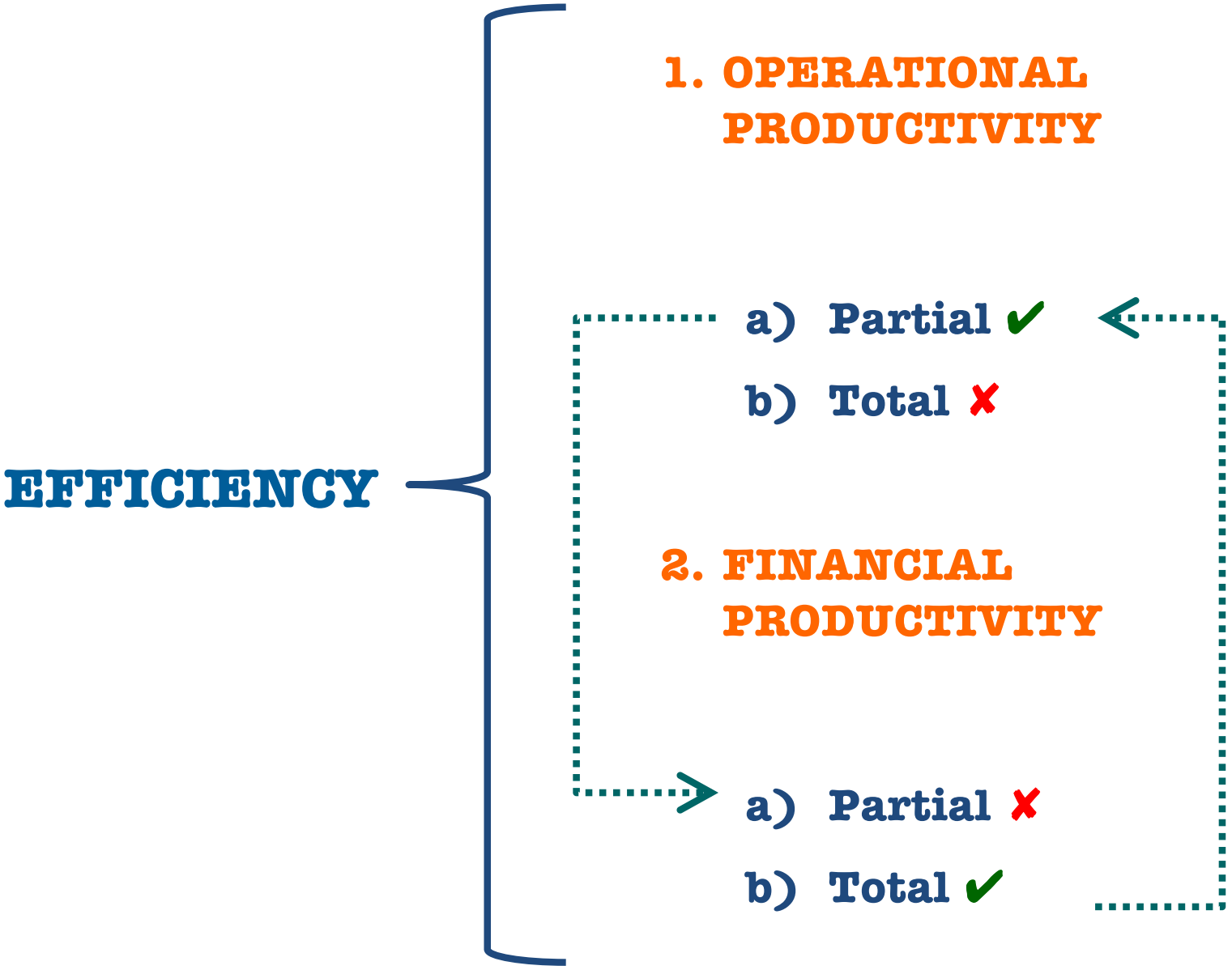

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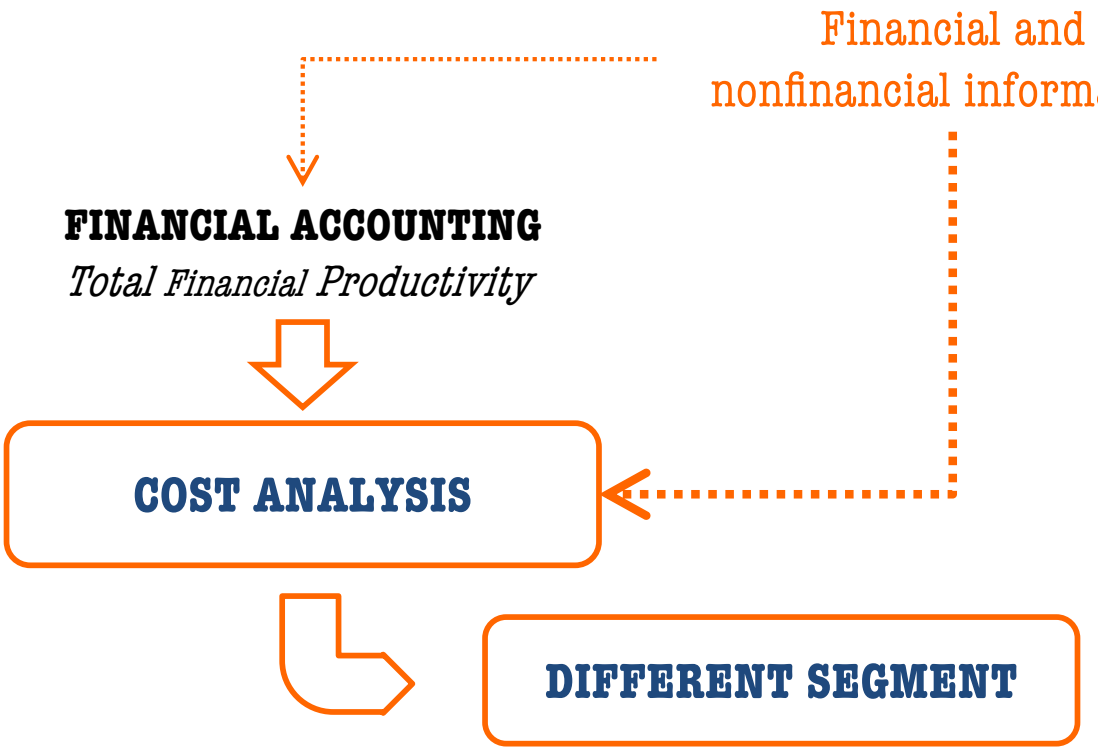

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COST COLLECTION SYSTEMS

Cost accumulation is the collection of cost data in some organized way by means of an accounting system.

Cost collection systems typically accounts for costs in two broad stages:

1. they initially **accumulates** costs classifying them **"by nature":** that is to say into categories that remind us the **type of resources purchased or consumed** (e.g., raw materials, depreciation, transports costs, rent expenses, wages and salaries, etc.). Later this criterion is combined with other two that focus their attention on **cost behavior** (fixed and variable costs) or on the **robustness of the** relation that link a cost to a specific cost objects (direct and indirect costs) .
2. They then **assign** these costs to cost objects.

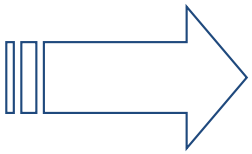
COST ANALYSIS

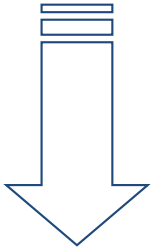
The concrete implementation of a proper cost analysis requires to make some basic decisions about the following issues:

- Cost Object
- Periodicity of the analysis (one time “had hoc” versus systematic)
- Portion of the cost base that is to be assigned to the cost object: selection of the “cost rule” that is to say of the evaluation criterion – in terms of cost – for the cost object)
- Structure of the cost flow: selection of the proper accumulation’s method
- Input measurement base

DIFFERENT COST OBJECTS

COST OBJECTS





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A RESOURCE AS A COST OBJECT

hours of work performed

tyres

lubricating oil

repairs and maintenance

driving activity

brakes

casualty insurance

mechanical parts

gasoline

Please note: the cost of operating a tractor is a **compound cost consisting of the sum of many elementary costs**. some of these costs are incurred exclusively for the operation of the tractor (tyres depreciation) others, however, are also incurred for other reasons (the cost of personnel who, in addition to doing other things, drive the tractor).

RELATION BETWEEN DIFFERENT COST OBJECTS

SPRAYER
(Resource)

TRACTOR
(Resource)

GRAPE TRANSPORTATION
(Activity)

PHYTOSANITARY TREATMENTS
(Activity)

VINEYARD
(Resource)

GRAPE
(WIP)

WINE
(WIP)

BOTTLE OF WINE
(PRODUCT)

A VAN AS A RESPONSIBILITY CENTER

cost of goods

carriage paid

custom duty paid

transit insurance

€

loading and unloading charges

tyres

lubricating oil

repairs and maintenance

gasoline

brakes

casualty insurance

mechanical parts

basic wage

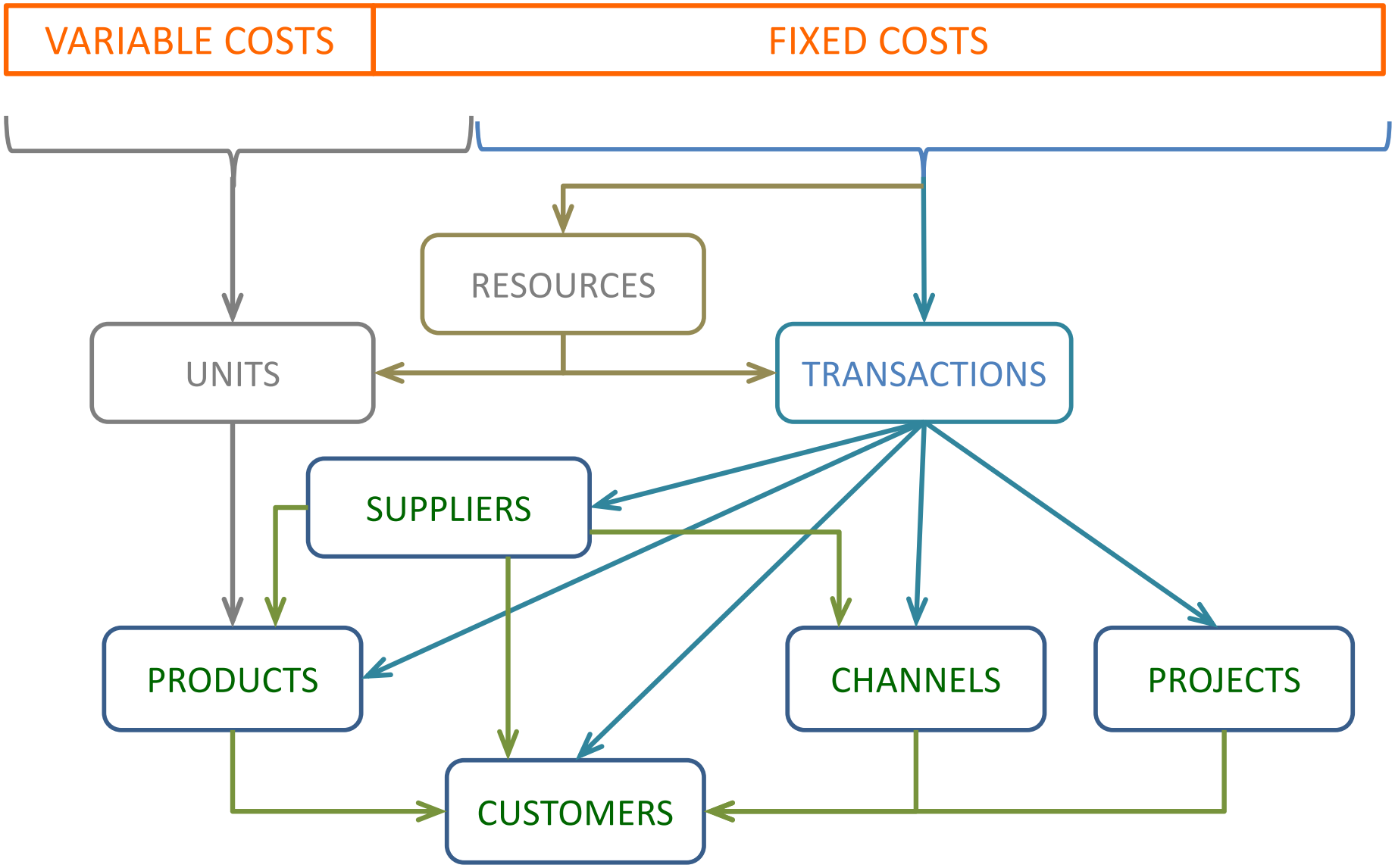
bonuses

dearness allowance

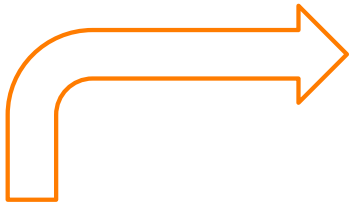
fringe benefits

employer's contribution to employees' state insurance

RELATION BETWEEN DIFFERENT COST OBJECTS



PERIODICITY OF THE ANALYSIS



SYSTEMATIC AND CONSTANT INFORMATION FLOWS

COST & REVENUES ANALYSIS

A set of logic, criteria, methods and techniques for the

- ✧ collection,
- ✧ classification,
- ✧ aggregation and
- ✧ attribution

of **costs** and **revenues**

COST SYSTEMS

Focused on cost-objects that are considered particularly relevant for day-by-day decisions and, therefore, that need constant monitoring

PRODUCTION OF "AD HOC" INFORMATION IN RELATION TO SPECIFIC DECISION MAKING

ONE-OFF COST ANALYSIS

Relating to specific cost-objects, from time to time different depending on the type of decision to be taken

DIFFERENT DECISIONS , DIFFERENT SETS OF INFORMATIONS

Decision to be made:

A. Things to do in Rome while visiting the city as a tourist for a five days period

- Different possible hotel/B&B accommodations
- Best restaurants in town
- Underground tickets and weekly pass
- Best Museum
- Exercise drills

B. Things to do in Rome while spending a six months period in the city for work

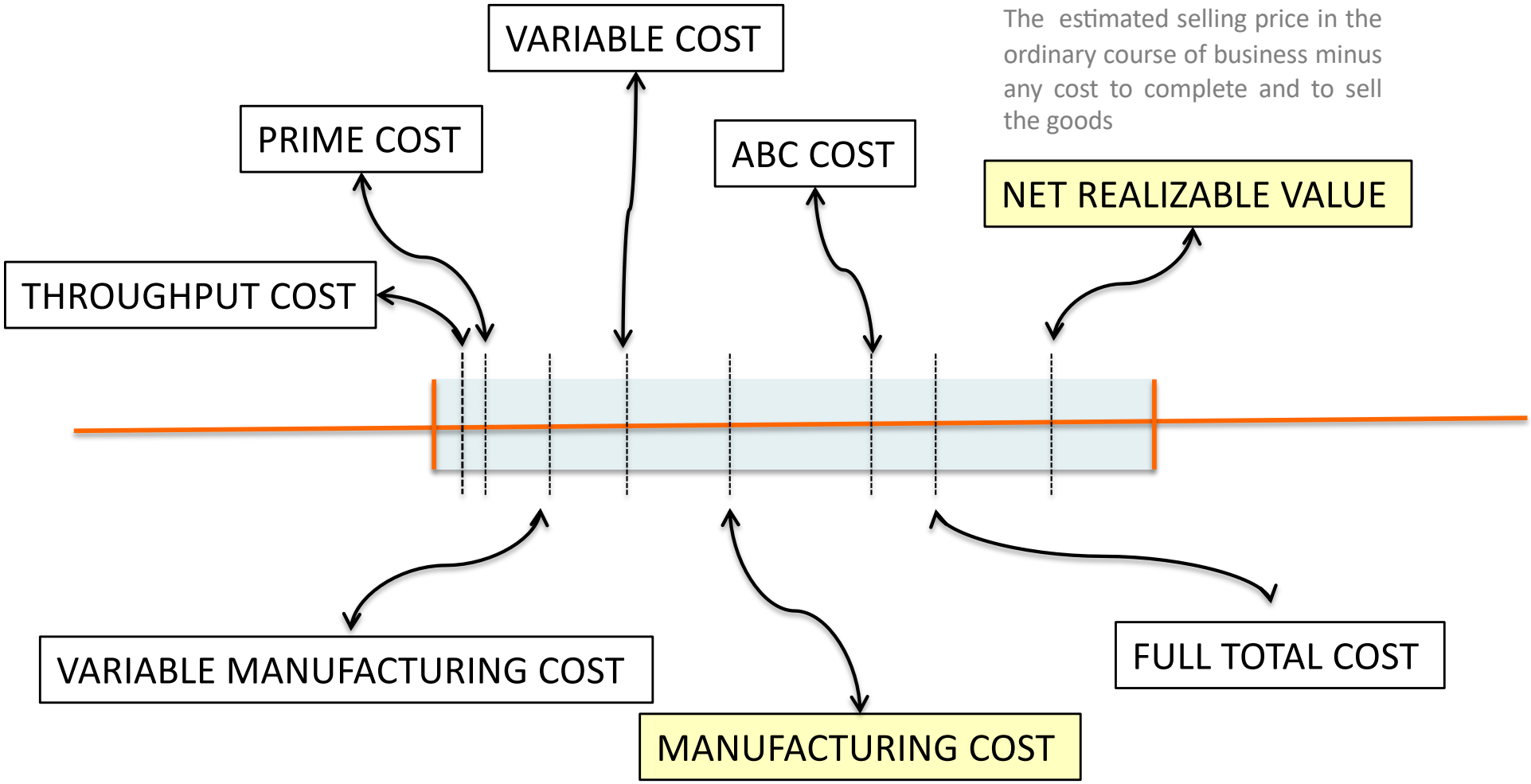
- Apartments monthly rates
- Convenient grocery stores nearby
- Used cars prices, buses and train monthly pass
- Places to visit in the surrounding area
- Gym and swimming pool memberships

DIFFERENT FUNCTIONS, DIFFERENT DEMANDS

Functions	Frequency	Allocation	Scope of System	Nature of Variability	Degree of Objectivity
Inventory valuation	Monthly or quarterly	Aggregate	Factory costs	Irrelevant	High
Operational control	Daily, by unit of work accomplished	None	Responsibility center	Short-term variable and fixed	High
Product cost measurement	Annually and at major change points	Extensive, down to individual products or product lines	Entire organization including marketing and distribution, engineering, service, and administration	All variable	Low

SOURCE: Kaplan, "One Cost System Isn't Enough", *Harvard Business Review*, January - February 1988

DIFFERENT VALUATION CRETERIA FOR A PRODUCT



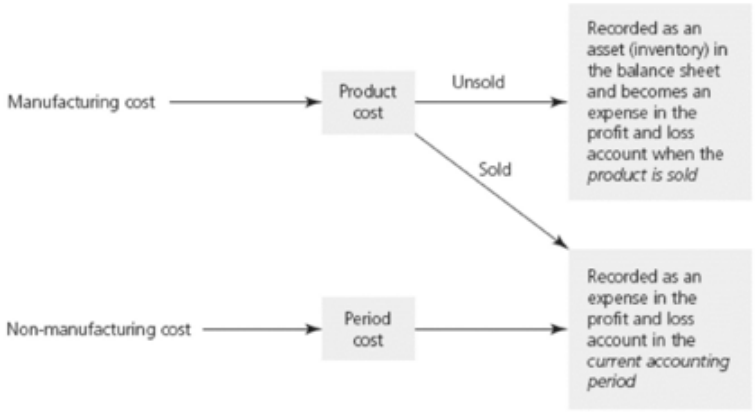
The estimated selling price in the ordinary course of business minus any cost to complete and to sell the goods

The costs necessary to convert raw materials into products. All manufacturing costs must be attached to the units produced for **external financial reporting under US GAAP**. The resulting unit costs are used for **inventory valuation** on the balance sheet and for the calculation of the **cost of goods sold** on the income statement.

COST OBJECTS AND COST RULES

COST ACCOUNTING

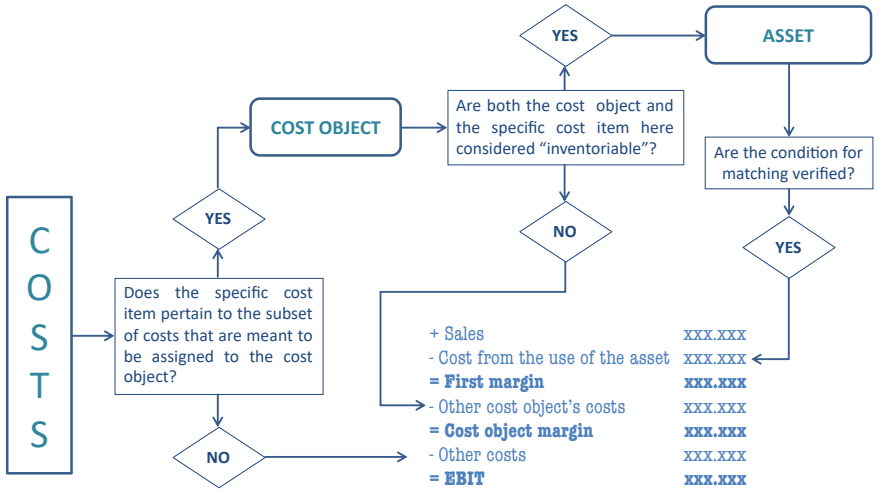
PRODUCT



Within financial accounting we essentially have a single cost object (the "product", typical or atypical, produced by the enterprise) and a single cost rule (called "absorption costing")

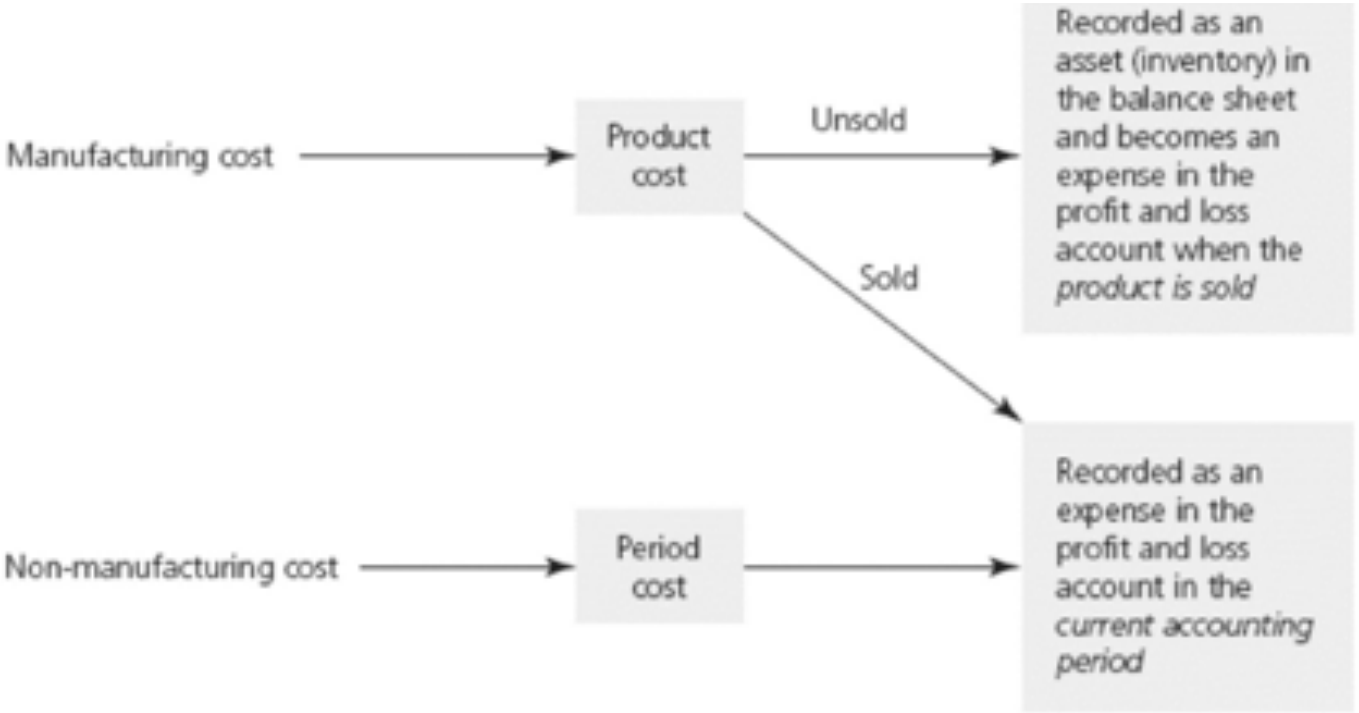
MANAGERIAL COSTING

PRODUCT **CUSTOMER** **DEPARTMENT** **SALE CHANNEL**

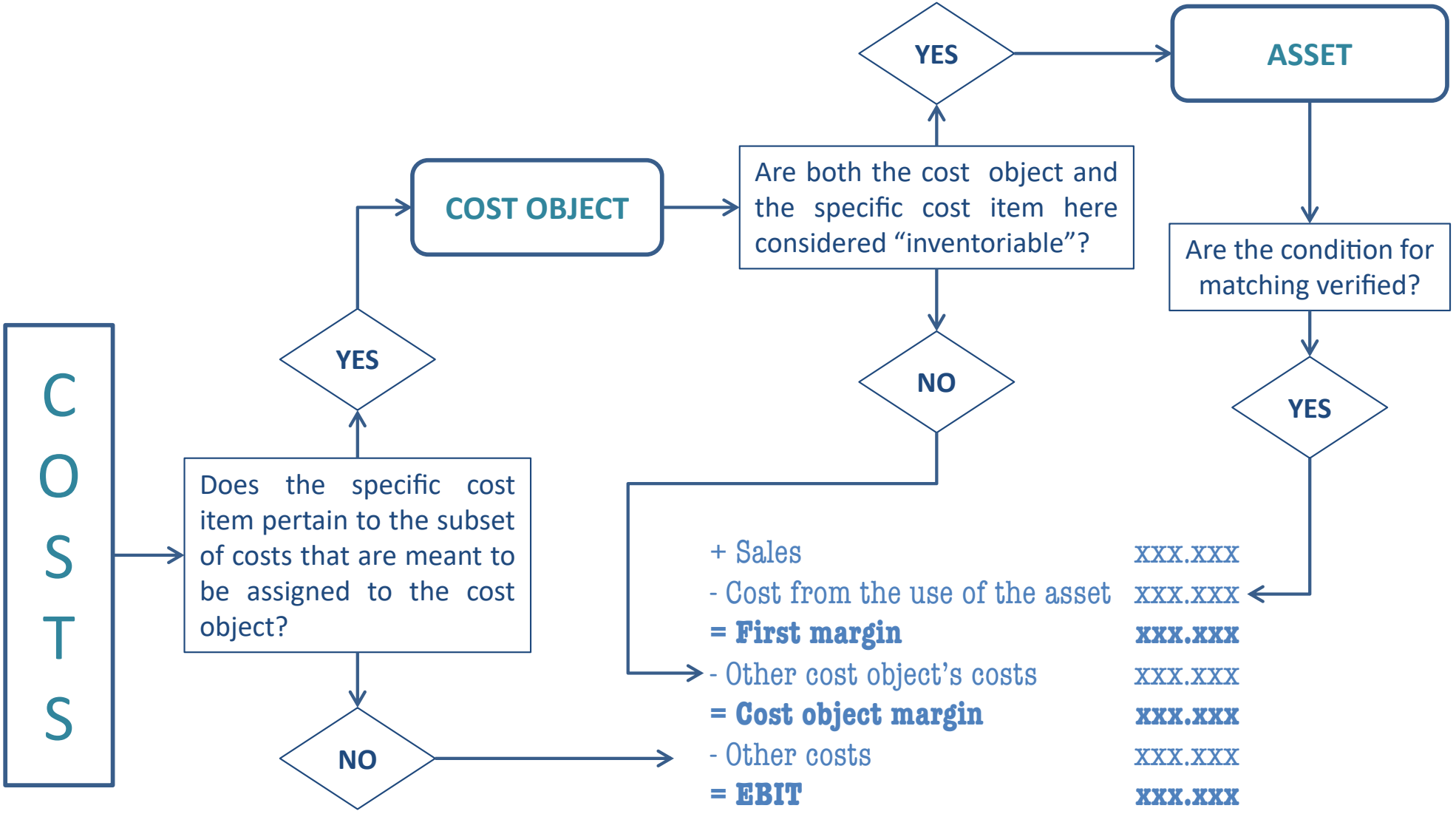


For managerial costing requirements we have, on the other hand, the need to calculate the cost of several different objects (several very different entities) and apply several cost rules in order to obtain the relevant information with respect to the decisions to be taken

ABSORPTION COSTING



VARIABLE COSTING



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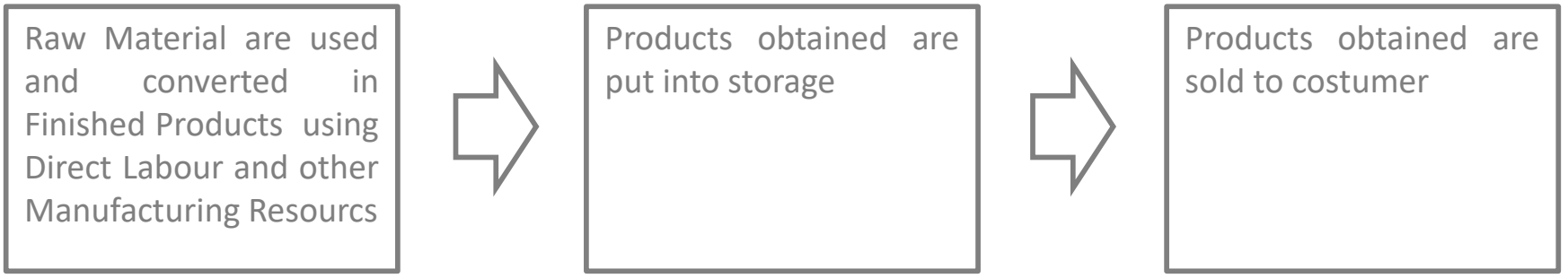
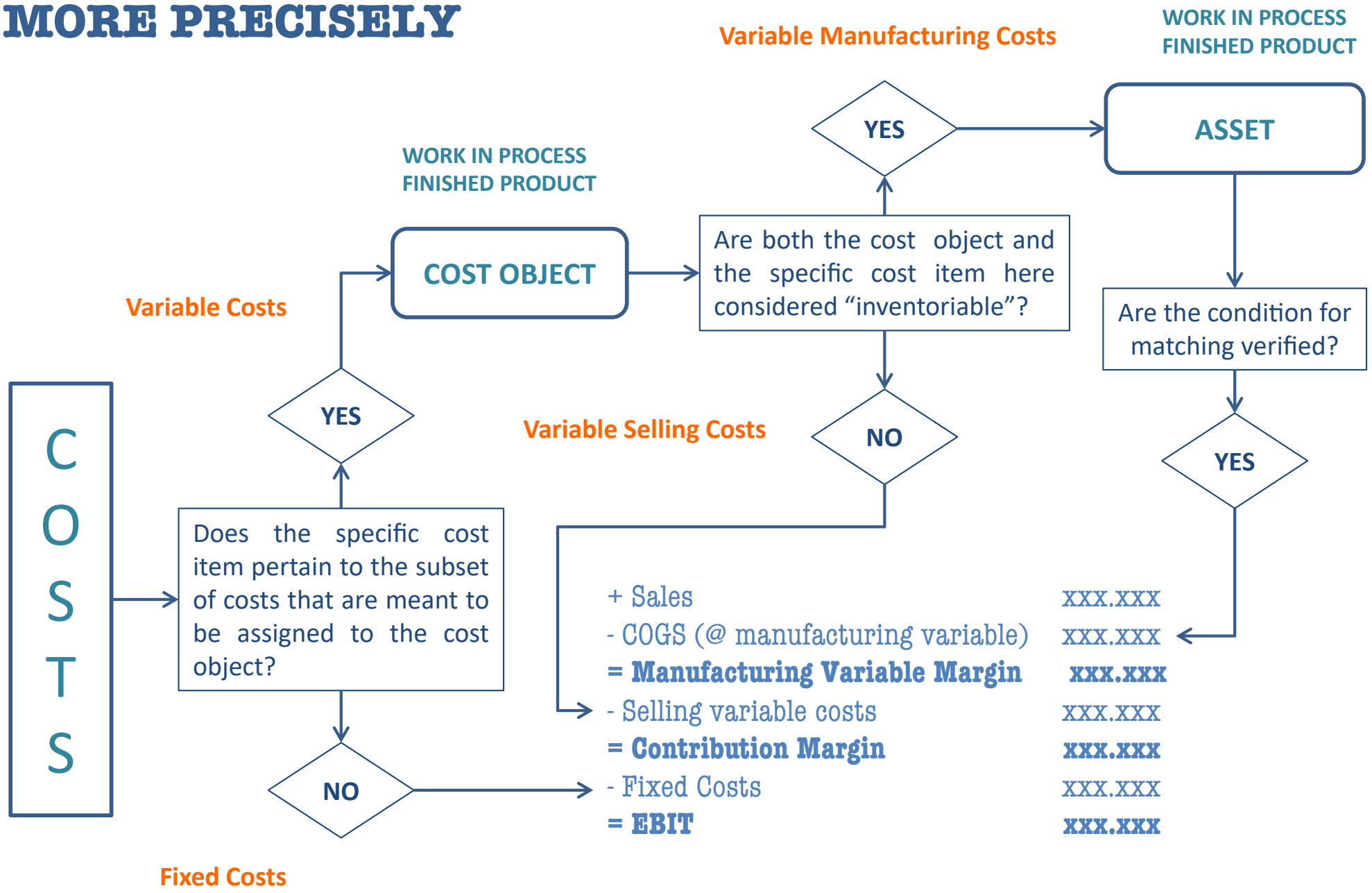


RAW MATERIALS ⇨ WORK IN PROCESS ⇨ FINISHED PRODUCT ⇨ COST OF GOODS SOLD

Variable **Manufacturing** Costs are incurred

Variable **Selling** Costs are incurred

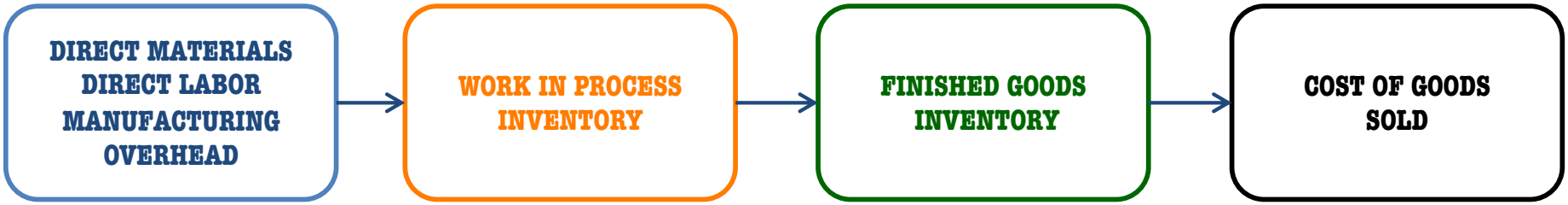
MORE PRECISELY



PROCESS COST AND JOB ORDER COST

Process Cost System			Job Order Cost System		
Company	Product		Company	Product	
Jones Soda, PepsiCo	Soft drinks		Young & Rubicam, J. Walter Thompson	Advertising	
ExxonMobil, Royal Dutch Shell	Oil		Disney, Warner Brothers	Movies	
Intel, Advanced Micro Devices	Computer chips		Center Ice Consultants, Ice Pro	Ice rinks	
Dow Chemical, DuPont	Chemicals		Kaiser, Mayo Clinic	Patient health care	

JOB COSTING SYSTEM



Job costing is a costing system that accumulates costs and assigns them to specific jobs, customers, projects, or contracts. The basic supporting document (usually in electronic form) in a job costing system is the **job cost sheet**. It records and summarizes the costs of direct materials, direct labor, and factory overhead for a particular job.

A **job costing system** is used by companies that produce **unique products or jobs**. Examples of companies that use job costing systems include Boeing (airplanes), Lockheed Martin (advanced technology systems), and Deloitte & Touche (accounting).

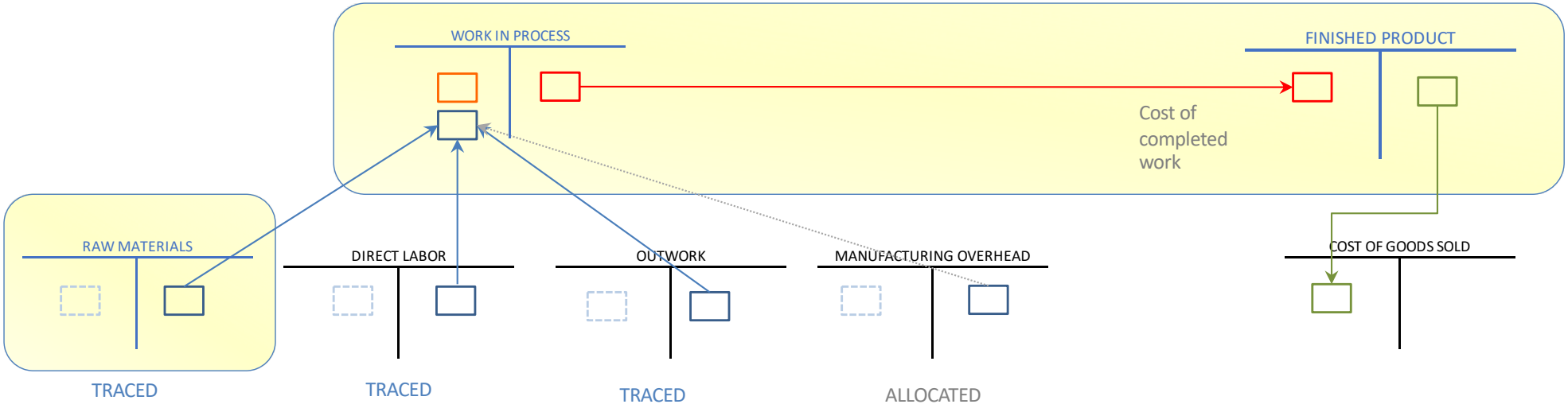
JOB COSTING SYSTEM

JOB COSTING SYSTEM

Automotive Job Costing Solutions

Automotive job costing can often be a complicated endevour. Getting an accurate sum of labour and materials can be the difference between profitability and loss, data inaccuracies or lack of tracking can ensure issues in the future. Keeping track of client and vehicle records is important for customer service. We have the solutions to get your business running at peak performance as well as giving you a complete view of your business activities.

FLOW OF COSTS IN JOB COST SYSTEM



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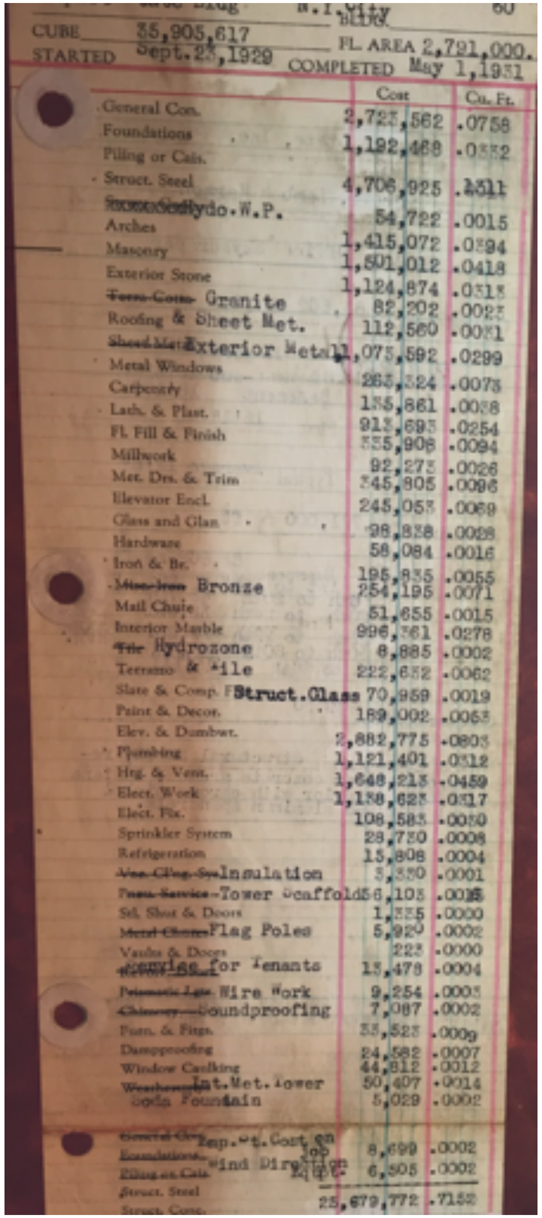
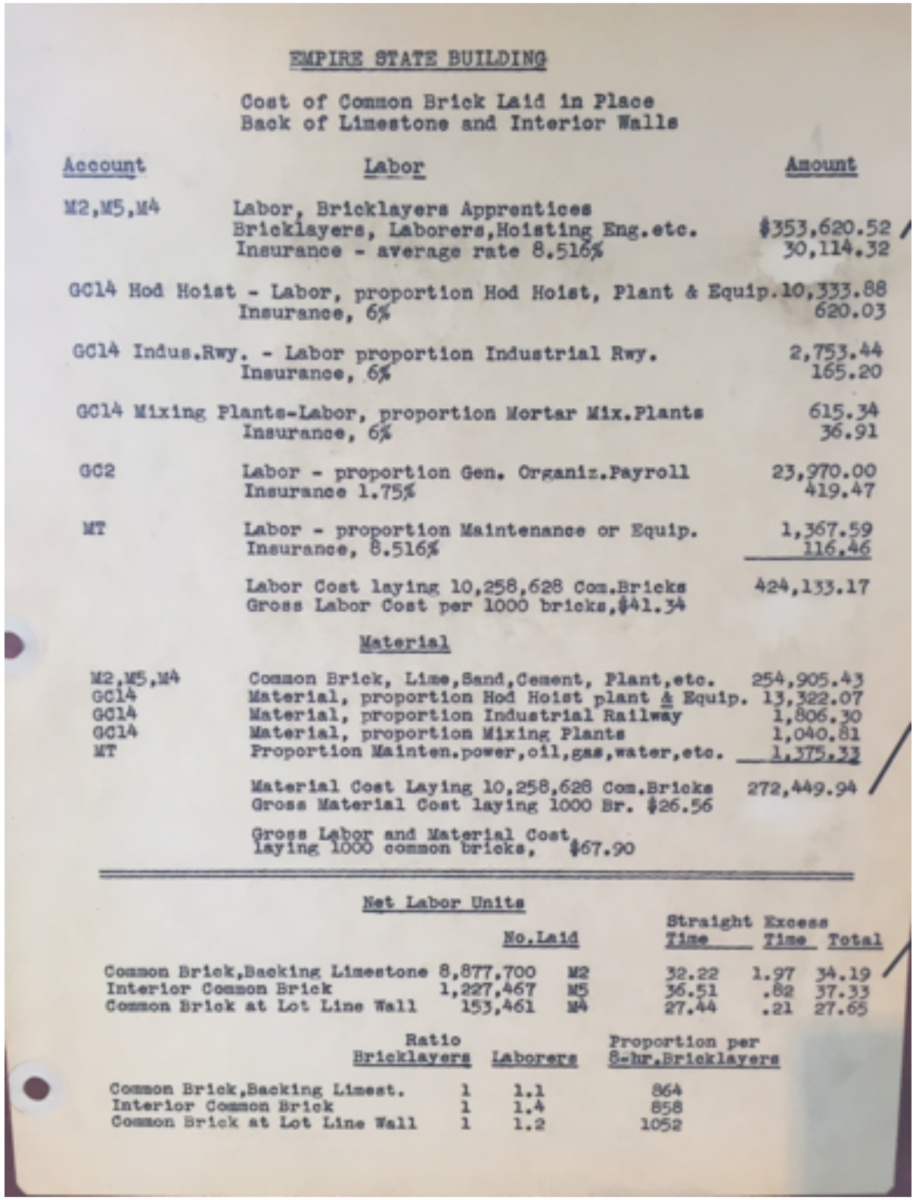


Bldg.	N.Y. City	60
CUBE 35,905,617	FL. AREA 2,791,000.	
STARTED Sept.25,1929	COMPLETED May 1,1931	

	Cost	Cu. Ft.
General Con.	2,723,562	.0758
Foundations	1,192,468	.0332
Piling or Cais.		
Struct. Steel	4,706,925	.1311
Hydo.W.P.	54,722	.0015
Arches		
Masonry	1,415,072	.0394
Exterior Stone	1,501,012	.0418
Terra Cotta Granite	1,124,874	.0313
Roofing & Sheet Met.	82,202	.0023
Sheet Metal Exterior Metal	112,560	.0031
Metal Windows	1,073,592	.0299
Carpentry	263,324	.0073
Lath. & Plast.	135,861	.0038
Fl. Fill & Finish	913,693	.0254
Millwork	335,908	.0094
Met. Drs. & Trim	92,273	.0026
Elevator Encl.	345,805	.0096
Glass and Glaz.	245,053	.0069
Hardware	98,838	.0028
Iron & Br.	58,084	.0016
Misc. Iron Bronze	195,835	.0055
	254,195	.0071
Mail Chute	51,655	.0015
Interior Marble	996,361	.0278
Tile Hydrozone	8,885	.0002
Terrazzo & Tile	222,652	.0062
Slate & Comp. F Struct.Glass	70,959	.0019
Paint & Decor.	189,002	.0053
Elev. & Dumbwt.	2,882,775	.0803
Plumbing	1,121,401	.0312
Htg. & Vent.	1,648,213	.0459
Elect. Work	1,138,623	.0317
Elect. Fix.	108,583	.0030
Sprinkler System	28,730	.0008
Refrigeration	13,808	.0004
Vac. Clng. Sys. Insulation	3,330	.0001
Tower Scaffold	56,103	.0016
Stl. Shut & Doors	1,335	.0000
Flag Poles	5,920	.0002
Vaults & Doors	223	.0000
Service for Tenants	13,478	.0004
Wire Work	9,254	.0003
Soundproofing	7,087	.0002
Furn. & Fixts.	33,523	.0009
Dampproofing	24,582	.0007
Window Caulking	44,812	.0012
Int.Met.Tower	50,407	.0014
Soda Fountain	5,029	.0002
Emp.St. Cost on Job	8,699	.0002
Wind Direction Equip.	6,505	.0002
	25,679,772	.7152



EMPIRE STATE BUILDING

Cost of Common Brick Laid in Place
Back of Limestone and Interior Walls

Account	Labor	Amount
M2,M5,M4	Labor, Bricklayers Apprentices Bricklayers, Laborers,Hoisting Eng.etc.	$353,620.52
	Insurance - average rate 8.516%	30,114.32
GC14	Hod Hoist - Labor, proportion Hod Hoist, Plant & Equip.	10,333.88
	Insurance, 6%	620.03
GC14	Indus.Rwy. - Labor proportion Industrial Rwy.	2,753.44
	Insurance, 6%	165.20
GC14	Mixing Plants-Labor, proportion Mortar Mix.Plants	615.34
	Insurance, 6%	36.91
GC2	Labor - proportion Gen. Organiz.Payroll	23,970.00
	Insurance 1.75%	419.47
MT	Labor - proportion Maintenance or Equip.	1,367.59
	Insurance, 8.516%	116.46
	Labor Cost laying 10,258,628 Com.Bricks	424,133.17
	Gross Labor Cost per 1000 bricks,$41.34	

Material

M2,M5,M4	Common Brick, Lime,Sand,Cement, Plant,etc.	254,905.43
GC14	Material, proportion Hod Hoist plant & Equip.	13,322.07
GC14	Material, proportion Industrial Railway	1,806.30
GC14	Material, proportion Mixing Plants	1,040.81
MT	Proportion Mainten.power,oil,gas,water,etc.	1,375.33
	Material Cost Laying 10,258,628 Com.Bricks	272,449.94
	Gross Material Cost laying 1000 Br. $26.56	

Gross Labor and Material Cost laying 1000 common bricks, $67.90

Net Labor Units

	No.Laid		Straight Time	Excess Time	Total
Common Brick,Backing Limestone	8,877,700	M2	32.22	1.97	34.19
Interior Common Brick	1,227,467	M5	36.51	.82	37.33
Common Brick at Lot Line Wall	153,461	M4	27.44	.21	27.65

	Ratio Bricklayers	Laborers	Proportion per 8-hr.Bricklayers
Common Brick,Backing Limest.	1	1.1	864
Interior Common Brick	1	1.4	858
Common Brick at Lot Line Wall	1	1.2	1052

REAL LIFE EXAMPLE

RAW MATERIALS

OUTWORK

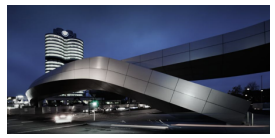
SUPPLIES WITH IINSTALLATION

PROCUREMENT

INBOUND LOGISTIC

STORAGE

DIRECT LABOR



SALES

ENGENEERING

CARPENTRY

SHEET METAL

ELEMETS

ASSEMBLY

PHYSICAL SPACES

UTILITY COSTS

TRAVEL COSTS

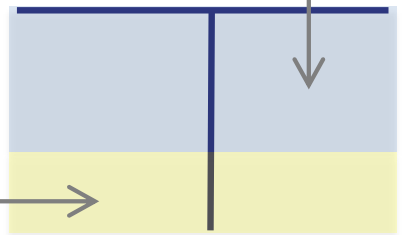
OTHER COSTS

ANCILLARY SERVICES

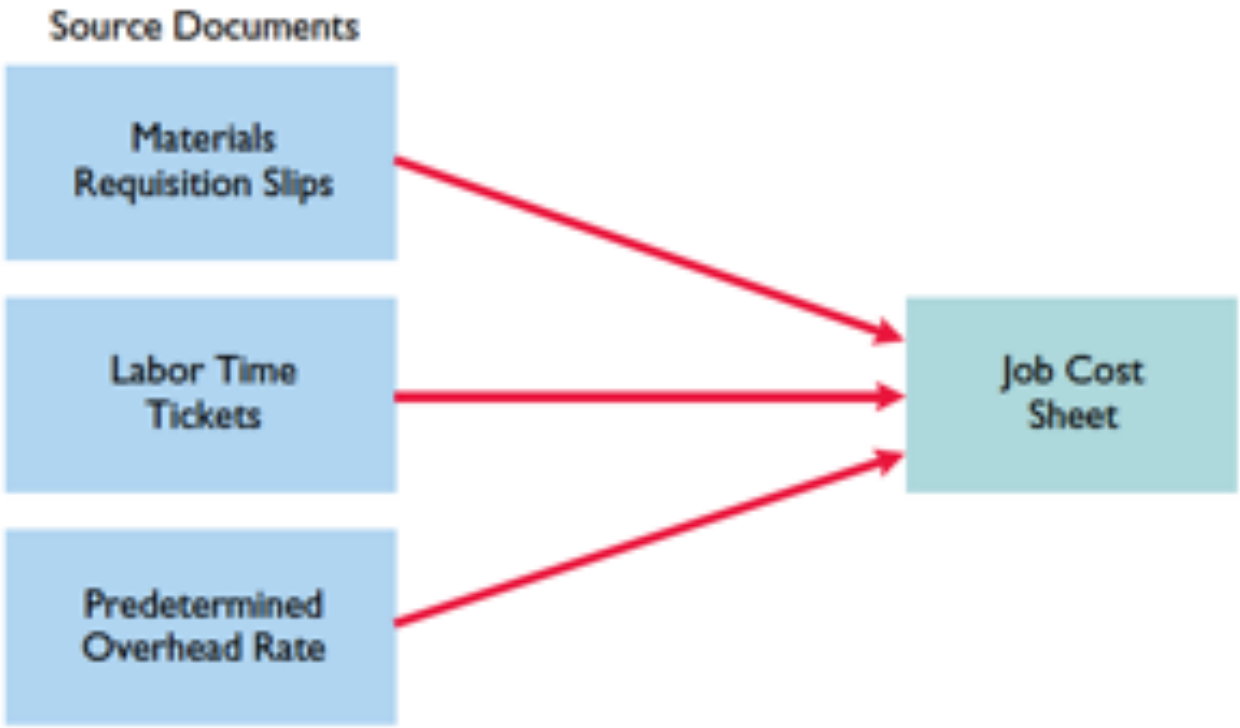
BUILDING

SHARED EQUIPMENT

INCOME STATEMENT

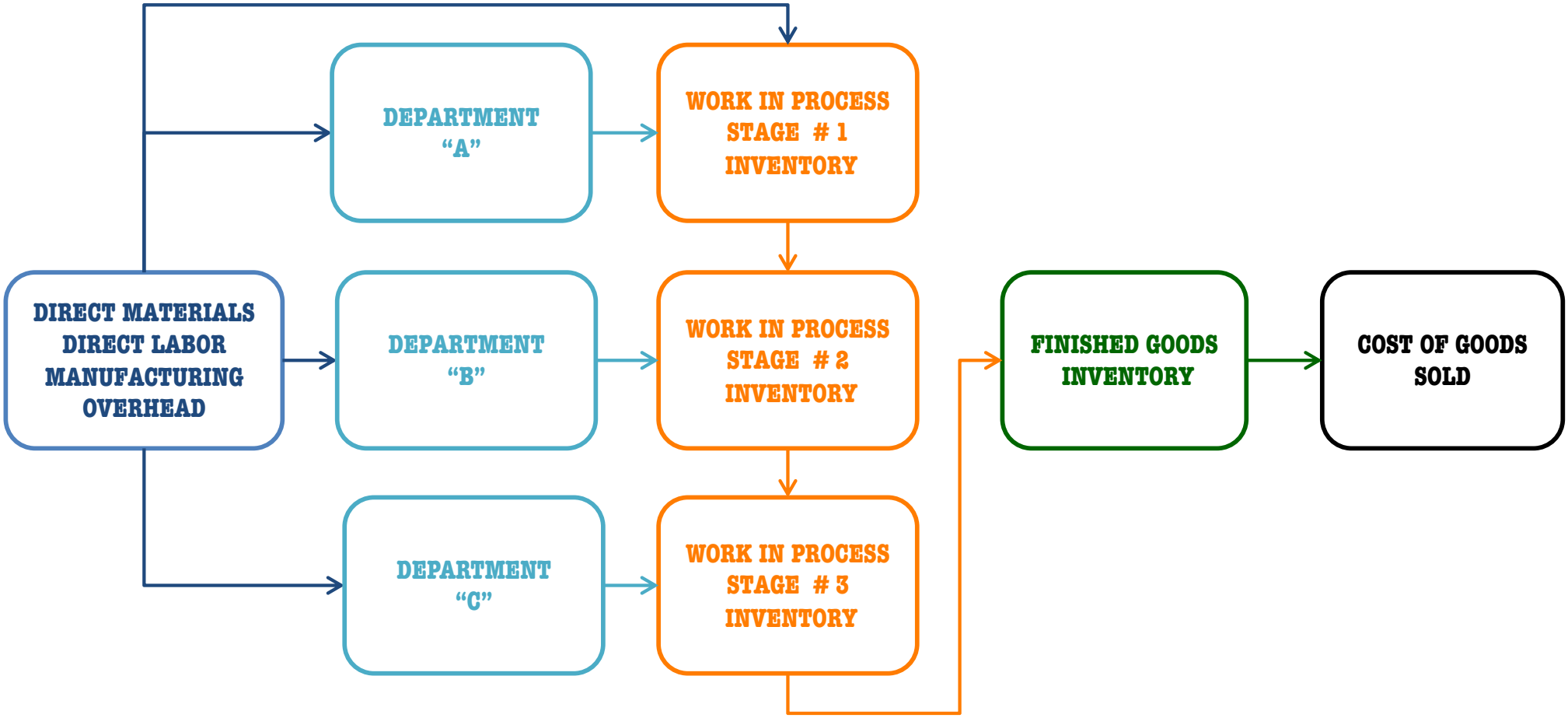


FLOW OF DOCUMENTS



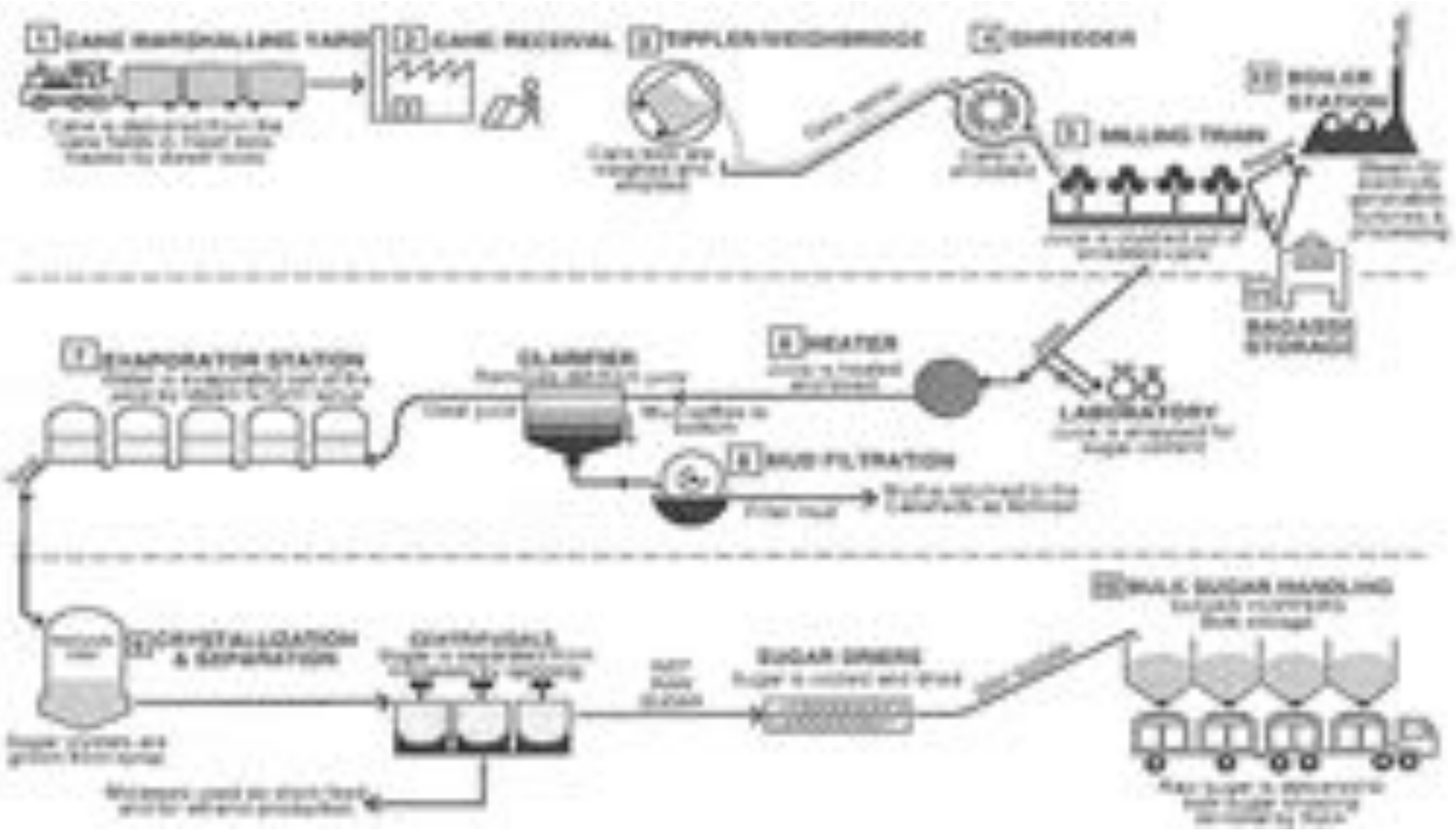
The job cost sheet summarizes the cost of jobs completed and not completed at the end of the accounting period. Jobs completed are transferred to finished goods to await sale.

PROCESS COSTING SYSTEM



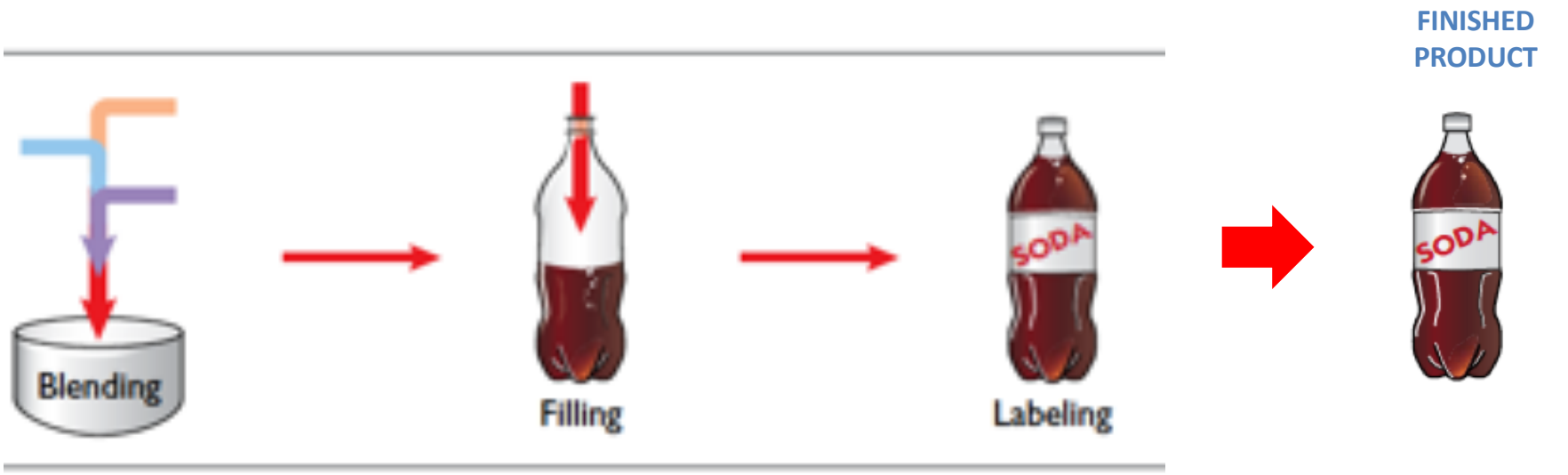
Process costing is a product costing system that accumulates costs according to processes or departments and assigns them to a large number of nearly identical products. A **process costing system** is used by companies that **employs a standardized production process to manufacture homogeneous products .** Examples of companies that use process costing include Chevron Corporation (petroleum products), the Wrigley Company (chewing gum), and Pittsburgh Paints (paint).

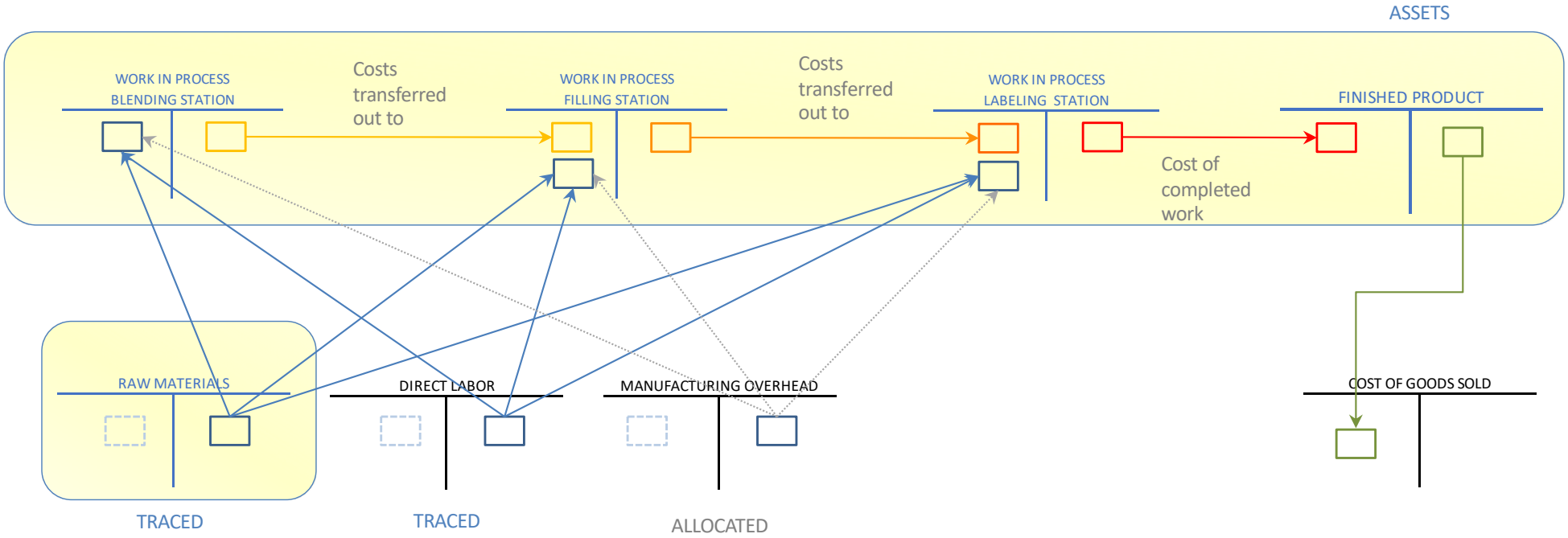
PROCESS COSTING SYSTEM



PROCESS COSTING SYSTEM

FLOW OF COSTS IN PROCESS COST SYSTEM





JOB ORDER VERSUS PROCESS COST SYSTEMS

Feature	Job Order Cost System	Process Cost System
Work in process accounts	One work in process account	Multiple work in process accounts
Documents used	Job cost sheets	Production cost reports
Determination of total manufacturing costs	Each job	Each period
Unit-cost computations	Cost of each job ÷ Units produced for the job	Total manufacturing costs ÷ Equivalent units produced during the period

FINANCIAL ACCOUNTING VS. MANAGERIAL ACCOUNTING

FINANCIAL ACCOUNTING

- Reports to those **outside** the organization:
  - Owners
  - Creditors
  - Tax Authorities
  - Regulators
- Emphasizes financial consequence of **past** activities
- Emphasizes **precision**
- Emphasizes **companywide** reports (focus on the **whole**)
- **Must** follow GAAP/IFRS
- **Mandatory** for external reports.

MANAGERIAL ACCOUNTING

- Reports to manager **inside** the organization for
  - Planning
  - Controlling
- Emphasizes decisions affecting the **future**
- Emphasizes **timeliness**
- Emphasizes **segment** reports (focus on **parts**)
- Need **not** follow GAAP/IFRS
- **Not mandatory**

"supporting documents" are normally needed (receipts, invoices, proofs of payment, etc.)

SOURCE: Adapted from Garrison, Noreen, Brewer, "Managerial Accounting", 16th Edition

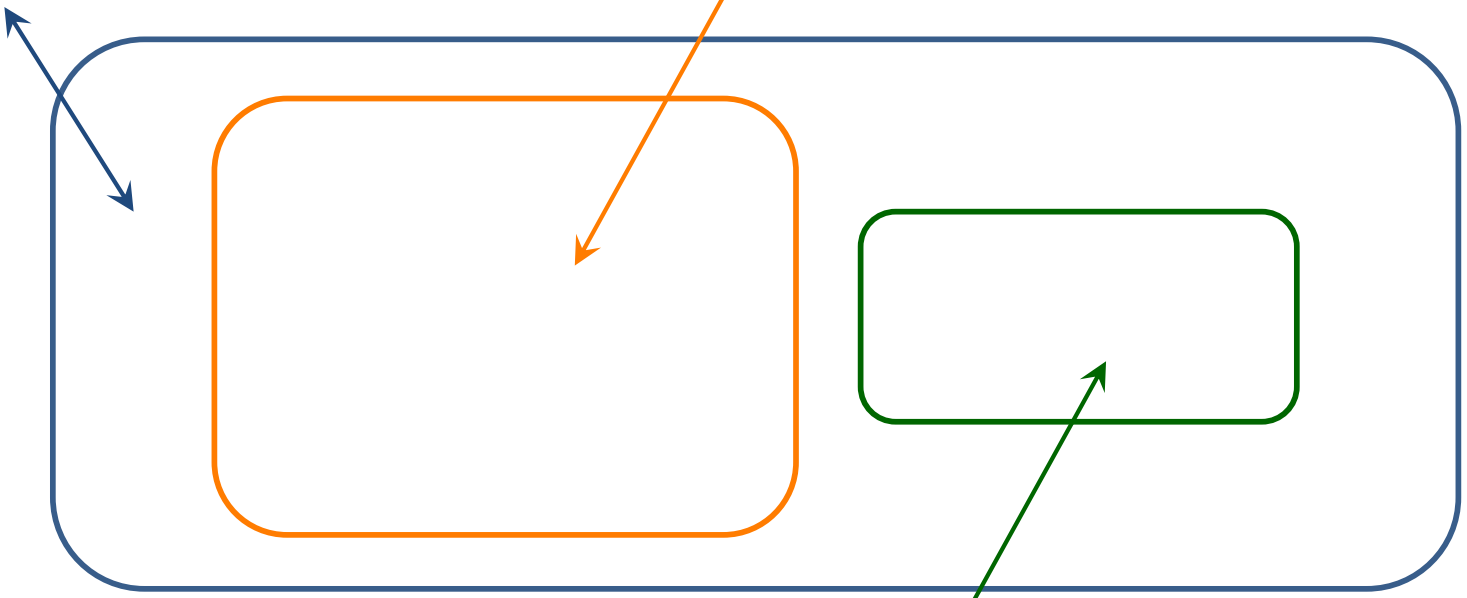
SOME BASIC DEFINITIONS

COSTS

All resources that are sacrificed or forgone in order to achieve a specific objective.

EXPENSES

Costs of assets consumed, or services used in the process of earning revenue.



OPPORTUNITY COSTS

Forgone benefits that could have been realized for the best forgone alternative use of an actual resource

INPUT MEASUREMENT BASE

	DIRECT COST	INDIRECT COST
ACTUAL COSTING SYSTEM	Actual	Actual
NORMAL COSTING SYSTEM	Actual	Standard
STANDARD COSTING SYSTEM	Standard	Standard

PREDETERMINED MANUFACTURING OVERHEAD RATE

$$\text{Predetermined manufacturing overhead rate} = \frac{\text{Total estimated manufacturing overhead costs}}{\text{Total estimated quantity of the manufacturing overhead allocation base}}$$

The most accurate allocation can be made only when total overhead cost is known—and that is not until the end of the period. But managers cannot wait that long for product cost information. So the predetermined manufacturing overhead rate is calculated before the period begins. Companies use this predetermined rate to allocate estimated overhead cost to individual jobs. The predetermined manufacturingoverhead rate is based on two factors:

- Total estimated manufacturing overhead costs for the period (in Smart Touch's case, one year)
- Total estimated quantity of the manufacturing overhead allocation base

The key to allocating (assigning) indirect manufacturing costs to jobs is to identify a workable manufacturing overhead allocation base. The allocation base is a common denominator that links overhead costs to the products. Ideally, the allocation base is the primary cost driver of manufacturing overhead—that is, the more "allocation base," the more overhead costs and vice-versa. As the phrase implies, a cost driver is the primary factor that causes (drives) a cost. Traditionally, manufacturing companies have used the following as cost drivers (allocation bases):

- Direct labor hours (for labor-intensive production environments)
- Direct labor cost (for labor-intensive production environments)
- Machine hours (for machine-intensive production environments)

SOME TAKEAWAY POINTS FROM MODULE # 8

- In financial accounting, the typical cost objects are finished and semi-finished products. These “entities” are tangible resources with an economic value that are controllable by the company that produces them and, therefore, can be found in the financial statements as assets. This means that the costs that are attributable to the products (both finished and semi-finished) can also be “inventoried” (that is to say their “amount” can be added to a stock inventory and therefore subtracted from the formation of the economic result) if the units to which they are allocated are still present in the inventory.

- Cost objects used in managerial costing do not always have these characteristics. There are, for example, cost objects such as activities performed, or customers served, or sales channels used, or others that cannot be reported as assets on the balance sheet. For this reason, for the purposes of the reasoning that we are about to do, we must begin by distinguishing the set of costs that can be attributed to a specific cost object from its possible subset that contains “inventoriable costs” (that is to say costs that can be actually “offset” by a corresponding increase in the value of inventories).

SOME TAKEAWAY POINTS FROM MODULE # 8

- The “cost collection and allocation process” can be viewed as a set of cost accumulation and allocation steps. We can think of the accumulation phases as the arrival and departure points of the process (but also the intermediate stopping points) while the allocation phases represent the moments of movement from a specific point to the next one.
- The wording "cost accumulation" identifies the activities of collecting a set of costs that refer to the same cost object. This means that normally the “cost” of a cost object is a compound cost, consisting of the sum of several elementary costs.
- The wording "cost allocation" identifies, instead, the transfer of a cost value previously recorded in relation to a cost object, to a subsequent cost object.
- As you certainly know, flow chart is a picture of the separate steps of a process in sequential order. Well, the “cost collection and allocation process” can be effectively represented thanks to the employment of a flow chart in which the stages are the moments of cost accumulation, and the vectors are the phases of cost allocation.

SOME TAKEAWAY POINTS FROM MODULE # 8

- In order to be truly effective, a process of accumulation and allocation of costs must portray as realistically as possible the flow of activities that make up the production process. In fact, it is these activities, and the ways in which they are carried out, that determine the transfer of the value contained in the resources first to the WIP and then to the finished products and from these eventually to the customers.
- Clearly, the activities that define production processes take a different form depending on the technology employed and the production process undertaken. The process of cost allocation must, therefore, respect these specificities and cannot take place in a standardized way, i.e., using using the same structure regardless of the specific process developed.
- They exist but of the general archetypes that can be used like bases of reference in order to distinguish two various modalities to configure the productive activities and therefore the flow of accumulation and attribution of the costs. These are: the “job costing system”, used by companies that produce unique products or jobs, and “process costing system” used instead by companies that employs a standardized production process to manufacture homogeneous products.

SOME TAKEAWAY POINTS FROM MODULE # 8

- There are three methods managers and accountants can use to calculate product unit cost:
  - Actual costing method,
  - Normal costing method, or
  - Standard costing method.
- The actual costing method uses the actual costs of direct materials, direct labor, and overhead when they become known to calculate the product unit cost. This means, many times, waiting until the end of the period when all the cost data are available. For most companies, this is not practical.
- The normal costing method combines the easy-to-track actual direct costs of materials and labour with estimated overhead costs to determine a product unit cost. The use of this costing method is widespread, since many overhead bills, such as utility bills, are not received until after products or services are produced and sold. For this reason, normal costing system that uses actual costs for direct materials, direct labour and other direct costs and applies indirect costs using a predetermined overhead cost rate.

SOME TAKEAWAY POINTS FROM MODULE # 8

- To compute the predetermined overhead rate, four steps are needed:
  1. Estimate total overhead costs for the operating period, usually a year.
  2. Select the most appropriate allocation base (i.e. the basis that best reflects the cause-effect relationship that links indirect costs to the chosen cost object)
  3. Estimate the total amount of the chosen allocation base for the operating period.
  4. Divide the estimated total overhead costs by the estimated amount of the chosen allocation base to obtain the predetermined overhead rate.
- The standard costing method uses estimated or standard costs of direct materials, direct labour, and overhead to calculate the product unit cost. This method is used because managers sometimes need product cost information before the accounting period begins so that they can control the cost of operating activities or price a proposed product for a customer. In such situations, product unit costs must be estimated, and the standard costing method can be helpful. Moreover, standard costing is very useful in performance management and evaluation because a manager can compare actual and standard costs to compute the variances. In such a way it becomes a tool for exercise a form of steering control and can be used for learning.