

### Seligram ETO

- > ETO: A support department / cost center
- > Who are ETO's customers? the departments producing ICA, ICB, Capacitor, Amplifiers and Diodes
- > Customers have to bear the cost of maintaining and operating ETO.
- > Any signs of problems?

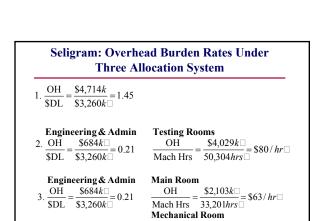


## **Main Questions**

- > Is the current costing system using direct labor dollar as the single allocation base - adequate? Are there signs in the case that it is not?
- > Why does the current system exist?
- As time has passed, which kind of testing within ETO is actually causing overheads for other departments? What are overheads being allocated by?
- > Therefore, getting which kind of testing (basic or advanced) done internally has a cost advantage over outside markets?
  - Departments that use basic testing are "overcosted" Departments that use advanced costing are "undercosted"
- What happens if departments that are mainly getting basic testing done leave? Excess capacity our old enemy, the death spiral

## The Two Alternate Allocation Systems

- Each takes total overheads of \$4,714k and splits it into two parts:
  - 685k, to be allocated based on direct labor dollars
  - 4,029k, to be allocated based on machine hours
- The second further splits the 4,029k into Main Test Room hours and Mechanical Test Room hours



 $\frac{\text{OH}}{\text{Mach Hrs}} = \frac{\$1,926k}{17,103hrs} = \$113/hr$ 

# Seligram: Exhibit 6

# ➤Capacitors

- Percentage direct labor dollars = 1,094/5,106 = 21%
- Percentage total machine hours = 7.5/83 = 9%
- Suggests capacitors are "overcosted" using an allocation base of direct labor dollars.

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# Seligram Main Points

- This case shows that <u>overtime, costs systems can become</u> <u>obsolete</u>. The current system penalizes lots that require more direct labor -- (i.e., labor intensive tests) and subsidized lots that require more equipment time.
- This case shows that <u>costs systems can affect managers</u> <u>actions</u>. The current cost system encourage division managers to produce components that require mechanical testing since these products appear to be cheaper to test.
- This case gives an example of the methods one might use to solve the common problem, i.e., allocating the costs of a cost center used by many divisions.



#### Wrap-up

- The focus of the Managerial Accounting Section has been on Cost Accounting for decision-making
- Allocation of costs is an important factor that affects product profitability and pricing decisions
- Two major allocation systems have been covered in class: Traditional Costing System and Activity-Based Costing (ABC) Systems
- The major issue in traditional costing systems is their continuous evolution as business realities change.
- > The major issue in ABC is the identification of objective cost drivers.



## **Pitfalls To Watch Out For In Costing Systems**

- > With traditional costing
  - Death spirals a direct result of using an allocation system that is "incorrect" either because it is outdated or excessively simple.
- ≻ With ABC
  - The sensitivity of cost allocations to choice of cost drivers.
  - The lack of acceptance by internal managers, especially if ABC shows them in a poor light
  - The tendency to accept easier solutions than the ones demanded as a result of ABC analysis.

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