KEY POINTS

Cost Behavior

• The behavior of a cost determines whether it is fixed, variable, or mixed.

• The classification of costs as fixed, variable, or mixed often requires use of assumptions and judgment.

• Direct costs are costs that are traced to individual jobs; all other costs are classified as indirect.

• Some costs that might potentially be traced to individual jobs are instead treated as indirect (i.e., overhead) costs.

Job Cost System

• Job costing systems typically focus on the assignment of direct and indirect costs to individual jobs. Such systems might not provide job contribution margins or other information that would be useful for decision making.

• The overhead cost allocation does not necessarily reflect the cost of overhead resources used by individual jobs.

• Poor quality cost assignment can cause other measures, such as job profits, to also be of poor quality. In turn, poor quality job cost information can lead to adverse economic consequences such as: (1) inappropriate decisions regarding the types of jobs to pursue and (2) miss measured incentive payments (for example, sales commissions).

Tracing Additional Costs

• Tracing additional costs to individual jobs reduces the proportion of total costs that are classified as overhead, in turn decreasing the degree of miss measurement from overhead allocation.

• The decision to trace additional costs to individual jobs has no effect on total company profits, but it usually alters the profits of individual jobs.
• It is less important to trace a cost that is relatively small because the additional effort might have little effect on individual job profits. The cost of adding more detail to the accounting system might exceed the benefits.

• Job costs and profits are likely to be miss measured when an allocation base that is not a cost driver is used to allocate overhead costs.

• Costs may be traced to jobs using estimation methods. For example, payroll taxes & benefit costs may be traced as a percent of direct labor costs.

Alternative Allocation Bases

• The choice of overhead allocation base has no effect on the total amount of overhead allocated to jobs, but it usually alters the profits of individual jobs. In turn, the choice of allocation base usually alters incentive payments (e.g., profit-based sales commissions).

• Ideally, the overhead allocation base should be a driver for the types of costs that are included in the overhead cost pool. Preference should be given to an allocation base that varies with relatively large costs in the overhead cost pool.

• Overhead cost allocations are likely to be viewed as arbitrary and unfair when the allocated costs are fixed and are not under the control of the individuals who are responsible for the jobs to which they are allocated.

• The cost of obtaining reliable allocation base information should be considered when evaluating the costs and benefits of alternative allocation bases.

• It may be possible to more accurately measure the cost of resources used by each job when overhead costs are separated into multiple pools representing different types of business activities.