

Topic 4. Cost allocation

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1. Cost of unused capacity and opportunity cost.
2. Common cost allocation
3. Determining Costs, basic planning/forecasting.

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Cost of unused capacity

Opportunity cost

Unused capacity

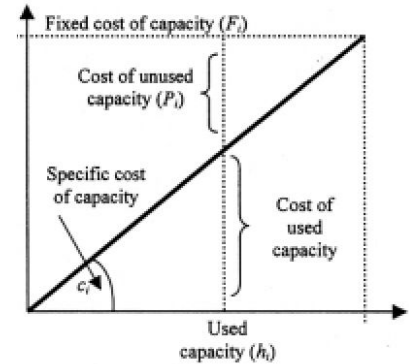
Total Capacity in most companies is defined as the maximum production/operating ability.

Idle/unused capacity is the remaining amount of capacity left in a company after productive/used capacity have been eliminated from total capacity.

For ex., total rooms 100, rooms booked 80, unused capacity 20 rooms.

Unused capacity = total capacity - used capacity.

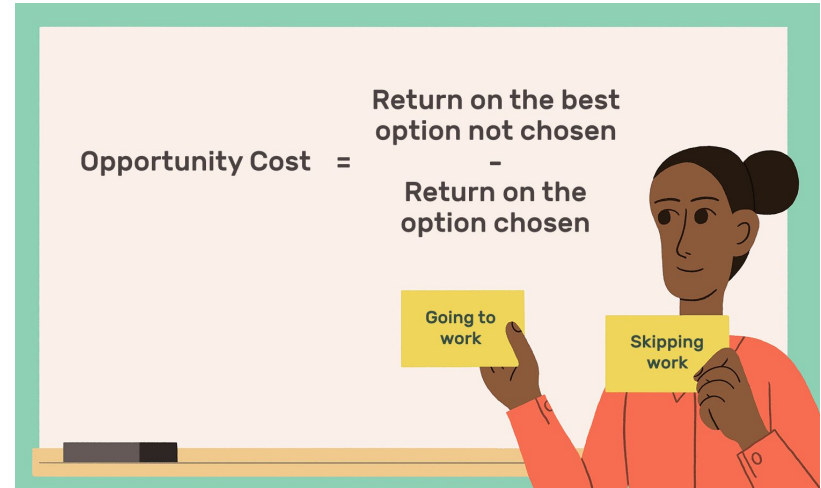
Unused capacity involves applying all actual fixed costs to product/service amount which has been used. This, in turn, increases cost per unit.



Opportunity forgone

The **opportunity costs** is the benefit you would have received by taking an alternative financial action.

The difference in return between a chosen investment and your forgone alternative is essentially your opportunity cost.



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Common cost allocation

Introduction

- How should the airline costs of a trip to attend job interviews from London to Dubai to Tunis and then return to London be allocated among the prospective employers in Dubai and Tunis?
- *Why do managers ask this questions? >>>*



Common cost

- A **common cost**
 - ▶ is a cost of operating a facility, operation activity or other cost object
 - ▶ that is shared by two or more users.

Example,

the cost of tickets for Paula from Galway

to visit possible employers in Moscow and Prague

with the round trip Galway-Moscow-Prague-Galway



Stand-alone cost-allocation method

- The **Stand-alone cost-allocation method**
 - ▷ uses information related to each cost object
 - ▷ as a separate operating entity
 - ▷ to determine the cost-allocation weights.
- + Fairness rationale

$$\text{Cost-Allocation weight} = \text{Stand alone cost} / \text{Total cost}$$

Stand-alone cost-allocation method. Calculations

Given:

- Common cost (CC)
- stand -alone cost of cost object 1 (SA1)
- stand -alone cost of cost object 2 (SA2)

Calculate: the cost for cost object 1 using stand-alone cost-allocation method

- *Cost-Allocation Weight for Object 1 = $(SA1) / (SA 1 + SA 2)$*
- *Cost-Allocation Weight for Object 2 = $(SA2) / (SA 1 + SA 2)$*
- *Common cost allocated to Object 1 = Cost-Allocation weight 1 * CC*
- *Common cost allocated to Object 2 = Cost-Allocation weight 2 * CC*

OR

*Common cost allocated to Object 1 = $(SA1) / (SA 1 + SA 2) * CC$*

Incremental cost-allocation method

- The **Incremental cost-allocation method**
 - ▷ rank the individual cost objects
 - ▷ and then uses this ranking to allocate costs among those cost objects.

First ranked object - primary party

Second-ranked - incremental party (can be more than one, should be ranked)

- Primary party receives the highest allocation of common costs.
- Second-ranked are usually new build departments, organizational units, etc.

Incremental cost-allocation method. Calculation

Given:

- Common cost (CC)
- stand -alone cost of Cost Object 1 (SA1)
- stand -alone cost of Cost Object 2 (SA2)
- stand -alone cost of Cost Object 3 (SA3)

Calculate: the cost for cost object 1, 2, 3 using incremental cost-allocation method

Priority 2 > 1 > 3

- Common cost allocated to Object 2 = SA 2
- Common cost allocated to Object 1 = CC - SA2 - SA3
- Cost of object 3 = CC- SA1

Conclusions. Cost allocation and costing systems

Cost allocation system should be chosen based on the cost-benefit approach.

Benefits of more accurate cost-allocation systems generally **increase** as:

(1) the variety of outputs increases

(if different outputs make different demands on resources);

(2) indirect costs increase

(greater potential for material misallocation)

(3) competition increases in the output market

(profit margins narrow, so there is less room for error).

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Basics of cost forecasting

Cost forecasting / justification

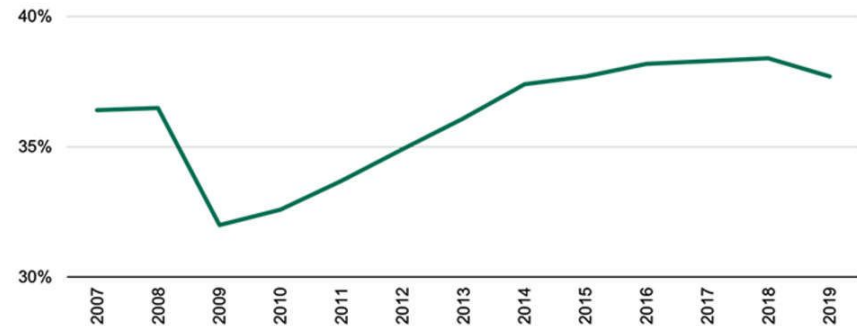
- **previous data of your own company*
- **analogy (based on the competitors)*
- **based on the industry standards/ ratios*
- **expert opinion*
- **primary data – request to the performer organization*
- **secondary data, i.e. internet sources*

Source:

<https://www.hospitalitynet.org/opinion/4099236.html>

2020 TRENDS® IN THE HOTEL INDUSTRY

GOP* Margin – Percent of Total Operating Revenue



Note: * Before Management Fees and Non-Operating Income and Expenses
Source: CBRE, Trends® in the Hotel Industry

“ Questions

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