

Lesson 1:

Introduction to Cost Accounting & Elements of Material Cost

1.1 Introduction

Management accounting plays an important role in every organization. It focuses on effective management of resources to improve customer value and shareholder value. Hence, this lesson provides an introduction to management and cost accounting, distinguish between financial and management accounting, role of management accounting in providing information to managers for planning, controlling, performance measurement.

1.2 Learning Outcomes

Upon completion this lesson, you should be able to:

- define management accounting;
- explain primary activity of management accounting;
- distinguish between financial and management accounting;
- describe primary function of cost and management accounting systems;

1.3 Required Readings

Drury, Chapter 1

1.4 Points to Ponder/Takeaways

Financial Accounting	The process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information.
Management Accounting	Managerial accounting is the development and use of accounting information for the purpose of planning, organizing, directing, and controlling a firm's investing, financing and operating activities.

1.5 Learning Material

1. Definition of management accounting

- the processes & techniques that focus on the effective & efficient use of organisational resources.

- to support managers in their tasks of enhancing both customer value and shareholder value.

2.Users of accounting information can be divided into two categories:

- (i) External parties outside the organization (financial accounting).
- (ii) Internal parties within the organization (management accounting).

3.Major differences between financial and management accounting:

Statutory requirement for public companies to produce annual financial accounts, whereas there is no legal requirement for management accounting.

Financial accounting reports describe the whole of the organization, whereas management accounting focuses on reporting information for different parts of the business.

Financial accounting reports must be prepared in accordance with generally accepted accounting principles (e.g.FRSs).

Financial accounting reports historical information, whereas management accounting places greater emphasis on reporting estimated future costs and revenues.

Management accounting reports are produced at more frequent intervals.

4.Summary of Major Differences Between Financial & Managerial Accounting

	Managerial Accounting	Financial Accounting
Purpose	To help mgt to: plan, direct, control & decision making	Communicate financial position to external users
Primary Users	Internal users	External users
Focus/Emphasis	Future-oriented	Past-oriented
Rules	Do not have to follow GAAP; cost vs. benefit	Accounting Standard, GAAP compliant
Reporting interval	Flexible, varying fr hourly to 10-15yrs	Less flexible: 1 yr

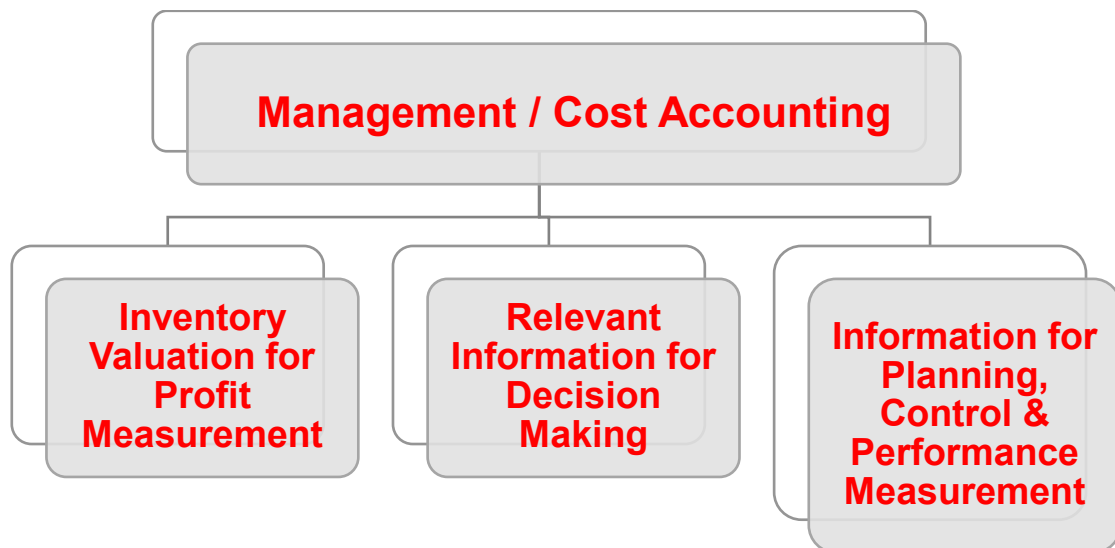
Range & quality of information	Financial & non-fin. data	Financial data
--------------------------------	---------------------------	----------------

5. Management Functions

Management accounting supports management and management process.

- Planning – developing goals and objectives, translating these objectives into courses of action.
- Directing – overseeing day-to-day operations.
- Controlling – evaluating results of operations.
- Decision making – continually making decisions.

Primary Function of Management / Cost Accounting



6. Primary functions of cost/management accounting systems

6.1 Inventory valuation for internal and external profit measurement

Allocate costs between products sold and fully and partly completed products that are unsold.

Example: Inventory Valuation and Profit Measurement

Consider a situation where a company has produced three products (A,B and C) during the period. The total costs for the period are £40 000. Product A has been sold for £20 000, product B has been completed but is in finished goods stock, and product C is partly completed. Costs must be traced to products to value stocks and cost of goods sold.

	£	£
Sales		20 000
Production cost		40 000
Less Closing stocks		
(B =£18 000,C =£8 000)		26 000
Cost of goods sold (A =£14 000)		14 000
Profit		6 000

Approximate but inaccurate individual product costs may be appropriate for profit measurement for financial accounting.

Example

Production expenses for the period =	£10m
Costs of products sold =	£7m
Cost of products not sold =	£3m

Note focus is on aggregate figures for financial accounting.

6.2 Provide relevant information to help managers make better decisions

- Profitability analysis
- Product pricing
- Make or buy (Outsourcing)
- Product mix and discontinuation

Example: Short-term decision

Cost information for providing guidance for decision-making
In theory cost information computed for stock valuation ought not to be used for decision-making.

A company is negotiating with a customer for the sale of XYZ.
The cost recorded for stock valuation purposes is:

	£
Direct materials	200
Direct labour	150
Fixed overheads	300
	650

The maximum selling price that can be negotiated is £500 per unit for an order of 100 units over the next three months.

Should the company accept the order?

Spare capacity	
Additional relevant costs (100 × £200)	£20 000
Additional sales revenue	<u>£50 000</u>
Contribution to profits	<u>£30 000</u>

6.3 Provide information for planning, control and performance measurement

Long-term and short-term planning (budgeting)

Periodic performance reports for feedback control

Performance reports also widely used to evaluate managerial performance

Note that costs should be assembled in different ways to meet the above three requirements.

Example: Operational control and performance measurement

The allocation of costs to products is not particularly useful for cost control purposes. Instead, costs should be traced to responsibility/cost centres to the person who is accountable for controlling the costs.

Example

Budgeted costs per unit:

Total	Product 1	Product 2	Product 3	
	£	£	£	£
Cost centre A	10	40	70	120
Cost centre B	20	50	80	150
Cost centre C	30	60	90	180
	60	150	240	450
Budgeted and actual production (units)	1000	1000	1000	

Operational control and performance measurement

Comparison of actual with budgeted costs by products

	Product 1	Product 2	Product 3	Total
	£000	£000	£000	£000
Budgeted cost	60	150	240	450
	(1,000 × £60)			
Actual cost	70	170	270	510
Variance	10A	20 A		30A
60A				

The variances are not identified to responsibility (cost centres)