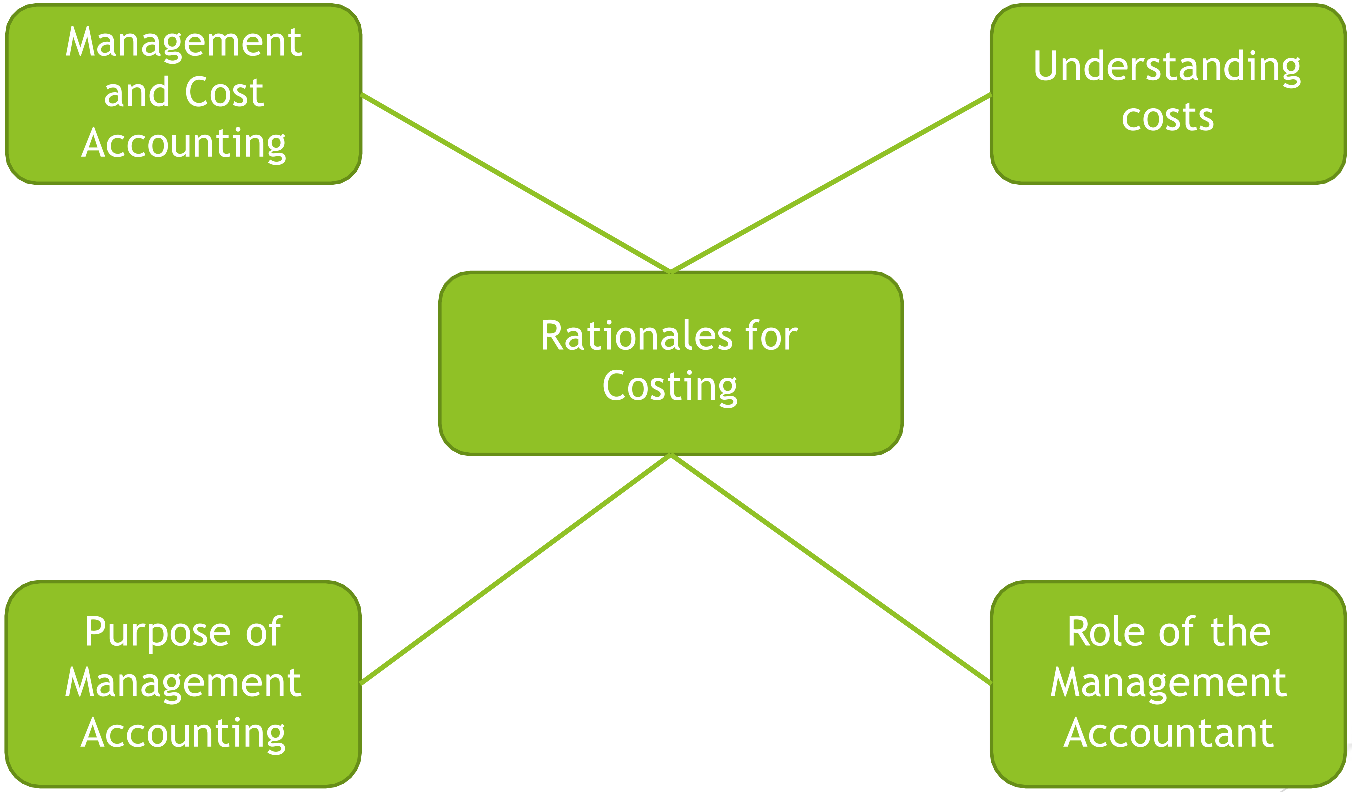
RATIONALES FOR COSTING

OVERVIEW


Management and Cost Accounting
Understanding costs
Rationales for Costing
Purpose of Management Accounting
Role of the Management Accountant

Management Accounting

The CIMA Terminology defines management accounting as

'the application of the principles of accounting and financial management to *create, protect, preserve and increase value* for the stakeholders of for profit and not-for-profit enterprises in the public and private sectors.'

Cost accounting is a sub-set of management accounting

Cost Accounting

The CIMA Terminology defines cost accounting as

'the gathering of cost information and its attachment to cost objects, the establishment of *budgets, standard costs and actual costs* of operations, processes, activities or products; and the analysis of variances, profitability or the social use of funds.'

Cost accounting tends to be more useful for operational and tactical decisions

COMPARISON

MANAGEMENT ACCOUNTING	FINANCIAL ACCOUNTING
For internal use	For external use
At the discretion of management	Statutory requirement
Concerned with the provision of information to management to aid decision making	Concerned with the production of statutory accounts for an organisation
Not governed by rules or regulations, can be provided in any format	Governed by many rules and regulations

PURPOSE OF MANAGEMENT ACCOUNTING

- ☐ Establishing the objectives and goals
- ☐ Management Accountant will create budgets

- ☐ Monitoring, measuring, evaluating and correcting actual results to ensure that the organisation’s plans are being achieved
- ☐ Management Accountant will analyse variances

- ☐ Considering information that has been provided and making informed decisions
- ☐ Different types of decisions (operational, tactical and strategic

THE MANAGEMENT ACCOUNTANT

The role of the management accounting within an organisation has changed in recent years. Management accountants today are seen as value-adding business partners.

They work as an integral part of multi-skilled management teams in carrying out the:

- formulation of policy and setting of corporate objectives
- formulation of strategic plans derived from corporate objectives
- formulation of shorter-term operational plans
- acquisition and use of finance
- design of systems, recording of events and transactions and management of information systems

THE MANAGEMENT ACCOUNTANT

- generation, communication and interpretation of financial and operating information (such as product costs) for management and other stakeholders
- provision of specific information and analysis on which decisions (such as how many units to produce or what products to make) are based
- monitoring of outcomes against plans (such as budgets) and other benchmarks and the initiation of responsive action for performance improvement
- derivation of performance measures and benchmarks, financial and non-financial, quantitative and qualitative, for monitoring and control; and
- improvement of business systems and processes through risk management and internal audit review.

The importance of understanding costs

Reasons for determining cost

There are a number of reasons why an organisation needs to know the cost of producing its product or providing its service.

- inventory valuation – inventory for products produced internally needs to be valued at production cost rather than simply purchase price.
- profit calculation – the cost of the product will be compared to the price in order to determine the profit per unit and subsequently the profit for the period.
- pricing – some organisations will use cost based pricing, whilst most organisations will aim to ensure that the product is priced above its cost.
- decision making – understanding the cost will aid decisions such as whether to accept a large, one-off sales contract at a reduced selling price.

Cost transformation model (by CGMA)

- Another reason for determining the cost of a product is contained in a model known as the cost transformation model.
- This model suggests that a focus on cost minimisation across an organisation through a change in culture and a focus on what drives costs (amongst other things) will result in better cost competitiveness for an organisation.
- This cost competitiveness could help the organisation beat rivals in the market and gain a larger market share.

The model has six suggested changes for organisations aimed at achieving this objective. These changes are:

Creating a cost conscious culture

The organisation should aim to be a cost leader so that its costs are lower than rivals and set a competitive benchmark. Everyone in the organisation should be motivated and enabled to reduce costs in whatever way possible. Technology can play a key role in reducing costs.

Understanding cost drivers

This involves investigating costs to determine why they change and how different variables impact on the cost. Plans should be put in place to reduce the drivers of costs as well as the costs themselves.

Managing the risks that come from a cost conscious culture

For example, reducing cost may result in reducing quality and customer satisfaction. The organisation should have a clear risk management process in place to identify, assess and manage such risks.

Ensuring products and services are profitable

It will be important that every product or service makes a positive contribution to overall organisational profits. This will involve understanding what drives costs for each individual product and allocating shared costs to products as accurately as possible

Maximising value from new products

The potential profitability of new products should be assessed before production begins. Also, as part of product design, the product or service should be made to be as flexible as possible so that it appeals to or can be adapted to satisfy as many customer segments as possible.

Maximising value from new products

Consider the environmental impact of products – negative impacts (such as creating unnecessary waste) can add costs as well as damaging reputation and sales


Engendering a cost-conscious culture
Managing the risks inherent in driving cost-competitiveness
Understanding cost drivers: Cost accounting systems and processes
Connecting Products with Profitability
Incorporating sustainability to optimise profits
Generating maximum value through new products

DEFINITIONS

Cost unit as ‘a unit of product or service in relation to which costs are ascertained’. Acost unit can be anything for which it is possible to ascertain the cost.

Cost centre is a production or service location, a function, an activity or an item of equipment for which costs are accumulated. It is one type of responsibility centre.

Cost object can be a product, service, centre, activity, customer or distribution channel in relation to which costs are ascertained.

Classification of Costs

In order to calculate costs we need to understand them. A key to this is understanding different ways in which costs can be classified.

There are three main ways to classify costs:

- by behaviour
- by element
- by nature

Classification of costs according to their behaviour

Cost behaviour

Fixed costs

- costs which don’t change as the activity level changes
- Eg: rent, rates, insurance and executive salaries.

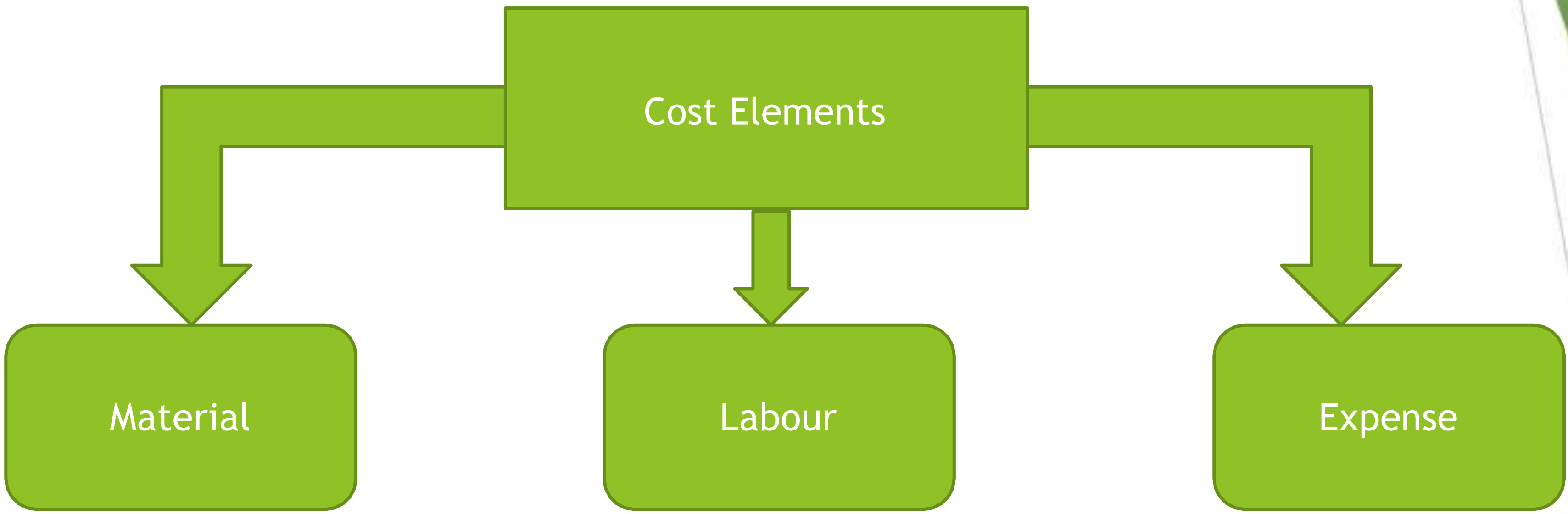
Variable costs

- costs which change in direct proportion to changes in the activity level
- Eg: direct material, direct labour and variable overheads.

Semi-variable costs

- costs which have both fixed and variable elements.
- Eg: gas and electricity.

Classification of costs according to their element



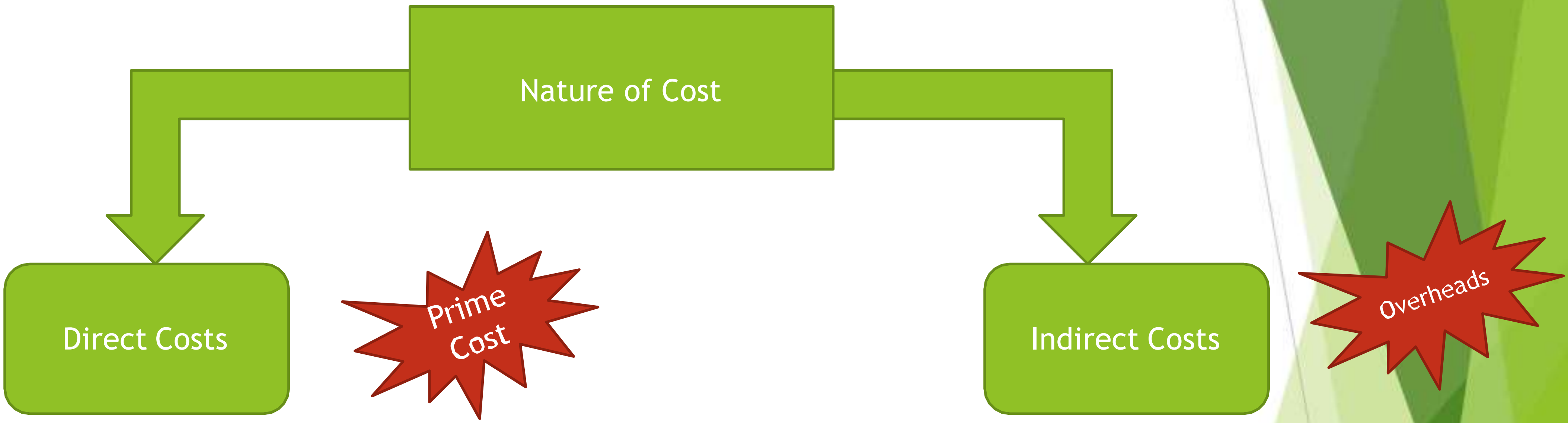
☐the components bought in by the company which are used in manufacturing the product.
☐Eg: the materials used by a food producer could be meat or vegetables.

☐the costs of the people working for the organisation.

☐These costs include wages and salaries, together with related employment costs.

☐the regularly incurred costs of running the business such as rent, business rates, utility costs, insurance, postage, telephones and similar items.

Classification of costs according to their Nature



- These can be clearly identified with the cost object we are trying to cost.
- Eg: suppose that a furniture maker is determining the cost of a wooden table. The manufacture of the table has involved the use of timber, screws and metal drawer handles

- Costs that cannot be directly attributed to a particular cost unit, although it is clear that they have been incurred in the production of the table
- Eg: Lubricating oils and cleaning materials Salaries of factory supervisors Factory rent and power

Alternative classification of costs by nature

☐costs which are only incurred if production takes place.
☐These include direct material, direct labour and absorbed production overheads.

Therefore if an organisation does not produce any items it will not incur any product costs.

☐costs which are incurred due to the passage of time
☐These include costs such as rent and rates, insurance, directors' salaries and depreciation.
These costs accrue on daily, monthly or annual basis and will still accrue even if an organisation does not produce any items.