
C H A P T E R O N E : C O S T A C C O U N T I N G T E R M I N O L O G Y A N D R E L A T I O N S H I P S

1. What is cost accounting?

CIMA defines cost accounting as “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”.

2. What is management accounting?

Management accounting is concerned with the provision of information to people within the organization to help them make better decisions.

3. What is financial accounting?

Financial accounting is concerned with the provision of information to external parties outside the organization.

4. Purpose of cost accounting?

Purposes of cost accounting are divided into the three broad categories:

- a) For stock valuation and profit measurement
- b) For decision-making and planning
- c) For control

a) For Stock Valuation and Profit Measurement

- For stock valuation and profit measurement, we must distinguish between assets and expenses.
- Assets are the resources that have been acquired and that are expected to contribute to future revenue. It will recorded as an asset in the balance sheet and becomes an expense in the profit and loss account in a later accounting period
- Expenses incurred when they have been consumed in the generation of revenue and have no future revenue-producing potential. It will recorded as an expense in the profit and loss account of the current accounting period
- Accountants classify costs as product costs and period costs
- **Product costs** are those costs that are identified with goods purchased or produced for resale. In a manufacturing organisation, they are costs that the accountant attaches to the product and that are included in the stock valuation for finished goods or for work in progress.
- **Period costs** are those costs that are not included in the stock valuation and as a result are treated as expenses in the period in which they are incurred
- In a manufacturing organisation, all manufacturing costs are regarded as product costs and non-manufacturing costs are regarded as period costs
- In manufacturing organisations, the calculation of product costs consists of three elements: direct materials, direct labour and manufacturing overhead.
- For stock valuation, the costs of a product are collected as follows:

	(\$)
Direct materials	xxx
Direct labour	<u>xxx</u>
Prime cost	xxx
Manufacturing overhead	<u>xxx</u>
Total manufacturing cost	<u>xxx</u>

- **Direct materials** consist of all those materials that can be physically identified with a specific product. For example, wood that is used to manufacture a desk can easily be identified as part of the product, and can thus be classified as direct materials.
- **Direct labour** consists of those labour costs that can be specifically traced to or identified with a particular product. Examples of direct labour costs include the wages of operatives who assemble parts into the finished product or machine operatives engaged in the production process.
- **Prime cost** refers to the direct costs of the product and consists of direct labour costs plus direct material costs plus any direct expenses.
- **Manufacturing overhead** consists of all manufacturing costs other than direct labour, direct materials and direct expenses. It therefore includes all indirect manufacturing labour and material costs plus indirect manufacturing expenses. Examples of indirect manufacturing expenses in a multi-product company include rent of the factory and depreciation of machinery.
- **Indirect materials** consist of materials used for the repair of a machine that is used for the manufacture of many different products. These items of materials cannot be identified with any one product, because they are used for the benefit of all products rather than for any one specific product.
- **Indirect labour** consists of those labour costs that cannot be specifically identified with the product. Examples for indirect labour are the salaries of factory supervisors or the wages paid to the staff in the stores department.

b) For Decision-Making and Planning

- Conventional cost accounting data collection system accumulate costs by products to meet the financial accounting requirements of allocating manufacturing costs incurred during a period between cost of sales and inventories
- Costs can be classifications into several groups:
 - i) Cost behaviour in relation to volume or activity
 - ii) Relevant and irrelevant cost
 - iii) Sunk costs
 - iv) Avoidable and unavoidable costs
 - v) Opportunity costs
 - vi) Incremental and marginal costs/revenues
- i) Cost Behaviour
 - ✓ Cost can be classified according to how they behave in response to a change of output.
 - ✓ **Fixed cost** remains constant over wide ranges of activity for a specified time period. Examples of fixed cost include depreciation of the factory, building and supervisors' salaries.
 - ✓ **Variable cost** consists a cost that varies with a measure of activity. Examples of variable costs include direct materials and direct labour.
 - ✓ **Semi-variable cost** includes both a fixed and a variable component. For example, the cost of maintenance is a semi-variable cost consisting of planned maintenance that is undertaken whatever the level of activity, an variable element that is directly related to the level of activity.
- ii) Relevant and irrelevant cost and revenues
 - ✓ For decision-making, costs and revenues can be classified according to whatever they are relevant to a particular decision.
 - ✓ Relevant costs and revenues are those future costs and revenues that will be changed by a decision, whereas irrelevant cost and revenues are those will not be affected by the decision.

- ✓ For example, if one is faced with a choice of making a journey by car or by public transport, the car tax and insurance costs are irrelevant, since they will remain the same whatever alternative is chosen. However, petrol costs for the car will differ depending on which alternative is chosen, and this cost will be relevant for decision-making.
- iii) Sunk cost
- ✓ These costs are the cost of resources already acquired where the total will be unaffected by the choice between various alternatives.
 - ✓ They are costs that have been created by a decision made in the past and that cannot be changed by any decision that will be made in the future.
 - ✓ Example for sunk costs is the written down values of assets previously purchased.
- iv) Avoidable and unavoidable costs
- ✓ Sometimes the terms “avoidable” and “unavoidable” costs are used instead of relevant and irrelevant costs.
 - ✓ Avoidable costs are those costs that may be saved by not adopting a given alternative, whereas unavoidable costs cannot be saved.
 - ✓ Therefore only avoidable costs are relevant for decision-making purposes.
- v) Opportunity cost
- ✓ An opportunity cost is a cost that measures the opportunity that is lost or sacrificed when the choice of one course of action requires that an alternative course of action be given up.
 - ✓ Opportunity costs only apply to the use of scarce resources. Where resources are not scarce, no sacrifice exists from using these resources.
- vi) Incremental and marginal costs/ revenues
- ✓ Incremental (also called differential) costs and revenues are the additional costs or revenues that arise from the production or sale of a group of additional units.
- c) **For Control**
- The allocation of costs to products is inappropriate for cost control, since the manufacture of the product may consist of several different operations, all of which are the responsibility of different individuals.
 - The product cost will not therefore pinpoint costs to areas of responsibility. To overcome this problem, company used system known as responsible accounting.
 - Responsibility accounting is based on the recognition of individual areas of responsibility as specified in a firm’s organisation structure. These areas of responsibility are known as “responsibility centers”.
 - There are three types of responsibility centre:
 1. A **cost centres** where managers are accountable for the expenses that are under their control. Cost centre also is a production or service location, function, activity or item of equipment for which costs are accumulated.
 2. A **profit centre** where managers are accountable for sales revenue and expenses, for example a division of a company that is responsible for the selling and production of a product
 3. An **investment centre** where managers are normally accountable for sales revenue and expense, but in addition are responsible for some capital investment decision and are thus able to influence the size of the investment
 - The manager of the responsibility centre should classify costs and revenues allocated to responsibility centres according to whether or not they are controllable or non-controllable.

- All costs are controllable by some management level. For example, top management has authority to dispose of facilities and increase or decrease the number of managers employed.

5. What is cost units?

- A cost unit is a unit of product or service in relation to which costs are ascertained
- Examples of cost units are cost per student, cost per site developed, cost per bottle and cost per case
- **Examples:** A production department in Ferry Company makes one product only. The department has 6 operatives and a departmental supervisor. Each operative is paid RM400 per week and this does not depend upon the production level. The supervisor is paid RM600 per week. The direct material cost is RM4 per unit of product. Normal production is 600 units per week. Calculate total cost per week and cost per unit for this product.

Solution:

Direct material (RM4 x 600units)	RM2,400
Direct labour (RM400 x 6 operatives)	2,400
Supervisor	<u>600</u>
Total cost of the product	<u>RM5,400</u>

$$\begin{aligned} \text{Cost per unit} &= \frac{\text{Total cost of the product}}{\text{Units produced}} \\ &= \frac{\text{RM5,400}}{600 \text{ units}} \\ &= \text{RM9 per unit} \end{aligned}$$

6. Classification of cost

- CIMA defines classification as: “The arrangement of items in logical groups having regard to their nature (subjective classification) or purpose (objective classification)
- Cost can be classified by **elements**: Direct cost and indirect cost.
- Cost can be classified by **function** that incurs the cost. Example, direct costs will substantially be production costs. If a rapid delivery courier sends an order for a customer, then the cost of this delivery is a direct costs but functionally it is a distribution cost.
- Cost can be classified by **normality**: Normal or abnormal. An abnormal cost needs to be identified since it suggests that some action is required. Most costs incurred are the normal cost, i.e. that cost expected in the normal course of business operations.
- Cost can be classified by **behaviour**: Variable cost, fixed cost or semi-variable cost.
- Costs can be classified as **controllable or uncontrollable**.

Learning Outcomes

- Explain the meaning of cost accounting terms as defined in the CIMA Management Accounting official terminology
- Describe the meaning and purpose of cost accounting
- Explain the cost centre and calculation for cost units
- Classify cost by behaviour such as into variable, semi-variable and fixed categories

Basic Reading

1. T Lucey (2001) Costing; 5th ed. London: Continuum
2. C Drury (2000) Management & Cost Accounting; 5th ed. London: International Business Press

Revision Questions

1. Explain definition of cost accounting?
2. Briefly explain purposes of cost accounting?
3. What is a difference between direct cost and indirect cost? Gives examples for each of the cost.
4. What are the types of responsibility centre?