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MANAGERIAL ACCOUNTING AND COST CONCEPTS

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OUTLINE OF THE LECTURE

1. Cost classifications for assigning costs to cost objects
2. Cost classifications for manufacturing companies
3. Cost classifications for preparing financial statements
4. Cost classifications for predicting cost behavior
5. Variable cost, fixed cost, mixed cost, sunk cost, opportunity cost

COST CLASSIFICATIONS

- Cost classifications for assigning costs to cost objects
  - Direct cost
  - Indirect cost
- Cost classifications for manufacturing companies
  - Manufacturing costs
  - Nonmanufacturing costs
- Cost classifications for preparing financial statements
  - Product costs
  - Period costs
  - Prime cost and conversion cost
- Cost classifications for predicting cost behavior
  - Variable cost
  - Fixed cost
  - Mixed costs

COST CLASSIFICATIONS FOR ASSIGNING COSTS TO COST OBJECTS

- Costs are assigned to cost objects for a variety of purposes including pricing, preparing profitability studies and controlling spending.
- A cost object is anything for which cost data are desired - including products, customers, jobs and organizational subunits.
- For purposes of assigning costs to cost objects. Costs are classified as either **direct** or **indirect**.

DIRECT x INDIRECT COST

- Direct cost – can be easily and conveniently traced to a specified cost object (for example salary of employees)

- Indirect cost – cannot be easily and conveniently traced to a specified cost object
  - Common cost – is incurred to support a number of cost objects but cannot be traced to them individually.
  - Common cost is a type of indirect cost

COST CLASSIFICATIONS FOR MANUFACTURING COMPANIES

- Manufacturing companies separate their costs into two broad categories:
  - Manufacturing costs
  - Nonmanufacturing costs

MANUFACTURING COSTS

- Most manufacturing companies further separate their manufacturing costs into following categories:
  - two direct cost categories - direct materials and direct labour
  - one indirect cost category - manufacturing overhead
- Direct materials – are materials that become an integral part of the finished product and whose costs can be conveniently traced to the finished product.
- Direct labour
- Manufacturing overhead

MANUFACTURING COSTS – DIRECT MATERIALS

- Direct materials are materials that become an integral part of the finished product and whose costs can be conveniently traced to the finished product.
- The materials that go into the final product are called **raw materials.**
- Raw materials refer to any materials that are used in the final product; and the finished product of one company can become the raw materials of another company.
- Raw materials may include both direct and indirect materials.

MANUFACTURING COSTS – DIRECT LABOR

- Direct labour consists of labour costs that can be easily traced to individual units of product.
- Direct labour is sometimes called *touch labour* because direct labour workers typically touch the product while it is being made.
- Labour costs that cannot be physically traced to particular products, or that can ben traced only at great cost and inconvenience, are termed **indirect labour**.
- Just like indirect materials, indirect labour is treated as part of manufacturing overhead.

MANUFACTURING COSTS – MANUFACTURING OVERHEAD (1)

- Manufacturing overhead includes all manufacturing cost expect direct materials and direct labour.

- Manufacturing overhead includes items such as indirect materials, indirect labour, maintenance and repairs on production equipment; heat and light, property taxes, depreciation, and insurance on manufacturing facilities.

- A company also incurs costs for heat and light, property taxes, insurance, depreciation and so forth, associated with its selling and administrative functions, but these costs are not included as part of manufacturing overhead.

MANUFACTURING COSTS – MANUFACTURING OVERHEAD (2)

- Only those costs associated with operating the factory are included in manufacturing overhead.
- Various names are used for manufacturing overhead – such as indirect manufacturing cost, factory overhead and factory burden.

NONMANUFACTURING COSTS

- Nonmanufacturing costs are often divided into two categories:
    1. Selling cost
    2. Administrative cost
- Nonmanufacturing costs are also often called selling, general and administrative costs or just selling and administrative costs.

NONMANUFACTURING COSTS – SELLING COST

- Include all costs that are incurred to secure customer orders and get the finished product to the customer
- Sometimes called order-getting and order-filling costs
- Examples of selling costs include advertising, shipping, sales travel, sales commissions, sales salaries and costs of finished goods warehouses
- Selling costs can be either direct or indirect costs
- For example, the cost of an advertising campaign dedicated to one specific product is a direct cost of that product, whereas the salary of a marketing manager who oversees numerous products is an indirect cost with respect to individual products

NONMANUFACTURING COSTS – ADMINISTRATIVE COSTS

- Include all costs associated with the general management of an organization rather than with manufacturing or selling

- Examples of administrative costs include executive compensation, general accounting, secretarial, public relations and similar costs involved in the overall, general administration of the organization as a whole.

- Can be either direct or indirect costs.

- For example, the salary of an accounting manager in charge of accounts receivable collections in the East region is a direct cost of that region, whereas the salary of a chief financial officer who oversees all of a company s regions is an indirect cost with respect to individual regions

COST CLASSIFICATIONS FOR PREPARING FINANCIAL STATEMENTS

- When preparing a balance sheet and an income statement, companies need to classify their costs as **product costs** or **period costs.**

- The matching principle is based on the accrual concept that costs incurred to generate a particular revenue should be recognized as expenses in the same period that the revenue is recognized.

- This means that if a cost is incurred to acquire or make something that will eventually be sold, then the cost should be recognized as an expense only when the sale takes place – that is, when the benefit occurs.

- Such costs are called **product costs**.

PRODUCT COSTS

- include all costs involved in acquiring or making a product
- in the case of manufactured goods, these costs consist of direct materials, direct labour and manufacturing overhead
- product costs are initially assigned to an inventory account on the balance sheet
- when the goods are sold, the costs are released from inventory as expenses (typically called cost of goods sold) and matched against sales revenue on the income statement
- because product costs are initially assigned to inventories, they are also known as **inventoriable costs**

PERIOD COSTS

- period costs are all the costs that are not product costs
- all selling and administrative expenses are treated as period costs
- for example, sales commissions, advertising, executive salaries, public relations and the rental costs of administrative offices are all period costs
- period costs are not included as part of the cost of either purchased or manufactured goods
- period costs are expensed on the income statement in the period in which they are incurred using the usual rules of accrual accounting

PRIME COST AND CONVERSION COST

- **prime cost -** is the sum of direct materials cost and direct labor cost
- **conversion cost -** is the cum of direct labor cost and manufacturing overhead cost
- the term conversion cost is used to describe direct labor and manufacturing overhead because these costs are incurred to convert materials into the finished product

SUMMARY

Product cost = Direct materials + Direct labour + Manufacturing overhead

Period cost = Selling expenses + Administrative expenses

Conversion cost = Direct labour + Manufacturing overhead

Prime cost = Direct materials + Direct labour

COST CLASSIFICATIONS FOR PREDICTING COST BEHAVIOR

- cost behavior refers to how a cost reacts to changes in the level of activity
- as the activity level rises and falls, a particular cost may rise and fall as well - or it may remain constant
- for planning purposes, a manager must be able to anticipate which of these will happen; and if a cost can be expected to change, the manager must be able to estimate how much it will change
- the relative proportion of each type of cost in an organization is known as its cost structure
  - an organization might have fixed costs, variable costs or mixed costs

VARIABLE COST

- a variable cost varies, in total, in direct proportion to changes in the level of activity
- include cost of goods sold for a merchandising company, direct materials, direct labor, variable elements of manufacturing overhead, such as indirect materials, supplies and power, and variable elements of selling and administrative expenses, such as commissions and shipping costs

For a cost to be variable, it must be variable with respect to something. That something is its activity base.

ACTIVITY BASE

- an activity base is a measure of whatever causes the incurrence of a variable cost

- an activity base is sometimes referred to as a cost driver

- some of the most common activity bases are direct labor-hours, machine-hours, units produced, units sold, the number of miles driven by salespersons, the number of pounds of laundry cleaned by a hotel, the number of call handled by technical support staff at a software company and the number of beds occupied in a hospital

FIXED COST

- is a cost that remains constant, in total, regardless of changes in the level of activity
- include straight-line depreciation, insurance, property taxes, rent, supervisory salaries, administrative salaries and advertising
- unlike variable costs, fixed costs are not affected by changes in activity
- consequently, as the activity level rises and falls, total fixed costs remain constant unless influenced by some outside force such as a landlord increasing your monthly rental expense
- fixed costs can be viewed as either committed or discretionary

COMMITTED FIXED COSTS

- committed fixed costs represent organizational investments with a multiyear planning horizon that can t be significantly reduced even for short periods of time without making fundamental changes

- include investments in facilities and equipment, as well as real estate taxes, insurance expenses and salaries of top management

- even if operations are interrupted or cut back, committed fixed costs remain largely unchanged in the short term because the costs of restoring them later are likely to be far greater than any short-run saving that might be realized

DISCRETIONARY FIXED COSTS

- often referred to as managed fixed costs
- usually arise from annual decisions by management to spend on certain fixed cost items
- examples of discretionary fixed costs include advertising, research, public relations, management development programs and internships for students
- can be cut for short periods of time with minimal damage to the long-run goals of the organization

MIXED COST

- contains both variable and fixed cost elements
- are also known as semivariable costs

DIFFERENTIAL COST X MARGINAL COST

- A difference in costs between any two alternatives is known as a differential cost
- A differential cost is also known as an incremental cost, although technically an incremental cost should refer only to an increase in cost from one alternative to another; decreases in cost should be referred to as decremental costs
- Differential cost is a broader term, encompassing both cost increases (incremental costs) and cost decreases (decremental costs) between alternatives
- Cost involved in producing one more unit of product is called marginal cost

OPPORTUNITY COST

- opportunity cost is the potential benefit that is given up when on alternative is selected over another
- opportunity costs are not usually found in accounting records, but they are costs that must be explicitly considered in every decision a manager makes
- virtually every alternative involves an opportunity cost
- For example, assume that you have a part-time job while attending college that pays €200 per week. If you spend one week at the beach during spring break without pay, then the €200 in lost wages would be an opportunity cost of taking the week off to be at the beach.

SUNK COST

- a sunk cost is a cost that has already been incurred and that cannot be changed by any decision made now or in the future
- because sunk costs cannot be changed by any decision, they are not differential costs
- and because only differential costs are relevant in a decision, sunk costs should always be ignored
- To illustrate a sunk cost, assume that a company paid € 500 several years ago for a special-purpose machine. The machine was used to make a product that in now obsolete and is no longer being sold. Even though in hindsight purchasing the machine may have been unwise, the € 500 cost has already been incurred and cannot be undone. And it would be folly to continue making the obsolete product in a misguided attempt to recover the original cost of the machine. In short, the € 500 originally paid for the machine is a sunk cost that should be ignored in current decisions.