Management Accounting I & II

Theory

Management involves planning, organising, controlling and decision making. In order to make good decisions and manage effectively, people need as much relevant information as possible at their disposal. Information should be useful, accurate, up to date and relevant to the decision-making process.

Planning is the setting of short-term and long-term goals/plans and drawing up policies to achieve them.

Organising is making the plans work by co-ordinating the various activities/departments within the firm.

Controlling is monitoring the plans and policies, ensuring that targets are achieved and that corrective action is taken if and when necessary.

Decision making is deciding between different courses of action. A cost-benefit analysis report is used.

Role of the cost and management accountant

The cost and management accountant engages in the following activities:

1. Established the cost of producing a product or service or running each department
2. Projects the future cost of a product/service and cost of running each department
3. Prepares production, departmental and master budgets
4. Compares the actual cost of a product/service with the budgeted cost

5. Uses variance analysis. This examines the differences between budgeted costs and actual costs and explains these differences
6. Communicates with department heads regarding variance analysis and corrective action
7. Gathers information that is useful, accurate, up to date and relevant to the decision making process

Uses of management accounting information

- The information helps management to compare the actual costs of producing a product or service with the budgeted cost and so helps to control costs
- Actual cost per unit can be used as an aid to fixing selling prices
- Budgeting is an essential tool in planning, co-ordinating and controlling the activities of the firm. Members of the team see the need to achieve targets
- Variance analysis is used to highlight areas where actual costs are not in line with planned costs and identifies areas where corrective action needs to be taken
- Capital investment appraisal helps you ensure that the best use is made of funds available for investment. It also ensures that growth can be achieved while ensuring that the risks to profitability are kept at acceptable levels

Relationship of management accounting to financial accounting

Financial accounting is concerned with:

- Recording, classifying and summarising transactions that have taken place
- Reporting on the effects of these transactions over an accounting period. The trading and profit and loss accounts and the cash flow statement summarise the effect of transactions over the accounting period.
- Presenting a true and fair view of the state of affairs of the business at the end of the accounting period. The balance sheet presents a view of the state of affairs of the business at the end of the accounting period.

Management accounting is concerned with:

- Monitoring and controlling the activities within the company
- Internal future planning and decision making

Relationship summary

Users

Management accounting has an internal focus, providing information to managers for the purpose of planning, organising, controlling and making decision

Financial accounting has both an internal and external focus, providing information to managers, shareholders and creditors

Time Focus

Management accounting is forward looking, providing future information by planning and budgeting.

Financial accounting records past events, providing information as in profit and loss account, cash flow statement and balance sheet.

Information

Management accounting is micro-accounting, providing information for cost centres/departments.

Financial accounting reports are prepared usually on an annual basis.

Regulation

Management accounting is not governed by any legal requirements.

Financial accounting is governed by legislation and accounting standards.

Task

Pause the video and answer the following questions.

1. Explain the four activities involved in management
2. Outline the role of the management accountant in an organisation
3. Compare management accounting to financial accounting

Cost Classification

The role of management accounting is to gather information about costs. In order for this information to be useful, it is necessary to categorise or classify it.

The purpose for which the information is required will determine the way in which costs are classified. This purpose can be called the **cost objective**.

We can now look at the more common ways of classifying costs. For a company engaged in manufacturing, costs would be classified as manufacturing or non-manufacturing at first.

Manufacturing costs

The cost of manufacturing a product consists of direct and indirect costs.

Direct costs

Direct costs are costs that are directly linked to a particular product or service. That is:

- Direct materials, e.g. raw materials
- Direct labour e.g. direct wages, manufacturing wages
- Direct expenses e.g. hire of special equipment or royalties for use of patent

Indirect costs/overheads

Indirect costs or overheads are costs which are not directly linked to the product or a service but must be included as part of the cost. This includes factory rent and rates, factory light and heat, depreciation of factory machinery, maintenance of machinery, production supervisors salaries etc.

Non-manufacturing costs

These are all the other costs involved in running a business, apart from the manufacturing costs and may be classified as:

- Selling and distribution overheads: These are indirect costs associated with the sale and distribution of goods to customers. They include delivery costs, advertising and sales promotion, showroom expenses etc.
- Administration overheads: These are indirect costs associated with running the business e.g. office light and heat, telephone, stationery, depreciation of office equipment etc.
    - Administration overheads and selling and distribution overheads are charged to the profit and loss account

Fixed and Variable Costs

A variable cost is a cost that will change as production increases or decreases. Variable costs vary directly with the level of output or activity. All direct expenses are variable costs e.g. raw materials, direct wages and direct expenses.

A fixed cost is a cost that demos not change as output increases. It remains the same whether the output is one unit or a hundred units. Examples of fixed costs are rent, rates and insurance.

Manufacturing/production overheads (fixed and variable)

Manufacturing overheads (production or factory overheads) are the costs of:

- Indirect materials, e.g. lubricants, cotton waste, hand tools, works stationery
- Indirect labour, e.g. foreman, supervisor, stores person
- Indirect expenses e.g. rent & rates, light and heat, power for machinery.

All direct costs are variable costs, but the production overheads can be divided into fixed or variable.

Fixed overhead costs/period costs

Fixed overhead costs are costs that are not affected by the level of output or activity. They are also known as period costs because they relate to a period of time and remain the same, irrespective of the level of output. A fixed cost is not affected by changes in the levels of output, e.g. rent & rates, insurance and factory supervisor's salary.

Example

We have the following overhead cost in James Ltd:

Rent	€ 7,000
Light & Heat	€5,000
Insurance	€3,000
Total fixed overhead	€15,000

Whether James Ltd make one unit or 20,000 units the company will still incur the total fixed overheads of €15,000. Whether it produces or not, the company has a contractual obligation to pay these costs. In order to recover the fixed overheads, they must be "built in" or absorbed as part of the cost price.

Variable overhead costs

These are costs that vary directly with the level of output or activity, e.g. power for machinery. Sales commission based on unit sales is a variable expense.

Controllable cost

This is a cost that can be influenced by its budget holder or manager. All variable costs are controllable by management. For example, the sales manager has control over the level of commission. A manager can be held responsible for these costs.

Uncontrollable cost

This is a cost where the manager of a particular area of activity has no control. For examples, the sales manager has no control over the rent of a factory or the rates that are payable. A manager cannot be held responsible for these costs.

Mixed costs (Higher level)

Sometimes it is not possible to classify all costs as either fixed or variable. Some costs are partly fixed and partly variable. They are known as mixed costs. Telephone bills and electricity bills are examples of mixed costs. They have a fixed standing charge but a variable charge per unit consumed.

Fixed Costs

Fixed costs remain the same irrespective of output. Examples include

- Rent of factory
- Supervisor's salary
- Depreciation

Variable costs

A variable costs acts in a liner fashion i.e. it varies directly with the level of output. E.g. 1 unit = € 10 therefore 10 units = €100, direct wages or expenses are examples.

Step fixed costs

Fixed costs remain the same within certain levels of activity. For example, rent is a fixed amount but if production increases, extra factory space may be required.

Step variable costs

Some variable costs may change in steps also. For examples, discounts may be available for bulk purchasing of materials. However, with variable costs, the steps tend to be so small that generally they are ignored. Example, raw materials costs may change slightly due the bulk discounts.

This is a method which is used to separate mixed costs into their fixed and variable components. Two levels of output are taken; a high level and a low level, the difference between both levels must be variable because the fixed cost remains the same irrespective of the level of output.

Example Question.

The following total costs have been recorded during the year:

Month	Unit of Output	Total Cost
January	30,000	110,000
April	50,000	150,000
July	20,000	90,000
October	80,000	210,000

You are required to:

a) Calculate the variable cost per unit and total fixed cost using the high/low method.
b) Calculate the costs incurred in December if output is expected to be 40,000 units.

	Units	Total Cost
High Output	80,000	210,000
Low Output	20,000	90,000
	60,000	120,000

Variable Cost = €120,000/60,000 = €2

By putting the variable cost into the different levels of output, we can find the fixed cost.

	High €	Low €
Total cost	210,000	90,000
Less Variable cost	160,000 (80,000 units x €2)	40,000 (20,000 x €2)
Fixed Cost	**50,000**	**50,000**

Total cost if expected output is 40,000 units

Fixed cost	50,000
Variable cost (40,000 €2)	80,000
Total cost	**130,000**

Ordinary Level Q19.1

Classify the following costs into manufacturing and non-manufacturing.

James ltd, a manufacturer, incurs the following costs:

1. Factory rent
2. Salesman's salary
3. Salary of factory supervisor
4. Materials used in production
5. Factory insurance
6. Office stationery
7. Advertising
8. Hire of special equipment
9. Depreciation on machines
10. Depreciation of office equipment
11. Wages of machinists
12. Factory machine power
13. Carriage inwards
14. Wages of receptionist
15. Repairs to machines

Higher Level Q19.2

a) Explain the difference between each of these and give an example of each:

- Variable costs and fixed costs
- Mixed costs and period costs
- Controllable costs and uncontrollable costs

b) The following costs have been recorded during the year:

Month	Unit of Output	Total Cost €
January	10,000	39,000
April	15,000	51,500
July	12,000	44,000
October	18,000	59,000

You are required to:

- Calculate the variable cost per unit and total fixed cost using the high/low method.
- Calculate the costs incurred in December if output is expected to be 20,000 units.