# ATD

## LEVEL III

# FUNDAMENTALS OF MANAGEMENT ACCOUNTING



# STUDY TEXT

**KASNEB JULY 2018 SYLLABUS**

**Revised on: January 2019**

## PAPER NO.10 FUNDAMENTALS OF MANAGEMENT ACCOUNTING

### GENERAL OBJECTIVE

This paper is intended to equip the candidate with knowledge, skills and attitudes that will enable him/her to apply the fundamentals of management accounting in decision making.

### LEARNING OUTCOMES

**A candidate who passes this paper should be able to:**

- Estimate the cost of goods and services
- Analyse product costs for manufacturing and non-manufacturing activities
- Prepare marginal and absorption cost statements
- Analyse an organisation's activities through budgetary control process
- Analyse variances for decision making
- Use computers in cost management

### CONTENT

**1. Nature and purpose of cost and management accounting**

- The nature of cost accounting and costing terms
- The role of cost accounting in management
- The purposes of cost accounting information
- Scope of cost accounting
- Meaning of management accounting, scope, limitations, applications
- Relationship between cost, financial and management accounting
- Selection of an ideal cost accounting system



**2. Cost classification**

- Definition and purpose of cost classification
- Methods of cost classification: By nature/elements of manufacturing costs; Functional classification; Behavioral classification; Controllability; Time; Financial accounting; Identification with inventory; For decision making

**3. Cost estimation**

- Meaning of cost estimation
- Methods of estimating cost; non-mathematical methods like engineering method, accounts analysis method and high-Iow method; mathematical methods like scatter graph method, OLS regression method (simple linear regression only)

**4. Cost accumulation**

- Accounting for materials and inventory; material cost records, purchasing procedures, receipt and issues of material, methods of valuing material issues, inventory control

procedures; economic order quantity (EOQ) and economic batch quantity(EBQ) models and back flush
- Accounting for labour: Methods of labour remuneration, labour control procedures, maintenance of labour records
- Accounting for overheads: Types of overheads, manufacturing, distribution and administration, service departmental cost allocation and apportionment, overheads analysis, overhead absorption rates, over or under absorption

**5. Cost bookkeeping**

- The flow of costs in a business enterprise
- Cost bookkeeping- interlocking and integrated ledger systems

**6. Costing methods**

- Job order costing
- Batch costing
- Process costing (including work in progress; joint and by-products)
- Service costing
- Unit costing

**7. Marginal and absorption costing.**

- Distinction between marginal and absorption costing, Valuation of products under marginal and absorption costing
- Preparation of marginal and absorption statements; cost of production and profit determination
- Reconciliation of marginal profit and absorption profits, Applications of marginal costing: Break-even analysis and charts (single product)
- Simplified decision problems; accept or reject, special order, dropping a product, make or buy and choice of a product where a limited factor exists



**8. Budgeting and budgetary control**

- Nature and purposes of budgets
- Preparation of budgets; master budgets, functional (department budgets, cash budgets), proforma financial reports (income statements and balance sheets)
- Purpose of budgetary control; operation of a budgetary control system, organisation and coordination of the budgeting function

**9. Emerging issues and trends**

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# TOPIC 1

# NATURE AND PURPOSE OF COST AND ACCOUNTING

## THE NATURE OF COST ACCOUNTING AND MANAGEMENT ACCOUNTING

Cost accounting is a type of accounting process that aims to capture a company's costs of production by assessing the input costs of each step of production as well as fixed costs such as depreciation of capital equipment. Cost accounting will first measure and record these costs individually, then compare input results to output or actual results to aid company management in measuring financial performance.

The nature of cost accounting can be brought out under the following headings:

1. **Cost accounting is a branch of knowledge:** Though considered as a branch of financial accounting, cost accounting is one of the important branch of knowledge, i.e., a discipline by itself. It is an organised body of knowledge consisting of its own principles, concepts and conventions. These principles and rules vary from industry to industry.

2. **Cost accounting is a science:** Cost accounting is a science as it is a body of systematic knowledge relating to not only cost accounting but relating to a wide variety of subjects such as law, office practice and procedure, data processing, production and material control, etc. It is necessary for a cost accountant to have intimate knowledge of all these field of study in order to carry on his day-to-day activities. But it is to be admitted that it is not a perfect science as in the case of natural science.

3. **Cost accounting is an art:** Cost accounting is an art in the sense it requires the ability and skill on the part of cost accountant in applying the principles, methods and techniques of cost accountancy to various management problems. These problems include the ascertainment of cost, control of costs, ascertainment of profitability, etc.

4. **Cost accounting is a profession:** In recent years cost accounting has become one of the important professions which has become more challenging.



While cost accounting is often used within a company to aid in decision making, financial accounting is what the outside investor community typically sees. Financial accounting is a different representation of costs and financial performance that includes a company's assets and liabilities. Cost accounting can be most beneficial as a tool for management in budgeting and in setting up cost control programs, which can improve net margins for the company in the future.

One key difference between cost accounting and financial accounting is that while in financial accounting the cost is classified depending on the type of transaction, cost accounting classifies costs according to information needs of the management. Cost accounting, because it is used as an internal tool by management, does not have to meet any specific standard and as result varies in use from company to company or from department to department.

**Development of Cost Accounting**

Scholars have argued that cost accounting was first developed during the industrial revolution when the emerging economics of industrial supply and demand forced manufacturers to start tracking whether to decrease the price of their overstocked goods or decrease production.

During the early 19th century when David Ricardo and T. R. Malthus were developing the field of economic theory, writers like Charles Babbage were writing the first books designed to guide businesses on how to manage their internal cost accounting.

By the beginning of the 20th century, cost accounting had become a widely covered topic in the literature of business management.

**Types of Cost Accounting**

**Standard Cost Accounting**



This type of of cost accounting uses ratios to compare efficient uses of labor and materials to produce goods or services under standard conditions. Assessing these differences is called a variance analysis. Traditional cost accounting essentially allocates cost based on one measure, labor or machine hours. Due to the fact that overhead cost has risen proportionate to labor cost since the genesis of standard cost accounting, allocating overhead cost as an overall cost has ended up producing occasionally misleading insights.

Some of the issues associated with cost accounting is that this type of accounting emphasizes labor efficiency despite the fact that it makes up a comparatively small amount of the costs for modern companies.

**Activity Based Costing**

Activity based accounting is defined as, "an approach to the costing and monitoring of activities which involves tracing resource consumption and costing final outputs, resources assigned to activities, and activities to cost objects based on consumption estimates. The latter utilize cost drivers to attach activity costs to outputs."

Activity based costing accumulates the overheads from each department and assigns them to specific cost objects like services, customers, or products. The way these costs are assigned to cost objects are first decided in an activity analysis, where appropriate output measures are cost drivers. As result, activity based costing tends to be much more accurate and helpful when it comes to helping managers understand the cost and profitability of their company's specific services or products. Accountants using activity based costing will pass out a survey to employees who will then account for the amount of time they spend on different tasks. This gives management a better idea of where their time and money is being spent.

**Lean Accounting**

Lean accounting is an extension of the philosophy of lean manufacturing and production developed by Japanese companies in the 1980s. Most accounting practices for manufacturing work off the assumption that whatever is being produced is done in a large scale. Instead of using standard costing, activity based costing, cost-plus pricing, or other management accounting systems, when using lean accounting those methods are replaced by value-based pricing and lean-focused performance measurements, for example, using a box score to facilitate decision making and create simplified and digestible financial reports.

**Marginal Costing**

Considered a simplified model of cost accounting, marginal costing (sometimes called cost-volume-profit analysis) is an analysis of the relationship between a product or service's sales price, the volume of sales, the amount produced, expenses, costs and profits. That specific relationship is called the contribution margin. The contribution margin is calculated by dividing revenue minus variable cost by revenue. This type of analysis can be used by management to gain insight on potential profits as impacted by changing costs, what types of sales prices to establish, and types of marketing campaigns.



**Types of Costs**

**Fixed Costs** are costs that don't vary depending ont he amount of work a company is doing. These are usually things like the payment on a building, or a piece of equipment that is depreciating at a fixed monthly rate.

**Variable costs** are tied to a company's level of production. An example could be a coffee roaster, who after receiving a large order of beans from a far-away locale, has to pay a higher rate for both shipping, packaging, and processing.

**Operating costs** are costs associated with the day-to-day operations of a business. These costs can be either fixed or variable depending.

**Direct costs** is the cost related to producing a product. If a coffee roaster spends 5 hours roasting coffee, the direct costs of the finished product include the labor hours of the roaster, and the cost of the coffee green. The energy cost to heat the roaster would be indirect because they're inexact, hard to trace.

## THE ROLE OF COST ACCOUNTING IN MANAGEMENT

Cost accounting is utilized for a number of purposes, some of which are briefly described in the following points:

a) **Accounting for costs**
This may be seen as a record keeping or score-keeping role. Information must be gathered and analyzed in a manner which will help in planning, controlling and decision making

b) **Planning and budgeting**
This involves the quantification of plans for future operations of the enterprise; such plans may be for the long or short term, for the enterprise as a whole or for the individual aspects of the enterprise.

c) **Control of operations of the enterprise**
Control may be assisted by the comparison of actual cost information with that included in the plan. Any differences between planned and actual events can be investigated and corrective action implemented as appropriate

d) **Decision making**
Cost accounting information assists in the making of decisions about future operations of the enterprise; such decisions making may be assisted by the information from cost techniques and cost-volume-profit analysis.



e) **Resource allocation decisions**
For example product pricing in determining whether to accept or reject jobs. This is based on cost and revenue implications of the relevant decisions

f) **Performance evaluation**
Cost accounting information is used to measure and evaluate actual performance so as to make a decision of the degree of optimality or efficiency of resource utilization.

## THE PURPOSES OF COST ACCOUNTING INFORMATION

Functions and objectives of cost and management accounting include the following:

1. Planning
2. Decision Making
3. Monitoring & Control
4. Accountability

**1. Planning**

Planning is an important function of management accounting which is most effectively performed by the preparation of budgets and forecasts.

Forecasting is the process of estimation of the expected financial performance and position of a business in the future. Common types of forecasts include cash flow forecast, projected profit and loss and balance sheet forecast. Forecasts assist in determining the likely change in the financial performance and position of a business when considered in the context of the various assumptions used in forming the projections. Forecasting is the starting point in determining the resource requirements of a business which are quantified into budgets.

Budgets quantify the financial targets to be achieved by the management of an organization. Budgeting process often begins with the preparation of a master budget which is then used as a basis for the preparation of departmental and operational budgets. Budgeting helps in the effective allocation of resources of an organization between competing needs (e.g. departments, products, etc) in order to achieve the financial goals of a business. Budgets and forecasts help businesses to deal with potential problems proactively and avoid foreseeable bottlenecks in business resources.

**2. Decision Making**

Management accounting facilitates the provision of financial information to management for decision making. Management accounting also involves the evaluation of alternative strategies and actions by the application of techniques and concepts such as relevant costing, cost-volume-profit analysis, limiting factor analysis, investment appraisal techniques and client / product profitability analysis.



**3. Monitoring & Control**

Control process in management accounting system starts by defining standards against which performance may be measured such as standard costs and budgets. Actual results are measured and any variance between targets and results are analyzed and where necessary, corrective actions are taken. Management accounting plays a vital role in the monitoring and control of cost and efficiency of the routine processes and as well as one-off jobs and projects undertaken by an organization.

**4. Accountability**

Management accounting lays great emphasis on accountability through effective performance measurement. By setting targets for strategic business units and as well as for departments, management accounting assists in the assignment of responsibility for the achievement of business targets by individual managers. Responsibility accounting is achieved by appraising the performance of managers responsible for their business units while giving due consideration for factors not within their control or influence.