JMC vLearning
"your virtual learning partner"

Introduction to Costing

AAT Level II

AFC - Advanced Financial Accounting & Costing

Chandima Prabhath

B.Sc (Accounting) Sp. (USJ), CA Finalist, CMA Finalist, AAT Finalist (Prize Winner), Dip. in English

JMC ජයසේකර කළමනාකරණ මධ්‍යස්ථානය JAYASEKERA MANAGEMENT CENTRE (PVT) LTD Estd. 1972

JMC Jayasekera Management Centre (Pvt) Ltd

Pioneers in Professional Education

65/2A, Chittampalam Gardiner Mawatha, Colombo 02 | T: +94 112 430451 | E: info@jmc.lk | F: +94 115 377917

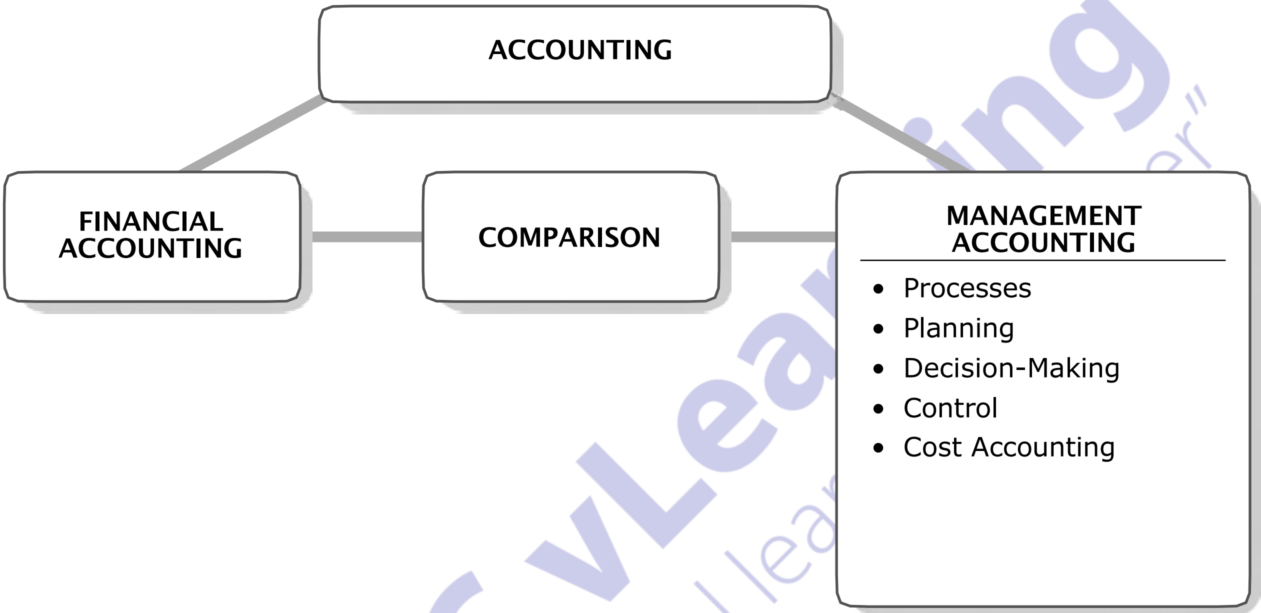
Chapter 01

AAT 02
Advanced Financial Accounting and Costing

Introduction to Cost Accounting

Chandima Prabhath
B.Sc. Accounting (special) USJ (UG)
AAT Passed Finalist (Prize Winner)
CMA Finalist (Prize Winner)
CASL (Finalist)

VISUAL OVERVIEW



1 Accounting

The primary functions of accounting are:

- To classify and record actual transactions in monetary terms.
- To present and interpret the results of transactions to assess:
  - performance over a period; and
  - financial position at a given date.
- To project, in monetary terms, future activities arising from alternative planned courses of action.

2 Financial Accounting

Financial accounting involves the following:

- Classifies and records actual transactions in monetary terms in accordance with established concepts, principles, accounting standards and legal requirements.

- Presents as accurate a view as possible of the effect of those transactions *over a period of time* and at *the end of that time*.

- That part of financial accounting which is concerned with the preparation of the financial statements is referred to as financial reporting.

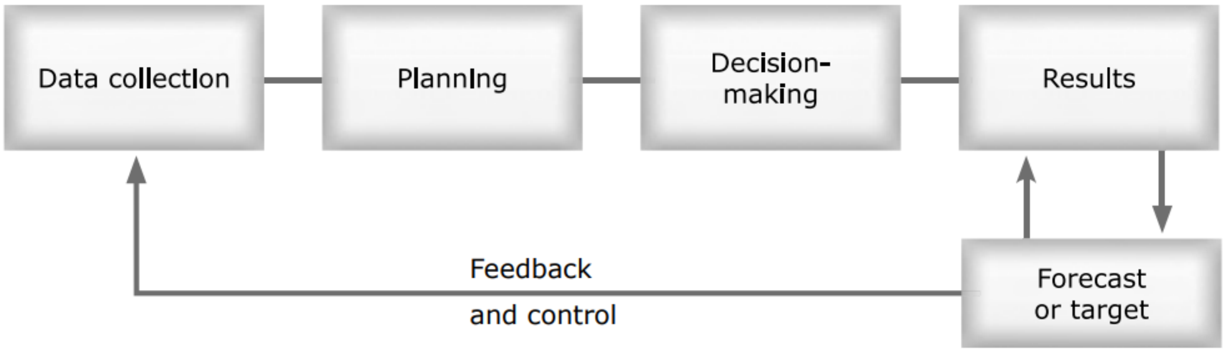
- A set of financial statements consists of:
  - Statement of Financial Position
  - Statement of Profit or Loss and Other Comprehensive Income
  - Statement of Cash Flows

3 Management Accounting

3.1 Processes

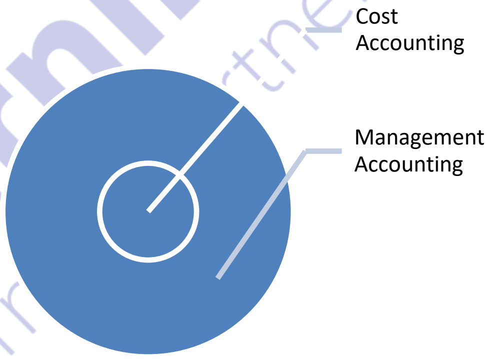
Management accounting is concerned with the provision of information to enable management to:

- formulate policies;
- plan (set objectives, select strategies);
- organize (establish sequence of tasks);
- make decisions on alternative courses of action;
- control activities (including safeguarding assets);
- manage and measure performance (including motivation).



3.2 Cost Accounting

Cost accounting is that part of management accounting which:



- Establishes budgets, standard costs and actual costs of:
  - operations/processes;
  - departments/products; and
- Analyses differences between budgeted or standard costs and actual costs.

3.2.1 Objectives (Scope) of Cost Accounting

1. Ascertainment of cost (Costing)
   a. This determined cost is useful for valuation of stocks, determination of selling price and other decisions.
2. Presentation of cost
   a. Presenting the cost information for effective decision making using various number formats
3. Controlling the cost

3.2.2 Arguments against Cost Accounting

1. It’s expensive
   a. Due to maintaining a separate workforce and a separate books of accounts for small and medium scale businesses this will be costly.
2. Less reliable due to usage of higher degree of assumptions
3. Most costing methods do not generate the expected results.
4. Matter of filling routine formats and statements

3.2.3 Role of a Cost Accountant at glance

1. Collecting operational cost data and preparing analysis reports.
2. Collect production data and inventory data for control.
3. Evaluate production costs, gains and losses.
4. Collect and analyze past year data to forecast budget for ensuring year
5. Design, create and implement strategies, best practices for improvement in costing system

4 Comparison

	Management Accounting	Financial Accounting
Users of information	Management only	Shareholders, banks, creditors, potential investors, customs and excise, government, taxation authorities
Format of information	Can take any form	Presentation regulated by law (e.g. Companies Acts) and accounting standards (e.g. IFRS)
Content	Includes future predictions (e.g. in budgets)	A summary of mainly historic information
Level of detail	More detailed (e.g. costs and revenues by department/ product)	As prescribed by users, legislation, etc
Frequency of preparation	Quarterly, monthly (even weekly)	Usually annually (more frequently for certain types of "public interest" companies)
Purpose of information	Useful to plan, control and make decisions	Stewardship and investment decisions
Basis of valuation	Relevant for decision-making (e.g. replacement cost)	Historical costs (as modified by revaluation of certain fixed assets)
Scope	Comparatively narrow	Scope is widely defined
Input Data	Uses present past and future data	Uses business's past data only

	Financial Accounting	Cost Accounting
Time Span	For a definite period	Transactions are identified with cost unit/object

Coverage of Transactions	Covers transactions of the whole business	Covers only a part of the transactions
Purpose	To present operational performance and financial position of the business	Aims to help the management for proper planning control and decision making
Analysis of expenditure	According to the function	On different basis such as direct and indirect variable and fixed
Efficiency	Overall results and financial position of the business is revealed by financial statements	The profitability of each department cost unit job or process
Material control	Does not say anything about the efficiency inefficiency of material handling because the figures are in total	Provides a system of good inventory control by prescribing procedures for purchases, storage issues etc
Independence of the system	Independent of cost accounting it can work even in the absence of custom accounting system	It depends upon financial accounting data
Reconciliation of results	Does not need any reconciliation	Needs reconciliation of its profit with those financial records

5 Other Basic Concepts

5.1 Cost – The amount of expenditure (actual or notional) incurred on or attributable to a specified thing or activity

5.2 C . A cost unit is a unit of product or service which is costed.

Industry / Enterprise		Cost unit
(01)	Printing	Per job or square feet
(02)	Transport	Per tonne Km or per passenger Km
(03)	Hospital	Per patient-day
(04)	Gas	Per cubic metre
(05)	Road contractors	Per Km / Per mile
(06)	Hotel	Bed night
(07)	Electricity	Per kilo watt – hour
(08)	Ready made garments	Per garment
(09)	Petrol and other fuel	Per litre
(10)	Bakery	Per bread
(11)	Educational institution	Per student / per batch
(12)	Water supply	Per litre / per gallon
(13)	Cement manufacturing	Per tone
(14)	Brick – making	1000 bricks

The type of information managers need depends on the nature of the centre they manage.

There are four main types of responsibility centres:

- Cost centre;
- Revenue centre;
- Profit centre; and
- Investment centre.

5.3 Cost Centre

Definition

Cost centre—a cost centre is the smallest segment of activity for which costs are separately accumulated.

- The manager of a cost centre is responsible only for spending (e.g. the training department in an accounting firm).
- Cost centre managers need to have regular information about the costs incurred in the department for which they are responsible. This may include:
  - Individual cost amounts;
  - Cost variances;
  - Cost per unit (e.g. per tonne-kilometre in transport industry);
  - Cost ratios (e.g. labour cost as % of total cost);
  - Cost per employee.

5.4 Revenue Centre

Definition

A **revenue centre** is devoted to generating revenue with no responsibility for costs (e.g. a sales centre).

They have few or no costs, or these are outside the control of the *revenue centre.*

Managers of revenue centres need sales-related information, for example:

- Sales volumes, prices, discount structures and revenues;
- Sales variances (detailed later in *Session 16*);
- Contribution/Sales ratio (i.e. how much contribution is generated for each $ of revenue).

5.5 Profit Centre

Definition

Profit centre—a *business segment* where revenues are received and expenditures incurred.

- Managers have responsibility for both revenues and costs (e.g. the manager of a restaurant, hotel, retail store, etc).
- Profit centre managers do not have the authority to make investment decisions.
- In addition to relevant revenue centre and cost centre information, profit centre managers will need information concerning:
  - Sales growth;
  - Sales variances (e.g. attributable to market share);

- Controllable (direct) profit, which is the profit calculated without including revenues and costs that are not under the direct control of the profit centre manager;
- Contribution and profit ratios (e.g. gross profit percentage).

5.6 Investment Centre

- In addition to the information required by profit centre managers, investment centre managers also will be interested in:
  - Return on investment (ROI), i.e. profit divided by the net assets of the centre;
  - Liquidity ratios;
  - Market share;
  - Product leadership;
  - Cash flow present values;
  - Asset ratios.

Definition

Investment centre— A profit centre which also has control over its capital expenditure (investment in assets) to some extent (e.g. up to a certain set monetary amount).