

MANAGEMENT ACCOUNTING

Introduction

Management Accounting: It is the process of identification, accumulation, analysis, preparation and communication of information used by management to plan, evaluate, control and make managerial decision.

Comparison between financial accounting and cost accounting

Similarities:

1. They are concerned with recording and representation of financial and cost data.
2. They apply the same principles of double entry when recording transaction.
3. They use the same documents i.e. the books of original entry

Differences

Financial accounting	Cost accounting
1. The reports are submitted to shareholders.	1. The reports are submitted to the management.
2. Preparation of the financial accounting is a statutory requirement.	2. Preparation of management accounting is a voluntary exercise.
3. Financial accounting statement are periodic.	3. Management accounting reports are continuous.
4. The statement are prepared as per the international accounting standards and international Financial reporting standards.	4. The statement are prepared as per chartered institute of management accounts.
5. Financial statement are subject to audit.	5 The managing accounting statement s are notsubject audit.
6. Financial accounting is conventional/static	6 Management accounting is dynamic it keeps onchanging from one organization to another.
7. Financial accounting emphasizes onrecording of the financial transactions.	7 Management accounting emphasizes on costcontrol.

Objectives/Advantages of management accounting

1. Cost control

It enables an organization to maintain the cost at desirable levels so as to minimize the wastage in the production process.

2. Decision making

Decision making is the selection of a course of action from among alternatives. Management accounting techniques like cost – volume-profit analysis, standard costing, budgetary control etc. assist the management in arriving at correct decision.

3. Planning

Planning is deciding in advance what is to be done. It provides costing and statistical data to be utilized in setting goals and formulating future policies.

4. Cost ascertainment/determination

It is important to determine the cost of producing a commodity or provision of service so as to assist the manager in making optimal decisions.

5. Disclosure of waste

Past experience of cost data on how to determine the future cost is normally used to improve efficiency so as to reduce or eliminate unnecessary expenditure. This will ensure that the costs are minimized.

6. Measure of efficiency

For performance evaluation, the standards are set in advance which will be compared with the actual performance to ascertain the difference.

The reason for the difference is also determined.

7. Setting the selling price

To come up with a realistic selling price an organisation must take into account the cost of production plus the required profit margin.

Limitations Management accounting

- a) Management accounting is not exact i.e. it involves inherent element of judgement
- b) Management accounting normally provide information for making optimal decisions in specific situations. However, there is no best decisions in all circumstances.
- c) It involves massive paper work i.e. cost items must be recorded separately.
- d) It is expensive to maintain cost accounting department in an organisation.
- e) Cost accounting only capture quantitative data and ignores qualitative data.

Limitation of financial accounting that led to introduction of management accounting

1. No standards to assess the performance – In financial accounting there is no well-developed system of standards to appraise the efficiency of the organisation in the use of materials, labour and overhead costs.
2. Provides only historical information – Financial accounting is mainly historical tells about the cost already incurred. It does not provide day to day cost information to management for making effective plans.
3. No classification of costs – In financial accounting there is no such system by which cost

are classified so as to give data regarding costs by department, processes products in the manufacturing divisions.

4. Not helpful in price fixation – In financial accounting cost are not available to aid in determining prices of products or services.

MANAGEMENT ACCOUNTING SYSTEM.

It is a combination of procedures and records designed to provide information required by the management in-order to conduct the operation of the organisation.

FEATURES OF AN IDEAL MANAGEMENT ACCOUNTING SYSTEM

1. Suitability to the business – Management accounting system should be made to suit the specific needs of an organisation.
2. Flexibility – The management accounting system should be designed in such a way that it may be flexible enough to be changed according to the fast changing conditions and circumstances of business and industry.
3. Cost effective – the system should be economical both in installation and operations.
4. Minimum clerical- Forms and procedures should be designed in such a way that clerical work is reduced to the minimum.
5. Uniformity of forms: All the forms, procedures used throughout the organisation should be uniform in size and quality of paper. This avoids confusion and leads to quicker and better understanding.
6. Adequate control of labour cost: There should be well defined procedures for recording of time and preparation of wage sheet.
7. Simplicity- The costing system should be simple to operate and easy to understand.
8. Effective control on material – Materials usually account for a greater proportion of the total cost there should be an efficient system of stores control.

Difficulties in the installation

- Lack of support from the top management.
- Resistance to change by the employees especially from the accounting department.
- Cost accounting installation could be expensive to an organisation.
- Lack of adequate expertise to run the system.
- Forms or records might be inappropriate i.e. may not contain the adequate information necessary.

Cost of classification

Cost classification refers to grouping together of costs.

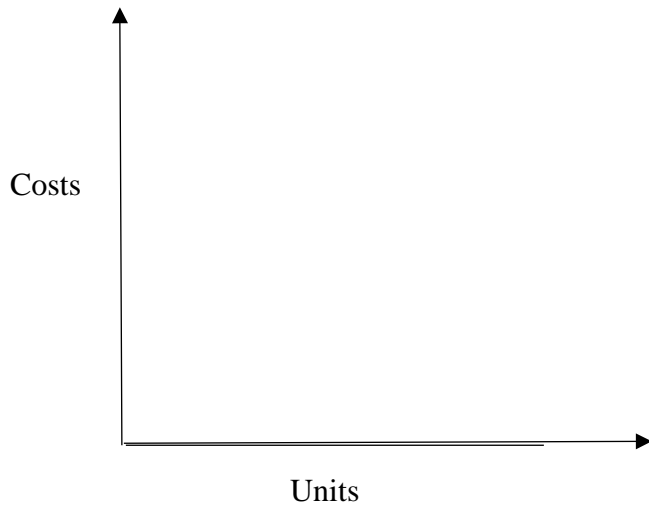
The following are the ways in which the costs are classified:

1. According to the behavior

This is based on the way in which a particular cost item responds to the volume of output.

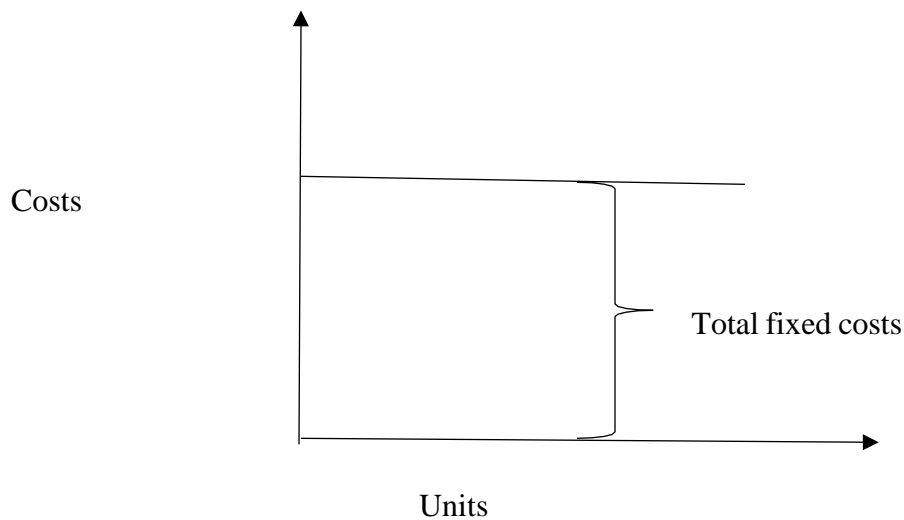
a) Variable costs

These are costs which changes with respect to the volume of production i.e. when the units produced increase they also increase and vice versa.



b) Fixed costs

These are the costs which remain constant irrespective of the number of units produced i.e. they are constant at all levels of production e.g. rent



c) Semi variable costs

These are the costs which are partially fixed and partially variable. It has a combination of both fixed and variable costs e.g. electricity bill.

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2. According to controllability

These costs are based on the ability to be maintained at desirable level by the management.

a) Controllable costs/shut down costs

These are the costs, which may directly be regulated at a given level of management authority. Variable costs are generally controllable by the departmental heads.

b) Uncontrollable costs

These are the costs which cannot be controlled or influenced by the manager concerned. They remain the same irrespective of the decision taken e.g. rent.

3 ACCORDING TO TIME

- a) Historical costs: They are costs that are ascertained after they have been incurred they are actual costs of the organisation.
- b) Predetermined costs – They are future costs which are ascertained in advance of the specification of all factors affecting the operations of the organisation.

4 ACCORDING TO IDENTIFICATION WITH THE COST UNITS

- a) Direct costs – They are costs incurred and can conveniently identified with a particular cost unit/product, process or a department. Therefore, all direct costs are prime costs.
- b) Indirect costs- They are costs, which cannot conveniently be identified with a particular cost unit, process or department

5. CLASSIFICATION ACCORDING TO FUNCTION

Function refers to various activities performed by an organisation

- i. Production costs – Are all costs relating to production of goods or services, whether direct or indirect.
- ii. Administration costs – Are costs incurred in connection with the general management of business e.g. office rent, audit and legal fees etc.
- iii. Marketing or selling costs – Includes all kind of expenses incurred for achieving sales of the products and services e.g. commission, salary of selling staff.
- iv. Distribution costs – Include all kinds of expenses incurred in distributing the products from their point of production to their customers.
- v. Research and development costs – These costs comprises development costs of new products, improvement related expenses etc.

Terms used in cost accounting

1. Cost

These are expenses incurred in producing one unit or providing services. They are normally expressed in monetary terms.

2. Cost unit

This is a unit of measurement of production of the smallest value. It is normally expressed in kgs, litres or any other relevant quantity.

3. Unit cost

This is the smallest amount incurred to produce one unit of a particular item. It is also known as cost per unit.

4. Cost center

This is a section of an organisation which consumes costs and * to a manager. This section is normally assigned a manager who is responsible for its expenditure e.g. production department.

5. Revenue center

This is a section of an organisation where the revenue is generated but the cost of making that revenue is not incurred in the section e.g. sales department

6. Profit center

This is a section of an organisation which generates revenue and incurs the cost of making that revenue. The manager is normally assessed based on the profit generated.

7. Responsibility center

This is a section of an organisation where a manager is assigned to be in charge. All the activities within that section are controlled by the manager.

8. Investment center

This is a section of an organisation where the manager is responsible for the revenue collected, costs incurred and other incomes from different sources such as dividends from shares. The manager here has got the power to acquire non-current assets.

Other types of costs

1. Out of pocket costs

These are the costs incurred and require cash payment within the accounting period. They are normally incurred when running the business. Depreciation does not require cash payment and therefore is not an example of out of pocket costs.

2. Normal costs

These are the costs incurred in the normal operations of the business e.g. salaries and wages

3. Abnormal costs

These are the costs incurred out of the normal business operations e.g. shut down costs of the factory, development costs etc.

4. Capital costs/capital expenditure/expenditure costs

These are the costs incurred in the acquisition of the capital items e.g. the cost of purchasing land and machinery

5. Revenue costs

These are the costs incurred in the day to day running of the business. They are normally incurred for the benefit of the ordinary transactions.

6. Imputed/notional costs

These are the costs incurred but does not require cash payment e.g. notional rent

7. Standard costs

These are estimated costs used by an organisation for budgeting purposes. They are always on per unit basis.

8. Actual costs

These are the costs incurred when the time which is budgeted for has come. It is the cost which is actually paid.

9. Sunk costs/historical costs

These are the costs which have already been incurred in the past and are not used for decision making.

10. Relevant costs

This is the extra costs incurred or avoided as a consequence of the decision made.

11. Marginal costs

This is the variable cost of production or transportation or marketing.

12. Incremental costs

This is the cost which increases as a consequence of the change in the decision made. They are normally used for decision making.

The scope of management accounting

The management accountants interpret the results and reports to the management and provides analysis, which assists in decision making in the following departments:

- **Production department**

In this department the personnel measure and report the manufacturing costs. The efficiency of the production department in transforming the materials in to the final products is evaluated for improvement.

- **Engineering department**

Cost accountants and engineers translates specification for the new products into estimated costs by comparing estimated costs and the projected sales. This will help the management to decide whether manufacturing a product will be profitable.

- **System design department**

Cost accountants are becoming more involved in designing computer integrated manufacturing system and the data base corresponding to the cost accounting needs.

This idea for the cost accountants, engineers and the system designers to develop a flexible production process which responds to the market needs is becoming popular.

- **Treasury department**

The treasurer uses budgets and related accounting reports developed by the cost accountants to forecast the cash flows and capital requirements.

Detailed cash reports indicate where there is excess funds to invest or where there is cash deficit which needs to be funded.

- **Financial accounting department**

The cost accountants work closely with the financial accountants who use the cost data to value inventory for external reporting.

- **Marketing department**

Marketing involves the cost accountants during the product innovation stage, manufacturing and the sales process. The marketing department develop the sales forecast to facilitate preparation of the product manufacturing schedule.

Cost estimates competition, supply, demand and the states of technology becoming the selling price that the product will be offered and command in the market.

- **Personal department**

This department administers the wage rate and the pay methods. This will ensure that the employees receive the correct dues. The department also maintains adequate labour records for legal and cost analysis purposes.