FUNDAMENTALS
OF
MANAGEMENT ACCOUNTING

ACCOUNTING TECHNICIAN DIPLOMA

ATD LEVEL III

STUDY TEXT
MANAGEMENT ACCOUNTING

GENERAL OBJECTIVE
This paper is intended to equip the candidate with knowledge, skills and attitudes that will enable him/her to apply management accounting principles and concepts in business

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-low 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
- Activity based costing

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
- 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
- Operating statements

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
- Distinction between budgeting and budgetary control in the private and public sectors
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Revised on: June 2016
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 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 on the 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.
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DEFINITION AND PURPOSE OF COST CLASSIFICATION

Definition
Cost classification is the process of grouping costs according to their common characteristics. A suitable classification of costs is of vital importance in order to identify the cost with cost centres or cost units. Cost may be classified according to their nature, i.e., material, labor and expenses and a number of other characteristics. The same cost figures are classified according to different ways of costing depending upon the purpose to be achieved and requirements of particular concern.

Purpose of cost classification

1. Preparation of budget: classification of cost helps in preparation of the budget of the organization. For preparing the budget of an organization one must know how and where exactly the expenses have been incurred in relation to manufacturing the product. On the basis of this classification of the cost an organization accordingly prepares its budget.

2. Helps in measuring efficiency: classification of cost helps in measuring the efficiency of the organization. On the basis of the places where the costs have been incurred and the amount of cost that has been incurred the efficiency of the organization can be judged.

3. Controlling cost:
   - Labour cost: with the help of classification of cost an organization can control its labour cost as well. If the labour complete their task well in time and with much efficiency then the organization would be able to reduce its labour cost.
   - Material cost: material cost can be controlled if material wastage is avoided and proper standardization of materials is used. Thus with the help of classification of cost an organization is able to reduce the cost incurred on materials and thus able to control material cost.
   - Overhead cost: overhead comprises indirect expenditure incurred in manufacturing. By knowing the amount that has been incurred under various heads an organization can device ways to reduce the cost. Thus with the help of classification of cost an organization is able to control overhead cost.
4. Expansion of the organization: if an organization knows where exactly it incurs expenditure then it can device ways to control these costs. Once an organization is able to control its cost then it can concentrate on its expansion. Thus with the help of classification of cost an organization is able to device ways for its expansion.

Thus, classification of cost is of immense importance for an organization. With the help of classification of cost an organization can make progress and also expand its production by controlling its cost. Thus in the long run an organization can move towards higher productivity and thus higher profits and can achieve its goals.

METHODS OF COST CLASSIFICATION

MANUFACTURING COSTS

Definition and Explanation of manufacturing cost:

Manufacturing costs are those costs that are directly involved in manufacturing of products and services. Examples of manufacturing costs include raw materials costs and salary of labor workers. Manufacturing cost is divided into three broad categories by most companies.

1. Direct materials cost
2. Direct labor cost
3. Manufacturing overhead cost.

Direct Materials Cost:

The materials that go into final product are called raw materials. This term is somewhat misleading, since it seems to imply unprocessed natural resources like wood pulp or iron ore. Actually raw materials refer to any materials that are used in the final product; and the finished product of one company can become raw material of another company. For example plastic produced by manufacturers of plastic is a finished product for them but is a raw material for Compaq Computers for its personal computers.

Direct Materials are those material that become an integral part of the finished product and that can be physically and conveniently traced to it. Examples include tiny electric motor that Panasonic uses in its CD players to make the CD spin. According to a study of 37 manufacturing industries material costs averaged about 55% of sales revenue.

Sometimes it is not worth the effort to trace the costs of relatively insignificant materials to the end products. Such minor items would include the solder used to make electrical connection in a Sony TV or the glue used to assemble a chair. Materials such as solder or glue are called indirect materials and are included as part of manufacturing overhead, which is discussed later on this page.
Direct Labor Cost:

The term direct labor is reserved for those labor costs that can be essentially traced to individual units of products. Direct labor is sometime called touch labor, since direct labor workers typically touch the product while it is being made. The labor cost of assembly line workers, for example, is a direct labor cost, as would the labor cost of carpenter, bricklayer and machine operator.

Labor costs that cannot be physically traced to the creation of products, or that can be traced only at a great cost and inconvenience, are termed indirect labor and treated as part of manufacturing overhead, along with indirect materials. Indirect labor includes the labor costs of janitors, supervisors, materials handlers, and night security guards. Although the efforts of these workers are essential to production, it would be either impractical or impossible to accurately trace their costs to specific units of product. Hence, such labor costs are treated as indirect labor.

In some industries, major shifts are taking place in the structure of labor costs. Sophisticated automated equipment, run and maintained by skilled workers, is increasingly replacing direct labor. In a few companies, direct labor has become such a minor element of cost that it has disappeared altogether as a separate cost category. However the vast majority of manufacturing and service companies throughout the world continue to recognize direct labor as a separate cost category.

According to a study of 37 manufacturing industries, direct labor averaged only about 10% of sales revenue.

Direct Materials cost combined with direct labor cost is called prime cost.

In equation form:

\[
\text{Prime Cost} = \text{Direct Materials Cost} + \text{Direct Labor Cost}
\]

For example total direct materials cost incurred by the company is $4,500 and direct labor cost is $3,000 then prime cost is $7,500 ($4,500 + $3,000).

Manufacturing Overhead Cost:

Manufacturing overhead, the third element of manufacturing cost, includes all costs of manufacturing except direct material and direct labor. Examples of manufacturing overhead include items such as indirect material, indirect labor, maintenance and repairs on production equipment and heat and light, property taxes, depreciation, and insurance on manufacturing facilities. Indirect materials are minor items such as solder and glue in manufacturing industries. These are not included in direct materials costs. Indirect labor is a labor cost that cannot be traced to the creation of products or that can be traced only at great cost and inconvenience. Indirect labor includes the labor cost of janitors, supervisors, materials handlers and night security guards. Costs incurred for heat and light, property taxes, insurance, depreciation and so forth associated with selling and administrative functions are not included in manufacturing overhead.
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TOPIC 3

COST ESTIMATION

MEANING OF COST ESTIMATION

A cost estimate is the approximation of the cost of a program, project, or operation. The cost estimate is the product of the cost estimating process. The cost estimate has a single total value and may have identifiable component values. A problem with a cost overrun can be avoided with a credible, reliable, and accurate cost estimate. An estimator is the professional who prepares cost estimates.

METHODS OF ESTIMATING COST

Non mathematical methods
These include;
   1. Engineering method
   2. Accounts analysis
   3. High-low method
Mathematical methods
These include;
   4. Scatter graph method
   5. Ordinary Least Squares Regression Method

Cost estimation methods are necessary only for costs that are identified as mixed costs. There is no need to apply an estimation method to break a cost into fixed and variable portions if you have already determined it is solely fixed or solely variable. All four methods produce estimates of amounts of fixed and variable costs.

The Goal of Cost Estimation

The ultimate goal of cost estimation is to determine the amount of fixed and variable costs to create a cost formula to be used to predict future costs. The cost formula, or cost equation, is the output of the cost estimation process. Because you have only one variable (number of units), the formula will be a straight line, or linear equation. (You should remember the concept of functions from your middle school math classes.1) The formula that represents the equation of a line will appear in the format of:
\[ Y = mx + b \]

where \( Y \) = total cost
\( m \) = the slope of the line, i.e., unit variable cost
\( X \) = the number of units of activity
\( b \) = the y-intercept, i.e., total fixed costs

Recall that the \( Y = VCx + TFC \) is the equivalent equation used in accounting for estimating costs. The total cost side of the equation (\( Y \)) can also be expressed as \( f(x) \) so that the formula appears as:

\[ f(x) = VCx + TFC \]

As such, the equation is often referred to as a function. In accounting, it is referred to as a cost function because the '\( Y \)' equates to total cost.

Determining a linear function is useful in predicting cost amounts at different levels of activity. This is useful because managers must be able to predict costs to plan for future operations. This is often accompanied by what-if analysis that assists with the preparation of budgets, pricing of products or services, and other key management functions.

**Cost Equation Components**

Your goal is to determine the cost equation for a particular cost, so that managers can estimate 'total' costs at various activity levels. The cost equation will contain the variable cost per unit and total fixed costs. These two amounts remain the same at all levels of activity within the relevant range.

The variable cost component of the cost equation is displayed with two decimals in standard form because it is a unit cost (and unit costs are always displayed with two decimal places). The total fixed cost component of the cost equation is displayed with no decimals.

1. **ENGINEERING METHOD**

The Engineering Cost Estimating method builds the overall cost estimate by summing detailed estimates done at lower levels of the Work Breakdown Structure (WBS). It’s a technique where the system being costed is broken down into lower-level components (such as parts or assemblies), each of which is costed separately for direct labor, direct material, and other costs. Engineering estimates for direct labor hours may be based on analyses of engineering drawings and contractor or industry-wide standards.

Engineering estimates for direct material may be based on discrete raw material and purchase part requirements. The remaining elements of cost (such as quality control or various overhead charges) may be factored from the direct labor and material costs. The various discrete cost estimates are aggregated by simple algebraic equations (hence the common name “bottoms-up”
estimate). The use of engineering estimates requires extensive knowledge of a system’s (and its components’) characteristics, and lots of detailed data.

Because of the high level of detail, each step of the work flow should be identified, measured, and tracked, and the results for each outcome should be summed to make the point estimate.

**The several advantages to the Engineering Cost estimating method include:**

- The estimator’s ability to determine exactly what the estimate includes and whether anything was overlooked,
- Its unique application to the specific program and manufacturer,
- That it gives good insight into major cost contributors, and
- Easy transfer of results to other programs.

**Some disadvantages of the Engineering Cost estimating method include:**

- It can be expensive to implement and it is time consuming
- It is not flexible enough to answer what-if questions
- New estimates must be built for each alternative
- The product specification must be well known and stable
- All product and process changes must be reflected in the estimate

**2. ACCOUNT ANALYSIS**

Under account analysis method, the accountant examines and classifies each ledger account as variable, fixed or mixed. Mixed accounts are broken down into their variable and fixed components. They base these classifications on experience, inspection of cost behavior for several past periods or intuitive feelings of the manager.

This is with a view to develop a cost function in the form \( y = a + bx \)

**Illustration**

Suppose a company ABC has the following costs with a value of 7000 units.

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
<th>Variable</th>
<th>Fixed</th>
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<tr>
<td>Direct labour</td>
<td>150,000</td>
<td>150,000</td>
<td>-</td>
</tr>
<tr>
<td>Materials</td>
<td>125,000</td>
<td>125,000</td>
<td>-</td>
</tr>
<tr>
<td>Repairs and maintenance</td>
<td>5,000</td>
<td>5,000</td>
<td>-</td>
</tr>
<tr>
<td>Depreciation</td>
<td>15,000</td>
<td>-</td>
<td>15,000</td>
</tr>
<tr>
<td>Administration overheads</td>
<td>1,000</td>
<td>-</td>
<td>1,000</td>
</tr>
<tr>
<td>Indirect labour</td>
<td>300,000</td>
<td>280,000</td>
<td>20,000</td>
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TOPIC 4

COST ACCUMULATION

DEFINITION

Cost accumulation is the use of an accounting system to collect and maintain a database of the expenses incurred by a business in the course of its operation.

The two main forms of cost accumulation are
a) a job order system where direct materials, staffing and overhead costs are collected under assigned job number
b) A process costing system where costs are maintained and associated with a particular cost center.

ACCOUNTING FOR MATERIALS AND INVENTORY

MATERIAL COSTING

Inventory consists of raw materials, W.I.P, consumer goods and spare parts etc. Material costing entails the study of the inventory control systems of the items.

Stock costs

i) Purchase costs
   Actual amount paid to the supplier of the stock item.

ii) Ordering costs
   Costs of obtaining inventory Include
   a) Clerical and admin cost associated with purchasing and receiving goods.
   b) Transportation costs from supplier

iii) Holding costs
   Are costs incurred as a result of keeping inventories of stores
   It depends in quantities held may include:-
   a) Cost of storage and stores operation e.g. rent and storage spares, salaries for staff.
   b) Insurance costs – the higher the rate for inventory held the higher the premium.
   c) Cost of capital – opportunity cost of capital held in the stocks
   d) Risks of deterioration / deterioration cost.
iv) Stock – out costs.
Arises where stocks kept are low which may lead to the company not being able to satisfy demand since stocks are not enough
These costs include:-
   a) Lost contribution due to unrealized sales.
   b) Loss of future sales due to dissatisfied customers.
   c) Loss of goodwill
   d) Cost of production stoppage
   e) Extra cost of urgent orders.

v) Optimal stock level
Stocks held should be maintained at optimal levels to help regulate the GNL of costs due to problem of overstocking and undertaking.

This levels will help determine when the order, how much to order, the quantity to be held. These levels include:-

a) The re-order level
This is that point once reached and order was to be placed with the supplier. It is the quantity in stocks that goods will be ordered to avoid stock-outs. It is determined by considering the expected demand during re-order or lead time.

This is the amount that will be consumed during the time for waiting for deliveries. It should satisfy the highest demand.

Recorder = max .consumption × max. Reorder period.

b) Maximum Stock level
The highest quantity of stock that can be held at any particular time .Stocks may not be allowed to go beyond this level.

Max. Stock Level = re-order level + orderquantity - (Minimum consumption × Min.re-order period)

c) Minimum stock levels
This is the lowest quantity of stocks that should be held. Stocks should not be allowed to fall below this level. Also known as buffer level
Max. Stock = re-order + re-order - (Normal × Normal)  
Level level quantity consumption lead time

Reorder level = Maximum Consumption x Maximum Re-order period  
280000 x 5=1,400,000 units

Minimum Stock Level = Reorder level (Normal cons. ×Normal lead-time)  
1,400,000 – (200,000 ×4) =600 units

Maximum Stock level = Reorder level + Qty. demanded – (Min stock ×Min. lead-time)  
= 1,400,000 + 5,000 – (50,000 ×3)  
= 1,381,000 units

STOCK VALUATION
In a period stocks are normally purchased at different price and for product costing purposes and profit determination stock have to be appropriately valued. This is because when stocks are transferred to the stores they loss their identity and the issue price may not be accurately determined because they are many in the store.

There are two systems of stock valuation i.e.

a) **Periodic stock take system /physical stock takes**  
   This involves actual counting, checking and verification of stock available in the stores at the end of the period. The stock will normally be determined after stock take to enhance accuracy, normally close down for the stock take exercise.

b) **Perpetual / Continuous system**  
   A transaction system where stock records are maintained as per transaction each receipt or issue of stock is recorded and stock records. Therefore readily available and this help address the problem of overstocking/under stocking.

To enhance accuracy each stock item must have its own stock record where the transactions will be recorded. There are several methods which can be used to maintain records for valuation purposes. These methods have been discussed below.

1) **First in first out (FIFO)**  
Accounting: Method of inventory valuation based on the assumption that goods are sold or used in the same chronological order in which they are bought. Hence, the cost of goods purchased first (first-in) is the cost of goods sold first (first-out). During periods of high inflation-rates, the FIFO method yields higher value of the ending inventory, lower cost of goods sold, and a higher gross profit (hence the higher taxable income) than that yielded by the last-in first-out (LIFO) method. The 'in' officebasket is an illustration of FIFO method.
Illustration
NyaliMbali Ltd. are retailers who sell ceramic tiles. During the months of July to September 2000, there were price fluctuations. Due to the above problem the company had to adjust its selling prices.

The following transactions took place during the period.
3 July Opening stock was 5,000 tiles valued at Sh 825,000.
10 July Orders placed with the company increased, so extra tiles had to be obtained from Mombasa. Therefore 22,000 tiles were purchased at a cost Sh 140 each but in addition, there was a freight and insurance charge of Sh 5 per tile.
31 July During the month 20,000 tiles were sold at a price of Sh 220 each.
4 August A new batch of 14,000 tiles was purchased at a cost of Sh 175 per tile.
30 August The sales for the month of August were 14,000 tiles at a selling price of Sh 230 each.
1 September A further 24,000 tiles were purchased at a cost of Sh 195 each.
30 September 270,000 tiles were sold during September at price of Sh 240 each.

The cost accountant of NyaliMbali Ltd decided he would apply first-in-first-out basis.

Required:
(i) A stores ledger account using first-in-first-out method and showing stock values at 30 September 2000.
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TOPIC 5

COST BOOKKEEPING

Introduction
Bookkeeping involves the recording, storing and retrieving of financial transactions for a company, nonprofit organization, individual, etc.

Common financial transactions and tasks that are involved in bookkeeping include:

- Billing for goods sold or services provided to clients.
- Recording receipts from customers.
- Verifying and recording invoices from suppliers.
- Paying suppliers.
- Processing employees' pay and the related governmental reports.
- Monitoring individual accounts receivable.
- Recording depreciation and other adjusting entries.
- Providing financial reports.

Today bookkeeping is done with the use of computer software.
COST Book keeping refers to a system of recording various cost information in the books of account. There are two main systems of cost book keeping. That is:

1. **Integrated cost accounting system** - A system of accounting where the cost and financial accounts are kept in the same set of books. This system avoids the need for separate set of books for financial and costing purposes.

2. **Interlocking cost accounting system** - Interlocking accounting system; this is an accounting system where separate cost accounting and financial

THE FLOW OF COSTS IN AN A BUSINESS ENTERPRISE

Flow of costs refers to the manner in which costs move through a firm. Typically, the flow of costs is relevant to a manufacturing environment where accountants must quantify what costs are in raw materials, work in process, finished goods inventory and cost of goods sold. Flow of costs does not only apply to inventory, but also to factors in other processes to which a cost is attached such as labor and overhead.
We say that costs flow through an accounting system. That is because they accumulate as the product progresses through the various stages of production. Let's look at a typical product. Before a product is started, no costs have been incurred. Workers stand ready to make the product, inventory waits patiently in the warehouse, and the manufacturing plant contains all the resources necessary to perform the manufacturing operation.

We first add materials into production, from the inventory. At the same time the accounting department transfers the cost of inventory items to the Work in Process account, and the product or job now has a value.

Next the workers start to convert the raw inventory into a product. As labor is added, the accounting department transfers payroll costs to the Work in Process account, increasing the value of the product or job. Overhead costs are allocated to the product or job, based on the costing method used. As work progresses on the product or job, it accumulates labor, materials and overhead costs. Finally, the total finished product or job cost is transferred to Finished Goods, and when it is sold the cost is transferred to cost of goods sold.

**COST BOOK KEEPING – INTERLOCKING AND INTEGRATED LEDGER SYSTEMS**

There are two systems of cost book keeping

1. Non-integrated/interlocking system
2. Integrated system

**INTERLOCKING LEDGER SYSTEMS**

Interlocking accounting system is a system in which company records his transactions on the basis of financial accounting principles and cost accounting principles separately. It means, there will be two records of accounts. One is financial accounts record and second is cost accounts record.

Features of Interlocking Accounting System

1. In interlocking accounting system, two set of accounts are prepared.
2. In interlocking accounting system, all big organisation, take benefits of cost accounts separately from financial accounts. So, it can more control on cost.
3. In interlocking accounting ledger, cost accounts are maintained in cost ledger and financial accounts are maintain in financial ledger.
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TOPIC 6

COSTING METHODS

Introduction
Manufacturing costing methods are accounting techniques that are used to help understand the value of inputs and outputs in a production process. By tracking and categorizing this information according to a rigorous accounting system, corporate management can determine with a high degree of accuracy the cost per unit of production and other key performance indicators. Management needs this information in order to make informed decisions about production levels, pricing, competitive strategy, future investment, and a host of other concerns. Such information is primarily necessary for internal use, or managerial accounting.

JOB ORDER COSTING

*Job order costing or job costing* is a system for assigning manufacturing costs to an individual product or batches of products. Generally, the job order costing system is used only when the products manufactured are sufficiently different from each other. (When products are identical or nearly identical, the *process costing system* will likely be used.)

Since there is a significant variation in the products manufactured, the job order costing system will create a job cost record for each item, job or special order. The job cost record will report the direct materials and direct labor actually used plus the manufacturing overhead assigned to each job.

An example of an industry where job order costing is used is the building construction industry since each building is unique. The manufacturers of custom equipment or custom cabinetry are also examples of companies that will keep track of production costs by item or job.

The job cost records also serve as the subsidiary ledger or documentation for the cost of the work-in-process inventory, the finished goods inventory, and the cost of goods sold.

ACCOUNTING FOR JOB ORDER COSTING

The following journal entries relate to material procurement and issue from the store to the production process.
1. (a) **Direct materials purchase**  
   Dr Stores ledger control A/c XX  
   Cr Cash A/c XX  
   To record cash purchases

   Dr Stores ledger control A/c XX  
   Cr Creditors A/c - for credit purchasers XX  
   To record credit purchases

(b) **Return of materials to suppliers**  
   Dr Cash A/c or creditors control A/c XX  
   Cr Stores ledger control A/c XX  
   To record return of materials to suppliers

(c) **Issue of materials from the store**  
   Dr W.I.P. Control A/c X  
   Cr stores ledger control A/c for direct materials. XX  
   To record issue of direct materials from the store

   Dr Factory overheads control A/c XX  
   Cr Stores ledger control A/c XX  
   To record issue of indirect materials from the store

Labour cost is measured and accumulated in the same way as material cost. It includes both direct and indirect labour. Direct labour can be traced directly to the individual job where as indirect labour cannot or if it has to be traced, it can only be done with expenditure of great effort.

Labour costs are accumulated based on the time tickets prepared by workers. The worker needs to indicate the duration of time he/she spent on a specific job or, when not assigned to a specific job, what type of indirect labour task he was assigned to and the amount of time expended on the task.

Total labour costs are calculated based on the time sheets submitted at the end of the day by all the workers. An example of a time ticket is shown below STING
Below are the journal entries passed to record direct and indirect labour.

2. (a) Direct Labor
   Dr W.I.P. Control A/e XX
   Cr Cash a/c XX
   To record direct labour Paid in cash

(b) Accrued Direct Wages
   Dr W.I.P. Control Ale XX
   Cr Wages Control Ale XX
   To record direct wages to be paid (accruing at a specific)

(c) Indirect Wages
   Dr Factory overheads control Al c XX
   Cr Wages Control Alc XX
   To record indirect wages (labour cost) incurred

Production overheads go along with direct materials and direct labour in determining the cost per unit or in batch processing or the cost of a particular job. However, it is difficult to assign manufacturing overheads because they cannot be traced directly to a particular job and it consists of many unlike items with the variable and fixed cost components with fixed cost constituting a large part of manufacturing overheads. Overheads are, therefore, assigned to units of production through an allocation process.

The following journal entries are passed to record production overheads allocated for a job.

3. Production Overheads

   (i) (Not yet paid)    Dr Factory overhead control A/ c XX
                        Cr Expenses/Creditor control A/c XX
                        To record unpaid production overheads

   (ii) (When paid)     Dr Expense / creditors Ale XX
                        Cr Cash A/c XX
                        To record payment of production overheads

After the allocation of manufacturing overheads, total cost for a job can then be determined and summarized in a job Cost Sheet or job cost account. Examples of the above are shown below
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TOPIC 7

MARGINAL AND ABSORPTION COSTING

Marginal and absorption costing are two different approaches to dealing with fixed production overheads and whether or not they are included in valuing inventory.

Definition of Marginal Costing

Marginal Costing, also known as Variable Costing, is a costing method whereby decisions can be taken regarding the ascertainment of total cost or the determination of fixed and variable cost in order to find out the best process and product for production etc.

It identifies the Marginal Cost of production and shows its impact on profit for the change in the output units. Marginal cost refers to the movement in the total cost, due to the production of an additional unit of output.

In marginal costing all the variable costs are regarded as product related costs while fixed costs are assumed as period costs. Therefore, fixed cost of production is posted to the Profit & Loss Account. Moreover, fixed cost is also not given relevance while determining the selling price of the product or at the time of valuation of closing stock (whether it is finished goods or Work in Progress).

Illustration

Suppose company X makes two products A and B. A takes 2 labor hours each to make and B takes 5 labor hours. What is the overhead cost per unit for A and B respectively if overheads are absorbed on the basis of labor hours?

Solution

**Step 1**- Estimate overheads for the period.

X estimates it to be shs. 50,000

**Step 2**- Estimate activity level for the period

X estimates a total of 100,000 direct labor hours will be worked

**Step 3**- Divide the estimated overhead by budgeted activity level.

Absorption rate = \text{Shs.} \frac{50,000}{100,000} = \text{Shs.}0.50 per direct labor hours

**Step 4**- Absorb overhead into the cost unit by applying absorption rate.
<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Labor hours/unit</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>Absorption Rate(SHS)</td>
<td>0.5</td>
<td>0.5</td>
</tr>
<tr>
<td>Overhead absorbed/unit</td>
<td>1</td>
<td>2.5</td>
</tr>
</tbody>
</table>

**Note:** The activity level of 100,000 hours is the basis over which the overheads will be absorbed. Different bases will be used as shown in the table illustration previously.

**Advantages of marginal costing**
1. Marginal costing is simple to understand.
2. By not charging fixed overhead to cost of production, the effect of varying charges per unit is avoided.
3. It prevents the illogical carry forward in stock valuation of some proportion of current year’s fixed overhead.
4. The effects of alternative sales or production policies can be more readily available and assessed, and decisions taken would yield the maximum return to business.
5. It eliminates large balances left in overhead control accounts which indicate the difficulty of ascertaining an accurate overhead recovery rate.
6. Practical cost control is greatly facilitated. By avoiding arbitrary allocation of fixed overhead, efforts can be concentrated on maintaining a uniform and consistent marginal cost. It is useful to various levels of management.
7. It helps in short-term profit planning by breakeven and profitability analysis, both in terms of quantity and graphs. Comparative profitability and performance between two or more products and divisions can easily be assessed and brought to the notice of management for decision making.

**Disadvantages of marginal costing**
1. The separation of costs into fixed and variable is difficult and sometimes gives misleading results.
2. Normal costing systems also apply overhead under normal operating volume and this shows that no advantage is gained by marginal costing.
3. Under marginal costing, stocks and work in progress are understated. The exclusion of fixed costs from inventories affects profit, and true and fair view of financial affairs of an organization may not be clearly transparent.
4. Volume variance in standard costing also discloses the effect of fluctuating output on fixed overhead. Marginal cost data becomes unrealistic in case of highly fluctuating levels of production, e.g., in case of seasonal factories.
5. Application of fixed overhead depends on estimates and not on the actuals and as such there may be under or over absorption of the same.
6. Control affected by means of budgetary control is also accepted by many. In order to know the net profit, we should not be satisfied with contribution and hence, fixed overhead is also a valuable item. A system which ignores fixed costs is less effective since a major portion of fixed cost is not taken care of under marginal costing.

7. In practice, sales price, fixed cost and variable cost per unit may vary. Thus, the assumptions underlying the theory of marginal costing sometimes becomes unrealistic. For long term profit planning, absorption costing is the only answer.

Definition of Absorption Costing

Absorption Costing is a method for inventory valuation whereby all the manufacturing expenses are allocated to the cost centers to recognize the total cost of production. These manufacturing expenses include all fixed as well as variable costs. It is the traditional method for cost ascertainment, also known by the name Full Absorption Costing.

In an absorption costing system, both the fixed and variable costs are regarded as product related cost. In this method the objective behind the assignment of the total cost to cost center is to recover it from the selling price of the product.

On the basis of function, the expenses are divided into Production, Administration and Selling & Distribution. The following are the types of Absorption Costing:

- Activity Based Costing
- Job Costing
- Process Costing

Illustration

PQR limited is a manufacturer of sports shoes. The company uses a standard system. The standard cost per pair of spots shoes is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Cost (Sh.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials</td>
<td>500</td>
</tr>
<tr>
<td>Direct labour: 4 hours × sh. 60 / hour</td>
<td>240</td>
</tr>
<tr>
<td>Production overheads</td>
<td></td>
</tr>
<tr>
<td>Variable 4 hours × sh. 30 / hour</td>
<td>120</td>
</tr>
<tr>
<td>Fixed</td>
<td>100</td>
</tr>
<tr>
<td>Standard production cost</td>
<td>960</td>
</tr>
<tr>
<td>Standard selling price</td>
<td>1,500</td>
</tr>
</tbody>
</table>

Additional information

1. During the month of March 2011, production was 10,000 units as planned but he sales made were 8,000 units
2. The total fixed production overhead variance during the month was sh. 100,000 adverse
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TOPIC 8

BUDGETING AND BUDGETARY CONTROL

Nature and Purposes of Budgets

A budget is a financial plan for the future concerning the revenues and costs of a business. However, a budget is about much more than just financial numbers.

Budgetary control is the process by which financial control is exercised within an organisation.

Budgets for income/revenue and expenditure are prepared in advance and then compared with actual performance to establish any variances.

Managers are responsible for controllable costs within their budgets and are required to take remedial action if the adverse variances arise and they are considered excessive.

A number of purposes of budgeting have been identified. They include:

1. Coordination
   The budgetary process requires that visible detailed budgets are developed to cover each activity, department or function in the organization. This is only possible when the effort of one department’s budget is related to the budget of another department. In this way, coordination of activities, function and department is achieved.

2. Communication
   The full budgeting process involves liaison and discussion among all levels of management. Both vertical and horizontal communication is necessary to ensure proper coordination of activities. The budget itself may also act as a tool of communication of what is expected of the departments and managers. High standards set calls for hard work and more input in terms of labour, time and other resources.

3. Control
   This is the process for comparing actual results with the budgeted results and reporting upon variances. Budgets set a control gauge, which assists to accomplish the plans set within agreed expenditure limits. The approach followed in the control process has five basic steps:
   i) Preparation of budgets based on the predetermined data on performance and prices.
   ii) Measurement of actual performance and recording the data.
   iii) Comparing the budget with the actual performance and recording the difference.
   iv) Ascertaining reasons for the differences through, including others, variance analysis.
   v) Taking corrective actions through administering of proper strategies and measures.
4. **Motivation**

Budgets may be seen as a bargaining process in which managers compete with each other for scarce resources. Budgets set targets, which have to be achieved. Where budgetary targets are tightly set, some individuals will be positively motivated towards achieving them. Involvement of managers in the preparation of budgets motivates them towards achieving the goals they have set themselves. However, imposing budgets on managers will be discouraging as they may perceive the targets as unattainable.

5. **Clarification of Responsibility and Authority**

Budgetary process necessitates the organization of a business into responsibility and budget centers with clear lines of responsibilities of each manager. This reduces duplication of efforts. Each manager manages those items directly under his or her control. To facilitate effective responsibility accounting, authority and responsibility relationship must be balanced.

6. **Planning**

It is by Budgetary Planning that long-term plans are put into action. Planning involves determination of objectives to be attained at a future predetermined time. When monetary values are attached to plans they become budgets. Good planning without effective control is time wasted. Unless plans are laid down in advance, there are no objectives towards which control can be affected.

**PREPARATION OF BUDGETS**

**MASTER BUDGET**

A master budget is a set of interconnected budgets of sales, production costs, purchases, incomes, etc. and it also includes pro forma financial statements. A budget is a plan of future financial transactions. A master budget serves as planning and control tool to the management since they can plan the business activities during the period on the basis of master budget. At the end of each period, actual results can be compared with the master budget and necessary control actions can be taken.

**Components of Master Budget**

Master budget has two major sections which are the operational budget and the financial budget. They have following components:

**Operational Budget**

1. Sales Budget
2. Production Budget
3. Direct Material Purchases Budget
4. Direct Labor Budget
5. Overhead Budget
6. Selling and Administrative Expenses Budget
7. Cost of Goods Manufactured Budget

Financial Budget

1. Schedule of Expected Cash Receipts from Customers
2. Schedule of Expected Cash Payments to Suppliers
3. Cash Budget
4. Budgeted Income Statement
5. Budgeted Balance Sheet

Note that all of the above component budgets may not be included in the master budget of every business. Some of these such as production budget and cost of goods manufactured budget are not need by a non-manufacturing business.

FUNCTIONAL BUDGET

Functional budget are prepared for an individual function. For each operation in the organization a budget is prepared
Sales budget, purchases budget, production budget, cash budget etc. are ex ample of functional budget. This budget are consolidated to arrive at a master budget

Usefulness

a) A functional budget give target to the individual functional manager
b) Those who actually implement the budget prepare the functional budget. They are familiar with the problems at the grassroots level. Therefore the budgets are more realistic and motivating.

Problems

(a) As the functional manager prepares the functional budget, the target may not be in line with the strategic objectives or may conflict with the organizational objectives or inter departmental objectives. This problem can be avoided by encouraging co-ordination between the functional managers.
(b) Functional budgets are based on forecasts. There are many extern al as well as well as internal environmental factors (such as a change in demand for a product, non-availability of a particular raw material high attrition causing shortages of skilled labour, etc.)that affect the functional budgets. If these factors behave differently than predicted, this may render the budgetary system ineffective

Production budget

The production budget is usually expressed in quantity and represents the sales budget adjusted for opening closing finished stocks and work in progress.
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