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Management Accounting

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	Page
Welcome to your ExPress notes	3
1. The Nature, Source and Purpose of Management Information	4
2. Cost Accounting Techniques	8
3. Budgeting	16
4. Standard Costing	25
5. Performance Measurement	32

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Steve Crossman
CEO The ExP Group

“Hello”

Thank you for downloading a copy of these ExPress notes and I hope you find them useful for your studies.

We provide these ExPress notes free of charge to individual students as part of our CSR initiatives. The notes are designed to help students assimilate and understand the most important areas for the exam as quickly as possible.

A word of warning though in that they have not been designed to cover everything in the syllabus so you should only use these notes for either an overview of the key areas before you start your main studies or as part of your final revision in the run up to your exams.

Importantly though, we want you to be successful in your exams so good luck with your studies and please do let us know how you get on.

All the best,
Steve

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About The ExP Group

We were born with one passion, with one aim, with one desire. To use technology the way it should be used. To use technology to open up education, and in particular financial education, to whoever needs it regardless of their income, wealth, race, sex, religion or location.

We wanted to use technology to empower individuals to develop themselves through financial expertise, organisations to improve their performance through enhanced human capital and ultimately communities and families to benefit as a result.

We're on target and since our birth we have had the privilege of working with and learning from inspirational individuals and organisations from all 4 corners of the world in countries as varied as the UK in the north, Singapore in the east, South Africa in the south and the Cayman Islands in the west.

We're only part way through our journey but we're doing better than we expected. The best is yet to come though,

Education + Technology = Ethical Empowerment.

Thank you for being part of our story.



The Nature, Source and Purpose of Management Information

KEY KNOWLEDGE - Good information

Using a well known mnemonic, The qualities of good information can be summarised in the word ACCURATE:

Accurate
Complete
Cost-beneficial
Understandable
Relevant
Adaptable
Timely
Easy to use

KEY KNOWLEDGE - Management Accounting

The process of identification, measurement, accumulation, analysis, preparation, interpretation and reporting of information used by management to set targets, plan resource allocation, evaluate investment choices and monitor/control the operating performance and the orderly conduct of the business.

Differences in purpose and scope, compared to Financial Accounting

- Aimed at internal users (as opposed to financial accounting, which is aimed at external stakeholders)
- Focused on present and future performance (as opposed to financial accounting, which reports past performance)
- Not required by law and not regulated by accounting frameworks (as opposed to financial accounting, which is a legal requirement and is regulated by accounting frameworks)

- Focused on specific areas or activities (as opposed to financial accounting, which provides a holistic view of company's performance)
- Employs non-financial indicators as well financial, while financial accounting uses only financial measures.

Managerial Processes

The key processes which face management can be divided into:

- Planning: Defining objectives and appropriate strategies for attaining them;
- Decision-making: Making choices, not only with regard to the selection of strategies, but also along the way as implementation proceeds;
- Control: Monitoring of performance during the course of business and taking remedial action steps as necessary

Planning

Planning occurs at different levels of the organisation:

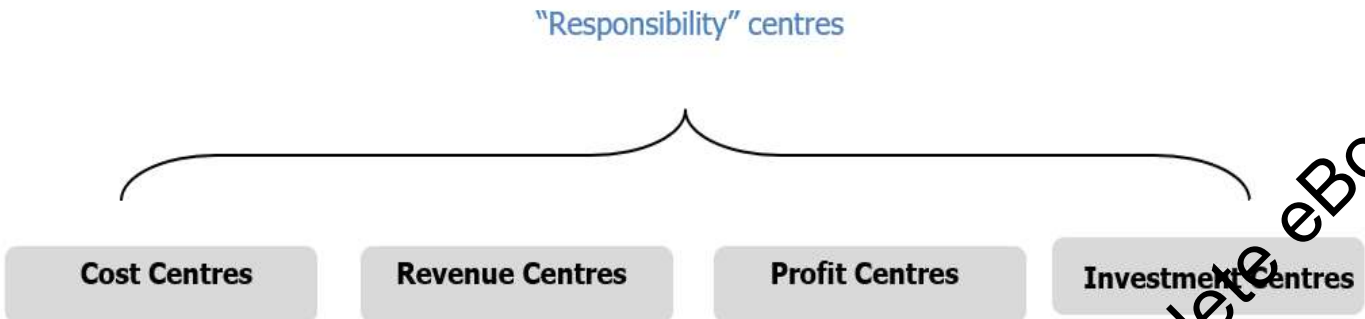
Strategic - the "big picture", long term issues and the whole company.

Tactical - medium term and focuses on use of resources.

Operational - short term "day to day" issues.

Responsibility centres

Related to the above is the notion of responsibility that attaches to each level of an organisation:



Cost centres: Responsible for current expenses only

Revenue centres: Responsible for revenues, but not current expenses other than marketing expenses

Profit centres: Responsible for revenues and current expenses

Investment centres: Responsible for revenues, current expenses and capital expenditure

Sources of data

The sources of data are almost infinite, and they must be selected and evaluated carefully based on reliability and relevance.

KEY KNOWLEDGE - Classifications of cost

Costs can be broken down into:

KEY KNOWLEDGE - Production vs. Non-Production costs

Costs can be broken down into:

Production costs: These are costs (both direct and indirect, also variable and fixed) which relate to the production of goods; this is also referred to as manufacturing or factory cost. It is these costs, accumulated, which provide the value at which goods are placed in inventory (prior to sale) and form the "cost of goods" value when sold.

Non-production costs: These are expenses that are incurred independent of production and include administrative, selling, distribution and finance costs. These costs can have the character of "period" costs, as they relate to the period of time in which they occur.

KEY KNOWLEDGE - Direct vs. Indirect costs

Direct costs: are costs that can be directly attributable to a product.

Indirect costs: these are costs that cannot be directly attributable to a product.

KEY KNOWLEDGE - Fixed vs. Variable costs

Fixed costs: are costs that remain constant regardless of the volume of production. A variety of indirect costs are fixed.

Variable costs: vary in proportion with the volume produced. Direct costs are by their nature variable in behaviour.

"Although a variable cost increases with the level of activity, the variable cost per unit remains fixed, while a fixed cost per unit falls with a rise in the level of activity."

Other types of costs:

Mixed costs: these are costs that contain a fixed and a variable element.

Step costs: costs that remain fixed within a defined range of production, but at a certain level of output increase in a significant way to a new (fixed) level.

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Cost Accounting Techniques

START - The Big Picture

This chapter summarises various issues concerning the key area of cost accounting techniques.

KEY KNOWLEDGE - Materials

The ordering, receiving and issuing of materials from inventory must be controlled according to procedures and documented at all stages with forms appropriate to the purpose.

The controls and procedures are designed to monitor inventory movements so as to minimise discrepancies and losses and theft.

KEY KNOWLEDGE - Economic Order Quantity

This is a method which seeks to minimize the costs associated with holding inventory.

To determine the total costs, the following data is required:

Q = order quantity

D = quantity of product demanded annually

P = purchase cost for one unit

C = fixed cost per order (not incl. the purchase price)

H = cost of holding one unit for one year

The total cost function is as follows:

$$\text{Total cost} = \text{Purchase cost} + \text{Ordering cost} + \text{Holding cost}$$

which can be expressed algebraically as follows:

$$TC = P \times D + C \times D/Q + H \times Q/2$$

It is this total cost function which must be minimized.

Recognising that:

- PD does not vary;
- Ordering costs rise the more frequently one places (during the year); and
- Holding costs rise the fewer times one places orders (due to larger quantities being ordered each time),

It follows that there is a trade-off between the Ordering and the Holding costs.

The optimal order quantity (Q^*) is found where the Ordering and Holding costs equal each other, i.e.

$$C \times D/Q = H \times Q/2$$

Rearranging the above and solving for Q results in $EOQ = \sqrt{2CD / H}$

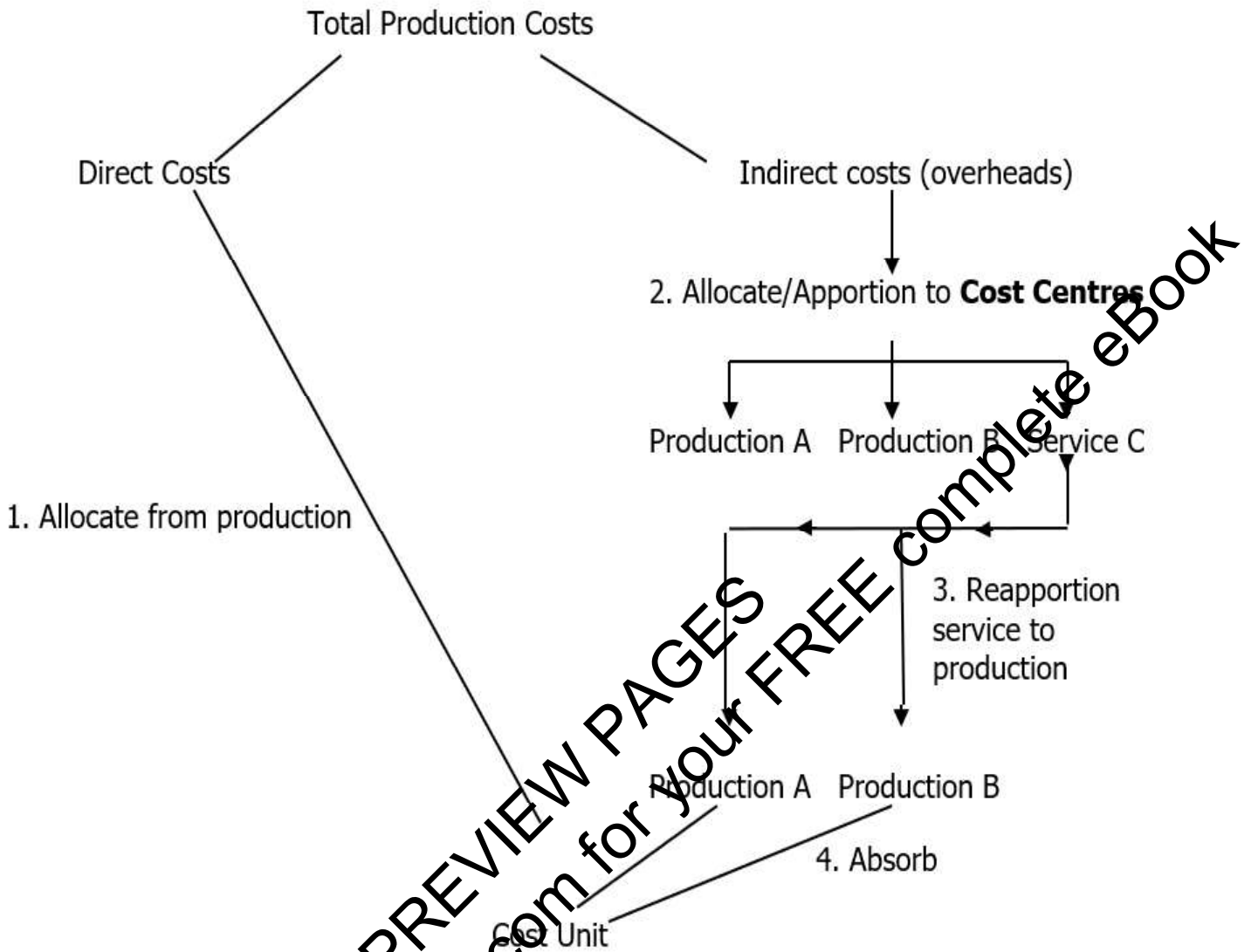
KEY KNOWLEDGE - Labour

Direct labour refers to work which is directly involved in the manufacture of a product.

Indirect labour (e.g. the supervisor's salary or that of a security guard) forms part of overhead costs.

KEY KNOWLEDGE - Absorption Costing

This is one method which seeks to make the link between overheads and (product) cost units.



The focus (above) is production. Overhead costs that are not incurred at the time of production do not find their way into inventory.

It is useful to think of production costs as being those that end up as part of the inventory (valuation) while other (non-production) costs are incurred outside, and normally after the product leaves inventory.

KEY KNOWLEDGE - Contribution

Contribution is defined as the difference between Sales revenue and the marginal cost of sales, or

$$\text{Contribution} = \text{Sales} - \text{Variable costs (both production and non-production)}$$

KEY KNOWLEDGE - Marginal Costing

A marginal approach to costing focuses on the variable (marginal) costs generated in a business and considers fixed costs as period costs. This allows the company to be able to quantify the amount by which its costs rise, if it produces/sells an additional unit of output.

Example

Below is data on a manufacturing company.

	\$
Selling price (per unit):	120
Cost card (per unit):	
Direct materials	45
Direct labour	18
Variable production O/Hs	<u>9</u>
Total variable costs	72

There is a variable selling cost of \$2 per unit

	Year 1 (units)	Year 2 (units)
Budget (normal) production	1,100	1,100
Actual Production	1,000	1,100
Actual Sales	950	1,150
Actual fixed production O/Hs	\$16,500	\$16,500
Actual SGA costs	\$7,000	\$7,000

Based on the above data a profit and loss statement for the Years 1 and 2 is shown on the next page.

Assume that the beginning inventory is zero.

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Profit/Loss (Marginal costing)

	Year 1 \$	Year 2 \$
Sales (950/1,150 units)	114,000	138,000
Less: Variable cost of sales		
Opening inventory	0	3,600
Production costs:		
Variable		
(1,000 x \$72)	72,000	
(1,100 X \$72)		79,200
Less: closing inventory		
(50 x \$72)	<u>(3,600)</u>	<u>0</u>
	(68,400)	(82,800)
Less: Variable selling costs		
(950 x \$2)	<u>(1,900)</u>	
(1,150 x \$2)		<u>(2,300)</u>
Contribution	43,700	52,900
Less: Fixed production O/Hs	(16,500)	(16,500)
Less: SGA costs	<u>(7,000)</u>	<u>(7,000)</u>
Profit	20,200	29,400

Inventory is valued at variable production costs.

KEY KNOWLEDGE Absorption Costing

This method argues that focusing on marginal costs is potentially misleading in the longer run because fixed production costs have also to be covered. Accounting conventions require that fixed production costs be reflected in each unit produced.

An example is shown below.

Revised cost card (Absorption costing)

Cost card (\$ per unit):

Direct materials	45
Direct labour	18
Variable production O/Hs	9
Fixed production O/Hs	<u>15</u>
Total production costs	87

Profit/Loss (Absorption costing)

	Year 1	Year 2
	\$	\$
Sales (950/1,150 units)	114,000	138,000
Less: Variable cost of sales		
Opening inventory	0	4,350
Production costs:		
Variable		
(1,000 x \$72)	72,000	
(1,100 X \$72)		79,200
Fixed		
(1,000 x \$15)	15,000	
(1,100 X \$15)		16,500
Less: closing inventory		
(50 x \$87)	<u>4,350</u>	0
Over/(under) absorption	<u>1,500</u>	<u>0</u>
	<u>(84,150)</u>	<u>(100,050)</u>
Gross Profit	29,850	37,950
Less: Variable selling costs		
(450 x \$2)	1,900	
(1,150 x \$2)		2,300
Less: S&A costs	<u>7,000</u> <u>(8,900)</u>	<u>7,000</u> <u>(9,300)</u>
Profit	20,950	28,650

Inventory is valued at the full production costs.

Summary of Absorption costing and Marginal costing formats

	Absorption Costing	Marginal Costing
Revenue		
Less: Cost of Sales	Variable/Fixed production costs	Variable production/ non-production costs
	Gross profit	Contribution
Less: Expenses	Variable/Fixed non-production costs	Fixed production/ non-production costs
Net Profit		

KEY KNOWLEDGE - Job Costing / Batch Costing

This refers to the calculation of costs associated with a specific job or customer order. This is appropriate in situations where each product or service is distinct, and possibly unique, in its delivery.

Batch costing is similar to job costing; the distinction lies in the identification of costs with specific batches, which are numbered (separately identified) for this purpose.

KEY KNOWLEDGE - Process Costing

Process costing is a technique that applies to the mass production of a large number of identical products, moving through a series of processing stages. The accumulated costs of production can be averaged over the number of items produced.

The average cost is determined by the following formula:

$$\text{Average cost per unit} = \frac{\text{Total cost of inputs} - \text{Scrap value of rejected units}}{\text{No. of units of input} - \text{Normal loss}}$$

The total cost of inputs refers to labour, materials and overhead costs of production. If losses occur along the way that necessitate the scrapping of defective units, then to the extent that these items fetch a scrap value, then that (scrap) value will reduce the total costs.

Similarly, an accounting is made of the number of units introduced into a process with the expectation that a normal loss will be incurred. The number of good units emerging from a process will therefore be the number of units entering it, minus the expected number lost in processing.

Abnormal gains and losses are accounted for as an adjustment to the accounts using the same value as the "good" output (deducted in the case of loss and added in the case of gains).