

ACCT 102- Managerial Accounting
Lecture Notes – Chapter 14: MANAGERIAL ACCOUNTING
CONCEPTS AND PRINCIPLES - Schmidt

MANAGERIAL ACCOUNTING BASICS

Purpose of Managerial Accounting

In ACCT 101, we learned the basics of financial reporting. The remainder of this course, except for financial statement analyses topics in Chapter 13, will look at how to gather and report information for managers in making planning and control decisions. Much of this learning will use manufacturing companies as the setting. The importance of managerial accounting analytical tools has increased as a result of the following changes in the business environment:

- a. **Lean business model**—goal is to *eliminate waste* while “satisfying the customer” and providing a “positive return to the company”. This results in *customer orientation* and is affected by the expanded competitive boundaries of the *global economy*.
- b. **Lean practices**, that follow an underlying philosophy of *continuous improvement*, include:
 1. **Total quality management (TQM)**—focuses on quality improvement and applies this standard to all aspects of business activities.
 2. **Just-in-time manufacturing (JIT)**—a system that acquires inventory and produces only when needed (as order received—a *demand-pull* system).

Exhibit 14.2 contrasts seven different characteristics of financial accounting compared to managerial accounting. The most important of these are:

1. Users and decision makers
 - a. In financial—Investors, creditors and other users *external* to the organization.
 - b. In managerial—Managers, employees and decision makers *internal* to the organization.
2. Purpose of information
 - a. In financial—Assist external users in making investment, credit and other decisions.
 - b. In managerial—Assist managers in making *planning* and *control* decisions.
3. Flexibility of practice
 - a. In financial—Structured and often controlled by GAAP.
 - b. In managerial—Relatively *flexible* (no GAAP constraints).

Managerial Cost Concepts

Product costs and period costs

An important part of this chapter is to understand that manufacturing companies must classify their costs into two distinct areas: product costs and period costs. Product costs are *capitalized* (treated as inventory, which is an asset). Period costs are charged to expense as incurred.

Product costs

Product costs include direct materials, direct labor, and factory overhead costs. Let's assume we are manufacturing men's long-sleeved, button-down shirts. The types of costs classified as product costs would be:

- **Direct materials (DM)**: the materials included in the final product. In this case, that would be the fabric and buttons. (Thread used is probably not expensive enough to warrant tracking and would be part of factory overhead).
- **Direct labor (DL)**: the wages of the employees who had a "hands on" role in making the shirts, such as the employees who sewed the shirts or placed the fabric over the pattern.
- **Factory overhead (FOH)**: all other manufacturing costs. Factory overhead consists of costs that cannot be traced to a single product. Examples are superintendents' salaries; repair and maintenance costs; factory rent; depreciation on factory equipment; and utilities costs to run the factory. In a modern factory, using robotics in place of human labor, factory overhead is the largest product cost.

Period costs

Period costs are those costs referred to in ACCT 101 as operating expenses. They are not directly involved in manufacturing product, nor are they factory overhead. Period costs are usually classified as either *administrative* or *selling* expenses.

Selling expenses are those costs incurred in the selling or marketing functions. Examples include salesperson's salaries or commissions, and advertising expense. All other operating expenses, such as the controller's salary, legal expense, and office costs, would be classified as administrative expenses.

Other important managerial cost concepts

Much of this chapter introduces us to various terms used in managerial accounting. Following is a list of many important terms.

- A. Cost behavior—At a basic level, a cost can be classified as *fixed or variable or mixed*.
 1. **Fixed cost**—cost does not change with changes in the volume of an activity (within a certain range of activity known as an activity's *relevant range*).

2. **Variable cost**—cost *changes* in proportion to changes in the volume of an activity.
 3. **Mixed**—combination of fixed and variable costs.
- B. Traceability—cost is traced to a *cost object* (a product, process, department or customer to which costs are assigned). Cost is classified as either a *direct or indirect cost*. To classify must identify the cost object.
1. **Direct costs**—those traceable to a single cost object.
 2. **Indirect costs**—are those that cannot be traced to a single cost object.
- C. Controllability—costs can be defined as controllable or not controllable and this classification is dependent on employee’s responsibilities (*hierarchical levels*).
- D. Relevance—costs classified by identifying it as either a sunk cost or an out-of-pocket cost.
1. **Sunk cost**—already incurred and cannot be avoided or changed. These costs are irrelevant to future decisions.
 2. **Out-of-pocket cost**—requires a future outlay of cash and is relevant for decision making.
 3. **Opportunity cost**—is the potential benefit lost by choosing a specific action from two or more alternative.
- E. **Prime costs**: direct materials costs plus direct labor costs.
- F. **Conversion costs**: direct labor costs plus factory overhead costs.

Reporting Manufacturing Activities

Balance sheet

Manufacturing companies typically have three different inventory accounts:

1. Raw Materials Inventory—goods acquired to use in making products.
Two types are:
 - a. *Direct materials*—physically become part of the product and are clearly identified with specific units or batches of product.
 - b. *Indirect Materials*—used in support of the production process. Generally, do not become a part of a product. Exception: materials that do become part of product, but have low or insignificant cost, and traceability to product is not economically sound (application of *materiality* principle).
2. Goods in Process Inventory—(or work in process inventory. These are products in the process of being manufactured but not yet complete.
3. Finished Goods Inventory—consists of completed products ready for resale.

Income statement (emphasis)

A manufacturing company calculates cost of goods sold as:

Beginning finished goods inventory + cost of goods manufactured – ending finished goods inventory.

Both the beginning and ending finished goods balances can be obtained from the Finished Goods account in the general ledger. **The challenge is in calculating cost of goods manufactured.** The summarized form of a Manufacturing Statement, which calculates cost of goods manufactured, is:

Direct materials used	\$XXX	**	
Direct labor incurred	+	XXX	
Factory overhead	+	<u>XXXX</u>	
=Total manufacturing costs		\$XXXX	
Add: goods in process, beginning of period		+	XX
Less: goods in process, end of period		-	<u>XX</u>
= Cost of goods manufactured		<u>\$XXXX</u>	

** Direct materials used is calculated as follows:

Raw materials inventory, beginning of period		\$XXX
Raw material purchases	+	<u>XXXX</u>
= Raw materials available for use		XXXX
Less raw materials inventory, end of period	-	<u>XX</u>
= Direct materials used		<u>\$XXX</u>