Accounting For Decision Making

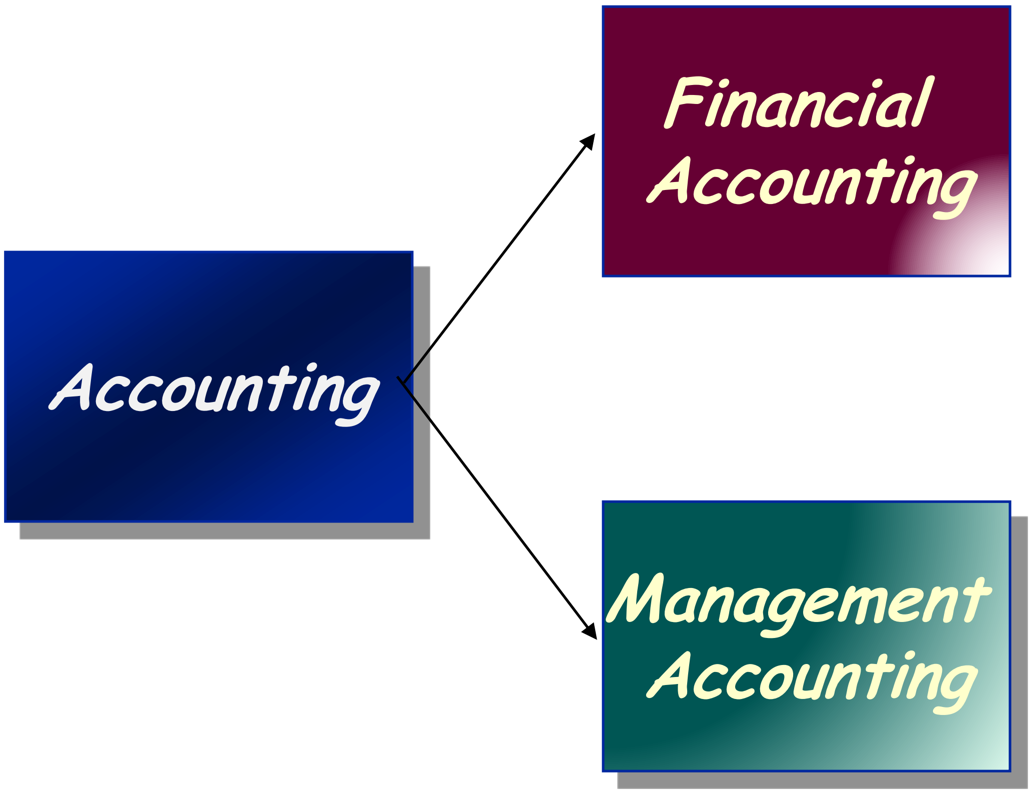
~ Topic 4 ~

Understanding Costs

Goals for this session…

- Understand the scope of management accounting;
- Define costs and explain why cost information is so important to managers;
- Explain the major concepts used for analysing the costs of decision alternatives including;
  - *current and future costs,*
  - *opportunity costs,*
  - *sunk costs, and*
  - *differential and non differential costs*
- Describe the various ways in which costs can be classified and used to inform managers' decisions and to support the planning and control of costs, according to
  - *cost behaviour relative to the level of activity,*
  - *place in the value chain,*
  - *cost traceability, and*
  - *cost controllability.*

Financial Accounting & Management Accounting…



Producing financial information for users who are ***external*** to the organisation such as shareholders, creditors, banks, ATO…

Processes and techniques that focus on the effective and efficient use of organisational resources, to **support managers** in their tasks of enhancing both customer value and shareholder value.

Understanding Costs…

- Costs – a vital consideration for every manager

- An essential element to achieving profitability and efficiency

- Can be classified and analysed in numerous different ways.

What is cost?

- a measure of something that has to be given up (or will be given up) in the process of doing things
- a sacrifice of values.
- an expenditure made to secure an economic benefit, generally for resources that promise to produce revenue (e.g. the cost of an asset, the costs associated with Operations).
- the value of the expenses incurred in producing a product or service to be sold (product cost).

Emphasis on costs

- Importance of cost information
  - all organisations incur costs
  - management decisions generally cause costs
  - managers need to understand cost causes to plan and control
- Role of non-financial information
  - decision makers also require qualitative information for decisions

Decision making – Types of Costs…

- Current Costs
- Opportunity Costs
- Sunk Costs
- Differential and Non-Differential Costs
- Fixed and Variable Costs
- Direct and Indirect Costs
- Controllable and Uncontrollable Costs
- Relevant Costs

- Current Costs
  - Costs incurred as activities take place
  - Need to be a good proxy for future costs to be relevant

For Example:

Estimated labour cost for product is $65.50 per 100 units.

Under what condition might this be a relevant cost?

- Opportunity Costs
  - Costs of foregoing the next best alternative
  - The potential benefit that is given up when one alternative is chosen over another
  - Not recorded in the accounting records
  - Requires serious thinking to identify alternatives

- Sunk Costs
  - Past outlays that are not relevant to future decision alternatives

    Example ???

- Differential and Non-Differential Costs
  - Differential Costs:
    - Costs which vary with decision alternatives
    - Need to be included in analysing the costs of decision alternatives
  - Non-Differential Costs:
    - Costs which **do not** vary with decision alternatives
    - Can be ignored in the cost analysis

- Fixed and Variable costs

  - Fixed costs - remain unchanged in total despite changes in the level of activity

    Examples…?

  - Variable costs - change in total, in direct proportion to a change in the level of activity

    Examples…?

• Direct and Indirect Costs

- Cost Object: items which are assigned a separate measure of cost (includes services/ products, customers)

- Direct costs:

Caused directly by, and traced specifically to a given cost object

Examples:

- *Direct Labour – the cost of labour that works directly on the project*
- *Direct Materials – the cost of materials used in producing the product.*

- Indirect costs:

- Costs related to a given cost object but not directly traceable to it
- Includes all costs of products incurred in producing the product, other than Direct Costs
- Must therefore be estimated by indirect means
- Often called Overhead, Factory Overhead, Manufacturing Overhead, Factory Burden or Burden

- Controllable and Uncontrollable costs

  - Controllable Costs

    Costs that can be significantly influenced by a manager

    Examples…?

  - Uncontrollable Costs

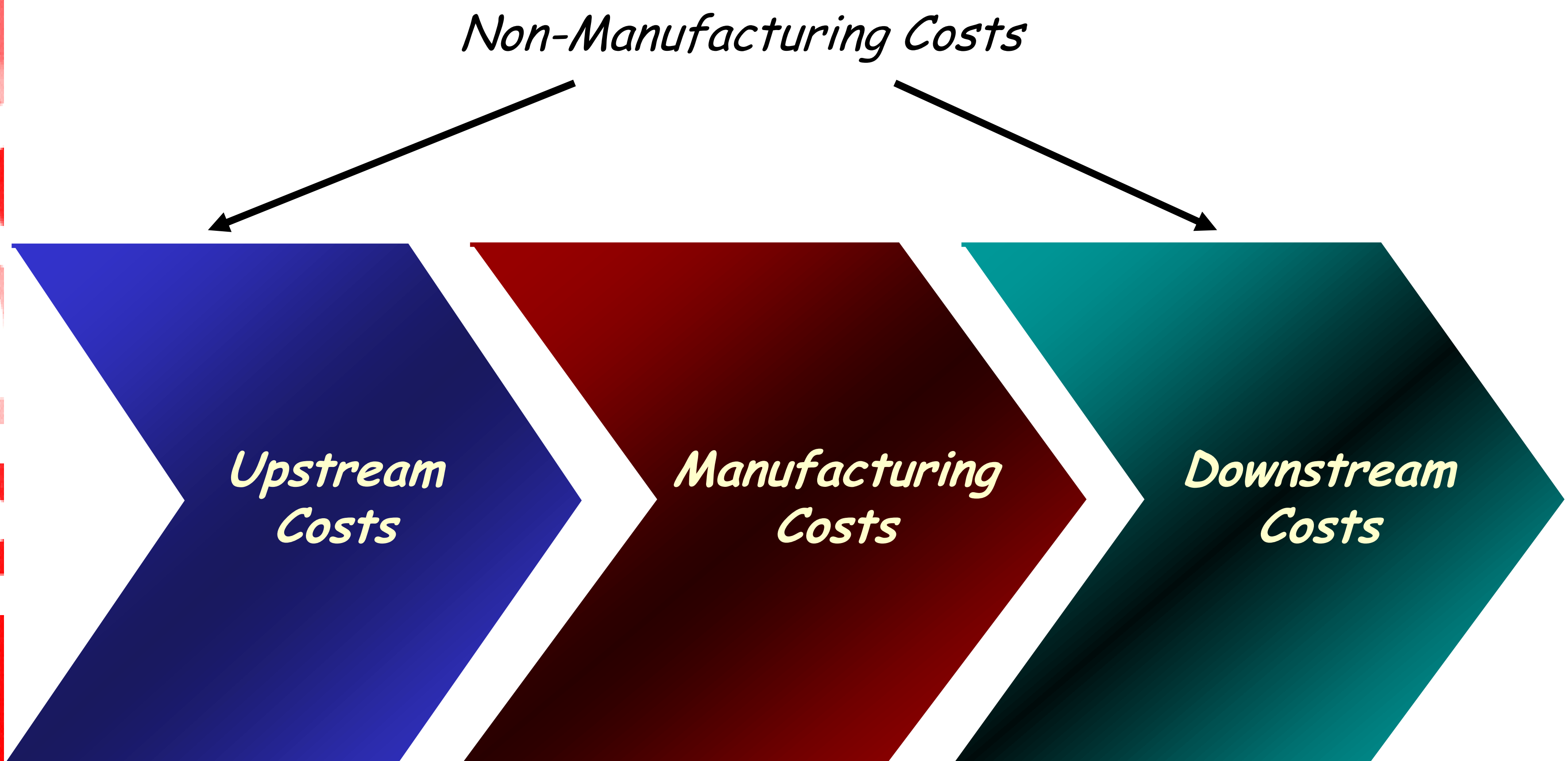
    Costs that are beyond the control of a manager

    Examples…?

The Value Chain

- Classifies costs on the basis of *when* they are incurred…
  - Upstream Costs ~ before production
  - Production or Manufacturing Costs ~ directly attributable to the product or service
  - Downstream costs ~ after production

Costs across the Value Chain



- R & D
- HRM

- Direct Labour
- Direct Material
- Manufacturing Overhead
- WIP
- Finished Goods
- COGS

- Sales & Marketing
- Distribution

- ***Upstream costs***

  - **Research and development** costs include the costs involved in developing new products and processes.

  - **Design** costs include the costs associated with designing a product or production process

  - **Supply costs** are the costs of sourcing and managing incoming parts, assemblies and supplies

- ***Production or Manufacturing costs***
  - **The costs incurred** to collect and assemble the resources used **to produce a product or service.**

- ***Downstream costs***
  - **Marketing costs** are the costs of selling products and the costs of advertising and promotion.
  - **Distribution costs** are the costs of storing, handling and shipping finished products.
  - **Customer service costs** are the costs of serving customers, including after-sales service.

Costs in Service Sector Organisations…

- Classifications have evolved in a manufacturing environment
- Reflects primary focus of estimating the cost of manufacturing inventory
- In most Service Organisations:
  - Services are consumed when produced – therefore there is no inventory
  - Labour is usually the major input and therefore the only direct product cost

Relevant Costs – a summary…

To be relevant to assist in making decisions, costs must…

- Reflect *Current Costs* or be a reliable estimate of future costs
- Include *Opportunity Costs*
- Be *Differential* – differ amongst various decision alternatives
- Exclude *Sunk Costs*
- Include *Variable Costs* but exclude *Fixed Costs*