

CHAPTER 2

MANAGERIAL ACCOUNTING AND COST CONCEPTS

AGENDA

Cost classifications for:

1. Financial statement preparation.
2. Predicting cost behavior.
3. Assigning costs to cost objects.
4. Making decisions

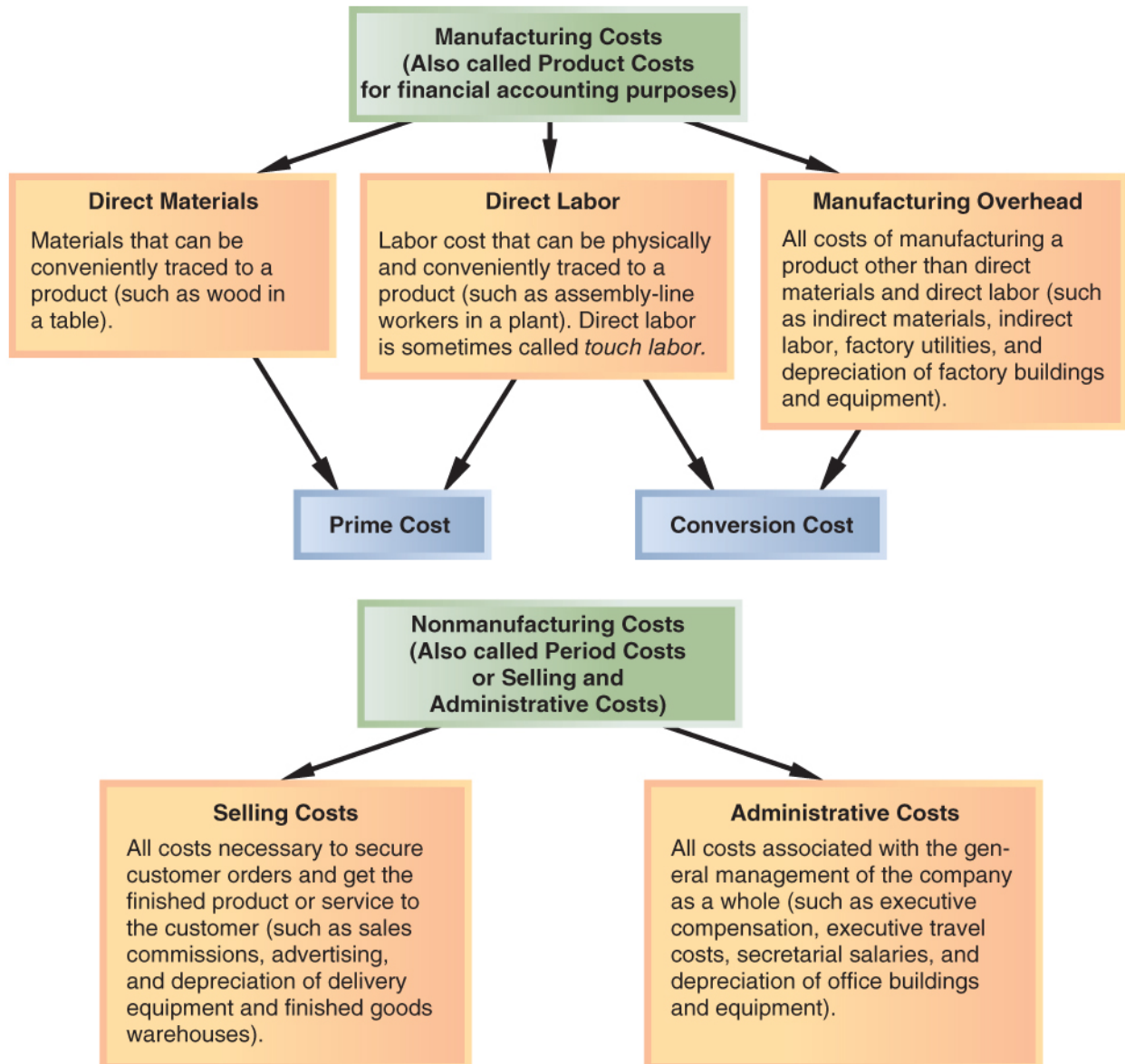
Appendix 2A: Least-squares regression computations using Microsoft Excel.

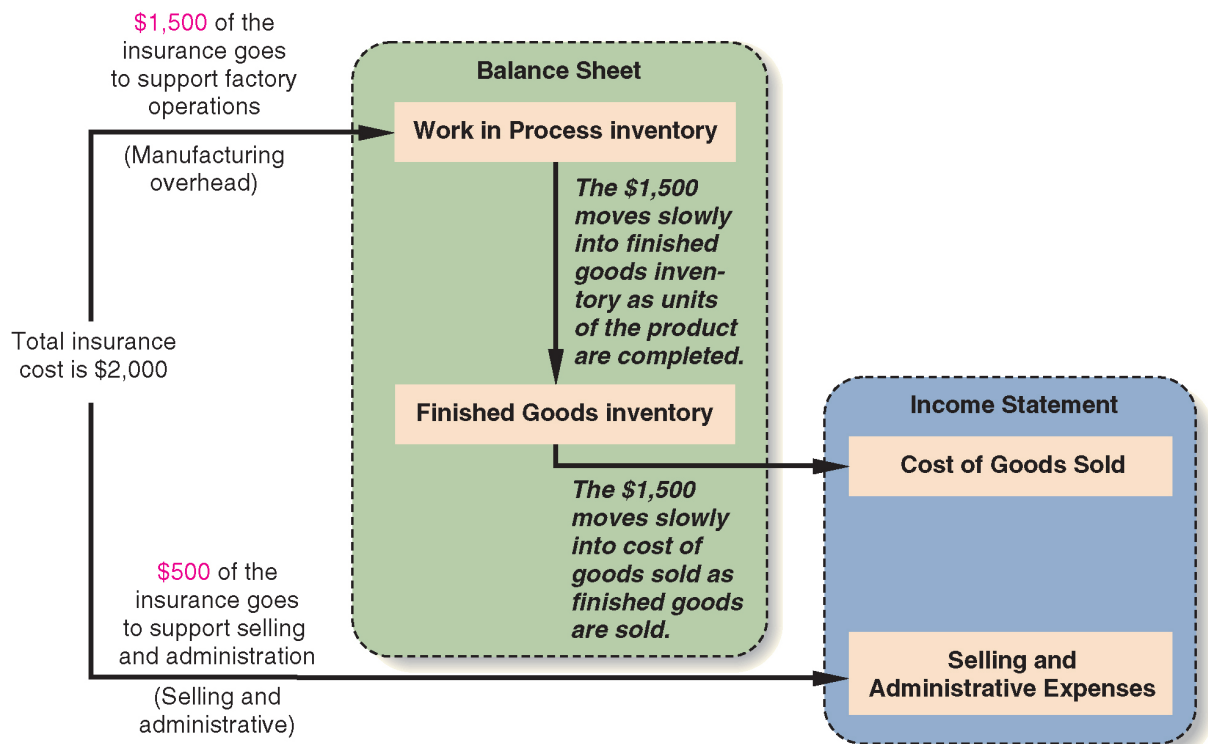
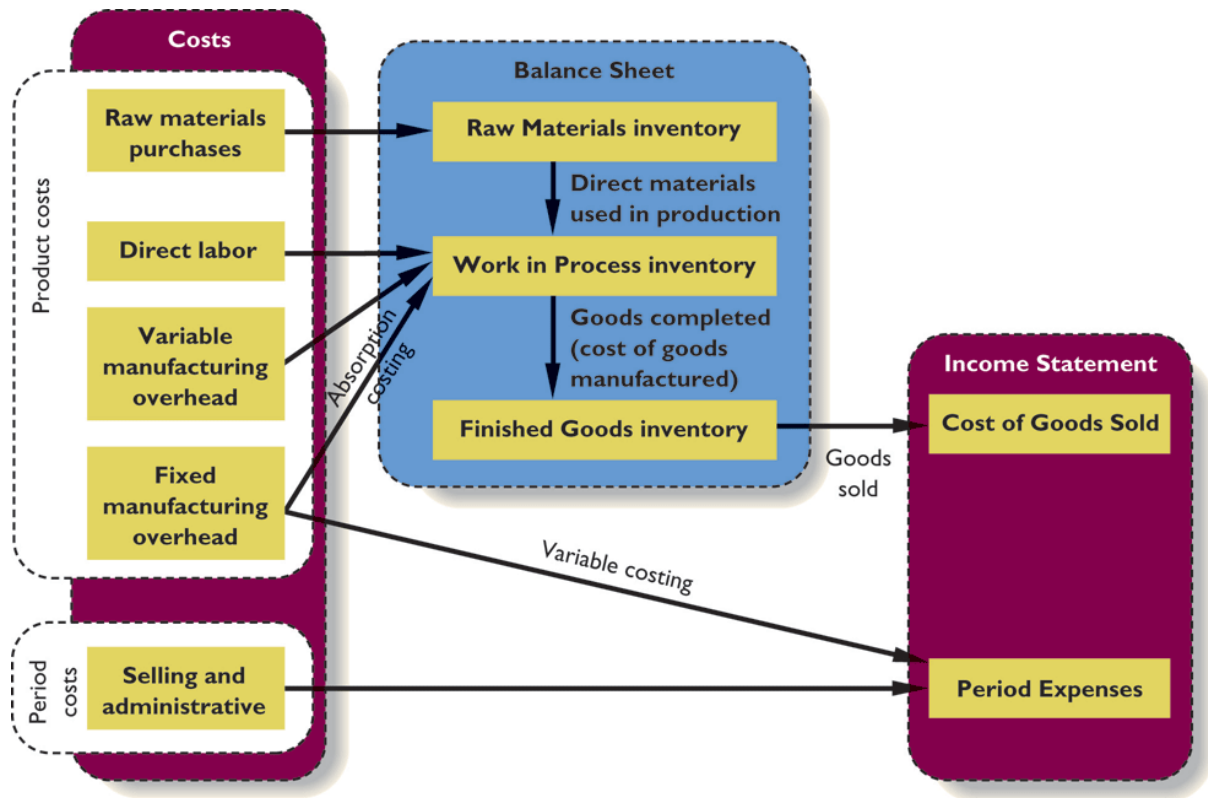
Appendix 2B: Cost of Quality.

COST CLASSIFICATIONS

<i>Purpose of classification</i>	<i>Cost classifications</i>
Preparing an income statement and balance sheet	<ul style="list-style-type: none"> • Product costs <ul style="list-style-type: none"> • Direct materials • Direct labor • Manufacturing overhead • Period costs (nonmanufacturing costs) <ul style="list-style-type: none"> • Selling costs • Administrative costs
Predicting changes in cost due to changes in activity	<ul style="list-style-type: none"> • Variable costs • Fixed costs • Mixed costs
Assigning costs	<ul style="list-style-type: none"> • Direct costs • Indirect costs
Making decisions	<ul style="list-style-type: none"> • Differential costs • Sunk costs • Opportunity costs

I. MANUFACTURING COST CLASSIFICATIONS FOR EXTERNAL REPORTING





II. COST CLASSIFICATIONS TO PREDICT COST BEHAVIOR

To predict how costs react to changes in activity, costs are often classified as variable or fixed.

VARIABLE COSTS

Variable cost behavior can be summarized as follows:

<i>Variable Cost Behavior</i>	
<i>In Total</i>	<i>Per Unit</i>
Total variable cost increases and decreases in proportion to changes in activity.	Variable cost per unit is constant.

EXAMPLE: A company manufactures microwave ovens. Each oven requires a timing device that costs \$30. The cost per unit and the total cost of the timing device at various levels of activity (i.e., number of ovens produced) would be:

<i>Cost per Timing Device</i>	<i>Number of Ovens Produced</i>	<i>Total Variable Cost—Timing Devices</i>
\$30	1	\$30
\$30	10	\$300
\$30	100	\$3,000
\$30	200	\$6,000

FIXED COSTS

Fixed cost behavior can be summarized as follows:

<i>Fixed Cost Behavior</i>	
<i>In Total</i>	<i>Per Unit</i>
Total fixed cost is not affected by changes in activity (i.e., total fixed cost remains constant even if activity changes).	Fixed cost per unit decreases as the activity level rises and increases as the activity level falls.

EXAMPLE: Assume again that a company manufactures microwave ovens. The company pays \$9,000 per month to rent its factory building. The total cost and the cost per unit of rent at various levels of activity would be:

<i>Rent Cost per Month</i>	<i>Number of Ovens Produced</i>	<i>Rent Cost per Oven</i>
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A GRAPHIC VIEW OF COST BEHAVIOR

TYPES OF FIXED COSTS

Committed fixed costs relate to investment in plant, equipment, and basic administrative structure. It is difficult to reduce these fixed costs in the short-term. Examples include:

- Equipment depreciation.
- Real estate taxes.
- Salaries of key operating personnel.

Discretionary fixed costs arise from annual decisions by management to spend in certain areas. These costs can often be reduced in the short-term. Examples include:

- Advertising; public relations.
- Research; management development programs.

RELEVANT RANGE

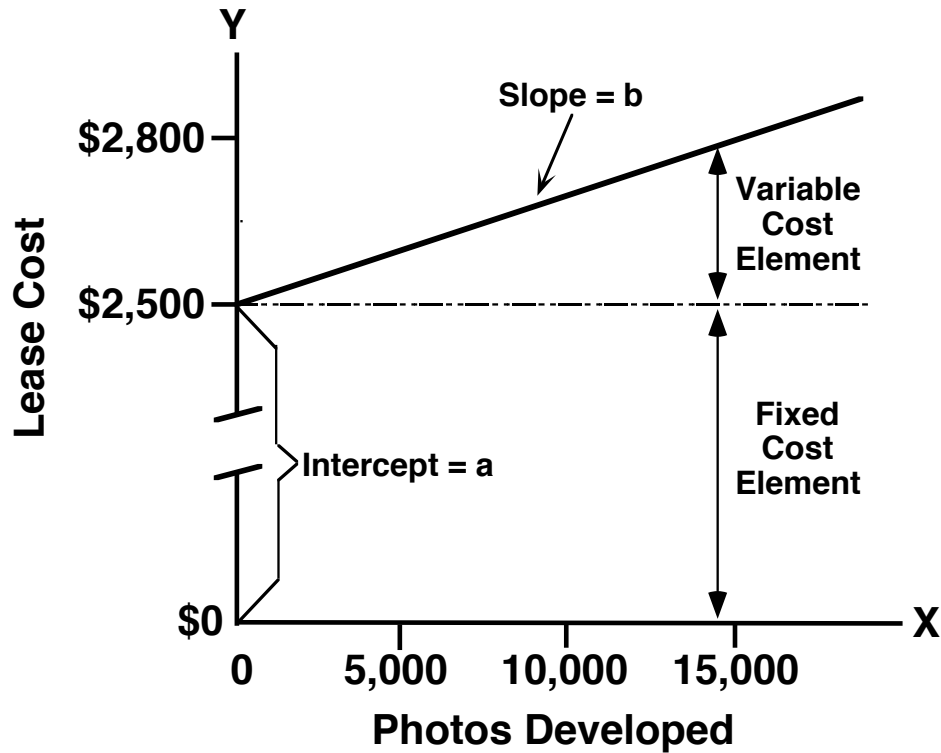
If activity changes enough, fixed costs may change. For example, if microwave production were doubled, another factory building might have to be rented.

The relevant range is the range of activity within which the assumptions that have been made about variable and fixed costs are valid. For example, the relevant range within which total fixed factory rent is \$9,000 per month might be 1 to 200 microwaves produced per month.

MIXED COSTS

A mixed (or semi-variable) cost contains elements of both variable and fixed costs.

Example: Lori Yang leases an automated photo developer for \$2,500 per year plus 2¢ per photo developed.



Equation of a straight line: $Y = a + bX$

$$Y = \$2,500 + \$0.02X$$

SCATTERGRAPH METHOD

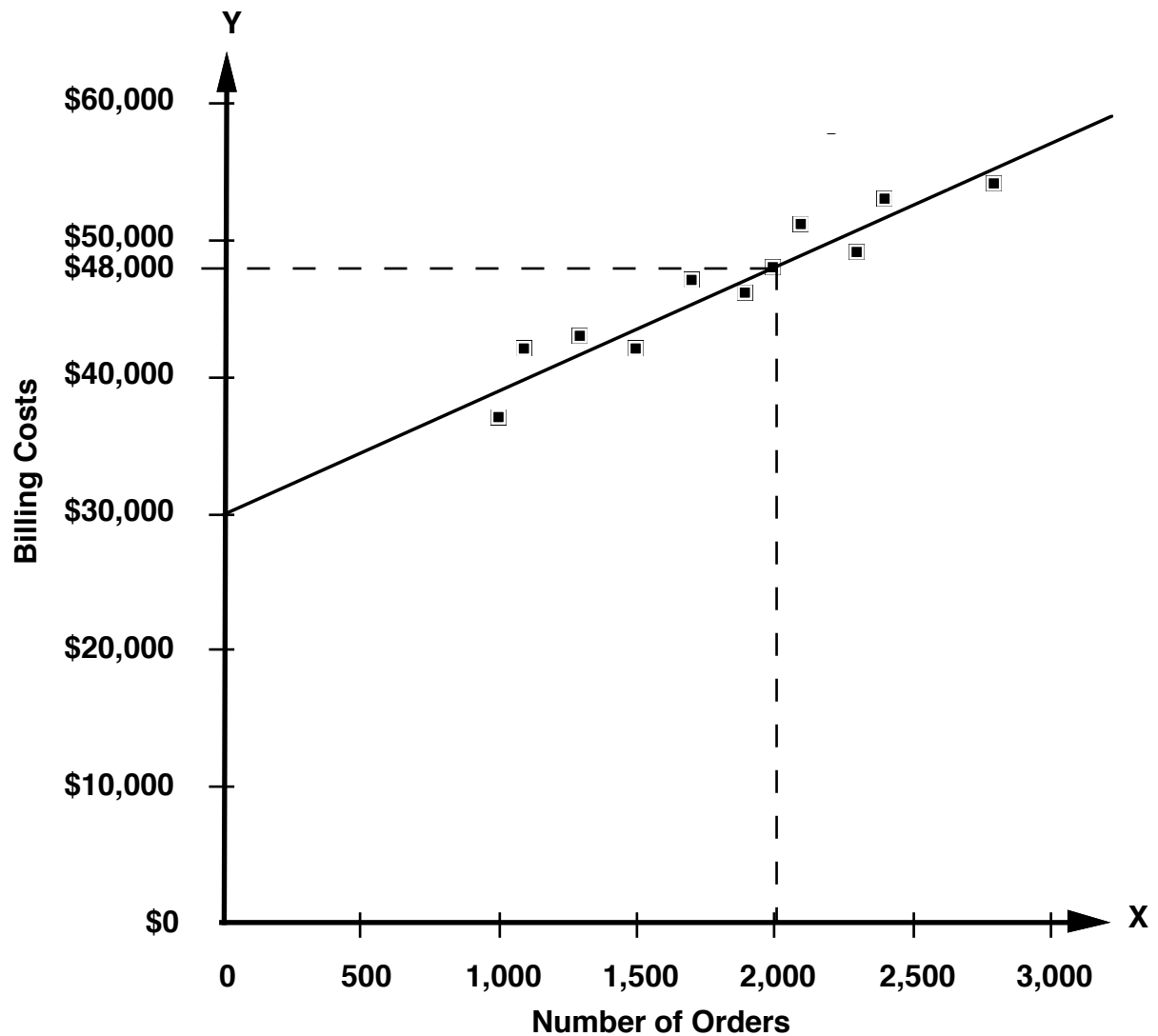
As the first step in the analysis of a mixed cost, cost and activity should be plotted on a scattergraph. This helps to quickly diagnose the nature of the relation between cost and activity.

Example: Piedmont Wholesale Florists has maintained records of the number of orders and billing costs in each quarter over the past several years.

<i>Quarter</i>	<i>Number of Orders</i>	<i>Billing Costs</i>
Year 1—1st	1,500	\$42,000
2nd	1,900	\$46,000
3rd	1,000	\$37,000
4th	1,300	\$43,000
Year 2—1st	2,800	\$54,000
2nd	1,700	\$47,000
3rd	2,100	\$51,000
4th	1,100	\$42,000
Year 3—1st	2,000	\$48,000
2nd	2,400	\$53,000
3rd	2,300	\$49,000

These data are plotted on the next page, with the activity (number of orders) on the horizontal X axis and the cost (billing costs) on the vertical Y axis.

A COMPLETED SCATTERGRAPH



The relation between the number of orders and the billing cost is approximately linear. (A straight line that seems to reflect this basic relation was drawn with a ruler on the scattergraph.)

Because a straight line seems to be a reasonable fit to the data, we can proceed to estimate the variable and fixed elements of the cost using one of the following methods.

1. High-low method.
2. Least-squares regression method.

ANALYSIS OF MIXED COSTS: HIGH-LOW METHOD

EXAMPLE: Kohlson Company has incurred the following shipping costs over the past eight months:

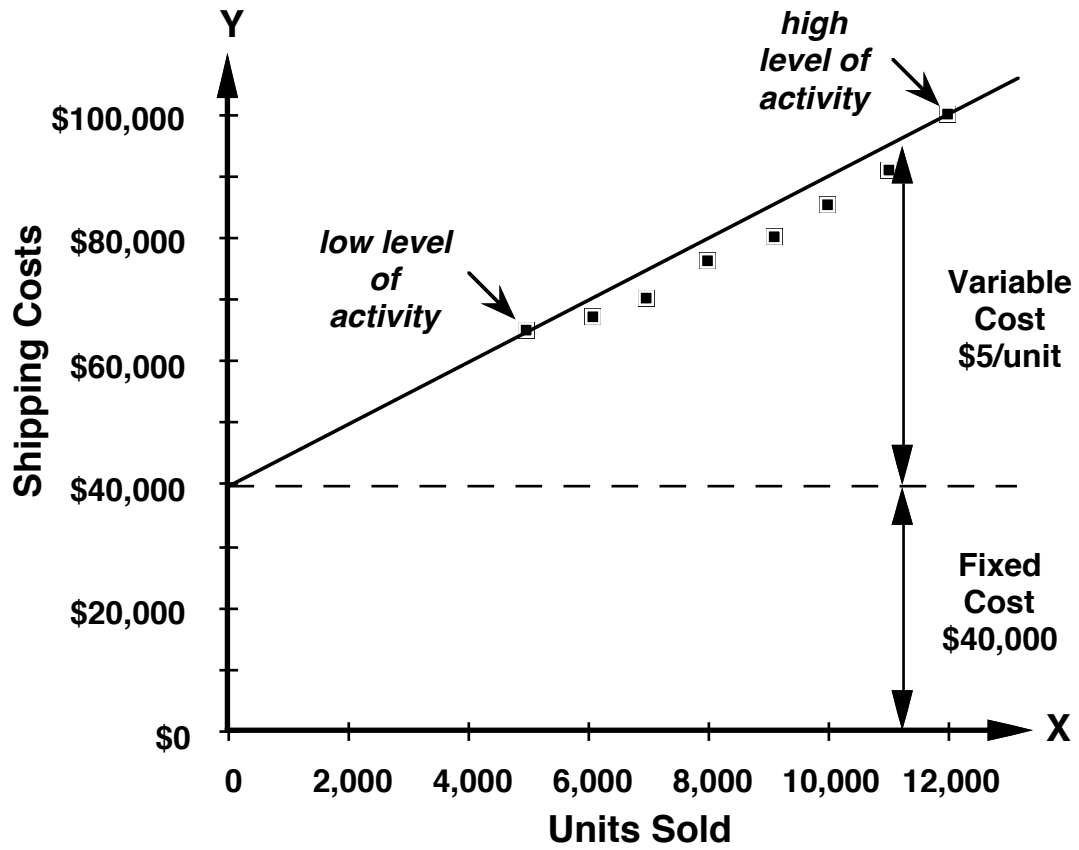
	<i>Units Sold</i>	<i>Shipping Cost</i>
January	6,000	\$66,000
February	5,000	\$65,000
March	7,000	\$70,000
April	9,000	\$80,000
May	8,000	\$76,000
June	10,000	\$85,000
July	12,000	\$100,000
August	11,000	\$87,000

With the high-low method, only the periods in which the lowest activity and the highest activity occurred are used to estimate the variable and fixed components of the mixed cost.

The cost formula for shipping cost is:

$$Y = \$40,000 + \$5X$$

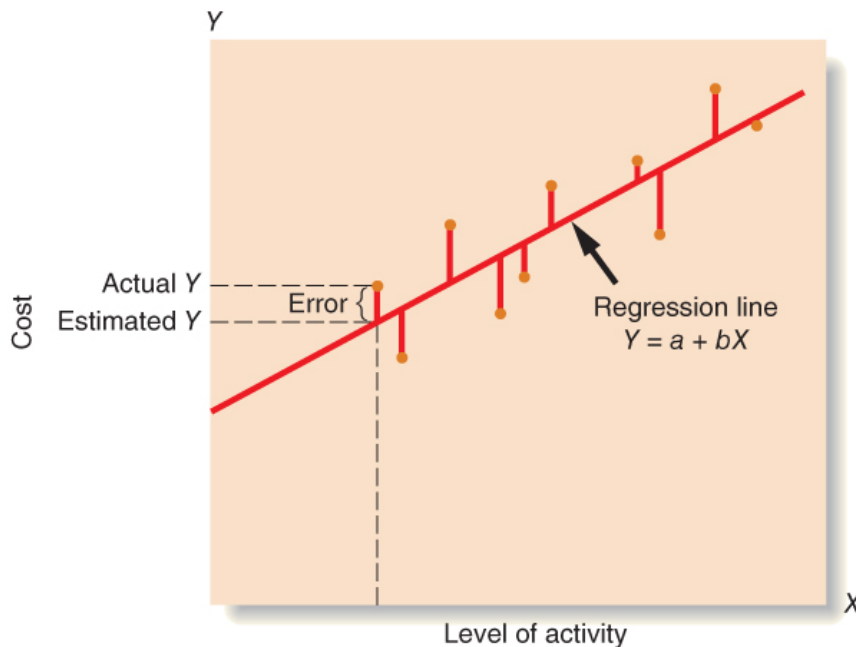
EVALUATION OF THE HIGH-LOW METHOD



The high-low method suffers from two major defects:

LEAST-SQUARES REGRESSION METHOD

The least-squares regression method for analyzing mixed costs uses mathematical formulas to determine the regression line that minimizes the sum of the squared “errors.”



TRADITIONAL VERSUS CONTRIBUTION INCOME STATEMENT

Traditional Format		Contribution Format	
Sales	\$12,000	Sales	\$12,000
Cost of goods sold*	<u>6,000</u>	Variable expenses:	
Gross margin	6,000	Cost of goods sold	\$6,000
Selling and administrative expenses:		Variable selling	600
Selling	\$3,100	Variable administrative	<u>400</u>
Administrative	<u>1,900</u>	Contribution margin	5,000
Net operating income	<u>\$ 1,000</u>	Fixed expenses:	
		Fixed selling	2,500
		Fixed administrative	<u>1,500</u>
		Net operating income	<u>\$ 1,000</u>

*For a manufacturing company, the cost of goods sold would include some variable costs, such as direct materials, direct labor, and variable overhead, and some fixed costs, such as fixed manufacturing overhead. Income statement formats for manufacturing companies will be explored in greater detail in a subsequent chapter.

III. COST CLASSIFICATIONS FOR ASSIGNING COSTS TO COST OBJECTS

COST OBJECT

A cost object is anything for which cost data are desired.

Examples of cost objects:

DIRECT COSTS

A direct cost is a cost that can be easily and conveniently traced to a particular cost object.

Examples of direct costs:

- The direct costs of a Ford SUV would include the cost of the steering wheel purchased by Ford from a supplier, the costs of direct labor workers, the costs of the tires, and so on.
- The direct costs of a hospital's radiology department would include X-ray film used in the department, the salaries of radiologists, and the costs of radiology lab equipment.

INDIRECT COSTS

An indirect cost is a cost that cannot be easily and conveniently traced to a particular cost object.

Examples of indirect costs:

- Manufacturing overhead, such as the factory managers' salary at a multi-product plant, is an indirect cost of any one product.
- General hospital administration costs are indirect costs of the radiology lab.

IV. COST CLASSIFICATIONS FOR DECISION-MAKING

DIFFERENTIAL COST

Every decision involves choosing from among at least two alternatives. Any cost that differs between alternatives is a differential cost. Only the differential costs are relevant in making a decision.

EXAMPLE: Bill is currently employed as a lifeguard, but he has been offered a job in an auto service center in the same town. When comparing the two jobs, the differential revenues and costs are:

	<i>Life- guard</i>	<i>Auto Service Center</i>	<i>Differential costs and revenues</i>
Monthly salary	\$1,200	\$1,500	
Monthly expenses:			
Commuting	30	90	
Meals	150	150	
Apartment rent	450	450	
Uniform rental	0	50	
Sunscreen	10	0	
Total monthly expenses	<u>640</u>	<u>740</u>	
Net monthly income	<u>\$ 560</u>	<u>\$ 760</u>	

OPPORTUNITY COST

An opportunity cost is the potential benefit given up when selecting one course of action over another.

EXAMPLE: Linda has a job in the campus bookstore and is paid \$65 per day. One of her friends is getting married and Linda would like to attend the wedding, but she would have to miss a day of work. If she attends the wedding, the \$65 in lost wages will be an opportunity cost of attending the wedding.

EXAMPLE: The reception for the wedding mentioned above will be held in the ballroom at the Lexington Club. The manager of the Lexington Club had to decide between accepting the booking for the wedding reception or accepting a booking for a corporate seminar. The hall could have been rented to the corporation for \$600.

SUNK COST

A sunk cost is a cost that has already been incurred and that cannot be changed by any decision made now or in the future. Sunk costs are irrelevant and should be ignored in decisions.

EXAMPLE: Linda has already purchased a ticket to a rock concert for \$35. If she goes to the wedding, she will be unable to attend the concert. The \$35 is a sunk cost that she should ignore when deciding whether or not to attend the wedding.

[However, any amount she can get by reselling the ticket is NOT a sunk cost. And while she should ignore the \$35 sunk cost, she should not ignore the enjoyment she would get if she were to attend the concert.]

APPENDIX 2A: LEAST-SQUARES REGRESSION COMPUTATIONS

Example: Montrose Hospital operates a cafeteria for employees. Management would like to know how cafeteria costs are affected by the number of meals served.

	<i>Meals Served</i> X	<i>Total Cost</i> Y
April.....	4,000	\$9,500
May.....	1,000	\$4,000
June.....	3,000	\$8,000
July.....	5,000	\$10,000
August.....	10,000	\$19,500
September.....	7,000	\$14,000

Statistical software or a spreadsheet program can do the computations required by the least-squares method. The results in this case are:

Intercept (fixed cost)	\$2,433
Slope (variable cost)	\$1.68
R ²	0.99

The fixed cost is therefore \$2,433 per month and the variable cost is \$1.68 per meal served, or:

$$Y = \$2,433 + \$1.68X,$$

where X is meals served.

R² is a measure of the goodness of fit of the regression line. In this case, it indicates that 99% of the variation in cafeteria costs is due to the number of meals served. This suggests an excellent fit.

APPENDIX 2B: QUALITY COSTS

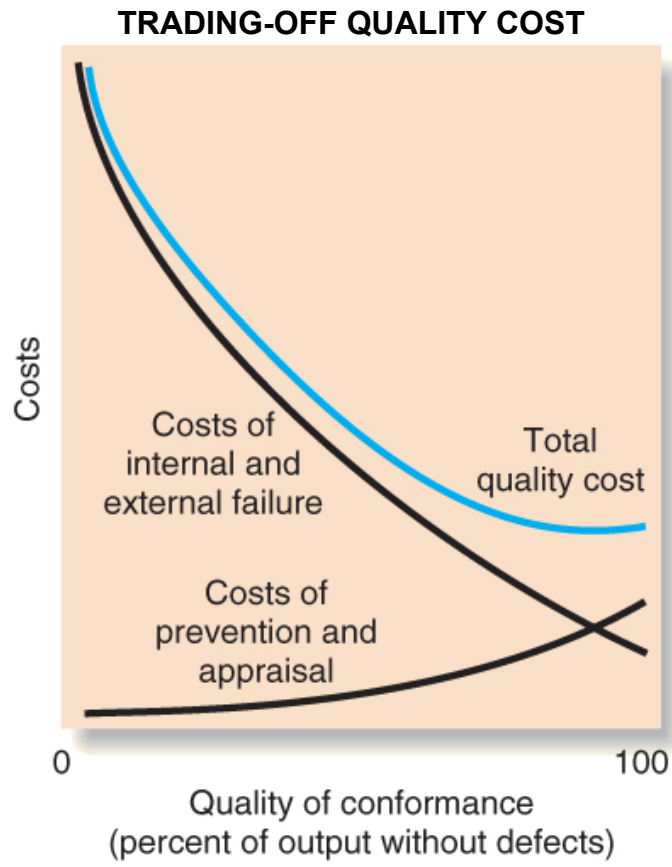
- The costs of correcting defective units *before they reach customers* are called internal failure costs. Examples:
 - Scrapped units.
 - Rework of defective units.
- Costs that are incurred by releasing defective units to customers are called external failure costs. Examples:
 - Costs of fixing products under warranty.
 - Loss of sales due to a tarnished reputation.
- The costs of internal and external failures can be avoided by:
 - Preventing defects.
 - Finding defective units before they are released.

The costs associated with these activities are called prevention costs and appraisal costs, respectively.

- Generally, prevention is the best policy. It is usually far easier and less expensive to prevent defects than to fix them.

EXAMPLES OF QUALITY COSTS

Prevention Costs	Internal Failure Costs
Systems development	Net cost of scrap
Quality engineering	Net cost of spoilage
Quality training	Rework labor and overhead
Quality circles	Reinspection of reworked products
Statistical process control activities	Retesting of reworked products
Supervision of prevention activities	Downtime caused by quality problems
Quality data gathering, analysis, and reporting	Disposal of defective products
Quality improvement projects	Analysis of the cause of defects in production
Technical support provided to suppliers	Re-entering data because of keying errors
Audits of the effectiveness of the quality system	Debugging software errors
Appraisal Costs	External Failure Costs
Test and inspection of incoming materials	Cost of field servicing and handling complaints
Test and inspection of in-process goods	Warranty repairs and replacements
Final product testing and inspection	Repairs and replacements beyond the warranty period
Supplies used in testing and inspection	Product recalls
Supervision of testing and inspection activities	Liability arising from defective products
Depreciation of test equipment	Returns and allowances arising from quality problems
Maintenance of test equipment	Lost sales arising from a reputation for poor quality
Plant utilities in the inspection area	
Field testing and appraisal at customer site	



QUALITY COST REPORTS

- Quality cost reports summarize prevention costs, appraisal costs, internal failure costs, and external failure costs that would otherwise be hidden in general overhead.
 - Managers are often surprised by how much defects cost.
 - The report helps identify where the biggest quality problems lie.
 - The report helps managers assess how resources should be distributed. If internal and external failure costs are high relative to prevention and appraisal costs, more should probably be spent on prevention and appraisal.
- Because quality cost reports are largely an attention-directing device, the costs do not have to be precise.
- Unfortunately, the cost of lost sales due to external failures is usually excluded from the reports due to measurement difficulties.

SAMPLE QUALITY COST REPORT

Ventura Company Quality Cost Report For Years 1 and 2				
	Year 1		Year 2	
	Amount	Percent*	Amount	Percent*
Prevention costs:				
Systems development	\$ 270,000	0.54%	\$ 400,000	0.80%
Quality training	130,000	0.26%	210,000	0.42%
Supervision of prevention activities	40,000	0.08%	70,000	0.14%
Quality improvement projects	210,000	0.42%	320,000	0.64%
Total prevention cost	650,000	1.30%	1,000,000	2.00%
Appraisal costs:				
Inspection	560,000	1.12%	600,000	1.20%
Reliability testing	420,000	0.84%	580,000	1.16%
Supervision of testing and inspection	80,000	0.16%	120,000	0.24%
Depreciation of test equipment	140,000	0.28%	200,000	0.40%
Total appraisal cost	1,200,000	2.40%	1,500,000	3.00%
Internal failure costs:				
Net cost of scrap	750,000	1.50%	900,000	1.80%
Rework labor and overhead	810,000	1.62%	1,430,000	2.86%
Downtime due to defects in quality	100,000	0.20%	170,000	0.34%
Disposal of defective products	340,000	0.68%	500,000	1.00%
Total internal failure cost	2,000,000	4.00%	3,000,000	6.00%
External failure costs:				
Warranty repairs	900,000	1.80%	400,000	0.80%
Warranty replacements	2,300,000	4.60%	870,000	1.74%
Allowances	630,000	1.26%	130,000	0.26%
Cost of field servicing	1,320,000	2.64%	600,000	1.20%
Total external failure cost	5,150,000	10.30%	2,000,000	4.00%
Total quality cost	\$9,000,000	18.00%	\$7,500,000	15.00%

*As a percentage of total sales. In each year sales totaled \$50,000,000.