Chapter 1

Introduction to Cost Accounting
Learning Objectives

- Explain the uses of cost accounting information.
- Describe the ethical responsibilities and certification requirements for management accountants, as well as corporate governance.
Learning Objectives (cont.)

- Describe the relationship of cost accounting to financial and management accounting.
- Identify the three basic elements of manufacturing costs.
- Illustrate basic cost accounting procedures.
- Distinguish between the two basic of cost accounting systems.
- Illustrate a job order cost system.
What is Cost Accounting?

- Cost Accounting provides the detailed information that management needs to control current operations and plan for the future.

- Management uses this information to decide how to allocate resources to the most efficient and profitable areas of the business.
Types of Businesses that use Cost Accounting

- All types of business entities-manufacturing, merchandising, and service businesses-require cost accounting information systems to track their activities.

- Manufacturers convert purchased raw materials into finished goods by using labor, technology, and facilities.
Types of Businesses that use Cost Accounting

- Merchandisers purchase finished goods for resale.
- For-profit service businesses, such as health clubs, accounting firms, and NHL hockey teams, sell services rather than products.
Types of Businesses that use Cost Accounting

- Not-for-profit service agencies, such as charities, governmental agencies, and some health care facilities, provide at little or no cost the user.
The Nature of the Manufacturing Process

• The nature of the manufacturing process requires that the accounting information systems of manufacturers be designed to accumulate detailed cost data relating to the production process.

• The manufacturing process requires the conversion of raw materials into finished goods through the use of labor and other factory resources.
The Nature of the Manufacturing Process

• Product quality is as important a competitive weapon as control in the global arena.

• ISO 9000 standards requires that manufacturers have a well-defined quality control system, and that they consistently maintain a high level of product quality.
Uses of Cost Accounting Information

- Principles of cost accounting have been developed to enable manufacturers to process the many different costs associated with manufacturing and to provide built-in control features.
Uses of Cost Accounting Information

- The information produced by a cost accounting system provides a basis for determining product costs and selling prices, and helps management to plan and control operations.
Uses of Cost Accounting Information

- Cost Accounting Information is used for:
  - Determining Product Costs and Pricing
  - Planning and Control
Professional Ethics, CMA Certification, and Corporate Governance

- IMA – Institute of Management Accountants
- CMA – Certified Management Accountant certificate
- Sarbanes-Oxley Act of 2002 – written to protect shareholders and stakeholders by improving corporate governance
Corporate governance is the means by which a company is directed and controlled.

- Key elements of Sarbanes-Oxley CEO and CFO certification of financial statements

Establishment of Public Company
Accounting Oversight Board (PCAOB)

- Prohibits a public accounting firm from providing non-auditing services to a company it audits.
- Requires that a company’s annual report contain an internal report on Professional Ethics, CMA Certification, and Corporate Governance.
Board of Directors’ responsible for hiring, compensating, and terminating the audit firm

Severe criminal penalties for the destruction or alternation of business documents and retaliation against “whistleblowers”
Relationship of Cost Accounting to Financial and Management Accounting

- Financial accounting meets the needs of investors, creditors, and other external users of financial information.
- Management accounting focuses on historical and estimated data that management needs to conduct ongoing operations and do long-range planning.
Relationship of Cost Accounting to Financial and Management Accounting

- Cost accounting includes those parts of financial and management accounting that collect and analyze cost information.
Relationship of Cost Accounting to Financial and Management Accounting

Figure 1-4  Users and Uses of Cost Accounting Information

<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Financial Accounting</th>
<th>Managerial Accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Users:</td>
<td>• External Parties (Shareholders, Creditors, Governments)</td>
<td>• Internal Parties (Managers)</td>
</tr>
<tr>
<td></td>
<td>• Managers</td>
<td></td>
</tr>
<tr>
<td>Focus:</td>
<td>Entire Business</td>
<td>Segments of the Business</td>
</tr>
<tr>
<td>Uses of Cost</td>
<td>Product Costs for Calculating Cost of Goods Sold (Income Statement) and Finished</td>
<td>• Budgeting</td>
</tr>
<tr>
<td>Information:</td>
<td>Goods, Work in Process, and Raw Materials Inventories (Balance Sheet) Using Historical</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Costs and Generally Accepted Accounting Principles</td>
<td>• Special Decisions Such as Make or Buy a Component, Keep</td>
</tr>
<tr>
<td></td>
<td></td>
<td>or Replace a Facility, and Sell a Product at a Special Price</td>
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<tr>
<td></td>
<td></td>
<td>• Nonfinancial Information Such as Defect Rates, Percentage</td>
</tr>
<tr>
<td></td>
<td></td>
<td>of Products Returned, and Percentage of On-Time Deliveries</td>
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<tr>
<td></td>
<td></td>
<td>(All of the Above Using a Combination of Historical Data,</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Estimates, and Future Projections)</td>
</tr>
</tbody>
</table>
Relationship of Cost Accounting to Financial and Management Accounting

Figure 1-5 Uses of Product Cost Data in Financial and Management Accounting

- **Financial Accounting** (for inventory costing purposes in the financial statements)
- **Cost Accounting** (product cost information)
- **Managerial Accounting** (for special reports to management for decision-making purposes)
# Relationship of Cost Accounting to Financial and Management Accounting

## Figure 1-6  Comparison of Service, Merchandising, and Manufacturing Businesses

<table>
<thead>
<tr>
<th>Business Sector</th>
<th>Examples</th>
<th>Product or Service</th>
<th>Inventory Account(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service</td>
<td>Hotels, attorneys, hair stylists, sports franchises</td>
<td>Intangible benefits such as lodging, legal defense, grooming, entertainment</td>
<td>None</td>
</tr>
<tr>
<td>Merchandising</td>
<td>Surf shops, electronics stores, sports memorabilia shops, beverage wholesalers</td>
<td>Tangible products purchased from suppliers in finished form</td>
<td>Merchandise inventory</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>Segway producers, manufacturers of electronic games, home builders</td>
<td>Physical products created by the application of labor and technology to raw materials</td>
<td>Finished Goods, Work in Process, Materials</td>
</tr>
</tbody>
</table>
Elements of Manufacturing Costs

- Manufacturing or production costs are classified into three basic elements: (1) direct materials, (2) direct labor, and (3) factory overhead.
Illustration of Accounting for Manufacturing Costs

Figure 1-11  Flow of Costs through the Ledger Accounts

- **Materials**
  - Cost of materials purchased
  - Cost of direct materials used
  - Cost of indirect materials used
- **Work in Process**
  - Cost of direct materials
  - Cost of indirect materials
  - Factory overhead
  - Cost of goods finished
- **Payroll**
  - Gross wages
  - Cost of direct labor
  - Cost of indirect labor
- **Finished Goods**
  - Cost of goods finished
  - Cost of finished goods sold
- **Factory Overhead**
  - Cost of indirect materials
  - Cost of indirect labor
  - Other indirect factory expenses
  - Transferred to Work in Process
- **Cost of Goods Sold**
  - Cost of finished goods sold
Cost Accounting Systems

• To provide management with data needed for effective cost control, two basic types of cost accounting systems have been developed:
  - Process Cost System
  - Job order Cost System

• Both systems are used to gather cost data and to allocate costs to goods manufactured.
Cost Accounting Systems

- In a job order cost system the output consists of special or custom-made products.
- The focus is on determining the cost of the individual specific job.
A process cost system accumulates costs for each department or process in the factory.
Cost Accounting Systems

• Some companies use both a job order and a process cost system.

• A standard cost system, which is not a third system can be used with either a job order of a process cost system, uses predetermined standard costs to furnish a measurement that helps management make decisions regarding efficiency of operations.
Illustration of a Job Order Cost System

- With a job order cost system, costs are accumulated by job.