



# AAT

## Elements of Costing

### Pocket Notes

These Pocket Notes support study for the following AAT qualifications:

AAT Foundation Certificate in Accounting – Level 2

AAT Foundation Diploma in Accounting and Business – Level 2

AAT Foundation Certificate in Bookkeeping – Level 2

AAT Foundation Award in Accounting Software – Level 2

AAT Level 2 Award in Accounting Skills to Run Your Business

AAT Foundation Certificate in Accounting at SCQF Level 5

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## Preface

These Pocket Notes contain the key things that you need to know for the exam, presented in a unique visual way that makes revision easy and effective.

Written by experienced lecturers and authors, these Pocket Notes break down content into manageable chunks to maximise your concentration.

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The background features several thick, overlapping, curved lines in a light pink color that sweep across the page from the bottom left towards the top right. The lines vary in opacity, creating a layered effect.

## **A guide to the assessment**

### The assessment

The assessment will be in a single section.

Expect to see 10 independent tasks, several broken down into more than one requirement.

Learners will be assessed by computer based assessment (CBA) and will be required to demonstrate competence across the entire assessment.

The time allowed for this assessment is **90 minutes**.

### Learning outcomes & weighting

1. Understanding the cost recording system within an organisation	20%
2. Use cost recording techniques	60%
3. Provide information on actual and budgeted costs and income	20%
Total	100%

**Pass mark**

The pass mark for the unit assessment is 70%

chapter

# 1

## Cost classification

- Financial accounting and management accounting.
- The aims of management accounting.
- Cost accounting.
- Terminology – cost units and cost centres.
- Cost classification:
  - overview.
  - by function.
  - by element.
  - by relationship to cost units.
  - by behaviour.
- The Hi-Low Method.



## Financial Accounting and Management Accounting

Characteristic	Financial Accounting	Management Accounting
Looks mainly at historical information.	✓	
Can include future forecasts and budgets.		✓
Formats dictated by accounting rules.	✓	
Content can include anything useful.		✓
Produced for shareholders and other external users.	✓	
Produced to help managers run the business.		✓
Produced in full once a year (and in some cases every 6 months).	✓	
Typically produced on a monthly basis.		✓

## The aims of management accounting

### Aims of management information

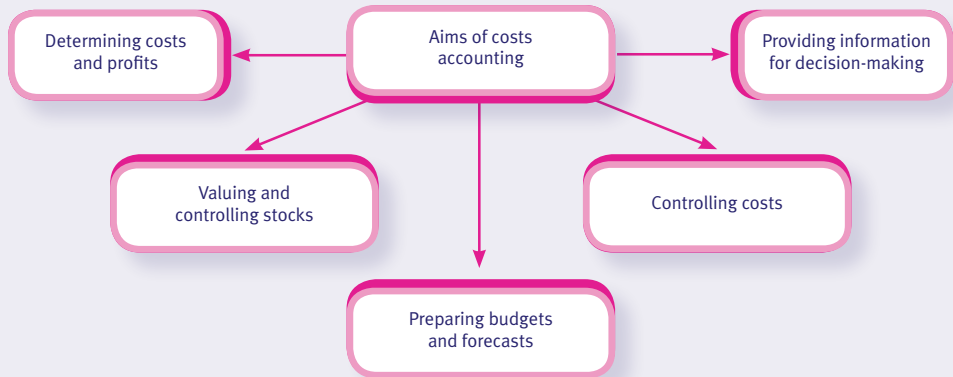


## Cost accounting

### Definition

Cost accounting is the process of calculating and recording the costs involved in the production and distribution of products and services.

Main reason for carrying out cost accounting: to calculate the cost of a product and therefore set the sales price of the item.



## Terminology – cost units and cost centres

Cost centre

= area of business for which costs will be separately ascertained.

Profit centre

= area of business for which costs and revenues are ascertained.

Investment centre

= area of business where costs, revenues and net assets are ascertained.

e.g.

### Example

#### Cost centres

##### Manufacturing organisation

Production cost centres

Service cost centres

Assembly line

Stores

Finishing

Maintenance

Packaging

Quality control

## Cost classification – overview

Purpose	Classification
Financial accounts	By function <ul style="list-style-type: none"><li>• cost of sales</li><li>• distribution costs</li><li>• admin expenses</li><li>• finance costs.</li></ul>
Cost control	By element <ul style="list-style-type: none"><li>• materials</li><li>• labour</li><li>• overheads.</li></ul>
Cost accounts	By relationship to cost units <ul style="list-style-type: none"><li>• direct</li><li>• indirect.</li></ul>
Budgeting, decision making	By behaviour <ul style="list-style-type: none"><li>• fixed</li><li>• variable</li><li>• semi-variable</li><li>• stepped.</li></ul>



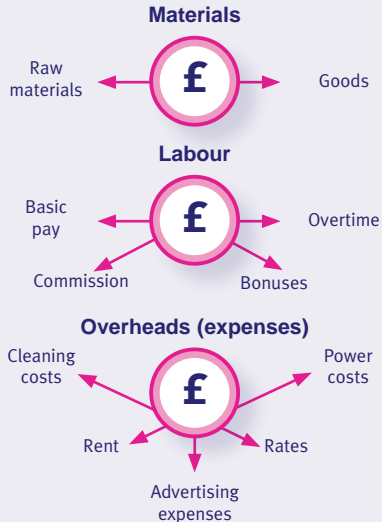
### CBA focus

Make sure you understand the different types of cost classification as this is a very common exam requirement.

## Cost classification – by function

Cost	Production = cost of sales	Distrib'n	Admin	Finance
Production labour	✓			
Production materials	✓			
Production supervisor salaries	✓			
Factory rent	✓			
Selling and distribution costs		✓		
Sales team commission		✓		
Delivery costs		✓		
Head office costs			✓	
IT support			✓	
HR support			✓	
Bank interest and charges				✓

## Cost classification – by element



## Cost classification – by relationship to cost units

- A **direct** cost is an item of cost that is traceable directly to a cost unit.

For example, the cost of a bought-in lights for a car manufacturer.

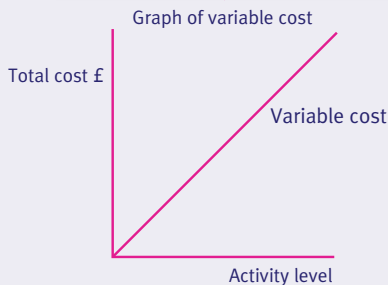
The total of all direct costs is known as the 'prime cost' per unit.

- An **indirect** cost is a cost that either cannot be identified with any one finished unit. Such costs are also often referred to as 'overheads'.

For example, the rent on a factory.

## Cost classification – by behaviour

A **variable cost** increases as the level of activity increases.

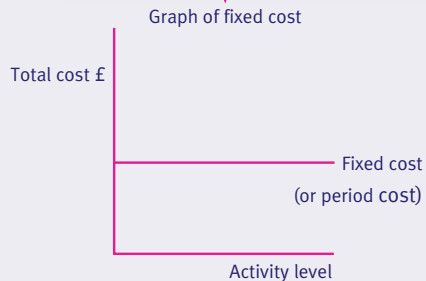


### Examples of variable costs:

Direct materials

Direct labour

A **fixed cost** does not increase as the level of activity increases.



### Examples of fixed costs:

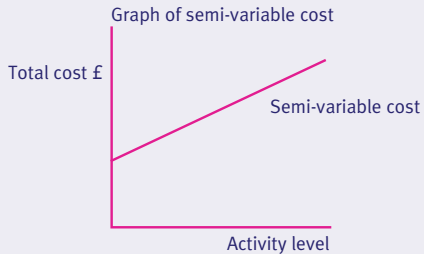
Business rates

Management salaries



## Cost classification

A **semi-variable cost** is one that contains both fixed and variable elements.



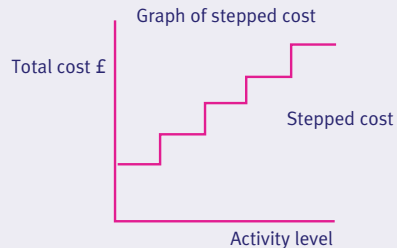
Semi-variable costs are also known as **semi-fixed costs** or **mixed costs**.

**Examples of semi-variable costs:**

Electricity costs – standing charge (fixed cost)  
– cost per unit used (variable cost)

Salesman's salary – basic (fixed) + bonus (variable)

A **stepped cost** is one that remains fixed over a certain range of activity, but increases if activity increases beyond that level.



**Examples of stepped costs:**

Inventory storage costs

Supervisor salaries

## The Hi-Low method

A method adopted to identify variable costs and fixed costs when only total costs are given.

### The process:

**Step 1:** Consider all activity levels given, and identify highest and lowest (in terms of numbers of units)

**Step 2:** Calculate difference for these two levels in terms of numbers of units and total costs

**Step 3:** Calculate variable cost per unit: difference in total costs ÷ difference in total units

**Step 4:** Calculate fixed costs. This is done by taking either the high level of units or the lower (doesn't matter which) and working out total variable costs for that level – number of units x figure calculated in step 3. Then deduct total variable costs from total costs to find fixed costs.

e.g

Example

A company reports the following results for 3 months:

Month	Units	Total costs (£)
January	700	4,400
February	850	4,700
March	950	4,900

**Step 1:** Highest number of units is 950 in March, lowest is 700 in January

**Step 2:** Difference in total units is  $(950 - 700) = 250$ . Difference in total costs is  $(£4,900 - £4,400) = £500$

**Step 3:** Variable cost per unit is  $£500 \div 250 \text{ units} = £2/\text{unit}$

**Step 4:** For 700 units, total variable costs =  $700 \times £2 = £1,400$ . Therefore fixed costs =  $£4,400 - £1,400 = £3,000$

If we now want to work out total costs for an output of 1,100 units, it will be:

Variable costs $(1,100 \times £2)$	£2,200
Fixed costs	£3,000
<b>Total costs</b>	<b>£5,200</b>