

CIMA

Subject P1

Management Accounting

Study Text



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# Introduction

## How to use the Materials

These official CIMA learning materials have been carefully designed to make your learning experience as easy as possible and to give you the best chances of success in your objective tests.

The product range contains a number of features to help you in the study process. They include:

- a detailed explanation of all syllabus areas
- extensive 'practical' materials
- generous question practice, together with full solutions.

This Study Text has been designed with the needs of home study and distance learning candidates in mind. Such students require very full coverage of the syllabus topics, and also the facility to undertake extensive question practice. However, the Study Text is also ideal for fully taught courses.

The main body of the text is divided into a number of chapters, each of which is organised on the following pattern:

- **Detailed learning outcomes.** These describe the knowledge expected after your studies of the chapter are complete. You should assimilate these before beginning detailed work on the chapter, so that you can appreciate where your studies are leading.
- **Step-by-step topic coverage.** This is the heart of each chapter, containing detailed explanatory text supported where appropriate by worked examples and exercises. You should work carefully through this section, ensuring that you understand the material being explained and can tackle the examples and exercises successfully. Remember that in many cases knowledge is cumulative: if you fail to digest earlier material thoroughly, you may struggle to understand later chapters.
- **Activities.** Some chapters are illustrated by more practical elements, such as comments and questions designed to stimulate discussion.
- **Question practice.** The text contains three styles of question:
  - Exam-style objective test questions (OTQs).
  - 'Integration' questions – these test your ability to understand topics within a wider context. This is particularly important with calculations where OTQs may focus on just one element but an integration question tackles the full calculation, just as you would be expected to do in the workplace.

- ‘Case’ style questions – these test your ability to analyse and discuss issues in greater depth, particularly focusing on scenarios that are less clear cut than in the objective tests, and thus provide excellent practice for developing the skills needed for success in the Management Level Case Study Examination.
- **Solutions.** Avoid the temptation merely to ‘audit’ the solutions provided. It is an illusion to think that this provides the same benefits as you would gain from a serious attempt of your own. However, if you are struggling to get started on a question you should read the introductory guidance provided at the beginning of the solution, where provided, and then make your own attempt before referring back to the full solution.

If you work conscientiously through this Official CIMA Study Text according to the guidelines above you will be giving yourself an excellent chance of success in your objective tests. Good luck with your studies!

Quality and accuracy are of the utmost importance to us so if you spot an error in any of our products, please send an email to [mykaplanreporting@kaplan.com](mailto:mykaplanreporting@kaplan.com) with full details, or follow the link to the feedback form in MyKaplan.

Our Quality Co-ordinator will work with our technical team to verify the error and take action to ensure it is corrected in future editions.

### Icon explanations



**Definition** – These sections explain important areas of knowledge which must be understood and reproduced in an assessment environment.



**Key point** – Identifies topics which are key to success and are often examined.



**Supplementary reading** – These sections will help to provide a deeper understanding of core areas. The supplementary reading is **NOT** optional reading. It is vital to provide you with the breadth of knowledge you will need to address the wide range of topics within your syllabus that could feature in an assessment question. **Reference to this text is vital when self-studying.**



**Test your understanding** – Following key points and definitions are exercises which give the opportunity to assess the understanding of these core areas.



**Illustration** – To help develop an understanding of particular topics. The illustrative examples are useful in preparing for the Test your understanding exercises.



**Exclamation mark** – This symbol signifies a topic which can be more difficult to understand. When reviewing these areas, care should be taken.



**New** – Identifies topics that are brand new in subjects that build on, and therefore also contain, learning covered in earlier subjects.



**Tutorial note** – Included to explain some of the technical points in more detail.

## Study technique

Passing exams is partly a matter of intellectual ability, but however accomplished you are in that respect you can improve your chances significantly by the use of appropriate study and revision techniques. In this section we briefly outline some tips for effective study during the earlier stages of your approach to the objective tests. We also mention some techniques that you will find useful at the revision stage.

### Planning

To begin with, formal planning is essential to get the best return from the time you spend studying. Estimate how much time in total you are going to need for each subject you are studying. Remember that you need to allow time for revision as well as for initial study of the material.

With your study material before you, decide which chapters you are going to study in each week, and which weeks you will devote to revision and final question practice.

Prepare a written schedule summarising the above and stick to it!

It is essential to know your syllabus. As your studies progress you will become more familiar with how long it takes to cover topics in sufficient depth. Your timetable may need to be adapted to allocate enough time for the whole syllabus.

Students are advised to refer to the examination blueprints (see page P.13 for further information) and the CIMA website, [www.cimaglobal.com](http://www.cimaglobal.com), to ensure they are up-to-date.

The amount of space allocated to a topic in the Study Text is not a very good guide as to how long it will take you. The syllabus weighting is the better guide as to how long you should spend on a syllabus topic.

## Tips for effective studying

- (1) Aim to find a quiet and undisturbed location for your study, and plan as far as possible to use the same period of time each day. Getting into a routine helps to avoid wasting time. Make sure that you have all the materials you need before you begin so as to minimise interruptions.
- (2) Store all your materials in one place, so that you do not waste time searching for items every time you want to begin studying. If you have to pack everything away after each study period, keep your study materials in a box, or even a suitcase, which will not be disturbed until the next time.
- (3) Limit distractions. To make the most effective use of your study periods you should be able to apply total concentration, so turn off all entertainment equipment, set your phones to message mode, and put up your 'do not disturb' sign.
- (4) Your timetable will tell you which topic to study. However, before diving in and becoming engrossed in the finer points, make sure you have an overall picture of all the areas that need to be covered by the end of that session. After an hour, allow yourself a short break and move away from your Study Text. With experience, you will learn to assess the pace you need to work at. Each study session should focus on component learning outcomes – the basis for all questions.
- (5) Work carefully through a chapter, making notes as you go. When you have covered a suitable amount of material, vary the pattern by attempting a practice question. When you have finished your attempt, make notes of any mistakes you made, or any areas that you failed to cover or covered more briefly. Be aware that all component learning outcomes will be tested in each examination.
- (6) Make notes as you study, and discover the techniques that work best for you. Your notes may be in the form of lists, bullet points, diagrams, summaries, 'mind maps', or the written word, but remember that you will need to refer back to them at a later date, so they must be intelligible. If you are on a taught course, make sure you highlight any issues you would like to follow up with your lecturer.
- (7) Organise your notes. Make sure that all your notes, calculations etc. can be effectively filed and easily retrieved later.



## Progression

There are two elements of progression that we can measure: how quickly students move through individual topics within a subject; and how quickly they move from one course to the next. We know that there is an optimum for both, but it can vary from subject to subject and from student to student. However, using data and our experience of student performance over many years, we can make some generalisations.

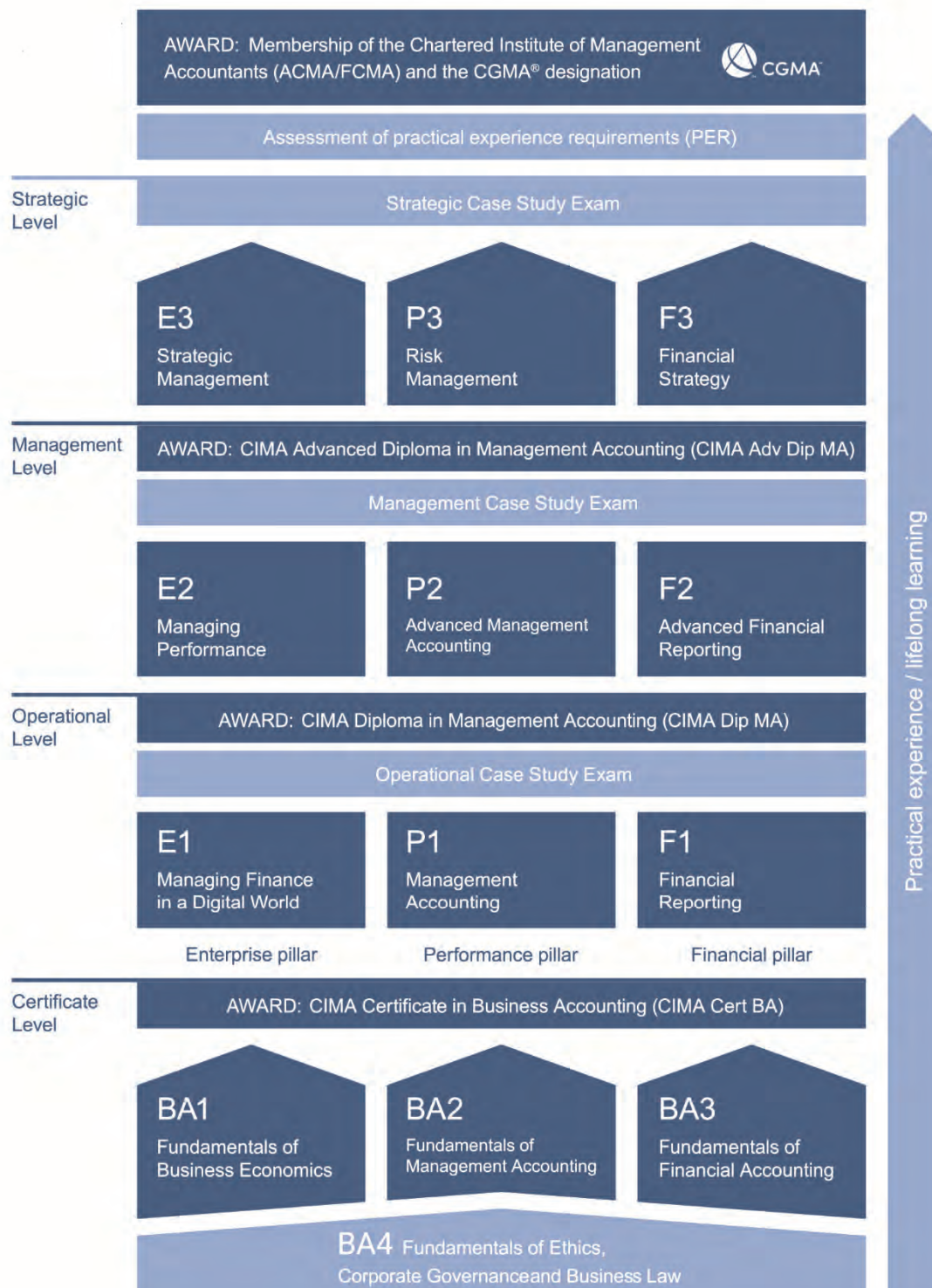
A fixed period of study set out at the start of a course with key milestones is important. This can be within a subject, for example 'I will finish this topic by 30 June', or for overall achievement, such as 'I want to be qualified by the end of next year'.

Your qualification is cumulative, as earlier papers provide a foundation for your subsequent studies, so do not allow there to be too big a gap between one subject and another. For example, P1 *Management accounting* builds on your knowledge of costing and decision making from BA2 *Fundamentals of management accounting* and lays the foundations for P2 *Advanced Management accounting* and all strategic papers.

We know that exams encourage techniques that lead to some degree of short term retention, the result being that you will simply forget much of what you have already learned unless it is refreshed (look up Ebbinghaus Forgetting Curve for more details on this). This makes it more difficult as you move from one subject to another: not only will you have to learn the new subject, you will also have to relearn all the underpinning knowledge as well. This is very inefficient and slows down your overall progression which makes it more likely you may not succeed at all.

In addition, delaying your studies slows your path to qualification which can have negative impacts on your career, postponing the opportunity to apply for higher level positions and therefore higher pay.

You can use the following diagram showing the whole structure of your qualification to help you keep track of your progress. Make sure you carefully review the 2019 CIMA syllabus transition rules and seek appropriate advice if you are unsure about your progression through the qualification.



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## Objective test

Objective test questions require you to choose or provide a response to a question whose correct answer is predetermined.

The most common types of objective test question you will see are:

- Multiple choice, where you have to choose the correct answer(s) from a list of possible answers. This could either be numbers or text.
- Multiple choice with more choices and answers, for example, choosing two correct answers from a list of eight possible answers. This could either be numbers or text.
- Single numeric entry, where you give your numeric answer, for example, profit is \$10,000.
- Multiple entry, where you give several numeric answers.
- True/false questions, where you state whether a statement is true or false.
- Matching pairs of text, for example, matching a technical term with the correct definition.
- Other types could be matching text with graphs and labelling graphs/diagrams.

In every chapter of this Study Text we have introduced these types of questions, but obviously we have had to label answers A, B, C etc. rather than using click boxes. For convenience, we have retained quite a few questions where an initial scenario leads to a number of sub-questions. There will be no questions of this type in the objective tests.

### Guidance re CIMA on-screen calculator

As part of the CIMA objective test software, candidates are now provided with a calculator. This calculator is on-screen and is available for the duration of the assessment. The calculator is available in each of the objective tests and is accessed by clicking the calculator button in the top left hand corner of the screen at any time during the assessment. Candidates are permitted to utilise personal calculators as long as they are an approved CIMA model. Authorised CIMA models are listed here: <https://www.cimaglobal.com/Studying/study-and-resources/>.

All candidates must complete a 15-minute exam tutorial before the assessment begins and will have the opportunity to familiarise themselves with the calculator and practise using it. The exam tutorial is also available online via the CIMA website.

Candidates may practise using the calculator by accessing the online exam tutorial.

### Fundamentals of objective tests

The objective tests are 90-minute assessments comprising 60 compulsory questions, with one or more parts. There will be no choice and all questions should be attempted. All elements of a question must be answered correctly for the question to be marked correctly. All questions are equally weighted.

## CIMA syllabus 2019 – Structure of subjects and learning outcomes

Details regarding the content of the new CIMA syllabus can be located within the CIMA 2019 professional syllabus document.

Each subject within the syllabus is divided into a number of broad syllabus topics. The topics contain one or more lead learning outcomes, related component learning outcomes and indicative knowledge content.

A learning outcome has two main purposes:

- (a) To define the skill or ability that a well prepared candidate should be able to exhibit in the examination.
- (b) To demonstrate the approach likely to be taken in examination questions.

The learning outcomes are part of a hierarchy of learning objectives. The verbs used at the beginning of each learning outcome relate to a specific learning objective, e.g.

**Calculate** the break-even point, profit target, margin of safety and profit/volume ratio for a single product or service.

The verb '**calculate**' indicates a level three learning objective. The following tables list the verbs that appear in the syllabus learning outcomes and examination questions.

## The examination blueprints and representative task statements

CIMA have also published examination blueprints giving learners clear expectations regarding what is expected of them.

The blueprint is structured as follows:

- Exam content sections (reflecting the syllabus document)
- Lead and component outcomes (reflecting the syllabus document)
- Representative task statements.

A representative task statement is a plain English description of what a CIMA finance professional should know and be able to do.

The content and skill level determine the language and verbs used in the representative task.

CIMA will test up to the level of the task statement in the objective tests (an objective test question on a particular topic could be set at a lower level than the task statement in the blueprint).

The format of the objective test blueprints follows that of the published syllabus for the 2019 CIMA Professional Qualification.

Weightings for content sections are also included in the individual subject blueprints.

## CIMA VERB HIERARCHY

CIMA place great importance on the definition of verbs in structuring objective tests. It is therefore crucial that you understand the verbs in order to appreciate the depth and breadth of a topic and the level of skill required. The objective tests will focus on levels one, two and three of the CIMA hierarchy of verbs. However, they will also test levels four and five, especially at the management and strategic levels.

Skill level	Verbs used	Definition
<b>Level 5 Evaluation</b> How you are expected to use your learning to evaluate, make decisions or recommendations	Advise Assess Evaluate Recommend Review	Counsel, inform or notify Evaluate or estimate the nature, ability or quality of Appraise or assess the value of Propose a course of action Assess and evaluate in order, to change if necessary
<b>Level 4 Analysis</b> How you are expected to analyse the detail of what you have learned	Align Analyse Communicate Compare and contrast Develop Discuss Examine Interpret Monitor Prioritise Produce	Arrange in an orderly way Examine in detail the structure of Share or exchange information Show the similarities and/or differences between Grow and expand a concept Examine in detail by argument Inspect thoroughly Translate into intelligible or familiar terms Observe and check the progress of Place in order of priority or sequence for action Create or bring into existence
<b>Level 3 Application</b> How you are expected to apply your knowledge	Apply Calculate Conduct Demonstrate Prepare Reconcile	Put to practical use Ascertain or reckon mathematically Organise and carry out Prove with certainty or exhibit by practical means Make or get ready for use Make or prove consistent/compatible

Skill level	Verbs used	Definition
<b>Level 2 Comprehension</b> What you are expected to understand	Describe Distinguish Explain Identify Illustrate	Communicate the key features of Highlight the differences between Make clear or intelligible/state the meaning or purpose of Recognise, establish or select after consideration Use an example to describe or explain something
<b>Level 1 Knowledge</b> What you are expected to know	List State Define Outline	Make a list of Express, fully or clearly, the details/facts of Give the exact meaning of Give a summary of

Information concerning formulae and tables will be provided via the CIMA website, [www.cimaglobal.com](http://www.cimaglobal.com).

# SYLLABUS GRIDS

## P1: Management Accounting

What the finance function does

### Content weighting

Content area		Weighting
A	Cost accounting for decision and control	30%
B	Budgeting and budgetary control	25%
C	Short-term commercial decision-making	30%
D	Risk and uncertainty in the short term	15%
		<b>100%</b>

## P1A: Cost accounting for decision and control

This section is about understanding why costing is done and what it is used for. It introduces candidates to the basic building blocks of costing and how to apply them in the costing methods and techniques organisations use. In a fast-changing digital world this understanding is critical and can enable candidates to develop their own ways of calculating costs when existing methods are no longer appropriate. Digital costing is introduced in this section.

Lead outcome	Component outcome	Topics to be covered	Explanatory notes
1. Distinguish between the different rationales for costing.	a. Define costing b. Distinguish between the rationales for costing	<ul style="list-style-type: none"> <li>• Inventory valuation</li> <li>• Profit reporting</li> <li>• Cost management and transformation</li> <li>• Decision-making</li> </ul>	This seeks to address the following pertinent questions: What are reasons for calculating costs? What types of costs are appropriate for a particular purpose and why?
2. Apply the main costing concepts to organisations and cost objects.	a. Explain the main costing concepts b. Apply costing concepts to different organisations and cost objects	<ul style="list-style-type: none"> <li>• Cost elements</li> <li>• Costs structure</li> <li>• Cost behaviour</li> <li>• Cost drivers</li> <li>• Costing applied to different types of organisations</li> <li>• Costing applied to digital cost objects</li> </ul>	Examine the basic building blocks of costing and how they apply to different types of organisations and operating contexts (e.g., manufacturing and service sectors). How has the digital world affected the nature of these building blocks of costing?
3. Apply costing methods to determine the costs for different purposes.	Apply the following: a. Cost accumulation, allocation, apportionment and absorption b. Standard costing c. Variance analysis (without mix and yield variance) d. Activity based costing e. Digital costing	<ul style="list-style-type: none"> <li>• Trace, classify and allocate costs</li> <li>• Marginal costing</li> <li>• Absorption costing</li> <li>• Price and rate variances</li> <li>• Usage and efficiency variances</li> <li>• Interpretation of variances</li> <li>• Product and service costing using ABC</li> <li>• Advantages of ABC over other costing systems</li> <li>• Features of digital costing</li> </ul>	Investigate how costs are traced, classified, accumulated, allocated, apportioned and absorbed to arrive at the costs of a product, service or other cost object. Calculate the costs of products or services using various costing methods. Determine which costing methods are appropriate and why?



## P1B: Budgeting and budgetary control

Taken together, budgeting and budgetary control is one way the finance function enables and shapes how organisations create and preserve value. This section examines the various reasons organisations prepare and use budgets, how the budgets are prepared, the types and sources of data, the technologies used to improve the quality of budgets, how budgets are implemented and the impact on the people who work with the organisation.

Lead outcome	Component outcome	Topics to be covered	Explanatory notes
1. Distinguish between the different rationales for budgeting.	<ol style="list-style-type: none"> <li>Explain the role of budgets.</li> <li>Distinguish between the different rationales for budgeting.</li> </ol>	<ul style="list-style-type: none"> <li>Planning</li> <li>Communication</li> <li>Coordination</li> <li>Motivation</li> <li>Control</li> </ul>	Why do organisations prepare budgets? In what ways are the different rationales for preparing budgets compatible with each other? How do organisations get the most out of the budgeting process?
2. Prepare budgets.	<ol style="list-style-type: none"> <li>Explain forecasting and its relationship with budgeting.</li> <li>Prepare master budgets.</li> <li>Conduct what-if analysis in budgeting.</li> <li>Describe the technologies available for improving budgeting.</li> </ol>	<ul style="list-style-type: none"> <li>Time series and trend analysis to forecast sales volumes</li> <li>Components of master budgets and their interaction with each other</li> <li>Limiting factors</li> <li>Stress testing budgets</li> <li>Big data analytics and budgets</li> <li>Alternative approaches to budgeting</li> </ul>	What is the process by which budgets are prepared? What types of budgets are required by organisations? What data do they use and where do they get the data from? How are those budgets prepared and presented? What technologies are available for improving the quality of the budgets?
3. Discuss budgetary control.	<p>Discuss:</p> <ol style="list-style-type: none"> <li>The concept of budgetary control</li> <li>Human dimensions of budgeting</li> </ol>	<ul style="list-style-type: none"> <li>Feedback and feedforward control</li> <li>Flexed budgets</li> <li>Target setting and motivation</li> <li>Controllable and uncontrollable outcomes</li> <li>Dysfunctional behaviours in budgeting</li> <li>Ethical considerations in budgeting</li> </ul>	What is budgetary control? Describe and discuss how and why the budgetary control system provides feedback and feedforward to the organisation. What are the behavioural impacts of budgetary control and how are they managed?

## P1C: Short-term commercial decision-making

Organisations cannot foresee every opportunity that might arise during their operations, so they need mechanisms by which to identify and take advantage of these opportunities as they arise. The primary objective of this section is to guide candidates in how to do this in the short term through effective decision-making. The finance function supports such decisions (e.g., pricing and product choice) using techniques such as relevant revenue and cost analysis and break-even analysis. Candidates are introduced to these techniques and the concepts that underpin the techniques. They are expected to be able to apply the techniques to support short-term decision-making.

Lead outcome	Component outcome	Topics to be covered	Explanatory notes
1. Describe the main types of short-term decisions made by organisations.	a. Describe pricing and revenue maximising decisions. b. Describe product decisions.	<ul style="list-style-type: none"> <li>• Marginal and full cost recovery for pricing decisions</li> <li>• Differences in pricing and revenue maximisation for the short term and long term</li> <li>• Product mix</li> </ul>	Describe the types of short-term decisions organisations make and the circumstances that give rise to them. What do these short-term decisions seek to achieve? How important are they to performance of organisations? The emphasis is on both revenue and costs.
2. Explain the underlying concepts used for short-term decision-making.	a. Explain the objectives of decision-making. b. Explain the underlying concepts of short-term decision-making.	<ul style="list-style-type: none"> <li>• Implications of commercial decision-making in the short term</li> <li>• Relevant revenues</li> <li>• Relevant costs</li> <li>• Difference with profit reporting</li> </ul>	What are the objectives and underlying concepts that are used to guide short-term decision-making and why? Distinguish between those concepts of revenue, costs and information from other concepts.
3. Apply appropriate techniques to support short-term decisions.	Apply the following to support short-term decision-making: a. Relevant cost analysis b. Break-even analysis c. Product mix decisions with constraints d. Data and technology	<ul style="list-style-type: none"> <li>• Make or buy decisions</li> <li>• Discontinuation decisions</li> <li>• Multi-product break-even analysis</li> <li>• Use of data and technology to analyse product mix decisions</li> <li>• Ethical considerations in short-term decision-making</li> </ul>	Use data (financial and non-financial) and the appropriate concepts and techniques to support decision-making to achieve organisational objectives of value creation and preservation.

## P1D: Risk and uncertainty in the short term

Budgets and decisions focus on the future. This introduces uncertainties and risks that need to be identified, assessed and managed. The aim of this section is to help candidates identify, assess and manage the risks and uncertainties associated with the short term.

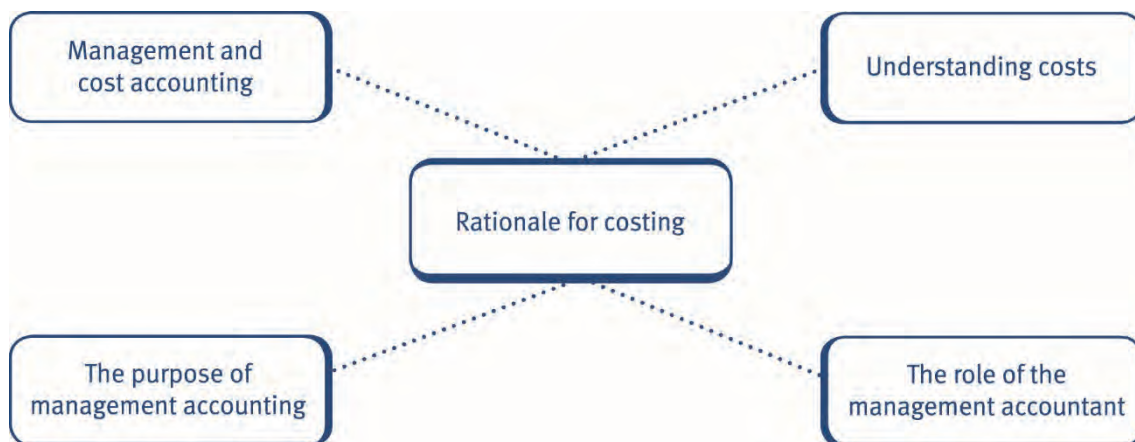
Lead outcome	Component outcome	Topics to be covered	Explanatory notes
1. Apply basic risk management tools in the short term.	<ol style="list-style-type: none"><li>a. Explain nature of risk and uncertainty in short term.</li><li>b. Apply basic sensitivity analysis to budgeting and short-term decision-making.</li></ol>	<ul style="list-style-type: none"><li>• Stress testing</li><li>• Sensitivity and what-if analysis</li><li>• Probability distributions</li><li>• Decision trees</li></ul>	What types of risks and uncertainties do organisations face when preparing and implementing budgets and when making short-term decisions? How are those risks and uncertainties identified, assessed and managed?

# Rationales for costing

## Chapter learning objectives

<b>Lead outcome</b>	<b>Component outcome</b>
A1. Distinguish between the different rationales for costing	(a) Define costing (b) Distinguish between the rationales for costing
A2. Apply the main costing concepts to organisations and cost objects	(a) Explain the main costing elements

## 1 Chapter overview diagram



In this chapter we will introduce cost and management accounting. These will be defined and their purpose explained. It will be important that you understand the reasons for calculating costs and how management accounting can play a role in the operations of a business.

For students who have studied at the CIMA Certificate level much of this chapter will be familiar to you.

## 2 Management and cost accounting

Accountancy involves the measurement, analysing and reporting of financial and non-financial information to help managers, shareholders and other interested parties make decisions about organisations.

As a student of CIMA, a major focus of your studies will be on a part of accountancy called management accounting.



The *CIMA Terminology* defines **management accounting** as 'the application of the principles of accounting and financial management to create, protect, preserve and increase value for the stakeholders of for-profit and not-for-profit enterprises in the public and private sectors.'

Cost accounting is a sub-set of management accounting. Cost accounting is focused more on calculating the costs of a product or service and extending this into potentially controlling and managing this cost. It means that the focus is often on short-term improvements and decisions.



The *CIMA Terminology* defines **cost accounting** as 'the gathering of cost information and its attachment to cost objects, the establishment of budgets, standard costs and actual costs of operations, processes, activities or products; and the analysis of variances, profitability or the social use of funds.'

Cost accounting tends to be more useful for operational and tactical decisions.



### Operational and tactical decisions

Operational decisions are decisions made mainly by low level managers which focus on day-to-day resource management. It will involve decisions such as where to employ staff, what type and how much staff to use, which machines to employ, what materials to use etc.

Tactical decisions are employed by middle-level managers and are more medium term in scope. It will involve decisions on areas such as staff training and recruitment, changing suppliers, purchasing new machines etc.

Management accounting will take a broader view of the business and take decisions that include a more strategic basis with a longer-term view.



### Strategic decisions

Strategic decisions are made by the highest level of management in an organisation. These decisions will consider areas such as whether to launch a new product, whether to expand into new markets or whether to buy other organisations.

Cost accounting mainly focuses on quantitative data such as how much a piece of material costs or how long staff should spend on providing a particular service (i.e. quantitative data is data that can be measured, often in financial terms).

Management accounting will expand this by adding qualitative data such as the impact on customer satisfaction or employee motivation. Qualitative data is much more difficult to measure and quantify.

### A comparison to financial accounting

---

Now that we are clear about the meaning of management accounting we can compare it with another branch of accounting, financial accounting, which you will study as part of your CIMA qualification.



The *CIMA Terminology* defines **financial accounting** as 'classification and recording of the monetary transactions of an entity in accordance with established concepts, principles, accounting standards and legal requirements and their presentation, by means of statements of profit or loss, statements of financial position and cash flow statements, during and at the end of an accounting period'.

Look back at the definition of management accounting and you will see that these two are very different.



**Details on the differences**

You can see from this that the role of the financial accountant is much more clearly defined and narrower than that of the management accountant. There is also a legal aspect to financial accounting. It is a legal requirement for organisations to produce financial statements which show a true and fair view of their financial position for each accounting period. There is no legal requirement to have management accounting. Financial accounting is also governed by many rules and regulations whereas there are no rules covering how the management accountant provides information. They will provide whatever is required by their managers in whatever format suits the particular organisation.

Financial accountants deal with historical (past) financial information, while management accountants deal with all types of information (financial and non-financial) both historical and future.

The main role of financial accounting is to produce the statutory financial statements, whereas management accountants provide any information needed by management.

It is important from this to see that the audiences using management and financial accounting information are different. Management accountants provide information internally to managers. The statutory financial reports produced by the financial accountants are available to the public and to anyone who has an interest in the organisation.

The differences can be summarised as follows:

<b>Financial accounting</b>	<b>Management accounting</b>
For external use	For internal use
Statutory requirement	At the discretion of management
Concerned with the production of statutory accounts for an organisation	Concerned with the provision of information to management to aid decision making
Governed by many rules and regulations	Not governed by rules or regulations, can be provided in any format



**Example 1**

Consider the following statements relating to management accounting:

- (i) The main purpose of management accounting statements is to provide a true and fair view of the financial position of an organisation at the end of an accounting period.
- (ii) Management information may be presented in any format deemed suitable by management.

**Which of the above statements is/are true?**

- A (i) and (ii)
- B (i) only
- C (ii) only
- D neither

### 3 The purpose of management accounting

While providing information for decision making is clearly key to what management accountants do, their role is usually expanded to include **three** main elements:

- **Planning**
- **Control**
- **Decision making.**

These three purposes of management accounting (planning, control and decision making) form the basis of your Management Accounting subject. Each of these areas will be looked at in detail throughout this text book.

#### Planning

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Planning involves establishing the objectives and goals of an organisation, i.e. what they are trying to achieve, and formulating relevant strategies (long-term actions to improve an organisation's position) that can be used to achieve those objectives and goals.

The management accountant will create **budgets** which explain the potential impacts of different courses of action. These budgets are financial plans of what will occur based on different assumptions.

Budgets are looked at in more detail in the budgeting chapter.

#### Control

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Control is the process of monitoring, measuring, evaluating and correcting actual results to ensure that the organisation's plans are being achieved. Information relating to the actual results of an organisation must be gathered and can be compared to the budget. The differences between the actual and the budgeted results can be calculated and reported to management. These are known as **variances**. This type of information facilitates managers to determine whether the organisation is in or out of control and take corrective action if necessary.

We will study variances in detail in later chapters.



### Decision making

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We have seen already that decision making involves considering information that has been provided and making informed decisions. In most situations, decision making involves making a choice between two or more alternatives. Managers need reliable information to compare the different courses of action available and understand what the consequences might be of choosing each of them.

Managers at different organisational levels will take different type of decisions (operational, tactical and strategic).



#### Illustration 1

XYZ is a successful pizza restaurant which currently operates a chain of four restaurants, all of which offer the same standard menu.

**Consider the following decisions which XYZ may have to make and suggest at what levels of management these decisions would be made.**

- Start producing frozen pizzas and selling these through supermarkets.
- Hire a new waiter in one of the restaurants.
- Decide on the pricing of the dishes on the standard menu.
- Open a new restaurant.

#### Solution

- Starting production and sales of frozen pizzas is a fundamental change to what the company currently do and involves entering a new market. This would therefore be a **strategic** decision.
- Hiring a new waiter would be an **operational** decision as it involves a day to day decision which should be able to be made at a lower level.
- Deciding on the pricing is likely to be a **tactical** decision. In general, the strategic decisions decide on which markets in which to operate and tactical decisions will decide on how to operate within these markets. Pricing would come under this remit.
- Opening a new restaurant is a more difficult one. In this case a decision to expand the number of restaurants would likely be a **strategic** decision. In some much larger organisations this type of decision would be made considered a tactical decision. However given that XYZ only has four restaurants, then the decision to open a fifth would likely be made by the senior managers.



### Example 2

LMN is an international clothing manufacturer specialising in producing waterproof jackets.

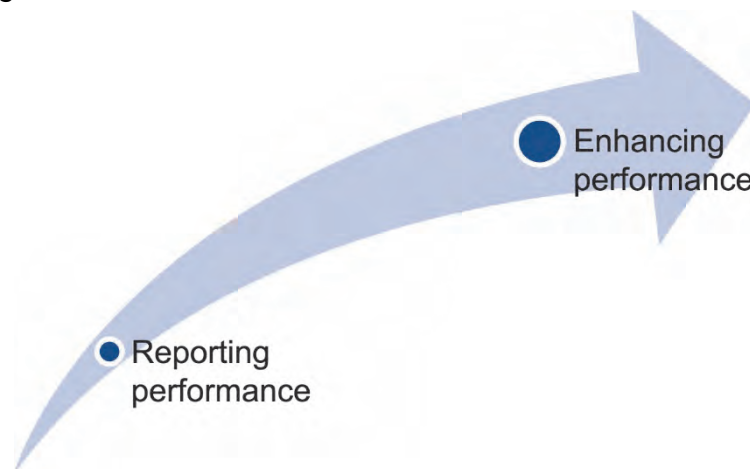
**Match the following decisions to the type of decision that is being made:**

Decision	Level
A decision to take over a rival company in order to expand its production into different markets	Strategic
A decision on the ordering of material for production	Tactical
A decision about the pricing of the products	Operational

## 4 The management accountant

At this point it is worth looking in more detail at the various roles management accountants play in organisations and how this has changed over the years.

The whole of the accountancy profession is changing, and this is especially true for the management accountant.



The traditional management accountant was largely involved in reporting business results to management, but this is no longer the case. Management accountants today are seen as **value-adding business partners** and are expected to not only forecast the future of the business, but to assist in delivering this future by identifying opportunities for enhancing organisational performance. Management accountants now work alongside business managers as mentors, advisors and drivers of performance.

Management accountants are an integral part of any business, providing a variety of information to management for the purposes of planning, control and decision making. Management accountants often hold senior positions in the organisation.



### CIMA's definition of the role of the management accountant

#### **The work of the Chartered Management Accountant (produced by CIMA):**

Chartered management accountants help organisations establish viable strategies and convert them into profit (in a commercial context) or into value for money (in a not-for-profit context). To achieve this, they work as an integral part of multi-skilled management teams in carrying out the:

- formulation of policy and setting of corporate objectives
- formulation of strategic plans derived from corporate objectives
- formulation of shorter-term operational plans
- acquisition and use of finance
- design of systems, recording of events and transactions and management of information systems
- generation, communication and interpretation of financial and operating information (such as product costs) for management and other stakeholders
- provision of specific information and analysis on which decisions (such as how many units to produce or what products to make) are based
- monitoring of outcomes against plans (such as budgets) and other benchmarks and the initiation of responsive action for performance improvement
- derivation of performance measures and benchmarks, financial and non-financial, quantitative and qualitative, for monitoring and control; and
- improvement of business systems and processes through risk management and internal audit review.

Through these forward-looking roles and by application of their expert skills management accountants help organisations improve their performance, security, growth and competitiveness in an ever more demanding environment.

We will start to look at some of these functions in the *Management Accounting* syllabus, and others will be studied in later subjects.

It can be seen from this that there is no one clear definition of the role of the management accountant. Their work, experience and responsibilities are extraordinarily varied and continue to change to reflect the changing needs of stakeholders.

## 5 The importance of understanding costs



The word '**cost**' can be used in two contexts. It can be used as a noun, for example when we are referring to the cost of an item. Alternatively, it can be used as a verb, for example we can say that we are attempting to cost an activity, when we are undertaking the tasks necessary to determine the costs of carrying out the activity.

The understanding of costs is fundamental to your accounting studies.

In financial accounting all costs must be recorded so that profit can be calculated and the true and fair financial position can be presented in the financial statements.

In management accounting an understanding of costs is required in order to carry out the three main functions of planning, control and decision making. If we understand and calculate costs, we can use this information in a number of ways such as:

- Determining the cost to manufacture a product or provide a service can be used to record costs in the financial statements.
- The cost per unit can be used to value inventory in the statement of financial position.
- Cost information can inform decisions on our products or services. Product and service costs can be used to determine the selling price we should charge for our products or services. For example, if the cost per unit is \$0.30, the business may decide to price the product at \$0.50 per unit in order to make the required profit of \$0.20 per unit.
- Knowing the profit (or, as we will see in a later chapter, the contribution of a product) can help determine the products and services we should supply and in what quantity.
- The cost can also act as a benchmark for future performance. Differences from the expected (or standard) cost can be calculated (known as variances) and evaluated.



### The cost transformation model

The CGMA cost transformation model is designed to help businesses to achieve and maintain cost competitiveness.

The model has six suggested changes for organisations aimed at achieving this objective. These changes are:

- Creating a cost conscious culture – the organisation should aim to be a cost leader so that its costs are lower than rivals and set a competitive benchmark. Everyone in the organisation should be motivated and enabled to reduce costs in whatever way possible. Technology can play a key role in reducing costs.
- Understanding cost drivers – this involves investigating costs to determine why they change and how different variables impact on the cost. Plans should be put in place to reduce the drivers of costs as well as the costs themselves.

- Managing the risks that come from a cost conscious culture – for example, reducing cost may result in reducing quality and customer satisfaction. The organisation should have a clear risk management process in place to identify, assess and manage such risks.
- Ensuring products and services are profitable – it will be important that every product or service makes a positive contribution to overall organisational profits. This will involve understanding what drives costs for each individual product and allocating shared costs to products as accurately as possible.
- Maximising value from new products – the potential profitability of new products should be assessed before production begins. Also, as part of product design, the product or service should be made to be as flexible as possible so that it appeals to or can be adapted to satisfy as many customer segments as possible.
- Consider the environmental impact of products – negative impacts (such as creating unnecessary waste) can add costs as well as damaging reputation and sales.

The model suggests a number of tools and models which can be used in order to achieve these changes. Many of these tools will be employed across your CIMA studies, some of them in this text, such as Activity Based Costing which considers cost drivers and how these can be used to allocate shared costs to products.

### Cost units, cost centres and cost objects

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Costs can be attributed to cost units, cost centres or cost objects.



The *CIMA Terminology* defines a **cost unit** as ‘a unit of product or service in relation to which costs are ascertained’.

This means that a cost unit can be **anything for which it is possible to ascertain the cost**. The cost unit selected in each situation will depend on a number of factors, including the amount of information available and the purpose for which the cost unit will be used.

A cost unit can be anything which is measurable and useful for cost control purposes. For example, a company manufacturing a mobile phone might calculate the cost per mobile phone. Or perhaps if the phones are made and sold in very large quantities the cost per 1,000 phones might be used instead.

Not all cost units will be for tangible items. Intangible items cannot be seen and touched and do not have physical substance but they can be measured, for example the cost per chargeable hour of accounting service.



A **cost centre** is a production or service location, a function, an activity or an item of equipment for which costs are accumulated.

A cost centre is one type of responsibility centre. Responsibility centres will be covered in the budgeting chapter. A cost centre is used as a ‘collecting place’ for costs.

The cost of operating the cost centre is determined for the period, and then this total cost is related to the cost units which have passed through the cost centre. An example of a production cost centre could be the machine shop in a factory. The production cost for the machine shop might be \$100,000 for the period. If 1,000 cost units have passed through this cost centre we might say that the production cost relating to the machine shop was \$100 for each unit. Other examples of a cost centre are a canteen department, a project management team or a subsidiary of a company. Costs could be collected for each of these cost centres. Every organisation will have its own cost centres for accumulating costs.



The *CIMA Terminology* contains the following for **cost objects**: 'For example a product, service, centre, activity, customer or distribution channel in relation to which costs are ascertained.'

All of the cost units and cost centres we have described in this chapter are therefore types of cost object.

### Classification of costs

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In order to calculate costs we need to understand them. A key to this is understanding different ways in which costs can be classified.

There are three main ways to classify costs:

- by behaviour
- by element
- by nature

What follows is some revision on these different types of classification

### Classification of costs according to their behaviour

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Before calculating costs we need to understand how different costs behave.

In cost accounting we typically classify costs by three types of behaviour:

- Fixed costs – costs which don't change as the activity level changes
- Variable costs – costs which change in direct proportion to changes in the activity level
- Semi-variable costs – costs which have both fixed and variable elements.



## Different cost behaviours

Many factors affect the level of costs incurred; for instance, inflation will cause costs to increase over a period of time. In management accounting, when we talk about cost behaviour we are referring to the way in which costs are affected by fluctuations in the level of activity. The level of activity can be measured in many different ways. For example, the number of units produced, miles travelled, hours worked, percentage of capacity utilised and so on.

An understanding of cost behaviour patterns is essential for many management tasks, particularly in the areas of planning, decision-making and control. It would be impossible for managers to forecast and control costs without at least a basic knowledge of the way in which costs behave in relation to the level of activity.

### Fixed cost

The CIMA Terminology defines a fixed cost as 'a cost which is incurred for an accounting period that, within certain output or turnover limits, tends to be unaffected by fluctuations in the levels of activity (output or turnover)'.

Examples of fixed costs are rent, rates, insurance and executive salaries. However, it is important to note that this is only true for the relevant range of activity. Consider, for example, the behaviour of the rent cost. Within the relevant range it is possible to expand activity without needing extra premises and therefore the rent cost remains constant. However, if activity is expanded to the critical point where further premises are required, then the rent cost will increase to a new, higher level. This cost behaviour pattern can be described as a stepped fixed cost. The cost is constant within the relevant range for each activity level but when a critical level of activity is reached, the total cost incurred increases to the next step.

This warning does not only apply to fixed costs: it is never wise to attempt to predict costs for activity levels outside the range for which cost behaviour patterns have been established.

Also, whilst the fixed cost total may stay the same within a relevant activity range, the fixed cost per unit reduces as the activity level is increased. This is because the same amount of fixed cost is being spread over an increasing number of units.



**Variable cost**

The CIMA Terminology defines a variable cost as a 'cost that varies with a measure of activity'.

Examples of variable costs are direct material, direct labour and variable overheads. In most examination situations, and very often in practice, variable costs are assumed to be linear.

Although many variable costs do approximate to a linear function, this assumption may not always be realistic. Non-linear variable costs are sometimes called curvilinear variable costs. There may be what are known as economies of scale whereby each successive unit of activity adds less to total variable cost than the previous unit. An example of a variable cost which follows this pattern could be the cost of direct material where quantity discounts are available.

On the other hand, there may be what are known as diseconomies of scale which indicates that each successive unit of activity is adding more to the total variable cost than the previous unit. An example of a variable cost which follows this pattern could be the cost of direct labour where employees are paid an accelerating bonus for achieving higher levels of output.

The important point is that managers should be aware of any assumptions that have been made in estimating cost behaviour patterns. They can then use the information which is based on these assumptions with a full awareness of its possible limitations.

**Semi-variable cost**

A semi-variable cost is also referred to as a semi-fixed, hybrid, or mixed cost. The CIMA Terminology defines it as 'a cost containing both fixed and variable components and thus partly affected by a change in the level of activity'.

Examples of semi-variable costs are gas and electricity. Both of these expenditures consist of a fixed amount payable for the period, with a further variable amount which is related to the consumption of gas or electricity.

Alternatively, the cost might remain constant up to a certain level of activity and then increase as the variable cost element is incurred. An example of such a cost might be the rental cost of a photocopier where a fixed rental is paid and no extra charge is made for copies up to a certain number. Once this number of copies is exceeded, a constant charge is levied for each copy taken.

**Classification of costs according to their element**

As well as classifying costs by their behaviour costs can also be classified according to their element.

Classifying costs according to their element means grouping costs according to whether they are **material**, **labour** or **expense** cost. These are the three main cost elements.





### Cost elements

**Materials** are the components bought in by the company which are used in manufacturing the product. For example, the materials used by a food producer could be meat or vegetables. Material costs include the cost of obtaining the materials and receiving them within the organisation.

**Labour** costs are the costs of the people working for the organisation. These costs include wages and salaries, together with related employment costs.

**Expense** costs are the regularly incurred costs of running the business such as rent, business rates, utility costs, insurance, postage, telephones and similar items.

**Note:** Within the cost classifications there can be subdivisions; for example, within the materials classification the subdivisions might include the following:

- Raw materials, that is, the basic raw material used in the manufacturing process.
- Components, that is, complete parts that are used in the manufacturing process.
- Consumables, that is, cleaning materials, etc.
- Maintenance materials, that is, spare parts for machines, lubricating oils, etc.

This list of subdivisions is not exhaustive, and there may even be further subdivisions of each of these groups. For example, the raw materials may be further divided according to the type of raw material, for example steel, plastic, glass, etc.

### Classification of costs according to their nature

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When costs are classified having regard to their nature, the broadest classification of this type is to divide costs into **direct** costs and **indirect** costs.

- Direct costs – costs which can be directly traced to the cost object that we are trying to cost.
- Indirect costs – costs which cannot be directly traced to a single cost object.



### Direct and indirect costs

**Direct costs** can be clearly identified with the cost object we are trying to cost. For example, suppose that a furniture maker is determining the cost of a wooden table. The manufacture of the table has involved the use of timber, screws and metal drawer handles. These items are classified as **direct materials**. The wages paid to the machine operator, assembler and finisher in actually making the table would be classified as **direct labour**. The designer of the table may be entitled to a royalty payment for each table made, and this would be classified as a **direct expense**.

The total of all direct costs is known as the **PRIME COST**.

**Indirect costs** cannot be directly attributed to a particular cost unit, although it is clear that they have been incurred in the production of the table. These indirect costs are often referred to as production **overheads**. Examples of indirect production costs are as follows:

<b>Cost incurred</b>	<b>Cost classification</b>
Lubricating oils and cleaning materials	Indirect material
Salaries of factory supervisors	Indirect labour
Factory rent and power	Indirect expense

It is important to realise that a particular cost may sometimes be a direct cost and sometimes an indirect cost. It depends on the cost object we are trying to cost.

For example, consider a member of a quality inspection department in a production factory. The salary for this employee will be a direct cost for the cost centre (the quality inspection department) if that is the object that we are trying to cost. But it would be an indirect cost for the units produced in the factory (the cost units) as it cannot be directly traced to one individual cost unit.

Another way of classifying costs by their nature is to classify a cost as a period or product cost.

- Product costs – costs which are only incurred if production takes place.
- Period costs – costs which are incurred due to the passage of time.



### Product and period costs

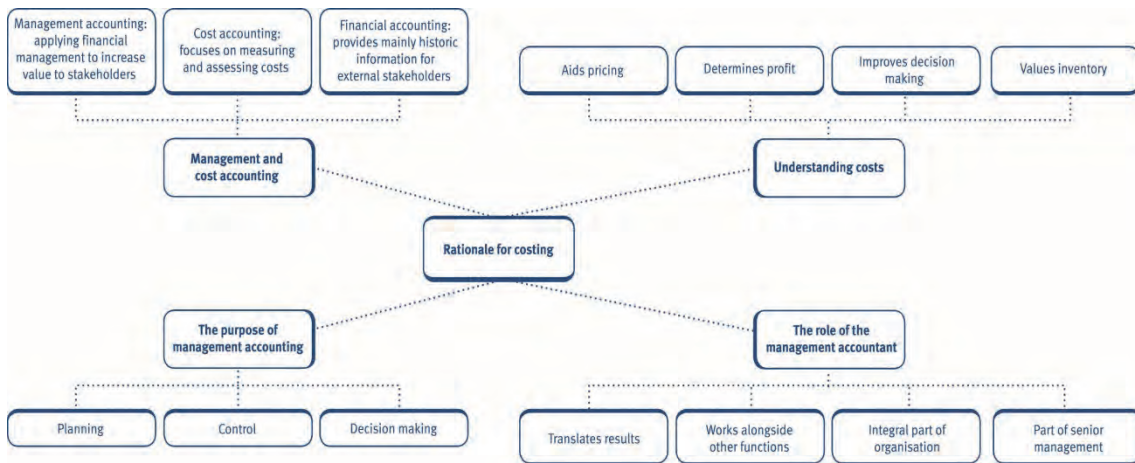
**Product costs** would include direct material, direct labour and absorbed production overheads. Therefore if an organisation does not produce any items it will not incur any product costs.

**Period costs** include costs such as rent and rates, insurance, directors' salaries and depreciation. These costs accrue on daily, monthly or annual basis and will still accrue even if an organisation does not produce any items.



It will be vital for most of the chapters in this syllabus that you understand the behaviour, elements and nature of different types of cost.

## 6 Chapter summary



## 7 Practice questions



### Test your understanding 1

**Direct costs are:**

- A costs that can always be identified with a single cost object
- B all costs that are expensed to the Income Statement
- C costs that can be attributed to a single accounting period
- D costs that change in direct proportion to the number of units produced.



### Test your understanding 2

Consider the following information characteristics.

**For each, decide which characteristic is most appropriate at the strategic level and which would be more appropriate at the operational level.**

	Strategic	Operational
Detailed/Summarised		
Historical/Future		
Focused/Wide ranging		
Frequent/Infrequent		



### Test your understanding 3

**State which three of the following characteristics relate to financial accounting:**

- A For internal use
- B Governed by rules and regulations
- C Required by law
- D Output is mainly used by external parties
- E One of its main purposes is planning

### Example and test your understanding answers



#### Example 1

**C**

Statement (i) is incorrect as providing a true and fair view of the financial position of the organisation is only relevant to financial accounting.



#### Example 2

The correct matching is:

Decision	Level
A decision to take over a rival company in order to expand its production into different markets	Strategic
A decision on the ordering of material for production	Operational
A decision about the pricing of the products	Tactical



#### Test your understanding 1

**A**

Direct costs are costs directly attributable to the item being costed, which can be a single unit or a batch of cost units. D may be true but is the definition of a variable cost. Direct costs will normally be charged to the Income Statement (option B), but not all costs that are charged to the Income Statement will be direct costs. Direct costs are attributed to units (or batches) not accounting periods.



#### Test your understanding 2

Strategic	Operational
Subjective	Objective
Summarised	Detailed
Future	Historical
Wide ranging	Focused
Infrequent	Frequent

**Test your understanding 3****B, C and D**

A and E relate to management accounting.

Management accounting is internally focused and one of its main purposes is planning.

Financial accounting is governed by rules and regulations, required by law and its output is mainly used by external parties.