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Management & Cost Accounting

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- Interpret accounting information for business decisions and budgeting
- Manage costs in your organisation

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by Mark Holtzman and Sandy Hood

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Introduction

Language is a funny thing, necessary but full of pitfalls. After all, as humorist Franklin P. Jones wrote, 'skating on thin ice can get you into hot water'! But if, as people say, accounting is the language of business, management accounting is the language inside a business. Accountants establish specific definitions for terms such as *revenue*, *expense*, *gross profit*, *assets* and *liabilities*. Everyone uses these same definitions when they announce and discuss these attributes, so that when a company reports sales revenue, for example, investors and other businesspeople understand how that figure was calculated. This way, companies, investors, managers and everyone else in the business community speak the same language – a language for which accountants wrote the dictionary.

Management accounting allows a company's managers to understand how their business operates, and gives them the information needed to make decisions. It helps them plan their business's activities and control its operations. For example, suppose that a marketing executive needs to set a price for a new product. To do so, that person needs to understand how much the product costs to produce, which is where management accounting comes in. Furthermore, the price needs to be set at an appropriate level so that at the end of the year (after the company sells all the products it's supposed to sell at whatever prices it sets), the firm earns the profit and cash flow that it projected. Here, too, management accounting proves its usefulness.

We often take management-accounting classes, and we always like to point out to students who the users of management-accounting information usually are: the managers, marketing professionals, financial analysts and information systems professionals working within a company. All have a role not only in developing management accounting information, but also and more importantly in using it to make better business decisions.

About This Book

If you accept that management accounting is the language inside a business, clearly running a business without understanding this topic is pretty difficult. Therefore, we've written this book for businesspeople – present and future – who want to better understand how to use management accounting to make decisions and how management accountants develop the information in reality.

We have a confession to make: we really love to do accounting, especially management accounting. And better yet, we love to convey our knowledge and enthusiasm for it. We believe that contribution margin (see Chapter 9) is the greatest thing since sliced bread and that the theory of constraints can solve most of life's problems (see Chapter 19).

In our view, an urgent need exists to redress the balance – to counter the bad rap that accounting gets for being boring (even financial accountants, of all people, trash their poor management brethren for being the most boring of all accountants). We want to show what we believe makes management accounting engaging and (yes) exciting, right here in this book.

Therefore, when you start reading our handiwork and find that you can't put this book down, don't blame us and our lame little puns. Instead, appreciate that after you start discovering accounting, it can be quite difficult to stop.

What You're Not to Read

We tried to write this book so that it spellbinds you, so that you can't stop reading until you've consumed every last word (though we don't mind if you're tempted to peek at the last few pages to see how it ends!).

That said, if you're very busy, feel free to focus on the most important stuff that you need to know and skip some of these less important elements:

- ✓ **Technical stuff:** Anything marked with this icon is especially interesting to management-accounting geeks like us. But if you're in a rush, you can skip these paragraphs safe in the knowledge that you aren't missing anything essential.
- ✓ **Sidebars:** These fascinating grey-shaded boxes include additional information that we think you may like, but you can pick up management accounting just fine without reading them.

Foolish Assumptions

We assume that you're one of the following:

- ✓ A college student taking a management-accounting course who needs some help understanding the topics you're covering in class. Specifically, you'll certainly find this book helpful supplementary reading if you're taking the level 3 and 4 AAT courses, or operational or managerial level CIMA courses, or the fundamental ACCA courses.

- ✔ A businessperson or entrepreneur who wants to know more about how to collect accounting information to make better business decisions.
- ✔ A recent college graduate interested in pursuing a career in management accounting, perhaps as a chartered management accountant.
- ✔ A professional accountant or bookkeeper looking for a straightforward refresher in the basics of management accounting.

How This Book Is Organised

Each of the five parts of this book tackles a different aspect of management accounting. The following sections explain how we organise the information so that you can find what you need quickly and easily.

Part I: Getting Started with Management and Cost Accounting

Part I gives you a taste of what management accounting is and why it's important. The chapters also review some important aspects of accounting that every businessperson needs to know. We hit profitability, efficiency, productivity and continuous improvement especially hard.

Part II: Understanding and Managing Costs

At its crux, management accounting is all about costs – be they direct, indirect, overhead or whatever – and how they behave. Part II explores the world of costs – what drives them up, down or sideways.

Part III: Planning and Budgeting

An important part of managing an organisation is planning for the future, and management accountants play a critical role in this process by preparing budgets, the topic of Part III. These budgets integrate information from every part of an organisation to develop a plan to meet managers' goals.

Part IV: Using Management Accounting for Evaluation and Control

Accountants have a reputation for being control freaks, but it's part of the job. Managers and management accountants not only plan but also need to control. This duty means that they monitor a company's performance carefully and compare that performance to their budgets. In this way, managers can identify and address problems quickly, before they become crises. We describe how managers can *flex* their budgets – that is, prepare budgets that can adapt to changing facts and circumstances. Part IV also explains how to evaluate and control the activities throughout an organisation, including using responsibility accounting, variance analysis and two techniques that managers use to run their companies: the balanced scorecard and the theory of constraints.

Part V: The Part of Tens

The chapters in this part provide you with a quick reference to the most important formulas in the book. We also share some career options for management accountants.

Hop online and visit www.dummies.com/extras/managementcostaccountinguk for a bonus Part of Tens chapter 'Ten Ratios to Know for Management Accountants', which includes helpful exam practice.

Icons Used in This Book



Throughout the margins of this book, we use certain symbols to emphasise important points. Watch for these icons:

This icon marks simple hints that can help you solve problems on tests and in real-life management accounting situations.



We use this icon to highlight information that's especially important to keep in mind. Tucking these facts away helps you keep key concepts at your fingertips.



This icon pops up alongside examples (surprise, surprise!) that show you how to apply an idea to real-world accounting problems.



Like building *Titanic II*, not every idea is a good idea. This icon alerts you to situations that require caution. Iceberg ahead!



We just had to share these interesting snippets of knowledge with you. If you're in a hurry, however, don't panic; just skip them.



This icon shows where we provide an exercise for you to try, so that you get to put some of your recently acquired expertise into practice.

Where to Go from Here

All the chapters in this book are modular, and so you can study and understand them without reading other chapters. Just go through the table of contents and select a subject that you want to know more about. We provide cross references to topics in other chapters where appropriate, so that if you skip a foundational concept crucial to what you're reading about, you know where to find what you need.

If you're looking to discover management accounting from scratch, or to unlearn some aspect that you fear you've got wrong, start with Part I to get the basics under your belt. We take special care to explain all the fundamentals that some management accounting texts skip. If you're a student with little or no background in accounting, make a point to read Chapter 2.

Management accounting itself is built on a few basic principles. In our experience, most students who have trouble with management accounting usually improve their performance after becoming more familiar with these basics. Therefore, to better understand these foundations, take a look at Chapter 3 (cost principles), Chapter 8 (cost behaviour) and Chapter 9 (contribution margin).



If you're studying for an accountancy exam, make sure that you know the relevant key formulas in Chapter 20.

6

Management & Cost Accounting For Dummies ---

Part I

Getting Started with Management and Cost Accounting



For Dummies can help you get started with lots of subjects. Visit www.dummies.com to learn more and do more with *For Dummies*.

In this part . . .

- ✓ Discover what management accountants do and why they do it.
- ✓ Find out what you can do to become a management accountant.
- ✓ Learn how different kinds of companies operate.
- ✓ Know how accountants measure profits, efficiency and productivity.
- ✓ Find out how managers apply continuous improvement.

Chapter 1

Planning and Control: The Role of Management Accounting

In This Chapter

- ▶ Appreciating the importance of management accounting
 - ▶ Costing business activities
 - ▶ Planning for profits and cash flow
 - ▶ Monitoring and evaluating company performance
-

Before embarking on a journey, you need a clear plan. Even if you're driving a familiar route and know where you're going and how you intend to get to your destination, you may well have landmarks along the way in mind. Perhaps you plan to take an hour to reach the motorway, spend another hour on it and allow 20 minutes for the final section of your trip.

When you have a plan, you can monitor it and revise your arrival time based on the times you achieve for each section. You can also check that your passengers are comfortable and happy with your driving.

These types of duties are central to *management accounting*: the collecting and monitoring of information about a venture to make sure that it's on track to meeting its goals. For the journey analogy, setting up the route and arrival time, considering the level of comfort for the passengers and adhering to the speed limit are goals within the plan. Monitoring how the journey is progressing and modifying the expected arrival time is control.

This chapter explains what management accountants do (in essence, planning and control) and why they do it. We explain what costs are and investigate different ways of measuring them. We also explore management planning, budgeting, and monitoring and evaluating operations, and discern the differences between management accounting and financial accounting.

Understanding What Management Accountants Do, and Why

Management accounting is at the heart of running a business. It provides the valuable information about the business that can help managers make important decisions. As we describe in this section, the process of gathering information involves the following aspects:

- ✓ Identifying different types of costs based on how they're used to provide the products or services of the business.
- ✓ Analysing costs to understand how they behave and how they'll respond to different activities.
- ✓ Planning and budgeting for the future.
- ✓ Evaluating and controlling operations by comparing plans and budgets to actual results.

For much more on the benefits that management accounting brings to businesses, turn to Chapter 2.

Distinguishing management from financial accounting

We want to clarify one issue here and now, and that's to explain the different aims and duties of management and financial accountants. In essence:



- ✓ **Management accounting** provides internal reports tailored to the needs of managers inside the company.
- ✓ **Financial accounting** is concerned with providing external financial statements for general use by people with a vested interest in the business.

Management accountants report the facts and figures they collect. Financial accountants need the management accountants' cost information for financial reports on past activities produced for shareholders, tax authorities and other stakeholders. Managers need the management accountants to provide the best quality information as a basis for decisions about future activities.

Table 1-1 compares the differences between management and financial accounting based on the information prepared.

Table 1-1 Contrasting Management and Financial Accounting

<i>Preparing Information</i>	<i>Management Accountants</i>	<i>Financial Accountants</i>
What info?	Internal reports	Financial statements
Who uses info?	Managers who work for the company	Stakeholders, such as shareholders, suppliers and government regulators
When is it prepared?	Whenever needed	Quarterly and annually
How detailed is it?	Very detailed, to address specific decisions to be made by managers	Very general, pertaining to the whole company
How is it prepared?	In accordance with the needs of managers and officers	In accordance with accounting standards depending on where the company is based
How is it verified?	By internal controls among management accountants	By external auditors

Identifying costs

Management accountants need to know what things are used for, to enable the calculation of the cost of the products the business makes.



Some costs are *direct* in that they belong to the product being made. Other costs are *indirect*: they may well be just as essential but they aren't specific to the product.

For example, to produce marmalade you need oranges, sugar, a clean kitchen and skilled labour, among other key inputs. The oranges are a direct cost; having a clean kitchen is indirect.

When the Financial Reports are produced at the end of the accounting period, the company has to know how much revenue was generated and what costs were incurred. Management accountants provide this information. They also organise it for internal reporting, such as showing the revenues, costs and profits of products and departments.

For loads more on direct and indirect costs, flip to Chapter 3.

Analysing costs

Business costs differ in the way they behave. If you make more marmalade, you need more oranges. Therefore, the total cost of oranges varies depending on the number of jars of marmalade that you make.



In this sense, the total cost of oranges is a *volume-based* cost: it varies depending on the volume of jars produced. Other costs may not change at all, whether you make 60 jars or 6,000 jars. For example, the annual fee for hosting the website advertising the marmalade doesn't change even if you make 600,000 jars! So this isn't a volume-based cost.

Management accountants collect the information necessary to discover how costs behave, and provide this info to management. Understanding cost behaviour is extremely useful when deciding how many items you need to sell to make a profit.

Planning and budgeting

Management accountants are involved in a business's planning and preparation for the years ahead. While managers look into the possible activities, management accountants add the numbers.

Within a business, employees and supervisors may suggest improvements to the business. Managers then select the ones that look viable and/or fit the strategic plan and management accountants draw up a budget to add values to the forecasts.

Flip to the later section 'Accounting for the Future: Planning and Budgeting' for more on this subject.

Evaluating and controlling operations

Planning is one thing, but execution is another. Management accountants are responsible for continuously monitoring performance, evaluating it and comparing it to the budget. This control allows managers to see how the business has progressed and where attention needs to be focused to ensure continued progress to the final goals. Evaluating and controlling operations keeps the business on track and also allows management to carry out comparisons between different branches.