

UNIT SEVEN

THEORY

ACCOUNTING
RIHAB FAISAL

Unit 7 | Manufacturing Accounts

- Cost of production of a manufacturing business
- Financial statements of a manufacturing business

7.1 | Cost of production

- Manufacturing
- Cost of production: need, elements
- Types of inventory
- Cost of sales

Manufacturing

- Manufacturing is the processing of raw materials into finished goods through the use of tools, human labor, machinery, and chemical processing.
- Manufacturing is a value-adding process allowing businesses to sell finished products at a higher price over the value of the raw materials used.
- Before the Industrial Revolution, most products were handmade using human labor and basic tools. The Industrial Revolution of the 19th century brought with it the advent of mass production, assembly line manufacturing, and the use of mechanization to manufacture larger quantities of goods at a lower cost.

Manufacturing business

- Any business that uses components, parts, or raw materials to make a finished good. These finished goods can be sold directly to consumers or to other manufacturing businesses that use them for making a different product.

Production cost

- The total cost incurred to produce a particular product within a specified time period is known as production cost.
- It is necessary to identify the expenses that are relevant to production in order to compute the total production cost.
- Importance of preparing a manufacturing account:
 - To determine the total manufacturing cost
 - To control manufacturing costs
 - To take manufacturing and pricing decisions

Elements of manufacturing costs

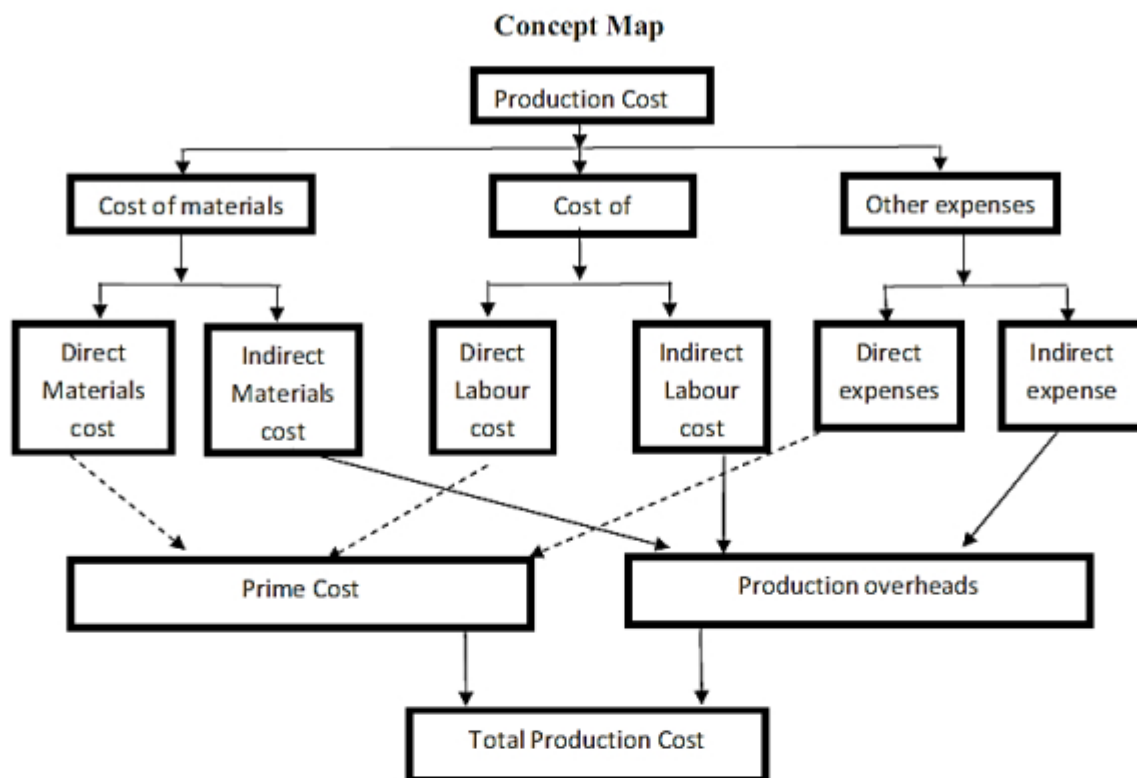
- Production cost can be classified into Prime cost (direct costs) and Production overheads (indirect costs).

Prime cost:

- Direct material cost
- Direct labour cost
- Direct other cost

Production overhead:

- Indirect material cost
- Indirect labour cost
- Indirect other cost

Production cost = Prime cost + Production overheads**Prime cost**

Prime cost = Direct material cost + Direct labour cost + Direct other costs

- **Direct material costs:** Cost of materials that can be directly identified with the production unit.
 - Furniture manufacturing – timber
 - Garment factory – cloth
- **Direct labour costs:** Wages paid to employees who can be clearly identified as directly contributing to the manufacturing process.
 - Furniture manufacturing – wages paid to carpenters
 - Garment factory – wages paid to machine operators
- **Direct other costs:** Expenses that are directly attributable to production but are not direct material or direct labour costs.
 - Cost of producing designs
 - Royalty payments on production units
 - Intellectual property fees: trademarks, copyright, license, franchise fees

Production overheads

Production overheads = Indirect material cost + Indirect labour cost + Indirect other costs

- **Indirect material costs:** Cost of materials which cannot be easily identified with the production unit.
 - Furniture manufacturing – cost of nails, polish, saws, and cutters
 - Garment factory – cost of lubricants, grease oil, and thread
- **Indirect labour costs:** Wages paid to employees who are not directly involved in the manufacturing process.
 - Furniture manufacturing – wages paid to supervisors and assistants
 - Garment factory – wages paid to factory manager and supervisors
- **Indirect other costs:** Expenses that are indirectly attributable to production but are not indirect material or indirect labour costs.
 - Factory rent
 - Factory insurance
 - Depreciation of factory building and machinery
 - Power consumption by factory
 - Telephone charges

Types of inventory

- Inventories are assets held for sale in the ordinary course of a business, held in the process of production for such sale, or held in the form of materials to be consumed in production.
- According to the above definition, the following types of stocks can be seen:
 - Raw materials
 - WIP goods (work in progress, semi-finished, incomplete)
 - Finished goods
- WIP products: Refers to partially completed goods that are still in the production process. These can be valued at prime cost or production overheads.

