Managerial Accounting

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We have previously touched upon **management accounting**, which is for **internal use** by officers, managers, etc. Management accounting is used to determine things like the selling price of a product, whether to create the product from scratch or buy it from somewhere and resell, etc.

There are several differences between financial accounting and management accounting, as shown below:

|  |  |  |
| --- | --- | --- |
|  | **Financial Accounting** | **Management Accounting** |
| Users | External | Internal |
| Timespan | Usually annual | Not fixed; Can be 1 hour or 15 years |
| Emphasis | Past-oriented, meaning we concentrate on past events | Future-oriented, meaning we concentrate on future events |
| Focus | For the entire company | Can be for the entire company or for a particular department |
| Format | Must follow format specified by company or country (e.g. GAAP for USA) | Not fixed |

## Types of Costs

### Manufacturing Costs

To manufacture a product, there are three types of costs associated directly with the process. These are called the **manufacturing costs** and they include:

* Direct material costs or raw material costs
* Direct labour costs, i.e. the salaries of the labours producing the products
* Factory overhead or manufacturing overhead, which refer to indirect costs related to the manufacture of the product such as the factory supervisor’s salary, security costs, factory rent, etc.

Manufacturing costs are also called **product costs** or **inventoried costs**.

The direct material costs and the direct labour costs combined are called the **prime cost**.

To convert raw material to a finished product, the direct labour costs and the factory overhead costs get involved, so these two costs combined are called the **conversion cost**.

### Administrative Costs

Besides the manufacturing costs, we also have some other costs incurred when running a day-to-day business:

* **General and Administrative Overhead** – These refer to costs in the corporate office, not the factory, and can include employee salaries, utility bills, rent, etc.
* **Selling and Distribution Overhead** – These include advertising costs, transport costs, salaries for sales people, showroom rent, etc.

The above two costs combined are called the **period costs**, since they apply to specific periods of time. They are registered in **financial statements**.

### Product Costs

The products that are manufactured can also be divided into two types of costs:

* **Cost of Goods Sold** – This is registered in the **income Statement**.
* **Inventory Cost** – This is the cost of the unsold goods. It is registered in the **Balance Sheet**.

This is why product cost is also called **inventoried cost**.

### Miscellaneous Costs

* **Opportunity Cost** – This refers to the cost of the opportunity not taken. Suppose we must decide between producing product A and product B and we decide to produce product A. In this case, the profit that we did not make due to not selling product B is the opportunity cost.
* **Sunk Cost** – This refers to past costs that are being ignored in the current decision-making process. Suppose we bought a car or a machine. The cost for these will be shown through depreciation, so the actual expense when we bought them is a sunk cost and will be ignored.

### Fixed and Variable Costs

**Fixed Costs** are costs that do not change, at least not on a regular basis, such as warehouse rent. **Variable Costs** are costs that are expected to change regularly, such as the cost of raw materials, which depends on the units of a product we are manufacturing.

Both these costs might change in reality, it is just that fixed costs are not expected to change for long periods of time. If we increase the number of products we manufacture for example, at some point we will need a larger warehouse, which means our warehouse rent, a fixed cost, will go up. Suppose our warehouse rent is and remains the same for the range of products to products. This is called the **relevant range** for .

Similarly, we can also have a relevant range for variable costs, due to bulk buying costs being lower than the normal material cost. Suppose for some material, we must pay per piece, but if we buy more than pieces, the price drops to per piece. If we buy more than , the price drops further to per piece. Thus, to is the relevant range for .