SOLUTIONS TO END-OF-CHAPTER QUESTIONS CHAPTER 10

RECALL AND REVIEW

Question 10.1

A cost object is anything for which a cost is measured. A cost object could be a product, service, centre, customer, activity or distribution channel. These examples, however, are not exhaustive and costs can be accumulated for any clearly defined activity or event.

Question 10.2

Cost accounting is a process of gathering cost information and allocating it to cost objects, producing budgets and comparing/analysing the actual and budgeted results. Cost accounting is one aspect of management accounting which is a broader concept. Management accounting is a process of providing decision-useful information, including cost information, in order to maximise value for stakeholders over the short, medium and long term.

DEVELOP YOUR UNDERSTANDING

Question 10.3

The following information will be relevant in putting together a business plan for the new cake shop (this list is not exhaustive and you may have included relevant points that are not presented below):

- Expected numbers of regular cakes to be sold in the shop on a daily basis
- Expected numbers of cakes for special occasions to be sold on a weekly or monthly basis
- Expected selling prices for regular and special occasion cakes
- Expected costs of ingredients for regular and special occasion cakes
- Expected baking costs for the cakes
- Expected packaging costs for the cakes
- Rental cost of the shop
- Any local business rates for the shop

- Expected usage of electricity and gas for heating and lighting the shop as well as for baking cakes
- Expected cleaning cost of the shop if your friend is not doing the cleaning himself
- Any other expected costs that the shop will incur on a regular basis
- Will your friend be running the shop entirely on his own or will he be hiring in assistants who will need to be paid? What are the expected costs of those assistants?
- Expected equipment costs (for example, ovens, fitting out the shop, the till, display cabinets)
- Website design and running costs
- Accountancy costs if your friend is not planning to produce his own annual accounts for taxation purposes
- Expected advertising costs
- Expected bank charges
- Expected inflows and outflows of cash
- Insurance quotes from insurance companies
- Competition in the local area
- Expected reaction of local competitors and what your friend will do in response to competitors cutting prices or expanding ranges offered
- Differentiating factors that make your friend's business different from competitors
- The market for the types of cakes your friend is planning to sell
- Longer-term plans if the business is successful, such as plans for home delivery, opening an on-site café to offer drinks and cakes together
- Opening times on each day of the week
- Details of the position of the shop, whether it is in a main shopping area or in a side street which suffers from reduced numbers of passers by
- Any market research on the number of shoppers in the area in which the shop is situated to gauge likely demand and the likely target audience
- Details of local disposable income to determine whether the local population is likely to buy cakes or lack the means to do so

» Question 10.4

Factors your friend should take into account when making her decision about which factory to rent for her expanded business (this list is not exhaustive and you may have included relevant points that are not suggested below):

- The factory rental costs, how affordable these are as business is built up in the new location
- Business rates expense for the new factory
- Any other costs that will be incurred by the new factory

- Whether the increased level of production, sales and profit will cover the increased rent and other costs of the expanded business
- The long-term strategic aims of the business over the next 5–10 years
- The expected wages/salary costs for new employees
- Availability of new employees in the local area to staff the factory
- Training costs for new employees
- Whether current employees will be willing to move with the business to the new location
- Accessibility of the new factory for both employees and transporters of goods to customers
- Road links to enable easy deliveries to customers
- Proximity of the new factory to major road networks
- Are there any bottlenecks on roads around the factory which could delay deliveries to customers?
- Requirements for new machinery to meet increased demand
- Cost of new machinery and expected annual running costs
- Costs of moving existing machinery from the current factory to the new factory
- If the old machinery is not being transferred to the new factory, how much this old machinery could be sold for
- Termination costs of the lease on the current factory
- Continued demand for flat-pack cardboard boxes in standard sizes
- Current orders from customers and whether customers will continue to order from the business
- Rival flat-pack cardboard boxes in standard sizes that customers might prefer
- Any new administrative procedures that will be required
- Whether the current accounting system and current accounting staff will be able to cope with the increased workload
- Any additional supervisory staff that will be required in the factory
- Whether the requirements of specific customers will continue to be met

» Question 10.5

Cost allocation entails three steps: determination, accumulation and allocation. Costs can be allocated to cost objects in different ways. The first step in the cost allocation process is to determine the most effective or appropriate way of gathering costs. Next, a decision has to be made to determine how to accumulate these costs and then allocate them to cost objects. Once costs have been allocated, this financial information can be distributed to users for review, analysis and interpretation. Costing information can be used to improve organisational efficiency and effectiveness through eliminating unnecessary costs or streamlining processes to improve profitability.

Question 10.6

	Financial accounting	Management accounting
(a) Frequency of reporting	Infrequent, usually annually	As frequently as required, weekly or even daily
(b) Decision usefulness of reports	Limited	Very high
(c) Main users	Outsiders i.e. shareholders, lenders and other creditors	Insiders i.e. managers
(d) Type of information generated	Financial information	Both financial and non-financial information
(e) Regulations to be followed	Highly regulated by the Companies Act 2006 and IFRS	Not regulated at all
(f) Comparability	High	Low
(g) Level of detail	Low	High

Question 10.7

Both management accounting and financial accounting derive their numerical input from the same internal sources. In the same way as financial accounting, management accounting uses the double-entry system to gather cost information and to allocate costs to cost objects. However, there is a difference in the level of detail reported. While financial accounting uses the summarised total figures, management accounting breaks the total figures down into their relevant constituent sub-headings. The output of management accounting is flexible reports based on management needs.

TAKE IT FURTHER

Question 10.8

Since John's business is a manufacturing company, precise cost information is very important in costing and pricing decisions and in planning for the future. Without a cost and management accountant, the company may not be managing its costs in the most effective way or pricing its products to maximise its financial returns. Accurate cost information is vital in making day-to-day operational decisions. In addition, the management accountant will take on the role of planning and budgeting to enhance the monitoring and control of operations into the future.

Question 10.9

Management accounting provides managers with information for use in planning, organising and controlling the operations of the organisation. In particular, management accounting identifies, generates, presents, interprets and uses relevant information in order to fulfil the following management functions:

- Inform strategic decisions
- Plan long, medium and short-term operations

- Determine capital structure
- Design reward strategies for staff and shareholders
- Control operations and ensure the efficient use of resources
- Measure and report financial and non-financial performance to management and other users
- Protect assets
- Implement corporate governance procedures, risk management and internal controls

Question 10.10

According to the IASB, useful financial information must possess the qualitative characteristics of relevance, faithful representation, timeliness, comparability, verifiability and understandability. Useful financial information is also subject to the tests of materiality (significant enough to have an effect on the decisions made by users on the basis of that information) and cost-benefit (the benefits of producing the information must outweigh the cost of providing it). Relevance, timeliness, comparability and understandability together with materiality and cost-benefit are equally applicable to management accounting information. However, management accounting information does not have to meet the qualitative characteristics of faithful representation or verifiability. These qualitative characteristics of financial information are only required when providing reports to third parties. Management accounting information is prepared for individuals within the organisation rather than for external individuals. Management put in place suitable internal controls to ensure that information generated by the accounting and other systems is accurate and complete. As management accounting information is prepared for internal use only, no further verification of the information presented is required. Only information that is reported to third parties (individuals outside the organisation) has to be faithfully represented, so, again, management accounting information does not need to be faithfully represented to be useful.