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COST ACCOUNTING

OBJECTIVE

development of detailed information
on the cost of producing a product or service

INTENDED USE

(1) by the financial system, for valuation of inventory and cost of goods sold
(2) by management, for making pricing, design engineering, production operations, and other management decisions

SERIOUS FLAWS

based on turn-of-the-century manufacturing firms

Cost Accounting attempts to ALLOCATE "product"-related costs to "inventory" at each stage of the "manufacturing" process

PRODUCT and PERIOD EXPENSES

First step in Cost Accounting is to define Product and Period Costs

PRODUCT EXPENSES

those that are selected to be matched in an accounting period to (probably future period) revenues derived from delivering the corresponding goods or services

PERIOD EXPENSES

all remaining expenses, which are expensed during the period in which they are incurred, irrespective of what or how much was produced or sold in that period

TIMING

the classification of costs (expenses) as either Product or Period affects the timing of expenses and therefore the timing of profit

(Example follows)

ILLUSTRATION

Given:

- $3,000 raw material in Inventory
- Work on product during month, incurring $2,000 in Production Line Costs
- Product unsold at the end of the month

If Production Line Costs are recorded as a Period Expense for the month:

- then Net Income declines by $2,000, and
- Inventory value remains at $3,000

If Production Line Costs are recorded as a Product Expense for the month (and thus added to the Inventory value):

- then Net Income is not affected, and
- Inventory value increases from $3,000 to $5,000

DEFINING PRODUCT COSTS

- **Material Only [Direct Material]**

- **Material and Labor [Prime Costs]**
  (Direct Material and Direct Labor)

- **Material, Labor, and Production Overhead [Direct (Variable) or Full-Absorption Costing]**
  (Includes Indirect Production Costs)

- **Material, Labor, Production Overhead, Engineering, Selling, and Administrative Expenses [Virtual elimination of Period Costs]**

COST ACCOUNTING UNREALISTIC ASSUMPTIONS

- Primary costs to be controlled are production costs
- Direct Labor is the key production cost
- Product costs based on Direct Material, Direct Labor, and production overhead yield relevant management information
- Primary costs to be reduced are production costs

Note: Cost accounting flow charts on page 334 (manufacturing model) and page 336 (market research firm model) are worth studying