Costing Theory

What's the difference between financial and management (cost) accounting?

- Financial accounting records transactions that have already happened whereas management accounting deals with estimates and predictions for the future.

- Financial accounting is compulsory, since firms are required by law to provide accounts for tax and legal purposes. Management accounting is an optional strategy for firms.

- Financial accounting is often aimed at external stakeholders (such as the government, investors or banks) whereas management accounting is normally completed for internal decision-makers such as managers.

Give Three Reasons for Product Costing.

It is used to decide the selling price of the product.

It is used to calculate the value of closing stock for the balance sheet.

It enables budgeted or predicted costs to be compared with actual costs.

What Are The Limitations of Marginal Costing?

1. The assumption that variable cost per unit remains the same will not always hold true at every level of production, since economies of scale may set in once certain production levels are reached.

2. Selling price will not always remain the same as the firm expands, since it may become possible to take advantage of high volume discounts on purchasing, by reducing the selling price to the consumer.

3. Fixed costs rarely remain completely fixed and are more accurately described as ‘step-fixed’ i.e. they will increase in stages as production increases (e.g. rent will go up as a bigger factory will need to be used).

4. Marginal costing assumes that mixed costs can be neatly separated into their fixed and variable components. This is not necessarily the case at every level of production since either component may change as volume increases or decreases.

What’s The Difference Between Marginal and Absorption Costing?

Closing stock is valued differently under each system. In marginal costing fixed costs are not included when calculating the cost of a product, whereas in absorption costing the cost of the fixed asset is ‘absorbed’ into the cost of the product. Absorption costing should be used as it agrees with standard accounting concepts.

List and Explain Two Assumptions of Marginal Costing.

1. It is assumed that fixed costs will always remain the same but in reality they are likely to be ‘step-fixed’ – i.e they will probably change at some level of production.

2. It is also assumed that selling price remains constant but again there are issues (such as discounts or unpredicted increases) that may change this.

Name Three Overhead Absorption Rates and State Why They Are Based on Budgeted Rather Than Actual Figures.

The overhead absorption rates are:
- Per labour hour
- Per machine hour
- Per unit

They are based on budgeted figures because actual figures may not be know until the end of the year and the firm will not be able to wait until then to decide the cost of the product.

Explain the Difference Between Allocation and Apportionment of Costs.

Allocation occurs where direct costs are linked specifically to the item being produced.
Apportionment occurs where indirect costs are divided out using a suitable basis.

Illustrate and Explain What is Meant By A Step-Cost.

This is a cost that might initially be regarded as fixed, but which at some point may actually change. The rent of a factory for example might be seen as a fixed cost but if the company continues to expand, they might need to rent a second factory and the cost that was previously fixed at a particular level will therefore be increased by the additional rental charge.