

# Cost accounting and the objectives

Finance



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**COST ACCOUNTING AND THE OBJECTIVES** Differentiate between relevant costs/revenues in choosing among alternatives such as "make or buy", "lease or buy" and understand the importance of including not only quantitative but also qualitative factors in the decision making process. Relevant costs/revenues are future differential costs/revenues. They are necessary for a decision. They are cash flows that arise from the direct consequence of the taken decision. They arise also incremental. However, irrelevant costs or revenues are not required for decisions to be made. Examples of such costs include sunk costs, non cash flow costs, committed costs, net book values and general fixed overheads. Relevant revenues/costs show future costs/revenues that will change by the decision taken while irrelevant costs/revenues are not affected by the decision. Inclusion of both quantitative and qualitative data ensures that an informed decision is made. This is because it ensures that all factors are taken into consideration.

2. Distinguish short-run from long-run pricing decisions including target-costing approach.

Short run pricing decisions has a less than one year time horizon while long-run pricing decisions have a year or longer time horizon. Example of short-run pricing decision is pricing a one-time only special order or adjusting output volume and product mix. A long run pricing decision includes pricing of a product in a major market where there is some leeway in price setting. Target pricing refers to an estimated price for a good or a service that prospective buyers will be willing to pay.

3. Evaluate business performance using the 4 perspectives of the balanced scorecard.

The balanced scorecard is a strategic planning as well as management

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technique used by organizations in aligning the performance of an organization to its objectives and vision. It has four perspectives namely, financial perspective, customer perspective, learning and growth perspective and business process perspective. Financial perspective learning and growth perspective measures employee retention, knowledge management and employee satisfaction. Business process perspective measures costs and quality of business processes. Customer perspective requires that customers be satisfied, retained to increase the company market share. Financial perspective advocates timely and accurate financial data.

4. Apply the concept of " cost pools" and bases for allocation using the direct, step and reciprocal methods, as well as accounting for joint costs, by-product costs, spoilage, rework and scrap.

A cost pool refers to a grouping of individual expenses or costs, regularly by division or a service center. It is from such cost pool that allocation of costs is made. For instance, the maintenance department cost is accumulated in a cost pool before allocated to the departments that use its services. Cost pools are normally utilized for the production overhead's allocation to production units, according to a number of accounting frameworks. They are likewise utilized in activity-based costing to apportion or allocate costs to activities.

5. Apply economic order quantity theory as a tool for the management and inventory control of materials.

Economic order quantity is an equation that determines the optimum order quantity that an organization should hold in inventory. It helps in reducing over stocking and controlling under stocking thus assisting in inventory management.

$Q^*$  is the EOQ,  $D$  is demand rate,  $K$  is set up cost and  $h$  is annual holding cost per unit.

6. Use capital budgeting techniques such as discounted cash flow, net present value, internal rate of return, payback method, accrual accounting rate-of-return and sensitivity analysis to evaluate long-term investment alternatives.

Discounted cash flow uses a concept of time value of money to value a project, an asset or a company. The estimated future cash flows are discounted using the cost of capital to arrive at present values. A project with highest discounted cash flow is selected. The sum of such future cash flows both inflow and outflow is the net present value which is the value of the cash flows. The net present value is then calculated by subtracting initial investment amounts from the total present values. Projects with positive NPVs are selected. IRR is the breakeven cost of capital as it represents the discount rate at which the investment's NPV is zero. Therefore, a project that has a greater IRR than the cost of capital is often accepted because it is viable. Payback period is the time that a project takes to recover its expenditure or its initial investment amount out of its cash inflows. A project with the shortest projected time is chosen. ARR refers to the ratio of average annual operating profit to average investment. For instance,  $ARR = (\text{Annual average operating profit} / \text{Average investment}) \times 100\%$ . ARR requires that a minimum target ARR be set so a project that achieves it or higher is selected. Sensitivity analysis is the investigation of how the vulnerability in the output of a scientific model or framework (numerical or generally) can be apportioned to diverse sources of uncertainty in its inputs. It is used in financial modeling in determining how a target variable may be affected by

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changes in the input variable. For instance, stock price can be determined to change by 2% for every 1 percent change in the net margin.

7. Apply transfer pricing concepts in setting appropriate domestic and international transfer prices.

Transfer pricing concepts help in the valuation of products and services for the purposes of trade. It is the setting up of prices among departments or divisions within an entity. Such concepts help set prices for goods and services that are sold between related legal entities within an entity.

Transfer pricing is the cost of product that is sold by a part of a company to another both locally and internationally.

8. Analyze return on investment using the DuPont method, residual income, and economic value methods to evaluate performance as an integral part of management control system.

Analysis of a company's performance shows the financial condition of an organization. Return on investment shows benefits those results for the investments of an enterprise. Du Pont method presents an analysis of a financial ratio that is based on the return on equity ratio. It analyses the ability of a firm to increase its return on equity by analyzing total asset turnover, profit margin and financial leverage. Residual income refers to the income that a company continues to generate after expending initial effort. It helps in equity valuation as it is the income generated after the true cost of capital has been accounted for. Economic value added indicates the true economic profit of an enterprise.

#### Reference

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