

Module 1 - Home

ACCOUNTING COST SYSTEMS AND COST BEHAVIOR

Modular Learning Outcomes

Upon successful completion of this module, the student will be able to satisfy the following outcomes:

- Case
 - Prepare a behavioral income statement.
- SLP
 - Formulate alternate profitability scenarios.
- Discussion
 - Differentiate between managerial and financial accounting.

Module Overview

Accounting Cost Systems

An internal accounting system accumulates and categorizes costs. Managers and others throughout the organization use this information to prepare external reports; plan and motivate subordinates; and make decisions. The term cost has many meanings so it is imperative to understand how the accounting system calculates costs. The use and purpose for which the information is required dictate how to define costs. If the information is not already available in the accounting system, additional work may be needed to pull out the information we need and the format in which it is needed.

Cost Behavior

Understanding how costs behave is important for planning and control. See below for definitions and explanations.

Variable costs

- A variable cost is a cost whose **total** dollar amount **varies in direct proportion** to changes in the activity level.
- An **activity base** (also called a **cost driver**) is a measure of what causes the incurrence of variable costs. As the level of the activity base increases, the total variable cost increases proportionally.
- Units produced (or sold) is not the only activity base within companies. A cost can be considered variable if it varies with activity bases such as miles driven, machine hours, or labor hours.
- Variable costs remain **constant if expressed on a per-unit basis**. For example, the cost per minute talked is constant, that is, two cents per minute.

It cannot be assumed that a certain type of cost is always variable or fixed. Examine the facts of each situation before deciding whether a cost is fixed or variable. For example, a company's employment policy may determine whether direct labor costs are fixed or variable with respect to volume of output.

Unit variable versus step-variable costs

- **Unit variable costs** - The amount used during the period varies in **direct proportion** to the activity level. The traditional long-distance phone bill is an example of a true variable cost.
- **Step-variable costs** - A resource that is obtainable only in large chunks and whose costs change only in response to fairly wide changes in activity. An example is a cost for a group rather than an individual

Fixed costs

A fixed cost is a cost whose **total** dollar amount **remains constant** as the activity level changes. For example, paying one amount for long-distance calling regardless of usage. Average fixed costs **per unit decrease** as the activity level increases.

Types of fixed costs

Committed fixed costs

These costs are **long-term** in nature (i.e., greater than one year).

Discretionary fixed costs

These costs usually arise from **annual decisions** by management to spend in certain fixed cost areas. Advertising may be an example.

Trends

The trend in many industries is toward **greater fixed costs** relative to variable costs. Automation leads to higher fixed costs.

Mixed costs (also called semi-variable costs)

A mixed cost contains **both** variable and fixed cost elements.

For example, utility bills often contain fixed and variable cost components. The fixed portion of the utility bill is constant regardless of kilowatt hours consumed. This cost represents the minimum cost that is incurred to have the service ready and available for use. The variable portion of the bill varies in direct proportion to the consumption of kilowatt-hours.

An equation can be used to express the relationship between mixed costs and the level of the activity. This equation can be used to estimate fixed and variable costs at various activity levels.

Module 1 - Background

Required Background Material

Let us start with two videos to provide a brief explanation of managerial accounting.

Management Accounting Versus Financial Accounting. (2014). Pearson Learning Solutions, New York, NY. Retrieved from <http://www.pearsoncustom.com/mct-comprehensive/asset.php?isbn=1269879944&id=11806>

Business Terms and Decisions. (2014). Pearson Learning Solutions, New York, NY. Retrieved from <http://www.pearsoncustom.com/mct-comprehensive/asset.php?isbn=1269879944&id=11613>

The next two resources introduce cost behavior.

Routh, B. (2010, Nov. 25). Cost Behavior: Variable costs versus Fixed Costs – Accounting. [Video File]. Retrieved from <https://www.youtube.com/watch?v=TLYwPogWdEU>

Slideshare. (n.d.). Determining How Costs Behave. Retrieved from <http://www.slideshare.net/mingxinlu/cost-accounting-determining-how-cost-behaves>

Dr. Walther's online textbook (www.principlesofaccounting.com) and associated videos provide more detail information about cost behavior and variable (behavioral, contribution margin) income statements.

Walther, I. (2014). Principles of Accounting. Chapter Seventeen. Introduction to Managerial accounting; and Chapter Nineteen. Job Costing and Modern Cost Management Systems. Retrieved from <http://www.principlesofaccounting.com/>

Suggested Resource

accountingexplanation.com. (n.d.). Advantages, Disadvantages, and Limitations of Variable Costing Systems. Retrieved

from http://www.accountingexplanation.com/advantages_disadvantages_limitations_of_variable_costing.htm