

PRINCIPLES OF COSTING

STUDY TEXT

Qualifications and Credit Framework

Q2022

This Study Text supports study for the following AAT qualifications:

AAT Level 2 Certificate in Accounting

AAT Level 2 Certificate in Bookkeeping

AAT Certificate in Accounting at SCQF Level 6

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INTRODUCTION

HOW TO USE THESE MATERIALS

These Kaplan Publishing learning materials have been carefully designed to make your learning experience as easy as possible and to give you the best chance of success in your AAT assessments.

They contain a number of features to help you in the study process.

The sections on the Unit Guide, the Assessment and Study Skills should be read before you commence your studies.

They are designed to familiarise you with the nature and content of the assessment and to give you tips on how best to approach your studies.

STUDY TEXT

This study text has been specially prepared for the revised AAT qualification introduced in February 2022.

It is written in a practical and interactive style:

- key terms and concepts are clearly defined
- all topics are illustrated with practical examples with clearly worked solutions based on sample tasks provided by the AAT in the new examining style
- frequent activities throughout the chapters ensure that what you have learnt is regularly reinforced
- 'pitfalls' and 'examination tips' help you avoid commonly made mistakes and help you focus on what is required to perform well in your examination
- 'Test your understanding' activities are included within each chapter to apply your learning and develop your understanding.

ICONS

The chapters include the following icons throughout.

They are designed to assist you in your studies by identifying key definitions and the points at which you can test yourself on the knowledge gained.



Definition

These sections explain important areas of Knowledge which must be understood and reproduced in an assessment.



Example

The illustrative examples can be used to help develop an understanding of topics before attempting the activity exercises.



Test your understanding

These are exercises which give the opportunity to assess your understanding of all the assessment areas.



Foundation activities

These are questions to help ground your knowledge and consolidate your understanding on areas you're finding tricky.



Extension activities

These questions are for if you're feeling confident or wish to develop your higher level skills.

Quality and accuracy are of the utmost importance to us so if you spot an error in any of our products, please send an email to mykaplanreporting@kaplan.com with full details.

Our Quality Co-ordinator will work with our technical team to verify the error and take action to ensure it is corrected in future editions.

Introduction to costing systems

Introduction

This chapter introduces the different costing systems used within organisations and their importance as sources of information for management accountants. The key differences between management and financial accounting are explored and some key terminology is introduced. This chapter contains some fundamental principles that the rest of the course is built on.

ASSESSMENT CRITERIA

Collection and classification of costs in different types of organisations (1.1)

Relationships between costing and financial accounting systems within organisations (1.3)

Sources of information on income and expenditure (1.4)

Differences between cost, profit and investment centres (1.5)

CONTENTS

- 1 Financial accounting and management accounting
- 2 Terminology – cost units and cost centres

**Test your understanding 2**

The table below lists some of the characteristics of financial accounting and management accounting systems.

Indicate the characteristics for each system by putting a tick in the relevant column of the table.

Characteristic	Financial accounting	Management accounting
Content can include anything useful.	<input type="checkbox"/>	<input type="checkbox"/>
To help managers run the business.	<input type="checkbox"/>	<input type="checkbox"/>
Formats dictated by accounting rules.	<input type="checkbox"/>	<input type="checkbox"/>
Looks mainly at historical information.	<input type="checkbox"/>	<input type="checkbox"/>
Produced for shareholders.	<input type="checkbox"/>	<input type="checkbox"/>

2**Terminology – cost units and cost centres****2.1 Cost units**

To help with the above purposes of planning, control and decision making, businesses often need to calculate a cost per unit of output.

A key question, however, is what exactly we mean by a 'unit of output', or '**cost unit**'. This will mean different things to different businesses but we always look at what the business produces.

- A car manufacturer will want to determine the cost of each car and probably different components as well.
- In a printing firm, the cost unit could be the specific customer order.
- For a paint manufacturer, the unit could be a litre of paint.
- An accountancy firm will want to know the costs incurred for each client. To help with this it is common to calculate the cost per hour of chargeable time spent by staff.
- A hospital might wish to calculate the cost per patient treated, the cost of providing a bed for each day or the cost of an operation.

5 Classification by behaviour

5.1 Cost classification by behaviour

The final cost classification we will look at is classifying costs depending on their behaviour.

In management accounting, when we talk about cost behaviour we are referring to the way in which **costs vary with differing levels of activity** (i.e. the number of cost units).

An understanding of cost behaviour patterns is essential for many management tasks, particularly in the areas of planning, decision making and control; in particular for **short-term budgeting** purposes.

For example, if a furniture manufacturer expected to produce 1,000 chairs in a particular month, what should the budget be for the costs of wood, labour, oil, selling costs, factory heat and light, manager's salaries, etc.? How would these costs differ (if at all) if it expected to produce 2,000 chairs instead?

To be able to answer such questions and to make budgeting and forecasting easier, costs are split into the following categories of behaviour:

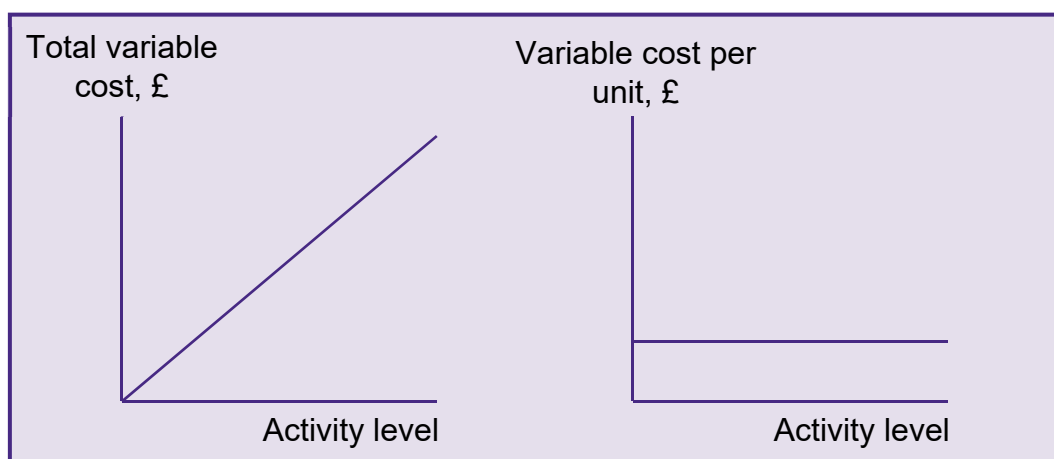
- Variable
- Fixed
- Stepped
- Semi-variable

5.2 Variable costs

Variable costs are costs that vary (usually assumed in direct proportion) with changes in level of activity. Variable costs are **constant per unit** of output and **increase in total in direct proportion to activity**.

For example, if you make twice the number of chairs then the total amount of wood used would double, and hence the **total cost increases proportionally**. This relationship is shown in the first of the following graphs.

The **variable cost per unit would remain the same**, as the cost of the wood needed in each chair is the same. This is shown in the second of the following graphs.



Example 1

If a business has total variable costs of £20,000 when it produces 1,000 units what is the variable cost per unit?

$$£20,000/1,000 = £20$$

What would be the total variable cost if the activity increased to 3,000 units?

$$£20 \times 3,000 = £60,000$$

5.3 Fixed costs

Fixed costs are costs that, in the short term, are not affected by changes in activity level. The **total cost stays constant** as activity levels change. For example, the rent on the factory. This is shown in the first of the following graphs.

The **fixed cost per unit reduces as the activity levels in increased**. This is because the same amount of fixed cost is being spread over an increasing number of units. This is shown in the second of the following graphs.

Note that the graph showing the variable cost per unit looks exactly the same as the total fixed cost graph. It is therefore always important to check the vertical axis on the graph as these two are easily confused.



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