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***Cost
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by Ken Boyd



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Dedication

I dedicate this book to my father, Bill Boyd, who is a hero to me. I would also like to dedicate this book to my wife and closest friend, Patty, and our children. Finally, this book is dedicated to the faculty and staff of three St. Louis schools: Chaminade College Preparatory School, St. Peter Catholic School in Kirkwood, and Visitation Academy. Thank you for your devotion and for educating our children.

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Introduction

The world needs accountants. People who know how to do accounting make the business world go round. Accountants analyze and report on every aspect of a business.

Cost accounting can be the most difficult accounting topic to grasp. This area has a unique language — a set of terms that differ quite a bit from other areas of accounting. Students and business owners may find cost accounting more challenging than other areas of accounting.

I wrote *Cost Accounting For Dummies* because your ability to understand this material has a huge payoff. Every business can be improved using cost accounting. The concepts help you to lower costs and increase profits. I'm passionate about helping you learn more about these critical topics.

About This Book

Some cost accounting books overwhelm you with dozens of complex topics. Not *Cost Accounting For Dummies*. Here, I focus on the really important topics that are used the most often. Accounting knowledge is meaningful when you can *use* it to solve a problem.

As a friend of mine once said, “It’s hard to drink out of a fire hose,” so I present the material in this book in an easy-to-read reference format. The book is logically divided into parts. Each part contains several chapters that are divided into readable “chunks” or sections. This system avoids blasting you with information. Instead, topics are introduced at a steady (but not overwhelming) rate, with concepts building on one another, making the reading (and understanding) easier.

The great thing about the book is that you decide where to start and what to read. It’s a reference book. You can locate a topic in the table of contents or the index, read about it, and move on. Accountants love organization (most accountants place their pencils in order from shortest to longest). This book is organized to be a quick reference.

Conventions Used in This Book

I use the following conventions throughout the text to make information consistent and easy to understand:

- ✓ All web addresses appear in `monofont`.
- ✓ New terms appear in *italic type* and are closely followed by an easy-to-understand definition.
- ✓ **Bold** is used to highlight the action parts of numbered steps.

In accounting, sometimes two terms can mean the same thing. Here are some of those terms that you find in this book:

- ✓ *Cost of sales* has the same meaning as *cost of goods sold*.
- ✓ *Sales* and *revenue* mean the same.
- ✓ *Indirect costs* has the same meaning as *overhead costs*.
- ✓ *Predetermined*, *budgeted*, and *planned* all have the same meaning.
- ✓ *Net income* is also *profit*, for the purposes of this book.

This book discusses three of the four basic financial statements. The fourth statement, statement of retained earnings, isn't covered. Three components of the statement — retained earnings, dividends, and net income — are addressed using the other three financial statements. So the fourth statement wasn't needed. I cover financial statements in Chapter 6.

When numbers appear, I use numerals, not words. This is common in accounting books.

Finally, keep in mind that companies sell both products and services. Some companies are manufacturers, and some are retailers. You see examples from both perspectives throughout the book.

What You're Not to Read

I've written this book so that you can find information easily as well as effortlessly understand what you find. And though it'd be great if you read every word, I've set off some text from the main information, text you can live without if you're just after the reference material.

The stuff set off from the main text is interesting. It's meant to be funny and sometimes thought-provoking. But if you're just after the nuts and bolts, you can come back to these items later:

- ✔ **Text in sidebars:** Sidebars are shaded boxes that usually give detailed examples or flesh out historical perspectives on the topic at hand.
- ✔ **Anything with a Technical Stuff icon:** This icon indicates information that's interesting but that you can probably live without. Read these tidbits later if you're pressed for time.

Foolish Assumptions

I had to make some assumptions about you, the reader. As I wrote the book, here's what I assumed:

- ✔ You're someone who needs an easy-to-read overview of cost accounting. Also, you want to investigate the topics that are used the most often to solve problems. You may be reading this book while taking a cost accounting course, but a business owner who needs more cost accounting knowledge should also find value in reading it.
- ✔ You're able to follow basic arithmetic and algebra. Many of items you need to calculate appear in the form of equations. Accountants love to create an x or y variable and then solve for that variable, using an equation.
- ✔ You have a beginner's-level knowledge of how a business works. You understand that sales less expenses equals profit. You're aware that a business needs to have capital (cash, equipment, and so forth) to operate.
- ✔ You're willing to read, pause, and assess what you've read. Learning cost accounting takes some effort. It's not the sort of thing you can rush through. Whereas the text makes it easy to find information, it takes some effort to understand what you read. After you get it, you can use cost accounting to improve your business for years to come.

How This Book Is Organized

This book is divided into parts that focus on the thought process of cost accounting. When an accountant is considering an issue related to costs, the parts broadly represent the steps he or she uses to resolve the issue — to plan (budget), make decisions, allocate resources, and ensure that a quality product or service is created.

Part I: Understanding the Fundamentals of Costs

So what exactly is cost accounting — and why should you care? Chapter 1 explains how cost accounting relates to other areas of accounting, but you still need to know basic terms, which you find in Chapter 2. You also learn about the types of costs and which are costs are most important. Chapter 3 is all about cost-volume profit (CVP) analysis, the starting point for planning your costs. Hey, accountants love to plan. You then learn about job costing and process costing in the next chapter. And Part I wraps up with Chapter 5 and activity-based costing (ABC). ABC teaches you how to dig deeper into your costs to find cost savings.

Part II: Planning and Control

Part II starts with Chapter 6 and a stroll through the budgeting process. Budgets are great if they are realistic and something you take seriously. You analyze the differences between your budget and actual results using variances — that's in Chapter 7. Moving on to Chapter 8, you get into overhead costs, which are often neglected in accounting, but these costs have a big impact on profit. If you're not careful, increasing overhead costs can cut into your profit. You go over inventory costs in Chapter 9, because inventory is often the most expensive cost in a business.

Part III: Making Decisions

You planned your business in Part II; now Part III helps you make good decisions in running your business. Cost drivers connect your business activities (sales and production, for example) to the costs you incur. You'll find cost drivers in Chapter 10. Chapter 11 explains how your business decisions need to be relevant. Relevant decisions are the important decisions — an area that you should focus on. And because you use costs to determine your product price, pricing decisions are discussed in Chapter 12.

Part IV: Allocating Costs and Resources

Ready, aim, fire. After you make decisions, you really should take action. Part IV covers allocating resources. Chapter 13 analyzes the profitability of your business. Most businesses have departments that share resources. The cost

of using those resources is defined as a *support cost* — see Chapter 14 for more. Chapter 15 addresses joint costs. These costs occur when you use the same production to produce multiple products. Everyone in your organization needs to understand how costs are shared. That process can prevent employee complaints down the road. Process costing is presented in detail in Chapter 16.

Part V: Considering Quality Issues

Successful businesses must deliver a quality product. I don't go back and buy from companies that don't sell a quality product. Chapter 17 deals with spoilage and rework. Spoiled products are defective products and can't be sold to a customer. Rework refers to fixing a defective product. When you order product, you should consider how to minimize your ordering costs, so Chapter 18 addresses that topic. Chapter 19 looks at quality issues related to production and product delivery, and also covers the critical issue of customer satisfaction. This section can make the difference between good companies and great ones.

Part VI: The Part of Tens

Every *For Dummies* book includes a Part of Tens. It's a great tool to have when you start using cost accounting. Sometimes you win, sometimes you lose, and sometimes it rains. Chapter 20 lists ten costing mistakes. Mistakes always cause you to incur more costs — and possibly end up with a net loss for the year. Improvements are covered in Chapter 21. This chapter is the payoff for the effort you've made to read this book. The concepts in Chapter 21 help you reduce costs and improve profits. Keep these points in the back of your mind as you manage your business. If someone asks you what's in this book, you might mention the Part of Tens.

Icons Used in This Book



To make this book easier to read and simpler to use, I include some icons that can help you find and fathom key ideas and information.

This icon appears whenever an idea or item can help reinforce your understanding of a concept. A tip might make it easier to remember a topic.



Any time you see this icon, you know the information that follows is so important that it's worth reading more than once.



This icon flags information that's a big concern. Warnings critical to your business are tagged with this type of icon.



This icon appears next to information that's interesting but not essential. Don't be afraid to skip these paragraphs. But come back at a later date and check them out. They'll be waiting for you.

Where to Go from Here

This book is organized so that you can go wherever you want to find complete information. Want to know about product pricing, for example? Head to Chapter 12. If you've taken an accounting course or two, start at Chapter 3 with cost-volume-profit. You can use the table of contents to find broad categories of information or use the index to look up more specific topics.

If you're not sure where you want to go, you may want to start with Part I. It gives you all the basic info you need to understand cost accounting and points to places where you can find more detailed information.

Part I

Understanding the Fundamentals of Costs

The 5th Wave

By Rich Tennant



"I'm not familiar with cost accounting terms.
What do you think that means?"

In this part . . .

So you're ready to learn all there is to know about cost accounting. You've come to the right place! Part I introduces cost accounting terms as well as some basic methods of analysis. You compare cost accounting to other accounting methods and learn four important cost terms: direct costs, indirect costs, fixed costs, and variable costs. You also find out about product and period costs, cost-volume-profit (CVP) analysis, and job costing. Process costing and the flow of manufacturing is also looked at.

Chapter 1

So You Want to Know about Cost Accounting

In This Chapter

- ▶ Understanding accounting methods
 - ▶ Comparing cost accounting systems
 - ▶ Controlling your costs
 - ▶ Applying a price to your product
 - ▶ Mulling over quality issues
-

In a nutshell, *cost accounting* is the process of analyzing and planning what it costs to produce or supply a product or service. The analysis helps reduce costs — and possibly eliminate them. Lower costs, of course, allow for increased profits.

Business folks use cost accounting to determine the profitability of a product. The rule is simple: The price should cover the product cost and generate a profit. Competition may dictate the price charged for a product. In other instances, a profit is added to a product cost to create a unique price.

This chapter introduces cost accounting and how to compare and contrast cost accounting with other accounting methods. The chapter also explains how cost accounting can help you improve your business, such as by using pricing, budgeting, and other tools that can help you become more profitable.

Comparing Accounting Methods

Accounting is the process of recording, reporting, and analyzing business transactions. It's the written record of a business. *Cost accounting* is the process of capturing all of the costs of “production,” whether a business manufactures products, delivers services, or sells retail items. Cost accounting is used for all types of businesses.

Often, cost accounting overlaps with other types of accounting, such as financial accounting and management accounting. If you have some knowledge about these other areas of accounting, that background can help you understand cost accounting. If not, no big deal. This section helps clarify what cost accounting is, how it's used, and how these accounting methods relate.

Financial accounting is a reporting process. An accountant reports on the financial position of a firm and the firm's performance by creating financial statements. The statements are used by external (outside) parties to show how the company is doing. External parties include *shareholders*, *creditors*, and *regulators*.

The external parties may not have an accounting background, so there are many rules of the road (and they are very specific) for creating financial statements. The rules exist so that each set of financial statements is standardized. If all companies follow the same set of rules to create financial statements, the information is usually comparable.

Financial accounting looks backward. It's *retrospective*. The accountant is creating financial statements for transactions that have already happened. So unlike cost accounting, financial accounting doesn't provide any planning or forecasting.

Your external users want financial statements on a periodic basis. Companies typically issue financial statements on a monthly, quarterly, or annual basis. External users want to know how you're doing — for a variety of reasons.

Considering your shareholders

If you own a business, *shareholders* own shares of your company in the form of common stock. That also means that shareholders own *equity* in your business. You may pay them a share of company earnings as a *dividend*.

Shareholders are interested in seeing the value of the business increase. As your sales and earnings grow, your company is seen as more valuable. A shareholder reviews your financial statements to see if sales and earnings are increasing. If they are, your shareholder is happy — she may even buy more of your common stock.

As sales and earnings grow, other investors may be willing to pay a higher price for your common stock. An existing shareholder might then sell his or her investment in common stock for a gain.

Mulling over creditors

Creditors are lenders. They lend your company money so you can purchase assets, which help your business operate. Assets are defined as items you use to make money in your business, like machinery and equipment. You sign a loan agreement with a lender, and that agreement states the interest rate for the loan and when the loan payments are due. You pay *interest* on the loan and also repay the original amount borrowed — the *principal* amount.