Chapter 10

Cost management and pricing

Introduction

In this chapter we look at the problems of cost measurement and control within management accounting and in particular at the issues of cost and resource allocation. We describe the traditional resource-based systems of cost allocation using a variety of cost drivers and applied to firms with service and cross-functional departments. The conceptual issues with cost allocation are then explored and a range of managerial interpretations offered as to why rational competitive firms engage in what from an economic perspective is irrational costing practice. From this, we explore some of the more modern methods of cost and resource allocation using output and activity measures. The techniques of activity-based costing are then explored with worked examples of the processes involved. A theme that is developed here is the analysis of generic cost drivers and the role of cost minimisation strategies in the development of quality and economy in the use of scarce resources. Finally, the chapter discusses the issue of cost-based and economic-based pricing systems.

Learning objectives

In this chapter the learning outcomes are distributed across two sections:

Cost management

- To be able to recognise the principal drivers of cost in organisations and to separate them into those that add value and those that do not.
- To understand the purpose of cost allocation and be able to define the meaning of the term 'full cost'.
- To be able to allocate cost with both single and multiple cost objects.
- To understand how indirect costs can be 'drawn down' to the unit level of production.
- To understand the differences and the relative advantages and disadvantages between resource- and activity-based cost management methods.

- To be able to understand the limitations of cost allocation methods and why they can lead to the mis-allocation of resources.

Pricing

- To understand the difference between market-based and cost-based pricing systems.
- To be able to describe market-based pricing systems and their appropriateness for different situations.
- To understand how full-cost product prices are built up using 'cost plus' and 'rate of return' pricing methods.
- To understand the intuition behind target costing and how it is used to drive down costs.

Cost management

In Chapter 8 we introduced the concept of direct and indirect cost. A direct cost is any cost that we can uniquely attribute to a given cost object and an indirect cost is any other cost that cannot be directly attributed but which has to be allocated to the cost object. 'Contribution' is the term we gave to the difference between directly attributable cost and directly attributable revenue. The first issue we address in this chapter is the basis upon which we can allocate indirect costs to specific cost objects and the rationale for doing so. Our second issue for discussion concerns the pricing of products and the different pricing approaches adopted by firms in practice. Pricing is one of the most difficult tasks faced by management: overpricing will lead to a loss of potential sales and possibly a fall in revenue, underpricing has the opposite effect. Product pricing methods fall into two broad categories: market-based and cost-based. We will describe the situation where each is relevant and the dangers and pitfalls of adopting the wrong approach. Finally, although we talk about 'products' and 'manufacturing' in this chapter nearly all the ideas and methods we discuss can be applied to service firms as well.

The impact of cost upon the firm

Costs are incurred whenever a firm decides to purchase any of the resources it needs for production. As we noted in Chapter 8, costs fall into a hierarchy: strategic or business-level costs being those required to create and sustain the business as a going concern, operational-level costs being those required to sustain the capacity of the business to conduct its day-to-day operations, and production-level costs being those required to produce and deliver the product or service concerned. However, there is a deeper level of analysis that suggests that costs arise along two different vectors or dimensions within the firm:

- The organisational or structural vector: these are all the costs required to maintain the business as an organisation. In general, it is possible for virtually any good or service to be produced by independent contractors in an open market. Adam Smith in his *Wealth of Nations* described how the 'invisible hand of the market' can bring about the production of complex goods without the need for any overall coordination. However, organising production through firms, where the costs of contracting in open markets is replaced by the costs of managing the firm, can sometimes be a more cost-effective method of production.