Chapter 8

The principles of cost and revenue measurement

Introduction

Management accounting is that branch of accounting concerned with providing information for managers and other internal users within the firm. In this chapter we will begin by laying down some important costing and revenue measurement principles before moving on to the important topics of decision matching and determining what are known as 'decision relevant costs and revenues'. This section is based on a small number of very straightforward ideas which once mastered will support a good proportion of your study in management accounting and, later in this book, investment appraisal. The second half of the chapter is devoted to more traditional approaches to cost measurement including how to prepare breakeven charts and the marginality rule.

Learning objectives

In this chapter there are eight learning outcomes divided into four sections.

Basic principles of costing

- To be able to distinguish between direct and indirect costs and revenues and consider their relationship to cost and revenue objects.

Costing for decisions: relevant costing

- To be able to identify costs that are relevant for decision-making purposes and those that are not.
- To be able to identify the opportunity costs of undertaking a particular course of action when production resources are in short supply.

Cost behaviour and cost/volume/profit analysis

- To distinguish between variable, fixed and other types of cost and revenue patterns.
- To be able to estimate a cost to output relationship on the basis of historical data.
- To be able to construct a flexible budget to include both linear and non-linear cost and revenue patterns.
- To create a breakeven graph over a relevant range of output.

Marginal analysis

- To understand the concept of marginal cost and marginal revenue and how to identify the output level that generates maximum profit for the firm.

Basic principles of costing

The role of management accounting is to produce information which will assist managers in their work. Management is a diverse function and there are many different activities which managers undertake. In practice, given this diversity of activity, it is easier to define management accounting in terms of the principles under which it operates rather than in terms of the decisions that managers are likely to make. Management accounting uses two matching principles which distinguish it from financial accounting:

- *Decision matching:* this is concerned with measuring the cost and revenue changes to a firm as a whole as a result of a specific decision that has been made or is being considered.
- *Allocation matching:* this is where the accountant attempts to match costs and revenues to the various productive activities which a firm undertakes or to different departments or divisions within the firm.

In this chapter we will explore both of these matching concepts. However, before we do so we will consider some important costing concepts.

Cost objects

A cost object is literally anything we wish to cost. So, for example, Virgin Atlantic may wish to cost a flight to Orlando. In that case, a flight to Orlando is the cost object. The company may wish to cost the operation of a Boeing 747-400 for a year's flying. A year's flying of such an aeroplane would therefore be the cost object. It may, at the other end of the spectrum, wish to cost the provision of a particular in-flight meal. Then that meal would be the cost object. The idea of a cost object is very general but very important because once defined we can then decide which costs are directly attributable to the given cost object and which are not.