**Module 1 - Background**

**Introduction to Managerial Accounting**

**The Variable Income Statement and Accounting Terminology**

**I. Income Statements**

This first module introduces the purpose of managerial accounting and the behavioral income statement. We are going to significantly amend the traditional financial income statement and also amend the way in which we interpret the numbers. The result is a powerful tool you will find useful in virtually every aspect of your business career.

Below is an example of an absorption income statement.

|  |  |
| --- | --- |
| Revenues (Sales) | $10,000 |
| less Cost of Goods Sold ( or Cost of Sales) | 4,000 |
| Gross Profit (Gross Margin) | $6,000 |
| Operating Expenses | 3,500 |
| Net Income | $2,500 |

Now, compare the above format to the variable costing approach.

|  |  |
| --- | --- |
| Revenue (Sales) | $10,000 |
| Variable Costs | 2,000 |
| Contribution Margin | $8,000 |
| Fixed Costs | 5,500 |
| Net Income | $2,500 |

Note that there are two essential differences in these statements.

First, there is major difference in the way costs are organized. In the absorption income statement, costs are organized by function - product costs versus operating costs. In the variable costing income statement, costs are organized by behavior - variable costs versus fixed costs.

Second, the traditional statement uses cost of goods sold as the intermediate step while the contribution margin statement uses contribution margin as the intermediate step.

The essential points in this module are:

Costs organized by cost behavior can be quite useful to decision making than costs organized by function.

Contribution margin is a very relevant point of information. It tells the user of the statement the net benefit to the organization that is the result of the activity. That is, we will incur the fixed costs in any event. The variable costs are incurred only as the activity level increases. Thus, the contribution margin (the difference between revenue and variable costs) is a measure of the benefit of that activity.

Net income will be the same under both approaches only when there is no change in beginning or ending inventory (assuming constant prices).

A word of warning, the variable costing approach and its interpretation are both very significant departures from the traditional absorption (financial) income statement. This module is going to require some new and innovative thinking. However, I promise you this: the results will prove to be exceptionally useful for the remainder of your career.

**II. A List of Accounting Terms**

**Cost behavior** refers to how a cost will react to changes in the level of activity within the **relevant range**. The most commonly used classifications of cost behavior are variable and fixed costs:

**Variable cost** - A cost that varies, in total, in direct proportion to changes in the level of activity. However, variable cost per unit is constant.

**Fixed cost** - A cost that remains constant, in total, regardless of changes in the level of the activity. However, if expressed on a per-unit basis, the average fixed cost per unit varies inversely with changes in activity.

**Mixed cost** – A cost that has both a variable and a fixed component. These costs need to be broken down into two components by using a modeling approach.

**Cost classifications for assigning costs to cost objects:**

**Cost object -** Anything for which cost data are desired including products, customers, jobs, organizational subunits, etc. For purposes of assigning costs to cost objects, costs are classified two ways:

**Direct costs -** Costs that can be easily and conveniently traced to a specified cost object.

**Indirect costs** - Costs that cannot be easily and conveniently traced to a specified cost object.

**Common costs** - Indirect costs incurred to support a number of cost objects. These costs cannot be traced to any individual cost object.

**Cost classifications for decision-making**

It is important to realize that every decision involves a choice between at least two alternatives. The goal of making decisions is to identify those costs that are either **relevant** or **irrelevant** to the decision. To make decisions, it is essential to have a grasp on three concepts:

**Differential costs** (or **incremental costs**) - A difference in cost between any two alternatives (a difference in revenue between two alternatives is called **differential revenue**).

Differential costs can be either fixed or variable.

**Opportunity cost**- The potential benefit that is given up when one alternative is selected over another.

These costs are not usually entered into the accounting records of an organization, but must be explicitly considered in all decisions.

**Sunk cost** - A cost that has already been incurred and that cannot be changed now or in the future.

**Behavioral income statement (variable costing)** terms:

**Contribution margin** – Sales (revenues) minus variable costs.

**Segment margin** – Contribution margin minus direct fixed (direct, traceable) costs.

**Common fixed costs** – Direct fixed costs (untraceable) are subtracted from the segment margin to arrive at operating income.

**Operating income** – Income from operations.

**Allocated expenses** – Common fixed costs allocated to products (services, product lines, etc.) based on some type of formula.

Note that terminology is somewhat inconsistent, but it something we just have to live with. It is not only readings that use inconsistent terminology, but the same holds true for the workplace.

If you cannot locate an article in one set of databases (such as EBSCO), try to find it in ProQuest.

**Required Background Materials**

Introduction to Managerial Accounting (2007, July 25) [Video File]. Retrieved from [*http://www.youtube.com/watch?v=pBCRmjnwWgo*](https://www.youtube.com/watch?v=pBCRmjnwWgo)

Martin, J.R. (n.d.) Management Accounting: Concepts, Techniques, and Controversial Issues - Chapter 1: Introduction. *Management And Accounting Web Home Page*. Retrieved from [*http://maaw.info/Chapter1.htm*](http://maaw.info/Chapter1.htm)

White, L., Clinton, B., van der Merwe, A., Cokins, G., Thomas, C., Templin, K., & Huntzinger, J. (2011). Why We Need a Conceptual Framework for Managerial Costing. Strategic Finance, 93(4), 36-42.

**Optional Resource(s)**

Accounting for Management (n.d.). Managerial or Management or Cost Accounting Terms and Definitions. Retrieved from [*http://www.accountingformanagement.com/managerial\_accounting\_defintions.htm*](http://www.accountingformanagement.com/managerial_accounting_defintions.htm)

**The following two texts can be used as additional background material throughout the course.**

Hermanson, R.H., Edwards, J.D., & Invacevich, S.D. (2011). Accounting Principles: A Business Perspective. *First Global Text Edition, Volume 2 Managerial Accounting*. Retrieved from [*http://textbookequity.com/oct/Textbooks/TBQ\_PA\_Accounting\_managerial.pdf*](http://textbookequity.com/oct/Textbooks/TBQ_PA_Accounting_managerial.pdf)

Walter, L.M. (2012). [*Principles of Accounting: A Complete Online Text*](http://www.principlesofaccounting.com/). Retrieved from [*http://www.principlesofaccounting.com/*](http://www.principlesofaccounting.com/)