Management Accounting

PRACTICAL CLASS 10

Production Losses

ACCOUNTING FOR PRODUCTION INEFFICIENCIES

So far, we have examined situations in which there are no losses i.e., all output within each process is fully completed. However, that is not necessarily the case.

In general, whatever is budgeted/expected is accounted in the **process cost/COGM**, whereas deviations from the budget/expectations go directly into the **P&L Account**.

Bonus:

The reasoning is similar to why we use Budgeted Overhead Rates and TSC to compute COGM 😊

Normal Losses	**Expected losses** that still occur under **efficient operating conditions** ***e.g. Scrap from Wood Cutting***
Abnormal Losses	**Unexpected losses** arising from inefficient operating conditions ***e.g. Miscutting, Defects…***
Scrap Value	**Residual Value** of an Asset's components when the asset is no longer usable

$$\boldsymbol{COGM_{Unit}} = \frac{\text{MC} - \text{Scrap Value of Normal Losses}}{\text{Expected Output}}$$

$$\boldsymbol{Expected\ Output} = \text{Production} + \text{Abnormal Losses}$$

Production Losses

STEP BY STEP

1) Expected production = Production + Abnormal losses

2) Scrap value normal losses = Normal loss units * Scrap value

3) COGM / unit = $\frac{\text{Total Manufacturing costs} - \text{Scrap Value Normal Losses}}{\text{Expected Output}}$

4) Value abnormal losses = Abnormal losses units * COGM/unit

5) Sales of scrapped abnormal units = Abnormal losses units * Scrap value

Profit = Sales revenues – COGS + (Scrap value – COGM/unit) * #Abnormal losses

Exercise

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