Unit-1

Introduction

Introduction:

Cost accounting is the application of accountingandcosting principles, methods, and techniquesintheascertainment of costs and the analysis of savingorexcess cost incurred as compared withpreviousexperience or with standards.

Cost accounting is one of the most important typeofaccounting, along with the industrial revolutionthecostth centuryingreat accounting has developed in the 18 Britain and United State of America. Cost systemwereinstalled in factories on an experimental basis. Duetoits utility it has developed during the periodbetween1920 & 1945.

Meaning of Cost:

In accounting, the term cost refers tothemonetaryvalue of expenditures for raw materials, equipment, supplies, services, labour, products, etc. It isanamountthat is recorded as an expense in bookkeepingrecords.

According to CIMA (Chattered Institute of Management& Accounts) of London the cost means " Theamountisexpenditure incurred to given thing".

Meaning of Costing:

The Institute of Cost and Management Accountants(ICMA) defines costing as the technique andprocessofascertaining costs.

This is a reasonable definition, but it only addressesthedimensions of technique and process. Toelaborateonthis, costing can also be defined as asystematicprocess for determining the unit cost of outputproduced or service rendered.

Meaning of Cost Ac ounting:

The cost accounting definition can be referredtoastheprocess of determining and controllingcoststhatoriginate with the tracking of expenditures andrevenuesor the principles on which they are computedandfinishwith the compilation of periodic statements.

Cost accounting is primarily focused on gettingasenseof where a company makes and spends value, aswell asproviding input into future profit-generatingactions.

Objectives of Cost ac ounting:

1. Determining the cost: It is basis objectiveofcostaccounting. It involves collection, recording, classifying, summarizing cost of every unit.

2. Control ing cost: Cost accountingdirectsthemanagement in the area cost control. It adoptsvarious cost control measures likecomparingactual performance with standard performancewiththe help of budgets.

3. Useful in Decision making process: Costaccounting is used in decision makingprocess. Itanalyse various alternative to select proper courseof action.

4. Fixation of price: Costing data providesan

appropriate base for fixation of price, usuallywhilepreparing the project on newproduct developmentestimates, tenders and quotations, cost dataarereliable sources for the fixation of price.

5. Comparison: In Cost Accounting preparationofcomparative cost schedules of different jobs, process & methods under different conditionstoselect the best course of the action is possible.

6. Determination of Profit: Cost Accountingprovidesthe scope for the ascertainment of profitabilityofvarious types processor, jobs, productsetcfromtheview point of capital invested. Costingalsoenablesthe management in times of depressionregardingpricing decision.

7. Provisions for formulating policies: Withthehelpofvarious tools & techniques some policescanbeformulated like make or buy decisionstoacceptexport order or not replacement, cost profit valueratio.

8. Expansion: Cost Accounting helpsthemanagement to take vital decisionssuchasintroduction of new products, replacement of labour, by machines & it advises the management onfutureexpansion, policies and proposed capital projects.

Importance of Cost Ac ounting:

A. Importance to Management: The importanceofcost accounting is very much useful totheManagement of an Organization, the importanceofCost Accounting is discussed in thefollowing section vividly:

Classification of Costs: Cost is a generictermthatneeds to be classified for further use. CostAccounting involves the recordingandclassification of all such costs. Costsinvolvetheprime cost, direct cost, factory cost, sellingcostand more other costs. Classificationallowsthemanagement of the costs and toascertaintheprofitability of any such processes andfurtheractivities. This also helps in calculatingtheefficiency.

Cost Control: This is efficient for thebusinesstofocus on controlling the cost of theinventory, labour, and various other kind overheadcosts. Forexample, to achieve maximumefficiencyintheirinventory management they can adopt theEOQtechnique which is the costing technique. Similarly, by analysing the costs of labour and thecapacityofmachinery their efficiency can be improvedalso.Cost accounting classifies the overheadsintofixedand variable.

Price Determination Cost accountingmakesthebasic distinction between fixed and variablecosts.This is then used by the company or thebusinessunit to fix the prices of the products, accordingtotheir costs of the product. The management herefinds the most ideal price for the product ortheservice, which is not too high and not toolow. Forexample, where the economy suffers adepressionperiod.

The businessman lowers the prices of hisproductsto survive the depression circumstancesintheeconomy. He can start this by tryingtocontrol thevariable costs and to allow himto fix theproduct'sprices.

Fixing of the Standards: The organizationsusethestandards to make the estimates andthebudgetsfor their future. They use this as thebasistomeasure the actual efficiency of theprocessorabout the department. This is an entirebranchofcost accounting which is known asStandardCosting dedicated priorly to this process.

B.Importance of Cost Ac ounting to others:

Workers: One of the biggest usesof costaccounting is that it helps us calculateefficiency.This will help the company come upwithanincentive scheme for workers who showefficiencyin their work, and thus they will beawardedaccordingly. It is also an incentive for workerswithlower efficiency to do better.

Government: Costing helps the government whenassessing for income tax or any other suchgovernment liabilities. It also helps set industrystandards and helps with price fixing, tariff plans, cost control etc.

Customers: The main aims of costingarecostcontrol and improvement in efficiency. Bothofthese are very beneficial to the company. Andultimately this benefit passes on to thecustomers

of the products or services.

Uses of Cost Ac ounting:

Cost al ocation: Managers can allocatecostsbyproduct line and per unit of productionor houroflabour.

1. Profit drivers: Cost accounting helpsbusinessowners gain a deeper understandingof their profitmargin and what drives it.

2. Budgeting and forecasting: Calculatingcostsforindividual activities helps senior managersplanforfuture spending and forecast their financesintothefuture.

3. Cost Savings: Using cost accounting, businessesmay be able to identify new efficienciestohelpsavemoney.

4. Quicker decisions: Cost accountingcanhelpmanagers respond quickly to changes inthemarket, such as when the cost of rawmaterialsincreases.

Dif erences between Cost ac ounting andFinancialac ounting:

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FINANCIAL

COMPARISON

ACCOUNTING

ACCOUNTINGFinancial

Meaning Cost

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BASIS FOR COST

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COMPARISON

ACCOUNTING ACCOUNTING

budgeting techniques.

Elements of Costs:

Below are the elements of costs:

1. Direct materials: It represents the rawmaterial orgoods necessary to produce or manufacturea product. The cost of direct material variesaccording to the level of output. For example, Milkis the direct material of ghee.

2. Indirect materials:

It refers to the material which we requiretoproducea product but is not directly identifiable. It doesnotform a part of a finished product. For example, the use of nails to make a table. The cost of indirectmaterial does not vary in the direct proportionofproduct.

3. <u>Direct Labour:</u> It refers to the amount whichpaidtothe workers who are directly engagedintheproduction of goods. It varies directly withthelevelof output.

4. <u>Indirect Cost:</u> It represents the amount paidto

workers who are indirectly engagedintheproduction of goods. It does not vary directlywiththe level of output.

5. <u>Direct Expenses:</u> It refers to the expensesthatarespecifically incurred by the enterprises toproduceaproduct. The production cannot take placewithoutincurring these expenses. It varies directlywiththelevel of production.

6. <u>Indirect Expenses:</u> It represents the expensesthatare incurred by the organization toproduceaproduct. These expenses cannot be easilyidentifiedaccurately. For example, Power expensesfortheproduction of pens.

7. <u>Overhead:</u> It refers to all indirect materials, indirect labour, or and indirect expenses.

8. <u>Factory Overhead:</u>

Factory overhead or Production Overheador WorksOverhead refers to the expenses whichafirmincursin the production area or within factory premises.

Indirect material, rent, rates and taxesof factory, canteen expenses etc are exampleof factoryoverhead.

9. <u>Administration Overhead:</u> Administrativeor OfficeOverhead refers to the expenses whichareincurredin connection with the general administrationoftheorganizations.

Salary of administrative staff, postage, telegramand telephone, stationery etc are examplesof

administration overhead.

10. Sel ing Overhead: All expenses that afirmincurs in connection with sales aresellingoverheads. Salary of sales department staff, travellers' commission, advertisement etcareexample of selling overhead.

11. Distribution Overhead: It representsallexpenses incurred in connection with thedeliveryordistribution of finished goods and servicesfromthemanufacturer to the consumer. For ex, Deliveryvan expenses, loading and unloading, customsduty, the salary of deliverymen are examplesofdistribution overhead.

Classification of Cost:

The following will be the types of cost classification.1.

Classification by Nature:

This classification of cost is based onthenatureofthe expenditure, which are the threebroadcategories as per this, namely Labour Cost, Materials Cost, and Expenses. This cost makesiteasier to classify them on a cost sheet. Theyhelpinestimating the total cost and also toestimatethework-in-progress cost.

🎬 Material costs: These are the costsofanymaterials that are used in the productionofgoods. This is further divided intofurther costs.For instance, we can classify material costs into spare parts, raw material cost, packaging

material cost, etc.

- 🎬 Labour costs: This cost includes thesalaryandwages paid to temporary andpermanentemployees for the manufacturingof thegoods.

- 🎬 Expenses: It includes all other expensesassociated with manufacturing andsellingtheservices or goods.

2. Classification by Functions:

This is the classification based on functional costs.The cost classification by function flowsthepatternof basic managerial activities. So, thiscostisclassified as production, administration, selling, etc.

- 🎬 Production Costs: These costs arerelatedtothe real construction or manufacturingofthegoods.

- 🎬 Commercial Costs: This cost includestheoperation of an enterprise except forthemanufacturing costs. It consists of theadmincosts, distribution and selling cost, etc.

3. Classification by Traceability:

This cost is classified into direct costsandindirectcosts. This classification is classifiedonthedegreeof traceability to the final product of thefirm.

- 🎬 Direct Costs: These are the coststhatareeasily related to a specific cost unit. Themostsignificant examples are the materialsusedto manufacture a product or the labour involvedinthe production process.

- 🎬 Indirect Costs: These costs are usedfor manypurposes, which are betweenmanycost centres or units. So we cannot put themtoonespecific cost centre—for instance, therentofthe place or the manager's remuneration. Wewill not be able to identify howtoestimatecosts to a specific cost unit.

4. <u>Classification by Normality:</u>

This classification is based on the costsasthenormal costs and abnormal costs. Thenormalcosts are the costs that happen at a givenpointofoutput, under the same set of conditionsinwhichthis point of output occurs.

- 🎬 Normal Costs: The cost of productionandalsothe part of the costing profit andloss. Theseare the type of costs that the organizationincurs at the standard level of output undernormal conditions.
- 🎬 Abnormal Costs: These costs arenot normallyoccurring at a particular level of outputinconditions in which normal levelsof outputhappen. These costs are calculatedaccordingto the profit and loss account; theyarenotapart of the production cost.

5. <u>Classification ac ording to Behaviour:</u> Cost behaviour

refers to the way different typesof

production costs change when there isachangeinthe level of production. There are threemaintypesof costs according to their behaviour:

- Fixed Costs: Fixed costs are thosewhichdonot change with the level of activitywithinthe relevant range. These costs will incur evenifnounits are produced. For example rent expense, straight-line depreciation expense, etc.

- Variable Costs: Variable costs changeindirectproportion to the level of production. Thismeans that the total variable cost increasewhen more units are produced anddecreaseswhen fewer units are produced. Although variable in total, these costs are constantperunit.

- Mixed Costs: Mixed costs or semi-variablecosts have properties of both fixedandvariablecosts due to the presence of bothvariableandfixed components in them. Anexampleof mixed cost is telephone expensebecauseit usually consists of a fixed component suchasline rent and fixed subscription chargesaswellas variable cost charged per minutecost.Another example of mixed cost isadeliverycost which has a fixed componentofdepreciation cost of trucks andavariablecomponent of fuel expense.

6. <u>Classification ac ording to Control ability:</u> As per this classification, we identify whether thecostis

controllable by nature or not. Naturally, therearetwotypes of costs under this classification –controllablecosts and uncontrollable costs.

🎬 Control able Costs: Controllablecostsarethose which can be influenced by theactionsofthe firm even to some limited extent. Soevenifthe cost is only partly controllable, wewill call itcontrollable costs. In an organization, thereare
various costs centres. These controllablecostsof a particular cost centre will beinfluencedand controlled by the actions of themanagerresponsible for that responsibility centre.

🎬 Uncontrol able Costs: On the other hand, uncontrollable costs are not in control ofthemanagement. They cannot be influencedbyany action taken by managers or thefirm. Sayfor example the rent of the factory.

This is an uncontrollable cost, asthemanagement has no say or influenceoverit. Infact, most fixed costs and overheadsareuncontrollable costs.

7. <u>Classification ac ording to Capital/Revenue:</u>

🎬 Capital cost: Capital cost are thosecost whichare incurred in purchasing in someassetsforthe purpose of increasing the earningcapacityof the business. Ex- Plant/Machinery
purchased, building purchased.

🎬 Revenue Cost: Revenue cost arethosecost

which incurred to maintainedtheearning capacity of the business. Ex- Costof maintaining the assets.

Cost object:

A cost object is an item for which a cost iscompiled.For example, this can be a product, product line, service, project, customer, distribution channel, or activity. Costobjects are used in activity-based costinganalysesasthe focal point of cost accumulations. Aclosereviewofcost objects is also useful for managingcoststhroughout an organization. Cost objects areoneoftheprimary targets of reporting within amanagerialaccounting system.

Cost Unit:

Cost unit, also known as the cost per unit, thecostofgoods sold or the cost of sales, is the amount of moneythat a company invests in manufacturing asingleunitofa saleable product. The cost of unit calculationappearsin the company's financial statement. It helpsthecompany determine if its production costsarelowerthan the sales revenue and whether it is profitingfromits product sales. Cost per unit calculationsareoftenused by businesses that are dependent onproduct sales, but service-based companies may also usethem.

Cost driver:

Cost drivers are the direct cause of a businessexpense.A cost driver is any activity that triggersacostofsomething else. An example of this couldbehowtheamount of water your office uses in a monthdetermines

the price of your water bill. The units of water arethecost drivers, and the water bill is the cost. Thisconceptdemonstrates that all activities require the consumptionof resources, and as people complete workactivities, there is an associated resource cost for eachactivity.

Cost centre:

A cost centre is a department or functionwithinanorganization that does not directly add toprofit butstillcosts the organization money to operate. Cost centresonly contribute to a company's profitabilityindirectly, unlike a profit centre, which contributes toprofitabilitydirectly through its actions. Managers of cost centres, such as human resources and accountingdepartmentsare responsible for keeping their costs inlineor belowbudget.

Cost reduction:

Cost Reduction is a process, which aims tolowertheunit cost of a product manufactured or servicerenderedwithout affecting its quality. It can be donebyusingnew and improved methods and techniques. Itascertains substitute ways to reduce theproductioncost of a unit.

Thus, cost reduction ensures savings inper unit costand maximization of profits of the enterprise. CostReduction aims at cutting off the unnecessaryexpenseswhich occur during the production Process, storage, selling and distribution of the product.

Cost control:

Cost Control is a process in whichwefocuson controlling the total cost throughcompetitiveanalysis. It is a practice which works toaligntheactual cost in agreement with the establishednorms.

It ensures that the cost incurred on productionshouldnot go beyond the pre-determined cost. Cost Controlinvolves a chain of various activities, whichstartswiththe preparation of the budget in relation toproduction.

Methods of Costing:

The various methods of costing are as follows:

1. Job costing: This is a method wherecostsarecollected and accumulated for each jobseparately.This is done because each job requiresdifferentmark and has separate identity andthereforeitbecomes essential to analyse and segregatecostsaccording to each job separately.

2. Batch Costing:

   Under this method, factories, which havetoproducea large number of parts, in order to makeaproductundertake the production of each part inbatches.Products are arranged in convenient batchesandeach batch is treated as one jobandcostiscalculated accordingly. For example, abicyclefactory may produce 10000 handles at onetimeand then take up the manufacture of other partsinother batches. The cost of eachbatchisascertained separately and the methodisknownasbatch costing.

3. Process Costing:

It is a method where costs are collectedandaccumulated according to department or processesand cost of each department or processisdividedby the quantity of production to arriveat costperunit. This method is useful in industriessuchaspaper, soap, textiles, chemicals, sugar andfoodprocessing products.

4.Operation Costing:

This is a more refinement and moredetailedapplication of process costing. Thisinvolvescosting by every operation instead of aprocess.Many operations are necessary to makeanarticle.This method has greater accuracy andcontrol.

5. Single (Unit or Output) Costing:

This method is applied where productionisuniformand consists of only a single product or twoor threetypes of similar products with variationonlyinsize, shape or quality. The information is presentedintheform of a statement known as cost sheet.

6.Operating Costing:

Where a business does not produce tangiblegoodsbut renders some service, the systemof costingwould be known as operating costing. Thisisusedto determine the costs of services renderedbyairways, railways, roadways, hospitals, powerhouses etc. For example a transport companyisinterested in knowing the cost of carryingoneton of goods per kilometre.

7. <u>Multiple Costing:</u>

This method is followed where the final productconsists of a number of separate parts, e.g., radioset, motor car, bicycle etc. The cost of eachparthas to be ascertained and then thecostofassembling the parts will be tabulated. Thecostofthe final product will consist of the cost all thepartsplus the cost of assembling them.

<u>Techniques of costing:</u>

The techniques of costing facilitatemanagerialdecision making. The different types are:

1. <u>Marginal Costing:</u> As per this technique, themanagement may decide the number of unitstobe produced. Suppose a toy unit isalreadyproducing 100 units of ‘Dancing Monkey’ toy, thistechnique will help the management understandthat if the production is increased to150, will itbeprofitable. In this technique, only thevariablecosts for additional units producedwill beconsidered. Fixed costs are not takenintoconsideration as they do not vary withchangesinproduction.
2. <u>Standard Costing:</u> In this technique of costingthecosts incurred are comparedtothepredetermined cost of the product, processorproject. The variances are analysedtobringabout cost-effectiveness.

3. Direct Costing: In this technique all thedirectcosts incurred for a particular product, processor project are charged to it and the indirect costsare written off to profit and loss.

4. Historical Costing: It is comparisonof all costsincurred after the process is performed.

5. Uniform Costing: In this technique samecostingpractices are followed across certainunitstofacilitate comparison.

6. Absorption costing: This is a methodoffullcosting. In this all costs are chargedtotheproduct, process or project.

Use of IT (Income Tax) in Cost Ac ounting: Limitations of Cost Ac ounting:

Despite several benefits offered by cost accounting, there are certain limitations also:

1. It is expensive: The systemof cost accountinginvolves additional expenditure to beincurredininstalling it and maintaining it.
2. The system is more complex: Asthecostaccounting system involves a number of stepsinascertaining cost, it is consideredtobeacomplicated system of accounting.
3. Inapplicability: All businesses cannot makeuseofasingle method and technique of costing. Italldepends upon the nature of businessandtypeofproduct manufactured by it.
4. Not suitable for smal organisations: Acostaccounting system is applicable only toalargeorganisation but not

suitable for small organisation.

5. Lack of social ac ounting: Cost account failstotake into account the social obligationofthebusiness. In other words, social accountingisoutside the purview of cost account.

6. No solution to problem: It only providesabasisfortaking right decisions but does not givesolutiontothe problems.

7. No uniformity: Lacks uniformity in application.

8. Biased: Many judgements are biasedanddependon the individual Discretion.

9. Not an exact science: Cost Accountingisnotanexact science. In the absence of it, variousdecisions are subject to certain judgements.

10. Assumptions: It is based onvariousassumptions leading to wrong conclusionsinsomecases.

<u>Cost Sheet:</u>

A cost sheet is a formal documentationof thefixed, variable, direct, and indirect costs a businessincursfrom start to finish in its production process. Basedonthis information, a company can determinethetotalproduction cost and fix the price per itemforthecommodities.

<u>Cost heads in a Cost Sheet:</u>

A cost sheet has four major cost heads, whichare;

1.<u>Prime Cost:</u> All the expenses directly involvedintheproduction process are prime costs. It alsopassesasflat, first, or basic cost.

Let’s say you run a bakery. Your prime costswouldbethe money spent on raw material like purchasingflourbags, paying workers’ wages, and other directproduction expenses.

Prime Cost Formula

Prime Costs = Direct Labour + Direct RawMaterial +Direct Expenses

2. Works Cost: Works cost is the sumof primecostsand factory costs or overhead expenses. Your overheadcosts are indirect costs like the money paidtoworkerswho are secondarily involved in the productionprocessand the money spent in taxes and utilities.

3. Cost of Production: You should account foranyexpenses incurred by your business operations, including the factory rent and work costs. Costofproduction is equal to work costs plus administrationoverhead minus the opening and closingstockforfinished goods.

4. Total Cost or Cost of Sales: Cost of salesisall theexpenses incurred during the productionplusothercosts for selling and distribution overhead. Thismetrichelps you to know the overall productionvalueofanitem based on the resources committed toit. Fromthecost of sales, you can peg the sales pricefor finished goods and calculate your profit.

Tenders and Quotation:

Tender: Tender is the process of asking supplierstobidon products/services required by a companywhereasquotation is the response to bidders, wheretheyquotetheir price for goods/services.

Quotation: Quotation is also termed as anestimationgiven by professionals for jobs.