

Unit-1

Introduction

Introduction:

Cost accounting is the application of accounting and costing principles, methods, and techniques in the ascertainment of costs and the analysis of saving or excess cost incurred as compared with previous experience or with standards.

Cost accounting is one of the most important types of accounting, along with the industrial revolution the costth centurying great accounting has developed in the 18 Britain and United State of America. Cost system were installed in factories on an experimental basis. Due to its utility it has developed during the period between 1920 & 1945.

Meaning of Cost:

In accounting, the term cost refers to the monetary value of expenditures for raw materials, equipment, supplies, services, labour, products, etc. It is an amount that is recorded as an expense in bookkeeping records.

According to CIMA (Chartered Institute of Management & Accounts) of London the cost means “The amount is expenditure incurred to given thing”.

Meaning of Costing:

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



This is a reasonable definition, but it only addresses the dimensions of technique and process. To elaborate on this, costing can also be defined as a systematic process for determining the unit cost of output produced or service rendered.

Meaning of Cost Accounting:

The cost accounting definition can be referred to as the process of determining and controlling costs that originate with the tracking of expenditures and revenues or the principles on which they are computed and finish with the compilation of periodic statements.

Cost accounting is primarily focused on getting a sense of where a company makes and spends value, as well as providing input into future profit-generating actions.

Objectives of Cost Accounting:

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

2. Controlling cost: Cost accounting directs the management in the area of cost control. It adopts various cost control measures like comparing actual performance with standard performance with the help of budgets.

3. Useful in Decision making process: Cost accounting is used in the decision-making process. It analyzes various alternatives to select the proper course of action.

4. Fixation of price: Costing data provides an



appropriate base for fixation of price, usually while preparing the project on new product development estimates, tenders and quotations, cost data are reliable sources for the fixation of price.

5. Comparison: In Cost Accounting preparation of comparative cost schedules of different jobs, process & methods under different conditions to select the best course of the action is possible.
6. Determination of Profit: Cost Accounting provides the scope for the ascertainment of profitability of various types of processes, jobs, products etc. from the view point of capital invested. Costing also enables the management in times of depression regarding pricing decision.
7. Provisions for formulating policies: With the help of various tools & techniques some policies can be formulated like make or buy decision to accept export order or not replacement, cost profit value ratio.
8. Expansion: Cost Accounting helps the management to take vital decisions such as introduction of new products, replacement of labour, by machines & it advises the management on future expansion, policies and proposed capital projects.

Importance of Cost Accounting:

A. Importance to Management: The importance of cost accounting is very much useful to the Management of an Organization, the importance of Cost Accounting is discussed in the following



section vividly:

Classification of Costs: Cost is a generic term that needs to be classified for further use. Cost Accounting involves the recording and classification of all such costs.

Costs involve the prime cost, direct cost, factory cost, selling cost and more other costs.

Classification allows the management of the costs and to ascertain the profitability of any such processes and further activities. This also helps in calculating the efficiency.

Cost Control: This is efficient for the business to focus on controlling the cost of the inventory, labour, and various other kind overhead costs. For example, to achieve maximum efficiency in their inventory management they can adopt the EOQ technique which is the costing technique. Similarly, by analysing the costs of labour and the capacity of machinery their efficiency can be improved also. Cost accounting classifies the overheads into fixed and variable.

Price Determination Cost accounting makes the basic distinction between fixed and variable costs. This is then used by the company or the business unit to fix the prices of the products, according to their costs of the product. The management here finds the most ideal price for the product or the service, which is not too high and not too low. For example, where the economy suffers a depression period.



The businessman lowers the prices of his products to survive the depression circumstances in the economy. He can start this by trying to control the variable costs and to allow him to fix the product's prices.

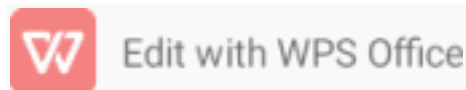
Fixing of the Standards: The organizations use the standards to make the estimates and the budgets for their future. They use this as the basis to measure the actual efficiency of the processor about the department. This is an entire branch of cost accounting which is known as Standard Costing dedicated priorly to this process.

B. Importance of Cost Accounting to others:

Workers: One of the biggest uses of cost accounting is that it helps us calculate efficiency. This will help the company come up with an incentive scheme for workers who show efficiency in their work, and thus they will be awarded accordingly. It is also an incentive for workers with lower efficiency to do better.

Government: Costing helps the government when assessing for income tax or any other such government liabilities. It also helps set industry standards and helps with price fixing, tariff plans, cost control etc.

Customers: The main aims of costing are cost control and improvement in efficiency. Both of these are very beneficial to the company. And ultimately this benefit passes on to the customers



of the products or services.

Uses of Cost Accounting:

Cost Allocation: Managers can allocate costs by product

line and per unit of production or hour of labour.

1. Profit drivers: Cost accounting helps business owners gain a deeper understanding of their profit margin and what drives it.
2. Budgeting and forecasting: Calculating costs for individual activities helps senior managers plan for future spending and forecast their finances into the future.
3. Cost Savings: Using cost accounting, businesses may be able to identify new efficiencies to help save money.
4. Quicker decisions: Cost accounting can help managers respond quickly to changes in the market, such as when the cost of raw materials increases.

Differences between Cost Accounting and Financial Accounting:

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budgeting techniques.

Elements of Costs:

Below are the elements of costs:

1. Direct materials: It represents the raw material goods necessary to produce or manufacture a product. The cost of direct material varies according to the level of output. For example, Milk is the direct material of ghee.

2. Indirect materials:

It refers to the material which we require to produce a product but is not directly identifiable. It does not form a part of a finished product. For example, the use of nails to make a table. The cost of indirect material

does not vary in the direct proportion of product.

3. Direct Labour: It refers to the amount which is paid to the workers who are directly engaged in the production of goods. It varies directly with the level of output.

4. Indirect Cost: It represents the amount paid to



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workers who are indirectly engaged in the production of goods. It does not vary directly with the level of output.

5. Direct Expenses: It refers to the expenses that are specifically incurred by the enterprises to produce a product. The production cannot take place without incurring these expenses. It varies directly with the level of production.

6. Indirect Expenses: It represents the expenses that are incurred by the organization to produce a product. These expenses cannot be easily identified accurately. For example, Power expenses for the production of pens.

7. Overhead: It refers to all indirect materials, indirect labour, or and indirect expenses.

8. Factory Overhead:

Factory overhead or Production Overhead or Works Overhead refers to the expenses which a firm incurs in the production area or within factory premises.

Indirect material, rent, rates and taxes of factory, canteen expenses etc are examples of factory overhead.

9. Administration Overhead: Administrative or Office Overhead refers to the expenses which are incurred in connection with the general administration of the organizations.

Salary of administrative staff, postage, telegram and telephone, stationery etc are examples of



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administration overhead.

10. Selling Overhead: All expenses that a firm incurs in connection with sales are selling overheads. Salary of sales department staff, travellers' commission, advertisement etc are example of selling overhead.


11. Distribution Overhead: It represents all expenses incurred in connection with the delivery or distribution of finished goods and services from the manufacturer to the consumer. For ex, Delivery van expenses, loading and unloading, customs duty, the salary of deliverymen are examples of distribution overhead.

Classification of Cost:

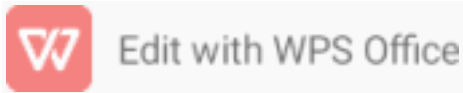
The following will be the types of cost classification. 1.

Classification by Nature:


This classification of cost is based on the nature of the expenditure, which are the three broad categories as per this, namely Labour Cost, Materials Cost, and Expenses. This cost makes it easier to classify them on a cost sheet. They help in estimating the total cost and also to estimate the work-in-progress cost.


 **Material costs:** These are the costs of any materials that are used in the production of goods. This is further divided into further costs. For instance, we can classify material costs

into spare parts, raw material cost, packaging




material cost, etc.


 Labour costs: This cost includes the salary and wages paid to temporary and permanent employees for the manufacturing of the goods.

 Expenses: It includes all other expenses associated with manufacturing and selling the services or goods.

2. Classification by Functions:


This is the classification based on functional costs. The cost classification by function flows the pattern of basic managerial activities. So, this cost is classified as production, administration, selling, etc.

 Production Costs: These costs are related to the real construction or manufacturing of the goods.

 Commercial Costs: This cost includes the operation of an enterprise except for the manufacturing costs. It consists of the admin costs, distribution and selling cost, etc.


3. Classification by Traceability:

This cost is classified into direct costs and indirect costs. This classification is classified on the degree of traceability to the final product of the firm.

 Direct Costs: These are the costs that are easily related to a specific cost unit. The most significant examples are the materials used to





manufacture a product or the labour involved in the production process.

 **Indirect Costs:** These costs are used for many purposes, which are between many cost centres or units. So we cannot put them to one specific cost centre—for instance, the rent of the place or the manager's remuneration. We will not be able to identify how to estimate costs to a specific cost unit.

4. Classification by Normality:

This classification is based on the costs as the normal costs and abnormal costs. The normal costs are the costs that happen at a given point of output, under the same set of conditions in which this point of output occurs.




 **Normal Costs:** The cost of production and also the part of the costing profit and loss. These are the type of costs that the organization incurs at the standard level of output under normal conditions.

 **Abnormal Costs:** These costs are not normally occurring at a particular level of output in conditions in which normal level of output happens. These costs are calculated according to the profit and loss account; they are not a part of the production cost.

5. Classification according to Behaviour: Cost behaviour refers to the way different types of




production costs change when there is a change in the level of production. There are three main types of costs according to their behaviour:


-  **Fixed Costs:** Fixed costs are those which do not change with the level of activity within the relevant range. These costs will incur even if no units are produced. For example rent expense, straight-line depreciation expense, etc.
-  **Variable Costs:** Variable costs change in direct proportion to the level of production. This means that the total variable cost increases when more units are produced and decreases when fewer units are produced. Although variable in total, these costs are constant per unit.
-  **Mixed Costs:** Mixed costs or semi-variable costs have properties of both fixed and variable costs due to the presence of both variable and fixed components in them. An example of mixed cost is telephone expense because it usually consists of a fixed component such as line rent and fixed subscription charges as well as variable cost charged per minute cost. Another example of mixed cost is a delivery cost which has a fixed component of depreciation cost of trucks and a variable component of fuel expense.

6. Classification according to Control ability: As per this classification, we identify whether the cost is




controllable by nature or not. Naturally, there are two types of costs under this classification – controllable costs and uncontrollable costs.

 **Controllable Costs:** Controllable costs are those which can be influenced by the actions of the firm even to some limited extent. So even if the cost is only partly controllable, we will call it controllable costs. In an organization, there are various cost centres. These controllable costs of a particular cost centre will be influenced and controlled by the actions of the manager responsible for that responsibility centre.

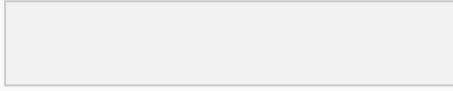
 **Uncontrollable Costs:** On the other hand, uncontrollable costs are not in control of the management. They cannot be influenced by any action taken by managers or the firm. Say for example the rent of the factory.

This is an uncontrollable cost, as the management has no say or influence over it. In fact, most fixed costs and overheads are uncontrollable costs.

7. Classification according to Capital/Revenue:

 **Capital cost:** Capital costs are those costs which are incurred in purchasing some assets for the purpose of increasing the earning capacity of the business. Ex- Plant/Machinery purchased, building purchased.

Revenue Cost: Revenue cost are those cost



which incurred to maintain the earning capacity of the business. Ex- Cost of maintaining the assets.

Cost object:

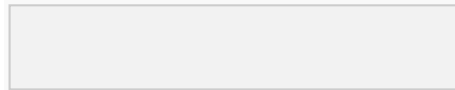
A cost object is an item for which a cost is compiled. For example, this can be a product, product line, service, project, customer, distribution channel, or activity. Cost objects are used in activity-based costing analyses as the focal point of cost accumulations. A closer review of cost objects is also useful for managing costs throughout an organization. Cost objects are one of the primary targets of reporting within a managerial accounting system.

Cost Unit:

Cost unit, also known as the cost per unit, the cost of goods sold or the cost of sales, is the amount of money that a company invests in manufacturing a single unit of a saleable product. The cost of unit calculation appears in the company's financial statement. It helps the company determine if its production costs are lower than the sales revenue and whether it is profiting from its product sales. Cost per unit calculations are often used by businesses that are dependent on product sales, but service-based companies may also use them.

Cost driver:

Cost drivers are the direct cause of a business expense. A cost driver is any activity that triggers a cost of something else. An example of this could be how the amount of water your office uses in a month determines



the price of your water bill. The units of water are the cost drivers, and the water bill is the cost. This concept demonstrates that all activities require the consumption of resources, and as people complete work activities, there is an associated resource cost for each activity.

Cost centre:

A cost centre is a department or function within an organization that does not directly add to profit but still costs the organization money to operate. Cost centres only contribute to a company's profitability indirectly, unlike a profit centre, which contributes to profitability directly through its actions. Managers of cost centres, such as human resources and accounting departments are responsible for keeping their costs in line or below budget.

Cost reduction:

Cost Reduction is a process, which aims to lower the unit cost of a product manufactured or service rendered without affecting its quality. It can be done by using new and improved methods and techniques. It ascertains substitute ways to reduce the production cost of a unit.

Thus, cost reduction ensures savings in per unit cost and maximization of profits of the enterprise. Cost Reduction aims at cutting off the unnecessary expenses which occur during the production Process, storage, selling and distribution of the

product.

Cost control:

Cost Control is a process in which we focus on controlling the total cost through competitive analysis. It is a practice which works to align the actual cost in agreement with the established norms.

It ensures that the cost incurred on production should not go beyond the pre-determined cost. Cost Control involves a chain of various activities, which starts with the preparation of the budget in relation to production.

Methods of Costing:

The various methods of costing are as follows:

1. Job costing: This is a method where costs are collected and accumulated for each job separately. This is done because each job requires different work and has separate identity and therefore it becomes essential to analyse and segregate costs according to each job separately.

2. Batch Costing:

Under this method, factories, which have to produce a large number of parts, in order to make a product undertake the production of each part in batches. Products are arranged in convenient batches and each batch is treated as one job and cost is calculated accordingly. For example, a bicycle factory may produce 10000 handles at one time and then take up the manufacture of other parts in other batches. The cost of each batch is ascertained separately and the method is known as batch costing.



3. Process Costing:

It is a method where costs are collected and accumulated according to department or processes and cost of each department or process is divided by the quantity of production to arrive at cost per unit. This method is useful in industries such as paper, soap, textiles, chemicals, sugar and food processing products.

4. Operation Costing:

This is a more refinement and more detailed application of process costing. This involves costing by every operation instead of a process. Many operations are necessary to make an article. This method has greater accuracy and control.

5. Single (Unit or Output) Costing:

This method is applied where production is uniform and consists of only a single product or two or three types of similar products with variation only in size, shape or quality. The information is presented in the form of a statement known as cost sheet.

6. Operating Costing:

Where a business does not produce tangible goods but renders some service, the system of costing would be known as operating costing. This is used to determine the costs of services rendered by airways, railways, roadways, hospitals, powerhouses etc. For example a transport company is interested in knowing the cost of carrying on ton

of goods per kilometre.

7. Multiple Costing:

This method is followed where the final product consists of a number of separate parts, e.g., radio set, motor car, bicycle etc. The cost of each part has to be ascertained and then the cost of assembling the parts will be tabulated.

The cost of the final product will consist of the cost of all the parts plus the cost of assembling them.

Techniques of costing:

The techniques of costing facilitate managerial decision making. The different types are:

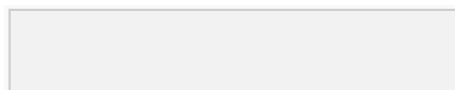
1. Marginal Costing: As per this technique, the management may decide the number of units to be produced. Suppose a toy unit is already producing 100 units of 'Dancing Monkey' toy, this technique will help the management understand that if the production is increased to 150, will it be profitable. In this technique, only the variable costs for additional units produced will be considered. Fixed costs are not taken into consideration as they do not vary with changes in production.
2. Standard Costing: In this technique of costing the costs incurred are compared to the predetermined cost of the product, process or project. The variances are analysed to bring about cost-effectiveness.

3. Direct Costing: In this technique all the direct costs incurred for a particular product, processor project are charged to it and the indirect costs are written off to profit and loss.
4. Historical Costing: It is comparison of all costs incurred after the process is performed.
5. Uniform Costing: In this technique same costing practices are followed across certain units to facilitate comparison.
6. Absorption costing: This is a method of full costing. In this all costs are charged to the product, process or project.

Use of IT (Income Tax) in Cost Accounting: Limitations of Cost Accounting:

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

1. It is expensive: The system of cost accounting involves additional expenditure to be incurred in installing it and maintaining it.
2. The system is more complex: As the cost accounting system involves a number of steps in ascertaining cost, it is considered to be a complicated system of accounting.
3. Inapplicability: All businesses cannot make use of a single method and technique of costing. It all depends upon the nature of business and type of product manufactured by it.



4. Not suitable for small organisations: A cost accounting system is applicable only to a large organisation but not

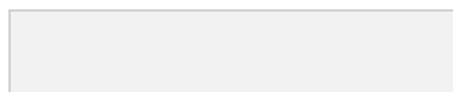
suitable for small organisation.

5. Lack of social accounting: Cost account fail to take into account the social obligation of the business. In other words, social accounting is outside the purview of cost account.
6. No solution to problem: It only provides a basis for taking right decisions but does not give solution to the problems.
7. No uniformity: Lacks uniformity in application.
8. Biased: Many judgements are biased and depend on the individual Discretion.
9. Not an exact science: Cost Accounting is not an exact science. In the absence of it, various decisions are subject to certain judgements.
10. Assumptions: It is based on various assumptions leading to wrong conclusions in some cases.

Cost Sheet:

A cost sheet is a formal documentation of the fixed, variable, direct, and indirect costs a business incurs from start to finish in its production process. Based on this information, a company can determine the total production cost and fix the price per item for the commodities.

Cost heads in a Cost Sheet:



A cost sheet has four major cost heads, which are;

1. Prime Cost: All the expenses directly involved in the production process are prime costs. It also passes as a flat, first, or basic cost.

Let's say you run a bakery. Your prime costs would be the money spent on raw material like purchasing flour bags, paying workers' wages, and other direct production expenses.

Prime Cost Formula

Prime Costs = Direct Labour + Direct Raw Material + Direct Expenses

2. Works Cost: Works cost is the sum of prime costs and factory costs or overhead expenses. Your overhead costs are indirect costs like the money paid to workers who are secondarily involved in the production process and the money spent in taxes and utilities.

3. Cost of Production: You should account for any expenses incurred by your business operations, including the factory rent and work costs. Cost of production is equal to work costs plus administration overhead minus the opening and closing stock for finished goods.

4. Total Cost or Cost of Sales: Cost of sales is all the expenses incurred during the production plus other costs for selling and distribution overhead. This metric helps you to know the overall production value of an item based on the resources committed to it. From the cost of sales, you can peg the sales price for finished

goods and calculate your profit.

Tenders and Quotation:

Tender: Tender is the process of asking suppliers to bid on products/services required by a company whereas quotation is the response to bidders, where they quote their price for goods/services.

Quotation: Quotation is also termed as an estimation given by professionals for jobs.
