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Unit - 1

Cost Accounting

→ It is the process of accounting for costs from the point at which expenditure is incurred or committed to the establishment of its ultimate relationship with cost centres and cost units.

→ Scope: It is not just restricted to the past but also concerned with the ascertainment of past, present and future (expected) costs of products manufactured or services supplied. The info supplied by it acts as a management tool for decision making to optimize utilization of scarce resources and further enhancing profitability by minimizing expenses. It is applied to all manufacturing and non-manufactu activities in which monetary value is involved to operate efficiently.

→ Nature:

- branch of accounting that deals specifically with the determination of costs of the products and services being manufactured.
- It is an important branch and organized body of knowledge which has its own tools and techniques.
- It is a science as it is a body of systematic knowledge relating to not only accounting but also law, office practices, data processing etc.
- It is an art as it involves the use of skills and experience of cost accountant in collection, classification and analysis

of the costs of the products.

→ It is not a pure profession by nature but it is emerging as a profession.

- It is based on the double entry system i.e. all transactions recorded have two fold aspect.
- It is a forward looking approach that aims at improving the efficiency of the manufacturing activities.
- It is an internal accounting i.e. there is no compulsion by law to prepare and publish the cost accounting records.

Management Accounting

- It refers to any form of accounting which enables a business to be conducted more efficiently by assisting in the creation of policy and in the day to day operations.

→ Scope:

- For an effective management accounting, a proper and well designed financial accounting system is required as it provides historical data for forecasting and planning financial activities for future period.

- Many techniques of cost control and profit planning such as standard costing, marginal costing etc are used by management accounting.

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- Forecasting and budgeting play a very significant role as forecasting helps in preparation of budget and budgeting helps management ~~accounting~~ accountant in exercising budgetary control.
- It has to depend on tax accounting and planning to minimize the tax liabilities and save more funds for the business.
- For effective and timely decisions, there should be a system of prompt and intelligent reporting to management, of both routine and special reports.
- Any system of of management accounting is incomplete without effective cost control procedures such as inventory control, labour control etc.
- It heavily depends on internal financial controls to plug loopholes in the financial system of the concern.
- Management accountant employs various techniques to analyse and interpret financial data which helps to achieve objectives of management in a more efficient manner.
- Management accountant is expected to maintain and control office routines and procedures.

→ Nature:

- The essential ~~is~~ aim is to assist management in decision making by providing the relevant information.
- Basic accounting info required by management accounting is derived from financial and cost accounting

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records.

- Info provided/ generated by management accounting is for internal use not be shared with outsiders.
- It is completely done voluntarily there is no statutory obligation.
- It is concerned with future as it relates to decision making which is done for future not for the past.
- ~~That~~ there is no specific format for the presentation of information to the management and done as seemed appropriate and efficient by the management accountant.

	Cost Accounting	Management Accounting
Scope	limited to providing cost info for managerial use	broader than cost accounting as it provides all types of info i.e cost and financial for managerial use.
Emphasis	cost determination and control for profit maximization	Focus on planning, controlling and decision making to maximize profit.
Techniques Employed	Standard costing, variance analysis, budgetary control etc.	It is uses these but in addition also uses ratio analysis, cash flow statement and various techniques of maths, eco etc whatsoever

		can help management in tasks
Evolution	mainly due to limitations of financial accounting	due to limitations of cost accounting. In fact it is an extension of managerial aspects of cost accounting.
Statutory Requirements	cost records made compulsory in selected industries by the govt.	purely voluntary and its use depends on its utility to the management.
Database	based on data from financial accounts.	based on data from financial and cost accounting and other sources
Status in Organization	placed at lower level than management accounting in hierarchy	placed at higher level than cost accounting
Installation	can be installed without management accounting	cannot be installed without proper system of cost accounting.

Cost management is planning and controlling of cost to prevent exceeding the budget.

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Cost

The amount of money needed to buy, do or make something.

Cost Control

- Maintaining the costs as per the set standards/budget
- To lay down a target, ascertain actual adherence to standards.
- Budget is prepared to compare actual performance with the set standards to take corrective actions.
- Major techniques are standard costing and budgetary control.
- It is a continuous function which helps ~~half~~ in analyzing the causes of variances.

Cost Reduction

- Process which aims at lowering per unit cost of the product or service without affecting the quality.
- Finding various ways to reduce per unit cost of production.
- cut-off unnecessary expenses.

Cost Unit

- It is unit of measurement of cost eg: cost per tonne of sugar, cost per meter of cloth
- Should be those which are natural to the

business and which are readily understood and accepted by all concerned.

Types of Cost Units

Units of Production
eg: a tonne of steel, meter of cable

Units of Service
eg: cinema seats, consulting hours

<u>Cost Centre</u>

- For determining cost, whole organization is divided into small parts and each part is treated as a cost centre of which cost is determined and used for the purpose of control.
- It can be a location, a person or item of equipment.

Primary Types

Personal Cost Centre
consists of a person or a group of persons

Impersonal Cost Centre
consists of a location or an item of equipment or group of these.

Functional Types

Production Cost Centre

cost centres where actual production takes place. eg: weaving department in a textile mill, melting shop in a steel mill

Service Cost Centre

cost centres which are ancillary to and render services to production cost centres. eg: power house, tool room.

Cost Ascertainment

→ concerned with computation of actual costs incurred.

→ ~~relates~~ refers to methods and processes employed in ascertaining costs.

→ methods are job costing, contract costing, process costing etc.

→ basic principles are same but ~~o~~these methods are designed to suit ~~different~~ needs of different business.

→ It has verily less utility because:

- actual cost can't be used for the purpose of price quotations and filling tenders.
- actual cost has practically no utility for cost control purposes.
- actual cost is ineffective as means of measuring performance efficiency.

→ Still it is very useful such as it reveals unprofitable activities.

Elements Of Total Cost

It is composed of three elements: labour, material and expense, each of which may be direct or indirect.

- Total Cost
  - Direct
    - Direct Material
    - Direct Labour
    - Direct Expenses
  - Indirect
    - Indirect Material
    - Indirect Expenses
    - Indirect labour

→ **Material Cost:**

→ cost of commodities supplied to a business

→ Includes: cost of procurement, freight inward, taxes etc.

→ Deduct: trade discounts, rebates, sales tax etc to determine cost of material

→ **Direct:**

- which can be easily identified with and allocated to cost units.
- generally becomes a part of the finished product. eg: cotton used in textile mill
- sometimes a material is not included in direct due to its small value and considered as indirect eg: nails used in making furniture

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→ **Indirect:**

- those materials which can't be conveniently identified with individual cost units.
- small and inexpensive and becomes a part of the product.
- donot physically becomes a part of the product eg: coal, lubricating oil, grease, sand paper etc.

→ **Labour Cost:**

→ payment made to the employees, permanent or temporary for their services.
→ includes: salary, wages, commission, fringe benefits like P.F., ESI etc.

→ **Direct:**

- wages paid to workers directly engaged in converting raw materials into finished goods. eg: machine operator, shoe maker etc.

→ **Indirect:**

- wages paid to those who are not directly engaged but only assist or help in production operations eg: supervisor, inspector, clerk etc.

→ **Expenses:**

→ All costs other than labour and material costs.
→ The cost of services provided to ~~a~~ a business

and the notional cost of the use of owned assets.

→ **Direct:**

- those expenses which are specifically incurred in connection with a particular job or cost unit.
- also called chargeable expenses
- eg: cost of patent rights, job processing charges, royalty paid in mining.

→ **Indirect:**

- these can't be directly identified with a particular job, process or work order and are common to cost units or cost centres eg: rent and rates, depreciation, insurance etc.

Prime Cost: sum of direct material, labour and expenses cost

* Direct material consumed = Opening + Purchases − Closing

Overheads

→ Aggregate of indirect material, labour and expenses cost.
→ It is the total of all indirect expenditure.
→ Comprises of those costs which the cost accountant is either unable or unwilling to allocate to particular cost units.
→ Departmentalization of overheads is the process of allocation and apportionment of overheads to different departments or cost centres.

→ **Allocation:**

- Assignment of whole items of cost directly to a cost centre.
- It can be made only when exact amount of overheads incurred in a cost centre is definitely known. eg: rent can't normally be allocated as it is payable for the whole factory.
- Cost centre must have caused the overhead cost to be incurred.

→ **Apportionment**

- Certain overhead costs can't be charged directly to any ~~one~~ one specific department.
- It is charging a fair share of an overhead cost to a cost centre, as it is common among multiple departments it is done proportionally.
- done on the basis of 3 principles:
  1. **Service or use:**
     - most common principle
     - greater the benefit received by a department larger the share should be borne by that department.

  2. **Survey method:**

     - Used for those over head costs that are not directly related to a department and to be distributed in a way which reflect the consumption by different departments.

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- eg: lighting expenses may be ~~app~~ apportioned on the basis of a survey of the number of light points, size, estimated hours of use etc.

3. Ability-to-pay method:

- based on theory of taxation
- considered inequitable as it penalizes the efficient and profitable departments
- those have the largest income should be charged with largest amount of overheads.

Preparation of Cost Sheet

- Statement which is prepared periodically to provide detailed cost of a cost centre or cost unit.

- It not only shows total cost but also it's components:

i) Prime Cost = Direct Material + Direct labour + Direct Expenses
ii) Works Cost / Factory Cost = Prime Cost + Factory Overheads
iii) Cost of Production = Works Cost + Administration Overhead
iv) Total Cost or Cost of Sales = Cost of production + Selling and distribution overhead

Overheads

Production (Factory) | Office and Administration | Selling and Distribution

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1. <u>Production Overheads</u>:-

→ also known as factory, works or manufacturing overheads

→ those overheads which are concerned with production function.

→ Includes indirect materials in producing goods and services -

→ Indirect material, Indirect labour, Indirect expenses

2. <u>Office and Administration Overheads</u>:

→ Indirect expenditures incurred in general administrative function i.e. formulating policies, planning, controlling, directing, motivating.

→ Are of general nature and no connection with production or sales activities.

→ Also classified into indirect materials, labour and expenses.

3. <u>Selling and Distributive Overheads</u>:

→ Selling overheads are the cost of promoting sales and retaining customers.

→ Distribution overheads include expenditure incurred from the time product is completed until it reaches its destination.

→ Also grouped into indirect materials, labour and expenses.

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Cost Sheet for....

Particulars	₹
Prime Cost	xxxx
Factory Cost	xxxx
Cost of Production	xxxx
Total Cost (Cost of Sales)	xxxx
+ Profit	xxxx
Sales	xxx

Classification of Cost

Identification with cost units

Direct

→ Incurred and easily identifiable with their cost ~~units~~ object
eg: cost of raw material used, cost of steel in machine making

Indirect

→ general and incurred for the benefit of a number of cost object. not any specific.
eg: depreciation of machine, Insurance

→ Nature of business and cost unit determine whether it is direct or indirect.

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Basis of behaviour/variability

Fixed
→ remains constant in totality over a specific period of time with change in volume of production.
→ With increase in output fixed cost per unit decrease but total FC remains constant
→ controlled by top level management

Variable
→ tend to vary in direct proportion to the volume of output.
→ Q↑ VC↑, Q↓ VC↓ but per unit VC remains constant
→ controlled by functional managers

Mixed
→ consists of both FC & VC
→ FC element is incurred irrespective of the level of activity.
→ VC element changes either at constant rate or in lumps.
→ There is no definite pattern of change.

On the basis of controlability

Controllable
→ cost directly regulated at a given level of management authority and kept within limits

Uncontrollable
→ cost which can't be influenced by the actions of a specific member.

→ Cost uncontrollable at a level is controllable at another level
→ All cost are controllable in long run at an appropriate level

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Basis of Profit Determination :

Product

→ all such cost involved in acquiring or making a product.

→ carried forward to next accounting period as part of unsold finished stock.

Period

→ those costs which are not necessary for production and are incurred even if there is no production

→ incurred for a time period and written off at the year end.

Special Costs :

→ **Relevant** : those future costs that will differ depending on the actions of the management. eg: when measuring firm's short-term adversity ability to survive only liabilities and future out of pocket costs are relevant.

→ **Irrelevant** : those cost which won't be affected by a decision. eg: while doing a journey by bus or car the cost of insurance of vehicle will not differ.

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→ **Shutdown**: unavoidable costs which continue to be incurred even when a plant is temporarily shut down. To be considered while planning a shutdown or continue decision. eg: rent, salary of permanent staff.

→ **Sunk**: historical cost that arise due to decisions made in past and can't be changed by any decision made in future. eg: investment in plant and machinery.

→ **Imputed/Hypothetical/Notional**: costs for which neither any transaction has taken place nor any cash outlay is there but it represents a sacrifice or resource use capable of being measured in monetary terms. Not recorded in financial accounts. eg: production in own premises for which no rent is paid but market value is £15k so £15k is imputed cost.

→ **Out of Pocket**: Those cost which require cash outlay due to a particular managerial decision. Represents both present and future outflow. eg: replacing own vehicle with private carrier.

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→ **Avoidable**: cost incurred if firm takes a decision related to production or investment. It is kind of variable and depends on level of output and external inputs.

→ **Unavoidable**: ~~co~~ cost that is still incurred even if decision of producing is not taken. Result of risk taken by firms in their industries for maintaining in the market and cover uncertainty of decisions of production.

→ **Expired**: cost that has been recognized as an expense when firm fully consumes or receives benefit from a cost.

→ **Unexpired**: Cost that has not yet been charged to expense because it still represents some residual value. Often associated with revenue that has not yet recognized and maintained as an asset in books.

→ **Opportunity**: Cost that measures the benefit that is lost or sacrificed when the choice of one course of action requires that other alternative be given up.

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Adjustments (Cost Sheet)

* Work in Progress Inventory

Work Cost = Prime Cost + Factory Overheads + Work in Progress (opening) - Work in Progress (closing)

* Finished Goods Inventory

Cost of Goods Sold = Cost of Production + Opening finished goods - closing finished goods

Total Sales = Cost of goods sold + selling and distribution overheads

* Raw material of direct nature is adjusted in Prime Cost while of indirect nature is adjusted in work cost.