COST ACCOUNTING

UNIT – I

Meaning of Cost:

In production, research, retail, and accounting, a **cost** is the value of money that has been used up to produce something or deliver a service, and hence is not available for use anymore. ... Usually, the price also includes a mark-up for profit over the **cost** of production.

Definition of Cost:

Cost has been defined in the terminology given by the Chartered Institute of Management Accountants (CIMA) as ‘the amount of expenditure incurred or attributed on a given thing’. More simply, it can be defined as that which is given or scarified to obtain something. Thus the cost of an article is its purchase or manufacturing price, i.e. it would consist of its direct material cost, direct labour cost, direct and indirect expenses allocated or apportioned to it.

Meaning of Cost Accountancy

Cost accountancy is a systematic process of applying the costing, as well as cost accounting methods in business activities. It ensures cost control and reduction.

Definition of Cost Accountancy:

The Chartered Institute of Management Accountants in England (CIMA) has defined Cost Accountancy as ‘the application of costing and Cost Accounting principles, methods and techniques to the science, art and practice of cost and the ascertainment of profitability. It includes the presentation of information derived there from for the purpose of management decision-making’. Cost Accountancy is, thus the science, art and the practice of cost accountant.

Meaning of Cost Accounting

It is a process via which we determine the costs of goods and services. It involves the recording, classification, allocation of various expenditures, and creating financial statements. This data is generally used in financial accounting.

This helps us calculate the costs of the various goods. It also involves a suitable presentation of this data for the purposes of cost control and guidance to the management.

It deals with the cost of every unit, job, process, order, service, etc, whichever is applicable and includes the cost ofS production, cost of selling and cost of distribution.

Definition of Cost Accounting:

The Chartered Institute of Management Accountants in England (CIMA) has defined Cost Accounting as, 'the process of accounting for cost from the point at which expenditure is incurred or committed to establishment of its ultimate relationship with cost centres and cost units. In its widest usage, it embraces the preparations of statistical data, the application of cost control methods and the ascertainment of the profitability of activities carried or planned'. It is a formal mechanism by means of which costs of products or services are ascertained and controlled.

Objectives of cost accounting:

- **Control and Reduce Cost**: Cost accounting continuously focuses on managing the cost of production per unit to improve profitability without compromising with the quality of the product.
- **Determine Selling Price**: It provides the total cost incurred in the product or service, which is the base for fixing an appropriate selling price.
- **Assist Management in Decision Making**: The reports and cost sheets generated based on cost accounting back the managerial decisions of the organization.
- **Ascertain Closing Inventory**: It determines the closing inventory value at the end of the financial year.
- **Ensure Profit from Each Activity**: Cost accounting reviews the cost and takes corrective actions at each level to ensure profitability from all business activities.
- **Budgeting**: It generates the estimated cost of products or services to assist in budget planning, implementation and control.
- **Setting Performance Standards**: It provides a standard cost of goods or services to sets a level for the future course of action.
- **Business Expansion**: It estimates the cost of production at different stages, based on this analysis, the management can plan for expansion of the business.
- **Minimizing Wastage**: Cost control and reduction so attained helps in reducing the wastage during the manufacturing process.
- **Improves Efficiency**: Cost accounting assures cost management, profit appreciation and less wastage which ultimately enhances the overall production and manufacturing process of products.

Scope of Cost Accounting:

Cost accounting is being widely applied by the production units to modify the process and maximise the profit.

Following are the various applicabilities of the cost accounting techniques:

- **Cost Analysis**: Cost accounting determines the deviation of the actual cost as compared to the planned expense, along with the reason for such variation.
- **Cost Audit**: To verify the cost sheets and ensure the efficient application of cost accounting principles in the industries, cost audits are done.
- **Cost Report**: Cost reports are prepared from the data acquired through cost accounting to be analysed by the management for strategic decision making.
- **Cost Ascertainment**: To determine the price of a product or service, it is essential to know the total cost involved in generating that product or service.
- **Cost Book Keeping**: Similar to financial accounting; journal entries, ledger, balance sheet and profit and loss account is prepared in cost accounting too. Here, the different cost incurred is debited, and income from the product or service is credited.
- **Cost System**: It provides for time to time monitoring and evaluation of the cost incurred in the production of goods and services to generate cost reports for the management.
- **Cost Comparison**: It examines the other alternative product line or activities and the cost involved in it, to seek a better opportunity for generating high revenue.
- **Cost Control**: Sometimes, the actual cost of a product or service becomes higher than its standard cost. To eliminate the difference and control the actual cost, cost accounting is required.
- **Cost Computation**: When the company is engaged in the production of bulk units of a particular product or commodity, the actual per-unit cost is derived through cost accounting.
- **Cost Reduction**: It acts as a tool in the hands of management to find out if there is any scope of reducing the standard cost involved in the production of goods and services. Its purpose is to obtain additional gain.

Advantages of Cost Accounting:

1. Elimination of Wastes, Losses and Inefficiencies

A good cost accounting system eliminates wastes, losses and inefficiencies by fixing standard for everything.

2. Cost Reduction

New and improved methods of production are followed under cost accounting system. It leads to cost reduction.

3. Identify the reasons for Profit or Loss

A good cost accounting system highlights the reasons for increasing or decreasing profit. If so, the management can take remedial action to maintain profitability of the concern. There is no possibility of shutting down of any product or process or department.

4. Advises on Make or Buy Decision

On the basis of cost information, the management can decide whether make or buy a product in open market. The management can rightly choose the best out of many alternatives. Sometimes, spare capacity can be used profitably.

5. Price Fixation

The total cost of a product is available in the costing records. It is highly useful for price fixation of a product.

6. Cost Control

Budgets are prepared and standards are fixed under cost accounting system. The expenses are not permitted beyond the budget amount. The actual performance is compared with standard to find the variation. If there is any variation, reasons are find out and the management can exercise control. Period to period cost comparison also helps cost control.

7. Assist the Government

Government can collect reasonable tax from the company and exercise price control.

8. Help the Trade Union

Bonus calculation is very easy to the trade union. Reasonable remuneration is also fixed on the basis of cost accounting information.

9. Marginal Analysis of Cost

It is done for facilitating the short-term decisions especially during depression period.

10. Fixation of Responsibility

Responsibility centers is fixed under cost accounting system. If responsibility is fixed, it becomes difficult to evade responsibility of performance and leads to effective performance.

11. Helps to Prepare Financial Accounts

The information like value of closing materials, work in progress and finished goods are necessary to prepare financial accounts. This information is supplied by the costing records and helps to prepare financial accounts without any further delay.

12. Prevention of Frauds

Introducing cost audit can prevent frauds. If so, correct and reliable data was available from the costing records which are highly useful to the government, share holders, the creditors and the like.

Disadvantages or Limitations of Cost Accounting

The limitations or disadvantages of cost accounting are listed below:

1. Only past performances are available in the costing records but the management is taking decision for future.

2. The cost of previous year is not same in the succeeding year. Hence, cost data are not highly useful.

3. The cost is ascertained on the basis of full utilization of capacity. If capacity is partly utilized, the cost may not be true.

4. Financial character expenses are not included for cost calculation. Hence, the calculated cost is not correct always.

5. In cost accounting, costs are absorbed on pre-determined rate. It leads to over absorption or under absorption of overheads.

6. Cost Accounting fails to solve the problems relating to work study, time and motion study and operation research.

7. Installation of Cost Accounting System requires the maintenance of many costing records. If results in heavy expenditure.

8. Delay in receiving costing information does not result in taking quality decision by the management

9. Rigid Cost Accounting System does not serve all purposes.

Cost Accounting Vs Financial Accounting:

BASIS FOR COMPARISON	COST ACCOUNTING	FINANCIAL ACCOUNTING
1. Meaning	Cost Accounting is an accounting system, through which an organization keeps the track of various costs incurred in the business in production activities.	Financial Accounting is an accounting system that captures the records of financial information about the business to show the correct financial position of the company at a particular date.
2. Information type	Records the information related to material, labor and overhead, which are used in the production process.	Records the information which are in monetary terms.
3. Which type of cost is used for recording?	Both historical and pre-determined cost	Only historical cost.
4. Users	Information provided by the cost accounting is used only by the internal management of the	Users of information provided by the financial accounting are internal and external parties like

BASIS FOR COMPARISON	COST ACCOUNTING	FINANCIAL ACCOUNTING
	organization like employees, directors, managers, supervisors etc.	creditors, shareholders, customers etc.
5. Valuation of Stock	At cost	Cost or Net Realizable Value, whichever is less.
6. Mandatory	No, except for manufacturing firms it is mandatory.	Yes for all firms.
7. Time of Reporting	Details provided by cost accounting are frequently prepared and reported to the management.	Financial statements are reported at the end of the accounting period, which is normally 1 year.
8. Profit Analysis	Generally, the profit is analyzed for a particular product, job, batch or process.	Income, expenditure and profit are analyzed together for a particular period of the whole entity.
9. Purpose	Reducing and controlling costs.	Keeping complete record of the financial transactions.

BASIS FOR COMPARISON	COST ACCOUNTING	FINANCIAL ACCOUNTING
10. Forecasting	Forecasting is possible through budgeting techniques.	Forecasting is not at all possible.

Cost Accounting vs Management Accounting:

Cost accounting is that section of accounting which strives at generating data to manage operations with a view to maximizing profits and performance of the company, it is also termed control accounting. On the contrary, management accounting is that type of accounting which support management in planning and decision-making and hence known as decision accounting.

What is Cost Accounting?

It is an accounting system that aspires to capture an enterprise's costs of manufacturing by evaluating the input costs of each step of manufacturing as well as fixed costs, namely, depreciation of capital equipment. Cost accounting will initially compute and document these costs separately, then analyse input outcomes to output or actual outcomes to assist the enterprise's management in computing financial accomplishment.

What is Management Accounting?

It refers to the outlining of financial and non-financial data for the utilisation of management of the enterprise. The data furnished is useful in outlining budgeting, forecasting plans, policies and strategies, evaluating the performance and making comparisons of the management.

Basis	Cost Accounting	Management Accounting
1. Meaning	Cost accounting is an accounting system that aspires to capture an enterprise's costs of manufacturing by evaluating the input costs of every step of manufacturing as well as the fixed costs, namely, depreciation of capital equipment.	Management Accounting refers to the outlining of financial and non-financial data for the utilization of management of the enterprise. It is also known as managerial accounting.
2. Data type	Quantitative	Both Quantitative and Qualitative
3.Scope	Focused on distribution, allocation, determination and accounting factors of the cost	Convey (impart) and effect factor of the cost
4. Objective	Determined in cost production	Furnishing data to the managers to fix goals and anticipate strategies
5. Specific procedure	Yes	No
6. Planning	Short term planning	Both Short and long term planning
7. Recording	Records both past and present data	Focuses more on scrutinizing for future projects
8.Interdependency	Can be installed without a Management accounting	Cannot be installed without cost accounting

ELEMENTS OF COST

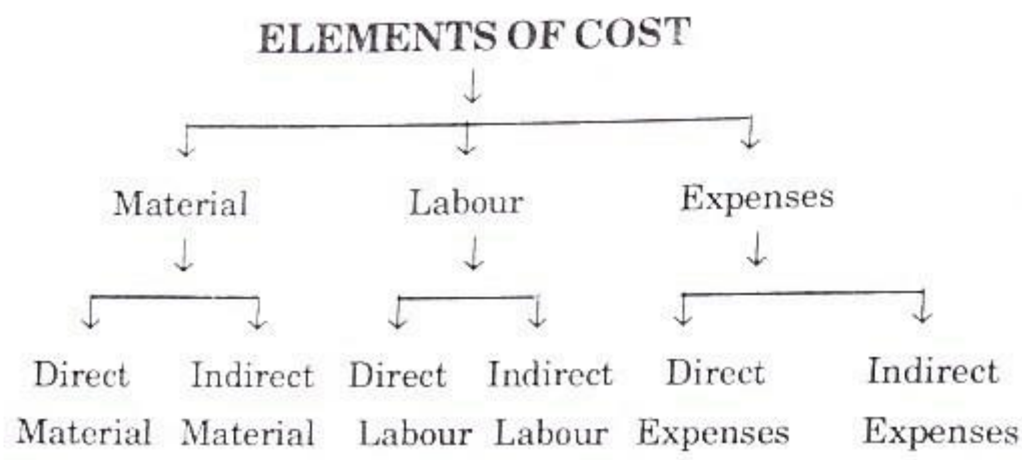
Elements of cost means all those expenses which contribute in the production of goods or services. These expenses may also be said as components or essential parts of cost of a product. As a matter of fact, elements of cost are the primary classifications of cost according to the factors upon which expenditure is incurred. The various elements of cost may be conveniently divided into three parts viz. : (1) Material, (2) Labour and (3) Expenses. Each of these can be direct or indirect.

1. **Material :** In the elements of cost, material has an important place because no goods can be produced without material. Material cost is usually a larger part of the total cost of a product. It can be direct as well as indirect.
    1. **Direct Material** : The material which is directly used in Production and which becomes an integral part of the finished goods is termed as direct material. Direct material has physical existence in the goods produced. In simple words, it is the material with which the goods are manufactured. For example sugar is manufactured by sugarcane, furniture by timber, cloth by yarn, etc. Some examples of direct material are given below :
        1. The material which is used directly in production like sugarcane in sugar industry, timber in chair or table, cloth in shirt.
        2. Material purchases for specific job or order. For example, bricks and cement are purchased for construction work.
        3. The product of a process which becomes the raw material for the next process. For example, in a cloth mill, the product of the spinning process becomes the direct material of the weaving process.
        4. Material which is issued from the store for completing the production work.
    2. **Indirect Material** : Material which is used indirectly in production is termed as indirect material. In other words, a material which is neither directly used in production nor becomes the integral part of the finished goods is termed as indirect material. The oil is used to keep the machinery in working order, the cloth is used for cleaning the machinery parts, etc. are the examples Of indirect material. However, in some cases, though material forms a part of finished product yet it is treated as indirect material, e.g., thread used in shirt stitching, nails

in shoes. This is because value of such materials is small and it is quite difficult and futile to measure them. According to ICMA, “Indirect material cost means material cost which cannot be allocated but which can be apportioned to or absorbed by cost centres or cost units.”

2. **Labour :** Labour is another important element of cost. The wages paid to the labour, employed in production, are included in the production cost as labour cost. Like material, labour can be divided into two parts viz., (i) direct labour and (ii) indirect labour.
    1. **Direct Labour :** Labour which are directly engaged in production or manufacture of goods is termed as direct labour. In simple words, it is the labour which can be specifically related to particular product, job work or process. For example, labour employed to manufacture furniture or to work on machines is direct labour. Direct labour is also termed as productive labour, factory labour, operating labour, etc. According to ICMA, “Direct wages : Wages which can be allocated to cost centres or cost units.’
    2. **Indirect Labour :** Labour which are not directly engaged in production operations but which helps in production operations is indirect labour. Such labour does not alter the condition or composition of the product. Wages paid to foremen, inspectors, time-keeper, store-keeper, gate-keeper, etc. are the examples of indirect labour cost. According to ICMA, “Indirect wages : Wages which cannot be allocated but which can be apportioned or absorbed by cost centres or cost units. “
3. **Expenses :** All expenses other than material and labour which are incurred in production, administration, selling and distribution are termed as expenses. These expenses can also be direct or indirect.
    1. **Direct Expenses :** All expenses other than direct material and direct labour which are directly incurred on a specific product, job or process are called as direct expenses. In other words, expenses which can be directly related to the cost of a particular product are termed as direct expenses. Payment of royalty for extracting minerals from mines, excise duty, rent for equipments used in a specific production, fee for drawing designs and charts for a specific job, etc. are the few examples of direct expenses.
    2. **Indirect Expenses :** Expenses which cannot related to specific work, job or process but which are related to the whole production, several jobs or processes, are termed as indirect expenses. The benefit of indirect expenses goes to more than one cost centres or units. The remuneration paid to the expert for repairing the machines of all the departments, is an

example of indirect expenses. The different elements of cost can be presented in the form of the following chart :



4. Overhead

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

1. 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 example of factory overhead.

2. 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 administration overhead.

3. Selling Overhead

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

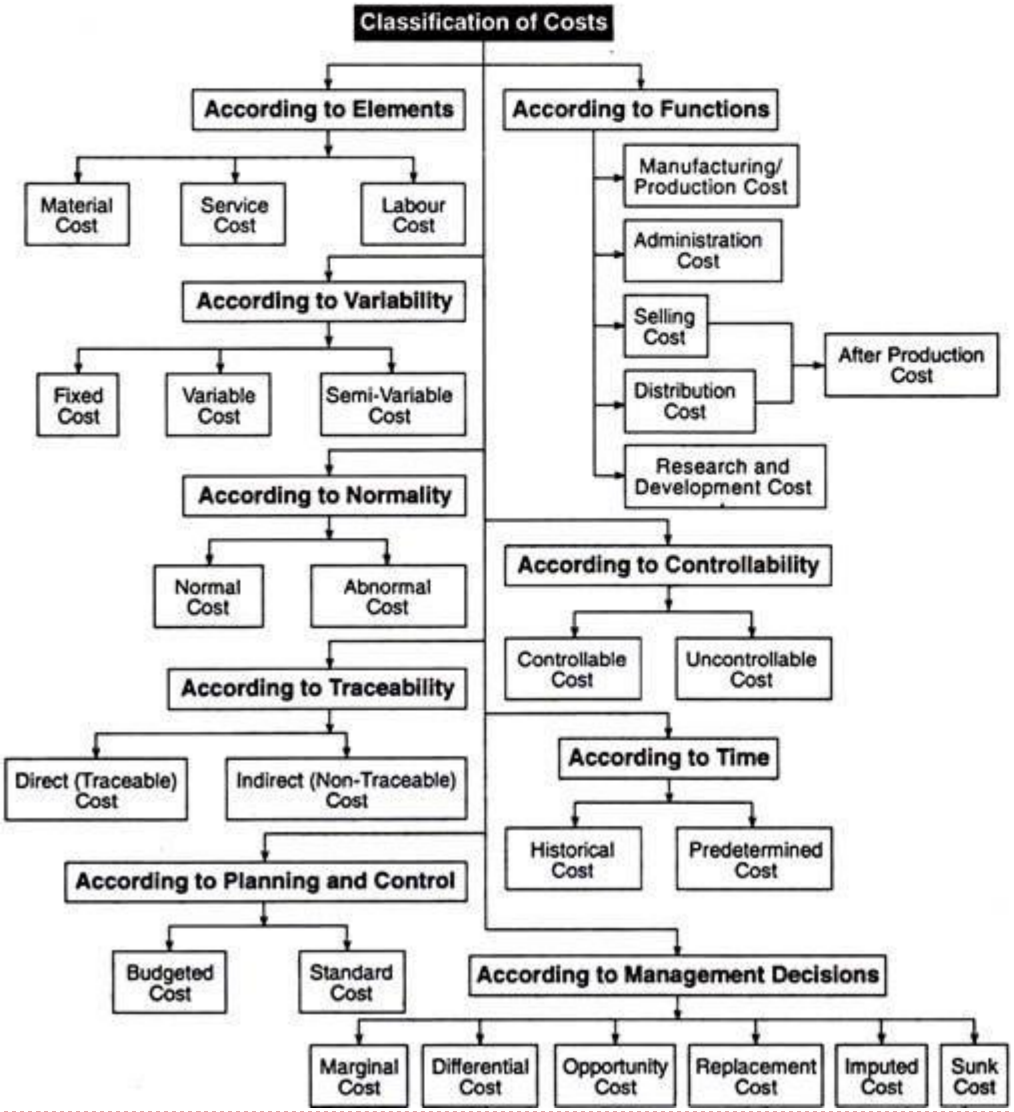
4. **Distribution Overhead**

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

Classification of Cost:

Classification of costs implies the process of grouping costs according to their common characteristics. A proper classification of costs is absolutely necessary to mention the costs with cost centres. Usually, costs are classified according to their nature, viz., material, labour, overhead, among others. An identical cost figure may be classified in various ways according to the needs of the firms.

The above classification may be outlined as:



However, the classification of cost may be depicted as given:

(a) According to Elements:

Under the circumstances, costs are classified into three broad categories Material, Labour and Overhead. Now, further subdivision may also be made for each of them. For example, Material may be subdivided into raw materials, packing materials, consumable stores etc. This classification is very useful in order to ascertain the total cost and its components. Same classification may also be made for labour and overhead.

(b) According to Functions:

The total costs are divided into different segments according to the purpose of the firm. That is why costs are grouped as per the requirements of the firm in order to evaluate its functions properly. In short, the total costs include all costs starting from cost of materials to the cost of packing the product.

It takes the cost of direct material, direct labour and chargeable expenses and all indirect expenses under the head Manufacturing/Production cost.

At the same time, administration cost (i.e. relating to office and administration) and Selling and Distribution expenses (i.e. relating to sales) are to be classified separately and to be added in order to find out the total cost of the product. If these functional classifications are not made properly, true cost of the product cannot accurately be ascertained.

(c) According to Variability:

Practically, costs are classified according to their behaviour relating to the change (increase or decrease) in their volume of activity.

These costs as per volume may be subdivided into:

(i) Fixed Cost;

(ii) Variable Cost;

(iii) Semi-variable Cost.

Fixed Costs are those which do not vary with the change in output, i.e., irrespective of the quantity of output produced, it remains fixed (e.g., Salaries, Rent etc.) up to a certain limit. It is interesting to note that if more units are product, fixed cost per unit will be reduced, and, if less units are produced, obviously, fixed cost per unit will be increased.

Variable Costs, on the other hand, are those which vary proportionately with the volume of output. So the cost per unit will remain fixed irrespective of the quantity produced. That is, there is no direct effect on the cost per unit if there is a change in the volume of output (e.g. price of raw material, labour etc.,).

On the contrary, semi-variable costs are those which are partly fixed and partly variable (e.g. Repairs of building).

(d) According to Controllability:

Costs may, again, be subdivided into two broad categories according to the performance done by any member of the firm.

They are:

(i) Controllable Costs; and

(ii) Uncontrollable Costs.

Controllable Costs are those costs which may be influenced by the decision taken by a specified member of the administration of the firm or, it may be stated, that the costs which at least partly depend on the management and is controllable by them, e.g. all direct costs, direct material, direct labour and chargeable expenses (components of Prime Cost) are controllable by lower management level and is done accordingly.

Uncontrollable Costs are those which are not influenced by the actions taken by any specific member of the management. For example, fixed costs, viz., rent of building, payment for salaries etc.

(e) According to Normality:

Under this condition, costs are classified according to the normal needs for a given level of output for a normal level of activity produced for such output.

They are divided into:

(i) Normal Costs; and

(ii) Abnormal Costs.

Normal Costs are those costs which are normally required for a normal production at a given level of output and which is a part of production.

Abnormal Costs, on the other hand, are those costs which are not normally required for a given level of output to be produced normally, or which is not a part of cost of production.

(f) According to Time:

Costs may also be classified according to the time element in it. Accordingly, costs are classified into:

(i) Historical Costs; and

(ii) Predetermined Costs.

Historical Costs are those costs which are taken into consideration after they have been incurred. This is possible particularly when the production of a particular unit of output has already been made. They have only historical value and cannot assist in controlling costs.

Predetermined Costs, on the other hand, are the estimated costs. Such costs are computed in advanced on the basis of past experience and records. Needless to say here that it becomes standard cost if it is determined on scientific basis. When such standard costs are compared with the actual costs, the reasons of variance will come out which will help the management to take proper steps for reconciliation.

(g) According to Traceability:

Costs can be identified with a particular product, process, department etc. They are divided into:

(i) Direct (Traceable) Costs; and

(ii) Indirect (Non-Traceable) Costs.

Direct/Traceable Costs are those costs which can directly be traced or allocated to a product, i.e. it includes all traceable costs, viz., all expenses relating to cost of raw materials, labour and other service utilised which can be traced easily.

Indirect/Non-Traceable Costs are those costs which cannot directly be traced or allocated to a product, i.e. it includes all non-traceable costs, e.g. salary of store-keepers, general administrative expenses, i.e. which cannot properly be allocated directly to a product.

(h) According to Planning and Control:

Costs may also be classified into:

(i) Budgeted Costs; and

(ii) Standard Costs.

Budgeted Costs refer to the expected cost of manufacture computed on the basis of information available in advance of actual production or purchase. Practically, budgeted costs include standard costs, both are predetermined costs and their amount may coincide but their objectives are different.

Standard Costs, on the other hand, is a predetermination of what actual costs should be under projected conditions serving as a basis of cost control and, as a measure of product efficiency, when ultimately aligned actual cost. It supplies a medium by which the effectiveness of current results can be measured and the responsibility for derivations can be placed.

Standard Costs are predetermined for each element, viz., material, labour and overhead.

COST SHEET

Meaning: Cost Sheet or a Cost Statement is "a document which provides for the assembly of the estimated detailed elements of cost in respect of cost centre or a cost unit." The analysis for the different elements of cost of the product is shown in the form of a statement called "Cost Sheet." The statement summarises the cost of manufacturing a particular list of product and discloses for a particular period:

(I) Prime Cost;
(II) Works Cost (or) Factory Cost;
(III) Cost of Production; (IV)Total Cost (or) Cost of Sales.

Importance of Cost Sheet

(1) It provides for the presentation of the total cost on the basis of the logical classification.

(2) Cost sheet helps in determination of cost per unit and total cost at different stages of production.

(3) Assists **in fixing** of selling price.

(4) It facilitates effective cost control and cost comparison.

(5) It discloses operational efficiency and inefficiency to the management for taking corrective actions.

(6) Enables the management in the preparation of cost estimates to tenders and quotations.

SPECIMEN OF COST SHEET:

Cost Sheet of _______ for the month of __________

Particulars	Details	Total Cost	Cost/ Unit
Direct Material (Raw Material Consumed):			
Opening Stock of Raw Material	X		
Add: Material Purchased	X		
Add: Carriage Inward	X		
	X		
Less: Closing Stock of Raw Material	(X)	X	X
Direct Labour		X	X
Direct Expenses		X	X
Prime Cost		**X**	**X**
Add: Factory Overhead:			
Indirect Material	X		
Indirect Labour (Wages)	X		
Factory Rent and Rates	X		
Power and Fuel	X		
Factory Lighting and Supervision	X		
Factory/Works Manager Salary	X		
Factory Water Supply	X		
Factory Insurance	X		
Factory Stationery	X		
Factory Cleaning			
Drawing Office Expenses	X		
Depreciation of Plant and Machinery	X		
Cost of Research and Equipment	X		
Other Factory Expenses	X		
	X		
Less: Sale of Scrap	(X)	X	X
		X	X
Add: Opening Stock of Work-in-Progress		X	X
		X	X
Less: Closing Stock of Work-in-Progress		(X)	X
Works Cost		**X**	**X**

Works Cost		**X**	**X**
Add: Office or Administration Overhead:			
Office Rent and Rates	X		
Office Lighting	X		
Office Stationery	X		
Depreciation and Repairs of Office Furniture	X		
Office Salaries	X		
Management Expenses	X		
Office Telephone and Postage Charges	X		
Legal Charges	X		
Bank Charges and Commission	X		
Office Cleaning	X		
Audit Fees	X		
Office Insurance	X		
Other Office Expenses	X	X	X
Cost of Production		**X**	**X**
Add: Finished Goods (Opening)		X	
		X	
Less: Finished Goods (Closing)		(X)	
Cost of Production of Goods Sold		X	**X**
Add: Selling and Distribution Overhead:			
Salesmen Salaries	X		
Salesmen Commission	X		
Showroom Expenses	X		
Showroom Rent and Rates	X		
Advertisement	X		
Sales Office Rent and Rates	X		
Travelling Expenses	X		
Warehouse Rent and Rates	X		
Warehouse Staff Salaries	X		
Depreciation and Repairs of Delivery Vehicle	X		
Carriage Outwards	X		
Debt Collection Charges	X		
Other Selling and Distribution Expenses	X	X	X
Total Cost / Cost of Goods Sold		**X**	**X**
Profit / Loss (difference of Sales and COGS)		X / (X)	X
Sales		X	X