CHAPTER 1 OVERVIEW OF COST

❖ COST, COSTING AND COST ACCOUNTING

Cost:

Cost is the amount of resources actual or notional which can be valued in terms of money that have been sacrificed to attain a particular objective.

Cost Accounting:

Cost Accounting is defined as the establishment of budgets, standard costs and actual costs of operations, processes, activities or products and the analysis of variances, profitability or the social use of funds.

Costing:

Costing is defined as the techniques and process of ascertaining costs.

Cost Accountancy:

Cost Accountancy has been defined as "the application of costing and cost accounting principles, methods and techniques to the science, art and practice of cost control and the ascertainment of profitability. It includes the presentation of information derived there from for the purpose of managerial decision making".

Cost accounting is different from costing in the sense that the former provides only the basis and information for ascertainment of costs. Once the information is made available, costing can be carried out arithmetically by means of memorandum statements.

❖ COST UNITS

A unit of product or service in relation to which costs are ascertained.

Industry	Cost Unit
Automobile	Number
Cement	Per Tonne/ Per Bag
Brick Works	Per 1000 bricks
Steel	Per Tonne
Transport	Passenger Km
Hospitals	Per Patient Per Day
Electricity Undertakings	Kilowatt hour

❖ COST CENTRES

A cost centre is a location, person or item of equipment for which costs may be ascertained and used for the purposes of cost control. In other words, a cost centre is a convenient unit of the organisation for which cost may be ascertained.

Cost Centres are of two types

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

Impersonal Cost Centres: It consists of a location or an item of equipment

❖ COST OBJECTS

Cost Object may be defined as anything for which a separate measurement of cost is required. It may be a product, service, activity or process etc. Sometimes the users of accounting information are interested in knowing cost of something which is called as cost object.

❖ COST DRIVER

A cost driver is any factor whose change causes a change in total cost of a related cost object. In other words, a change in the level of cost driver will cause a change in the level of the total cost of a related cost object.

❖ COST CONTROL

It is a process to ensure that appropriate action is taken if costs exceed the budgeted or standard cost or actions which needs to be taken for the same

❖ COST REDUCTION

Cost reduction means permanent reduction in the cost of goods manufactured or services rendered by eliminating wasteful and inessential elements but without impairing the quality and essential characteristics of products.

❖ MANAGEMENT ACCOUNTING AND ITS FUNCTIONS

Accounting involves preparation of final accounts (balance sheet and profit and loss account) and their analysis and interpretation.

Accounting is thus made up of

a) Financial Accounting (Preparing Final Accounts)
b) Management Accounting (analysis and interpretation or accounts).

DEFINITION:

"Any form of accounting which enables a business to be conducted more efficiently can be regarded as Management Accounting."

Scope:

Management accounting is the application of the principle of accounting and financial management to create, protect, preserve and increase value for the stakeholders of for-profit and not-for-profit enterprises in the public and private sectors. Management accounting is an integral part of management. Its scope covers:

a) Formulation of plans to meet objectives (strategic planning);
b) formulation of short-term budgeting/profit planning (operation planning);
c) corrective action to bring plans and results into line (financial and performance control);
d) recording and reporting of financial transactions and events (financial accounting);
e) recording and reporting of costs (cost accounting);
f) acquisition and use of finance (financial management);
g) communication of financial and operating information (Management Information System-MIS);
h) reviewing and reporting on systems and operations (internal audit, management audit).

Functions:

a) **Budgeting:**
A budget provides a detailed analysis of how the organization intends to get and use resources. The management accountant prepares various budgets based on strategic planning covering sales, costs and expenses, assets, liabilities and cash-flows as well as other non-financial factors.

b) **Cost management:**
The management accountant helps in cost management – in identification and reduction of waste in the organization which makes more resource available for investment and innovation.

c) **Reporting:**
The management account provides comprehensive reports about the organizations' past performance, business model, risks and strategy.

d) **Investment decisions:**
The management accountant performs relevant calculations and analysis of risks and returns to determine whether the organization should make a particular investment or not. This ensures that better investments are made and risky investments are avoided.

e) **Price and product decisions:**
The management accountant provides information to the management for deciding what to produce or what service to provide and determining the selling price for products and services. This increases the profitability of the business.

f) **Project management:**
The management accountant provides information about project plans, budgets and costs.

g) **Resource allocation:**
The management accountant helps in the optimal distribution of scarce resources across the organization.

h) **Risk management:**
Risk management is the process of understanding, managing and controlling the risks that the organization must face when attempting to achieve its corporate objectives.

❖ SCOPE, OBJECTIVES, IMPORTANCE OF COST AND MANAGEMENT ACCOUNTING

The limitations of financial accounting increase the importance of cost accounting. The management of any company dealing in manufacturing of products or rendering services has to ensure that there are no wastages, no idle time of labour or machines, efficiency and productivity of labour is increased. Cost accounting increases the overall productivity of an organization and serves as an important tool, in bringing prosperity to the nation. Cost control, elimination of wastage and efficiency lead to the progress of industry and consequently of the country as a whole.

The basic objective of management accounting is to assist the management in proper planning, organizing, directing and controlling based on the data available through the Cost Accounting.

- Ascertainment and classification of cost.
- To determine the selling price of the product i.e. price fixation
- Cost control and cost reduction.
- To indicate to the management any inefficiencies and various waste and sources of such wastage.
- Ascertain profit of each activity and how these profits can be maximized.
- To exercise effective control on the stocks of raw materials, work-in-progress, consumable stores and finished goods in order to minimize the capital locked up in these areas.
- To assist management in decision making about future expansion policies and proposed capital projects.
- It helps in assessing the performance of workers and rewarding them suitably through incentives and bonus.
- To organize an effective information system so that different levels of management may get the required information at the right time in right form for carrying out their individual responsibilities in an efficient manner;
- To organize the internal audit system to ensure effective working of different departments;
- To supply useful data to the management for taking various financial decisions, such as introduction of new products, replacement of labour by machine etc.;
- To provide specialized services of cost-audit in order to prevent the errors and frauds, and to facilitate prompt and reliable information to management;
- It ensures optimum utilization of the scarce economic resources of the country.
- To arrive at standard costs for comparison of actual cost
- Cost Accounting is an aid to creditors, employees and national economy
- Cost accounting involves the preparation of budgets and, come out with forecasts to make viable and valuable decisions for the future. Many decisions are taken based on the projected figures of the budget.
- In cost accounting the manager prepares monthly or quarterly statements which reflect the cost and income data identified with the sale of that period.
- There are no set of rules and regulations to be followed while preparing these statements but the management can set their own principles. In management accounting there is no specific time span for its statement and report preparation. It makes use of both cost as well as financial statements to analyze the data.

❖ CRITICISMS OR LIMITATIONS OF COST ACCOUNTING

- It is argued that cost accounting is duplication when a good Financial Accounting system is already in operation.
- Cost Accounting is inapplicable in non-profit organisations, agriculture, concerns producing single products, etc
- A Cost Accounting system is quite expensive to install and operate.
- Non co-operation from staff also may lead to failure of the system in many concerns.
- It represents the base for taking the best decisions but does not give outright solution to the problem.
- Most of cost accounting techniques are based on presumed notions.
- If the system is not revised as per the changing circumstances, it will become a matter of routine forms and statements.
- The results shown by cost accounts differ from those shown by financial accounts. Thus preparation of reconciliation statements is necessary to verify their accuracy.

❖ VARIOUS REPORTS PROVIDED BY COST ACCOUNTING DEPARTMENT FOR DECISION MAKING

- Cost sheet
- Reconciliation of Actual Profit with Budgeted Profit
- Report of Capital Expenditure, Research and Development Expenditure.
- Material Consumption Report
- Inventory report, work in Progress, finished goods report.
- Labour Utilization Report
- Labour Turnover Report.
- Overhead Report
- Sales Report

❖ ESSENTIAL FEATURES OF A GOOD COST ACCOUNTING SYSTEM

- The cost accounting system should be suitable to the nature of business.
- It should be simple and easy to operate
- Input data should be accurate
- Relevant data only should be used
- Management should have faith in costing system and should provide help as far as possible
- Executives should also provide there useful services in developing a good costing system
- It should be cost effective
- System should be smoothly and effectively implemented
- The system should enable prompt reporting
- The persons using the reports should be able to understand and use the information.
- External factors e.g. Government Regulations, market requirement should also be taken into consideration.

❖ ESSENTIAL FACTORS FOR INSTALLING A COST ACCOUNTING SYSTEM

- Objectives of Cost Accounting system
- What would be the scope and coverage of Cost Accounting System?
- What would be the organizational set up?
- What would be the technical aspects and what techniques would be used in production?
- How the society would be benefited by the system of Cost Accounting?
- What would be the effect of expansion?
- What would be the requirement of information to serve the purpose of cost Accounting?
- The system should be flexible to adopt the changing requirements of business?

❖ Practical difficulties will you expect and how will you overcome the same.

a) **Lack of Top Management Support-** Installation of a Costing system do not receive the Support of Top Management.

b) **Resistance from Cost Accounting Department Staff -** The staff resists because of risks of losing their jobs.

c) **Non-Co-Operation from Operating Departments-** Because of increase in responsibility and paper work, operating staff may not co-operate.

d) **Shortage of Trained Staff-** Since installation of Cost Accounting System involves specialized work, there may be a shortage of trained staff.

e) **Heavy Costs:**
The costing system will involve heavy costs unless it has been suitably designed to suit specific requirements.

The above problems can be overcome by the following remedies

a) To sell the idea to top management.
b) Resistance and non-co-operation can be overcome by behavioral approach.
c) Proper training should be provided
d) Regular meeting should be held with Cost Accounting Staff and other user departments.
e) Supervision and continuous evaluation

❖ CLASSIFICATION OF COST

Basis	Classification
Nature	Material Labour, Expenses
Cost Centre	Direct Material, Direct Labour, Direct Expenses, Indirect Material, Indirect Labour, Indirect Expenses
Functions	Factory Overheads, Office Overheads, Selling Overheads
Time	Historical Cost, Pre-determined Cost, Standard Cost, Estimated Cost
Management Decision Making	Marginal Cost, Differential Cost, Opportunity Cost, Replacement Cost, Relevant Cost, Imputed Cost, Sunk Cost, Normal Cost, Abnormal Cost, Avoidable Cost, Unavoidable Cost, etc.
Production Process	Batch Cost, Process Cost, Operation Cost, Operating Cost, Contract Cost, Joint Cost
Behavior	Fixed Cost, Variable Cost and Semi- Variable Cost

❖ OBJECTIVES OF MATERIAL CONTROL

a) There should be proper cooperation and coordination among the departments involved in purchasing, receiving, inspection, storage, production, sales, accounting etc to minimize disruption in production and lose sales
b) There should be proper scheduling of materials
c) A good method of classification and codification of materials should be followed
d) Purchase of material as per requirement.
e) Material can be purchased at optimum price.
f) Ordering quantity for each type of material should also be fixed so that Carrying cost and holding cost can be minimized.
g) Unnecessary losses can be avoided or can be minimized.
h) Purchases can be made at right time and at right or optimum price.
i) Accounting of raw material can be properly made.
j) The storage of raw materials should be well planned to avoid losses
k) Adequate records to control materials during production should also be maintained to ensure that there is minimum possible wastage
l) Information about availability of materials should be made continuously available to the management so that planning may be properly done.
m) Sales manager, purchasing executive and production manager usually favour, though for different reasons, the policy of carrying larger amount of stocks, whereas the financial manager will prefer to keep investment in material at the lowest possible level. However, in a large number of organizations material control is generally made the specific responsibility of purchasing department.

❖ LABOUR COST AND WHAT ARE ITS OBJECTIVES

Labour cost means amount paid to labour and workers for getting the work done from the workers. In other words amount paid by an enterprise to the human for work done by them is called labour cost. Various types of payments made to labour are as follows:

MONETARY/PECUNIARY BENEFITS

a) Basic Wages
b) Dearness Allowances
c) Production Bonus

DEFERRED MONETARY BENEFITS

a) Employer's Contribution to PF / ESIC
b) Retirement Gratuity
c) Profit Bonus

FRINGE BENEFITS/ NON- PECUNIARY BENEFITS

a) Free or subsidized food
b) Free or subsidized housing
c) Free or subsidized education to children
d) Medical & Hospital facilities
e) Expenses incurred on Canteen, sports club etc.

Objectives:

a) To keep labour cost at optimum level.
b) To keep labour cost at industry standards.
c) To motivate the workers.
d) To keep production cost at optimum level.
e) To improve the profitability and productivity.
f) To contribute employees welfare fund.

❖ TECHNIQUES OF LABOUR COST CONTROL

a) Manpower requirements should be assessed.
b) Record of time keeping and time booking should be maintained.
c) Record of idle time and its analysis should be maintained.
d) Record of time and motion study should be kept.
e) Adequate control over labour turnover should be maintained.
f) Wages and incentive system should be properly introduced.
g) Overtime should be properly authorized.
h) Control over contract, casual or other workers.
i) Job evaluation and Merit rating.
j) Improvement in labour productivity.

❖ TIME KEEPING AND ITS OBJECTIVES

Meaning: It means a record of time spent by a worker in a factory.In other words, total time spent by a worker inside the factory.

Purpose of time keeping:

a) Pay roll preparation
b) Finding out the labour cost of a job
c) To distinguish between normal and over time, late attendance and early leaving
d) To provide internal check against dummy workers
e) Attendance register should be maintained.
f) Cost should be properly classified as direct cost and indirect cost to facilitate control.
g) A proper record of overtime should be maintained.
h) Record of idle time should also be kept.
i) Proper and adequate discipline should prevail in the organization.
j) A record of statutory compliance should be maintained.
k) Production overhead should be properly absorbed using labour hour rate.

❖ SHORT NOTES ON COLLECTION AND CLASSIFICATION OF OVERHEADS

Overheads

Overhead cost is also known as the total cost of Indirect Materials, Indirect Labour and Indirect Expenses.

Overheads are the indirect costs which cannot be allocated to any specific job, process because they are not capable of being identified with specific job or process. Overheads include cost of indirect materials, indirect labour, indirect expenses which cannot be conveniently charged to any job, process, cost unit etc.

Collection of Overheads:

Collection of overheads means the collecting of indirect expenses from books of account and other records in logical groups having regard to their nature and purpose. Overheads are collected on the basis of pre-planned groupings called cost pools (groups or heads).

Classification of overheads:

Classification of overheads means the process of grouping of overheads according to their common characteristics. Overheads can be classified in different ways as follows:

a) On the basis of behaviour – (a) Fixed (b) Variable (c) Semi Variable Expenses
b) On the basis of Function –
    a. Production Overheads
    b. Administration overheads
    c. Selling and Distribution Overheads

❖ NOTIONAL EXPENSES

Expenses that are usually incurred should be included in costs even if a particular firm is not required to pay for such expenses. Rent for own premises is an example. If a firm occupies its own buildings, it does not pay any rent for it, but for costing purposes, an appropriate amount of rent is be included in costs