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INTRODUCTION TO COST ACCOUNTING

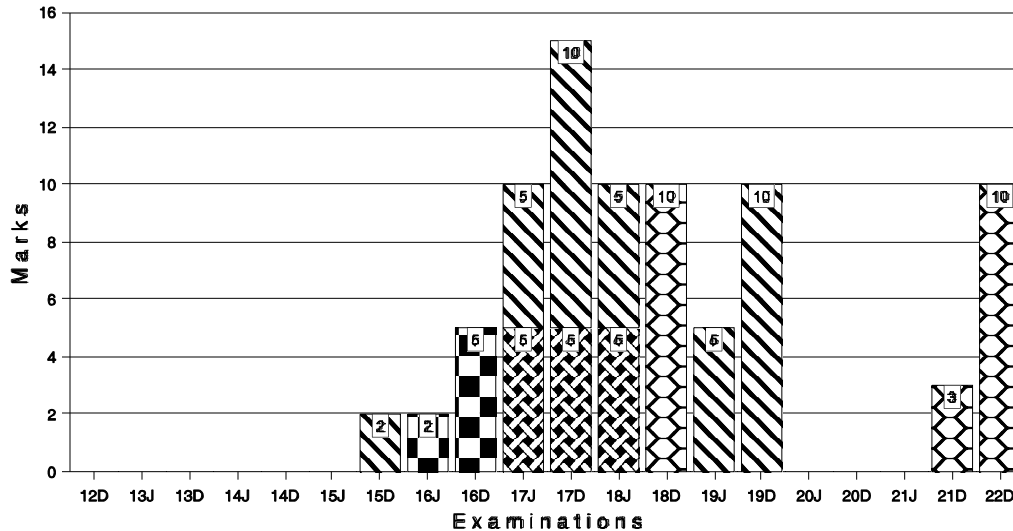
THIS CHAPTER INCLUDES

- Introduction
- Important Cost Accounting Terms
- Elements of Cost
- Classification of Cost

Marks of Objective, Short Notes, Distinguish Between, Descriptive & Practical Questions

Legend

 Objective  Short Notes  Distinguish  Descriptive  Practical



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CHAPTER AT A GLANCE

1. Meaning

1. **Cost:** Cost refers to the expenditure incurred in producing a product or in rendering a service. It is expressed from the producer or manufacturer's viewpoint. (not that of consumer/ end user.) Cost ascertainment is based on uniform principles and techniques.
2. **Costing:** The technique and process of ascertaining cost.
3. **Cost Accounting:** The process of accounting for cost which begins with recording of income and expenditure or the bases on which they are calculated and ends with the preparation of periodical statements and reports for ascertaining and controlling costs.
4. **Cost Accountancy:** 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 for the purpose of managerial decision- making.

2. Objectives of Cost Accounting

Ascertainment of Cost:

1. Determination of selling price
2. Cost Control and Cost Reduction
3. Ascertaining the profit of each activity
4. Assisting management in decision-making

3. Advantages of a Cost Accounting System

1. Profit Measurement and Analysis
2. Cost Reduction
3. Cost Comparison and Cost Control
4. Identification of losses and inefficiencies
5. Financial Decision Making
6. Price Determination

4. Features of a Good Cost Accounting System

1. Accuracy of data
2. Relevance of data
3. Simple and easy to operate
4. Participative Roll of executives
5. Cost - Effective
6. Management's Role
7. Smooth implementation

5. Factors for Installing a Cost Accounting System

1. Scope of Coverage
2. Objective
3. Technical aspects
4. Organisational Set-up
5. Impact of expansion on cost
6. Psycho-social aspects
7. Impact on Accounting System
8. Information requirements

6. Classification of Cost**1. On the basis of Time Period**

- (a) Historical Cost
- (b) Current Cost
- (c) Pre-determined Cost

2. On the basis of Behaviour/Nature/ Variability

- (a) Variable Cost
- (b) Fixed Cost
- (c) Semi – variable Cost

3. On the basis of Elements

- (a) Materials
- (b) Labour
- (c) Expenses

- 4. On the basis of Relationship**
 - (a) Direct Cost
 - (b) Indirect Cost
- 5. On the basis of Controllability**
 - (a) Controllable Costs**
 - (i) Time
 - (ii) Location
 - (iii) Product/Output
 - (b) Non-Controllable Cost**
- 6. On the basis of Normality**
 - (a) Normal cost
 - (b) Abnormal Cost
- 7. On the basis of Functions**
 - (a) Production Costs
 - (b) Administration Costs
 - (c) Selling Cost
 - (d) Distribution Cost
 - (e) Research Cost
 - (f) Development Costs
 - (g) Pre-Production Cost
 - (h) Conversion Cost
- 8. On the basis of Attributability to the Product**
 - (a) Period cost
 - (b) Product Cost
 - (i) Preparation of Financial Statements
 - (ii) Product pricing
 - (iii) Cost-plus-Contract with Government Agencies
- 9. On the basis of Relevance to decision making**
 - (a) Relevant Cost
 - (i) Marginal Cost
 - (ii) Differential Cost
 - (iii) Opportunity Cost
 - (iv) Out-of-pocket Cost
 - (v) Replacement Cost

- (vi) Imputed Cost
- (vii) Discretionary Cost
- (b) Irrelevant Costs
 - (i) Sunk Cost
 - (ii) Committed Cost
 - (iii) Absorbed Fixed Cost

7. Other Costs

1. **Explicit Cost:** This is also known as out of pocket cost. It refers to cost involving immediate payment of cash. Salaries, wages, postage and telegram.
2. **Implicit Cost:** This cost does not involve any immediate cash payment. It is not recorded in the books of account. It is also known as economic cost or imputed cost.
3. **Estimated Cost:** Estimated costs are prospective costs since they refer to prediction of cost.
4. **Shut down Cost:** In other words, all fixed costs which cannot be avoided during the temporary closure of a plant will be known as shut down cost.
5. **Absolute Cost:** It refers to the cost of any product, process or unit in its totality. Here the cost depicted in absolute amount may be called absolute cost and are base cost on which further analysis and decisions are based.

8. Cost Sheet

Meaning: A Cost Sheet is a statement which shows the break-up and build-up of costs. It is a document which provides for the assembly of the detailed cost of a cost center or a cost unit.

Uses: The following are the uses of the Cost Sheet.

1. Presentation of Cost information.
2. Determination of Selling Price.
3. Ascertainment of Selling Price.
4. Product-wise and Location-wise Cost Analysis.
5. Inter-firm and Intra-firm Cost Comparison.
6. Preparation of Cost Estimates for submitting tenders / quotations.

9. Cost Period

The period to which the Cost relates is called Cost period. It is also called the control period since cost ascertainment is for the purpose of control. Generally, the cost period is shorter than the financial period used for reporting purposes.

Cost Unit

It is a unit of production, service or time or combination of these, in relation to which costs may be ascertained or expressed. Cost units differ from one business to the other. They are usually units of physical measurement like number, weight, area, volume, time, length and value. Illustrations are as under:

Industry or Product	Cost Unit	Industry or Product	Cost Unit
Paints	Litres	Automobiles	Number
Cement	Tonne	Gas	Cubic meter
Power	Kilo-watt hour	Brickworks	Thousands
Transport	Tonne - kilometer or Passenger- kilometer	Interior Decoration	Each Contract

Responsibility Center

It is an activity Center of a business organisation entrusted with a special task.

It is a unit of function of a business organisation headed by an executive responsible for its performance.

TYPES OF RESPONSIBILITY CENTRES

Particulars	Cost Centres	Revenue Centres	Profit Centres	Investment Centres
Meaning	A Center for which a standard amount	A center devoted to raising	A Center whose performance is measured in	A Center responsible for earning profits

	of cost is predetermined and used for control.	revenue (no responsibility for production)	terms of income earned and cost incurred (profit earning)	and also for asset utilisation.
Primary responsibility	Cost reduction and cost control	Generation of sale revenue.	Profit earning	Earning return of investments
Performance evaluation	Standard cost less actual cost	Budgeted revenue less actual revenue	Budgeted profits less actual profits	Budgeted ROI less actual ROI.

METHODS OF COSTING

1. Job Costing	The cost of each job is ascertained separately. It implies that the direct cost of each job is traceable and identifiable. It is suitable in all cases where work is undertaken on receiving a customer's order/ assignment. Some examples are printing press, motor workshop, etc.
2. Batch Costing	It is used where the output under a particular work order consists of similar units. It may not be economically feasible to ascertain cost per unit. Hence a collection or a lot of units called a batch is taken for cost ascertainment purposes. Each batch is treated as a unit of cost and thus separately costed. Here cost per unit is determined by dividing the cost of the batch by the number of units produced in the batch.
3. Contract Costing	A larger job is called a contract. Generally, execution of work is distributed over two or more financial years. Hence, the cost of each contract is ascertained separately. It is suitable for firms engaged in the construction of bridges, roads, buildings etc.

4.	Single or Output Costing	Cost is ascertained for a product, the product being the only one produced like bricks, coals, etc.
5.	Process Costing and Operation Costing	The cost completing each stage of work is ascertained, like cost of making pulp and cost of making paper from pulp. In mechanical operations, the cost of each operation may be ascertained separately, the name given is operation costing.
6.	Operating or Services Costing	Ascertainment of cost of rendering or operating a service is called Service Costing or Operating Costing. It is used in the case of concerns rendering services like transport, cinema, hotels, etc. where there is no identifiable tangible cost unit.
7.	Multiple Costing	It represents a combination of two or more methods of costing outlined above. For example, if a firm manufactures bicycles including its components; the parts will be costed by batch costing system but the cost of assembling the bicycle will be computed by the Single or output costing method. The whole system of costing is known as multiple costing.

FOR ASCERTAINING COST, FOLLOWING TYPES OF COSTING ARE USUALLY USED

- | | |
|----|--------------------|
| 1. | Uniform Costing |
| 2. | Marginal Costing |
| 3. | Absorption Costing |
| 4. | Direct Costing |
| 5. | Standard Costing |
| 6. | Historical Costing |

SHORT NOTES

2018 - Dec [8] Answer the following questions:

- (a) State the advantages of cost control (*any five*) (5 marks)
(b) Describe briefly the main scope of cost accountancy. (5 marks)

Answer:

(a) Advantages of Cost Control:

The advantages of cost control are mainly as follows:

- (i) Achieving the expected return on capital employed by maximising or optimizing profit.
- (ii) Increase in productivity of the available resources.
- (iii) Reasonable price of the customers.
- (iv) Continued employment and job opportunity for the workers.
- (v) Economic use of limited resources of production.
- (vi) Increased credit worthiness.
- (vii) Prosperity and economic stability of the industry.

(b) Scope of Cost Accountancy:

The scope of cost accountancy is very wide and includes the following:

- (a) **Cost Ascertainment:** The main objective of cost accounting is to find out the cost of product/service rendered with reasonable degree of accuracy.
- (b) **Cost Accounting:** It is the process of accounting for cost which begins with recording of expenditure and ends with preparation of statistical data.
- (c) **Cost Control:** It is the process of regulating the action so as to keep the element of cost within the set parameters.
- (d) **Cost Reports:** This is the ultimate function of Cost Accounting. These reports are primarily prepared for use by the management at different levels. Cost Reports help in planning and control, performance appraisal and managerial decision making.

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- (e) **Cost Audit:** Cost Audit is the verification of correctness of Cost Accounts and check on the adherence to the Cost Accounting Plan, its purpose is not only to ensure the arithmetic accuracy of cost records but also to see the principles and rules have been applied correctly.

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2021 - Dec [1] Write Short Notes on Differentiate between Operation Cost and Operating Cost - **(3 marks) [Sec. C - LAQ Six]**

Answer:

Please refer 2017 - Dec [8] (b) on page no. 19

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2022 - Dec [8] Write short notes on the following questions:

- (a) Enumerate what are the objectives of cost accounting.
(d) Enumerate what are the advantages of cost control.

(5 marks each)

DISTINGUISH BETWEEN

2017 - June [8] Answer the following question:

- (c) Differentiate between Financial Accounting and Management Accounting. **(5 marks)**

Answer:

The main differences between Financial Accounting and Management Accounting are as follows:

	Financial Accounting	Management Accounting
(a)	Provides general business information like P&L account, Balance Sheet	Specific information relating to specific problems and decision making.

(b)	Information for owners and outside parties	Information is for management for optimizing decisions.
(c)	Importance is on recording rather than control	Emphasis is on control like using details of materials, labour, etc for standard costing, budgetary control.
(d)	All commercial transactions between the business and external parties are recorded.	Concerned with Internal transaction not involving payment or receipt
(e)	Only those transactions that can be measured in monetary terms are recorded.	Other parameters like cost units, apportioning bases are also recorded.
(f)	Efficiency of resource utilization - men/materials or machine is not available	Available for corrective action.
(g)	Stocks are valued at cost or market value, whichever is lower.	Always valued at cost.
(h)	Records are maintained as per Companies Act and as per Income Tax Act.	Records are maintained as per Companies Act only in certain cases, that too as per Cost Accounting requirements, but mainly to suit the management for efficiency and control.

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2017 - Dec [8] (b) Differentiate between Operation Cost and Operating Cost. **(5 marks)**

Answer:

Operation Cost: Operation cost is the cost of a specific operation involved in a production process or business activity. The cost unit in this method is the operation, instead of process. When the manufacturing method of a concern consists of a number of distinct operations, operating costing is suitable.

Operating Cost: Operating cost is the cost incurred in conducting a business activity. It refers to the cost of concerns which do not manufacture any product but which provide services. Industries and establishments like power house, transport and travel agencies, hospitals, schools etc. Which undertake services rather than the manufacture of products, ascertain operating costs. The cost units used are Kilo Watt Hour (KWH), Passenger Kilometer and Bed in the Hospital etc.

Operation costing method constitutes a distinct type of costing but it may also be classed as a variant of process cost since costs in this method are usually compiled for a specified period.

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2018 - June [8] Answer the following:

(a) Differentiate between cost control and cost reduction. **(5 marks)**

Answer:

Cost Control vs. Cost Reduction: Both Cost Control and Cost Reduction are efficient tools for management but their concepts and procedure are widely different. The main differences are as follows:

	Cost Control	Cost Reduction
(i)	Cost Control represents efforts made towards achieving target or goal.	Cost Reduction represents the achievement in reduction of cost.
(ii)	The Process of Cost Control is to setup a target, ascertain the actual performance and compare it with the target, investigate the variances, and take remedial measures.	Cost Reduction is not concerned with maintenance of performance according to standards.
(iii)	Cost Control assumes the existence of standards or norms which are not challenged.	Cost Reduction assumes the existence of concealed potential savings in standards or norms which are therefore subjected to a

		constant challenge with a view to improvement by bringing out savings.
(iv)	Cost Control is a preventive function. Costs are optimized before they are incurred.	Cost Reduction is a corrective function. It operates even when an efficient cost control system exists. There is room for reduction in the achieved costs under controlled conditions.
(v)	Cost Control lacks dynamic approach.	Cost Reduction is a continuous process of analysis by various methods of all the factors affecting costs, efforts and functions in an organization. The main stress is upon the why of a thing and the aim is to have continual economy in costs.

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DESCRIPTIVE QUESTIONS

2015 - Dec [1] Answer the question:

(c) Narrate any two practical difficulties in installing a costing system.

(2 marks) [CMAIG - II]

Answer:

Practical difficulties in installing a costing system:	
(a) Lack of support from top management	In most cases, cost accounting system is introduced without the support of the top management in all the functional areas. Even the Managing Director or chairman often introduces the costing system without consulting the departmental heads. The departmental

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	managers treat this as interference in their work. Thus, it creates a fear in the minds of the departmental managers.
(b) Resistance from the existing staff	Whenever a new system is introduced, resistance is natural as the existing staff may feel that they would lose their importance and may feel insecure of their position in the organization.

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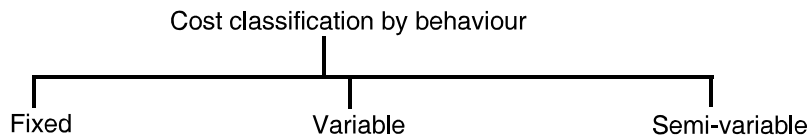
2017 - June [8] Answer the following question:

(d) How would you classify costs based on behaviour? Give an example to explain each class. **(5 marks)**

Answer:

Classification based on Behaviour– Fixed, Semi-variable or Variable:

Costs are classified based on behaviour as fixed cost, variable cost and semi-variable cost depending upon response to the changes in the activity levels.



Fixed Cost: Fixed cost is the cost which does not vary with the change in the volume of activity in the short run. These costs are not affected by temporary fluctuation in activity of an enterprise. These are also known as period costs.

Example: Rent, Depreciation etc.

Variable Cost: Variable cost is the cost of elements which tends to directly vary with the volume of activity. Variable cost has two parts (i) Variable direct cost (ii) Variable indirect costs. Variable indirect costs are termed as variable overheads.

Example: Direct labour, Outward Freight. etc.

Semi-Variable Costs: Semi variable costs contain both fixed and variable elements. They are partly affected by fluctuation in the level of activity. These are partly fixed and partly variable costs and *vice versa*.

Example: Factory supervision, Maintenance etc.

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2017 - Dec [8] Answer the following questions:

- (a) “Cost Accounting and Management Accounting are inter-dependent.” Do you agree, discuss,
- (d) What is Responsibility Accounting? Also state the Principles of Responsibility Accounting. **(5 marks each)**

Answer:

(a) Cost Accounting: In cost accounting, primary emphasis is on cost and it deals with its collection, analysis, relevance, interpretation and presentation for various problems of management.

Management Accounting: It utilizes the principles and practices of financial accounting and cost accounting in addition to other management techniques for efficient operations of a concern. It widely uses different techniques from various branches of knowledge like Statistics, Mathematics, Economics, Law and Psychology to assist the management in its task of maximizing profits or minimizing losses. The main thrust in management accounting is towards determining policy and formulating plans to achieve desired objectives of management.

From the above discussion it may be concluded that cost accounting and management accounting are inter-dependent, greatly related and inseparable.

Answer:

(d) Responsibility Accounting:

- It is a system of accounting that recognizes various responsibility centres throughout the organisation and reflects the plans and actions of each of these centres by assigning particular revenues and costs of the one having the pertinent responsibility.

- It is a system in which the person holding the supervisory posts as president, function head, foreman, etc. are given a report showing the performance of the company or department or section as the case may be. The report will show the data relating to operational results of the area and the items of which he is responsible for control.
- Responsibility accounting follows the basic principles of any system of cost control and standard costing. It differs only in the sense that it lays emphasis on human beings and fixes responsibilities for individuals. It is based on the belief that control can be exercised by human beings, so responsibilities should be fixed for individuals.

Principles of Responsibility Accounting:

- (i) A target is fixed for each department or responsibility Center.
- (ii) Actual performance is compared with the target.
- (iii) The variances from plan are analysed so as to fix the responsibility.
- (iv) Corrective action is taken by higher management and is communicated.

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2018 - June [8] Answer the following:

- (b) Cost accounting has emerged as a specialized discipline due to various factors. List out these factors. (*Any five*) **(5 marks)**

Answer:

The main factors attributable for emerging cost accounting as a specialized discipline are as under: (Any Five Factors)

- (i) Limitations placed on financial accounting.
- (ii) Improved cost consciousness.
- (iii) Rapid industrial development after industrial revolution and World wars.
- (iv) Growing competition among the manufacturers.
- (v) To control galloping price rise, the cost of computing the precise cost of product / service.

- (vi) To Control Cost, several legislations passed throughout the World and in India too, such as Essential Commodities Act, Industrial Development and Regulation Act (IDRA), etc.

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2019 - June [8] Answer the following question:

- (b) State the main objectives of Cost Accounting. **(5 marks)**

Answer:

Main Objectives of Cost Accounting:

The main objectives of cost accounting are as under:

- (i) To ascertain the costs under different situations using different techniques and systems of costing.
- (ii) To determine the selling prices under different circumstances.
- (iii) To determine and control efficiency by setting standards for Materials, Labour and Overheads.
- (iv) To determine the value of closing inventory for preparing financial statements of the concern.
- (v) To provide a basis for operating policies of the concern

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2019 - Dec [8] Answer the following question:

- (a) Explain the concept of Opportunity Cost and Imputed Cost with suitable examples.
- (b) State the limitations of Cost Accounting System. **(5 marks each)**

Answer:

(a) Opportunity Cost :

Opportunity cost is the value of alternatives foregone by adopting a particular strategy or employing resources in specific manner. It is the cost of next best alternative. It is the return expected from an investment other than the present one. These refer to costs which result from the use or application of material, labour or other facilities in a particular manner which has been foregone due to not using the facilities in the manner originally planned. Resources (or input) like men, materials, plant and machinery, finance etc., when utilized in one particular way,

yield a particular return (or output). If the same input is utilized in another way, yielding the same or a different return, the original return on the forsaken alternative that is no longer obtainable is the opportunity cost. For example, if fixed deposits in the bank are proposed to be withdrawn for financing project, the opportunity cost would be the loss of interest on the deposits. Similarly, when a building leased out on rent to a party is got vacated for own purpose or a vacant space is not leased out but used internally, say, for expansion of the production programme, the rent so foregone is the opportunity cost.

Imputed Cost:

Imputed cost is hypothetical or notional cost, not involving cash outlay and computed only for the purpose of decision-making. In this respect, imputed cost is similar to opportunity cost. Interest on funds generated internally, payment for which is not actually made is an example of imputed cost. When alternative capital investment projects are being considered out of which one or more are to be financed from internal funds, it is necessary to take into account the imputed interest on own funds before a decision is arrived at.

(b) Limitations of Cost Accounting System are as follows:

- (i) Like any other system of accounting, Cost Accountancy is not an exact science but an art which has been developed through theories and accounting practices based on reasoning and commonsense. Many of the theories can neither be proved nor can be disproved. They have grown up in course of time to become conventions and accepted principles of Cost Accounting.
- (ii) These principles are by no means static, they are changing from day to day and what is correct today may not be correct in the circumstances tomorrow.
- (iii) In cost accounting, no cost can be said to be exact as they incorporate a large number of conventions, estimations and flexible factors such as:-
 - (a) Classification of costs into its elements.
 - (b) Materials issue pricing based on average or standard costs.

- (c) Apportionment of overhead expenses and their allocation to cost units/centres.
- (d) Arbitrary allocation of joint costs.
- (e) Division of overheads into fixed and variable.
- (iv) Cost Accounting lacks the uniform procedures and formats in preparing the cost information of a product/ service.
- (v) Keeping in view above limitations, all Cost Accounting results can be taken as mere estimates.

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PRACTICAL QUESTIONS

2016 - June [1] (g) A company has 1,000 units of obsolete items which are carried in inventory at the original purchase price of ₹ 36,000 although their market value as scrap is only ₹ 4,000. If the items are re-worked for ₹ 12,000, they can be sold for ₹ 22,000. Find the relevant cost for selling the items. **(2 marks) [CMAIG - II]**

Answer:

Relevant cost for selling the items

Particulars	Amount (₹)
Re-work cost	12,000
Add: Opportunity cost (scrap value)	4,000
	16,000

Note: If the obsolete items were sold as scrap in the market they would have realised ₹ 4,000 but now the items are re-worked and not sold as scrap. So, ₹ 4,000 has to be considered as opportunity cost.

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2016 - Dec [3] (b) Classify the following costs according to function and under the appropriate element of cost in the context of a jute bag manufacturing unit:

- (i) Nuts and Bolts
- (ii) Commission on sales
- (iii) Printing and Stationery
- (iv) Product Catalogue
- (v) Secondary packing material used in the delivery van. **(5 marks)**

Answer:

Element Function	Material	Labour	Expense
Production Overheads	Nuts and Bolts (i)		
Administration Overheads	Printing & Stationery (iii)		
Selling Overheads	Product Catalogue (iv)	Commission on Sales (ii)	
Distribution Overheads	Secondary Packing material item in delivery van (v)		

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Repeatedly Asked Questions		
No.	Question	Frequency
1.	Write Short Notes on Differentiate between Operation Cost and Operating Cost - 17 - Dec [8] (b), 21 - Dec [1]	2 Times
2.	Enumerate what are the objectives of cost accounting. 19 - June [8] (b), 22 Dec [8] (a)	2 Times
3.	Enumerate what are the advantages of cost control. 18 - Dec [8] (a), 22 - Dec [8] (d)	2 Times