Cost

Costistheamountofexpenditureincurredor attributabletoagiventhing.

Costing

"Techniquesandprocessofascertainingcosts".

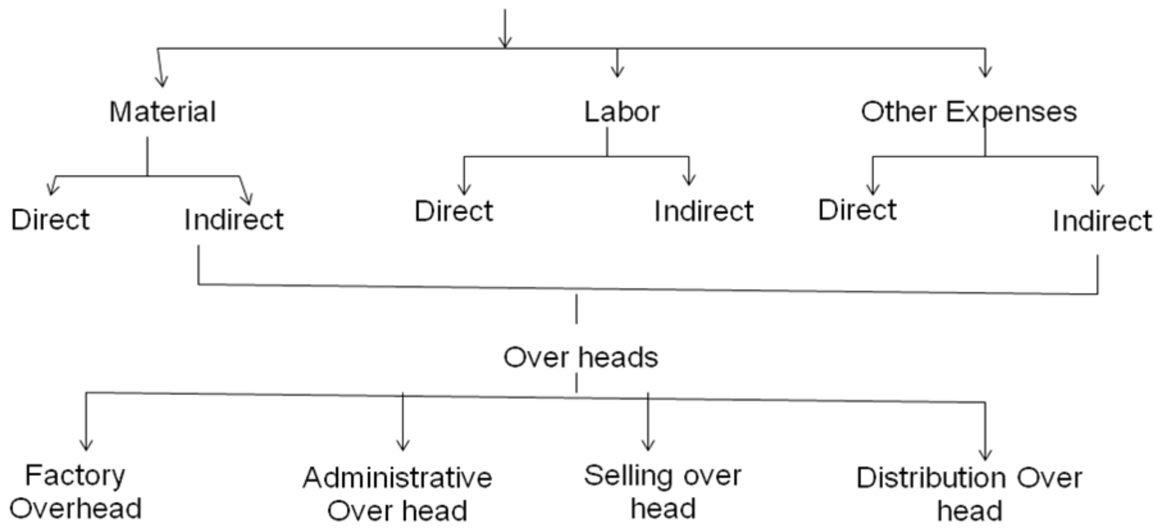
CostAccounting

CostAccountingistheprocessofrecording,classifying,allocating&reportingvariouscostsincurredinthebusiness.

CostAccounting-Objectives

1. Costfindings
2. Controlofcost
3. ReductionofCost
4. Fixationofsellingprice
5. Providinginformationforframingbusinesspolicy

Elementofcost



ClassificationofCosts

1. ByNatureorElementorAnalyticalClassification

According to this classification, the costs are divided into three categories i.e. Materials,Labour and Expenses. There can be further sub classification of each element; for example,material into raw material components, and spare parts, consumable stores, packing material etc.This classification is important as it helps to find out the total cost, how such total cost isconstitutedandvaluationofworkinprogress.

2. ByFunctions

According to this classification costs are divided in the light of the different aspects ofbasics managerial activities involved in the operation of a business undertaking. It leads togrouping of cost according to the broad divisions or functions of a business undertaking i.e.,production, administration selling and distribution. According to this classification costs aredividedasfollows:

ManufacturingandProductionCost:Thisisthetotalofcostsinvolvedinmanufacture,constructionandfabricationofunits ofproduction.

Commercial Cost: This is the total of costs incurred in the operation of a businessundertaking other than the cost of manufacturing and production. Commercial cost may furtherbe sub-divided into (a) administrative cost and (b) selling and distribution cost. These terms willbe explainedinasubsequentchapter.

4. AsDirectandIndirect

According to this classification, total cost is divided into direct costs and indirect costs.Directcostsarethosewhichareincurredforandmaybeconvenientlyidentifiedwithaparticular cost centre or cost unit. Materials used and labour employed in manufacturing anarticle or in a particular process of production are common examples of direct costs. Indirectcosts are those cost which are incurred for the benefit of number of cost centres or cost units andcannot be conveniently identified with a particular cost centre or cost unit. Examples of indirectcost include rent of building,managementsalaries, machinery depreciation etc. The nature ofthe business and the cost unitchosen will determine which costs are directandwhich areindirect. For example,the hire of a mobile craneforuse by a contractor at site would beregarded as a direct cost but if the crane is used as a part of the services of a factory, the hirecharges would be regarded as indirect cost because it will probably benefit more than one costcentre. The importance of the distinction of costs into direct and indirect lies in the fact thatdirect costs of a product or activity can be accurately determined while indirect costs have to beapportionedoncertainassumptions as regardstheirincidence.

5. ByVariability

According to this classification, costs are classified according to their behaviour inrelation to changes in the level of activity or volume of production. On this basis, costs areclassifiedintothree groups viz.fixed,variableandsemi-variable.

(i) **Fixed or period costs** are commonly described as those which remain fixed in totalamount with increase or decrease in the volume of output or productive activity for agiven period of time. Fixed cost per unit decreases as production increases and increasesas production declines. Examples of fixed costs are rent, insurance of factory building,factory manager's salary etc. These fixed costs are constant in total amount but fluctuateper unit as production changes. These costs are known as period costs because these aredependent on time ratherthan on output. Such costs remain constantperunit of timesuch as factory rent of Rs.10,000 per month remaining same for every month irrespectiveofoutputofeverymonth.

(ii) **Variable or product costs** are those which vary in total in direct proportion to thevolumeof output.Thesecostsperunitremainrelativelyconstantwithchangesinproduction. Thus, variable costs fluctuate in total amount but tend to remain constant perunit as production activity changes. Examples are direct material costs, direct labourcosts, power, repairs etc. Such costs are known as product costs because they depend onthequantumofoutputratherthanontime.

(iii) **Semi-variablecosts**arethosewhicharepartlyfixedandpartlyvariable.Forexample, telephone expenses included a fixed portion of annual charge plus variablechargeaccordingtocalls;thustotaltelephoneexpensesaresemi-variable.Otherexamples of such costs are depreciation, repairs and maintenance of building and plantetc.

6. ByControllability

Under this, costs are classified according to whether or not they are influenced by theactionsofagivenmember oftheundertaking.Onthisbasisitisclassifiedintotwocategories:

(i) **Controllable costs** are those which can be influenced by the action of a specifiedmember of an undertaking, that is tosay, costs which are atleastpartly within thecontrol of management.Anorganizationisdividedintoanumberof responsibilitycentres and controllable costs incurred in a particularcost centre can be influencedbythe action of the manager responsible for the centre. Generally speaking, all direct costsincludingdirectmaterial,directlabourandsomeoftheoverheadexpensesarecontrollable bylowerlevelofmanagement.

(ii) **Uncontrollablecosts**arethosewhichcannotbeinfluencedbytheactionofa specified member of an undertaking that it is to say, which are within the control ofmanagement.Mostofthefixedcostsareuncontrollable.Forexample,rentofthebuilding is not controllable and so are managerial salaries. Overhead cost, which isincurred by one service section and is apportioned to another which receives the service,isalsonotcontrollablebythelatter.

The distinction between controllable and uncontrollable is sometimes left to individualjudgment and is not sharply maintained. It is only in relation to a particular level of managementor an individual manager that we may say whether a cost is controllable or uncontrollable. Aparticularitem of costwhichmay be controllablefrom the pointof viewof onelevel ofmanagement may be uncontrollable from another point of view. Moreover, there may be an itemof cost which is controllable from long term point of view and uncontrollable from short termpointofview.Thisis partlysointhecase offixedcosts.

7. ByNormality

Under this, costs are classified according to whether these are cost which are normallyincurred as a given level of output in the conditions in which that level of activity is normallyattained.Onthisbasis,itisclassifiedintotwocategories:

(a) **Normal cost:** It is the cost which is normally incurred at a given level of output inthe conditions in which that level of output is normally attained. It is a part of cost ofproduction.

(b) **Abnormal cost:** It is the cost which is not normally incurred at a given level ofoutput in the conditions in which that level of output is normally attained. It is not a partofcostofproductionandchargedtoCostingProfitandLoss Account.

8. ByCapitalandRevenueorFinancialAccountingClassification

The cost which is incurred in purchasing assets either to earn income or increasing theearning capacity of the business is called capital cost. For example, the cost of a rolling machinein case of steel plan. Such cost is incurred at one point of time but the benefits accruing from itare spread over a number of accounting years. It any expenditure is done in order to maintain theearning capacity of the concern such as cost of maintaining an asset or running a business it isrevenue expenditure e.g. cost of materials used in production, labour charges paid to convert

thematerialintoproduction,salaries,depreciation,repairsandmaintenancecharges,sellingand distribution charges etc. The distinction between capital and revenueitemsisimportant incosting as all items of revenue expenditure are taken into consideration while calculating costwhereascapitalitems arecompletelyignored.

9. ByTime

Costcanbeclassifiedas(i) Historicalcostsand(ii)Predeterminedcosts.

i) **Historical costs**:Thecostwhichisascertainedaftertheirincurrenceiscalledhistorical costs. Such costs are available only when the production of a particular thinghas already been done. Such costs are only of historical value and not at all helpful forcostcontrolpurposes.Basic characteristics ofsuchcosts are:

(a) Theyarebased onrecorded facts.

(b) Theycanbeverifiedbecausetheyarealwayssupportedbytheevidenceoftheiroccurrence.

(c) Theyaremostlyobjectivebecausetheyrelateto happeningswhich havealreadytakenplace.

ii) **Predetermined costs:** Such costs are estimated costs i.e. computed in advance ofproduction taking into consideration the previous period’s costs and the factors affectingsuch costs. Predetermined cost determined on scientific basis becomes standard cost.Such costs when compared with actual costs will give the reasons of variance and willhelp the management to fix the responsibility and to take remedial action to avoid itsrecurrenceinfuture.

Historical costs andpredeterminedcosts are notmutually exclusivebutthey worktogether in the accounting system of an organization. In competitive age, it is better to lay downstandards, so that after comparison with the actual, the management may be able to take stock ofthe situation to find out as to how far the standards fixed by it have been achieved and takesuitable action in the light of such information. Therefore, even in a system when historical costsare used, predetermined costs have a very important role to play because a figure of historicalcostbyitselfhasnomeaningunlessitisrelatedtosomeotherstandardfiguretogivemeaningfuli nformationtothemanagement.

10.AccordingtoPlanningandControl

Planning and control are twoimportant functions of management. Cost accountingfurnishesinformationtothemanagementwhichishelpfulistheduedischargeofthesestwo functions.Accordingtothis,costscanbeclassifiedasbudgetedcostsand standardcosts.

i) **Budgeted costs**: Budgeted costs represent an estimate of expenditure for differentphases of business operations such as manufacturing, administration, sales, research anddevelopment etc. coordinated in a well conceived framework for a period of time infuture which subsequently becomes the written expression of managerial targets to beachieved. Various budgets are prepared for various phases, such as raw material costbudget, labour cost budget, cost of production budget, manufacturing overhead budget,officeandadministrationoverheadbudgetetc,Continuouscomparisonofactualperfor mance (i.e. actual cost) with that of the budgeted cost is made so as to report thevariationsfromthe budgetedcosttothe managementforcorrective action.

ii) **Standard Cost:** Budgeted costs are translated into actual operation through theinstrumentofstandardcosts.TheInstituteofCostandManagementAccountants,London defines standard cost as follows: "Standard cost is the predetermined cost basedon a technical estimate for materials, labour and overhead for a selected period of timeandfor a prescribed set of working conditions". Thus, standard cost is a determination,inadvanceofproductionofwhatshouldbethecost.

Budgeted costs and standard costs are similar to each other to the extend that both ofthem represent estimates for cost for a period of time in future. In spite of this, they differ in thefollowingaspects:

1. Standard costs are scientifically predeterminedcosts of every aspect of businessactivity whereas budgeted costs are mere estimates made on the basis of past actualfinancialaccountingdataadjustedtofuturetrends.Thus,budgetedcostsareprojectio noffinancialaccountswhereasstandardcostsareprojectionofcostaccounts.
2. The primary emphasis of budgeted costs is on the planning function of managementwhereas the main thrust of standard costs is on control because standard costs layemphasisonwhatshouldbethe costs.
3. Budgetedcostsareextensivewhereasstandardcostsareintensiveintheirapplication.Budge tedcostsrepresentamacroapproachofbusinessoperationsbecause theyare estimatedinrespectofthe operationsofa department.Contraryto

this, standard costs are concerned with each and every aspect of business operation carried in adepartment.Thus,budgetedcostsdealwithaggregateswhereasstandardcostsdealwithindividual parts which make the aggregate.For example,budgeted costs are calculated fordifferentfunctions of the business i.e. production,sales, purchases etc. whereas standard costsarecompiledforvariouselementsofcostsi.e.materials,labourand overhead.

11. ForManagerialDecisions

Onthisbasis,costsmaybeclassifiedintothefollowingcosts:

i) **Marginal cost:** Marginal cost is the total of variable costs i.e. prime cost plusvariable overheads. It is based on the distinction between fixed and variable costs.Fixedcosts are ignoredandonlyvariable costs are takenintoconsiderationfordetermining the costofproductsandvalue ofworkinprogressandfinishedgoods.

ii) **Out of pocket costs**: This is that portion of the cost which involves payment tooutsiders i.e., gives rise to cash expenditure as opposed to such costs as depreciation,which do not involve any cash expenditure. Such costs are relevant for price fixationduringrecessionorwhenmake orbuydecisionis tobemade.

iii) **Differential costs**: The change in costs due to change in the level of activity orpattern or method of production is known as differential costs. It the change increasesthe cost, it will be called incremental cost. If there is decrease in cost resulting fromdecrease ofoutput,thedifferenceis knownasdecrementalcost.

iv) **Sunkcosts:**Asunkcostisanirrecoverablecostandiscausedbycompleteabandonment of a plant. It is the written down value of the abandoned plant less itssalvage value. Such costs are not relevant for decision making and are not affected byincrease ordecreaseinvolume.

v) **Imputed costs**: These costs are those costs which appear in cost accounts only e.g.national rentchargedon business premises ownedby theproprietor,interestoncapital for which no interest has been paid. These costs are also known as notionalcosts. When alternative capital investment projects are being evaluated it is necessaryto consider the imputed interest on capital before a decision is arrived as to which isthe mostprofitableproject.

vi) **Opportunity cost**: It is the maximum possible alternative earning that might havebeenearnediftheproductivecapacityorserviceshadbeenputtosomealternative use.In simple words,itis the advantage,in measurable terms,which hasbeenforegone due to not using the facility in the manner originally planned. For example,if an owned building is proposed to be used for a project, the likely rent of thebuildingisthe opportunity costwhich shouldbetakenintoconsideration whileevaluatingtheprofitabilityoftheproject.

vii) **Replacement cost**: It is the cost at which there could be purchased an asset ormaterialidenticaltothatwhichisbeingreplacedorrevalued.Itisthecostofreplacementatcurrentmarketprice.

viii) **Avoidableandunavoidablecost**:Avoidablecostsarethosewhichcan beeliminated if a particular product or department, with which they are directly related,is discontinued. For example, salary of the clerks employed in a particular departmentcan be eliminated, if the department is discontinued. Unavoidable cost is that costwhich will not be eliminated with the discontinuation of a product or department. Forexample, salary of factory manager or factory rent cannot be eliminated even if aproductis eliminated.