INDO – AMERICAN COLLEGE , CHEYYAR
Class: II M.Com.,
Subject : ADVANCED COST ACCOUNTING (MCM43)

UNIT-I

Nature and significance of cost accounts-Definition of Costing, Scope, Objectives, Functions and limitations of cost accounting-Installation of costing system-Elements of Cost- Cost centre and profit centre-Preparation of Cost sheet, tender of quotations.

1. NATURE AND SIGNIFICANCE OF COST ACCOUNTS

The broad definition of cost accounting and nature of cost is the process of identifying, summarizing, and interpreting information needed for:

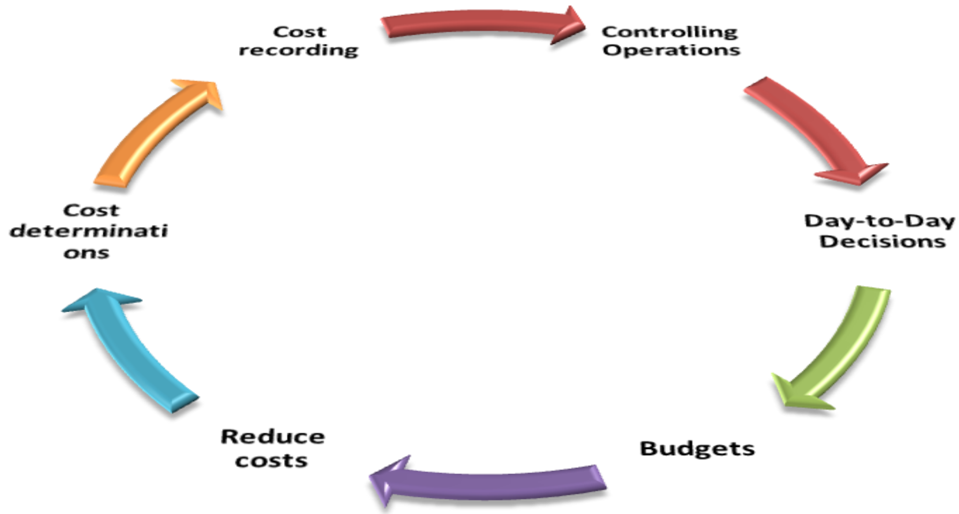
- Planning and Control
- Management Decisions
- Product Costing

So that, it means all manufacturing process should be controlled by cost accounting in details.

Note that product costing is number 3, since in most companies, the more important activities relate to **planning and control** and special decisions rather than to the more mechanical aspects of accumulating and computing product costs.

The various activities (Nature and purpose) of a cost department under the broad definition cover a wide range of responsibilities:

1. Preparing data required in **planning and controlling operations**.
2. Preparing data in connection with **day-to-day decisions** or special projects that require a choice among alternative courses of action.
3. Participating in the creation and **execution of budgets**.
4. Establishing procedures to improve operations and **reduce costs**.
5. Developing cost Systems and analyses to improve **cost determination** and review of variances
6. Cost recording and **reporting of costs** by product or department.



2. SIGNIFICANCE OF COST ACCOUNTING

Cost accounting is very important for a business

•**It helps** you to determine the cost of products or services you are providing.

•**It provides information** to internal users like managers, supervisors, etc.

• It facilitates **managerial decision making**.

• It distinguishes between **avoidable and unavoidable losses**.

• It helps you in **controlling** the cost of products and services and minimizing the wastage of inputs.

•As cost accounting is a system of continuous reporting. Cost is predetermined and this helps in taking corrective action at appropriate stages .

• In cost accounting, Expenses are classified into direct and indirect items and are apportioned to each process and department as required.

• It helps us to appraise the efficiency of workers , materials and costs as developed standards are fixed to measure the efficiency of workers with what should have been accomplished in producing and selling of products during the specific period.

3. DEFINITION

Cost accounting is the accounting method for ensuring cost-effectiveness by accumulating, organising, recording, calculating, analysing and assessing the overall expenses incurred on a product, process or project, etc. It is mostly used in industrial units or factories where the goods are manufactured.

4. SCOPE OF COST ACCOUNTING

Cost accounting is being widely applied by the production units to modify the process and maximize 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 Contol**: 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.

5. OBJECTIVES OF COST ACCOUNTING

Cost accounting aims at eliminating the loopholes in the production process and ensures manufacturing of goods at the lowest possible cost.

Other than this, there are multiple objectives of the cost accounting practices. Let us now discuss its importance in detail:

- **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.

6. FUNCTIONS OF COST ACCOUNTING OR COST-ACCOUNTANT:

According to Blocker and Weltemer 'Cost Accounting is to serve management in the execution of policies and in comparison of actual and estimated results in order that the value of each policy may be appraised and changed to meet the future conditions'.

Following are main functions of cost accounting:

(i) To work out cost per unit of the different products manufactured by the organisation;

(ii) To provide an accurate analysis of this cost;

(iii) To maintain costs to the lowest point consistent with the most efficient operating conditions. It requires the examination of each cost in the light of the service or benefit obtained so that the maximum utilization of each rupee will be obtained;

(iv) To work out the wastage in each process of manufacture and to prepare reports as may be necessary to assist in the control of wastage;

(v) To provide necessary data for the fixation of selling price of commodities manufactured;

(vi) To compute profits earned on each of the products and to advise management as to how these profits can be improved;

(vii) To help management in **control of inventory** so that there may be minimum locking up of capital in stocks of raw materials, stores, work-in-process and finished goods

(viii) To install and implement cost control systems like Budgetary Control and Standard Costing for the control of expenditure on materials, labour and overheads;

(ix) To advise management on future expansion;

(x) To advise management on the profitability or otherwise of new lines of products;

(xi) To **carry out special cost studies and investigations** which are invaluable to management in determining policies and formulating plans directed towards profitable operations.

7. LIMITATIONS OF COST ACCOUNTING

Cost accounting is a complex stream of accounting. It requires a lot of analysis and calculations to give accurate results.

To know more about the limitations or objections about cost accounting, read below:

Cost accounting is not sufficient alone to control or reduce the cost of products or services. It is necessary to use the data so generated to take corrective actions which require a lot of **experience and expertise**.

Moreover, it differs from the financial accounting we practice in day to day life. To get an accurate result, a **reconciliation statement** has to be prepared.

In the books of accounts, many entries have to be made twice; once in the final accounts and then in the cost accounts, which is a tedious process. Due to the **lengthy process** of **duplicate entries**, there is a need for additional efforts from the personnel. Thus it increases the **labour charges** for the organisation.

It is majorly applicable to the industries, factories and manufacturing units where some production function takes place. It is **less useful for service industries**.

8. INSTALLATION OF A COSTING SYSTEM

The fundamental factors that a Cost Accountant should consider while introducing a system of costing are:

(i) The existing organisation should be disturbed as little as possible.

(ii) There should be a gradual and smooth introduction of the system.

(iii) While over-elaboration of records should be avoided, it would be false economy to prune out essentials and impair efficiency.

Steps for Installation - The steps to be taken in installing a costing system are given below:

1. Objective to be Achieved through the Costing System:

The costing system will be simple if the objective is only to determine cost but it will have to be elaborate if the objective is to have information which will help management in exercising control and taking decisions.

2. Studying the Existing Organisation and Routine:

In this connection the points to be noted are—the nature of the business and of the operations or process carried on, extent of responsibility and authority attached to the various functionaries, the lay-out of the factory with particular reference to the manufacturing departments, the methods of dealing with wastage of materials, the system of time recording and the methods of computing and paying wages, the system of issuing orders for production to the factory and the amount of fixed, semi-variable and variable overheads.

3. Deciding the Structure of Cost Accounts:

What system of cost accounting is suitable and the extent of details required can be decided after a thorough study of the manufacturing process and their ancillary services. The structure of cost accounts should follow the natural production line; the sequence can be simple, analytical or synthetic. The designing of the system should be such that there is a gradual build up of the cost at each significant stage of production as the product proceeds to completion.

4. Determining the Cost Rates:

This entails a thorough study of factory conditions and decisions are to be made about classification of cost into direct and indirect, grouping of indirect costs into production, selling, administration etc., treatment of wastes of all kinds, methods of pricing issues, methods of recovering overheads and calculation of overhead rates. A complete cost accounting code should be drawn up so that expenditure may be quickly classified in the office as to both source and cause.

5. Introducing the System:

No costing system can be expected to function effectively unless co-operation of all the officials could be obtained. Before the system is put into effect, the implications of the system should be explained to all indicating to them the benefits that will accrue to each and to the business as a whole.

However, complete the system is, it should be introduced only by stages and the existing routines and practices should be utilised unless there are good grounds to supersede them. For example, a start could be made with the stores by introducing proper accounts of receipts and issues, opening of bin cards, stores ledgers etc.

6. Organising the Cost Office:

It is always better that the cost office is situated adjacent to the factory so that delay in routing out documents or in clearing up discrepancies and doubts, is avoided. The costing staff must be allowed to have access to the works if they are to perform their duties properly.

The size of staff would depend on the volume of work involved. A costing organisation is not worth its existence if it cannot present figures with speed and accuracy and observe simplicity in the presentation of results.

9. ELEMENTS OF COST

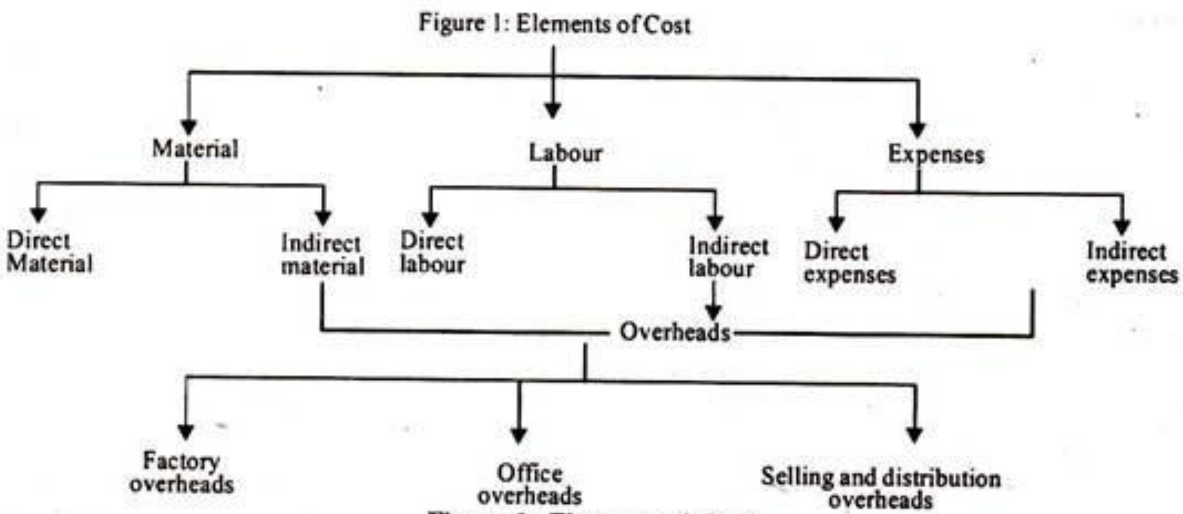


Figure 1: Elements of Cost

I. MATERIAL:

Material may be classified into direct material and indirect material.

Direct Material:

CIMA defines material cost as "the cost of commodities supplied to an undertaking." All materials, which becomes an integral part of the finished product and which can be conveniently allocated to specific physical units is termed as direct material.

Some of the examples are all material components or spare parts specifically purchased, produced or supplied from stores, primary packing materials, and purchased or partly produced components. It is also called as process material or production material.

Indirect Material:

All material, which is used for secondary purposes and cannot be allocated conveniently to specified physical units, is called as indirect material. A few examples are consumable stores, oil and waste, printing and stationery material, and etc. Indirect material may be used at the factory, office or selling and distribution divisions.

II. LABOUR:

Human effort required to convert materials into finished products is termed as labour. It may be classified into direct labour and indirect labour.

Direct labour:

Labour, which plays an active and direct part in the production of a particular product, is termed as direct labour. CIMA defines labour cost as "the cost of remuneration (wages, salaries, commission, bonus, etc.) of the employees of an undertaking." Direct labour cost can be conveniently and specifically charged to specific products.

Indirect labour:

It is employed to carry out tasks incidental to goods produced or services rendered. Indirect labour cost cannot be practically traced to specific units of output. A few examples indirect labour costs are wages of storekeeper, salaries of office staff and salesmen, directors' fees, etc. It may be incurred in the factory, office, and selling and distribution divisions.

III. EXPENSES:

CIMA defines expenses as "the cost of services provided to an undertaking and the notional cost of the use of owned assets." It may be classified into direct expenses and indirect expenses.

Direct Expenses:

These are expenses, which can be directly allocated to a particular job, product or unit of service; They are also called as 'chargeable expenses.' Examples of such expenses are hire charges paid to some special machinery required for a particular contract, cost of designs or mould incurred in toy manufacturing, cost of blocks needed in book publishing, etc.

Indirect Expenses:

These are expenses, which cannot be conveniently and directly allocated to a particular job, product or unit of service. They are incurred in common and can be apportioned to various cost centers or cost units proportionately on some basis. Examples of such expenses are factory rent, lighting, insurance, office and administration expenses, selling and distribution expenses, etc.

OVERHEADS:

The aggregate of indirect material cost, indirect labour cost, and indirect expenses is termed as overheads. Thus all indirect costs are overheads.

They may be classified broadly into types:

(a) Factory or Works Overheads:

These are indirect costs incurred inside a factory or works. Examples are factory supplies such as oil, consumable stores, lubricants, indirect labour such as factory manager's salary, timekeeper's salary, etc., and indirect expenses such as factory rent, factory lighting, factory insurance, etc.

(b) Office and Administration Overheads:

These are indirect costs incurred in the general and administrative office. Examples are indirect materials such as stationery, brooms, dusters, etc, and indirect labour such as salaries of office staff, directors' fees, etc., and indirect expenses such as rent, insurance, lighting, etc., of the office.

(c) Selling and Distribution Overheads:

These are indirect costs incurred in connection with the selling and distribution of goods and services. Examples are indirect materials such as packing materials, printing and stationery materials, etc., and indirect labour such as salaries of sales staff and sales manager, commission, etc., and indirect expenses such as advertising expenses, insurance, godown rent, etc.

10. COST CENTRE AND PROFIT CENTRE

MEANING COST CENTRE:

A Cost Centre is a department or a unit which supervises, allocates, segregates, and eliminates all sorts of costs related to a company. The cost centre prime work is to check the cost of an organisation and to limit the unwanted expenditure the company may acquire.

The cost can be the determination of both person and location. In multinational companies, the cost centre is authorised to decrease and manage the cost. These costs are generally monitored by analysing and deducting the actual cost incurred with the standard cost.

Few types of cost centre are mentioned below:

- Production Cost Center
- Personal Cost Center
- Service Cost Center
- Impersonal Cost Center
- Process Cost Center
- Operation Cost Center

For example, the customer service department may not generate direct profits for a business, but it supports to control the expenses of business (by conceptualising what customers want) and also aids in reducing the costs of a company.

MEANING PROFIT CENTRE:

A Profit Centre is a division or department of a company which operates for the calculation of profit. In an organisation, different profit centres are managed by the managers, who identifies profits on the basis of costs and revenues. Profit Centre is accountable for all the actions associated with the sale of goods and production.

The principal object of the profit centre is to generate and maximise the profit, by minimising the cost incurred and increasing sales. This objective helps to uplift the profit-making capability of a company. The accomplishment of a profit centre is estimated in terms of profit growth, during a definite period. The achievement of a profit centre is examined by subtracting the actual cost from the budgeted cost.

The difference between the Cost Centre and Profit Centre

Basis	Cost Centre	Profit Centre
Meaning	A cost Centre is a unit of a company that supervises the all the cost of a company	A Profit Centre is a department of an organisation which identifies a profit
Purposes	Controls cost and perform cost reduction	To generate and maximise the profit

Calculation of Performance	By analysing and deducting the actual cost incurred with the standard cost.	By subtracting the actual cost from the budgeted cost.
Area of operation	Narrow	Wide
Nature of work	Less Demanding	Very Demanding

11. COST SHEET OR STATEMENT OF COST

Meaning of Cost Sheet:

Cost Sheet is a statement which presents detailed information relating to the various stages of cost. It also shows the total cost of the product manufactured during a particular period of time. Thus, the cost sheet is prepared for a particular period of time monthly, quarterly, yearly etc.

A Specimen of cost sheet is given below:

Statement of cost and profit (with stocks)

	Particulars	Rs.	Rs.
	Opening Stock of raw materials	xxx	
Add:	Purchase of raw materials	xxx	
	Expenses, duties and taxes on materials purchased	xxx	
		xxxx	
Less:	Closing stock of raw materials	xxx	
	Raw Materials Consumed		xxxx
	Direct Wages or Productive wages		xxx
	Direct or chargeable expenses		xxx
	Prime Cost		xxxx
Add:	Factory Overheads		xxx
Add:	Opening stock of work-in-progress		xxx
			xxxx
Less:	Closing stock of work-in-progress		xxx
	Work cost or Factory cost		xxxx
	Office and Administrative overheads		xxx
Add:	***Cost of Production***		xxxx
	Opening stock of finished goods		xxx
Add:			xxxx
	Closing stock of finished goods		xxx

Less:	***Cost of production of goods sold***		xxxx
	Selling and Distribution overheads		xxx
Add:	***Cost of sales***		xxxx
	Profit (Less: Loss)		xxx
Add:	***Sales***		xxxx

12. TENDERS AND QUOTATIONS:

Generally, production cost is ascertained after the completion of production work. But sometimes it becomes necessary to ascertain the production cost before commencing the production work. For example, a contractor will have to estimate his contract cost before commencing the contract work. Often, the manufacturer is required to quote the estimated price by adding some profit for getting the orders from customers. Such estimated price is known as ' Tender price or Quotation price'.

Hence, the following items are to be analysed while preparing the tender:

1. Direct materials
2. Direct wages
3. Factory overheads
4. Administrative overheads
5. Selling and distribution overheads, and
6. Expected profit.

Overheads:

The amount of overheads is to be estimated on the basis of past experience as a percentage as given below:

(a) Percentage of work on cost on direct wages
Work on cost / Direct wages x 100.

(b). Percentage of Office & administrative on cost on work cost
Office & administrative on cost / Work cost x 100

(c). Percentage of Selling & distribution overheads on works cost
Selling & distribution overheads / Work cost x 100

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