

# INTRODUCTION TO COST ACCOUNTING

## MEANING:

### COST:

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

### COSTING:

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

### COST ACCOUNTING:

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

### OBJECTIVES and IMPORTANCE:

- 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.
- Ascertain profit of each activity.
- To assist management in decision making.
- It helps in assessing the performance of workers and rewarding them suitably through incentives and bonus.
- 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.

### CRITICISMS or LIMITATIONS:

- 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 organizations, agriculture, concerns producing single products, etc.
- A cost accounting system is quite expensive to install and operate.
- Non-cooperation from staff also may lead to failure of the system in many concerns.
- It represents the base of talking the best decision 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.

### Essential features of a good cost accounting system

- The persons using the reports should be able to understand and use the information.
- External factors, for example, government regulations, market requirements should also be taken into consideration.
- 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 a paid and costing system and should provide help as per as possible.
- System should enable prompt reporting.
- Executives should also provide their useful services in developing the costing system.
- It should be cost effective.
- System should be smoothly and effectively implemented.

### CLASSIFICATION OF COST:

| BASIS                      | CLASSIFICATION   |
|----------------------------|--|
| NATURE                     | Material labour, expenses  |
| COST CONTRE                | Direct material, direct labour, direct expenses, indirect material, indirect labour, indirect expenses.  |
| FUNCTION                   | 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  |
| BEHAVIOUR                  | Fixed cost, variable cost and semi-variable cost   |

### CONTEXT OF COST

Cost is a generic term and is always advisable to qualify the word 'COST' to show exactly what it means e.g. prime cost, factory cost, cost of production, total cost, standard cost, marginal cost, etc. thus the use of the term 'cost' without qualification is misleading. The concept of cost is thus not something definite and care must be taken to qualify it according to its context.

### DIRECT COST:

Cost that can directly be identified or a cost centre or cost unit is termed as direct cost. It is that cost without which manufacturing cannot be commenced.

Direct cost is also called as **traceable costs**.

Direct materials, direct labour, direct expenses are termed **direct costs**.

### INDIRECT COST:

Cost that cannot be directly identified to a particular product or cost centre or cost unit is termed as indirect cost. It is that cost without which production cannot be completed and sold in the market. They are also known as **overheads**.

Factory overheads, office & administration overheads, selling & distribution overheads are termed as **indirect costs**.

### **VARIABLE COST:**

Variable cost is that cost which is directly dependent on production and it increases as the production increases and vice-versa. Variable cost per unit remains same within a range of activity.

eg. direct material, direct labour, sales commission etc.

### **FIXED COST:**

Fixed cost is that cost which does not change with the change in level of activity. Total cost remains same within a range of activity. Fixed cost per unit decreases if production increases and vice-versa.

Eg. rent, depreciation, audit fees, salaries etc.

### **UNCONTROLLABLE COSTS:**

Uncontrollable costs are the costs which cannot be influenced by the action of a specified member of an undertaking at a given level of authority.

Eg. Taxes, interest on borrowing etc.

**Opportunity cost** - Opportunity cost is the cost of selecting one course of action and the losing of the opportunities to carry out another course of action. It is the amount that can be recovered if the asset is utilised in its next best alternative. opportunity costs are not recorded in books. it is important in decision making and comparing alternatives.

For example - if anyone decides to start his own business then he will have to forego the job options which will be the opportunity cost of starting on business.

**Replacement cost** - Replacement cost is a cost at which material identical to that to be replaced could be purchased at a later date of valuation. The replacement cost is a cost of replacing an asset at any given point of time either at present or in the future.

**Relevant cost** - Relevant cost is a cost appropriate in adding to make specific management decisions. business decisions involve planning for future and consideration of several alternative courses of action. In this process, the costs which are affected by the decisions are future costs. Such costs are called relevant costs because they are pertinent to the decisions in hand. The cost is said to be relevant if it helps the manager in taking a right decision in furtherance of the company's objectives.

**Normal cost** - The normal cost is normally incurred at a given level of output in the conditions in which that level of output is achieved. Normal cost includes those items of cost which occur in the normal situations of the production process or in the normal environment of the business. the normal idle time is to be included in the ascertainment of normal cost.

**Abnormal cost** - It is an unusual or atypical cost whose occurrence is usually irregular and unexpected and due to some abnormal situation the production. Abnormal cost arises due to idle time for some heavy breakdown or abnormal process loss; they are not considered in the cost of production for decision making and charged to the profit and loss account.

**Shutdown cost** - The shutdown costs are the costs incurred in relation to the temporary closing or department division or enterprise. Such costs include those of closing as well as those of re-opening. The shutdown costs I defined as those costs which would be incurred in the event of suspension of the plant operation and which would be saved if the operations are continued.

**Abandonment cost** - The abandonment cost is the cost incurred in closing down a department or division or withdrawing a product used to operate in a particular sales territory etc. The abandonment costs are the cost of retiring altogether from service, abandonment arises when there is complete cessation of activities and creates a problem as to the disposal of assets.

→ **DISTINGUISH COST ON THE BASIS OF RELEVANCE AND IRRELEVANCE FOR DECISION MAKING:**

**The following are relevant costs for decision making;**

- a. Marginal cost
- b. Differential cost
- c. Opportunity cost
- d. Out of pocket cost
- e. Replacement cost
- f. Imputed cost
- g. Discretionary cost

**The following are irrelevant costs for decision making;**

- a. Sunk cost
- b. Committed cost
- c. Fixed cost absorbed