Hi Friends,

I am attaching herewith the notes on Basic Cost Accounting Theroy in very easy & Attractive format relevant for CA-PCC/IPCC, B.Com(P/H), BBA, BBE.

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1. DEFINITIONS	
Introduction	• Cost is a measurement, in monetary terms, of the amount of resources used for the purpose of production of goods or rendering services. • Cost is the amount of actual or notional expenditure relating to a product, job, service, process or activity. • Cost is often used as a generic term to describe various types of costs. • Costing is the technique and process of ascertaining costs.
Cost Accountancy	✓ Cost Accountancy is 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	• Cost Accounting is the process of accounting from the point at which expenditure is incurred or committed to the establishment of its ultimate relationship with cost centers and cost units. It includes: – Collecting, classifying, recording, allocating and analyzing costs – Preparation of periodical statements and reports for ascertaining and controlling costs – Application of cost control methods – Ascertainment of profitability of activities carried out or planned.
Objective of Cost Accounting	• To ascertain cost • To control cost • To provide information for decision making • To determine selling price • To ascertain costing profit
Advantage of Cost Accounting	• Helps in ascertainment of cost • Helps in control of cost • Helps in decision making (make or buy, retain or replace, continue or shut down, accept or reject orders, etc) • Helps in fixing selling prices • Helps in inventory control • Helps in cost reduction • Helps in measurement of efficiency • Helps in preparation of budgets • Helps in identifying unprofitable activities • Helps in identifying material losses • Helps in identifying idle time, idle capacity • Helps in improving productivity • Helps in cost comparison
Pre-requisites for installation	The essential factors to be considered while designing a Cost Accounting System are as follows :

of Cost accounting System	✓ **Size of the organization** with a view to finding out the manner on which the system could be introduced ✓ **Areas of functioning** wherein the management's action will be most beneficial ✓ **Management's policies and expectations** should be designed after a careful study. ✓ **Methods & procedures in vogue** for purchase, receipts, storage and issue of material, methods of wage payment etc. ✓ **Technical aspects** of the business should be studied thoroughly by the designers. ✓ The **maximum amount of information** that would be sufficient should be secured. ✓ **Various forms** to be used by costing system for various data collection and dissemination. ✓ The **degree of accuracy** of data to be supplied by the system and how verification of such data can be brought about. ✓ The manner in which the **benefits** of installation of the cost accounting system should be explained. ✓ The manner in which an **integral system of accounts** can be devised so as to automatically reconcile financial profit with costing profit with the help of control accounts. ✓ **Information requirements** of management, the nature of reports to be generated through the cost accounting system ✓ The **objective of costing system** i.e whether it is for price fixation or for cost control or for a particular management decision.
Difficulties in Installing Cost Accounting System	Following initial difficulties are likely to be experienced when a new costing system is introduced : • **Lack of support** from other departmental heads • **Resistance** from accounting staff • **Non co-operation** from the supervisory staff • **Shortage of trained staff**
Essential of a Good Cost Accounting System	✓ **Suitability** – to the nature of business ✓ **Tailor made system** – to meet requirements of the business ✓ **Simplicity** – easy to understand and simple to operate ✓ **Economical** – to install and operate ✓ **Flexibility** – to adapt to the changing business needs ✓ **Accuracy** – must provide accurate information ✓ **Promptness** – of information ✓ **Support of staff** – must have staff co-operation and participation ✓ **Cost control** – must ensure cost control in various fields ✓ **Clearly defined Cost Centers** – least ambiguity ✓ **Detail** – give relevant details but avoid unnecessary detail

Difference between Financial Accounting & cost Accounting

No.	Basis	Financial Accounting	Cost Accounting
1.	Objective	Financial performance and position	Ascertain cost and cost control
2.	Costs and profits	Shows overall costs and profit / loss	Shows details for each product, process, job, contract, etc
3.	Control / Report	Emphasis on reporting	Emphasis on control and reporting
4.	Decision making	Limited use	Designed for decision making
5.	Responsibility	Does not fix responsibility	Can effectively fix responsibility
6.	Time frame	Focus on historical data	Focus on present and future
7.	Type of reports	General reports like P&L Account, Balance Sheet, Cash Flow Statement	Can generate special reports and analysis
8.	Legal need	Statutory requirement	Voluntary, except for some cases
9.	Transactions	Records external transactions	Records internal and external transactions
10.	Reader	Everybody	Internal management
11.	Formats	Standard, as per law	Tailor made
12.	Access	Everybody, except for some	Very limited access
13.	Unit of value	Monetary	Monetary and physical

Limitation of Cost Accounting

- ✓ It is **not an exact science** and involves_inherent element of judgement.
- ✓ Cost **varies with purpose**. Therefore cost collected for one purpose will not be suitable for another purpose.
- ✓ Cost accounting presents the base for taking the best decisions. It does **not give an outright solution** .
- ✓ Most of the cost accounting techniques are based on some **pre-assumed** notions.
- ✓ The **apportionment of common costs** comes under a lot of criticism.
- ✓ There are **different views** held by different experts on the treatment of certain items of cost.

Responsibility centre

Meaning

- When an organization is divided into different sub- units according to the responsibility and for each sub-unit, a specified individual is made responsible, then the sub-unit thus formed is termed as a responsibility centre. Thus, a responsibility centre is defined as an activity centre of a business organization entrusted with a special task.
- The specified individual is held accountable only for those activities which he directly affects. Under modern budgeting and control, finance executives tend to apply the concept of responsibility centres for the purpose of control.

	Types ✓ Cost centres - Refer below ✓ Profit centres - Centres, which have the responsibility of generating and maximising profits , are called profit centres. ✓ Investment centres - Centres which are responsible for earning an optimum return on investments are termed as investment centres. ✓ Revenue centres - Centres which are devoted to raising revenue with no responsibility for production are called revenue centres. Eg. Sales centre. ✓ Contribution centres - Profit centres whose expenditure are reported on a marginal cost basis, are called contribution entres.
Cost Centre	• A Cost Centre refers to a section, segment or subdivision of an organization of which costs are charged. For example a cost centre may be Allocation e.g. departments sales A person e.g. machine operators, salesman etc. • Cost Centre can be classified as under: a. **Based on Type:** i. Personal Cost Centre ii. Impersonal Cost Centre **b. Based on Role:** i. Production Cost Centre ii. Service Cost Centre **c. Based on Activity:** i. Operation Cost Centre ii. Process Cost Centre
Cost Unit	✓ It is a unit of product, service or time (or combination of these) in relation to which costs may be ascertained or expressed. ✓ Cost units are usually the units of physical measurement like number, weight, area, volume, length, time and value. ✓ A few typical examples of cost units are given below: **Industry or Product** — **Cost Unit Basis** Automobile — Number Cement — Tonne/per bag etc.
Profit Centre	• A profit centre is any sub-unit of an organisation to which both revenues and costs are assigned, so that the responsibility of sub-unit may measured. In profit centre, both inputs and outputs are capable perform in financial terms and it provides more effective assessment of the managers performance since costs and revenues are measured in monitory terms
Cost Classification	✓ **Nature of expense** : Material, Labour, Expenses ✓ **Relation of Cost Centre** : Direct & Indirect for Material, Labour, Expenses ✓ **Functions / activities** : Production, Administration, Research & Development, Selling & Distribution. ✓ **Behavior wise** : Fixed ,Variable & Semi- variable. ✓ **Management decision making**: Relevant, Opportunity & sunk cost , etc. ✓ **Production Process** : Batch, Process, Operating, Operation, Contract & Joint

	✓ **Time period** : Historical, Predetermined, Standard & Estimated
Investment centre	• It is defined as a centre which is concerned with earning an adequate return on investment. The main objective of an investment centre is to maximize the earnings in relation to investments or capital employed.
Direct Expenses	✓ Direct Expenses are also termed as **'Chargeable expenses'**. These are the expense which can be allocated directly to a cost unit. According to Chartered Institute of Management Accountants, London, direct expenses are 'cost other than materials and wages which are incurred for a specific product or saleable services'. Examples of direct expenses are: (i) Hire charges of special machinery or plant for a particular production order or job. (ii) Payment of royalties (iii) Cost of special moulds, designs and patterns. (iv) Experimental costs before undertaking the job concerned.

	Difference Between Cost Reduction & Cost Control	
Basis	**Cost Conrol**	**Cost Reduction**
	It represents Efforts made towards achieving a target or a goal.	It represents achievement of reduction of cost.
	The process of cost control is to set-up a target, investigate the variation and take remedial action.	Cost reduction is not contended merely with the maintenance of performance with standard.
	It assumes existence of norms or standards which are not challenged.	It assumes that standards can be improved.
	It is Preventive function	It is corrective function.
	Sometimes, it lacks a dynamic approach.	It is continuous process of analysis of all the factors affecting cost.

Cost Allocation and Cost Apportionment	
Cost Allocation	Cost allocation refers to the allotment of whole items of costs to cost centres. For example, if a worker is employed in department "A", then the wages paid to the worker are allocated or charged to department "A". This process of charging the entire wages (being 'cost') of the worker to department "A" is termed as cost allocation.
Cost Apportionment	It is the process of distributing an item of cost over several cost centers or cost units. Thus, one item of cost is charged to two or more cost centers or cost units. Normally overheads (indirect costs) are charged to cost centers or cost units by way of apportionment in proportion to the anticipated benefits.

Cost Classification	
Traceablility	<u>Direct Costs</u> :- The expenses incurred on material and labor which are economically and easily traceable

	for a product, service or job are considered as direct costs. In the process of manufacturing of production of articles, materials are purchased, laborers are employed and the wages are paid to them. Certain other expenses are also incurred directly. All of these take an active and direct part in the manufacture of a particular commodity and hence are called direct costs. Indirect Costs :- The expenses incurred on those items which are not directly chargeable to production are known as indirect costs. For example, salaries of timekeepers, storekeepers and foremen. Also certain expenses incurred for running the administration are the indirect costs. All of these cannot be conveniently allocated to production and hence are called indirect costs.
Behaviour or variability	Fixed Cost The cost which does not vary but remains constant within a given period of time and a range of activity inspite of the fluctuations in production is known as fixed cost. Some of its examples are as follows: • Rent or rates • Insurance charges • Management salary Fixed costs are sometimes referred to as "period costs" and variable costs as "direct costs" in system of direct costing. Fixed costs can be further classified into: • Committed fixed costs • Discretionary fixed costs **Committed fixed costs** consist largely of those fixed costs that arise from the possession of plant, equipment and a basic organization structure. For example, once a building is erected and a plant is installed, nothing much can be done to reduce the costs such as depreciation, property taxes, insurance and salaries of the key personnel etc. without impairing an organization's competence to meet the long-term goals. **Discretionary fixed costs** are those which are set at fixed amount for specific time periods by the management in budgeting process. These costs directly reflect the top management policies and have no particular relationship with volume of output. These costs can, therefore, be reduced or entirely eliminated as demanded by the circumstances. Examples of such costs are research and development costs, advertising and sales promotion costs, donations, management consulting fees etc. These costs are

also termed as managed or programmed costs.

Variable costs

The cost which varies directly in proportion with every increase or decrease in the volume of output or production is known as variable cost. Some of its examples are as follows:

- Wages of laborers
- Cost of direct material
- Power

Semi-variable costs

The cost which does not vary proportionately but simultaneously does not remain stationary at all times is known as semi-variable cost. It can also be named as semi-fixed cost. Some of its examples are as follows:

- Depreciation
- Repairs

Product, Period & Pre-production costs

Product Cost

The costs which are a part of the cost of a product rather than an expense of the period in which they are incurred are called as "product costs." They are included in inventory values. In financial statements, such costs are treated as assets until the goods they are assigned to are sold. They become an expense at that time. These costs may be fixed as well as variable, e.g., cost of raw materials and direct wages, depreciation on plant and equipment etc.

Period Costs

The costs which are not associated with production are called period costs. They are treated as an expense of the period in which they are incurred. They may also be fixed as well as variable. Such costs include general administration costs, salaries salesmen and commission, depreciation on office facilities etc. They are charged against the revenue of the relevant period. Differences between opinions exist regarding whether

	certain costs should be considered as product or period costs. Some accountants feel that fixed manufacturing costs are more closely related to the passage of time than to the manufacturing of a product. Thus, according to them variable manufacturing costs are product costs whereas fixed manufacturing and other costs are period costs. However, their view does not seem to have been yet widely accepted. <u>Pre-Production Costs</u> These costs forms the part of development cost, incurred when a trial production run, preliminary to formal production run. These costs are incurred when a new factory is in the process of establishment or a new project is undertaken or a new product line or product is taken up, but there is no established or formal production to which such costs may be charged. These costs are normally treated as deferred revenue expenditure (except the portion which has been capitalized) and charged to the costs of future production.
Controllability	<u>Controllable Costs</u> These are the costs which can be influenced by the action of a specified member of an undertaking. A business organization is usually divided into a number of responsibility centers & each such centre is headed by an executive. Controllable costs incurred in a particular responsibility centre can be influenced by the action of the executive heading that responsibility centre. <u>Uncontrollable costs</u> Costs which cannot be influenced by the action of a specified member of an undertaking are known as uncontrollable costs. For example, expenditure incurred by, say, the Tool Room is controllable by the foreman in charge of that section but the share of the tool – room expenditure which is apportioned to a machine shop is not to be controlled by the machine shop foreman.
Elements	<u>Material</u> Cost of tangible, physical input used in relation to output/production i.e. cost of raw material, consumable stores, maintenance items etc. <u>Labour</u> Cost incurred in relation to human resources of the enterprises i.e. wages to workers, salary to office staff, training expenses etc. <u>Expenses</u>

	Cost of operating and running the enterprises, other than materials and labour, this is the residual category of costs i.e. Factory Rent, office maintenance, salesmen salary etc.
Normality	Normal cost Costs, which can be reasonably expected to be incurred under normal routine and regular operating conditions. Abnormal cost Costs over and above normal cost, which is not incurred under normal operating conditions i.e. fine & penalties.
Decision Making	A. Relevant Costs :- Relevant costs are those which change by managerial decision 1. Marginal cost It is the amount at any given volume of output by which aggregate cost changes if the volume of output changes increases/decreases) by one unit. *2. Differential cost* The difference in total cost between two alternatives is termed as differential cost. In case the choice of an alternative results in an increase in total cost, such increased costs are known as incremental costs. While assessing the profitability of a proposed change, the incremental costs are matched with incremental revenue. 3. Opportunity cost This cost refers to the value of sacrifice made or benefit of opportunity foregone in accepting an alternative course of action. For example, a firm financing its expansion plan by withdrawing money from its bank deposits. In such a case the loss of interest on the bank deposit is the opportunity cost for carrying out the expansion plan 4. Out of pocket Expense It is that portion of total cost which involves cash outflow. This cost concept is a short run concept & is used in decisions relating to fixation of selling price in recession, make or buy, etc. Out-of-pocket costs can be avoided or saved if a particular proposal under consideration is not accepted. 5. Discretionary Costs These are the costs, which may be avoided in the short run by management decisions. For example advertising, research and development cost. B. Irrelevant Costs Irrelevant costs are those which do not get affected by the decision

	1. Sunk Costs Sunk costs are historical or past costs. These are the costs which have been created by a decision that was made in the past and cannot be changed by any decision that will be made in the future. Investments in plant and machinery, buildings etc. are prime examples of such costs. Since sunk costs cannot be altered by decisions made at the later stage, they are irrelevant for decision-making. 2. Committed Costs A cost, which has been already committed by the management, is not relevant for decision-making. This should be contrasted with discretionary costs, which are avoidable costs. 3. Absorbed Fixed Costs Fixed costs which do not change due to increase or decrease in activity is irrelevant for decision making. Although such fixed costs are aborbed in costs of production at a normal rate, they are irrelevant for managerial decision making. However if fixed costs are avoidable then they become relevant.
Cash Outflow	Explicit Costs These are also known as **out of pocket costs**. They refer to those costs which involves immediate payment of cash. Salaries, wages, postage and telegram, interest on loan etc. are some examples of explicit costs. Implicit Costs Implicit costs do not involve any immediate cash payment. These are also known as **imputed costs or economic costs.** Implicit costs are not recorded in the books of account but yet, they are important for certain types of managerial decisions such as equipment replacement and relative profitability of two alternative courses of action.