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Cost concepts

1. "Cost may be classified in a variety of ways according to their nature and the information needs of the management." Explain.

Ans: Costs can be classified according to their nature and information needs of the management in the following manner :

i. By element : Under this classification costs are classified into (a) Direct costs and (b) Indirect costs according to elements viz., materials, labour and expenses.

ii. By function : Hence costs are classified as : production cost; administration cost; selling costs; distribution cost; research cost; development cost, etc.

iii. By behavior :According to this classification costs are classified as fixed; variable and semi variable costs. Fixed costs can be further classified as committed and discretionary.

iv. By controllability : Costs are classified as controllable and non-controllable costs.

v. By normality : Under this classification costs are segregated as normal and abnormal costs.

Management of a business house requires cost information for decision making under different circumstances. For example they required such information for fixing selling price , controlling and reducing costs. To perform all these functions a classification of cost according to their nature and information needs is an essential pre-requisite of the management.

2. "Relevant cost analysis helps in drawing the attention of managers to these elements of cost which are relevant for the decision." Comment.

Ans : Relevant costs are pertinent or valid costs for a decision. These bear upon or ' influence decision' and are directly related to the decisions to be made. These are critical to the decision, and have significance for it. These are the cost which generally respond to managerial decision making, and have significance in arriving at correct conclusions. These costs are capable of making a difference in user-decisions and enter into a choice between alternative courses of action. In specific terms, relevant costs for decisions are defined as 'expected future costs that will differ under alternatives".

Relevant costs are futuristic in nature. These are the costs that are expected to occur during the time period covered by the decision. The costs are different between alternatives being considered.

3. What is Responsibility Accounting ?

Answer :
It refers to a control system of management accounting and reporting. The basis of Responsibility Accounting is the creation/recognition of various responsibility/decision centres in an organisation. The individual managers of these centres are made responsible for the insurance and control of costs relating to their responsibility centres.

The main feature of responsibility accounting is that it is more concerned with control of costs than their determination. The system would trace costs (revenues, assets and liabilities, also where relevant) to the individual managers who are primarily responsible for making decisions about the costs under review. In other words, the executive in charge of every responsibility centre would have authority to incur costs relating to his responsibility centre and accountable to them. If he does not have the authority to incur costs he will also not be responsible for their control. The performance of the managers of the various responsibility centres is judged by assessing how far they have been able to monitor those costs which were under their control. This is done by furnishing the department heads with performance reports from time to time. These reports will exclude all apportioned and policy costs not subject to their control. Thus responsibility accounting is based on the principle that an executive will be held accountable only for those acts over which he has control.

Responsibility accounting system can be tailored according to the needs of an organisation. An effective system of responsibility accounting would require that the require that the responsibility of each executive is clearly defined. He should know, what he is required to do and what performance is expected of him.

4. Explain, briefly, the terms Expense Centre, Profit Centre and Investment Centre.

Answer:
Expense Centre : A centre or a unit of an organisation for whom a standard amount of cost to be incurred is predetermined and its performance its performance is evaluated by making a comparison between standard and actual costs is known as an expense centre. Any difference between standard and actual cost should be segregated further under two heads viz., controllable and un-controllable for an objective evaluation of expense centre performance.

Profit Centre : A unit of an organisation headed by an individual fully responsible for all costs, revenues and profitability of its operations is known as a profit centre. The individual is authorised to plan and look after production, financial and accounting activities of the centre. A concern may be divided into a number of profit centre. Based on logical division of activities, profit for each centre may be ascertained separately. Creation of profit centre facilities management control.

Investment Centre : A centre whose managers are normally accountable for sales revenue and expenses but in addition they are also responsible for some capital investment decisions and are thus able to influence the size of the investment. Return on investment (ROI) and Residual Income (RI) are usually used to evaluate the performance of investment centres.

5. Discuss the merits and demerits of using profit centre and cost centre as ways of measuring managerial performance.

Answer : A profit centre is that segment of activity of a business which is responsible for both revenues and expenses and discloses the profit of a particular segment of activity. It is created as a result of decentralisation of operations to measure the performance of divisional executives. Each profit centre has a profit target and also enjoys authority to adopt such policies as are necessary to achieve its targets.

The chief merit of profit centre is that it makes its managers responsible for the profit performance – achieving the budgeted amount of profit during a period. Under profit centre concept the whole organisation is dividend into a number of divisions, the performance of each division is measured in terms of both the income that is earned and the costs that are incurred. Managers in each division have freedom in making decisions. They need not obtain approval from corporate headquarters for every expenditure. The main demerit in the working of this system is the incapability of executives to determine suitable transfer price amicably.

A cost centre is the smallest segment of activity or the area of responsibility for which costs are accumulated. Cost centres are created for accounting / ascertaining costs and their control. Such centres make all possible efforts to minimise costs. Standard amount of costs to be incurred by each cost centre is predetermined. The performance of each cost centre is evaluated by comparing the actual amount with the standard / budgeted amount. Success towards the achievement of cost standards speak about the performance of cost centre executives.

While judging the performance of managers of cost centres, it is essential to differentiate between controllable costs and uncontrollable costs. In practice it would not be so easy to do so. This is one of the demerit of cost centres. Seldom an individual can have complete control over all the factors that may influence a given cost element. By this criteria, no cost can be theoretically classified as a controllable.

6. Explain the concept of discretionary costs. Give three examples. Discuss, how control may be exercised over discretionary costs.

Answer.
Discretionary cost can e explained with the help of following two important features.

i. They arise from periodic (usually yearly) decisions regarding the regarding the maximum outlay to be incurred.
ii. They are not tied to a clear cause and affect relationship between inputs and outputs.

Examples of discretionary costs includes : advertising, public relations, executive training, teaching, research, health care and management consulting services.

The note worthy feature of discretionary costs is that managers are seldom confident that the "correct" amounts are being spent.

Control over discretionary costs :To control discretionary costs control points / parameters may be established. But these points need to be devised individually. For research and development function to control discretionary costs, dates may be established for submitting major reports to management. For advertising and sales promotion, such costs may be controlled by pre-settings targets. In the case of employees benefits, discretionary costs may be controlled by calling a meeting of employees union and making them aware that the company would meet only the fixed costs and the variable costs should be met by them.

7. Distinguish between 'Committed Fixed Costs' and 'Discretionary Fixed Costs'.

Answer : Committed fixed costs, are those fixed costs that arise from the possession of : (.i) a plant, building and equipment (e.g. depreciation, rent, taxes, insurance premium etc.) or (ii) a functioning organisation (i.e. salaries of staff). These costs remain unaffected by any short-run actions. These costs are affected primarily by long-run sales forecasts that, in turn indicates the long-run capacity targets. Hence careful long range planning, rather than day-to-day monitoring, is the key to managing committed costs.

Discretionary fixed costs, (some called managed costs or programmed costs). These costs have two important features :

i. they arise from periodic (usually yearly) decisions regarding the maximum outlay to be incurred, and
ii. they are not tied to a clear cause-and-effect relationship between inputs and outputs. Examples of discretionary fixed costs includes – advertising, public relations, executive training, teaching, research, health care etc. These costs are controllable.

8. Briefly explain the concept of 'Opportunity Cost'.

Answer: It may be defined as prospective change in cost following the adoption of an alternative machine, process, raw materials, specification or operation. In other words, it is the cost of opportunity lost by the diversion of an input factor from one use to another.

It is measure of the benefit of opportunity foregone. The opportunity cost of the value of opportunity foregone is taken into consideration when alternatives are compared.

The introduction of opportunity cost concept is helpful to the management in making profitability calculations when one or more of the inputs required by one or more of the alternative courses of action is already available. These inputs may nevertheless have a cost and this is measured by the sacrifice made by the alternative action chosen or the cost that is given up in order to make them available for the current proposal.

9. What are incremental costs and sunk cost ? Discuss

Answer: Incremental costs : The difference in total cost between two alternatives is an incremental cost. It is synonymous to differential cost. Incremental cost arise due to change of the level of activity. The change may be due to adding of a new product; change of channels of distribution, adding capacity etc. Incremental costs are not necessary variable in nature.

Sunk Cost : Cost which do not change under given circumstances and do not play may role in decision making process are known as sunk costs. They are historical costs incurred in the past. In other worlds, these are the costs which have been incurred by a decision made in past and cannot be changed by any decision made in the future. These costs are, however, best basis of predicting future cots. Amortisation of past expenses is the clearest kind of sunk cost.

10. What is meant by Incremental Revenue ?

Answer: Incremental revenue is the additional revenue that arise from the production or sale of a group of additional units. It is one of the two basis concepts the other being incremental cost which go together with differential cost analysis. Incremental cost in fact is the added cost due to change either in the level of activity or in the nature of activity.

11. Briefly explain the implications of replacement costs and historical costs in financial reporting.

Answer : Replacement costs and historical costs are two alternative methods of showing assets in financial reporting. Historical cost is the actual cost of an asset at the time of its acquisition. Replacement cost is the cost to be incurred on an asset if it is replaced. These two cost concepts, on which valuation of assets is based for financial reporting purposes, differs because of price variations over a period of time. In case the price of an asset remains the same with the passage of time then historical cost coincides with replacement cost.

Under financial reporting viz. In the balance sheet assets are recorded at their historical cost. When prices rise substantially over a period of time, historical cost do not properly indicate the actual costs. For managerial decisions, therefore these costs should properly be adjusted for price changes. The distinction between historical costs and replacement cost is thus relevant when past experience has to be considered as a guide to future costs for a proposed course of action .

12. What is cost analysis ? How it is useful in decision making ?

Answer : Cost analysis is the break up/classification of the aggregate costs into relevant types. Such an analysis of ` cost is an essential pre-requisite of controlling costs as well as of decision making.

Identifiability of cost (direct cost) with units of products of operations is one such basis of cost classification. The importance of distinguishing costs as direct or indirect lies in the fact that direct costs of a product or an activity can be accurately allocated while indirect costs have to be apportioned on the basis of certain assumptions. Thus it is helpful for management if costs are classified on the basis of their identifiability with the units of products, processes or work orders. This is so because direct costs are controllable at the operational level whereas indirect costs are not amenable to such control.

For the purpose of decision making and control, costs are distinguished on the basis of their relevance to the different types of decisions and control functions. Thus, expenditure which has taken place, is irrecoverable in a situation, is regarded as sunk cost. Cost incurred as a result of past decisions which cannot be altered by another decision at a subsequent date is known as sunk cost. Thus, for decisions with future implications, a sunk cost is an irrelevant cost. If a decision has to be made whether to replace the existing plant, the book value of the existing plant is to be regarded as a sunk cost as it is irrelevant to the question of its replacement. The decisive factor would be the difference in income which will result from the installation of a new plant, and the expected rate of return on the new investment.

Costs which are relevant are only to be taken into account and all such costs are analysed accordingly. Present and future cash expenditure connected with a decision are the result of proper cost analysis.

13. Indicate the major areas of short-term decisions in which differential cost analysis is useful.

Answer: Cost information is required both for short-term and long-run managerial problems. Differential costs are of particular use in short-term problems which are non-repetitive, one time, ad-hoc problems. The following are the most common short-term problems and areas where differential cost analysis may be deployed.

1. Accept – or –reject special may be deployed.

2. Make – or – buy decisions.
3. Sell – or –process decisions.
4. Reduce – or – maintain price decisions.
5. Add – or – drop production decisions.
6. Operate -- or – shut down decisions.

14. What do you understand by 'Departmentalization of Overheads'? What are its advantages ?

Answer. Departmentalization of Overheads is the process of identification of overheads expenses (allocation) and allotment of due share of common expenses (apportionment) to different production/service departments or cost centres.

Advantages :

1. Ascertainment of cost with reasonable accuracy and fixation of selling prices of products ;
2. Control of departmental expenses ;
3. Judging the relative profitability of the departments or contribution made by each department to the total profit of the organization ;
4. Decision making.