Chapter 1

Fundamentals of Cost Accounting

What is the reason behind origin of Cost Accounting:-

Cost Accounting is comes in existence due to major limitations of Financial Accounting. Financial Accounting only provides information about overall business and not for a department or a unit. It only provides overall picture of a business and not the detail of cost incurred in producing an article or a component. Cost element always ignored in Financial Accounting. Financial Accounts only provides profit of a business but not provides the cost data.

Cost Accounting made from "Two Different Word"

Cost And **Accounting**

In this subject, the concentration is on different element of Cost, different method which determines cost of a product or service. Costing technique is mainly use in manufacturing unit

> **Cost accounting** is a process of recording, classifying, analyzing, summarizing, allocating and evaluating various alternative courses of action for the control of **costs**. Its goal is to advise the management on the most appropriate course of action based on the **cost** efficiency and capability.

Objects of Costing:

a) **Ascertainment of costs:** Costing is to ascertain cost of each product, process or operation and to ensure that all expenses have been absorbed in the cost of products, the techniques and process of costing are used.

b) **Cost Control:** Costing systems are installed in order to control the costs. This may be achieved with the help of certain techniques likes standard costing, budgetary control,

c) **Guide to fix setting price:** Costing helps to serve as a Guide to price fixing.

d) **Guidelines for Management:** Costing helps management in conducting its business with utmost efficiency. Costing provides Cost data. Cost data provides guidelines for the formulation of business policy and policy decision like a) introduction or discontinuance of a product, b) Utilisation of idle plant capacity, c) make or buy decision, d) selling goods in global market.

Other objectives of costing:

- ❖ To ascertain the cost per unit of different product
- ❖ To organise cost reduction programmes
- ❖ To ascertain the profitability of each of the products
- ❖ To exercise effective control of stock of raw materials, work in progress, consumable stores and finished goods.
- ❖ To organise internal audit system.
- ❖ To provide specialised service of cost audit

Definition of Cost Control

Cost Control is a process which focuses on controlling the total cost through competitive analysis. It is a practice which works to maintain the actual cost in agreement with the established norms. It ensures that the cost incurred on an operation should not go beyond the pre-determined cost.

Cost Control involves a chain of functions, which starts from preparation of the budget in relation to the operation, thereafter evaluating the actual performance, next is to compute the variances between the actual cost & the budgeted cost and further, to find out the reasons for the same, finally to implement the necessary actions for correcting discrepancies.

The major techniques used in cost control are standard costing and budgetary control. It is a continuous process as it helps in analysing the causes for variances which control wastage of material, any embezzlement and so on.

Definition of Cost Reduction

Cost Reduction is a process, aims at lowering the unit cost of a product manufactured or service rendered without affecting its quality by using new and improved methods and techniques. It ascertains substitute ways to reduce the cost of a unit. It ensures savings in per unit cost and maximization of profits of the organisation.

Cost Reduction aims at cutting off the unnecessary expenses which occur during the production, storing, selling and distribution of the product. To identify cost reduction, the following are the major elements:

- Savings in per unit cost.
- No compromise with the quality of the product.
- Savings are non-volatile in nature.

Tools of cost reduction are Quality operation and research, Improvement in product design, Job Evaluation & merit rating, variety reduction, etc.

Key Differences Between Cost Control and Cost Reduction

The following are the major differences between Cost Control and Cost Reduction:

1. The activity of maintaining cost as per the established norms is known as cost control. The activity of decreasing per unit cost by applying new methods of production in such a way that it does not affect the quality of the product is known as cost reduction.
2. Cost Control focuses on decreasing the total cost while cost reduction focuses on decreasing per unit cost of a product.
3. Cost Control is temporary in nature. Unlike Cost Reduction which is permanent.
4. The process of cost control is completed when the specified target is achieved. Conversely, the process of cost reduction has no visible end as it is a continuous process that targets for eliminating wasteful expenses.
5. Cost Control does not guarantee quality maintenance. However, 100% quality maintenance is assured in case of cost reduction.
6. Cost Control is a preventive function as it ascertains the cost before its occurrence. Cost Reduction is a corrective action.

Cost Control is temporary in nature. Unlike **Cost Reduction** which is permanent. The process of **cost control** is completed when the specified target is achieved. Conversely, the process of **cost reduction** has no visible end as it is a continuous process that targets for eliminating wasteful expenses.

COMPARISON CHART

BASIS FOR COMPARISON	COST CONTROL	COST REDUCTION
Meaning	A technique used for maintaining the costs as per the set standards is known as Cost Control.	A technique used to economize the unit cost without lowering the quality of the product is known as Cost Reduction.
Savings in	Total Cost	Cost Per Unit
Retention of Quality	Not Guaranteed	Guaranteed
Nature	Temporary	Permanent
Emphasis on	Past and Present Cost	Present and Future Cost
Ends when	The pre-determined target is achieved.	No end
Type of Function	Preventive	Corrective

Categories of Cost: -

Total cost of a product is group under three main Categories in cost Accounting

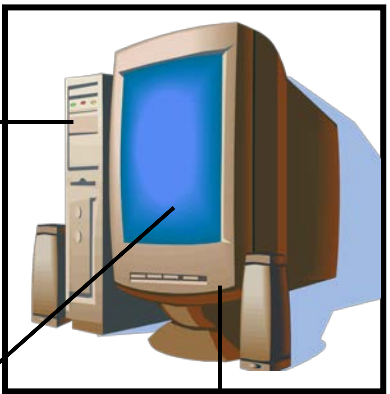
- **Material Cost**
- **Labour Cost**
- **Expenses**

Elements of Cost

Material Cost | **Labour Cost** | **Other Expenses**

In cost Accounting it is possible to calculate what cost is incurred in manufacturing this computer

Three type of cost is involve in making this Computer



Material cost

- **Direct Material**: Plastic, Metal Wire and Glass
- **Indirect Material**: Screws, switch Battery, Software

Labour Cost

- **Direct Labour**: Assembler, Software Engineer
- **Indirect Labour**: Salesman, Delivery Boy

Expenses

- **Direct Expenses**: Excise Duty, Custom Duty
- **Indirect Expenses**: Advertisement and Display Expenses

Meaning of "Element of Costs":-

There are three broad elements of Cost – Material Cost, Labour Cost and Expenses. Each of these three costs may be direct and indirect.

Material:-

Materials which are present in the finished goods are called Material. Materials may be Direct or Indirect

Direct Material: - Material by which a product is identified is called Direct Material or material by which product is known in the market is called Direct Material. For example, Cloth in Dress making; Plastic in Plastic Chair; Iron in Iron Chair

Indirect Material: - Materials, which are also present in the product but not easily identified in the product is called indirect material. It is use in very little quantity in the product. For example, Consumable Stores, Oil, Lubricant and Cotton waste and other factory Supplies, Materials of little value used in Production such as Screws, Nuts, Bolts, Enamel, Paints and Nails, Small tools , Printing and Stationery etc.

Labour:-

Workers which are engage in organization are called Labour or employees who do "Physical Work" are called Labour. Labour may be Direct or Indirect

Direct Labour: - Labour Force which are directly engage in converting Raw material in to Finished goods or directly involve in producing goods are called Direct Labour Example of Direct Laborer are *Machine Operator, Carpenter, Weaver, Shoemaker, Baker*. These wages can be conveniently identified with a Particular Product, Job or Process

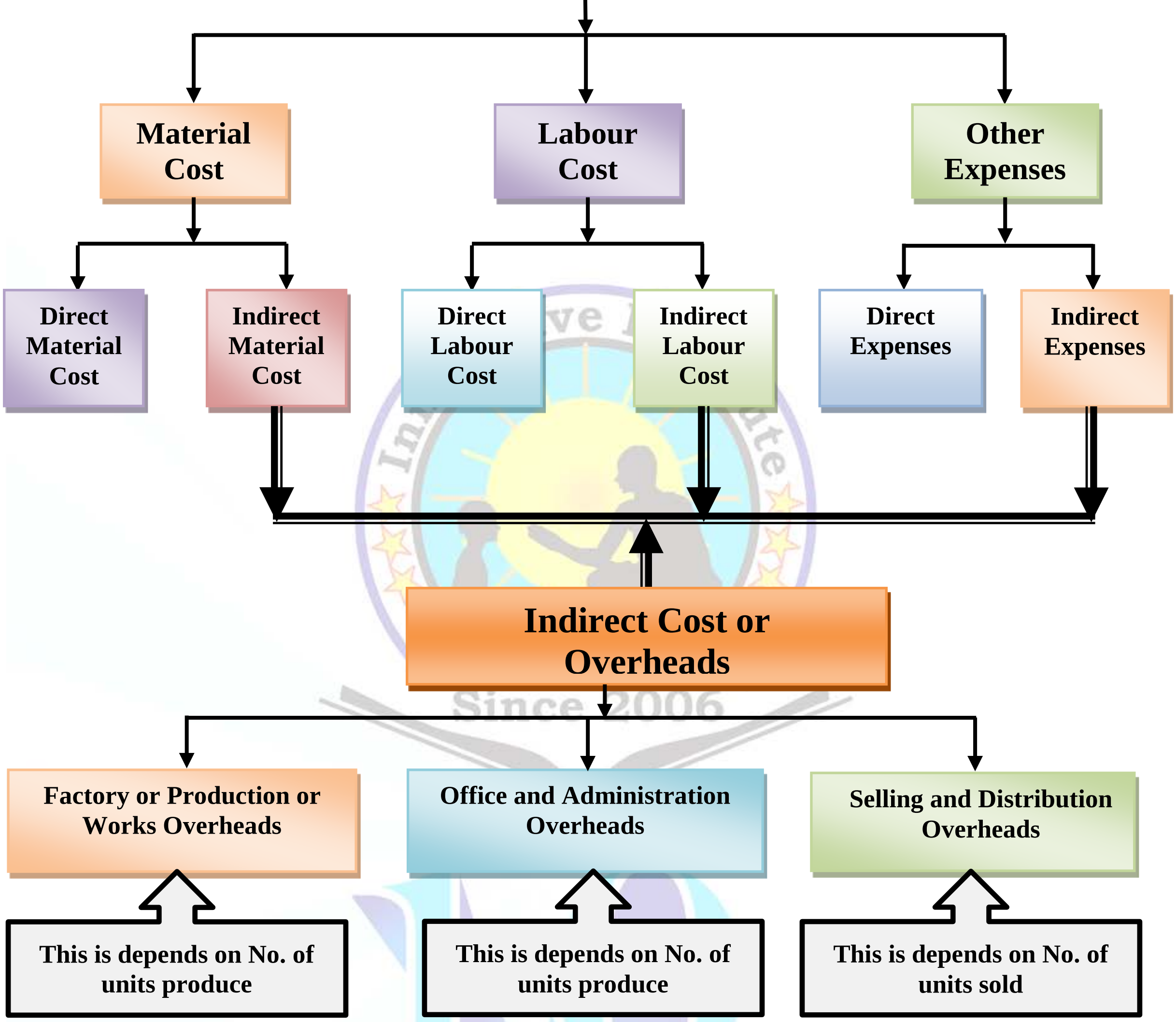
Indirect Labour: - Labour Force which are not directly engage in producing goods are called Indirect Labour and wages paid to these workers are called Indirect Labour Cost. Examples of Indirect Laborer are *Supervisor, Inspector, Clerk, Cleaner, Store-Keeper, Foremen, Maintenance Worker, Directors, Manager or Salesman, Peon,*

Expenses: - All Expenses incurred in producing goods other than Material and Labour is calling Expenses. Expenses may be direct or indirect

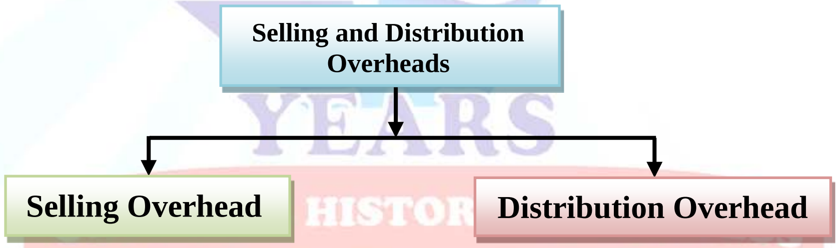
Direct Expenses: - Expenses which are directly charged to the product is called Direct Expenses or expenses which can be identified on the product are called Direct Expenses. For Example, Excise Duty, Royalty, Surveyor's Fees, Expenses –Direct- Factory, Hire Charges of some Special Machinery required for a particular Contract, Cost of Defective Work incurred in connection with a particular job or contract

Indirect Expenses: - Expenses, which are not charge on a particular product, is called Indirect Expenses. These are Common Expenses

Elements of Cost



Certain times Selling and Distribution Costs may be group separately



Cost Sheet:-

Cost Sheet is a periodical document, which is prepared weekly, fortnightly, monthly or quarterly. It is define as "a statement which provides for the assembly of the estimated detail cost of a cost centre or a cost unit". Cost sheet are prepared for the use of management

(i) To compare the cost of two periods and

(ii) To fix the selling price of the product

The total cost is analyzed in to Prime cost, Factory Cost, Office Cost or Cost of Production

Format of "Cost Sheet"

Particulars	Rs.	Rs.
Direct Raw Materials Consumed		xxxx
Direct Labour		xxxx
Direct Expenses		xxxx
Prime Cost or Basic Cost		xxxxx
Add; Factory or Production or Manufacturing or Works Overheads		xxxx
Factory Cost or Works Cost or Manufacturing Cost		xxxxx
Add: Office and Administration Overhead		xxxxx
Total Cost of Production or Office Cost		xxxxx
Add: Selling and Distribution Overhead		xxxx
Cost of Sales or Total Cost		xxxxx
Add: Profit or Profit Margin		xxxx
Sales Revenue or Total Sales		xxxxx

Example 1:-

Prepare Cost Sheet from the following data provided by Aruna Industries Ltd. for the following year ended 31st March 2012;

Particulars	Rs.
Raw Materials	15,000
Direct Labour	9,000
Direct Expenses	2,000
Factory Expenses	11,000
Office Expenses	5,000
Selling Expenses	3,000
Sales	50,000

Solution:

Cost Sheet

Particulars	Rs.
Raw Materials	15,000
Direct Labour	9,000
Direct Expenses	2,000
Prime Cost	**26,000**
Add:- Factory Overhead	11,000
Factory Cost / Work Cost	**37,000**
Add:- Office & Administration Overhead	5,000
Cost of Production	**42,000**
Add:-Selling & Distribution Overhead	3,000
Total Cost / Cost of Sales	**45,000**
Add:-Profit	5,000
Total Sales	**50,000**

Format of "Detailed Cost Sheet"

(When opening Stock and Closing Stock of Raw Materials, Semi Finished Goods or Work in Progress and Finished Goods are given)

Particulars	Rs.	Rs.
Direct Raw Materials Consumed :-		
Opening Stock of Raw Materials	xxxx	
Add: Purchase of Raw Materials during the Period	xxxx	
	xxxx	xxxx
Less: Closing Stock of Raw Materials	(xxxx)	
Direct Labour		xxxx
Direct Expenses		xxxx
Prime Cost or Basic Cost		xxxxx
Add; Factory or Production or Manufacturing Overheads		xxxx
Gross Factory Cost or Gross Works Cost		xxxxx
Add: Opening Semi Finished Goods or Work in Progress		xxxx
Processed Cost		xxxx
Less: Closing Semi Finished Goods or Work in Progress		xxxx
Factory Cost or Works Cost or Manufacturing Cost		xxxxx
Add: Office and Administration Overhead		xxxxx
Cost of Production or Office Cost		xxxxx
Add: Opening Stock of Finished Goods		xxxx
Cost of Goods available for sale		xxxx
Less: Closing Stock of Finished Goods		xxxx
Cost of Goods Sold		xxxxx
Add: Selling and Distribution Overhead		xxxx
Cost of Sales or Total Cost		xxxxx
Add: Profit or Profit Margin		xxxx
Sales Revenue or Total Sales		xxxxx

Opening Stock of Finished Goods + Production of Finished Goods = Sales of Finished Goods + Closing Stock of Finished Goods

Example 2:-

From the followings information prepare cost sheet to find out the amount of profit

Particulars	Rs.
Raw Material Purchased	28,800
Work Overheads	10,000
Stock:	
Raw Material :	
1st January 2012	4,000
31st January 2012	4,800
Finished Goods (800 Quintals) as on 1st January 2012	3,200
Work in Progress :	
1st January 2012	960
31st January 2012	3,200
Direct Labour	20,000
Direct Expenses	2,000
Office and Administration Overheads	1,600
Sales (Finished goods)	70,000

Advertising discount allowed and selling cost is Re. 0.40 per quintal. During the month 12,800 quintal of the commodity were produced

Solution:

Cost Sheet

Particulars	Rs.	Rs.
Direct Raw Material Consumed		
Opening Stock of Raw Material	4,000	
Add: Raw Material purchased	28,800	
	32,800	
Less: Closing Stock of Raw Material	4,800	28,000
Direct Labour		20,000
Direct Expenses		2,000
Prime Cost		**50,000**
Add: Work overheads		10,000
Gross Factory Cost		**60,000**
Add: Opening work in Progress		960
Less: Closing work in Progress		3,200
Factory Cost		**57,760**
Add: Office and Administration Overheads		1,600
Cost of Production		**59,360**
Add: Openings stock of Finished Goods		3,200
Cost of Goods sold		**62,560**
Add: Selling and Distribution Overheads:		
Advertising, Discount Allowed & Selling cost (13,600 × 0.40)		5,440
Total Cost		**68,000**
Add: Profit (Balancing Figure)		2,000
Total Sales		**70,000**

Note: - Selling & Distribution expenses are incur on "No. of units sold"

Format of "Cost Sheet"

Direct Materials ➢ All Material or components Specifically purchased, Produced or requisitioned from Stores ➢ Primary Packing Materials such as Carton, Wrapping, Cardboard, Boxes etc. ➢ Materials Used in Packing ➢ Purchased or Partly Produced Goods ➢ Freight on Materials or Carriage inward ***Less:- Abnormal Loss of Raw Materials*** ***Purchase Returns*** ***Raw Material Wastage*** (Direct Material is also described as raw material, Process Material, Prime Material, Production Material, Stores Materials, and Constructional Materials etc.)	xxxx xxxx xxxx xxxx xxxx (xxxx) (xxxx) (xxxx)	xxxx
Direct Labour ➢ Wages paid to laborers ➢ Labour required to producing ➢ Manufacturing Wages ➢ Factory or Productive Wages (Direct Labour is also described as Process Labour, Productive Labour, Operating Labour, Manufacturing Labour, Direct Wages etc.)	xxxx xxxx xxxx xxxx xxxx	xxxx
Direct Expenses ➢ Chargeable Expenses ➢ Excise Duty, Royalty, Surveyor's Fees ➢ Expenses –Direct- Factory ➢ Hire Charges of some Special Machinery required for a particular Contract ➢ Cost of Defective Work incurred in connection with a particular job or contract	xxxx xxxx xxxx xxxx xxxx	xxxx
Prime Cost or Basic Cost		xxxx
Add: Factory or Production or Manufacturing Overheads Less:- Sale of Factory Wastage or Factory Scrap of Materials	xxxx (xxxx)	xxxx
Factory Cost or Works Cost		xxxxx
Add: Office and Administration Overhead		xxxxx
Cost of Production		xxxxx
Add: Selling and Distribution Overhead		xxxx
Cost of Sales or Total Cost		xxxxx
Add: Profit or Profit Margin		xxxx
Sales Revenue or Total Sales		xxxxx

Factory or Production or Manufacturing Costs	Office and Administration Overheads	Selling and Distribution Overheads
Indirect Material:- ➢ Consumable Stores ➢ Oil, Lubricant and Cotton Waste and other factory Supplies ➢ Materials of little value used in Production such as Screws, Nuts, Bolts, Enamel, Paints and Nails, Small tools ➢ Cost of Moulds **Indirect Labour:-** ➢ Wages of Foreman ➢ Wages of Fire man ➢ Work Consultancy ➢ Indirect Wages ➢ Store-Keeper Wages ➢ Salary of Work Manager ➢ Unproductive Wages ➢ Wages of Indirect Worker ➢ Works Director's Salary ➢ Expenses of Training Staff ➢ Salary of Factory Clerk **Indirect Expenses:-** ➢ Rent, Rates and Taxes for Factory Land and Buildings ➢ Insurance of Factory Building, Plant etc. ➢ Depreciation of Plant and Machinery, Loose Tools ➢ Factory Employees State Insurance ➢ Factory Employees Welfare Service ➢ Pay for Holiday and Sick Leave ➢ Contribution to Provident Fund of Factory Staff ➢ Works Stationery and telephone Expenses ➢ Repair and Maintenance of Factory ➢ Drawing Office Salaries ➢ Factory Lighting, Heating, Refrigeration and Air conditioning ➢ Designing Expenses ➢ Production Control, Progress department and inspection overhead ➢ Experimental Expenses ➢ Power or Electric Power or Motive Power, Power and Fuel ➢ Haulage ➢ Factory Cleaning ➢ Water Supply ➢ Estimating Expenses ➢ Insurance of Stock of Raw Materials	**Indirect Material:-** ➢ Office Printing and Stationery **Indirect Labour:-** ➢ Office Manager's Salary ➢ Company Secretary's Salary ➢ Fees of the Board ➢ Office Consultancy ➢ Salary of Office Staff ➢ Director's Fees ➢ Salary of Administrative Directors **Indirect Expenses:-** ➢ Rent, Rates and Taxes for Office Land and Buildings ➢ Insurance of Office Building ➢ Legal Charges ➢ Audit Fees ➢ Bank Charges ➢ General Expenses ➢ Office Expenses ➢ Financial Charges ➢ Telephone, Postage and Telegram ➢ Counting House Salaries ➢ Depreciation of Office Building ➢ Repair, Renewal and Maintenance of Office Building ➢ Office Lighting, Heating, Refrigeration and Air conditioning ➢ Certain type of Expenses on Subscription ➢ Counting office salary	**Indirect Material:-** ➢ Packing Materials ➢ Materials Used in selling the Product **Indirect Labour:-** ➢ Salaries of Sales men ➢ Salary of Godown Keepers ➢ Sales men's Commission ➢ Marketing Director's Salary ➢ Marketing Consultancy **Indirect Expenses:-** ➢ Advertisement and Display in Shop ➢ Price List, Catalogues etc. ➢ Carriage outward ➢ Entertainment of Marketing Division ➢ Sample, Free Gift etc. ➢ Bad and Doubtful Debts ➢ Depreciation and Running Expenses of Delivery Van, Trucks etc ➢ Travelling Expenses of Marketing Staff ➢ Commission allowed to customers ➢ Legal Charges incurred for recovery of Debts ➢ Sales Designing Expenses ➢ Sales and Estimating office expenses ➢ Market Research Expenses ➢ Showroom Expenses ➢ Insurance of Godown ➢ Freight on Sales ➢ Rent of Warehouse ➢ Discount on sales ➢ Shortage in Stocks of Finished Goods ➢ Commission of Travelling Agents ➢ Sales Commission ➢ Lighting Sales Deptt. ➢ Printing and Stationery of Sales Deptt. ➢ Warehouse Charges ➢ Sales Promotion ➢ Distribution Deptt.'s Salary and Expenses ➢ Upkeep of Delivery Van ➢ Loading Charges ➢ Collection Charges ➢ Cost of Preparing Tenders ➢ Agent's Commission

Items Excluded From Cost Accounts

Appropriation of Profits	Items of Pure Finance	Abnormal Gain and Losses
➢ Appropriation of Sinking Fund ➢ Dividends Paid ➢ Taxes of Incomer or Profits ➢ Transfer to General Reserve ➢ Amount Written off Goodwill, Preliminary Expenses, Underwriting Commission, etc. ➢ Capital Expenditure Specifically charged to Revenue	➢ Provision for Bad Debts ➢ Charitable Donations ➢ Interest Received on Bank Deposits ➢ Penalty Payable by Law ➢ Losses due to Scrapping of Machine ➢ Transfer Fees received ➢ Interest, Dividend etc. received on Investment ➢ Cash Discount ➢ Demurrage Charges	➢ Loss on sale of Plant and any other Fixed Assets ➢ Profit on sale of Plant and any other Fixed Assets

Items Included in the Cost Accounts only

(Notional Expenses)

⇒ Charges in lieu of Rent Where Premises are owned

⇒ Interest on Capital employed in Production, but upon which no Interest is actually paid if the firm decided to treat Interest as part of Cost

⇒ Salary for the Proprietor where he works but does not charged as a salary

IMPORTANT POINTS:-

- Stock or Inventory Consists Three items
  1. Raw Materials
  2. Work in Progress or Semi-Finished Goods
  3. Finished Goods

- Cost of Production means cost incurred to Producing Finished Goods

$$\text{Cost of Production Per Unit} = \frac{\text{Cost of Production}}{\text{No. of Units Produced}} = \text{Rs. …… Per unit}$$

If Cost of Production is 1,50,000 and Goods produced is 15,000 then Cost of Production per unit is Rs. 10 (1,50,000/15,000)

- Closing Stock of Finished Goods are Valued at "Cost of Production per unit"

- Opening Stock of Finished Goods are valued at given in question or previous Cost of production per unit (but certain time Cost of production per unit is not given then it is also calculated at current Cost of Production per unit).

Classification of Cost

On the following Basis Cost may be classified

Type of Cost

- Nature of Elements
- Traceability to object
- Functions
- Variability
- Controllability
- Normality
- Decision Making
- Cash outflow

1. Nature of Element:-

On the basis of element Cost is classified into:-

Material: -

Material is the item by which a product is made. Cost which is incurred in producing Material is Called Material Cost. For example - cost of Raw Material

Labour: -

Payment made to human (Worker) is called Labour Cost. For example - Wages and Salary

Expenses:-

All cost incurred in producing and Selling goods other than Material Cost and Labour Cost are called Expenses. For example-Power, office Maintenance, Depreciation Taxes

2. Traceability to object:-

On the basis of Traceability to object Cost is classified into:-

Direct Cost:-

Cost which can be allocated directly to the product is called Direct Cost. Cost which is identified with the product is called Direct Cost. For Example - Material Cost such as Wood in Furniture, Iron in Iron Chair

Indirect Cost: -

Cost which cannot directly allocate to the product is called Indirect Cost. For Example –Nail used in Furniture

3. Function:-

On the basis of Function Cost is classified into:-

Production Cost: -

Cost which is incurred to producing goods is called Production Cost. It begins with cost of supplying Material, wages paid to workers and end with Primary packing of the product. For Example- Direct Material, Direct Labour and Overhead.

Selling Cost:-

Cost which incurred to Create and stimulates demand and Securing order is called Selling Cost. For Example - Advertising Expenses.

Distribution cost:-

Cost which begins making the packed product available for dispatch and end with making the reconditioned returned empty package, if any available for sale. For Example:-Freight and Transportation Cost

Administrative Cost:-

The cost incurred to formulating the policy, directing the organization and controlling the operations of the organization but not directly related with production. For Example salary of office Staff

Research Cost: -

The cost incurred for researching new or improved products, new application of Materials, or improved methods.

Development Cost: -

The cost incurred in the process which begins with the implementation of the decision to produce a new or improved product and end with commencement of Formal production of that product or by that method.

Pre-Production Cost:-

The part of Development Cost incurred in making a trail production run preliminary to formal product.

Conversion Cost:-

It is the cost incurred to convert raw materials into finished goods. It is the sum of direct wages, Direct Expenses and overheard cost of converting raw Materials to the Finished Stage or converting a material from one stage of production to the next.

Product Cost: -

Cost necessary for production is called Production Cost. These are the cost which are assigned or charged to the product

4. Variability or Behavior:-

On the basis of Variability or behavior cost is classified into:-

Fixed Cost: -

Cost which remains constant in Total. Cost which remains static or constant irrespective of changes in output is regarded as Fixed Cost. So it is fixed at different level of output. Change in output up to a certain extent does not affect the Costs For Example - Rent. AMC

Level of output / Production Volume	Total Fixed cost	Fixed cost Per unit
5000 units	Rs. 25,000	Rs.5
10,000 units	Rs. 25,000	Rs.2.5
15,000 units	Rs. 25,000	Rs.1.67
20,000 units	Rs. 25,000	Rs.1.25

Here there is no any relationship between Level of output and Fixed Cost Whether output is 500 units or 2,000 units

Variable Costs: -

Cost which change with production. Costs which directly change with the level of output is called Variable Cost. Variable Costs per unit are same at different level of output but in total it will be different. For Example Cost of Raw Material

Level of output / Production Volume	Variable cost per unit	Total Variable Cost
5000 units	Rs. 10 per unit	Rs. 5,000
10,000 units	Rs. 10 per unit	Rs. 10,000
15,000 units	Rs. 10 per unit	Rs. 15,000
20,000 units	Rs. 10 per unit	Rs. 20,000

Here there is a direct relationship between Level of output and Fixed Cost. As soon as Level of output is Increase Variable cost will also increase.

5. Controllability:-

On the basis of controllability Cost is classified into:-

Controllable Cost: -

Cost which can be influence by the action of a specific member of an undertaking. For Example –Raw Material Cost, Labour Cost

Uncontrollable Cost:-

Cost which cannot be influence by the action of a specific member. For Example –Rent cost

6. Normality:-

On the basis of Normality Cost is classified into:-

Normal Cost:-

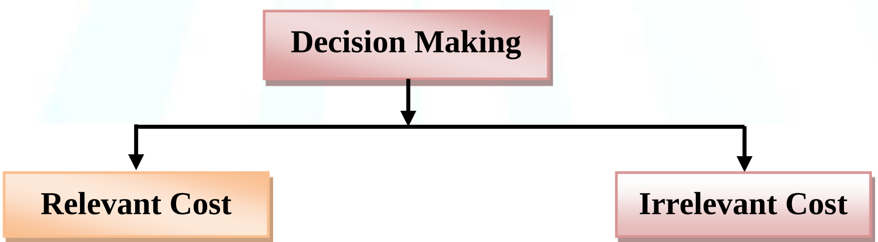
Cost which are expected to be incurred in Normal Routine. For Example – Raw Material Cost

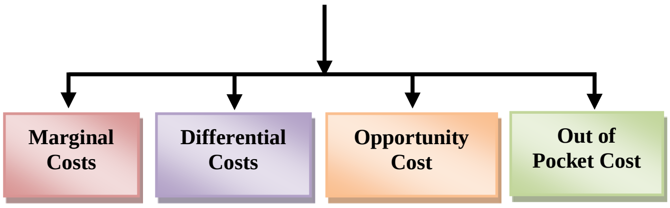
Abnormal Cost: -

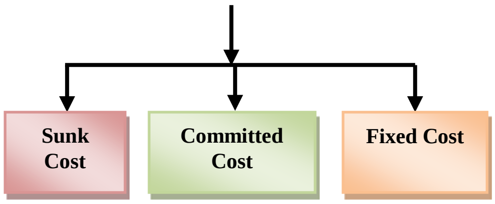
Costs which are over and above normal Cost. For Example – Cost of Wastages

7. Decision Making:-

On the basis of Decision Making Cost is classified into:-







Relevant Cost: - Relevant costs are costs relevant for a specific purpose or situation. In the context of decision making, only those costs are relevant which are pertinent to the decision making only those costs are considered. Since we are concerned with future costs only while making a decision, historical costs, unless they remain unchanged in the future period are irrelevant to the decision making process.

Marginal Cost –

Marginal cost is the aggregate of variable costs, i.e. prime cost plus variable overhead. Marginal cost per unit is the change in the amount at any given volume of output by which the aggregate cost changes if the volume of output is increased or decreased by one unit. Marginal costing system is based on the system of classification of costs into fixed and variable. The fixed costs are excluded and only the marginal costs, i.e the variable costs are taken into consideration for determining the cost of products and the inventory of work-in-progress and completed products.

Differential cost - (Incremental and excremental costs)

It represents the change (increase or decrease) in total cost (variable as well as fixed) due to change in activity level, technology, process or method of production, etc. For example if any change is proposed in the existing level or in the existing method of production, the increase or decrease in total cost or in specific elements of cost as a result of this decision will be known as incremental cost or decremented cost.

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.

Out-of-pocket cost –

It is that portion of total cost, which involves cash outflow. This cost concept is a short-run concept and 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.

Irrelevant Cost

Sunk Costs

These are historical costs which are incurred in the past. These costs were incurred for a decision made in the past and cannot be changed by any decision that will be made in future. In other words, these costs play no role in decision making, in the current period. While considering the replacement of a plant, the depreciated book value of the old plant is irrelevant, as the amount is a sunk cost which is to be written off at the time of replacement.

Other remaining type of cost

Shut down costs –

Those costs, which continue to be, incurred even when a plant is temporarily shut down e.g. rent, rates, depreciation, etc. These costs cannot be eliminated with the closure of the plant. In other words, all fixed costs, which cannot be avoided during the temporary closure of a plant, will be known as shut down costs.

Explicit Costs –

These costs are also known as out of pocket costs and refer to costs involving immediate payment of cash.

Examples of explicit costs: - Salaries, wages, postage and telegram, printing and stationery, interest on loan etc.

Implicit Costs –

These costs do not involve any immediate cash payment. They 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. As such they are also known as imputed costs or economic costs.

Imputed costs –

These costs are notional costs which do not involve any cash outlay.
Examples of imputed costs: - Interest on capital, the payment for which is not actually made.
These costs are similar to opportunity costs.

Product costs –

Costs that become part of the cost of goods manufactured are called product costs. Such costs are incurred on manufacturing process either directly as material and labor costs or indirectly as overheads. Since the matching principle of accounting requires expenses to be matched to the revenue they generate, therefore it is necessary to expense product costs only when the revenue from the sale of products is realized. This is achieved by debiting product costs to the cost of goods manufactured and thus expensed only at the time of sale of such goods.

Examples of products costs are raw material, labor, factory depreciation, fuel and packaging costs.

Period costs –

Period costs are basically all costs other than product costs. These are not incurred on the manufacturing process and therefore these cannot be assigned to cost goods manufactured. Period costs are thus expensed in the period in which they are incurred.

Example of period costs are advertising, sales commissions, office supplies, office depreciation, legal and research and development costs.

Period costs may be further classified into selling costs and administrative cost

Meaning of Research Cost:

The research expenditure is the cost of searching for new products, new manufacturing process, improvement of existing products, processes or equipment. The development expenditure is the cost of putting research result on commercial basis.

Some of the costs relating to research and development are given below:

(a) Cost of raw materials used in research,

(b) Salaries and wages of R & D staff,

(c) Subscriptions to books and journals,

(d) Subscriptions to research associations,

(e) Cost of tests conducted and trail runs,

(f) Depreciation, insurance, repairs and maintenance of buildings and research equipment, plant etc.,

(g) Patent fees,

(h) Upkeep and maintenance of R & D office, and

(i) Travelling cost for surveys etc.

The research and development expenditure is a deferred charge which is in the nature of non-recurring expenditure which are expected to be of financial benefit to several accounting periods of indeterminate total length. It is the expenditure incurred for searching a new product or improved product or new methods of production and improved technologies.

The research costs are incurred for carrying basic research or applied research. But the development costs start with decision taken to produce new product or improved product and when the decision is taken to adopt new technologies and new production methods.

The objective in carrying basic research is to improve the existing scientific and/or technical knowledge. But the applied research is carried for a purpose directed towards a specific practical aim or objective.

Treatment of Research Cost:

The treatment of research costs is studied under two heads:

(1) Basic research costs.

(2) Applied research costs.

(a) Basic Research Costs:

These costs relate to all existing products, methods of operation, techniques of production and therefore, the basic research costs should be treated as production overhead for the period during which it has been incurred and has to be absorbed into product costs.

(b) Applied Research Costs:

The applied research costs classified into two for absorption purpose:

(i) If applied research costs relate to improvement of existing products and methods of production, it should be treated as manufacturing overhead for the period and has to be absorbed to the product cost.

(ii) In case, applied research costs are incurred for searching new products or methods of production etc., then such costs are amortised to the product that is newly invented or new method of production adopted. The whole of such expenditure should not be absorbed in the year in such expenditure has been incurred but a part of it should be carried over. The expenditure which, though of revenue nature, is spread over a number of years because its benefit is derived during those years.

When the applied research aimed at improvement of existing product or to invent a new product or development of new technology, and if the research work appears failure in getting the desired results, then such applied research expenditure is charged against profit in the Costing Profit and Loss Account of one or more years depending upon the size of expenditure incurred.

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MCQ

1. Direct Material Cost plus Direct Labour Cost is called	
(a) Prime Cost (b) Conversion Cost	(c) Product Cost (d) All of these
2. The combination of direct material and direct labour Cost is	
(a) Total Production Cost (b) Prime Cost	(c) Conversion Cost (d) Total Manufacturing Cost
3. Prime Cost is calculated as under	
(a) Manufacturing Cost / Cost of Goods Sold (b) Direct Material plus Factory Overheads	(c) Direct Labour + Direct Material (d) None of these
4. Prime cost is	
(a) The total of direct costs (b) All costs incurred in manufacturing a product	(c) The material cost of a product (d) The cost of operating a department
5. Prime cost + Factory overhead cost is:	
(a) Conversion Cost (b) Production Cost	(c) Total Cost (d) None of given option
6. Selling and distribution overhead does not include:	
(a) Cost of Warehousing (b) Repacking Cost	(c) Transportation Cost (d) Demurrage Charges
7. The Salary of factory clerk is treated as :	
(a) Direct Labour Cost (b) Indirect Labour Cost	(c) Conversion Cost (d) Prime Cost
8. All of the following compose cost of goods sold EXCEPT:	
(a) Raw material (b) Labour	(c) Capital (d) Factory Overhead

9. Marketing involves the following except :
(a) Designing (b) Selling (c) Publicity (d) Distribution

10. Cost of sales is :
(a) Total costs incurred in production, administration and marketing functions
(b) Works cost plus administration overheads
(c) Aggregate of works, administration and marketing overheads
(d) Prime costs plus marketing overheads

11. Cost can be classified according to :
(a) Elements (b) Functions (c) Behavior (d) All of the above

12. The functional classification of costs include the following except :
(a) Prime Cost Elements (b) Production Cost (c) Administration Cost (d) Marketing Cost

13. Which of the following is not included in the administration cost?
(a) Salaries of General Office Staff
(b) Salaries of Foremen
(c) Office supplies and expenses
(d) Postage, Stationery, telephone etc.

14. The main purpose of cost accounting is to :
(a) Maximize profits
(b) Help in inventory valuation
(c) Provide information to management for decision making
(d) Aid in the fixation of selling price

15. Which of the following best describes the manufacturing costs?
(a) Direct materials, direct labor and factory overhead
(b) Direct materials and direct labor
(c) Direct materials, direct labor, factory overhead, and administrative overhead
(d) d. Direct labor and factory overhead

16. Which of the following is indirect cost?
(a) The depreciation of machinery
(b) The overtime premium incurred at the specific request of a customer
(c) The hire of tools for a specific job
(d) All of the given options

17. An organization sold 4,000 units and have closing finished goods 3,500 units and opening finished goods units were 1,000.The quantity of units produced would be:
(a) 7,500 units (b) 6,500 units (c) 4,500 units (d) 8,500 units

18. Sales are Rs. 4,50,000. Beginning finished goods were Rs. 23,000. Ending finished goods are Rs. 30,000. The cost of goods sold is Rs. 3,00,000. What is the cost of goods manufactured?
(a) Rs. 3,23,000 (b) Rs. 3,30,000 (c) Rs. 2,93,000 (d) None of the given options

19. If Units sold = 10,000; Closing finished goods = 2,000; Opening finished goods = 1,500; What will be the value of units manufactured?
(a) 9,500 (b) 10,500 (c) 13,500 (d) 6,500

20. Calculate the amount of direct labor if: Direct material = 15,000; Direct labor = 70% of prime cost
(a) 6,429 (b) 30,000 (c) 10,500 (d) 35,000

21. A typical factory overhead cost is:
(a) Distribution (b) Internal audit (c) Compensation of plant manager (d) Design

22. If Direct Material = 12,000; Direct Labor = 8,000 and other Direct Cost = 2,000 then what will be the Prime Cost?
(a) 12,000 (b) 14,000 (c) 20,000 (d) 22,000

23. The components of factory overhead are as follows:
(a) Direct material + Indirect material + Direct expenses
(b) Indirect material + Indirect labor + Others indirect cost
(c) Direct material + Indirect expenses + Indirect labor
(d) Direct labor + Indirect labor + Indirect expenses

24. Factory Overhead cost includes:

(a) Factory Rent
(b) Property Tax
(c) Salaries of Factory Clerk Design
(d) All of the given

25. Consider the following data pertaining to the production of a company for a particular month :
Opening stock of raw material Rs. 11,570
Closing stock of raw material Rs. 10,380
Purchase of raw material during the month Rs. 1,28,450
Total manufacturing cost charged to product Rs. 3,39,165
Factory overheads are applied at the rate of 45% of direct labour cost.
The amount of factory overheads applied to production is

(a) Rs. 65,025
(b) Rs. 94,287
(c) Rs. 95,020
(d) Rs. 1,52,624

26. The following information was taken from Smart Company's accounting records for the year ended March 31, 2013 :

	Rs.
Increase in raw materials inventory	15,000
Decrease in finished goods inventory	35,000
Raw materials purchased	4,30,000
Direct labour payroll	2,00,000
Factory overhead	3,00,000
Freight	45,000

There was no work in process inventory at the beginning or end of the year. Smart's 2,000 cost of goods sold is :

(a) Rs. 9,50,000
(b) Rs. 9,65,000
(c) Rs. 9,75,000
(d) Rs. 9,95,000

27. Which of the following costs is part of the prime cost for manufacturing company?

(a) Cost of transporting raw materials from the suppliers premises
(b) Wages of factory workers engaged in machine maintenance
(c) Depreciation of truck used for deliveries to customers
(d) Cost of indirect production materials

28. Direct material opening inventory add net purchases is called

(a) Material consumed
(b) Material available for use
(c) Total material purchased
(d) Material ending inventory

29. Which of the following is to be called product cost?

(a) Material cost
(b) Labor cost
(c) FOH cost
(d) All of the given options

30. All Indirect cost is charged / record in the head of

(a) Prime Cost
(b) FOH Cost
(c) Direct Labour Cost
(d) None of the given options

31. Interest on own capital is a:

(a) Cash cost
(b) Notional cost
(c) Sunk cost
(d) Part of prime cost

32. If:
Cost of opening finished goods Rs. 2,000
Cost of goods to be produced Rs. 6,000
Operating expenses Rs. 1,000.
Which of the following is the cost of goods available for sale?

(a) Rs. 8,000
(b) Rs. 4,000
(c) Rs. 7,000
(d) Rs. 9,000

33. Which of the following item is included in both prime cost as well as conversion cost

(a) Direct Material Cost
(b) FOH Cost
(c) Direct Labour Cost
(d) None of these

PGT Commerce

1. Prime cost plus variable overhead is known as:
(a) Production cost
(b) Total cost
(c) Marginal cost
(d) Cost of sales

P.G.T. K.V.S. 2016

2. Conversion cost is equal to total of:
(a) Material cost and direct wages
(b) Direct wages and factory overhead
(c) Material cost and indirect wages
(d) Material cost and factory overhead

P.G.T. K.V.S. 2016

4. Which one is true?
(a) Incremental cost is a type of differential cost.
(b) Opportunity cost helps in ascertainment of cost.
(c) Variable cost per unit fluctuates with the volume of production
(d) Conversion cost is the sum total of direct material cost and direct wages cost.

P.G.T. K.V.S. 2016

5. Which one is true?
(a) All future costs are not relevant costs
(b) Difference in costs between alternatives is termed as relevant cost
(c) Past costs are significant for decision making
(d) Contribution margin is also known as Net Income

P.G.T. K.V.S. 2016

6. The salary of factory clerk is treated as
(A) Direct labour cost
(B) Indirect labour cost
(C) Conversion cost
(D) Prime cost

DSSSB PGT (2015 Tier II)

7. The main purpose of cost accounting is to
(A) Maximize profits
(B) Help in inventory valuation
(C) Aid in the fixation of selling price
(D) Provide information to management for decision-making

DSSSB PGT (2015 Tier II)

8. Which of the following cost is used in the calculation of cost per unit?
(A) Total production cost
(B) Cost of goods sold
(C) Cost of goods manufactured
(D) Cost of goods available for sales

DSSSB PGT (2015 Tier II)

9. Sales commissions are classified as
(A) Prime cost
(B) Period cost
(C) Product costs
(D) Indirect labour

DSSSB PGT (2015 Tier II)

10. If the direct labour is Rs. 42,000 and FOH is 40% of conversion cost, what will be the amount of FOH?
(A) Rs. 63,000
(B) Rs. 30,000
(C) Rs. 28,000
(D) Rs. 16,800

DSSSB PGT (2015 Tier II)

11. Opportunity cost is the best example of
(A) Sunk cost
(B) Standard cost
(C) Relevant cost
(D) Irrelevant cost

DSSSB PGT (2015 Tier II)

12. Wage, Rent and Materials are examples of
(A) Implicit cost
(B) Explicit cost
(C) Direct cost
(D) Manufacturing cost

DSSSB PGT (2015 Tier II)

13. Interest on own capital is a
(A) Cash cost
(B) Notional cost
(C) Sunk cost
(D) Part of prime cost

DSSSB PGT (2015 Tier II)

14. The basic research cost should be treated as
(A) Product cost
(B) Production cost
(C) Production overhead
(D) Period cost

DSSSB PGT (2015 Tier II)

M.Com (Entrance) Previous Year Questions

1. Cost reduction is achieved through : *M.Com (Entrance 2009)*

(a) Economic batch quantity
(b) Production planning and control
(c) Inventory control
(d) All of the above

2. Conversion cost is equal to the total of : *M.Com (Entrance 2009)*

(a) Material cost and direct wages
(b) Material cost and indirect wages
(c) Direct wages and factory overheads
(d) Material cost and factory overheads

3. If prime cost is Rs. 50,000, works overhead are 40% on prime cost and office overhead are 20% on works overhead the cost of production is : *M.Com (Entrance 2010)*

(a) Rs. 74,000
(b) Rs. 85,000
(c) Rs. 84,000
(d) Rs. 1,00,000

4. Which of the following product cost is both a prime cost and conversion costs? *M.Com (Entrance 2011)*

(a) Direct Material
(b) Manufacturing overhead
(c) Direct Labour
(d) All of these

5. Manufacturing costs are known as product costs. Which of the following best describes those costs. Which are considered to be manufacturing costs?: *M.Com (Entrance 2011)*

(a) Direct material, Direct Labour and Factory overheads
(b) Direct Material and Direct Labour only
(c) Direct Labour and Factory overheads
(d) Direct Material, Direct Labour Factory overheads and Administrative overheads

6. Incremental costs are same as : *M.Com (Entrance 2011)*

(a) Standard Cost
(b) Prime Cost
(c) Differential Cost
(d) None of these

7. The Distinction between fixed costs and variable costs depends on : *M.Com (Entrance 2011)*

(a) Opinion of the Cost Accountant
(b) Cost behavior
(c) Policy of the Management
(d) The amount of expenditure incurred

8. Prime cost is : *M.Com (Entrance 2012)*

(a) All costs incurred in manufacturing a product
(b) Total cost of direct of product
(c) Materials cost of product
(d) Cost of operating a department

9. The salary a student foregoes while in a college is an example of : *M.Com (Entrance 2012 ; 2014)*

(a) Opportunity cost
(b) Sunk cost
(c) Direct cost
(d) Variable cost

10. Many companies recognize three major categories of costs of manufacturing a product. These are direct materials direct labour and overhead. Which of the following in an overhead cost in the production of an automobile? *M.Com (Entrance 2012;2013)*

(a) Cost of small tools used in mounting tyres on each automobile
(b) Cost of tyres on each automobile
(c) Cost of labourers who place tyres on each automobile
(d) Delivery cost for the tyres on each automobile

11. Fixed costs are conveniently deemed to be : *M.Com (Entrance 2013; 2014)*

(a) Constant per unit of output
(b) Constant in total when production volume change
(c) Outside the control of management
(d) Those unaffected by inflation

12. The types of costs presented to management for a non-routine decision should be limited to : *M.Com (Entrance 2013)*

(a) Relevant costs
(b) Controllable costs
(c) Standard costs
(d) Conversion costs

13. Which of the following is not an indirect cost? *M.Com (Entrance 2013)*

(a) Wages of production department machine operator
(b) Wages of a production department cleaner
(c) Materials used for machine maintenance
(d) Materials used to clean the production department floor

14. In order to identity costs that relate to a specific product, an allocation base should be chosen that: *M.Com (Entrance 2013)*

(a) Does not have a cause and effect relationship
(b) Has a cause and effect relationship
(c) Considers variable costs but not fixed costs

(d) Considers direct materials and direct labour but not factory overhead.	
15. Cost incurred in the past are:	*M.Com (Entrance 2014 ; 2016)*
(a) Opportunity costs (b) Direct cost	(c) Sunk costs (d) Variable Cost
16. Bad Debts are treated as :	*M.Com (Entrance 2014)*
(a) Direct Expenses (b) Cost of production	(c) Selling Overheads (d) Distribution Overheads
17. Payment of royalties is :	*M.Com (Entrance 2014)*
(a) Direct Expenses (b) Charged to P and L account	(c) Factory overhead (d) Administration cost
18. Which of the following is not included in (changed to) factory overhead?	*M.Com (Entrance 2015)*
(a) Factory depreciation and supplies (b) Cost of Service departments	(c) Cost of marketing departments (d) Cost of maintenance departments
19. In behavioral analysis, costs are divided into :	*M.Com (Entrance 2016)*
(a) Production and non-production costs (b) Controllable and non-controllable costs	(c) Direct and indirect costs (d) Fixed and variable cost
20. Calculate the prime cost from the following information: Direct material purchased: Rs. 1,00,000 Direct material consumed: Rs. 90,000 Direct labour: Rs. 60,000 Direct expenses: Rs. 20,000 Manufacturing overheads: Rs. 30,000	*M.Com (Entrance 2018)*
(a) Rs.2,00,000 (b) Rs.2,10,000	(c) Rs.1,80,000 (d) Rs.1,70,000

M.Com (Entrance) Previous Year Questions – BHU

1. For each product profit and loss could be revealed by

(a) Finance Accounting (b) Management Accounting
(c) Cost Accounting (d) Both (1) and (3)

M.Com (Entrance 2018)

2. Which one of the following is not a factory overhead?

(a) Indirect wages (b) Leave wages
(c) Overtime premium (d) Productive wages

M.Com (Entrance 2018)

U.G.C. N.E.T. Previous Year Questions

1. Who are the customers of cost and management accounting?

(a) Managers (b) Creditors
(c) Lenders (d) Consumers

UGC-NET Paper II (December 2005)

2. A variable such as activity that causes cost over a given time is

(a) Cost Driver (b) Cost Behaviour
(c) Cost Centre (d) None of the above

UGC-NET Paper II (December 2009)

3. The main purpose of Cost Accounting is to

(a) Assist management to decision making
(b) Maximize profits and minimize losses
(c) Comply norms issued by the Government of India from time to time
(d) Prepare cost accounts in line with the accounting standards.

UGC-NET Paper II (December 2010)

4. Conversion cost is the sum of :

(a) Indirect wages and factory overhead
(b) Direct wages, direct expenses and factory overhead
(c) Direct material cost and indirect wages
(d) Prime cost and selling & distribution overhead

UGC-NET Paper II (June 2012)