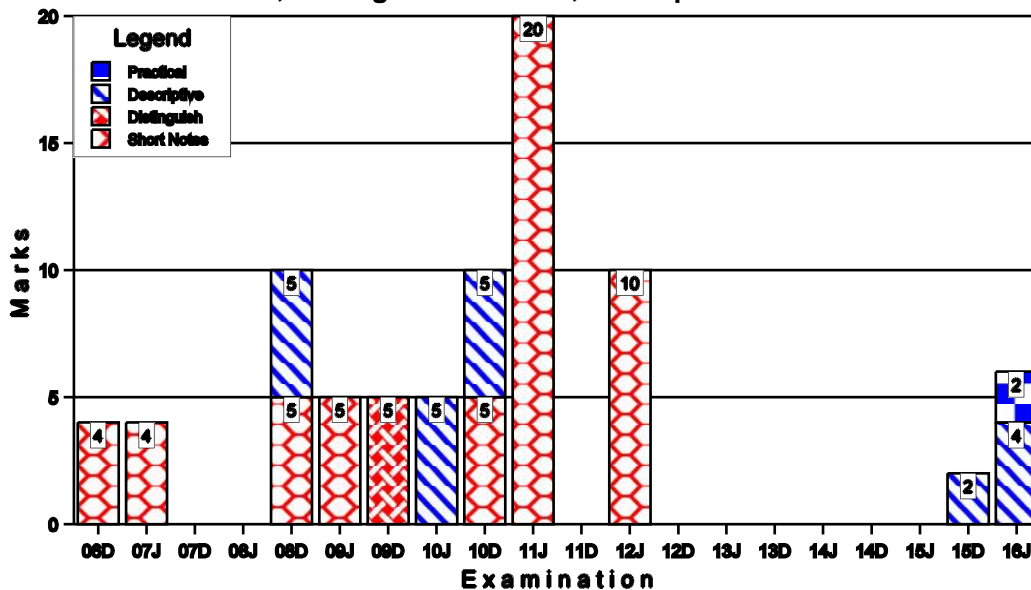


1

Cost Accounting - Basic Concepts & Treatment of Special Items

This Chapter Includes: Cost Accounting : Necessity & Importance; Cost Department, Costing System, Design of Forms & Records, Treatment of: R & D Expenses, Preliminary Expenses, Rectification Expenses, Obsolescence Cost.

Marks of Short Notes, Distinguish Between, Descriptive & Practical Questions



Summary of Chapter at a Glance

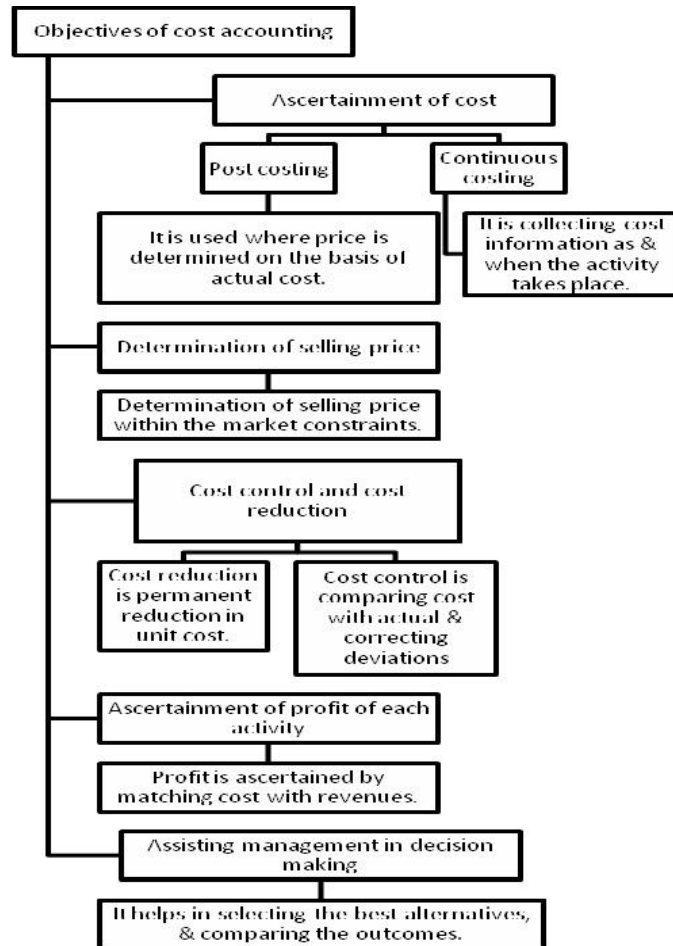
1.1 Definitions:

- 1.1 Costing:** According to CIMA costing is defined as “the technique and process of ascertaining costs.”
- 1.2 Cost Accounting:** According to CIMA “Cost accounting is a process of accounting costs from the point at which expenditure is incurred or committed to the establishment of its ultimate relationship with cost centres and cost unit.

In its widest usage it embraces the preparation of statistical data, the application of cost control method and ascertaining of profitability of activities carried out or planned.”

1.3 Cost Accountancy: According to CIMA Cost accountancy is defined as “the application of costing and cost accounting principles, methods and techniques to 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.”

1.2 Objectives of cost accounting:

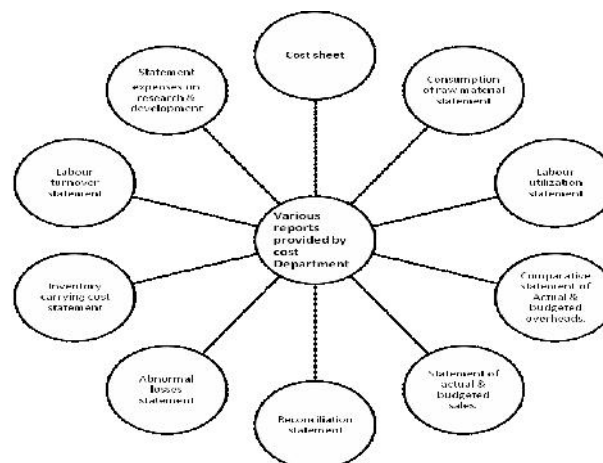


1.3 Advantages of cost accounting:

- It helps in cost control.
- It helps in decision making.
- It helps to identify profitable and unprofitable activities.
- It helps in fixation of selling price.
- It aids in formulating prices.
- It identifies idle capacity.
- It helps in inventory control.
- It identifies causes for increase or decrease in profit.
- It prevents frauds and manipulation.
- It checks accuracy in financial statements

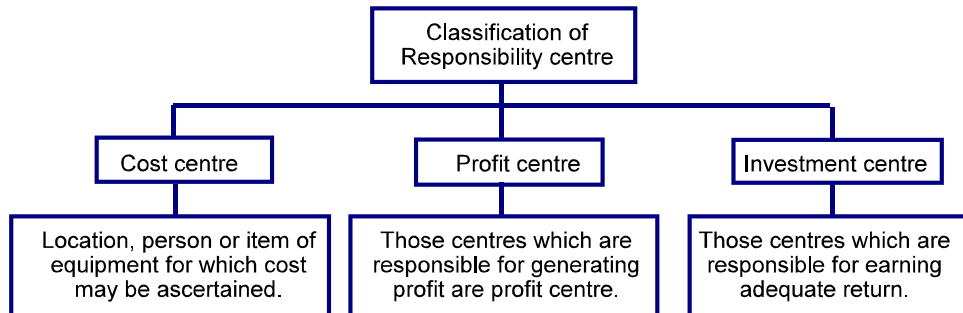
1.4 Essentials for Cost accounting system are:

- It requires support of executives or top management.
- It should be suitable to the organisation.
- Cost should be Controllable.
- Cost of system should be accurate.
- The system should be Specially designed.
- Integration with financial accounts.
- Accrual reports.
- Avoid unnecessary details.
- Continuous training of staff is required.

1.5 Various reports provided by Cost Department:

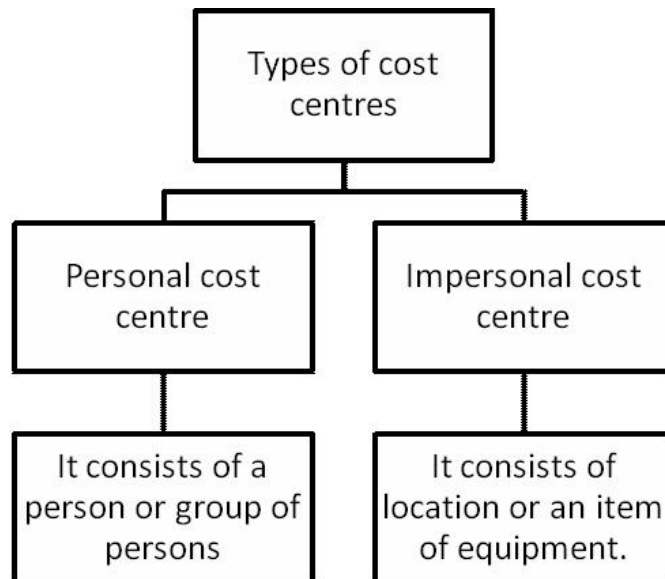
1.6 Cost concepts:

- **Cost**
It is defined as “the amount of expenditure incurred on, or attributable to, a given thing.”
- **Cost object**
 - It can be anything for which a separate measurement of cost is desired.
 - Eg: Product, service, project, customer, activity, etc.
- **Direct cost**
 - Those costs which are directly identifiable with the product are direct costs.
 - Eg: direct material, direct labour, direct expenses, etc.
- **Indirect cost**
 - Those costs which cannot be directly identified with the product are indirect costs.
 - Eg: indirect material, labour, etc.
- **Pre-determined cost**
Costs which are determined in advance i.e. before the actual cost is incurred on the basis of some factors are predetermined costs.
- **Total cost**
 - The sum of all the costs is total cost.
 - Total cost = variable costs + fixed costs
- **Responsibility centre**
It is defined as an activity centre of a business organisation entrusted with a special task.



- Cost centre**

- It is defined as “a location, person or an item of equipment (or group of these) for which cost may be ascertained.”
- It is used for controlling costs.



- **Cost unit**
It is a unit of production, service time or a combination of these, in relation to which costs may be ascertained or expressed.

Industry or Product	Cost unit basis
Construction	each contract
Nuts & bolts	gross
Power	KWH
Chemicals	litre, Gallon, Kg, etc.
Transport	passenger-Km, etc.

- **Profit centre & Investment centre**
Profit centre - Those centres which are responsible for generating profit are profit centre.
Investment centre - Those centres which are responsible for earning adequate return.
- **Cost allocation & Cost absorption**
 - Cost allocation is defined as the process of allotment or identification of whole items to cost centre or unit.
 - Cost absorption is process of absorbing all indirect costs allocated or apportioned over particular cost centre.
- **Differential cost**
 - It is defined as the change in total cost due to various factors.
 - Differential cost calculations include both variable and fixed costs which are affected by the alternative courses of action.
- **Imputed cost**
 - Notional costs which are not actually incurred but considered in cost accounts are imputed cost.
 - Eg: notional rent in respect of own building, etc.
- **Capitalized cost**
Those costs which are initially recorded as assets and subsequently treated as expense are capitalized costs.
- **Product cost & Period cost**
 - Product costs are those costs which are assigned to the product.
 - It is included in the inventory valuation.
 - Eg: direct material cost, direct wages cost, etc.

- Period costs are those which cannot be assigned to the particular product.
- These are charged against revenue.
- Eg: administrative expenses, selling & distribution expenses, etc.
- **Opportunity cost**
 - It is the cost of next best activity which is to be foregone.
 - It is applied in managerial decision making where various alternatives are available.
- **Out of pocket cost**
 - It is the cost which will be actually incurred on the additional unit of output.
 - It is relevant in case of trade depression, competition, etc.
 - Only payments to outsiders are considered.
- **Shut down cost**

Costs which will continue to be incurred even if business is temporarily shut down are shut down costs. Eg: depreciation, rent, etc.
- **Sunk cost**
 - The cost which had already been occurred in the past & is not relevant for the current period are sunk costs.
 - This is irrecoverable cost.
 - The loss will be treated as sunken loss.
 - Eg: the WDV of machine less its realizable value will not be taken for machine replacement decision.
- **Discretionary cost**
 - These costs are not fixed in nature.
 - They are incurred in accordance with certain policy decision of top management.
 - These are also known as programmed cost.
 - Eg: advertising, research & development etc.
- **Engineered cost**

Those costs which result specifically from clear cause & effect relationship between inputs & outputs.

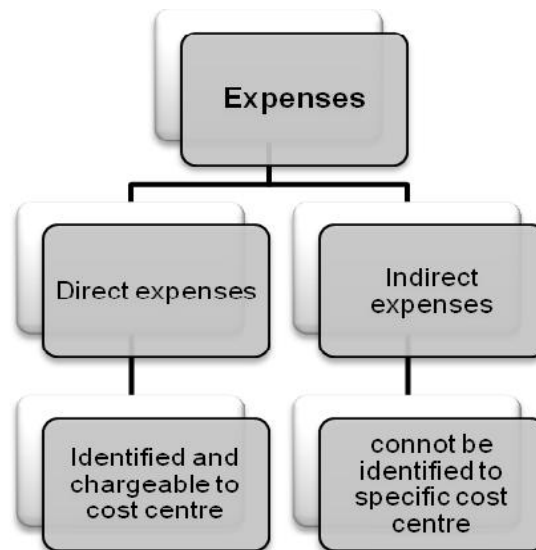
- **Explicit cost & Implicit cost**
 - Explicit costs involve immediate outflow of cash.
 - They are entered into the books of account.
 - Eg: salaries, wages, postage & telegram, etc.
 - They are also known as out of pocket costs.
 - Implicit costs do not involve immediate outflow of cash.
 - They are not recorded in the books of account.
 - They are also known as economic costs.
- **Conversion cost**

The sum total of direct wages & production overheads, in relation to conversion of raw materials into WIP and finished goods is conversion cost.
- **Controllable & Uncontrollable cost**
 - Controllable costs are those which can be controlled.
 - Costs which can be influenced by the action of members of organisation.
 - For Eg: direct costs are controllable costs.
- **Uncontrollable cost**
 - Are those which cannot be controlled
 - Costs which cannot be influenced by the action of members of organisation.
 - There is a very thin line between controllable & uncontrollable cost as no cost is uncontrollable.
- **Pre-production cost**

It is the part of development cost incurred in making a trial production run prior to formal production.
- **Chargeable Expense**
 - These are also called direct expenses.
 - These expenses are directly charged to product or cost unit.
 - These are treated as a part of prime costs.
 - They are directly identifiable.
 - Eg: Cost of patent rights, hire charges of special plant, experimental costs, Royalty paid in mining, costs of special layouts and designs, etc.

- **Relevant Cost**

- This signifies cost including future costs which are relevant to a particular decision in hand.
- It helps the management in decision making.
- Relevant costs are also called out of pocket costs unless these are used in different context.
- Only those costs are relevant if they help the management in taking right decision to achieve organisation objective.
- For Eg: if a manufacturer is considering closing down of unprofitable shop, wages payable to workers are relevant costs.

1.7 Expenses:**1.7(a) Direct Expenses**

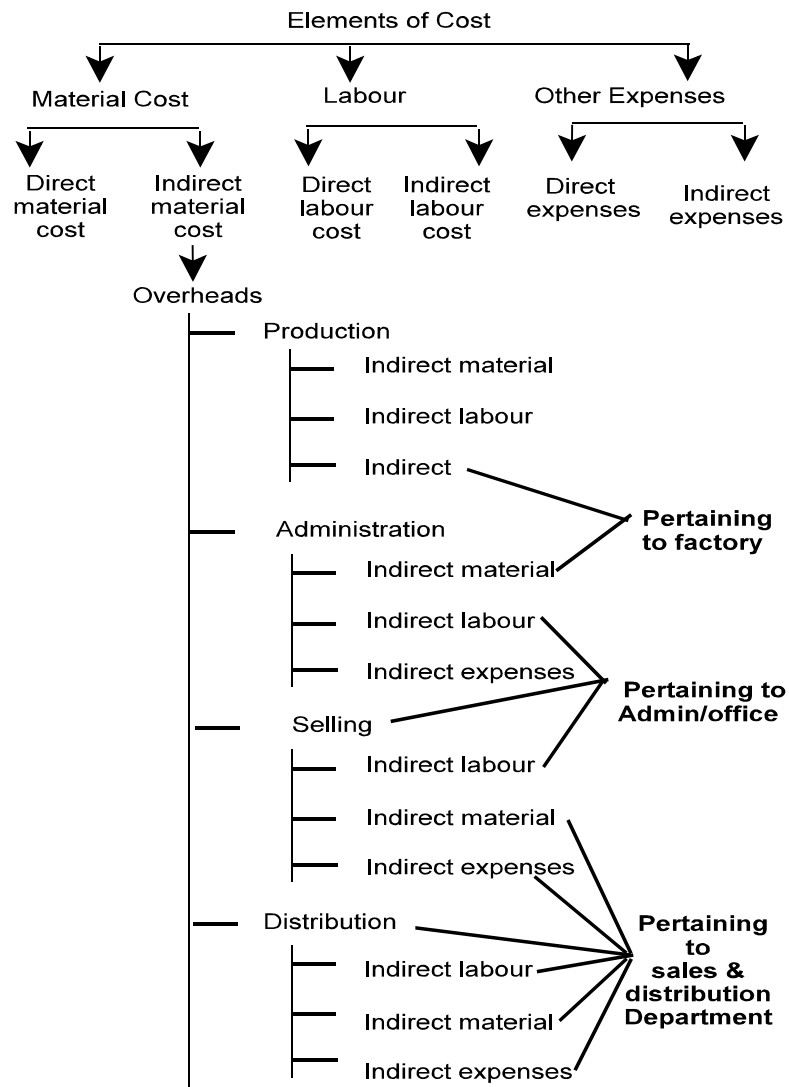
CIMA has defined direct expenses as “direct expenses are those expenses which can directly be identified with and allocated to cost centers or units.” Thus, they are directly identifiable and chargeable to a product process, job, contract and service. They form a major part of prime cost. Example: Cost of patent rights, hire charges of special plant, experimental costs, Royalty paid in mining, costs of special layouts and designs, etc.

1.7(b) Indirect Expenses

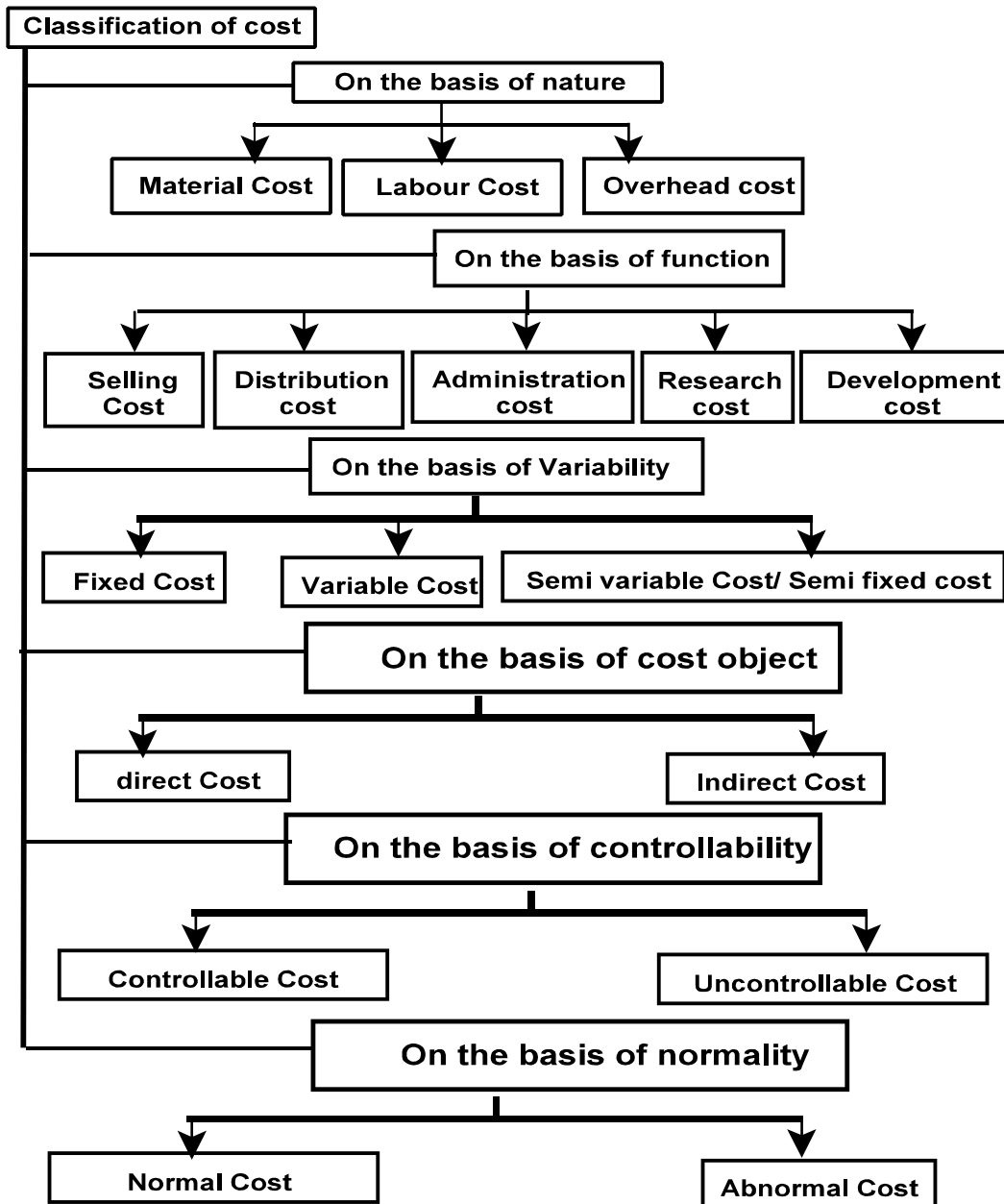
Indirect Expenses cannot be identified to product, process, job & service.

For example Rent, repair, rates, depreciation of Factory building, etc.

1.8 Elements of Cost:



1.9 Classification of Costs:

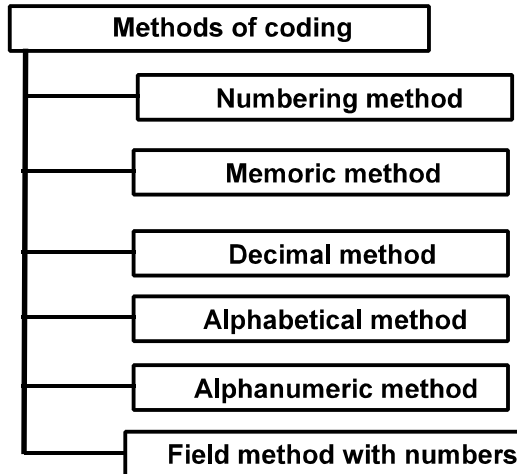
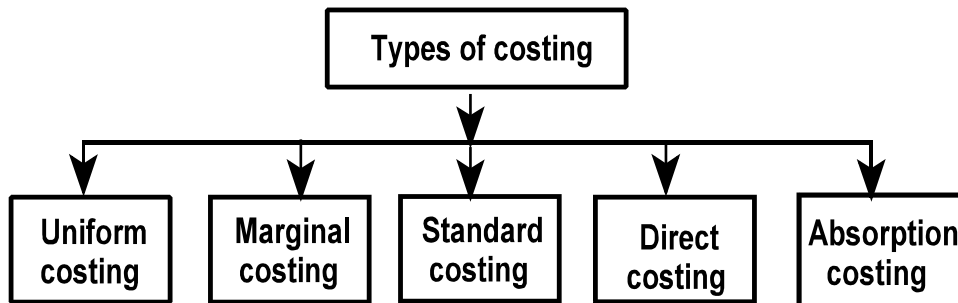


1.10 Coding system:

CIMA defines coding system as “a system of symbol designed to be applied to classified set of item to give a brief account reference, facilitating entry collation and analysis”.

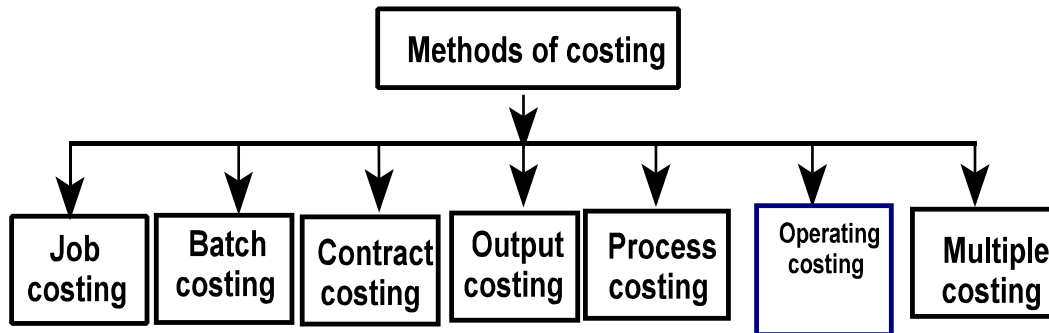
1.11 Advantages of coding system:

- It saves time.
- It reduces data storage capacity.
- It reduces ambiguity.
- It facilitates data processing in computerised system.

**1.12 Types of costing:**

Uniform costing	Marginal costing	Standard costing	Historical costing	Direct costing	Absorption costing
When all the firms agree to follow same costing system.	Where cost is charged after segregating fixed & variable cost.	Standard costing is a pre-determined cost to be used as a measure with which actual cost may be compared.	Cost is ascertained when actually it has incurred.	It is a method of costing in which all direct costs are charged from operations.	Charging all costs of product or period is absorption costing.

1.13 Methods of Costing



Job costing	Batch costing	Contract costing	Output costing	Process costing	Operating costing	Multiple costing
Method of ascertaining cost	A form of job costing, where	Each contract is considered as	Only one product is produced.	It is a process of costing where	Operating costing method of	It is combination of two or

10.14

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according to the jobs performed.	similar units are called a batch. A batch is used as a cost unit for ascertaining cost.	cost unit. An account is opened for each contract in books of contractor		material passes through number of processes till the conversion into final product.	ascertaining the cost of providing services. It is used in undertakings which Provides Services.	more methods of costing
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SHORT NOTES

2006 - Dec [8] Write a short note on the following:

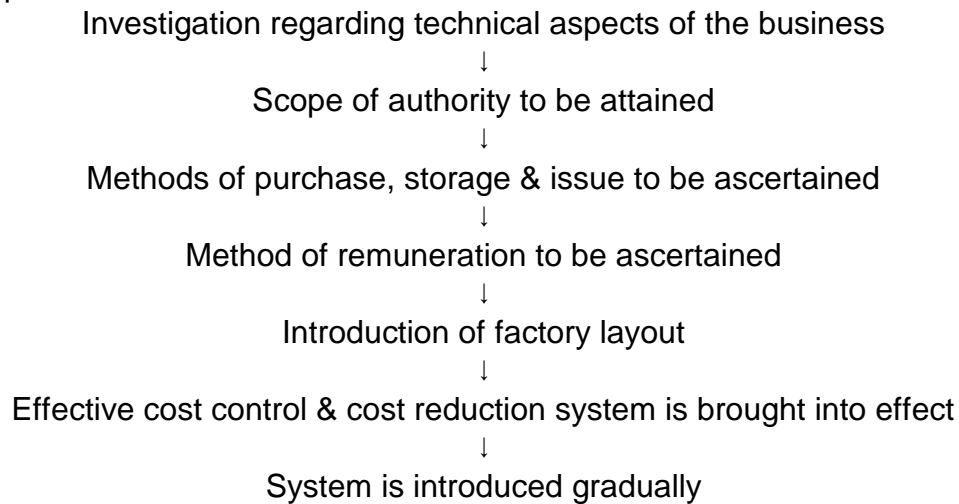
(d) Installation of a cost system

(4 marks)

Answer :

Installation of a cost system:

Steps:



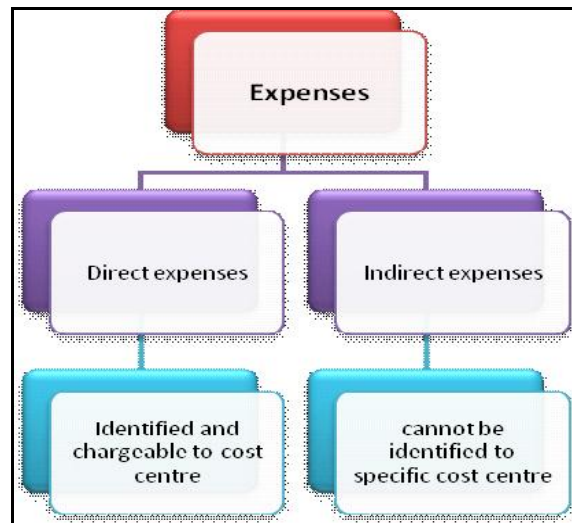
2007 - June [8] Write a short note on the following:

(a) Direct Expense

(4 marks)

Answer :

CIMA has defined direct expenses as “direct expenses are those expenses which can directly be identified with and allocated to cost centers or units.” Thus, they are directly identifiable and chargeable to a product process, job, contract and service. They form a major part of prime cost. Example: Cost of patent rights, hire charges of special plant, experimental costs, Royalty paid in mining, costs of special layouts and designs, etc.



2008 - Dec [8] Write a short note on the following :

(d) Uniform Costing

(5 marks)

Answer :

Uniform Costing: It is the practice of using the same costing principles and/or practices by a number of firms in the same industry. It helps in inter firm comparison, fixation of price, cost control and cost reduction and in seeking tax relief or protection from Government. For better perception and judgment of performance of individual units/undertakings by a comparative study, the performance/achievement must be expressed in the same denomination so that like is compared with like.

2009 - June [8] Write a short note on the following:

(c) Profit Centre;

(5 marks)

Answer :

Profit Centre : A centre whose performance is measured in terms of both, the expenses it incurs and revenue it earns is called as profit center. Thus the profit centre is that segment of the activity of a business with which both the revenues and expenses are identified and profit or loss made by that particular segment of activity is ascertained.

Profit centre is a responsibility centre for which both costs and revenues are accumulated.

As defined by CIMA London, profit centre is “a part of business accountable for costs and revenues” It may be called a Business Unit or Strategic Business Unit. The object of profit centre is to maximize the centre’s profit i.e. difference between revenues and expenses.

2010 - Dec [8] Write short note on the following:

(e) Supply-chain Analysis.

(5 marks)

Answer :

It refers to flow of goods, services and information from the initial sources of materials and services to the delivery of products to customers regardless these are related to same organization or any other organization. Customers expect improved performance from companies through supply chain system. Customers expect that companies should perform all these activities in an efficient manner so as to maintain quality and easy availability of products.

2011 - June [4] (a) Write a brief note on Management Accounting.

(5 marks)

Answer :

Management Accounting : Management accounting is concerned with accounting information which is useful for the management. It is “the presentation of accounting information in such a way as to assist the management in the creation of policy and day to day operation of the undertaking”. It includes the methods and concepts necessary for effective planning, for choosing between alternative business actions and for control through the evaluation and interpretation of performance. It embraces within its fold several subjects and cost accounting is one of them.

2011 - June [5] (b) Write a note on Chargeable Expenses. (5 marks)

Answer :

Chargeable Expenses:

- These are also called direct expenses.
- These expenses are directly charged to product or cost unit.
- These are treated as a part of prime costs.
- They are directly identifiable.
- e.g. Cost of patent rights, hire charges of special plant, experimental costs, Royalty paid in mining, costs of special layouts and designs, etc.

2011 - June [8] Write short notes on the following :

(a) Profit Centre, (5 marks)

(c) Cost Control and Cost Reduction, (5 marks)

Answer :

(a) *Please refer 2009 - June [8] (c) on page no.28*

Answer :

(c) Cost Control & Cost Reduction : Cost control and cost reduction are two different concepts. Cost control has the objective to achieve cost targets while cost reduction is directed to explore the possibility of improving the targets themselves.

Cost reduction is a continuous process and has no visible end while cost control ends when targets are achieved.

- Cost control aims at maintaining the costs in accordance with established standards.
- Cost control seeks to attain lowest possible cost under existing conditions.
- Cost control is a preventive function.
- Cost reduction is concerned with reducing costs.
- Cost reduction recognizes no condition as permanent ,since a change will result in a lower cost.
- Cost reduction is a corrective function.

2012 - June [8] Write short notes on the following :

(a) Absorption Costing;

(b) Cost Control and Cost Reduction; (5 marks each)

Answer :

(a) Absorption Costing :

This is total cost technique under which total cost is charged as production cost. Under absorption costing, all manufacturing costs are 'absorbed' in the cost of production. In this system, fixed factory overheads are absorbed on the basis of a predetermined overhead rate based on normal capacity. Under/over absorption overheads are adjusted before computing profit for a particular period. Closing stock is also valued at total cost which includes fixed factory overheads (and sometimes administration overhead also).

Limitations of Absorption Costing :

- (i) A portion of fixed cost is carried over to the subsequent accounting period as part of closing stock. This is an unsound practice because costs pertaining to a period should not be allowed to be vitiated by the inclusion of costs pertaining to the previous period and vice versa.
- (ii) Absorption costing is dependent on the levels of output which may vary from period to period, and consequently cost per unit changes due to the existence of fixed overhead. Unless fixed overhead rate is based on normal capacity, such changed costs are not helpful for the purposes of comparison and control.

Answer :

(b) Please refer 2011 - June [8] (c) on page no.29

DISTINGUISH BETWEEN

2009 - Dec [5] (a) Distinguish between Cost control and Cost reduction.

(5 marks)

Answer :

Difference between Cost Control and Cost Reduction can be summarized in the following table:

Cost control	Cost reduction
1. The word 'control' indicates an exercise in restraint. When	1. Cost reduction involves target of cost reduction. It believes in the

<p>expenses are controlled, they are restrained from growing larger than they should grow. Cost control is cost management. It is meeting the budgeted targets set.</p> <ol style="list-style-type: none"> 2. It is an organized and intentional effort to limit the growth of cost within limits. 3. It is a reactive measure to stem cost growth to stay within budget. It is an effort to limit the growth of cost. 4. In business practices, Cost control is a much better plan of action. It involves creation of responsibility centres with clearly defined authorities and responsibilities. 5. Motivating and encouraging employees to accomplish budgetary goals is one of the essential aspects of cost control. 	<p>premise that there is always scope for further improvement. There is a concern for reducing the expenses that are too high.</p> <ol style="list-style-type: none"> 2. It is an organized and intentional one time or continuous initiative taken with the goal to reduce cost from current level to a lower level. 3. It is a proactive effort to actually reduce costs from baseline. 4. It is an initiative taken with the goal to reduce costs from the current level to a desired lower level on a permanent basis. It is a reaction to a problem. 5. The goal of cost reduction can be achieved in two ways. First-reduce the cost/unit and second-increase productivity. Reducing wastages, improving efficiency, searching for alternatives, etc., can effect cost reduction.
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DESCRIPTIVE QUESTIONS

2008 - Dec [4] (a) "Costs may be classified in a variety of ways according to their nature and the information needs of the management" - Explain.
(5 marks)

Answer :

Cost classification is the process of grouping costs according to their characteristics. Costs are classified or grouped according to their common characteristics. Costs may be classified according to elements, according to functions or operations, according to their behaviour, according to controllability or according to normality.

The breakup of the aggregate costs into relevant types, is an essential pre-requisite of decision making as well as of controlling costs. Classification of costs on different basis is thus necessary for various purposes. For the purpose of decision-making and control, costs are distinguished on the basis of their relevance to different type of decisions and control functions. 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. This is so because direct costs are controllable at the operational level whereas indirect costs are not amenable to such control.

2010 - June [3] (a) What is meant by 'Relevant Cost'? Explain with the help of illustration. (5 marks)

Answer :

Relevant costs are those costs which are appropriate to a specific management decision. These are represented by future cash flows whose magnitude will vary depending upon the outcome of the management decision made.

- (a) **Relevant costs are the future costs:** A decision is about the future; it cannot alter what has been done already. A cost that has been incurred in the past is totally irrelevant to any decision that is being made now. Costs that have been incurred include not only costs that have already been paid, but also costs that are subject of legally binding contracts.
- (b) **Relevant costs are cash flows:** Only cash flow information is required. This means that costs or charges which do not reflect additional costs, should be ignored for the purpose of decision-making.
- (c) **Relevant costs are incremental costs:** Only costs which will differ under some or all the available opportunities should be considered.

Illustration: For example, if an employee is expected to have no other

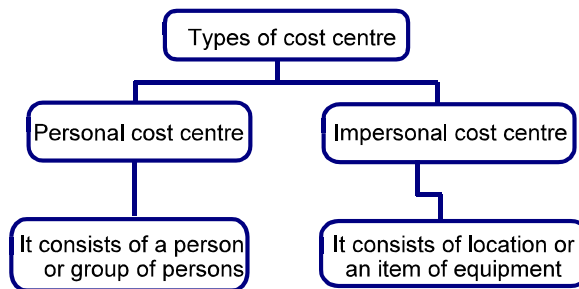
work to do during next week, but will be paid his basic wages (of, say ₹1,000 per week) for attending work and doing nothing. His manager might decide to give him a job which earns only ₹ 400 and it will be incurred anyway whether the employee is given work or not.

2010 - Dec [2] (b) Explain 'Cost Centre' and 'Cost Unit'. (5 marks)

Answer :

Cost centre

- (a) It is defined as "a location, person or an item of equipment (or group of these) for which cost may be ascertained."
- (b) A cost centre is the smallest organizational sub-unit for which separate cost allocation can be done.
- (c) It is used for controlling costs.



Cost unit

It is an unit of production, service time or a combination of these, in relation to which costs may be ascertained or expressed. A cost unit is an unit of product or unit of service to which costs are ascertained by means of allocation, apportionment and absorption.

Industry or Product

Construction
Nuts & bolts
Power
Chemicals
Transport

Cost unit

each contract
gross
KWH
litre, Gallon, Kg, etc.
passenger-Km, etc.

10.22

■ *Solved Scanner* CMA Inter Gr. II Paper 10 A (New Syllabus)

2015 - Dec [1] Answer the question:

(c) Narrate any two practical difficulties in installing a costing system.

(2 marks)

Answer:

Practical difficulties in installing a costing system:

(a) **Lack of support from top management:**

In most cases, cost accounting system is introduced without the support of the top management in all the functional areas. Even the Managing Director or chairman often introduces the costing system without consulting the departmental heads. The departmental managers treat this as interference in their work. Thus, it creates a fear in the minds of the departmental managers.

(b) **Resistance from the existing staff:**

Whenever a new system is introduced, resistance is natural as the existing staff may feel that they would lose their importance and may feel insecure of their position in the organization.

2016 - June [7] (b) Narrate the accounting treatment of scrap. (4 marks)

PRACTICAL QUESTIONS

2016 - June [1] (g) A company has 1,000 units of obsolete items which are carried in inventory at the original purchase price of ₹ 36,000 although their market value as scrap is only ₹ 4,000. If the items are re-worked for ₹ 12,000, they can be sold for ₹ 22,000. Find the relevant cost for selling the items. (2 marks)

Repeatedly Asked Questions		
No.	Question	Frequency
1	Write short notes on Profit Centre, 09 - June [8] (c), 11 - June [8] (a)	2 Times
2	Write short notes on the Cost Control and Cost Reduction 11 - June [8] (c), 12 - June [8] (b)	2 Times