

# Chapter 1

## Basic Cost Concepts

### CHAPTER OVERVIEW

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## 1.1 Basics

### 1.1.1 Definitions of “Cost”, “Value” and “Price”

1. **Meaning of Cost:**

- (a) **Cost** refers to the expenditure incurred in producing a product or in rendering a service. [Cost = Expenditure (actual or notional) incurred on or attributable to a specified article, product or activity.]
- (b) **Cost** is a measurement, in monetary terms, of the amount of resources used for the purpose of production of goods or rendering services.
- (c) Cost is expressed from the Producer or Manufacturer’s viewpoint, (i.e. not that of Consumer/ end user).
- (d) Cost ascertainment is based on uniform principles and techniques.

2. **Comparative Analysis between Value, Price and Cost:**

Particulars	Value	Price	Cost
(a) <b>Meaning</b>	Relative Worth of a commodity to an individual at a particular point of time.	Amount paid by consumer in exchange for a product / service.	Expenditure incurred in producing a product or in rendering a service.
(b) <b>Ascertainment</b>	User’s viewpoint.	Consumer’s viewpoint.	Producer’s viewpoint.
(c) <b>Differentiation / Subjectivity</b>	Different persons attach different values to a product at different points of time.	Price differentiation / discrimination is possible on customer / time basis.	Ascertained on the basis of uniform principles. Hence it is objectively determined.
(d) <b>Inference</b>	<b>Opinion</b>	<b>Policy</b>	<b>Fact</b>

### 1.1.2 “Costing”, “Cost Accounting” and “Cost Accountancy”

1. **Costing:** The technique and process of ascertaining costs.
2. **Cost Accounting:** The process of accounting for cost which begins with recording of income and expenditure or the bases on which they are calculated and ends with the preparation of periodical statements and reports for ascertaining and controlling costs.

- Cost Accountancy:** The application of costing and cost accounting principles, methods and techniques to the science, art and practice of cost control and the ascertainment of profitability. It includes the presentation of information derived therefrom for the purpose of managerial decision-making.

### 1.1.3 Objectives of Cost Accounting

The **primary** objective of study of cost is to **contribute to profitability** through Cost Control and Cost Reduction. The following objectives of Cost Accounting can be identified –

- Ascertainment of Cost:** This involves collection of cost information, by recording them under suitable heads of account, and reporting such information on a periodical basis.
- Determination of Selling Price:** Selling Prices are influenced by internal and external factors. However, generally, prices cannot be fixed below cost. Hence, Cost Accounting is required for determination of appropriate Selling Prices.
- Ascertaining the profit of each activity:** Profit of each department / activity / product can be determined by comparing its revenue with appropriate cost. So, Cost Accounting ensures profit measurement on an objective basis.
- Assisting Management in decision-making:** Business decisions are taken after analysing cost and benefits of each option, and the Manager chooses the least cost option. Thus, Cost Accounting and reporting system assists Managers in their decision-making process.
- Cost Control and Cost Reduction:** In the long run, higher profits can be achieved only through Cost Control and Cost Reduction. Cost Accounting seeks to ensure profit by providing support for cost control / reduction decisions.

### 1.1.4 Cost Reduction vs Cost Control

Particulars	Cost Reduction	Cost Control
1. <b>Concept and Process</b>	Cost Reduction involves – (a) Analysis of each activity into Value-Added and Non-Value Added Components, (b) Simplification of Value-Added Activities, (c) Elimination of Non-Value-Added Activities, (d) Continuous Study for better way of doing things.	Cost Control involves – (a) Determination of Pre-Determined Standards or Results, (b) Measurement of Actual Performance, (c) Comparison of Actuals with Standards, (d) Analysis of Variances and Action.
2. <b>Permanence</b>	Permanent, Real and genuine savings in cost.	Could be a temporary saving also.
3. <b>Saving Focus</b>	Saving in Cost per unit.	Saving either in Total Cost or Cost per unit.
4. <b>Product Quality</b>	Product's Utility, Quality & Characteristics are retained.	Quality Maintenance is not a guarantee.
5. <b>Performance Evaluation</b>	It is not concerned with maintenance of performance according to standards.	The process involves setting up a target, investigating variances and taking remedial measures to correct them.
6. <b>Nature of Standards</b>	Continuous process of critical examination, includes analysis and challenge of standards.	Control is achieved through compliance with standards. Standards by themselves are not examined.
7. <b>Dynamism</b>	Fully dynamic approach.	Less dynamic than Cost Reduction.
8. <b>Target Achievement</b>	There is no end for Cost Reduction, it is an ongoing and continuous activity.	Cost Control ends when the relevant control points / targets are achieved.
9. <b>Coverage</b>	Universally applicable to all areas of business. Does not depend upon standards, though target amounts may be set.	Limited applicability to those items of cost for which standards can be set.
10. <b>Nature of Costs</b>	Emphasis here is partly on present costs and largely on future costs.	Emphasis on present and past behaviour of costs.
11. <b>Analysis</b>	To find out substitute ways and new means.	Competitive analysis of actual results with established norms.
12. <b>Nature of Function</b>	Corrective Action – operates even when efficient cost control systems exist. There is room for reduction in the achieved costs.	Preventive Function – costs are optimized before they are incurred.
13. <b>Tools and Techniques</b>	(a) Value Engineering, (b) Standardisation and Simplification, (c) Work Study, (d) Variety Reduction, (e) Quality Measurement & Research, (f) Operations Research, (g) Market Research, (h) Job Evaluation and Merit Rating, (i) Improvement in Product Design, (j) Mechanisation and Automation, etc.	Budgetary Control and Standard Costing.

### 1.1.5 Scope of Cost Accounting

The scope of Cost Accounting, involves the following activities / aspects –

1. **Costing**, i.e. ascertaining costs. According to CIMA, an Entity's costing system is the foundation of the internal financial information system for Managers. It provides the information that management needs to plan and control the Entity's activities and to make decisions about the future.
2. **Cost Accounting**, i.e. accounting for costs from two viewpoints, viz. – (a) Management's internal information needs, and (b) legal compliance when Companies (Cost Accounting Records) Rules apply to such Company,
3. **Cost Analysis**, i.e. (a) product-wise and location-wise cost analysis, (b) factor-wise cost analysis, etc.
4. **Cost Comparison**, i.e. (a) Budget vs Actual Comparison, (b) Evaluation of different courses of action, e.g. Cost of Make vs Cost of Buying, etc.
5. **Cost Control**, i.e. identifying ways and means of reducing and controlling costs, both short run and long run.
6. **Cost Reports**, for planning and control, performance appraisal and managerial decision-making, and also
7. **Cost Compliance**, i.e. Statutory Compliance with Companies (Cost Accounting Records) Rules, if applicable.
8. **Cost Management**, i.e. application of management accounting concepts, methods of collections, analysis and presentation of data to provide the information needed to plan, monitor, and control costs.

### 1.1.6 Importance of Cost Accounting to Business Concerns

Cost Accounting information and reports helps management of Business Enterprises in the following areas –

1. **Decision Making:** Business decision-making requires analysis of statements indicating the likely effect of various cost control and revenue generation measures on the profits. Cost Accounting Department can draw up Profitability Statements based on **Sensitivity Analysis**, which will aid business decision-making.
2. **Cost Control / Reduction:** Cost Accounting provides Management with valuable information to **control / reduce costs**. For example, Material Costs may be controlled / reduced by – (a) ensuring un-interrupted supply of material and spares for production, (b) avoiding excessive locking up of funds / capital in stocks of materials and stores, and (c) use of techniques like Value Analysis, Standardization, etc. Similarly, Labour Cost can be controlled/ reduced by monitoring over idle time, workers' efficiency and Labour Turnover Rates.
3. **Budgeting:** Budget Estimates (in both quantities and values) are drawn up by Cost Accounting Department, before the start of each activity, to ensure that a practicable course of action is identified, and the actual performance corresponds with the estimated or budgeted performance.
4. **Measuring Efficiency:** For measuring efficiency, Cost Accounting Department can provide information about standards and actual performance of the concerned activity.
5. **Price Determination:** Cost Accounting provides valuable information, which enables Management to fix appropriate selling prices for different items of products and services, in varying circumstances.
6. **Curtailement of Loss during off-season:** Cost Accounting can also provide information, which may enable reduction of OH, by utilizing idle capacity during the off-season or by lengthening the season.
7. **Expansion:** Cost Accounting may provide estimates of production of various levels of activity, based on which Management may be able to formulate its approach to expansion.

### 1.1.7 Cost Accounting vs Financial Accounting

The broad areas of difference between Financial and Cost Accounting are –

Particulars	Financial Accounting	Cost Accounting
1. <b>Users of Information</b>	Financial Statements are used by internal management and also outside parties like Government, Creditors, Customers, Employees, etc.	Detailed cost information is presented to internal management for proper planning, decision-making and cost control.
2. <b>Statutory Compliance</b>	Requirements of Statutes like Companies Act, Income Tax Act, etc. are met through Financial Accounting.	Generally Cost Accounting is voluntary, except in cases where Cost Accounting Records Rules mandatorily apply to the enterprise.
3. <b>Nature / Objectivity</b>	Transactions are recorded in a subjective manner. Accounting Policies may differ from one Firm to another Firm.	Expenditure is recorded in an objective manner. Costing principles and techniques are generally uniform to all Firms.
4. <b>Focus</b>	Focus of accounting is on recording the transactions.	Focus of accounting is to control cost.
5. <b>Nature of Costs</b>	Generally Historical Costs are used for recording purposes. Projected Financial Statements may also be drawn for budgeting purposes.	It considers both historical costs and pre-determined Costs. It also extends to plans and policies to improve future performance.

Particulars	Financial Accounting	Cost Accounting
6. <b>Stock Value</b>	Stocks are valued at Cost or NRV whichever is less.	Stocks are valued generally at Cost.
7. <b>Cost Analysis</b>	Cost / Expenditure and Profits are generally shown as a whole for the period.	Costs are analysed product-wise, department-wise, activity-wise, etc.
8. <b>Time Period</b>	Financial Statements are generally prepared at the end of the financial period, usually one year, for reporting purposes.	Cost data and reports are presented on a continuous basis for the Cost Period. The cost period (also called Control Period) may be shorter than the financial year.
9. <b>Forecasting &amp; Planning</b>	Has limited use for forecasting and planning. Only broad parameters like GP, NP, ROI, EPS, etc. can be laid down.	Specific and detailed plan for each product / activity / sub-level can be laid down. Hence, more useful for budgeting.
10. <b>Utility for decisions</b>	Helps only for <b>future decisions</b> with respect to product pricing, make or buy, asset retainment vs replacement, etc.	Helps <b>current &amp; future decisions</b> , e.g. product price reduction and higher volume to earn target profit, resource re-allocation, etc.
11. <b>Control and Assessment</b>	Financial Accounting suffers from limitations of lack of analysis of information, and absence of detailed control and assessment parameters.	Better tools of control, analysis and assessment are available. Some examples are Variance Analysis, Budgetary Control, & Marginal Costing.

**Note:** Cost Accounting supplements Financial Accounting for analysis and decision-making purposes, as described above.

### 1.1.8 Cost Accounting vs Management Accounting

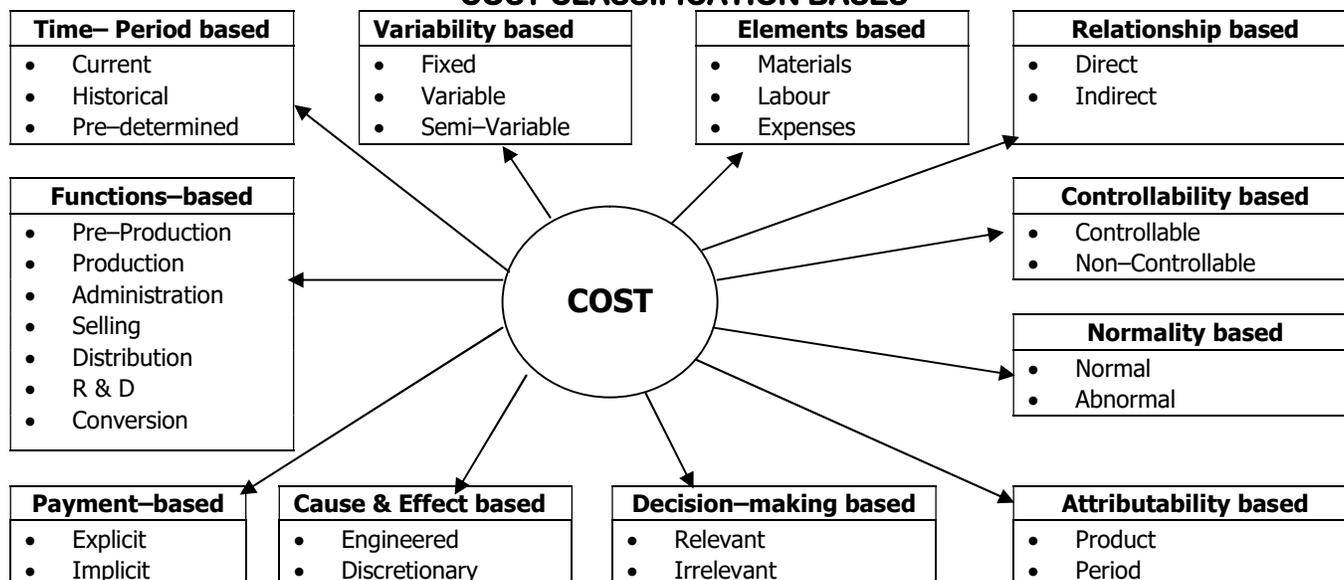
The broad areas of difference between Management Accounting and Cost Accounting are –

Particulars	Management Accounting	Cost Accounting
1. <b>Meaning</b>	Application of the principles of Accounting and Financial Management, to create, protect, preserve and increase value of the Stakeholders of For-Profit and Not-For-Profit Entities in public & private Sector.	Process of accounting for cost, beginning with recording of income and expenditure and ending with preparation of periodical statements and reports for controlling costs.
2. <b>Origin / Development</b>	Management Accounting has developed as a separate area due to the needs of the modern business enterprises, in all industries / services / sectors.	Development of Cost Accounting is related to industrial revolution in manufacturing sector. New Cost Management Techniques have been developed in due course for all Sectors.
3. <b>Objective</b>	To provide relevant information for the planning and control functions of Management.	To record and ascertain the cost of producing a product or rendering a service.
4. <b>Scope</b>	Covers areas like Financial Accounting, Cost Accounting, Budgeting, Cash Flow Planning, etc.	Restricted to Cost Accounting area only.
5. <b>Primary Activity</b>	Provision of information to Internal Users for decision making.	Accumulation and Allocation of Costs to various Cost Objects.
6. <b>Aspects</b>	Considers both qualitative and quantitative aspects.	Records only quantitative aspects.
7. <b>Nature of Data</b>	Uses past figures for the purposes of projecting into the future. External Data is also considered.	Primarily considers internal data, and both past and present figures.
8. <b>Regulations</b>	Not covered by any specific Rules and Regulations.	Cost Accounting Standards and Rules apply.

**Common Points:** Points applicable for both Cost and Management Accounting are given below –

<b>Role / Objectives</b>	<ol style="list-style-type: none"> <li>To provide relevant information to management for decision making,</li> <li>To assist management for planning, measurement, evaluation and controlling of business activities.</li> <li>To aid in allocation of cost of Products and Inventories for both external and internal Users.</li> </ol>
<b>Functions</b>	<ol style="list-style-type: none"> <li>Collection and Accumulation of Cost for each element of cost.</li> <li>Assigning the Costs to Cost Objects to ascertain cost.</li> <li>Controlling Costs through – (a) establishing Budgets and Standards for a particular period or activity, (b) comparison with the actual assigned/ascertained cost, (c) analysis &amp; reporting of deviations, if any.</li> <li>Establishing a MIS Management Information System (MIS) to provide relevant and timely information related to both internal and external to the Firm, to enable management decision-making on all aspects relating to business operations.</li> <li>Evaluating Responsibility Centres, by – (a) gathering data like time taken, wastages, process idleness, etc. (b) analysing the data, (c) preparing reports for necessary actions.</li> </ol>

### COST CLASSIFICATION BASES



#### 1.1.9 Cost Classification based on Time Period

Based on Time Period, Cost can be classified as under –

1. **Current Costs**, i.e. Costs relating to the present period.
2. **Historical Costs**, i.e. Actual Costs of acquiring assets or producing goods or services. They are 'post-mortem' costs ascertained after they have been incurred and they represent the cost of actual operational performance.
3. **Pre–determined Costs**, i.e. Costs for a product computed in advance of production, on the basis of a specification of all the factors affecting cost and cost data. Pre–Determined Costs may be either Standard or Estimated.
  - (a) **Standard Costs** are pre–determined norms applied as a scale of reference for assessing actual cost, whether these are more or less. Standard Cost serves as a basis of cost control and as a measure of productive efficiency when ultimately compared with an Actual Cost. It provides Management with a medium by which the effectiveness of current results is measured, and responsibility for deviation is identified.
  - (b) **Estimated Costs** of a product are prepared in advance prior to the performance of operations or even before the acceptance of sale orders. These are prospective costs or predicted costs.

#### 1.1.10 Cost Classification based on Behaviour / Nature / Variability

On the basis of Behaviour / Nature / Variability, Costs are classified as under –

	Type and Description	Examples
1.	<b>Fixed Cost</b> is the cost which does not vary with the change in the volume of activity in the short–run. These costs are not affected by temporary fluctuation in activity of an enterprise. These are also known as <b>Period Costs</b> .	Salaries, Rent, Insurance, Audit Fees, Depreciation, etc.
2.	<b>Variable Cost</b> is the cost of elements which tends to directly vary with the volume of activity. Variable Cost has two parts – (a) Variable Direct Cost, and (b) Variable Indirect Costs. Variable Indirect Costs are termed as Variable Overhead.	Materials Consumed, Direct Labour, Sales Commission, Royalties, Freight, Packing, etc.
3.	<b>Semi Variable Costs</b> contain both fixed and variable elements. They are partly affected by fluctuation in the level of activity.	Repairs and Maintenance, Power, Water, Telephone, Lighting, etc.

#### 1.1.11 Committed Fixed Costs vs Discretionary Fixed Costs

Particulars	Committed Fixed Costs	Discretionary Fixed Costs
1. <b>Meaning</b>	These are Fixed Costs that arise from the possession of – <ul style="list-style-type: none"> <li>• Assets, i.e. Plant, Building and Equipment (e.g. Depreciation, Rent, Taxes, Insurance Premium etc.) or</li> <li>• A basic organisation (e.g. Salaries of Staff)</li> </ul>	<ul style="list-style-type: none"> <li>• These are Fixed Costs incurred as a result of Management's discretion / decision.</li> <li>• It arises from periodic (usually yearly) decisions regarding the maximum outlay to be incurred. (e.g. Advertising)</li> </ul>