B.com 4th Semester
Cost Accounting

Q:- Explain Direct cost and Indirect cost.

Ans:- I. **Direct Cost -** Those costs which are directly identifiable and has direct relation with the finished product are called direct cost.

- Change of output has direct impact on these costs and are varied according to variation in the number of units of finished product produced.
- These costs forms part of the prime cost of the product.
- E.g. Direct material cost, direct labour cost, direct expenses(Royalty on production) etc.

II. **Indirect Cost**

- Those costs which cannot be directly identifiable and allocable in relation to a particular product are called indirect costs or in other words these are called Overhead.
- Overheads may be in factory, administration, selling department or Distribution department.
- E.g. Electricity of office , Telephone bill, Salary of office staff.

Q:-Explain Responsibility Centre, cost centre, investment centre and profit centre .

Ans:- **Responsibility centre:-** It is an activity centre of a business organization entrusted with a special task. It is a unit of function of a business organization headed by an executive responsible for its performance.Responsibilities centre are of three types.

(i) Cost Centre /Cost Object - It can be defined as, 'a production or service, function, activity or item of equipment whose costs may be attributed to cost units. In simple words, a cost center is nothing but a location, person or item of equipment for which cost may be ascertained and used for the purpose of cost control. A cost center is the smallest organizational sub unit for which separate cost allocation is attempted'.

- **Personal Cost Centre** - A personal cost centre consists of a person or a group of persons.
- **Impersonal cost centre** – It is one which consists of a department, plant, or item of equipment.

(ii) Profit Centre :- Profit Center is defined as, 'a segment of the business entity by which both revenues are received and expenses are incurred or controlled'. Such revenues and expenditure are being used to evaluate segmental performance as well as managerial performance.

(iii)Investment Centre :- Those centre which are responsible for earning adequate return on investment.

Q.:- Explain different types of costs

Ans:- **(1) Classification according to elements:-**

a) Material Cost:- It is the cost of material of any nature used for the purpose of production of a product of a service. It includes cost of procurement , freight inwards, taxes and duties, insurance, etc, directly attributable to the acquisition. Trade discounts rebates , duty drawbacks, sales tax are deducted .

b) Labour Cost:- Means the payment made to the employees, permanent or temporary for their services. Includes salaries and wages paid to employees. Salaries and wages include all fringe benefits like PF contribution, Gratuity, ESI, Overtime, Incentive, Bonus, Ex-Gratia, leave encashment , wages for holidays and idle time. Etc.

c) Expenses:- Expenses are other than material cost and labour cost, which are involved in an activity. Expenditure on account of utilities, payment for bought out services, job processing charges etc. can be termed as expenses.

(2) Classification according to nature :-

a) Direct costs are the costs which are identifiable with the product unit or cost center.

b) Indirect costs are not identifiable with the product unit or cost center and hence they are to be allocated, apportioned and then absorb in the production units.

(3) Classification according to behavior

a) Fixed Costs :-Out of the total costs, some costs remain fixed irrespective of changes in the production volume. These costs are called as fixed costs. The feature of these costs is that the total costs remain same while per unit fixed cost is always variable. Fixed Costs are further divided into Committed Fixed costs and Discretionary fixed cost:

- Committed Fixed Costs are incurred to maintain certain facilities and cannot be quickly eliminated. The management has little or no discretion in this cost e.g . rent,insurance etc.
- Discretionary Fixed Costs are not related to the operations and can be controlled by the management. These costs result from special policy decisions , new researches etc. and can be eliminated or reduced to a desirable level at the discretion of the management.

b) Variable Costs :- These costs are variable in nature, i.e. they change according to the volume of production. Their variability is in the same proportion to the production. Variable cost per unit remain same but in totality they vary according to the quantity of production.

c) Semi-variable Costs :- Certain costs are partly fixed and partly variable. These costs are neither totally fixed nor totally variable. Maintenance costs, supervisory costs etc are examples of semi-variable costs. These costs are also called as 'stepped costs'.

(4) Classification according to functions :-

i. Production Costs:-All costs incurred for production of goods are known as production costs.

ii. Administrative Costs:- Costs incurred for administration are known as administrative costs. Examples of these costs are office salaries, printing and stationery, office telephone, office rent, office insurance etc.

iii. Selling and Distribution Costs :-All costs incurred for procuring an order are called as selling costs while all costs incurred for execution of order are distribution costs. Market research expenses, advertising, sales staff salary, sales promotion expenses are some of the examples of selling costs. Transportation expenses incurred on sales, warehouse rent etc are examples of distribution costs.

iv. Research Costs :- Cost of development of new product and manufacturing process, improvement of existing products, process and equipment, finding new uses for known products, solving technical problems arising in manufacture and application of products, etc.

v. Development costs:- The cost of the process which begins with the implementation of the decision to produce a new or improved product or to employ a new or improved method and ends with commencement of the production of that product or by that method.

vi. Pre-Production Costs:- The part of development cost incurred in making a trial production run prior to formal production.

vii. Conversion cost:- The total of Direct wages, direct expenses and production overhead , cost of converting raw-material into finished goods.

(5) Classification according to association with product

a) Product cost :- Product costs are those which are traceable to the product and included in inventory values. In a manufacturing concern it comprises the cost of direct materials, direct labour and manufacturing overheads. Product cost is a full factory cost. Product costs are used for valuing inventories which are shown in the balance sheet as asset till they are sold. The product cost of goods sold is transferred to the cost of goods sold account.

b) Period Cost:-Period costs are incurred on the basis of time such as rent , salaries etc include many selling and administrative costs essential to keep the business running. Though they are necessary to generate revenue, they are not associated with production, therefore , they cannot be assigned to a product. They are charges to the period in which they are incurred and are treated as expenses

(6) Classification according to time :-

a) Historical Costs :-These are the costs which are incurred in the past, i.e. in the past year, past month or even in the last week or yesterday. The historical costs are ascertained after the period is over. In other words it becomes a post-mortem analysis of what has happened in the past. Though historical costs have limited importance, still they can be effectively used for predicting the future costs.

b) Predetermined Cost:-These costs relating to the product are 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. Standard Cost is a predetermined calculation of how much cost should be under specific working conditions. It is based on technical studies regarding material, labor and expenses. The main purpose of standard cost is to have some kind of benchmark for comparing the actual performance with the standards. On the other hand, estimated costs are predetermined costs based on past performance and adjusted to the anticipated changes. It can be used in any business situation or decision making which does not require accurate cost.

(7) Classification of Costs for Management decision making :-One of the important function of cost accounting is to present information to the Management for the purpose of decision making. For decision making certain types of costs are relevant.

i. Relevant Cost :- The relevant cost is a cost which is relevant in various decisions of management.Decision making involves consideration of several alternative courses of action. In this process, whatever costs are relevant are to be taken into consideration. In other words, costs which are going to be affected matter the most and these costs are called as relevant costs. Relevant cost is a future cost which is different for different alternatives. It can also be defi ned as any cost which is affected by the decision on hand. Thus in decision making relevant costs play a vital role.

a. Marginal Cost :- Marginal cost is the change in the aggregate costs due to change in the volume of output by one unit.

b. Differential Costs(Incremental Costs) :- Differential costs are also known as incremental cost. This cost is the difference in total cost that will arise from the selection of one alternative to the other. In other words, it is an added cost of a change in the level of activity. This type of analysis is useful for taking various decisions like

- change in the level of activity,
- adding or dropping a product,
- change in product mix, make or buy decisions,
- accepting an export offer and so on.

c. Opportunity Costs :- It is the value of benefit sacrificed in favor of an alternative course of action. It is the maximum amount that could be obtained at any given point of time if a resource was sold or put to the most valuable alternative use that would be practicable. Opportunity cost of goods or services is measured in terms of revenue which could have been earned by employing that goods or services in some other alternative uses.

d. Replacement Cost:- This is the cost at which existing items of material or fixed assets can be replaced. It is the cost of replacing existing assets at present or at a future date.

e. Imputed Costs(Notional costs):-Some costs are not incurred and are useful while taking decision pertaining to a particular situation. These costs are known as imputed or notional costs and they don’t enter into accounting system. E.g. Owners salary, Rent of own building engaged in business.

ii. Controllable Costs and Uncontrollable cost:-

- Controllable costs:- These are the costs which can be influenced and controlled by managerial action.
- Noncontrollable cost:- These are costs that cannot be influenced and controlled by a specific member of the organization.

Controllability of costs is subject to the following factors

a) Time:- Certain costs are controllable in long run and not in the short run.

b) Location:- Certain costs are not influenced and decided at a particular location/cost centre. For example, if rent agreement of all factory premises are executed centreally at the Head office , factory managers cannot control the incurrence the rent cost.

c) Product:- Certain costs are controllable by reference to one product or market segment and not by reference to the other. For example, some products require more advertising and sales promotion efforts than other products.

iii. Shutdown Cost :- These costs are the costs which are incurred if the operations are shut down and they will disappear if the operations are continued. Examples of these costs are costs of sheltering the plant and machinery and construction of sheds for storing exposed property. Computation of shutdown costs is extremely important for taking a decision of continuing or shutting down operations.

iv. Capacity Cost :-These costs are normally fixed costs. The cost incurred by a company for providing production, administration and selling and distribution capabilities in order to perform various functions. Capacity costs include the costs of plant, machinery and building for production, warehouses and vehicles for distribution and key personnel for administration. These costs are in the nature of long-term costs and are incurred as a result of planning decisions.

v. Sunk costs:- A Sunk Cost is one that has already been incurred and cannot be avoided by decisions taken in the future. As it refers to past costs, it is unavoidable cost. It can be defined as “ an expenditure for equipment productive resources which has no economic relevance to the present decision making process”. This cost is not useful for decision making as all past costs are irrelevant

vi. Urgent Costs :- These costs are those which must be incurred in order to continue operations of the firm. For example, cost of material and labor must be incurred if production is to take place.

vii. Joint Costs:- The processing of a single raw material results in two or more different products simultaneously. The joint products are not identifiable as different types of product until a certain stage of production known as the split off point is reached. Joint costs are cost incurred upto the point of separation. One product may be of major importance and others of minor importance which are called by –products.

viii. Common Costs:-Common Costs are those costs which are incurred for more than one product , job, territory or any other specific costing object. They are not easily related with individual products and hence are generally apportioned.

ix. Out of Pocket costs:- These are costs which entail current or near fufure outlays of cash for the decision at hand. Such costs are relevant for decision making , as these will occur in near future. Out of pocket costs can be avoidable if the particular proposal under consideration is not accepted.

x. Avoidable and Unavoidable cost:-

- Avoidable costs are those cost which under given conditions of performance efficiency should not have been incurred. Cost variances which are controllable may be termed as Avoidable costs.
- Unavoidable costs are inescapable costs which are essentially to be incurred , within the limits provided for it. It is the cost that must be incurred under a programme of business restriction. It is fixed in nature.