

MASTER OF COMMERCE

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BY

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Topics for Discussion: Elements of Cost Accounting, Component of Cost Accounting, Component of Total Cost, Cost Sheet and Installation of Costing System.

1. ELEMENTS OF COST ACCOUNTING

Follows are the basic Elements of Costs:

A. Material

Material is an important ingredient of production. Material is classified in two ways, one is Direct Material and other is Indirect Material.

(i) **Direct Material:** The materials are directly contributed to a product and easily identifiable in the finished product are called **direct materials**. For example, paper in books, wood in furniture, and leather in shoes are direct materials.

(ii) **Indirect Material:** Material which is usually of lower cost items or supporting materials, used in a finished product are called **indirect materials**. For example, the length of thread used in a garment, and buttons used in shirt.

Furthermore, these can be categorized into three different types of inventories in different ways; raw materials, work-in-progress, and finished goods.

B. Labour or Wages

Labour is also one of the important elements of production. Labour is classified in two different ways.

(i) **Direct Labour:** Any wages paid to workers or a group of workers which are directly engaged in the activity of production and directly associate in the conversion of raw material into finished goods are called **direct labour**.

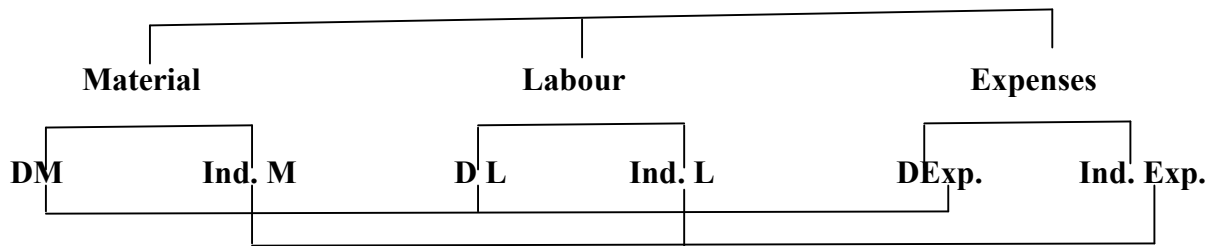
(ii) **Indirect Labour:** Wages paid to trainee or apprentices does not come under the category of direct labour as they have no significant value are called indirect labour.

C. Expenses: Expenses for material and labour are jointly known as expenses. Expenses is divided into two categories; i.e.; direct and indirect expenses.

(i) **Direct Expenses:** Direct expenses are incurred directly on a particular product, Job or cost units. For example, hiring plant or equipment for job, cost of designs and patterns, fees paid to architects, surveyors and consultants, insurance charges on special materials chargeable to a job, etc.

(ii) **Indirect Expenses:** Indirect Expenses are those expenses which cannot be directly charged to cost units are known as indirect expenses. For example, insurance, power, lighting and heating, rent, rates and taxes, depreciation etc.

Elements of Cost



Prime Cost

All direct material, direct labour and direct expenses are called Prime Cost.

All indirect material, indirect labour and indirect expenses are called overheads.

Overheads include factory overhead, office and administration overhead and selling and distribution overhead.

Overheads

OVERHEADS

- Production or works overhead including factory staff
- Administration overhead including office staff
- Sales overhead including production and maintenance of catalogues, advertising, exhibitions, sales staff, cost of money
- Distribution overhead
- Maintenance and repair including office equipment and factory machinery
- Supplies
- Utilities including gas, electric, water, sewer, and municipal assessments
- Other variable expenses
- Salaries/payroll including wages, pensions, and paycheck deductions
- Rent, mortgage, property taxes
- Depreciation (durable goods including machinery and office equipment)
- Other fixed expenses

COMPONENTS OF COST

Components mean part or very important area of a product. In cost accounting cost classification and analysis is done with the view to estimate cost. This classification is also necessary to control the cost. Thus, it can be said that components of cost means expenditure incurred on resources which are helpful in production, for example, material, labour and expenses. Use of these components is done in special meaning and these are again classified into direct and indirect costs.

1. Material

Material means those items which are used for manufacturing of a product. In an industry different types of items are used. These items are called as material.

Thus material cost is the cost of commodities supplied to an undertaking. Material cost can be divided into two parts as follows;

(i) Direct Material Cost: It refers to those materials which become a major part of the finished product and can be easily traceable to the units. Direct material is directly related to production. So, direct material costs can be defined as material costs which can be directly allocated to cost centres or cost units.

Whether a particular material is raw or not is only a relative and not an absolute point for example, cotton is the raw material and cloth is finished product in case of a textile mill, but cloth is raw material for readymade garment manufacturing company. Again it is also not necessary that the material should become a part of the finished product. Thread buttons, nails, gum, mate strips etc. no doubt, become part of a finished product but yet, they are not direct material.

(ii) Indirect Material Cost: All materials which are used as ancillary to production and which cannot be conveniently signed to specific physical units is termed as indirect material e.g., oil, grease, consumable stores etc, According to CIMA London, “Indirect material cost is material cost which cannot be allocated but which can be apportioned to or absorbed by cost centres or cost units.”

2. Wages/Labour

Wages means all payments are made to employees directly or indirectly. It includes overtime wages, bonus, and perquisites, e.g., facility of car, house facility, reimbursement of material bill etc. Labour cost can be divided into two parts as follows:

(i) Direct Labour Cost: It is defined as wages paid to workers who are engaged in production process whose time can be conveniently and economically traceable to units of products, e.g., wages paid to compositors in a printing press etc. It is also known direct wages.

According to CIMA London “Direct wages is that wages which can be allocated to cost centers or cost unit.”

(ii) Indirect Labour Cost: Some workers not involves directly in conversion of product but helps indirectly. Labour is employed for the purpose of carrying tasks incidental to good or service provided. It cannot be practically traced to specific units of output e.g., wages of storekeepers, foreman, timekeepers, supervisors, inspectors but which can be apportioned or absorbed by cost centre or cost units is indirect wages.

3. Expenses: Expenses for material and labour all other expenses are jointly known as expenses, i.e. third component of cost. It includes depreciation on

machinery and other assets, electricity expenses, rent etc. Its also includes national cost or imputed cost i.e. rent of own house, interest on owners capital etc.

According to CIMA London, “Expenses means, the cost of service provided to an undertaking and the national cost of all the use of owned assets.”

Expenses can be divided in the two parts which are as follows:

(i) Direct Expenses: These expenses are incurred on a specific cost with and identifiable with the cost units. According to CIMA London, “Direct expenses means, expenses which can be allocated to cost centres or cost units.” It is also known as chargeable expenses. e.g., hiring of equipment for job, depreciation, repairs of machine etc.

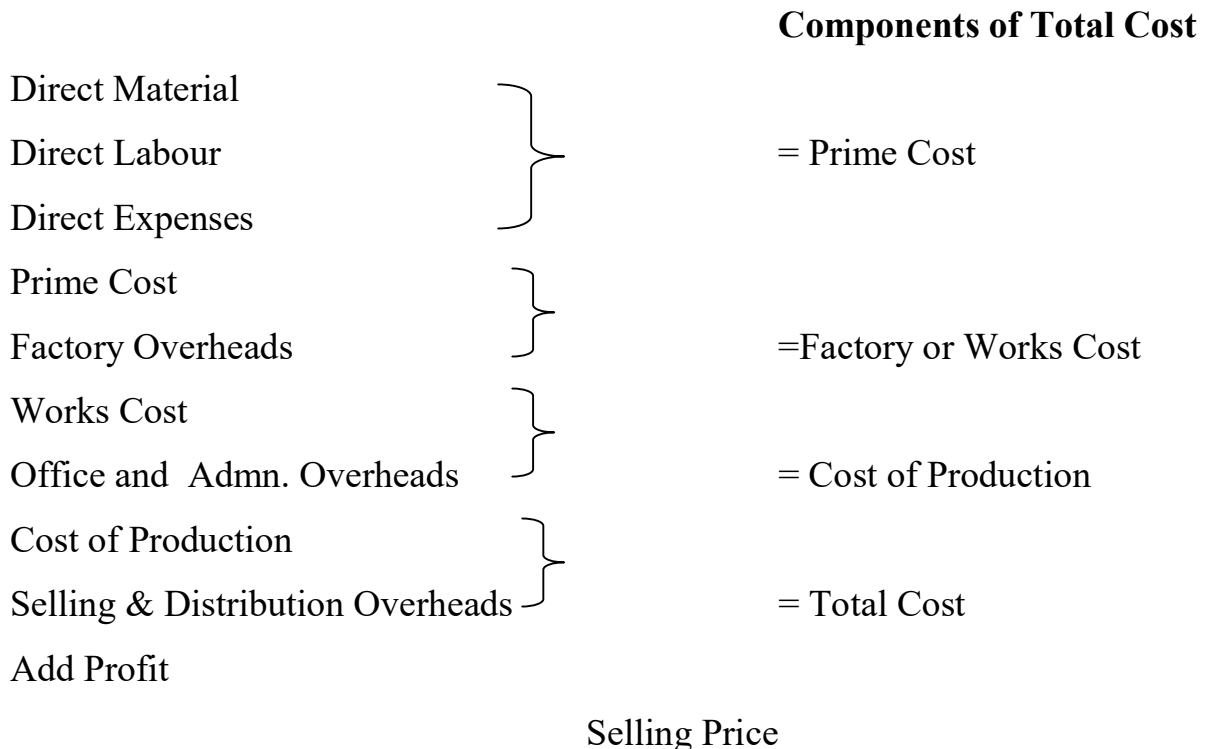
(ii) Indirect Expenses: These are expenses which cannot be directly, conveniently and wholly allocated to cost centre or cost units. According to CIMA London, “Indirect expenses are expenses which cannot be allocated but which can be apportioned to absorb by cost centres or cost units e.g., rent, rates and taxes, insurances, power, lighting and heating, depreciation etc.”

COMPONENTS OF TOTAL COST

- 1. Prime Cost:** It consist costs of direct material, direct labour and direct expenses. It is also known as basic cost.
- 2. Factory Cost:** It comprises of prime cost and in addition, works or factory overheads which include costs of indirect labour and indirect expenses. This cost is also known as works cost, production or manufacturing cost.
- 3. Office Cost:** If office and administration overheads are added to factory cost office cost is arrived at. This is also termed as administration cost or total cost of production.

4. Total Cost: Selling and distribution overheads are added to the total cost of production to get the cost of sales.

The various components of total cost can be depicted through the help of the following chart:



COST SHEET

Cost sheet is an analytical statement of expenses relating to production of an article which informs regarding total cost, per unit cost and quantity of production.

According to **Wheldon**, “*Cost sheets are prepared for the use of management and consequently, they must include all the essential details which will assist the manager in checking the efficiency of production.*”

In the words of **C.I.M.A., London**, “*Cost sheet is a cost schedule or document which provides for the assembly of the estimated detailed cost in respect of a cost centre or cost unit.*”

When cost per unit of production is not necessary to calculate then a statement of cost is prepared to ascertain total cost and profit or loss on production.

Cost Sheet or Statement of Cost
For the year ending.....

Output.....units

Particulars	Total Cost	Cost Per Unit
	Rs.	Rs.
Direct Materials	XXXX	XXXX
Direct Wages	XXXX	XXXX
Direct Expenses	XXXX	XXXX
Prime Cost	XXXX	XXXX
Factory Overhead	XXXX	XXXX
Works Cost	XXXX	XXXX
Office & Admn. Overhead	XXXX	XXXX
Cost of Production	XXXX	XXXX
Selling & Distribution Overhead	XXXX	XXXX
Total Cost	XXXX	XXXX
Profit % on Cost or Selling Cost	XXXX	XXXX
Sales	XXXX	XXXX

Components of Total Cost

Output.....units

Particulars	Total Cost	Cost Per Unit
	Rs.	Rs.
Direct Materials Consumed (Add. Op. Stock + Purchase – Closing Stock)	XXXX	XXXX
Direct Wages	XXXX	XXXX
Direct Expenses	XXXX	XXXX
Prime Cost	XXXX	XXXX
Factory Overhead (Add. Opn. Work in Progress – Closing wip	XXXX	XXXX
Works Cost	XXXX	XXXX
Office & Admn. Overhead Op. Stock of Finished Goods – Closing S f g)	XXXX	XXXX
Cost of Production	XXXX	XXXX
Selling & Distribution Overhead	XXXX	XXXX
Total Cost	XXXX	XXXX
Profit % on Cost or Selling Cost	XXXX	XXXX
Sales	XXXX	XXXX

INSTALLATION OF A COSTING SYSTEM

MAIN STEPS FOR INSTALLATION OF A COSTING SYSTEM

The costing system of an organisation should be carefully planned in order to achieve its objectives. The important steps for the **installation of a costing system** are discussed below:

1. Determination of objectives: The first step is to clearly lay down the objectives of the costing system. If the objective is only to ascertain the cost, a simple system will be sufficient. However, if the objective is to get information for decision making, planning and control, a more elaborate system of costing is necessary.

2. Objectives to be achieved: The objective to be achieved should be very clear so that a thrust is given to that aspect. If the main objective is to expand production then the costing system should give more attention to production aspect, if the emphasis is to improve marketing of products that area should be cared well.

3. Study of the Nature of Business: The nature of the business and other technical should be carefully analysed. Such an analysis is necessary to decide the method of costing to be adopted.

4. Study the Product: The study of the product is very essential. The nature of the product determines the type of costing system to be used. A product requiring high costs on materials will need a costing system giving main emphasis on pricing, storing, issuing and controlling of material cost.

On the other hand, if the product requires high labour cost then efficient system of time-recording and wage payment will be essential and the same will be true of overhead cost too.

5. Study of the Nature of Organisation: The costing system should be designed to meet the requirements of the organisation. Hence, it is necessary to study the nature, size and layout of the organization.

6. Deciding the Structure of Cost Accounts: A suitable costing system can be developed on the basis of the study of the nature of business and organization. The structure of cost accounts should be simple and in accordance with the natural production process.

7. Determination of Cost Rates: This step involves a thorough study of the following points:

- i. Classification of costs into direct and indirect costs.
- ii. Grouping of indirect costs (overheads).
- iii. Methods of pricing issues.
- iv. Treatment of all types wastes.
- v. Absorption of overheads.
- vi. Calculation of overhead rates.

8. Organisation of the Cost Office: The cost office is responsible for the efficient operation of the costing system. The cost office, with adequate staff must be located as close as possible to the factory.

9. Introducing the System: After completion of the above steps, the costing system may be formally introduced.

10. A Follow-up: A follow-up of the system is essential to make it practicable and useful.

Once a problem is faced then efforts should be made to rectify it. The system should be readjusted to make it more useful and efficient.

THE END