SEM 3- MATERIAL SET 1

MANAGEMENT ACCOUNTANCY

SEMESTER 3

CONCEPTS OF COST ACCOUNTANCY , MANAGEMENT ACCOUNTANCY, DIFFERENT TYPES OF COST

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Meaning of cost

Meaning of Cost :

Cost has been defined in the terminology given by the Chartered Institute of Management Accountants (CIMA) as 'the amount of expenditure incurred or attributed on a given thing'. More simply, it can be defined as that which is given or scarified to obtain something. Thus the cost of an article is its purchase or manufacturing price, i.e. it would consist of its direct material cost, direct labour cost, direct and indirect expenses allocated or apportioned to it.

Meaning of Cost Accountancy :

The Chartered Institute of Management Accountants in England (CIMA) has defined Cost Accountancy as 'the application of costing and Cost Accounting principles, methods and techniques to the science, art and practice of cost and the ascertainment of profitability. It includes the presentation of information derived there from for the purpose of management decision-making'. Cost Accountancy is, thus the science, art and the practice of cost accountant.

Cost Accountancy is science because it is the systematic knowledge which a cost accountant should possess so that he may properly discharge his responsibility and functions. Cost Accountancy is also an art because it includes the ability and skill with which a cost accountant becomes able to apply his knowledge to the various problems like ascertainment of costs, control of costs, ascertainment of profitability, replacement of plants and technology, marginal costing, etc.

Cost Accountancy is also practicing the practice of a cost accountant. It includes his continuous efforts in presentation of information for the purpose of managerial decision-making. Cost Accountancy consists of several subjects, such as Cost Accounting, Costing, Cost Control and Cost Audit.

Meaning of Costing :

Costing has been defined by the Institute as, 'the technique and process of ascertaining cost'.

Wheldon defines costing as "Costing is the classifying, recording, and appropriate allocation of expenditure for the determination of the costs of products or services; and for the presentation of suitably arranged data for the purposes of control and guidance of the management. It includes the ascertainment of the cost of every order, job, contract, process, service or unit as may be appropriate. It deals with the cost of production, selling and distribution."

Thus, costing means such an analysis of information as to enable management to know the cost of producing and selling, that is the total cost of various products and services and also to know how the total cost is constituted.

Meaning of Cost Control :

Cost control has been defined as 'the guidance and regulation by executive action of costs of operating on undertaking'. It is primary job of a cost-accountant, besides ascertainment of cost, to furnish different types of statements and information as to enable the management to control the cost of operating their business. Cost control is' exercised through a number of techniques such as Standard Costing and Budgetary Control.

Standard Costing is a system which seeks to control the cost of each unit through determining beforehand what should be the cost and then its comparison with actual cost and also analysis of variances together with their causes. Budgetary Control means laying down in monetary and quantitative terms what exactly has to be done and how exactly it has to be done over a coming period and then to ensure that actual results do not diverge from the planned course more than necessary.

Meaning of Cost Audit :

Cost Audit has been defined by the Institute as 'the verification of cost accounts and a check on the adherence to the cost accounting plan. It is an independent expert examination of the cost accounts of different outputs of an undertaking and a verification whether such accounts of the different output, serve the purpose intended.'

Meaning and Definition of 'Cost Accounting' : **[1993, 1997, 2007, 2013, 2015]**

The Chartered Institute of Management Accountants in England (CIMA) has defined Cost Accounting as, 'the process of accounting for cost from the point at which expenditure is incurred or committed to establishment of its ultimate relationship with cost centres and cost units. In its widest usage, it embraces the preparations of statistical data, the application of cost control methods and the ascertainment of the profitability of activities carried or planned'. It is a formal mechanism by means of which costs of products or services are ascertained and controlled.

It is concerned with accumulation, classification, analysis and interpretation of cost data for three major purposes : (a) ascertainment of cost, (b) operational planning and control, and (c) decision-making.

Objectives of Cost Accounting : **[1997, 2013]**

Important objectives of cost accounting are as follows :

1. Ascertainment of Cost : The primary objectives of the cost accounting is to ascertain cost of each product, process, job, operation or service rendered.

2. Classification of Cost : Cost accounting classifies cost in to different elements such as materials, labourer and expenses. It has further been divided as direct cost and indirect cost for cost control and recording.

3. Control of Cost : Cost accounting aims at controlling cost by setting standards and compared with the actual, the deviation or variation between two is identified and necessary steps are taken to control them.

4. Determination of Selling Prices : Cost accounting guides management in regard to fixation of selling prices of the products. It is also helpful for preparing tender and quotations.

5. Ascertainment of Profitability : Cost accounting determines the profitability of each product, process, job, operation or service rendered. The statement of profit or losses and Balance Sheet also submitted to the management periodically.

6. Formulating Policies : Cost Accounting records supply necessary and adequate information to the management so that the management can frame sound policies on marketing, finance, personnel and the like. For example, the amount of increased profit by introducing a new product is illustrated with the help of cost information.

7. Cost Negotiation : The basic industries may have to face problems of price negotiation with the government authorities. Cost Accounting System provides a basis for such negotiation.

8. Forecasting : The management can forecast the cash position in a particular date with the help of cash budget. Likewise, there is a possibility of forecasting increased or changes in profit with the help of changes in the sales mix or product mix.

9. Planning of Capital Expenditure and Capital Structure : The cost accounting data relating to operating cost, cost behaviour at different levels of activities, rapidity of turnover, working capital requirements and the like are highly useful for proper planning of capital expenditure and capital structure.

10. Facing Depression : Cost reduction and cost control are necessary during depression period. The reason is that the selling price should be a lowest. If not so, the business cannot survive. The lowest selling price is fixed by reducing the necessary expenses, avoiding unnecessary expenses, selecting new product or product mix, searching new sales areas, framing new sales policy, creating cost consciousness, reduce the wastage, diverting to new line of activities and the like. In this way, an organization may face the depression for effective functioning.

11. Planning to Close Down : The last step of an organization is close down the department. A Cost Accountant may recommend the close down a department after studying the trends of various conditions well in advance so that much capital is not lost due to late closing down.

12. Helps to take Make or Buy Decision : The cost accounting records supply the information relating to the expenses incurred for manufacture a product. The cost of such product is compared with the rate at which the same product is available in the open market. If the market rate is low, the Cost Accountant recommends buying the product in the open market. If not so, the same product may be manufactured. In this way, the cost accounting helps the management to take a decision of make or buy a specified product.

Main essentials of a good Cost Accounting System : **[2015]**

Essentials of a good Cost Accounting System are as follows :

1. Simplicity : It must be simple, flexible and adaptable to the changing conditions. And it must be easily understandable to the personnel. The information provided must be in the proper order, in right time and to the right persons so as to be utilized fully.

2. Flexibility and Adaptability : The costing system must be flexible to accommodate the changing conditions and circumstances. The expansion, contraction of changes must be adopted in the existing system with minimum changes.

3. Economy : The costing system must suit the finance available. The expenditure must be less than the benefits derived from the system adopted.

4. Comparability : The management must be able to make comparison of the facts and figures with the past figures, figures of other concerns, or other departments of the same concern.

5. Minimum Changes to the Existing one : When introducing a costing system, it may cause minimum change to the existing set up of the business.

6. Uniformity of Forms : Forms of different colours can be used to distinguish them. Forms must be uniform in size and quality. Form should contain instructions to fill, to use and for disposal.

7. Less Clerical Work : Printed forms will involve less labour to fill in, as the workers may be a little educated. They may not like to spend much time in filling the forms.

8. Efficient Material Control and Wage System : There must be a proper procedure for recording the time spent on different jobs, by workers for the payment of wages. A systematic method of wage system will help in the control of labour cost. Since the cost of material forms a great proportion to the total cost, there must be an efficient system of stores control.

9. A Sound Plan : There must be proper and sound plans to collect, to allocate and to apportion overhead expenses on each job or each product in order to find out the cost accurately.

10. Reconciliation : The systems of costing and financial accounting must be facilitated to reconcile in the easiest manner.

11. Overall Efficiency of Cost Accountant : The work of the cost accountant under a good system of costing must be clearly defined as to his duties and responsibilities to the firm are very essential.

Main functions of a Costing System : **[1994]**

A brief explanation of the functions of cost accounting is presented below :

1. Book-keeping : It involves recording of cost according to pre-arranged or predetermined classification.

2. Cost Control : The cost control is exercised through cost collection, cost analysis, cost presentation and cost interpretation.

3. Cost Analysis : It deals with determination of different relationship between cost and various determinants of costs.

4. Cost Comparison : The cost of alternative products, activities, methods or areas is compared in the field of production or distribution.

5. Cost Planning : It involves the accounting of all costs in the records in a proper manner.

6. Cost Finding : It is the measurement or estimation of different products, departments or other segments of the company's operations.

Importance and Advantages of Cost Accounting :

The importance and advantages of cost accounting are as follows:

1. Helps in controlling cost : cost accounting helps in controlling cost by applying some techniques such as standard costing and budgetary control.

2. Provides necessary cost information : it provides necessary cost information to the management for planning, implements and controlling.

3. Ascertains the total per unit cost of production : it ascertains the total and per unit cost of production of goods and services that helps to fix the selling prices as well.

4. Introduces cost reduction programs : it helps to introduce and implement different cost reduction programs.

5. Discloses the profitable and non profitable activities : it discloses the profitable and non profitable activities that enable management to decide to eliminate or control unprofitable activities and expand or develop the profitable activities.

6. Provides information for the comparison of cost : it provides reliable data and information which enable the comparison of cost between periods, volume of output, determent and processes.

7. Checks the accuracy of financial accounts : it helps checking the accuracy of financial accounts. This is done by preparing cost reconciliation statement.

8. Helps invests and financial institutions : it is also advantageous to investment and financial institutions since it discloses the profitability and financial position in which they intend to invest.

9. Beneficial to workers : it is beneficial to workers as well since it emphasizes the efficient utilization of labour and scientific systems of wages payment.

Limitations of Cost Accounting :

Besides a number of advantages, cost accounting sufferers from a number of limitations. Some of them are mentioned below :

1. Lack of uniformity : cost accounting lacks a uniform procedure. It is possible that two equally competent cost accountants may arrive at different results from the same information. Keeping this limitation in view, all cost accounting results can be as mere estimates.

2. Conceptual diversity : there are a large number of conventions and flexible factors such as classification of cost into its elements, issue materials on average or standards price, apportionment of overhead expenses, arbitrary allocation of joint costs, division of overhead into fixed and various and variable costs, division of cost into normal and abnormal and controllable and non-controllable and adoption of marginal and standard costs due to which it becomes difficult to have exact costs. In which a contacts, the reliable of cost accounting might be low.

3. Costly : there are many formalities which are to be observed by a small and medium size concerned due to which the establishment and running costs are so much that it becomes difficult for their concerned to afford us cost. Thus it can be used only by big concerned.

4. Ignorance of futuristic situation : the contribution of cost accounting for heading futures situation has not been much for example, it is has not evolved so far any tool for heading inflation situation.

5. Lack of double entry systems : under cost accounting. A double entry system is not adopted that does not enable to checks the arithmetic's accuracy of the transaction and locate the errors.

6. Developing stage : cost accounting is to development stage since its principle concepts and conversions are not fully developed.

Meaning and Definitions of Management Accounting : [1994, 1997, 1999, 2011]

Management Accounting is the presentation of accounting information in order to formulate the policies to be adopted by the management and assist its day-to-day activities.

In other words, it helps the management to perform all its functions including planning, organising, staffing, directing and controlling.

According to J. Batty : "Management Accountancy is the term used to describe the accounting methods, systems and techniques which, with special knowledge and ability, assist management in its task of maximising profit or minimising losses."

According to R. N. Anthony : "Management Accounting is concerned with accounting information that is useful to management."

According to CIMA : "The application of professional knowledge and skill in the preparation of accounting information in such a way as to assist management in the formulation of policies and in the planning and control of the operation of the undertakings."

According to American Accounting Association : "It includes the methods and concepts necessary for effective planning for choosing among alternative business actions and for control through the evaluation and interpretation of performances."

Objectives of Management Accounting : **[1995, 1999, 2011]**

The main objectives of management accounting is to help the management to take quality decision for controlling the business activities effectively. The other objectives and the following functions of management accounting are performed to achieve all the objectives.

1. Presentation of Data : Both profit and loss account and balance sheet are not useful for taking a decision. Hence, the contents of profit and loss account and balance sheet are modified and rearranged in such a manner that helps the management for taking decision through various techniques.

2. Modifies Data : The financial accounting information is modified according to the management expectations. For example, total purchase figures are modified month wise, product wise, supplier wise and territory wise.

3. Forecasting : The management can forecast the achievement of objectives for short term and long term. The accountant provides necessary information and data for forecasting.

4. Analysis and Interpretation of Data : The financial accounting data is rearranged for proper analysis. Comparative and common size statements are prepared for the meaningful interpretation of data. Ratios are calculated and likely trends are projected.

5. Help in Organizing : Organizing refers to allocation of company resources to various departments and assignment of duties to employees at various levels of management. The modified data and analysis and interpretation are helping the management for organizing.

6. Means of Communication : The analysis and interpretation of modified data is conveyed to the employees of an organization as a whole. More meaningful information is supplied to all levels of management executives. In this way, rearranged and modified data are used as means of communication under management accounting system.

7. Planning : The fund flow statement, cash flow statement, budgeting, standard costing, capital budgeting and marginal costing are used for planning purpose. These are important tools of management accounting.

8. Facilitates Control : Management accounting translates the objectives into achievements within a specified time. This is possible through budgetary control and standard costing which are an integral part of management accounting. In this way, management accounting facilitates control.

9. Decision-making : Modified data, analyzed and interpreted information are highly useful to management for taking quality decision and policy formulation.

10. Using of Qualitative Information : Qualitative information means data cannot be measured in terms of rupees, units, kgs, tons, metres and the like. Employees efficiency, policy of management, employer and employee relationship etc are the examples for qualitative information. These types of information are also used in the management accounting system.

11. Coordination : The preparation of budgets on functional basis is the fixation of targets for each department separately. The objectives of organization is achieved through attainment of targets of all the departments. The preparation of periodical performance report of all the departments under management accounting system brings coordination among all the departments.

12. Motivating Employees : The preparation of budgets and adoption of standard costing technique are automatically motivating the employees indirectly. If the budgets are achieved and if there is any favourable variances under standard costing technique, a suitable monetary and non-monetary motivating schemes are prepared and implemented.

Relationship between Cost Accounting and Management Accounting : **[2015]**

Cost Accounting and Management Accounting are closely related to each other. The relationship between Cost Accounting and Management Accounting can be understood by the following points :

1. The extension of managerial aspects of cost accounting is the management accounting.
2. Management uses cost accounting data to minimise the cost and evaluate the performance as a basis for decision making.
3. It is for this reason that most of the cost accounting concepts are also used in management accounting.
4. Cost Accounting and Management Accounting both are using almost similar techniques for satisfying their objectives.
5. Although there is some overlapping in the areas of cost accounting and management accounting, the two are not synonymous.

Distinguish between Cost Accounting with Management Accounting: **[2015]**

The differences between cost accounting and management accounting are as follows :

Basis of Comparison	Cost Accounting	Management Accounting
1. Meaning	The recording, classifying and summarising of cost data of an organisation is known as cost accounting.	The accounting in which the both financial and non-financial information are provided to managers is known as Management Accounting.
2. Information Type	Quantitative.	Quantitative and Qualitative.
3. Objective	Ascertainment of cost of production.	Providing information to managers to set goals and forecast strategies.
4. Scope	Concerned with ascertainment, allocation, distribution and accounting aspects of cost.	Impart and effect aspect of costs.
5. Specific Procedure	Yes	No
6. Recording	Records past and present data.	It gives more stress on the analysis of future projections.
7. Planning	Short range planning.	Short range and long range planning.
8. Interdependency	Can be installed without management accounting.	Cannot be installed without cost accounting.

Pre-requisites for Installation of good Cost Accounting System :

Every organization is interested to get maximum benefits from the installation of Cost Accounting System. The following points have to be carefully considered by the organization before installing a Cost Accounting System. Hence, these points are considered as pre-requisites of a good cost accounting system.

1. **Simplicity :** The costing system should be simple, informative and easy to operate. It must suit to the requirements of the concern.
2. **Highly Economical :** The benefits derived from the system must more than compensate the expenses incurred in the installation and operation of the system in the organization. In short, the system should be highly economical.
3. **Understandability :** The employees concerned should be able to understand the system without much difficulty. The purpose of costing records and reports should be clear to all.
4. **Promptness and Regularity :** There should be promptness and regularity in the preparation and presentation of cost reports.
5. **Size, Layout and Nature of Business :** These are playing vital roles in deciding the requirements of an organization. The installation expenses should not overweigh the expected benefits. Trading concern requires little cost accounting service. But, the manufacturing concern requires much service from the cost accounting system.
6. **Nature, Methods and Stages of Production :** These determine the methods of costing to be applied. A system of cost accounting is to be developed in such a way that cost is identified at every stage of production.

7. Organizational Activities and set up : The existing cost control activities are carefully examined. If there is any defect or loopholes, such defect and loopholes should be rectified before installing cost accounting system. Further, the cost accounting system should not disturb the existing organizational set up and if necessary, it should be introduced gradually.

8. Existing Departments and their work : Generally, every manufacturing organization has separate departments for manufacturing, administration, sales and distribution. Now, the working efficiency of all these departments is examined along with their cooperation with other departments. If there is any in efficiency find out in any department, suitable suggestions may be provided to improve the efficiency.

9. Knowing the Product : The nature of a product determines to a great extent the type of costing system to be adopted. A product requiring high value of material content requires an elaborate system of materials control. Similarly, a product requiring high value of labour content requires an efficient time keeping and wage systems. The same is true in case of overheads.

10. Organizational Hierarchy : The existing organization structure should be distributed as little as possible. It becomes, therefore, necessary to ascertain the size and type of organization before introducing the costing system. The scope of authority of each executive, the sources from which a cost accountant has to derive information and reports to be submitted at various managerial levels should be carefully gone through.

11. Objective : The objectives and information which management wants to achieve and acquire should also be taken care of. For example, if a concern wants to expand its operations, the system of costing should be designed in a way so as to give maximum attention to production aspect. On the other hand, if a concern were not in a position to sell its products, the selling aspect would require greater attention.

12. Technical Details : The system should be introduced after a detailed study of the technical aspects of the business. Efforts should be made to secure the sympathetic assistance and support of the principal members of the supervisory staff and workmen.

Practical difficulties in Installing good Cost Accounting System :

The important difficulties in the installation of a costing system and the suggestions to overcome them are as follows:

1. Lack of Support from Top Management : Often, the costing system is introduced at the behest of the managing director or some other director without taking into confidence other members of the top management team. This results in opposition from various managers as they consider it interference as well as an uncalled check of their activities. They, therefore, resist the additional work involved in the cost accounting system.

This difficulty can be overcome by taking the top management into confidence before installing the system. A sense of cost consciousness has to be instilled in their minds.

2. Resistance from the Staff : The existing financial accounting staff may offer resistance to the system because of a feeling of their being declared redundant under the new system.

This fear can be overcome by explaining the staff that the costing system would not replace but strengthen the existing system. It will open new areas for development which will prove beneficial to them.

3. Non-Cooperation at Other Levels : The foreman and other supervisory staff may resent the additional paper work and may not cooperate in providing the basic data which is essential for the success of the system. This needs re-orientation and education of employees. They have to be told of the advantages that will accrue to them and to the organization as a whole on account of efficient working of the system.

4. Shortage of Trained Staff : Costing is a specialized job in itself. In the beginning, a qualified staff may not be available. However, this difficulty can be overcome by giving the existing staff requisite training and recruiting additional staff if required.

5. Heavy Costs : The costing system will involve heavy costs unless it has been suitably designed to meet specific requirements. Unnecessary sophistication and formalities should be avoided. The costing office should serve as a useful service department.

Chspter 2

Cost concepts, terms and classification of costs

This Chapter Comprises of : Cost, Cost object, Cost units and Cost Centres, Types of costs, classification of costs- Direct-Indirect, Elementwise, Functionwise, Behaviourwise, Sunk Cost, opportunity Cost. Costing Methods and Techniques (introduction only)

Short-Essay or Essay Type Theoretical Questions **5 or 10 Marks**

[1998]

Concept and Definitions of Cost :

In business and accounting, cost is the monetary value that a company has spent in order to produce something. Cost denotes the amount of money that a company spends on the creation or production of goods or services. It does not include the mark-up for profit.

From a seller's point of view, cost is the amount of money that is spent to produce a good or product. If a producer were to sell his products at the production price, his costs and income would break even, meaning that he would not lose money on the sales. However, he would not make a profit. **From a buyer's point of view** the cost of a product is also known as the price. This is the amount that the seller charges for a product, and it includes both the production cost and the mark-up, which is added by the seller in order to make a profit. In accounting, the term cost refers to the monetary value of expenditures for raw materials, equipment, supplies, services, labour, products, etc. It is an amount that is recorded as an expense in bookkeeping records.

The **Terminology of ICMA, London** defined the cost 'as the amount of expenditure actual or notional, incurred on or attributable to a specific thing or activity. '**The American Accounting Association (AAA)** expressed it as the sacrifice in monetary terms or release of value for the acquisition or creation of economic resources. According to them "cost is a foregoing, measured in monetary terms, incurred or potentially to be incurred to achieve a specific objective. "**The American Institute of Certified Public Accountants (AICPA)** used the term in a broader sense. According to its **Terminology**, "cost is the amount measured in money of cash expended or other property transferred, capital stock issued, services performed or a liability incurred in consideration of goods and services received or to be received." However, **CIMA, London** is in the opinion that the word 'cost' can rarely stand alone and should be qualified as to its nature and limitations.

Meaning of Cost Objectives :

A cost object is any item for which costs are being separately measured. It is a key concept used in managing the costs of a business. Here are some types of cost objects :

1. Output : The most common cost objects are a company's products and services, since it wants to know the cost of its output for profitability analysis and price setting.

2. Operational : A cost object can be within a company, such as a department, machining operation, production line, or process. For example, you could track the cost of designing a new product, or a customer service call, or of reworking a returned product.

3. Business relationship : A cost object can be outside of a company - there may be a need to accumulate costs for a supplier or a customer, to determine the cost of dealing with that entity. Another variation on the concept is the cost of renewing a license with a government agency.

It may be necessary to have a cost object in order to derive pricing from a baseline cost, or to see if costs are reasonable, or to derive the full cost of a relationship with another entity.

A cost object may be the subject of considerable ongoing scrutiny, but more commonly a company will only accumulate costs for it occasionally, to see if there has been any significant change since the last analysis. This is because most accounting systems are not designed to accumulate costs for specific cost objects, and so must be reconfigured to do so on a project basis. An annual review is common for many cost objects. If an analysis is especially complex, the review may be at an even longer interval.

[2001,2014]

Meaning of Cost unit :

Cost unit is that unit of measurement which is helpful to classify the cost and measure the cost of products and services. Before measuring the cost, we should determine the cost unit. It should be different according the nature of products and nature of business. You normally see, the vendor of medicine will sell you the medicine in the form of batch of 12 or 20 tablets. These batch is also cost unit. Following are the examples of cost unit.

(i) Brick works	per 1000 bricks made
(ii) Collieries	per ton of coal raised
(iii) Textile mills	per yard or per lb. of cloth manufac- tured or yarn spun
(iv) Electrical companies	per unit of electricity generated
(v) Transport companies	per passenger km.
(vi) Steel mills	per ton of steel made

Cost units for the below mentioned Industries : **[2010]**

1. Transport 2. Power 3. Hospital 4. Advertising. **[2017]**

5. Cement 6. Textile 7. Hospital 8. Timber 9. Transport 10. Readymade Garments.

Nature of Industries	Cost Units
1. Transport	Ton – km; Passenger – km
2. Power	KWH
3. Hospital	Bed – Occupied : Out - Patients
4. Advertising	Each Job
5. Cement	Per Bag per day
6. Textile	Per Meter per day
7. Hospital	Patient-Day, Per Bed-Per Day
8. Timber	Per Square Feet per day
9. Transport	Tonne km, Passenger km, Seat km, etc
10. Readymade Garments	Per Piece per day

Meaning and Definition of Cost Centre: **[1998, 2000, 2011,2014]**

According to E. L. Kohler, a cost centre is "an organisational division, department or self-division, a group of machines, men or both. It includes any unit of activity into which a manufacturing plant or other operating organisation is divided for purposes of cost assignment and allocation".

Similarly, according to the Terminology of CIMA, London, a cost centre "is a location, person or item of equipment or group of these, for which cost may be ascertained and used for the purpose of cost control."

Thus, a Cost Centre covers a location (e.g., a department, person-e.g., machine operator), and a item of equipment (e.g., plant or machine).

Different Types of Cost Centre: **[1998, 2000, 2011,2014]**

1. **Personal Cost Centre :** When a Cost Centre deals with a person or group of persons, it is known as Personal Cost Centre.

2. **Impersonal Cost Centre :** When a Cost Centre deals with a location or equipment or both, it is called Impersonal Cost Centre.

3. **Production Cost Centre :** When a Cost Centre deals with a product or manufacturing work e.g. machine shop, it is called Production Cost Centre.

4. **Service Cost Centre :** When a Cost Centre deals with or is engaged in rendering services to the Production Cost Centre, it is called Service Cost Centre.

5. **Operation Cost Centre :** It is applicable in case of manufacturing concerns. It consists of machines or persons which follow similar activities.

6. **Process Cost Centre:** It is also applicable in case of manufacturing concerns. Process Cost Centre is applied in case of particular or specific process of a manufacturing enterprise.

Purposes of Cost Centre: **[1998, 2000, 2011,2014]**

The purposes of Cost Centre are as follows :

1. Cost Centre brings responsibility and, as such, it is also called Responsibility Centre. In other words, for controlling cost of a centre, the manager of that cost centre is, no doubt, responsible for the purposes.
2. Cost Centre helps to recover the overhead expenses. Overhead is recovered on the predetermined rate. Rate is predetermined on the basis of the nature of completion of work or the process followed.

Distinguish between : Cost Centre and Cost Unit : **[1997, 2006]**

The differences between Cost Centre and Cost Unit are as follows :

Cost Centre	Cost Unit
Cost centres are the smallest segment of activity or area of responsibility for which costs are accumulated or ascertained. **ICMA**, England defines cost centre are the 'allocation, person or item of equipment for which cost may be ascertained and used for the purpose of cost control'. Cost centres are the natural division of the organisation in to convenient units for the purpose of cost ascertainment and control. These are the department of the organisation, but sometimes a department may also contain several cost centres.	Cost units is device for the purpose of breaking up cost in to smaller sub-divisions. **ICMA**, England defines, cost unit is 'a unit of quantity of product, service, or time in relation to which cost may be ascertained or expressed'. Ordinarily cost unit is the expression in the form of count, weight, dimension etc. Cost unit is the unit of measurement of different types of products. For example, ton in case or coal, Yards in case of cloth, Liter in case of petrol etc.

Different types of costs in Cost Accounting :

One can understand the cost accounting properly only after knowing various types of cost. Hence, the understanding of types of cost enables proper application of cost accounting principles. Therefore, certain types of cost are briefly explained below.

1. **Historical Cost :** It is the post mortem of cost, which is already incurred. This type of cost reports the past events. If the time lag between the cost incurred time and reporting time is very short, quality decision may be taken. If not so, these costs are irrelevant for decision-making.
2. **Future Cost :** These types of costs are expected and incurred in the days to come.
3. **Replacement Cost :** It is the cost required to replaced any existing asset at present.
4. **Standard Cost :** It is a scientifically predetermined cost, which is arrived at assuming a specific level of efficiency in material utilization, labour and indirect expenses.
5. **Estimated Cost :** It is an assessment of what will be the cost approximately. It is based on the past experience and adjusted according to the expected future changes.
6. **Product Cost :** It is the cost of a finished product.
7. **Production Cost :** It is the combination of both prime cost and absorbed production overhead.
8. **Direct Cost :** It is a cost, which can be easily identified with a specific saleable cost unit.
9. **Prime Cost :** It is the aggregation of direct material cost and direct labour cost. The term direct refers to elements of costs, which are easily traceable to a particular unit of output.
10. **Indirect Cost :** It is the cost, which cannot be easily or directly identified to the unit of output or to the segment of a business operation.
11. **Fixed cost :** It is otherwise called fixed overhead and period cost. A cost, which is incurred for a specific period and does not get affected by fluctuations in the levels of activity (output or turnover). For example Rent, Salaries and the like.
12. **Variable Cost :** It is the cost, which is varying or fluctuating according to the levels of activity (output or turnover) in direct proportion.
13. **Opportunity Cost :** It is the value of a benefit sacrificed in favour of an alternative course of action.
14. **Imputed Cost :** It is otherwise called Notional Cost and Hypothetical Cost. A cost that has not involve cash outflow from the business organization. It does not appear in the financial records but relevant to the decision-making. For example : Interest on Capital. **CIMA** defines notional cost as, the value of a benefit where no actual cost is incurred.
15. **Programmed Cost :** A cost which is incurred under any specific programme of an organization. This is reflecting top management policies and decisions.

16. Controllable Cost : It is the cost, which can be influenced by budget holder. In other words, a cost may be controllable by managerial supervision.

17. Non-Controllable Cost : It is the cost that cannot be easily controllable at any level of managerial supervision.

18. Joint Cost : It is the cost of a process, which results in producing more than one main product.

19. Sunk Cost : CIMA defines sunk cost as,

the past cost is not taken into accounts in decision making.

20. Postponable Cost : A cost can be shifted to future with little or no effect on the efficiency of current operations.

21. Out of Pocket Cost : It is the cost which results in cash outflow from the business organization due to a particular managerial decision.

22. Differential Cost : It is the difference of cost between the total costs of two alternatives that are calculated to assist decision-making.

23. Conversion Cost : It is also called production cost. Direct material cost is not included in the production cost. It is the cost incurred for converting the raw material into finished product. In other words, it is the combination of direct labour, direct expenses and factory overhead.

24. Capacity Cost : It is an alternative term used for fixed cost. It is the cost of providing facilities through a system for a particular period. The capacity cost is classified into two categories. They are Standby Cost and Enabling Cost.

25. Standby Cost : It is the cost that is to be incurred continuously even though the operations or facilities are shutdown temporarily. For example, Depreciation.

26. Enabling Cost : It is the cost that is not to be incurred if the operations or facilities are shutdown temporarily.

27. Committed Cost : It is a fixed cost of the company resulted from the earlier decision of the management. For example: Insurance Premium. The amount of insurance premium cannot be controlled at present on a short run basis.

28. Avoidable Cost : It is the specific cost of an activity or a sector of a business that can be avoided if that activity or sector is not in operation.

29. Decision Driven Cost : It is the cost incurred by the company due to its policy decision up to the stage of altering such decision. It does not vary with changes in the level of output or operational activities.

30. Marginal Cost : It is the cost of one more unit of product or service, which can be avoided if that unit is not produced or provided.

31. Quality Related Costs : These are the costs incurred for ensuring and assuring quality as well as the loss incurred even though the quality is not achieved. Quality related costs are classified as prevention cost, appraisal cost, internal failure cost and external failure cost.

32. Prevention Cost : It is the cost incurred to reduce the appraisal cost to a minimum.

33. Appraisal Cost : It is the cost incurred initially for ascertaining conformance of quality of product according to the requirements. For example: Inspection and testing cost.

34. Internal Failure Cost : A cost is arising from inadequate quality discovered before the transfer of ownership from supplier to purchaser.

35. Relevant Costs : CIMA defines relevant costs as costs appropriate to a specific management decision.

36. Social Responsibility Cost : CIMA defines social responsibility cost as tangible and intangible costs and losses sustained by third parties or the general public as a result of economic activity.

37. Target Cost : CIMA defines target cost as, a product cost estimate derived from a competitive market price. Used to reduce costs through continuous improvement and replacement of technologies and processor

38. Inventorial Cost : It is the cost incurred for manufacturing a product and considered as assets under generally accepted accounting principles. For example: Research and Development cost. The inventorial cost becomes expenses when the products are sold.

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39. Deferred Cost : The Company does not receive an economic benefit of a cost during the accounting period in which the cost is incurred. Such cost is termed as deferred cost. For example: Prepaid Insurance. It is otherwise called as unexpired expenses or unexpired cost and treated as an asset.

40. Expense : It is an expired cost and the company has received its economic benefit. Moreover, the economic benefit is more than the expired cost. For example: Rent paid for the accounting period.

41. Loss : It is also an expired cost and the company has received its economic benefit. But, the received economic benefit is less than the expired cost.

Different Classification of Cost : [1994]

Different classification of cost are discussed below :

A. Classification of Cost on the basis of Ease of Traceability :

1. Direct costs : those that can be traced directly to a particular object of costing such as a particular product, department, or branch. Examples include materials and direct labour. Some operating expenses can also be classified as direct costs, such as advertising cost for a particular product.

2. Indirect costs : those that cannot be traced to a particular object of costing. They are also called common costs or joint costs. Indirect costs include factory overhead and operating costs that benefit more than one product, department, or branch.

B. Classification of Cost on the basis of element or nature :

On the basis element, cost can be divided into material, labour and expense. They have been mentioned in details in the following.

1. Materials : Materials are needed to produce or provide services. They can be classified into direct and indirect are given below:

(i) Direct material : it means the materials which from part of finished output and can be identified with the finished product easily. For example: wood, plywood, adhesive, wood polish, mails etc. in case of manufacturing cloth, cost of iron in case of manufacturing machinating cotton yarn, cost of yarn in case of manufacturing furniture, cost of iron in case of manufacturing machinery etc. the main feature of direct materials in that enter into and form part of the finished product.

(ii) Indirect material cost : it refers to the material cost, which cannot be allocated but can be apportioned to or absorbed by cost centres or cost unit. These are the materials, which cannot be traced as part of the product, and their cost is distributed among the various cost centre or cost units on some equitable basis. Examples of indirect materials are cost and fuel for generating power, cotton waste, lubricating oil and grease used in maintaining the machinery, materials consumed for repair and maintenance work, dusters and brooms used for cleaning the factory etc.

2. Labour : Labour is needed to convert the raw materials into finished products. It is also needed to supply the goods in the hand of ultimate consumer. It can further be divided into two types as given below:

(i) Direct labour : is the workforce, which is directly involved on production. It refers to lab our cost, which can be identified with and allocate to cost centres or cost units. It includes the remuneration paid for converting the raw material into finished products or for altering the construction, composition or condition of the or ducts manufactured by an undertaking. For example, wages paid for spinning yarn inn case of spinning mills, wages paid for weaving cloth in case of cloth mills, wages paid to a mason for construction of a building by a building contractor etc.

(ii) Indirect labour cost : refers to the labour cost or wages, which cannot be allocated but can be apportioned to or absorbed by cost centres or cost units. For example; salary paid to factory manager, salary paid to factory supervisor or foremen, salary paid to general manager or sales manager etc.

3. Other expenses : The expenses which are needed in course of production and distribution except material and labour fall into this category. They can be divided into two types as mentioned below:

(i) Direct expenses : these costs are also called chargeable expenses. They are the expenses other than direct material and labour cost, and can be identified with and allocated to cost centres or cost units. Direct expenses are those which are incurred for each unit of manufacture specifically and identifiable with them. For example, royalties paid on the basis of output, hire charges of special plant or machinery, carriage and freight on direct material purchased, import duty and octopi paid on the purchase of imported direct materials, amount payable to sub-contracts etc.

(II) Indirect expense : refer to the expenses, which cannot be allocated but can be apportioned to or absorbed by cost centres or cost units, for example; rent taxes, and insurance of factory building, factory lighting, repairs to factory building, depreciation to plant and machinery, repairs to machinery, depreciation and insurance of office building, depreciation and insurance of showroom building etc. are known as indirect expenses.

C. Classification of Cost on the basis of function :

Based on the functions, the cost be classified into production cost, administration cost, selling and distribution cost, and research and development cost.

1. Production cost : It includes all direct material, direct labour, direct expenses and manufacturing expenses. It refers to cost concerned with manufacturing activity, which starts with supply of material and ends with primary packing of the product.

2. Administration cost : It is incurred for carrying the administrative function of the organization i.e. cost of policy formulation and its implementation to attain the objective of the organization. It should not be related to research, development, production, distribution or selling activities. It is also called office cost.

3. Selling and distribution cost : The selling cost refers to the cost of selling function i.e., the cost of activities relating to create and stimulate demand for company's products and to secure orders. The distribution costs are incurred to make goods available to the customers. These costs include the cost of maintaining and creating demand of product, making the goods available in the hand of customer. They are also called total cost or cost of sales.

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

D. Classification of Cost on the basis of behaviour or variability :

On the basis of the behaviours in relation to changes in the volume of activity, cost may be classified as, fixed cost, various costs and semi-variable cost.

1. Fixed cost : Fixed Cost or Period Cost: Fixed costs are those costs which remain fixed irrespective of the change in volume of output. As production increases cost per unit of the fixed cost decreases and as production decreases fixed costs are, rent of the factory building depreciation, salary of the office manager etc.

Fixed costs can be classified into the following categories:

(a) Committed Costs : These costs are the result of inevitable consequences of commitments previously made or are incurred to maintain certain facilities and cannot be quickly eliminated. The management has little or no discretion in such type of costs e.g. rent, insurance, depreciation on building or equipment purchased.

(b) Policy and Managed Costs : Policy costs are incurred for implementing some management policies as executive development, housing etc. and are often discretionary. Managed costs are incurred to ensure the operating existence of the company e.g., staff services.

(c) Discretionary Costs : These costs are not related to the operation but can be controlled by the management. These costs arise from some policy decisions, new researches etc. and can be eliminated or reduced to a desirable level at the discretion of the management.

2. Variable cost : Variable Cost or Product Cost : Variable costs are those costs which vary in direct proportion to the volume of output. As production increases total cost increases but also per unit remains constant. As production decreases total cost decreases and cost per unit also decreases. Example of variable costs are, cost of raw materials labour etc.

3. Semi-variable cost : Semi-Variable Cost or Semi-Fixed cost: These costs are partly fixed and partly variable. Examples of variable costs are telephone rent. It includes partly fixed charge up to a certain level and then varies according to the calls.

E. Classification of Cost on the basis of Managerial Decisions :

1. Sunk Cost : A sunk cost is an irrecoverable cost and is caused by complete abandonment of a plant. It is the written down value of the abandoned plant less its salvage value. Such costs are historical costs which are incurred in the past and are not relevant for decision-making and are not affected by increase or decrease in volume.

Thus, expenditure which has taken place and is irrecoverable in a situation is treated as sunk cost. For taking managerial decisions with future implications, a sunk cost is an irrelevant cost. If a decision has to be made for replacing the existing plant, the book value of the plant less salvage value (if any) will be a sunk cost and will be irrelevant cost for taking decision of the replacement of the existing plant.

2. Opportunity Cost : It is the maximum possible alternative earning that might have been earned if the productive capacity or services had been put to some alternative use. In simple words, it is the advantage, in measurable terms, which has been foregone due to not using the facility in the manner originally planned. For example, if an owned building is proposed to be used for a project, the likely rent of the building is the opportunity cost which should be taken into consideration while evaluating the profitability of the project.

Distinguish between Direct Cost and Indirect Cost : **[1997, 1998, 2014]**

Direct Cost and Indirect Cost are purely opposite in nature although these are both elements of cost. The main differences between them are stated below :

Basis for Comparison	Direct Cost	Indirect Cost
1. Meaning	A cost that is easily attributable to a cost object is known as Direct Cost.	Indirect Cost is defined as the cost that cannot be allocated to a particular cost object.
2. Benefits	Specific projects	Multiple projects
3. Aggregate	When all the direct costs are taken together they are known as prime costs.	Total of all the indirect costs is called as overheads or on cost.
4. Traceable	Yes	No
5. Classification	Direct material, direct labour, direct expenses	Indirect material, indirect labour, indirect overheads