



SYLLABUS

Class – B.Com II Year

Subject: Cost Accounting

Unit-I	Cost: Meaning, Concept and Classification. Elements of Cost, Nature & Importance, Material Costing. Methods of Valuation of Material issue. Concept and material control and its techniques. Labour Costing, Methods of Wages payments.
Unit- II	Unit Costing, Preparation of Cost Sheet and Statement of Cost (Including calculation of tender price) Overhead costing, (Including calculation of machine hour rate.)
Unit – III	Contract and Job costing, operating costing. (Transport Cost).
Unit – IV	Process Costing (Including Inter process profit and Reserve). Reconciliation of Cost and Financial Accounts.
Unit – V	Marginal Costing- Profit – Volume Ratio, Break – Even Point, Margin of Safety, Application of Break-even Analysis. Standard Costing and variance Analysis (Material and labour only)



UNIT-I

COST ACCOUNTING-AN INTRODUCTION

Introduction:-

cost accounting is the branch of accounting. It has been developed due to the limitations of financial accounting. In these days of cut throat competition, it is vital that a business concern should conduct its activities with the least chance of being kicked out of business. Those concern which don't take such precautions and which dnt try to continuously improve, their products and service and bring down cost and prices will sooner or later find themselves out of business. Cost accounting plays a big role in the case.

Costing - terminology

Costing relates to the determination of cost of a product manufactured or service rendered. In order to ascertain cost, it involves system, methods and techniques of accumulation, classification and analysis of cost.

Cost Accounting: - *"The process of accounting for cost from the point at which expenditure is incurred or committed to the establishment of its ultimate relationship with cost centres and cost units. The term 'cost Accountancy' includes*

(i) Costing

(ii) Cost Accounting.

Its purposes are

(i) Cost control,

(ii) Profitability-ascertainment and serves as an essential tool of the management for decision-making.

Cost Centre

Cost Centre is defined as "a location or person or place or machine or item of equipment or thing for which cost can be ascertained and used for the purpose of cost control." Cost centre can be classified as:

- 1. Process cost centre is one in which a specific process or a continuous sequence of operations is carried out on a regular basis.*
- 2. Production cost centre is one in which production activity is carried where the shape of raw material is converted into a finished product.*
- 3. Service cost centre are those which render services to the other cost centres. For examples a maintenance & repair department, store department etc.*
- 4. Impersonal cost centre is one which consists of a location or item of equipment (or group of these).*
- 5. Personal cost centre is one which consists of a person or group of persons.*
- 6. Operation cost centre is one which consists of those machines and/or persons carrying out similar operations.*

Profit Centre

It means a centre responsible for adopting ways and avenues to earn maximum possible profit on a product or any other activity of business, by making market surveys, suggests localities for publicity, helps to formulate sales policies and suggests to add more values to the product at the same or cheaper costs.



Cost Unit

Cost unit may be defined as "a quantitative unit of product or service in relation to which costs are ascertained."

The main objective of overhead accounting is to ascertain the total cost of production and per unit. Therefore it is necessary to understand the meaning of unit. The quantity of production on which cost and selling price are based is called unit. In other words unit of cost is the quantity analysis of the product or service on the basis of which cost is ascertain. Unit refer to the quantity of product for example pound, meter, centimeter etc.

Types of unit of cost

1. **Simple unit:-** by simple unit we mean that unit which can be ascertained only in one unit and the meaning is also simple like kilogram, per meter, per ton, per dozen, per quantial.
2. **Composite unit:-** it means that unit which is a combination of two words of a simple unit. For example per patient per day, per ton kilometer, per passenger kilometer, per kilowatt hour, etc.

NATURE AND CHARACTERISTICS OF COST ACCOUNTING

1. Cost accounting is a special branch of accounting having its own specific significance based on double entry system.
2. It ascertains cost of products and services through the process of accumulation, classification, analysis and recording.
3. It determines the cost of incomplete work or job.
4. The extensive use of this system involves application of statistical data, control methods & techniques and determining profitability.
5. This system provides measures for control and guidance for various levels of management.
6. Helpful in decision making process.

SCOPE OF COST ACCOUNTING

1. Analysis of the profitability of product, service, job or activities.
2. Analysis of profitability of various departments of segments of the organization.
3. Analysis of the type and nature of cost.
4. Explanation of the causes of variances between actual cost and standard cost.
5. Helpful in determination of selling price.
6. Analysis of the change in profit as per the change in level of production.
7. Analysis of the profit or loss of the organization.
8. Assist in management information system.
9. Provides basis for the application of techniques of management accounting.
10. Helpful for manufacturing and service rendering organization.



Difference between cost accounting and financial accounting

<i>S.No.</i>	<i>Cost Accounting</i>	<i>Financial Accounting</i>
1.	Kept by business engaged either in manufacturing either in manufacturing or in rendering services where the cost per unit is to be ascertained.	Kept by all types of business houses, big or small, whether engaged in trading, manufacturing or non-profit making associations.
2.	Maintain full and detailed records pertaining to all the three elements of cost, viz., materials, labour and expenses.	Records all types of expenses and incomes and also items of profit appropriation. However, they do not keep detailed records of elements of cost.
3.	Provide data and reports to management for cost-ascertainment, planning, control and decision-making.	Provide general information to management and outside parties in the form of Profit & Loss A/c and Balance Sheet of the business as a whole.
4.	Ascertain the cost of each product, job or order and then show profit/loss made on each.	Do not show profit/loss on each product, job or order individually.
5.	Provide information to management as and when desired, daily, weekly, monthly, quarterly, etc.	Provide operating net result and financial position at the end of financial year.
6.	To calculate the cost, the indirect expenses include there in are based on estimates. Greater control is exercised on materials and stores, labour and overhead costs by budgetary control and standard costing. No emphasis is given to cash-in-hand and Bank transactions.	Show historical costs, i.e., they include expenses having actually been incurred in the financial year. Greater emphasis is laid on cash and financial position. They do not attach that importance to control of materials, labor and overheads.
7.	As the cost is available, it is easier to fix selling price and quote for tenders	No correct tender prices can be quoted.
8.	The production costs of a period can be compared with previous corresponding period and the difference analyse.	Such comparison of costs of individual production is not easy.
9.	Provide information on the relative efficiency of plant, machinery, labour and departments.	The relative efficiency of workmen, plants, etc., cannot be easily judged.
10.	Stocks are valued at costs.	Stocks are valued at cost price or market price, whichever is lower.
11.	These accounts are for internal transactions and do not form the basis of receipts and payments to outside parties. The companies Act has made it obligatory for certain industries to maintain Cost	They form basis for external transactions also, and record receipts, payments and credit transactions. It is almost necessary to maintain this accounting to run business. To meet the requirements of
12.		
13.		

FUNDAMENTAL PRINCIPLES OF COSTING

1. Cost is related to its cause.



2. *Cost is charged after it is incurred.*
3. *Abnormal costs are excluded from costing.*
4. *Past costs are not charged to future periods.*
5. *The concept of conservatism has no place in costing.*
6. *Accounting for cost is based on Double-entry Principle.*

OBJECTS AND FUNCTIONS OF COST ACCOUNTING

- i. *To ascertain the cost per unit of the different products manufactured by a business concern.*
- ii. *To advise management on future expansion policies and proposed capital projects.*
- iii. *To organize the internal audit system to ensure effective working of different departments.*
- iv. *To help in supervising the working of punched card accounting or data processing through computers.*
- v. *Provide useful data to the management for taking decisions.*
- vi. *To find out costing profit or loss by identifying with revenues the cost of those products or services.*
- vii. *To provide specialized services of cost audit in order to prevent the errors and frauds and to facilitate prompt and reliable information to the management.*
- viii. *To organize cost reduction programmes with the help of different departmental managers.*
- ix. *To provide requisite data and serves as a guide to price fixing of products manufactured or services rendered.*
- x. *To help in the preparation of budgets and implementation of budgetary control.*
- xi. *To guide management in the formulation and implementation of incentive bonus plans based on productivity and cost savings.*
- xii. *To supply useful data to the management to take various financial decisions such as introduction of new products, replacement of labour by machine etc.*
- xiii. *To organize an effective information system so that different levels of management may get required information at the right time in right form for carrying out their individual responsibilities in an efficient manner.*

TECHNIQUES AND METHODS OF COSTING

1. *Historical Costing. "The ascertainment of costs after they have been incurred." Under this method all the expenses incurred on the production are first incurred and then the costs are ascertained.*
2. *Standard costing. "The preparation and use of standard costs, their comparison with actual costs and the analysis of variances to their causes and points of incidence."*
3. *Marginal Costing. "The ascertainment of marginal costs and of the effect on profit of changes in volume or type of output by differentiating between fixed costs and variable costs."*
4. *Direct Costing. "The practice of charging all direct costs to operations, processes or products, leaving all the indirect costs to be written off against profits in the period in which they arise."*
5. *Absorption Costing. "The practice of charging all costs, both variable and fixed, to operations, processes or products."*
6. *Uniform Costing. "The use by several undertakings of the same costing principles and/or practices."*



Methods of Costing

1. Job costing.
2. Contract Costing.
3. Batch Costing.
4. Target Costing.
5. Process Costing.
6. Single or Output Costing.
7. Operation Costing.
8. Departmental Costing
9. . Composite or Multiple Costing.

ANALYSIS AND CLASSIFICATION OF COST

MATERIALS COST

Material cost is of two types, viz.,

- (i) Direct Materials Cost, and
- (ii) Indirect Material cost.
 - i. Direct Materials Cost. Is one which can be identified with and allocated to cost centres or cost units." E.g., timber in furniture-making; clay in brick-making; cement, stones, etc., in building.
 - ii. Indirect Materials Cost. Which cannot be allocated but which can be apportioned to or absorbed by, cost centers or cost units. For example, power, fuel, repair and maintenance etc.

LABOUR COST

"The Labour Cost is the cost of remuneration (wages, salaries, commissions, bonus, etc.) of the employees of an undertaking."

- i. Direct Labour Cost. Direct Labour Cost are the cost which can be identified with and allocated to cost centers or cost units.
- ii. Indirect Labour Cost. is one which cannot be allocated but which can be apportioned to, or absorbed by, cost centers or cost units."e.g. Wages of indirect labour; Wages of idle time.

OVERHEADS

Overheads are the aggregate of the cost of indirect material, indirect labour and such other expenses, which cannot be conveniently charged direct to specific cost centre or cost units.

ANALYSIS OF TOTAL COST

1. Prime Cost.- The aggregate of Direct material Cost, direct Labour Cost and Variable Direct expenses (or chargeable expenses) is the prime Cost.
2. Factory Cost.- Factory Cost is the total of Prime Cost + Factory Overheads,
3. Cost of Production.- The total Factory Cost and Office and Administration Overheads is the office Cost or Cost of Production.
4. Total Cost.= Cost of Production + Selling & Distribution Overheads.

CLASSIFICATION OF COST AND COST CONCEPT

The cost-classification is the process of grouping costs according to their characteristics.

1. **According to Elements.** The cost is classified into
 - (i) Direct cost, and
 - (ii) Indirect cost according to elements, viz., materials, Labour and Expenses.



2. According to Functions.

The cost is classified into the following:

- i. Production Cost, or Manufacturing Cost, or Factory Cost, ii. Administration Cost, iii. Selling Cost, and iv. Distribution Cost.

3. According to Nature. The cost is classified into the following:

- i. Fixed Cost is "a cost which tends to be unaffected by variations in volume of output.
- ii. Variable Cost is "a cost which tends to vary directly with volume of output.
- iii. Semi-fixed or Semi-variable Cost is 'a cost which is partly variable.'

4. According to Controllability.

- i. Controllable cost. This is a cost which can be influenced by the action of a specified member of an undertaking.
- ii. Uncontrollable Cost. It is the cost which cannot be influenced by the action of a specified member of an undertaking, such as fixed costs.

5. According to Normality. The cost is classified into (i) Normal cost, and (ii) Abnormal cost.

- i. Normal cost. It is the cost at a given level of output in the condition at which that level of output is normally attained.
- ii. Abnormal cost. It is a cost which is beyond normal cost.

6. According to Relevance to Decision-making and Control.

- i. Shut-down Cost. A cost which will be required to be incurred even though a plant is closed or shut-down for a temporary period, e.g., the cost of rent, rates, depreciation, maintenance expenses etc.
- ii. Sunk cost. A cost which has been incurred in the past or sunk in the past and is not relevant to the particular decision-making. E.g. written down book value of the plant.
- iii. Opportunity Cost. The costs which are related to the sacrifice made or the benefits foregone are opportunity costs.
- iv. Imputed Cost. It is a hypothetical cost required to be considered to make costs comparable. Interest on one's own capital.
- v. Out-of-Pocket cost. A cost which will have to be paid to outsiders as against costs such as depreciation, which do not require any cash payment.
- vi. Replacement Cost. It is the cost of replacing a material or assets, by purchase from the current market.
- vii. Marginal Cost. Marginal cost refers to the increase or decrease in total cost caused due to increase or decrease in output by one single unit.
- viii. Differential Cost. The change in total cost due to the change in method or technique of production or change in level of production is called differential cost.
- ix. Standard Cost. Standard cost is a predetermined cost or estimate which is compared with the actual cost in order to determine variance and carry out an analysis of variance for cost control.
- x. Relevant Cost. The relevant costs are those costs which aid to make specific management decisions.

7. Product Cost & Period Cost



The product cost is the total of cost that is associated with a unit of product. The cost in forming the product viz., direct material, direct labor, factory overhead constitute the product cost.

Period cost, on the other hand, are costs that tends to be unaffected by changes in level of activity during as given specific time period. E.g., Selling & distribution cost

SIGNIFICANCE OF COST ACCOUNTING

It discloses the profitable and unprofitable activities in a concern and hence necessary adjustments are done.

- i. *It enables the concern to measure its efficiency and then maintain or improve.*
- ii. *It is helpful to the consumer by ensuring lower prices. iv. It is useful to the government in the form of duties paid.*
- v. *It discloses the relative efficiency of different workers in a concern.*
- vi. *Through it the exact causes of decrease or an increase in profit or loss can be detected.*
- vii. *It provided information upon which estimates and tenders are based. viii. It guides future production policies.*
- ix. *It helps in increasing profits by disclosing the sources of loss or waste and by suggesting such controls so that the same may not be repeated.*
- x. *It enables a periodical determination of profits or losses without restoring to stock taking.*

ADVANTAGES OF COST ACCOUNTING

A. To the Management

1. *Action against unprofitable Activities*
2. *Facilities Decision Making*
3. *Inventory Control*
4. *Budgetary Control*
5. *Facilitation cost control*
6. *Prevents Fraud*
7. *Tool of Management Control*
8. *Measuring rods*
9. *Future Prospects*

B. To the Employees

1. *Sound Wage Policy*
2. *Security of Job*
3. *Distinction between Efficient and Inefficient Workers*

C. To the Creditors

Bankers, creditors, investors etc., can have a better understanding of the firm as regard the process and prosperity, before they offer financial leading.

D. To the Government

1. *For government wage tribunals, for deciding the state subsidy to industry.*
2. *In the preparation of national plans, economic development etc.*
3. *Cost audit is important and industries have to keep books of ac materials, labour and other costs.*

E. To the Public



1. Removes all types of wast ages and inefficiencies.
2. Facilities the customers to pay fair price.
3. Development and prosperity of industries will create employment opportunities.

CHARACERTISTICS OF A GOOD COSTING SYSTEM

1. Accuracy
2. Promptness
3. Equity
4. Observation and Resulting
5. Simplicity
6. Periodical Result
7. Elasticity
8. Reconciliation with Financial Accounts
9. Comparability

Material Costing

Material or inventory cost control is defined as a systematic control and regulation of purchase, storage and usage of materials in such a way as to maintain an even flow of production at proper times and valued at right prices at the same time avoiding excessive investment in inventories.

Objectives of Material control

- i. No under stocking or over stocking
- ii. Economy in purchasing
- iii. Proper Quality
- iv. Minimum wastage
- v. Information about material availability

Principles or Essentials of Material Control

- i. Proper co-ordination and Co-operation between various departments- Purchase, Stores, Inspection, Accounting etc.
- ii. Proper classification and codification of materials
- iii. Proper scheduling of material requirements.
- iv. Perpetual inventory system should be operated
- v. Various stock levels to be fixed
- vi. Proper system of internal check to be introduced for adequate safeguards and supervision
- vii. Regular reporting to management regarding purchase, issues and stock of materials.
- viii. Proper storage and usage of materials to avoid theft and wastages.

Functions of purchasing department:

- i. Determination of quality to be purchased
- ii. Determination of ordering point.
- iii. Determination of price at which to be purchased.

Purchase Procedure: -

- i. Initiating the purchase



- ii. Receiving of the purchase requisitions.
- iii. Deciding important factors relating to purchase.
- iv. Inviting tenders and selecting suppliers.
- v. Preparation and execution of purchase orders
- vi. Receipt of materials
- vii. Inspection and testing of materials received
- viii. Debit note upon the supplier in respect of rejected materials.
- ix. Passing invoices for payment.

Stores Organization and control Objectives

- i. Receive materials, check them and place them properly
- ii. To issues the materials to jobs on the basis of store requisitions
- iii. To enter all the receipts and issues in the bin card and show the balance
- iv. Avoiding overstocking and under stocking by checking the ordering points of different materials.
- v. Maintain, preserve and protect the materials during storage
- v. Maintain up-to-date stores records
- vi. To report on obsolete and slow moving materials, waste, scrap, etc.
- viii. Requisitioning further supplies from purchasing department.

Stores Records

- i. Perpetual Inventory Records are those which show movement of stores, i.e. receipt and issues.
Eg. Bin Card and stores ledger
- ii. Documents are those which authorize movement of materials into or out of stores e.g. Goods received Note, Bill of materials, material requisition note, materials return note, etc.

Techniques of Inventory Control

1. **ABC Technique:** - It is a value based system of material control where materials are classified according to their value, A, B and C, so that costly and valuable materials are given greater attention and care.
 'A' items are high value items which consist of only a small percentage of total items handled and hence require tight control.
 'B' items are medium value materials which should be under normal control procedures
 'C' items are low value materials which represent a large number of items and require economical control procedures, and least attention.
2. **Stock Levels:** - To avoid under stocking and overstocking, maximum, minimum and reorder levels are fixed.

Factors which influence stock levels are

- a. Anticipated rate of consumption
- b. Account of capital available
- c. Availability of storage space
- d. Storage/ warehousing cost
- e. Procurement cost
- f. Reliability of suppliers
- g. Minimum order quantities imposed by suppliers
- h. Risk of loss due to obsolescence, deterioration, evaporation and fall in market prices



- I. **Maximum Level:** - It indicates the maximum quantity of inventory item which can be stored at any given time

$$\text{Maximum Level} = \text{Minimum Stock} + \text{Economic Order quantity}$$

Or

$$= \text{Reorder Point} + \text{Reorder quantity} -$$

$$[\text{Minimum Consumption} \times \text{Minimum reorder Period}]$$

- ii. **Minimum Level:** - It indicates the minimum quantity of stock that should always be maintained so that there is no risk of stoppage of production.

$$\text{Minimum Level} = \text{Reorder Point} - [\text{Average Consumption} \times \text{Average}$$

re-order period]

- iii. **Re-order Level or Re-order Point:** - This is that level of material at which purchase requisition is initiated for fresh supplies.

$$\text{Re-order Level} = \text{Maximum consumption} \times \text{Maximum Re-order period}$$

- iv. **Danger Level:** - It is that level at which normal issued are stopped and materials are issued for important jobs only.

$$\text{Danger Level} = \text{Normal consumption} \times \text{Maximum re-order period under emergency}$$

$$\text{condition v. Average stock Level} = \frac{1}{2} \times [\text{Minimum Level} + \text{Maximum Level}]$$

Or

$$\text{Minimum Level} + \frac{1}{2} \times [\text{EOQ or re-order quantity}]$$

3. **EOQ [Economic or order quantity] or Re-order quantity:** - EOCs is that size of the order which gives maximum economy in purchasing any material and ultimately contributes towards maintaining the material at optimum level and at minimum cost. While setting EOQ, two types of costs are considered

- i. **Ordering cost:** - Cost of placing orders.

- ii. **Carrying Cost:** - Cost of holding stock in storage

$$2AO$$

$$\text{EOQ} = \frac{2AO}{C}, \text{ where } A = \text{annual consumption in units, } O = \text{ordering cost per order,}$$

C = storage or carrying cost as a percentage of inventory.

Control Ratios

4. **Inventory turnover Ratios:** - This tells us how many times in a year is are used up and replaced. The greater the stock turnover, the more efficient is the stock policy. It indicates the rate of consumption, i.e. whether materials are moving fast or slowly. A high stock turnover ratio indicates fast moving materials and a low ratio indicates slow moving materials

$$\text{i. Stock Turnover Ratio} = \frac{\text{Cost of Materials consumed during the period}}{\text{Average stock of materials during the period}}$$

$$\text{ii Finished Stock Turnover Ratio} = \frac{\text{Value of Finished Stock sold in the period}}{\text{Value of Average stock held during the period}}$$

$$\text{iii Inventory Turnover in terms of days} = \frac{\text{Days of the period}}{\text{Stock Turnover Rate}}$$

Or

$$\text{Value of Average} \times \text{Days of the period}$$

$$\text{Material consumed}$$

- Iv **Input – Output Ratio:** - This is the ratio of raw material put into manufacture and standard raw material content of the actual output. The formula is

$$\frac{\text{Input Units}}{\text{Standard Units}}$$



× 100

5. **Perpetual Inventory system and system of store verification:** - Perpetual Inventory aims at devising the system of records by which the receipts and issues of material stores may be recorded immediately at the time of each transaction and the balance may be brought out so as to show the up-to-date position. This system is operated by: -
- Reconciliation of stock bin cards and stores ledger accounts
 - Physical stock verification which is of two types: -
 - Periodic stock verification &
 - continuous stock verification

Advantages of Perpetual Inventory System

- Records are updated
- Materials are within Minimum and Maximum Limits
- Purchases are requisitioned at appropriate time
- Facilitates preparation of interim P & L Account and Balance Sheet.
- Acts as moral check on staff of stores Department.
- A system of internal check remains in operation all the time.
- Discrepancies are readily discovered and rectified.
- Slow moving, dormant and obsolete materials are readily notified to purchase department
- A detailed and reliable check on stores is obtained.

6. Budgetary Techniques for Inventory standards:-

- Fixation of material cost planning
- Preparation of material budget

Pricing of Materials Issued

1. Cost Price

Methods: -

- First-in-First-Out Methods – FIFO
- Last in first Out Method – LIFO
- Highest in First Out Method – HIFO
- Base stock Method
- Specific Price Method.

2. Average rate Method: -

- Simple Average Method
- Weighted Average Method

3. Market Price Method: -

- Replacement Price Method.
- Realizable Price Method.

4. National Price Method: -

- Standard Price Method.
- Inflated Price Method.



Treatment of material Wastage/ Losses

1. **Material Losses may be normal as well as Abnormal.**

Normal Loss: - Which has to be incurred and is unavoidable e.g., evaporation in case of liquid materials, loss due to loading and unloading of materials, etc.

Abnormal Loss: - which arises due to inefficiency in operations or mischief, e.g., theft, pilferage, breakage, fire etc.

Accounting Treatment: - In order to absorb normal material losses in cost, the rates of usable materials in stock are inflated so that such losses are covered. Normal material loss is transferred to factory overhead.

Abnormal material losses are charged to Costing profit and loss account.

2. **Waste:** - It is that part of basic raw material which is lost in processing and has no recovery value **Accounting:** - If it is normal, the cost will be absorbed by the good production and if it is abnormal, then it is transferred to Costing profit and loss account.

Formulae

1. Economic Order Quantity (EOQ)

$$EOQ = \sqrt{\frac{2AB}{CC}}$$

Where, A = Annual consumption

B = Ordering cost / Procurement cost/ buying cost/ set up

cost CC = Carrying cost / Holding cost/ Storage cost

CC = Cost per unit x $\frac{\text{Rate of inventory carrying cost}}{100}$

- Economic Order Quantity (EOQ)

$$EOQ = \sqrt{\frac{2AB}{CC}} \times \sqrt{\frac{P}{P-D}}$$

Where, D = Demand of item or Consumption

P = Production of item or Procurement rate

- Economic Order Quantity (EOQ)

$$EOQ = \sqrt{\frac{2AB}{CC}} \times \sqrt{\frac{CC+CS}{CS}}$$

Where, CS = Cost of storage

- Ordering Cost – Per order
- Carrying cost – Per unit per year
- Shortage cost – Per unit per year

2. Total Cost

Total Cost = Total Ordering Cost + Total Carrying Cost + Total

Purchase Cost a. Total Ordering Cost = $\frac{\text{Annual Usage}}{EOQ} \times \text{Ordering Cost per unit}$

b. Total Carrying Cost = $\frac{EOQ}{2} \times \text{Carrying Cost per unit}$

c. Total Purchase Cost = Annual Usage x Ordering Cost per unit

3. Variable Cost

Variable cost = Ordering Cost + Carrying Cost

4. Number of Orders

Number of orders = $\frac{\text{Annual Usage}}{EOQ}$



Number of orders cannot come in Decimal

5. Time Between Placing Order

$$\text{Time between placing order} = \frac{\text{No. of working days}}{\text{No. of orders}}$$

6. Cycling Time

$$\text{Cycling Time} = \frac{\text{No. of working days}}{\text{No. of orders}}$$

7. Run Time

$$\text{Run Time} = \frac{\text{EOQ}}{\text{Production in a day}}$$

Note – *○ If Discount is given in question then, cost per units will be changed in all cases. ○ If information is given in months then, all items are converted into months.*

○ Carrying cost is changed when % of carrying cost is given on cost.

8. Re-order Level

$$\text{Reorder Level} = \text{Maximum usage Rate} \times \text{Maximum Reorder Period/Lead time}$$

OR

$$(\text{Lead Time} \times \text{Average Daily Consumption}) + \text{Safety Stock}$$

9. Minimum Level

$$\text{Minimum Level} = \text{Reorder Level} - (\text{Average Daily Consumption} \times \text{Average order Period})$$

10. Maximum Level

$$\text{Maximum level} = \text{Reorder level} + \text{Reorder Quantity} - (\text{Minimum consumption} \times \text{Minimum Reordering Period})$$

OR

$$\text{Demand (Review Period} \times \text{Lead Time)} + \text{Safety Stock}$$

11. Average Stock Level

$$\text{Average Stock Level} = \text{Minimum Stock Level} + \frac{1}{2} \text{ of Reorder Quantity}$$

12. Danger Level

$$\text{Danger level} = \text{Average consumption} \times \text{Maximum Reorder Period for emergency purchases}$$

13. Inventory Turnover Ratio

$$\text{Inventory Turnover Ratio} = \frac{\text{Material Consumed}}{\text{Average Raw Material}}$$

$$\text{○ Material Consumed} = \text{Opening Stock of Raw material} + \text{Purchases} - \text{Closing Stock of Raw Material}$$

$$\text{○ Average Raw Material} =$$

$$\frac{\text{Opening Stock} + \text{Closing Stock}}{2}$$

$$\text{○ Inventory Velocity}$$

$$\frac{\text{Days in a year}}{\text{Inventory Turnover Ratio}}$$

$$= \text{Inventory Turnover Ratio}$$



ACCOUNTING FOR LABOUR

Labour cost, representing the human contribution to production is an important factor of cost which requires constant control, measurement and analysis.

Classification of Labour Cost

- i. **Direct Labour:** - It is the cost of that labour that is directly engaged in production work and can be conveniently identified or attributed wholly to a particular job, process or cost unit.
- ii. **Indirect Labour:** - It is the cost paid to those workers who are not directly engaged in converting raw materials into finished product and cannot be conveniently identified with a particular job, product or cost unit. E.g. supervisors, cleaners' instructors, peons etc.

Labour Cost Control Factors

- i. Production Planning
- ii. Setting up of standards
- iii. Use of Labour Budgets
- iv. Study of the effectiveness of wage policy
- v. Labour performance Reports.

Organization for Accounting and control of Labour cost

- i. Personnel Department
- ii. Engineering and work study Department
- iii. Time Keeping Department
- iv. Payroll Department
- v. Cost Accounting Department

Labour turnover

The rate of change in the composition of the labour force in an organization during a specified period is called Labour turnover.

Causes of Labour Turnover

- i. Low wages and allowances
- ii. health and bad working conditions
- iii. Lack of safety measures, medical facilities, transport facility, etc.
- iv. Dissatisfaction due to various causes like working hours, improper placement, unfair method of promotion, bad relationship with fellow workers, bad training facilities etc.
- v. Inadequate job security and retirement benefits
- vi. Marriage in case of female workers
- vi. Change of job for better opportunities
- vii. Death or retirement.
- ix. Seasonal character of the Industry



Reduction and Control of Labour turnover

1. Devising a suitable and satisfactory wage policy.
2. Providing working conditions conducive to health and efficiency.
3. Impartial and sympathetic attitude of personnel management
4. Introducing financial and non financial incentive plans
5. Providing promotional opportunities.
6. Encouraging labour participation in management
7. Introduction of effective grievance procedure
8. Strengthening the welfare measures

Methods of Measurement of labour turnover: -

i. **Separation Method: -**

$$\text{Labour Turnover rate} \times 100 = \frac{\text{No. of Workers left during a period}}{\text{Average No. of workers during the period}}$$

ii. **Replacement Method:**

$$\text{Labour Turnover Rate} = \frac{\text{No. of workers replaced during the period}}{\text{Average No. of Workers during the period}} \times 100$$

iii. **Flux Method: -**

$$\text{Labour Turnover Rate} = \frac{\text{No. of workers left} + \text{No. of workers replaced}}{\text{Average No. of workers}} \times 100$$

Idle Time:

Idle time is time lost by workers who are paid on time basis. Idle time represents the time for which they are paid but no production is obtained. For example time lost between factory gate and the department, time when production is interrupted due to break down, tea breaks etc. Causes – Idle time may occur owing to productive, administrative or economic causes.

Over Time –the time worked over and above the normal hour is termed as overtime. The remuneration usually paid for the overtime work is at double the normal rate.

Need of overtime

1. Increase in demand for the products where the production during the normal hours falls short to meet it;
2. Shortage of workers due to absence or non-availability and so it is decided to give overtime work to the existing staff;
3. Utilization of perishable raw material by working overtime;
4. Execution of urgent orders, to complete the work on the same day.
5. Shortage of equipment, machines, or space for the completion of jobs.
6. Lack of administrative control on workers, on account of which the production during normal hours remains less than the standard output and overtime work has to be done by the workers.



Disadvantages of overtime working:-

1. Work efficiency is reduced. It is too much to expect of a tired worker to work as efficiently during overtime as in normal hours;
2. Worker's health is adversely affected;
3. The quality of the output is affected; and
4. The cost of production rises due to increased labour cost.

Methods of Remuneration

1. **Time Rate system:** -Under this system workers are paid according to the time for which they work. Payment may be on hourly basis, daily basis, weekly or monthly.

Suitability of this method

- a. Where quality of work is more important than quantity
- b. Where output cannot be measured in quantitative terms
- c. Where output is beyond the control of the worker
- d. Where work is done on a small scale so that close supervision is possible
- e. Where the worker is a learner or an apprentice.

2. **Piece Rate system:** - Here wages = Rate per unit x No. of units produced.

Suitability of this method: -

- a. Where production is standardized and repetitive in nature
- b. When the aim is continuous maximum production
- c. Where output can be measured
- d. Where workers continue at the same job for long periods
- e. Where standard time required completing a job can be measured accurately.

Various Incentive Schemes

1. **Halsey Premium Plan:** -In this system, a standard time is fixed for each job. Wages are paid for actual time spent on the job and bonus or premium is paid in a fixed proportion to time saved, i.e.

50% or 40%

$\text{Total earnings} = \text{Time Rate} \times \text{Time Taken} + 50\% \text{ of } [\text{time saved} \times \text{Time Rate}]$

2. **Halsey Weir Plan:** - Same as above except that the bonus is equal to 30% the time saved.

3. **Rowan Plan:** -

$$\begin{aligned} \text{Total earnings} &= [\text{Time Rate} \times \text{Time Taken}] + \text{Bonus} \\ \text{Bonus} &= \frac{[\text{Time Rate} \times \text{Time Taken} \times \text{Time saved}]}{\text{Time Allowed}} \end{aligned}$$

3. **Taylor's different Piece Rate Plan:** -In this system

- i. Day wages are not guaranteed
- ii. Standard time is set for each job
- iii. Two piece rates are fixed for each job – Higher and Lower rate

The lower piece rate is payable where a worker takes longer time than the standard time and higher rate is payable where a worker completed the work within the standards time.



Merrick differential Piece Rate system: - This plan lays down three rates

Percentage of standard Output

Up to 83%

83% to 100%

Above 100%

Piece rate

normal Piece rate

110% of Normal Piece Rate

120% of Normal Piece Rate

4. **Emerson's Efficiency Plan:** - Here the standard of efficiency is start 66 2/3%. A worker gets guaranteed time wages for efficiency up to the standard. Bonus is payable as follows: -

Efficiency

Below 66 2/3%

66 2/3% to 100%

Over 100%

Bonus

Time wages (No bonus)

Bonus increases in steps and rises to 20% at

100% efficiency

20% bonus plus 1% bonus for each increase of 1%

inefficiency

5. **Gantt's Task and bonus Plan:** - In this plan,
a. Day wages on time basis are guaranteed
b. A standard is set and remuneration is calculated as follows: -
When output is below standard – payment at time rate
When output is at standard – payment at time rate plus 20% bonus
iii. When output is above standard: - payment at higher piece rate

6. **Bedeaux Point Premium Plan:** - In this plan standard time of each job is determined in minutes known as Bedeaux points or B's. One B unit represents the amount of work which an average worker can do in one minute.

$$\text{Total Earnings} = \text{Time rate} \times \text{Time Taken} + \frac{\text{No. of B's Saved}}{60} \times \text{Hourly rate} \times$$

Group bonus Plans

These may be adopted in the following circumstances:-

- Where it is not possible to measure the performance of each individual worker
- Where the workers constituting a group possess the same or equal efficiency and skill.
- Where the number of workers constituting a group is not very large
- Where production is dependent on collective effort of a group of workers as a whole.

Types of group Bonus Plans

- Priestman's Output Bonus Plan
- Cost Bonus Scheme
 - Nunn-Bush Scheme
 - Scanlan Scheme
 - Rucker Acheme
 - Towne Gain Scheme



Co-Partnership and Profit sharing

Co-Partnership is a scheme whereby employees are given an opportunity to share in the capital of the business and to receive a part of the profit that accrues to their share of ownership.

Under the profit sharing schemes, the workers are paid in addition to wages a predetermined share of the profits of the undertaking.

Formulae

Measurement of Labour Turnover

1. Separation Method
$$= \frac{\text{No. of employees left during the period}}{\text{Average No. of employees during the period}} \times 100$$
2. Replacement Method
$$= \frac{\text{No. of employees replace in the period}}{\text{Average No. of employees during the period}} \times 100$$
3. Flux Method
$$= \frac{\text{No. of separation} + \text{No. of replacement}}{\text{Average No. of employees during the period}} \times 100$$
4. Average Number of Employees
$$= \frac{\text{No. of employees at the beginning} + \text{No. of employees at the end}}{2}$$

Incentive Schemes

1. Halsey Plan

Guaranteed wages = Time taken x Rate per hour

Actual Wage = Guaranteed Wage + Bonus (Time x Rate per hour x Percentage of bonus) [Assume % of Bonus = 50% (if nothing is given)]

2. Rowan Plan

Guaranteed wages = Time taken x Rate per hour

Actual Wage = Guaranteed Wage + Bonus

Bonus = $\frac{\text{Time saved}}{\text{Standard Time}} \times \text{Time} \times \text{Rate} \times \text{Rate per hour}$

3. Taylor's Differentiate Price Rate Plan

Actual Salary = under standard x Low piece Rate
OR

Actual Salary = Standard or more than standard x High Piece Rate

4. Gantt Bonus System

Guaranteed wage = Standard Time x Standard Rate per hour
○(Up to Standard)

Guaranteed wage = Standard Time x Standard Rate per hour

Actual Wage = Guaranteed Wages + Bonus Of guaranteed Wage
○(Above standard)

Actual Wage = No. of Units x High Piece Rate

5. Merrick Differentiate/ Multiple Rate Method

Guaranteed Wage = Actual no. of units x Normal Piece Rate



Actual Wage according to % of efficiency

a. (Up-to 83%) Guaranteed wage = Actual Wage

b. (Above 83% and up-to 100%)

Actual Wage = Guaranteed Wage + 10% of Bonus of Guaranteed Wage

c. (Beyond 100%)

Guarantees Wages + 20% of Bonus of Guaranteed Wage

Percentage of efficiency = $\frac{\text{No. of units produced}}{\text{Standard Time}} \times 100$ [Case I – Units given]

OR

$\frac{\text{Standard Time}}{\text{Time Taken}} \times 100$ [Case II – Time given]

6. **Emerson Efficiency Plan**

Guaranteed Wages = Actual Time x Standard Rate per hour OR

Guaranteed Wage = Standard no. of Units x Normal Piece Rate

Actual Wage according to % of efficiency

a. (Up-to 66.66%) Guaranteed wage = Actual Wage

b. (Above 67 and up-to 100%)

Actual Wage = Guaranteed Wage + Mentioned or 20% of Bonus of Guaranteed

Wage c.(Beyond 100%)

Actual Wage = Guarantees Wages + + Mentioned or 20% of Bonus of Guaranteed Wage +

Each 1% increase in efficiency beyond 100%

7. **Bedeaus Point Premium Plan**

Guaranteed wage = Time Taken x Rate per hour

Actual Wage = Guaranteed wage + Bonus (Time saved x Rate per hour x Percentage of bonus)

[Assumed Bonus % = 75% (if nothing is given)]

8. **Barth Method**

Wages = $\sqrt{\text{Standard time}} \times (\text{Actual time}) \times \text{Rate}$

9. **Time Wage/Rate system**

Actual Wage = Actual Time x Rate per hour

10. **Piece Rate Wage**

Actual Wage = No. of piece or standard time x Rate per piece of Rate per hour

Note – Dearness allowance always calculated on actual time. (D.A. = Actual time x D.A. Per hour)



UNIT-II

UNIT COSTING

"Single or Output Cost System is used in business where a standard product is turned out and it is desired to find out the cost of basic unit of Production." - J.R. Batliboi

Unit or output costing is used in those industries or organization where standard products are produced from a common process and all the units produced are more or less similar to each other. This method is also known as single costing method.

Definition of Unit or Output costing

Herold J. Wheldon – "Production cost accounting or unit cost accounting is such a method of cost ascertainment which is based on production unit. It is applicable where the production work is done continuously and the units are of same types of manufactured identical."

From the analysis of the above definition it is clear that generally this method is used in those industries, where following characteristics are found-

1. Production should be uniform or homogeneous and a continuous affair;
2. The units of production should be identical
3. The cost units should be physical and natural
4. Per unit cost has to be determined, for example per, ton metre, per kg, etc.

Objectives of unit or Output costing

The following are the main objectives for its application

1. To know the total cost of production and per unit cost within specific period.
2. To classify cost under related categories such as Prime Cost, works cost, cost of Production, etc. and having its detailed analysis in order to determine per unit cost.
3. To determine the effect of each element of cost on total cost so as to have control over cost.
4. To compare the cost during two or more periods and to make efforts for cost control on the basis of comparative analysis.
5. To determine proposed setting price to earn desired profit
6. To determine tender price on the basis of cost data and future prospects

In this method there is no need of apportionment of cost because all the expenses are made on a similar type of production. But where production is done for various grades or for various size, their expenses have to be apportioned on the basis of size or grades in detail.

Elements of Cost under unit or output costing

In output costing in order to determine total cost and per unit, collection of various elements of cost is done as follows -

Material – the quantity and value of material consumed is determined by preparing a Material Abstract. The materials which are issued from stock are valued on an appropriate basis.

Labour – As required. Wages Analysis Sheet is prepared so that direct and indirect labour cost can be determined.

Direct Expenses – In addition to material and labour, there are certain other expenses incurred which are termed as direct expenses.

Overheads – the overheads are debited to production for the period for which the cost is being determined. These overheads expenses are taken from the financial records. There are certain expenses which cannot be determined before the end of the accounting period.



Methods of determining unit cost

In those industries where production is carried out on mass scale and on a continuous basis and standards products are manufactured, the total cost and per unit cost can be determined by the use of following methods –

1. Cost Sheet
2. Statement of Cost

Cost Sheet

Meaning of Cost Sheet

Cost sheet is a statement which is used to determine the total cost of goods produced or units in a specific period and in which total cost, per unit cost and incurred at various stages from manufacturing a product to the stage of making it saleable are shown. In this way, it can be said that cost sheet is a statement in which the cost of production is presented in an analytical way.

Definition of Cost Sheet

ICMA, London – ‘Cost sheet is a document which provides for the assembly of the detailed cost of a cost centre or cost unit.’

W.W. Bigg – “the expenditure which has been incurred upon production for a period is extracted from the financial books and the records set out in a memorandum statement.

Characteristics and objects of cost Sheet

1. The cost sheets are produced under Unit costing methods of costing because its object is to determine per unit cost.
2. The cost sheet is a periodic document which may be prepared weekly, fortnightly, monthly or quarterly.
3. The object of preparing a cost sheet is to ascertain the total cost and the burden of each individual cost on the cost per unit of production for the period.

Difference between Cost Account and Cost Sheet

S.No.	Base	Cost Accounts	Cost Sheet
1	Nature	Cost Account is based on double entry principle and has Dr. and Cr. sides.	Cost sheet is not based on double entry principle.
2	Period	Cost Account shows the costs but only after the end of the year or period when they are closed	Cost sheet are prepared during the continuity of production
3	Comparative Study	The cost account are not helpful to know comparative costs	Cost sheet are helpful to know comparative costs.
4	Reconciliation	The cost accounts are useful in reconciling the profits of financial books with cost books	The cost sheet are not reconcile.
5	Cost per unit	Cost accounts do not show cost per unit in a detailed	Cost sheet ascertain cost per unit
6	Record are prepared	Cost accounts are prepared in the form of accounts	Cost sheets are prepared in form of statement



Indirect Expenses

These are classified into three groups i.e., factory overheads, administration overheads, selling and distribution overheads. They are usually charged at a predetermined rate.

Administration (Office) overheads may include

- *Office expenses*
- *Legal expenses*
- *Rent and taxes*
- *Directors fees*

Audit fees

- *General expenses*
- *Printing and stationary*
- *Bank charges postage and stamp etc.*



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Factory overheads includes –

- Factory expenses
- Motive power
- Heritage
- Factory light and heat
- Factory rent and rates
- Losses tools written off
- Unproductive wages · Technical directors salary · Depreciation on plants etc.
- Stores overheads
- Municipal tax

- Laboratory expenses
- Supervision charges
- Repair
- Fuel and power
- Wages and Foreman
- Light and water
- Fuel and gas
- consumable
- stores Factory
- lighting Oil and water.

Selling and distribution overheads includes –

- Selling expenses
- Unkeep of delivery vans
- Commission on sales
- Warehouse expenses
- Bad debts
- Advertisement expenses
- Carriage outwards

- Expenses of demonstration
- Salaries of commission of salesman
- Sales office expenses
- Cost of free gifts, samples
- Salary of warehouse staff
- Expenses of warehouse
- Van trucks etc.

It will be proper to know the important basic formula to arrive the cost of material consumed is –

Cost of material consumed – value of opening stock of raw material + purchase value of raw material – value of costing stock of raw material.

Below is given a list of typical cost units used in different industries –

Industry	Cost unit
Colliery	Per tone of coal
Sugar	Per quintal
Cotton textiles yarn	Per pound
Cloth	Per meter
Paper	Per kg
Steel	Per tonne
Automobile	Per automobile i.e., number
Power	Per kilo watt hour

Items not included in cost –



renaissance

college of commerce & management

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- *Income tax*
- *Interest on capital*
- *Dividend paid*
- *Goodwill, preliminary expenses written*
- *Donation off*
- *Cash discount*
- *Obsolescence loss from machinery*
- *Interest on debenture*

Methods for finding up unit costing

Following methods are used for finding up unit's costing –

1. *Cost Sheet*
2. *Cost Statement*
3. *Production Account*
4. *Trading and profit & loss account and manufacturing account*

Cost Sheet

<i>Particulars</i>	<i>Amount</i>
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Opening stock of Direct Material		----
(+) Purchase of Raw material		----
(+) Carriage on Purchases		----
(-) Closing stock of raw material		----
(-) Sale of Raw material		----
(-) Abnormal Wastage		----
(+) Direct Wages		----
(+) Direct Expenses	Material Consumed	----
(+) Factory/work overheads	Prime Cost	----
(+) Opening stock of work in progress		----
(-) Closing stock of work in progress	Gross Factory Cost	----
(+) Office overhead	Factory Cost/ Work Cost	----
(+) Opening stock of finished goods		----
(+) Purchase of Finished Goods	Cost of Production	----
(-) Goods stock of Finished goods		----
(+) Selling & Distribution Overheads	Cost of Goods sold	----
(+) Profit	Total Cost	----
	Sales	----

Calculation of Tender Price

The price at which the supplier offers his goods for sale, is known as Quotation or Tender –
The tender price should be calculated carefully in the following way –

1. The cost sheet of the produce being for sale, gives the cost of production. If there is a change in the price of material and cost of labour should be taken into account while quoting a price. s
2. The cost price per unit should be carefully examined.
3. Where quotation is given for a job, the actual material and direct labour costs can be ascertained and overheads are charged by a percentage selected base.
4. All possible changes in costs over the previous period should be taken in view preparing the statement.

Instructions for calculation the tender price –



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1. First prepare cost sheet
2. Determine cost per unit
3. In absence of information the percentage is Calculated for factory overhead on direct labour and office overhead on works cost.
4. Percentage of profit is calculated either on cost or on selling price.
5. The tender price is easily calculated when the percentage of profit and cost per unit is determined.

OVERHEAD COSTING

Accounting for overheads

Overheads are those indirect, operating costs of a business enterprise which cannot be traced directly to any specific product, job, or process because they cannot be directly attached or marked to any specific activity or cost centre.

Overhead Accounting involves: -

- A. Classification, Codification & Collection of overheads
- B. Allocation, Apportionment and absorption of overheads.

A. Classification of Overheads

1. Elements wise Overheads

- i. Indirect Material – e.g. Consumable stores, loose tools, etc.
- ii. Indirect Labour – e.g. Salary of foremen, store-keeper, supervisors, etc.
- iii. Indirect Expenses – e.g. Factory rent lighting, heating, insurance, administration, and selling & distribution expenses.

2. Function-wise Classification

- i. Production or Manufacturing Overheads: - E.g. Indirect material Indirect labour & indirect expenses
- ii. Administration overheads: - Audit fees, postage and telephone
- iii. Selling & distribution overheads: e.g. Advertising, showroom expenses, traveling expenses, etc.

3. Classification According to Behaviour or Variability

- i. Fixed Overheads are those which tends to be unaffected by variation in the volume of output.
E.g. rent and rates, managerial salaries.
- ii. Variable Overheads are those which tends to vary in direct proportion to changes in the volume of output. E.g. indirect material, indirect labour.
- iii. Semi Variable overheads are those which are partly fixed and partly variable? E.g. depreciation, repairs & maintenance, telephone etc.

4. Classification According to Controllability

- i. **Controllable Cost:** - Which Can be controlled by the action of a specified members of the department e.g. variable cost
- ii. **Uncontrollable Costs:** - Which cannot be controlled by the action of specified members of the undertaking. E.g. fixed cost.

Departmentalization of overheads: - This is the problem of (allocation and apportionment of overheads to production and service department)

Cost allocation: - The allotment of whole items of cost to cost centers or cost units is called cost allocation.

Apportionment of cost: - Where the expense is common and related to various cost centers or units, then it is to be allotted to different cost centers on an appropriate basis. This process is called Apportionment.

Primary distribution of overheads: - This is the process of allocation and apportionment of different items of overheads to all the departments.



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Secondary distribution of overheads: - This is the process of re-distribution of the overheads cost of service department among the production department.

Methods: -

Direct Redistribution

Simultaneous equation method

Step ladder method

Repeated Distribution method

Objectives of Departmentalization

1. Ensures greater accuracy in cost ascertainment.
2. Control of overhead cost
3. Use of different methods of absorption
4. Valuation of work-in-progress
5. Cost of service departments can be ascertained
6. Accurate forecasting and estimation and decision making.

Common Bases of Apportionment of Overheads

Direct Allocation	Consumable stores, specific expenses
Floor Area of Department	Rent and other building expenses, lighting & heating,
Direct Labour hours or Direct wages or No. of workers	Supervision, Administration Compensation to workers, Holiday Pay, ESI & PF contribution, fringe Benefits. Labour welfare expenses, Time Keeping, canteen Expenses.
Capital values of building or plant:-	Depreciation, insurance charges, rent, repairs & maintenance etc.
Light Points	Lightning expenses
Kilowatt hours/Machine hours	Electric power
Wight or volume of material or value of materials	Material handling, stores overheads
Technical estimates	Power, light, internal transport, managerial salaries etc.

Absorption of overheads

Absorption means distribution of overhead expenses allotted to a particular department over the units produced in that department. So charging of overheads to cost units is called absorption of overheads.

Determination of overhead rates

1. Actual Rate – $\frac{\text{Actual overhead}}{\text{Actual Base}}$
2. Predetermined Rate $\frac{\text{Budgeted Overheads}}{\text{Budgeted Base}}$
3. Standard Rate – $\frac{\text{Standard Overhead}}{\text{Standard Base}}$
4. Blanket Rate – $\frac{\text{Total overheads for the factory}}{\text{Total quantity of the entire factory}}$

Under Absorption and over Absorption of overheads



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Under Absorption: - If the amount absorbed on predetermined rates is less than the overheads actually incurred, it is called under absorption or under recovery.

Over Absorption: - If the amount absorbed is more than the actual overheads, it is known as over absorption or over-recovery.

Causes of Under/Over Absorption of overheads

- I. Error in estimating overheads
 - li. Error in estimating quantum of production
 - lii. Actual hours worked may be more or less than those anticipated.
- iv. The basis upon which factory overheads are recovered from production may no longer be correct on account of changes in prices of materials or wage rates.
- v. WIP may not have been charged with its share of overhead cost accounts.
- vi. Seasonal fluctuations in overheads from time to time.
- vii. Unanticipated changes in methods of production and production capacity.

Accordinging Treatment of Under/Over Absorption

- i. **Writing off to costing P & L A/c:** - This is used when account of under or over absorption is quite negligible or when under absorption is due to abnormal factors like idle capacity, defective planning, etc.
- ii. **Absorption in the subsequent year:** - Here the under or over absorption amount is transferred to Overhead Reserve Account or Suspense Account for carry over to the next accounting year.
- iii. **Application of supplementary Rates:** - Where the amount of under or over absorption is significant, a supplementary overhead absorption rate is calculated by dividing the under or over absorbed amount by the actual base. Adjustment is made in the cost of:
 - a. Work in progress
 - b. Finished stock
 - c. Cost of sales

In case of under absorption, the over head is adjusted by a positive rate, since the amount is to be added. Over absorption is adjusted by a negative rate, since the amount is to be deducted.

Methods of Absorption of overheads

Direct Material Cost Method
Direct Labour Cost Method
Direct Labour Hour Method
Prime Cost Method
Machine Hour Rate Method
Production Units Method or Rate Per Unit of Output.

MACHINE HOUR RATE

Machine hour rate is cost of running a machine for one hour. It is different for different types of machine.

An actual or pr-determined rate of cost apportionment or overhead absorption which is calculated by dividing the cost to be apportioned or absorbed by the number of hours for which a machine or machines are operated or expected to be operated.

Comprehensive machine hour rate – when the direct wages of machine operators are included in machine hour rate, it is known as comprehensive machine hour rate.

Bases of apportionment of different overhead to machines

S.No.	Expenses	Basis
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1.	Fixed Charges <i>Rent and Rates</i>	<i>Floor area occupied by each machine including the surrounding space.</i>
2.	<i>Heating and lighting</i>	<i>The number of points used plus cost of special lighting or heating for any individual machine, alternatively according to floor area occupied by each machine.</i>
3.	<i>Supervision</i>	<i>Estimated time devoted by the supervisory staff to each machine. On basis of past experience</i>
4.	<i>Lubricating oil and consumable stores</i>	<i>Insurable value of each machine</i>
5.	<i>Insurance</i>	<i>Equitable basis depending on facts</i>
6.	<i>Miscellaneous expenses</i>	
1. 2.	Variable Expenses <i>Depreciation</i>	<i>Cost of machine less residual value spread over its working life. Actual consumption as per meter reading</i>
3.	<i>Power</i>	<i>Cost of repairs spread over its working life.</i>
	<i>Repairs</i>	

Advantages

1. It helps in analyzing the comparative efficiency of machine and comparing the overheads charges in various departments.
2. It expresses the quantitative analysis of time and cost of operating of each machine.
3. Managerial decision making is facilitated regarding use of manual labour in place of machines.
4. This is the most scientifically correct way of analyzing production overheads.
5. The cost analysis prepared here is more reliable for management to make decisions.
6. This method provides necessary information for estimating cost of production, laying down standards and estimating selling price of output.
7. This method can be very effective in valuing the cost of in operational machinery if the costs are bifurcated into fixed and variable.

Disadvantages

1. Those costs are not at all considered which are not in consideration with hours of operation of machinery.
2. If manual labor is also equally important part of cost then the results of cost estimation will be misleading.
3. Because of calculating the hours of operation separately for this method the whole process seems to be costly.
4. If the production programme is not pre-decided then estimation of operating hours becomes difficult.
5. Blanket overhead rates cannot be used here therefore this method becomes more expensive.

UNIT-III

CONTRACT COSTING

It is one of the methods of cost accounting. This method is used in such industries where work is performed on contract basis. Contract costing is a part of specific order costing method where work is performed as per requirement or specification of the customer or contactee. Contract costing is also known as "terminal costing" or construction costing. It is used in civil engineering works such as road



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making, building construction, dam construction, bridge construction etc. Here the work is not done within the four walls of the factory, but outside the factory which is called site.

Terminology used in contract costing:

1. **Contractor and contactee** – the person under the terms of agreement, promises to complete a particular work is called contractor. The person whom such promise is given is called contactee.
2. **Contract price** – it is the consideration given to contractor for the construction work. Normally contract price of every contract is based on the cost involved in the contract.
3. **Work in progress** – Entire work done before the stage of completion of contract is work-in-progress. In other words when the contract is not completed till the end of accounting year the architect is required to value the work in progress. Such work in progress is classified into two parts – (a) Work certified
(b) Work uncertified.
 1. **Work certified** – that part of work-in-progress which has been approved or certified or authenticated and valued by the expert called certifier or a valuer, is known as work certified.
 2. **Work uncertified** - it is that part of work-in-progress which has not been approved by the expert.
4. **Retention money and cash ratio** – payment by the contactee is always linked to the value of the work certified. Generally the monthly, quarterly or annual payments are a percentage of work certified, e.g. 70 or 90 percent or any other percentage agreed upon between the contractor and the contactee. At the completion of contract the entire balance amount is paid to the contractor. Some contractees pay interest on retention money. Retention money serves as a security with the contactee. It may be adjusted against the defective work found later.
5. **Escalation, DE-escalation or reserve clause** -This clause is generally provided in long term contracts with a view to protecting both the contract and the contactee against fluctuations in the prices of inputs to the contract mainly material and labour.
6. **Cost plus contracts** – cost plus contract is a contract in which the contract price is not fixed at the time of entering into the contract. The contract price is determined by adding a specified amount of percentage of profit to the cost allowed in the contract.

Contract

A/c

Date	Particulars	Amount	Date	Particulars	Amount
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To Material purchased	-----	By Material/Plant transferred to	-----
To Material issued from stores	-----	other contract	-----
To plant issued	-----	By material/plant returned to stores	-----
To plant purchased	-----	By cash a/c [material or plant sold]	-----
To Direct Labour	-----	By P&L a/c Material/plant stolen or destroyed	-----
To Indirect labour	-----	By material/Plant in hand or at site	-----
To Direct Expenses	-----	(If contract is completed)	
To Indirect Expenses	-----	By Contractees A/c	
To Supervision Charges	-----	By P & L A/c (Loss)	-----
To Sub contract cost	-----	(If contract is incomplete)	
To cost of extra work done	-----	By W.I.P. A/c	
To P & L A/c (Profit on sale)	-----	W.C.	
(If contract is completed)	-----	.....
To P & L A/c (Profit)		W.U.C	
(If contract is completed)	-----	.....	-----
To Balance c/d (Total Profit)	-----	By P & L A/c (Loss)	
	-----		-----
To P & L A/c			
To W.I.P. A/c (Reserve)		By Balance b/d	

WORK - IN - PROGRESS A/c

Date	Particular	Amount	Date	Particular	Amount
	To Contract A/c			By Contract A/c (Reserve)	.....
	W.C.			By Bal. C/d	.....
	W.U.C. ....	.....		

Contractees A/c

Date	Particular	Amount	Date	Particular	Amount
1 st yr Dec.31	To Balance c/d	1 st yr Dec.31	By Cash
2 nd yr June 30	To Contract A/c	2 nd yr Jan.01	By Bal. b/d
				By Cash



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			June 30		
	

BA LANCE SHEET
As on 31st December x x x 1

		By W.I.P. A/c ----	
		- Cash Received ----	-----

Rules regarding Transfer of profit – to Profit & Loss A/c

(A) If contract is completed -

The whole amount of Profit or Loss will be transferred to P & L A/c

(B) If contract is incomplete

(i) In case of Loss: The whole amount of Loss will be Trans to P & L A/c
(ii) In case of Profit:-

(a) If the value of W.C. is less than 1/4th of the contract price - Nil

(b) If the value of W.C. is 1/4th or more than it but less 1/2 of the contract price

$$= \text{Total Profit} \times 1/3 \times \text{Cash Received} / \text{W.C.}$$

C) If the value of W.C. is 1/2 of the contract price or more than it

$$= \text{Total Profit} \times 2/3 \times \text{Cash Received} / \text{W.C.}$$

In Case of Loss

The excess of debit over the credit items of the contract account is the loss. This loss is to be transferred to Profit & Loss A/c

Important Points while Preparing Contract A/c

- The expenses incurred on contract are written on the debit side of contract A/c for e.g., Material, Labour, Direct expenses, Indirect expenses, Subcontract cost etc.
- If any material loss or theft in a contract, it should be recorded in the credit side of Contract A/c as in the name of Profit & Loss A/c.
- If any material and plant sold in the contract the sales price is written on the credit side of Contract A/c and then calculated the profit of loss and it is transferred to P & L A/c. If profit is there, it should be appeared on the debit side of P & L A/c, and loss should be appeared on the credit side of P & L A/c
- Material at site, plant at site, stores at site should be written on the credit side of Contract A/c
- If only depreciation of plant is given in the sum, then depreciation is written on the debit side of Contract A/c
- If work certified amount is not given in the sum, then, following formula is used for calculating work certified amount –

$$\text{Work Certified} = \frac{\text{Cash received} \times 100}{\% \text{ of cash received}}$$

- Depreciation is calculated by following formula when rate of depreciation is not given –

$$\text{Per hour Rate} = \frac{\text{Estimated working life of plant}}{\text{Cost of plant} - \text{Scrap value}}$$

$$\text{Per hour Rate} = \text{Estimated working life of plant}$$



Job Costing

Job costing is that part of cost accounting which finds cost of material, produced under a specific order. There goods are produced for immediate delivery for each job costing, the cost is calculated separately for each job order because every work order differs from person to person.

Thus, job costing is that method of cost accounting where cost is determined according to quantity of product, special material equipment, labour and expenses required to fulfill the order.

Job accounting has the following features

1. It differs order to order.
2. It is based on intermittent production and not continuous.
3. In job costing method, each job is treated as a separate cost unit.
4. In job cost, the final cost of production is ascertained after the completion of the job.

Objects of Job Costing

1. Job costing helps to find out the profit or loss job wise.
2. Job costing helps to management to recognize profitable or non profitable job work.
3. Costing of old job helps to ascertain the cost of same type of new job work.
4. actual cost is compared to standard cost in job costing method which helps to control the cost in case of repeat job order.

PROCEDURE OF JOB COSTING

The following procedure is adopted in case of job costing method –

1. **Job Number** - First of all each job is given a separate number for its identification.
2. **Production order** - Production order is a written order given to for men to start the job. In this order job number, quantity to be produced design, specific requirement time etc. are mentioned.
3. **Job Cost Sheet**— A separate job cost sheet is prepared for each job. This job cost sheet carries the details of expenditure incurred on that particular job.
4. **Completion Certificate** - After completion the job. The production department sends the job completion certificate and a copy of job cost sheet to costing department.

Difference between Contract Costing and Job Costing

The difference between these two may be cleared as follows-

S.No	Bases of Difference	Contract	Job Costing
1	Nature or work	It is related to contraction generally	It is related to production process.
2	Amount and Time	Contract is having huge amount and longer period	Job is related for shorter period and small amount.
3	Sub contractor	In case of contract work	The subcontractor may be contracted and their cost will be part of contract costing.
4	Industry	Contract costing method is used in contraction industry e.g., Road	It is applied in industries which manufacture products or provide services against specific orders such as printing press, furniture makers general engineering concerns etc.



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5	Work site	<i>In the contract work is done out the work shop generally. Place of contraction is the work site/work shop.</i>	<i>Here works is completed in the workshop only</i>
6	Determination of profit or loss	<i>In this method profit or loss is also determined on incomplete contract</i>	<i>In this method profit or loss is calculated after the completion of job</i>
7	Nature of Expenses	<i>Most of the expenses under contract costing are direct in nature.</i>	<i>In Job costing expenses may be direct and indirect both.</i>

Batch Costing

Meaning

There are some such products whose cost of production can be calculated unit wise (for an individual unit). For example bolts nuts, pins, screw bread, biscuits, etc. In such a case firms which are producing these products, use the batch costing method in batch costing each batch of production is treated as an separate job work and cost is determined accordingly.

Procedure of Costing

Batch costing does not differ from job costing in respect of accounting procedure. Like job costing each batch is given a separate number and cost sheet is prepares. The overheads are distributed by a proper method.

In this method cost of plant and its setting is treated as fixed overheads and it is distributed among the batched by the proper methods.

Economic Batch Quantity

In this method that quantity of product is calculated which make the cost of batch economical or least? Thus, economic batch quality is that best possible size of output which gives that minimum cost and maximum product.

To calculate the economic batch quantity the following two types of cost are considered –

1. Setting cost of plant.
2. Cost of shortage – Rent of warehouse, insurance expenses, interest on borrowing

$$\text{Economic Batch Quantity} = \sqrt{\frac{2 \times U \times S}{C}}$$

U = No. of units to be produced in a year

S = Set up cost per batch

C = Carrying costs per units

OPERATING COSTING

Meaning of Operating Costing –

Operating costing is adopted by those businesses which operate services. These service organizations render services instead of producing & their main feature. The service may be sold by the enterprises to consumers, e.g. Bus companies, tramways, railways, airways & shipping companies, hotels, banking finance and consultancy firms, electricity boards, gas, water and other utility undertakings. The service may also be used within the enterprise e.g. cafeteria, boiler house etc. Operating costing is a



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method of cost accounting designed to determine the cost of services, and hence justifiably also called services costing.

According to CIMA England "Operating costing applies where standardized services are provided either by an undertaking or by a cost centre within an undertaking".

Normally, operating costs are period costs. Expenses accumulated for a period say, quarterly or monthly are related to the quantum of services rendered during the period. In some cases, however, operating costs could also be sold as terminal costs. When a plane is chartered for a specific trip, its cost would be calculated as if it is an independent job.

Characteristics –

The following characteristics are usually found in industries where operating cost is used –

- i) Services rendered to customers are of unique type.
- ii) A large proportion of the total capital is invested in fixed assets & comparatively less working capital is required.
- iii) The distinction between fixed cost and variable cost is of particular importance because the economics & scale of operations considerably affect the cost per unit of service rendered. For example, fixed cost per passenger will be lower if buses in Transport Company run capacity packs.

This method of costing can be used in the following service undertakings –

- i) **Transport services** – Bus, truck companies, Tramways, Railway, Airlines.
- ii) **Supply services** – Gas Company, water supply, electricity, boiler House etc.
- iii) **Welfare services** – Hospital, Canteen, Hotel, and Public Library.
- iv) **Public services** – Road maintenance, Road lights & other public utility services etc.

Cost unit – The selection of suitable cost unit may sometimes prove difficult. The cost units may be of the following two types –

- i) Simple cost unit.
- ii) Composite cost unit.

Simple cost unit – The unit may be simple as under unit costing as per bed in case of hospital, per 1000, liters in case of water works, per child in one of the schools, per cup of tea or per dish in case of canteen services etc.

Composite cost unit – In this type more than one unit are combined together as per passenger km in case of bus companies.

S.No.	Undertaking/Business	Cost Units
1	Transport Business, Tram, Railways, Roadways	Per-passenger-km, per seat-km.
2	Trucks and other loading vehicles.	Per-tone or quintal-km.
3	Hospital – Indoor - Outdoor	Per bed-day Per patient-day
4	Electricity supply	Per Kwt-hour
5	Water supply	Per Gallon-hour, per 1000-litres
6	Canteen	Meals per-person, per cup-tea etc.
7	Boiler House	Per cub centimeter gas or steam
8	Hotel	Per-room-day, per-passenger-day



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9	Cinema, Theater etc.	Per-person per show
10	Road Maintenance	Per-km.

Build-up of Costs -

After determining the unit of cost to which the total expenditure is to be apportioned, the process of collecting the necessary data about costs of operating the service is carried over. The data after collection are classified under two heads -

- Fixed or standing charges
- Variable charges.

This is done so that greater control can be exercised over new costs. In whatever quantum the service is rendered, fixed cost or standing cost shall not change and the management should concentrate over such costs.

The expenses which vary according to a change in the operating level are grouped separately and sometimes such expenses are placed in sub-groups like

- Maintenance charges
- Running Expenses.

This is done to have a better idea about the cost structure. Costing in some specified undertaking has been explained in detail.

Transport Costing -

Transport is one of the service performed by air, water, railways, tramways roadways, goods carries, etc. such businesses naturally take to the method of operating costing, with a view to finding the total cost of each vehicle and then applying it to the unit cost. The cost information helps not only in charging for the service against departments and outsider customers, but in making comparison between vehicles inter se and alternative modes of transport.

To calculate the operating expenses following work should be done -

- Collection of service expenses for specified period.
- Division of collected expenses between fixed & variable expenses.
- Calculation of units for service rendered.
- Calculation of per unit cost by dividing total expenses with units.
- Adding the profit in per unit cost and take the decision as for fixing rates per passenger per kilometer or per ton km. etc.

Collection of operating cost -

For each vehicle or for generator or pumping set etc. a log book is maintained to record various details during a given period of time. Particulars regarding capital, maintenance and running costs, trips made, fuel & oil supplied; worker's time spent and exceptional delays are invaluable for working out the cost services. These enable the management to make suitable allocation of vehicles and thus avoid unnecessary or duplicate trips and waste or idle running capacity.

From following specimen given it will be seen clearly -

Vehicle No. :	Operating Cost Statement		Stationed at:	
Carrying capacity :	January 2009		Route No. :	
Particular	Budget		Actual	
	Total	Per ton Km.	Total	Per ton Km.



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A. Standing Charges:	Rs.	Rs.	Rs.	Rs.
1. License fee				
2. Insurance				
3. Road tax				
4. Administration				
5. Depreciation, if charged on time basis				
6. Interest				
Total				
B. Maintenance Charges:	Rs.	Rs.	Rs.	Rs.
1. Garage expenses				
2. Repairs & overhauling				
3. Oiling & servicing				
4. Spare parts & components				
Total				
C. Running Charges:				
1. Petrol or diesel				
2. Oil & greases				
3. Running staff salaries				
4. Wear & tear of tyres, tubes				
5. Insurance of transit goods				
6. Vehicle depreciation if charges on mileage run basis				
Total				
D. Total Operating Cost (A+B+C) E. Total Ton-kms. or passenger-km. F. Cost per ton-km or passenger-km. G. Revenue Earned H. Net Profit				
Remarks if any	Cost Accounting			

Classification of Expenses Accumulated

Operating expenses for a specified period are classified into two parts –

- i) Fixed charges, &
- ii) Variable charges.

- i) **Fixed charges** – License fee, insurance, road tax, garage rent, salary of the supervisory and office staff, director's fees, interest on capital, wages of the driver, conductor and cleaner etc. (if paid on time basis).
- ii) **Variable charges**– Depreciation of vehicle, cost of petrol, diesel, mobile oil, grease and other lubricants, wages of drivers and cleaners (if paid on mileage run-basis), Repairs and overhauling expenses. Oiling and servicing charges, wear and tear of tyres and tubes, Gas and electricity charges, Insurance on transit goods.

Some authors have allocated these expenses in three parts as under –

- i) **Standing Charges (Fixed)** – License fee, insurance, road tax, interest on capital, depreciation of vehicles, and salary of the supervisory and office administration staff.
- ii) **Maintenance charges (Semi Variable)** – Repairs and renewals, Garage and terminal office rent, rates etc. staff salaries of garage and terminal office, spare parts, oiling and servicing charges (routine).



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- iii) **Running Charges (Variable)** – Cost of petrol, diesel, mobile oil, grease and other lubricants, depreciation of tyres, tubes and battery, Insurance of transit goods, wages of drivers and cleaners (if paid on mileages run basis).

Calculation of Ton Kilometers or per Passenger Kilometers

In transport business before calculation of running expenses. It is necessary to know the meaning of the words ton kilometer or passenger kilometer. Their meaning is being explained here under –

- Ton Kilometer** – It refers to the calculation of cost of carrying one tone load to one kilometer.
- Passenger Kilometer** – It refers to the estimation of cost incurred on carrying a passenger one kilometer.

Calculation of Operational Cost

Before calculating operation cost fixed and variable expenses are added. Thereafter following formula is used for its estimation –

- a. **In relation to a transport company carrying passengers –**

$$1. \text{ Operating Cost per Km} = \frac{\text{Total standing and Running expenses}}{\text{Kilometer}}$$

$$2. \text{ Operating cost per passenger Km} = \frac{\text{Total standing and Running expenses}}{\text{Total passenger km}}$$

- b. **In relation to a goods carrier transport company –**

$$1. \text{ Operating Cost per Km} = \frac{\text{Total standing and Running expenses}}{\text{Total ton km}}$$

$$2. \text{ Operating cost per ton Km} = \frac{\text{Total standing and Running expenses}}{\text{Total ton km}}$$

UNIT-IV

PROCESS COSTING

Definition:

Some important definitions of process costing are as under –

“Process cost accounts are applied to concerns which produce a commodity that has to go through several processes and which requires to know the cost of each process”. – **Charles**.

“Process costing is used to ascertain the cost of each stage of manufacture where material is passed through various operations to obtain a final product to result, with by products in many cases at different stages. – **Lunt and Ripley**

Application of process costing –

Process costing is employed in the following types of industries –

- Food processes industries, e.g., flour mills, meat products, milk dairy, confectionaries, fruits and vegetables processing etc.
- Other industries involving a sequence of processes, e.g., paper mills, cement works, coke works, canning factory, textile manufacture, cartoon making, etc.



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- 3) *Metallurgical industries, e.g., iron and steel, aluminum, wire drawing and netting and polishing, alloy production etc.*
- 4) *Chemical industries, e.g., drugs and pharmaceuticals, paints soap making, production of sugar, molasses and alcohol, breweries, distilleries, oil refining, etc.*

Salient features/essential characteristics of process costing -

- 1) *The cost per unit produced is the average cost which is calculated by dividing the total process cost by the number of units produced.*
- 2) *Some loss of materials in processes (due to chemical reaction, evaporation, etc.) is unavoidable.*
- 3) *The production is continuous and the final product is the result of a sequence of processes.*
- 4) *Processing of raw materials may give rise to the production of several products. These several products produced from the same raw material may be termed as joint products or byproducts.*
- 5) *The products are standardized and homogeneous.*
- 6) *Costs are accumulated process-wise.*
- 7) *The sequence of operations or processes is specific and pre-determined.*
- 8) *The finished product of each but last process becomes the raw material for the next process in sequence and that of the last process is transferred to the finished goods stock.*

Advantages / uses/ need of process costing -

Main uses of process costing are as follows -

- 1) *System of standard costing can be applied with ease in case of process accounts.*
- 2) *Valuation of inventory of work-in-process of different processes and finished products is facilitated by process accounts.*
- 3) *Cost of individual processes as well as of finished products can be ascertained at short intervals.*
- 4) *Make or buy decisions for different processes can be taken in the light of costs at different processes. For example, in case of textile manufacture if the cost at weaving process is higher than the price at which plain cloth can be purchased from outside, the company may decide to buy plain cloth from outside and perform the process of printing only. If weaving costs are lower, the weaving process is also performed.*
- 5) *Effectiveness at each process is determined on the basis of costs incurred at individual process.*
- 6) *Since output at each process is homogeneous, average cost per unit can be easily calculated.*
- 7) *Separate cost ascertainment for each process has motivational impact. Employees at the process resulting in cost economies can be rewarded, and those not performing up to the mark can be reprimanded.*
- 8) *Cost control is facilitated as it is ascertained as to where excessive cost has been incurred and where wastages and scraps are high.*

Limitations of process costing -

Major limitations of process costing are -

- 1) *Process costs throw light on efficiency level of entire group of people working at a process, not on the efficiency of individuals.*
- 2) *Determination of cost at processes is by itself not sufficient for cost control, make or buy decisions or for motivational measures.*
- 3) *In case production at a process is not homogeneous as in the case of foundries making casting of different sizes, shapes and of different qualities involving different alloys, the average per unit cost based on total output and total cost at a process will be misleading.*
- 4) *Process costs are historical costs and suffer from all weaknesses of such costs.*
- 5) *Valuation of inventories where there is work-in-progress at processes, involves lot of estimation.*
- 6) *Determination of cost of by-products and joint-products is also a mere estimation.*

Principles of process costing -



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The following principles should be followed for ascertaining costs at processes –

- 1) *Output of one process is transferred to the next process and that of final process is transferred to finished goods account.*
- 2) *Cost per unit at processes is ascertained at the end of each specified period, e.g., on monthly or quarterly basis.*
- 3) *All normal losses should be charged to the output at the processes. However, cost per unit must never be influenced by abnormal gains and losses.*
- 4) *Each processes is taken as a cost centre, i.e., all direct and indirect costs are assigned to processes on appropriate basis.*
- 5) *In case of by-products and joint-products, their share in joint costs should be carefully estimated and credited to the main process.*
- 6) *In case there are incomplete units at the process at the beginning and at the end of the period, equivalence of incomplete units is determined.*

Normal and Abnormal losses:

Normal Process Loss: That amount of loss which cannot be avoided because of the nature of material or process is normal process loss. Such a loss is quite expected under normal conditions. It is caused by factor like chemical change, evaporation withdrawals for tests or sampling, unavoidable spoiled quantities etc.

Abnormal Process Loss: This type of loss consists of loss due to carelessness, machine break down, accident, use of defective material etc. Thus in cases due to abnormal factors it represents a loss which is over and above the normal loss.

Accounting Treatment of normal loss:

It is a fundamental costing principle that the cost of normal losses should be borne by the good production. Normal loss is generally determined as a percentage of input. Sometimes such a loss is due to cost of weight, say due to evaporation a chemical action. Since such a wastage is not physically present, obviously it cannot have any value.

However when normal loss is physically present in the form of scrap it may have some value, i.e. it may be sold at some price. Whenever scrapped material has any value, it is credited to the process account. This illustrated below.

Accounting Treatment of Abnormal Process Loss

It is been stated earlier that abnormal loss is due to carelessness, accidents, machine, breakdown and other abnormal reasons. Unlike normal loss, abnormal loss is not absorbed by good production, rather it is transferred to costing P & L a/c. This is because if the cost of abnormal loss were to fall upon the good production the cost there will fluctuate and the information provided would be misleading. In order to overcome this and also to disclose the cost of abnormal loss, the following procedure may be adopted :

- (a) Allow for normal loss in the manner described earlier.
- (b) After considering normal loss, find out the cost per unit that process. This is done by the following formula process.

$$\text{Cost per unit} = \frac{\text{Total cost} - \text{value of normal loss}}{\text{Units introduced} - \text{normal loss units}}$$

- (c) Multiply the cost per unit (calculated as above) by the number of units of abnormal loss. This gives the total value of abnormal loss.
- (d) Credit the relevant process account with the quantity and value of abnormal loss.
- (e) The balance figure in the process account is the cost of good units produced in the process. This can also be found by multiplying cost per unit with the number of good units produced.



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- (f) *Open Abnormal loss account and debit it with the quantity and value of abnormal loss shown in the process account sale proceed from abnormal loss are credited to abnormal loss account. Any balance left in this account is net loss and transferred costing P & L a/c.*

Fifty units are introduced into a process at a cost of rupee one each. The total additional expenditure incurred by the process is Rs. 30 of the units introduced 10% are normally spoiled in the spoiled in the course of manufactures these possess a scrap value of Rs. 0.25 each. Owing to an accident, only 40 units are produced. You are required to propose (i) Process a/c and (ii) abnormal loss a/c.

Abnormal Gain or Effectiveness –

The normal process loss represents the loss that would be expected under normal conditions. It is an estimated figure. The actual loss may be greater or less than the normal loss. If the actual loss is greater than normal loss, it is known as abnormal loss. But if actual loss is less than normal loss, a gain is obtained which is termed as abnormal gain or effectiveness. The value of abnormal gain is calculated in a manner similar to abnormal loss. It is shown on the debit side of the Process Account and credit side of the Abnormal Gain Account. Like abnormal loss, it is ultimately transferred to Costing Profit and Loss Account.

Joint and By Products

Joint products: The term joint products are used for two or more products of almost equal economic value which are simultaneously produced from the same manufacturing process and the same raw material. Joint products thus represent two or more products separated in the course of processing each product being in such proportion as the main product.

Characteristics:

- (a) *Joint products are produced from the same raw material by natural proportion.*
- (b) *They are produced simultaneously by a common process.*
- (c) *They are comparatively of almost equal value.*
- (d) *Joint products may be saleable after separations or may be further processed by incurring additional costs to make them stable or an improved product.*

A classic example of joint products as given above is found in oil refining, where items like petrol diesel, naphtha, kerosene etc. are produced from the crude oil. Other example are in flour mill where joint products are hides, canned meat, fertilizers etc. The joint product is also used to describe various qualities of the same product, as for example many grades of coal which may be produced in coal mining. Examples of Joint Products

Industry	Joint Products
1. Oil Refining	Petrol, Diesel, Kerosene grase lubricating oils.
2. Dairy	Skimmed Milk, butter
3. Meat processing	Meat, Hides
4. Mining	Several metals from the same or example copper, silver, zinc etc.

By Product:

By products are products of relatively small value which are incidentally and unavoidably produced in the course of incidentally and unavoidably produced in the course of manufacturing the main product. For example in sugar mills the main products is sugar. But bagasses and molasses of comparatively smaller value are incidentally produced and thus are by products, other examples of by products are oil cake produced in the extraction of edible oil, cotton seed produced cotton textile industry etc. These by products are unavoidably produced and are of secondary value. The sales value of these by products is much less as compared to the main product is much loss as compared to the main



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product. For example sales value of byproducts bagasse and molasses is much less than that of the main products sugar.

By Products may be :

(a) *Those sold in their original form without further processing.*

(b) *Those which require further processing*
Distinctions between Joint Products By Products.

A product may be treated as a joint product in one business & the same product may be treated as byproduct in another business. However the following factors should be considered to determine if a product is a joint product as a byproduct.

- (a) *Relative sales value: If the sales value of all the products all more or less equal they all treated as joint products. If however there are wide differences in the relative sales values of products, the product with the greater sales value is treated as the main products & the products of lower value are treated as by products.*
- (b) *Objective of manufacture : If the objective of manufacturing is product A, they unwanted products B & C be treated by products.*
- (c) *Policy of Management : The management may decide to treat a particular product as the main product & the other product as by products. Alternatively it may choose to treat all product as joint products.*

Examples of By Products:

Industry	Joint Products
1. Sugar	Bagasse Molasses
2. Butter textile	Cotton seed
3. Edible oil	Oil cake
4. Meat	Bones
5. Rice mills	Husk.

Distinction between Joint Product and By Product -

The point of distinction of Joint products and by products is a question of commercial importance, business objectives, profit pattern, certainty of market, necessity of further process etc. The important features distinguishing Joint Products and by products are -

- 1) *Joint products are the products of equal economic importance, while by products are of lesser economic importance.*
- 2) *Joint products are produced from same input and process where as by products are produced from wastage, scarp and discarded material of the main process.*
- 3) *Joint products are not produced incidentally but by products emerge incidentally also.*
- 4) *Joint products have significant impact on total cost at the point of separation, whereas by products have little impact on total cost.*
- 5) *Joint products require further processing, while the byproduct generally do not require to be processed any further.*

Joint Expenses -

There are certain industries where products are simultaneously produced and the same are referred to joint products. Expenses incurred are also joint in this case.



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Joint in this case means that the products from the same basic raw material. Examples may include oil industry, gasoline, fuel oil, lubricants, crude oil etc.

The aim of analyzing joint expenses is to –

- i) *Correct collection, compilation and classification of process cost.*
- ii) *Determine profit or loss on each line of manufacture. iii) Determine the pattern of production and the most profitable product mix.*
- iv) *Study the effect on cost and profits due to increase or decrease in production of joint products in order to fix prices.*
- v) *Determine the profitability of selling joint products and by-products as they come out at the split off point and maximize profit through marginal contribution analysis.*

When accounting for joint products, the products are not identifiable as different individual products until a certain stage of production known as the split off point. All costs incurred before the split off point are called joint products costs. Joint costs should be shared properly otherwise valuation will be difficult.

Average Unit Cost Method –

In this method, the total costs are assessed, yielding an average unit cost with one net profit for the total operation. It is applicable where processes are common and inseparable for joint products and where the resultant products can be expressed in some common unit.

Physical Unit Method –

A physical base such as raw material weight, linear measure volume etc. is applied in apportioning pre-separation point costs to joint products. For example, if there is 40% beef in product X and 60% beef in product Y, 2/10 of the cost upto separation point will be charged to X and 6/10 to Y. It is not a good method in areas for instance one product is a gas and another is liquid.

Survey Method –

In this method all the important factors e.g. volume, selling price, technical side, marketing process etc. affecting costing are ascertained by means of extensive survey. Point values or percentage are given to individual products according to their relative importance and costs are apportioned on the basis of total points. These ratios should be revised from time to time depending on the factors affecting production and sales.

Contribution (Gross Margin) Method –

In this method the marginal cost of the joint cost is apportioned on the basis of weight or quantity or each product and fixed cost on the basis of marginal contribution made by each of the products. The method provides useful information for taking decision on maximization of profits by rearrangement of products and sales mix.

Market Value Method –

This is the most popular method of apportioning expenses that are joint. The joint costs are split into the ratio of selling price of each individual products and the costs are based on these ratios.

Oil Crushing, Refining and Finishing Process –

1. *Crushing process*
2. *Refining process*
3. *Finishing process*

Crushing Process –

In this process raw material i.e. oil seeds or coconut or copra or kernels etc. are used. Other expenses of the process are debited, sale of bags or sacks is credited. Oil cakes or oil residue are sold as a



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byproduct is also credited. The output is crude oil transferred as input in the next process. There are may be loss in weight in the process.

Refining Process –

Crude oil from crushing process is debited, other materials, wages and overheads of the process are debited. Loss weight if any, is credited. The output is refined oil. Fats and residual oil may be obtained as by products which are credited. The output being refined oil is transferred to the next process i.e. finishing process.

Finishing Process –

Refined oil obtained from refining process is debited. Other materials, wages and overheads of the process are debited. Sale of by product and loss in weight are credited. Sundry sales of finished oil are also credited. The balance of this process is credited as cost of production of refined oil. Cost of drums or barrels or tins for storage of refined oil is also debited to find out cost of stored finished oil.

If sale of finished oil is given in the question, then finished Stock A/c should be opened after finishing process A/c and in such a case cost of goods transferred from Finishing Process A/c, Cost of Packing material and sale of Finished oil are shown in Finished Stock A/c and the profit or loss is transferred to Profit & Loss A/c.

Inter-Process Profit –

Generally, the output of one process is transferred to another on cost basis. Similarly, goods manufactured in the final process are also transferred at cost to Finished Stock A/c. But sometimes it is desirable by a manufacturing concern to value goods processed by each process at a price corresponding to the market price of comparable goods. Thus profit or loss made by each process is revealed and the efficiency of a process is not affected by the efficiency or inefficiency of a previous process. The market price of the goods processed being generally higher than the cost of the process, each process account will show some profit. This profit is termed as inter-process profit.

Advantages of Inter Process Profit –

1. **Introducing of Working Efficiency of Process** – In this case, a process is doing well maintaining profits or loss is utilized by this method. It knows that process is working at loss and to remove default of this process and default gets by attempts of remove difficulties of that process, finished stock is treated as cheaper rate from markets and finished production of that process.
2. **Compare to other Process** – Transfer of cost including profits and compare to different process, cost is deficit by trying cost less product by that working efficiency increased.
3. **Confidential of Real Profits** – Cost transfer with profit to next process. Profits are confident in every cost plus profit in process.
4. **Decision to do Work by Self** – Trader may acknowledge of any cost of production of process transfer to contractor which production will be effected in surplus or deficit.

Limitations of Inter Process Profit –

1. **Imaging Profit** – We cannot tell real profits to inter process profits, this is only imaginary profits. Its main reason that is not sale in fact to transfer of goods in inter process.
2. **Difficulty in Calculation of Real Profit** – In this method, unrealized profits is calculated for the calculation of real profits become its calculation is very difficult.
3. **Unrealized Profit** – Opening stock and closing stock is taking to all the method, unrealized profit is included in that process in which book profits and real profits is not a acknowledge.

Computation of Inter-Process Profit –

Under this method, the output of first process after charging certain profit is transferred to second process and the output of second process after charging certain profit is again transferred to third



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process. But in every process there remains certain stock which includes the part of profit of previous process. Thus profit included in the stock by previous process, is known as unrealized profit. Therefore, at the end of year the amount of profit included in the closing stock should be computed and the provision for unrealized profit should be made from the amount of total profit.

It is essential for calculation of unrealized profit for reserve –

1. *In this first method, closing stock is not make of reserve of unrealized profit.*
2. *Calculation of profit of transfer of goods by an cost of $\frac{1}{4}$ or 20/80 or 25%.*
3. *Calculation of reserve of unrealized profit by method for closing stock difference of its called unrealized profit –*

Unrealized profit = Value of closing stock – Cost of closing stock OR

$$\text{Cost of closing stock} = \frac{\text{Stock} \times \text{Cost Amount}}{\text{Total Amount}}$$

RECONCILIATION

Reconciliation of cost accounting and financial accounting Profit

A statement prepared to reconcile the difference between the profits as shown by cost book and financial books for a particular accounting period is called “reconciliation statement”.

Reconciliation of these cost and financial accounts means tallying the profits revealed by the two sets of books. Reconciliation is aimed to find out the reasons for disagreement of two profits.

Reasons for Disagreement in Profit –

A number of reasons may be attributed to the disagreement between the costing and financial profit.

The chief ones may include –

1. *Items shown only in Financial Accounts*
2. *Items shown only in Cost Accounts*
3. *Estimation of Indirect Expenses*
4. *Differences due to different basis of Stock Valuation and Depreciation*
5. *Abnormal Losses and Gains*

Methods of reconciliation

Reconciliation can be done by any one of the following two methods –

1. *By preparing reconciliation statement.*



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2. By Preparing memorandum reconciliation statement.

By preparing reconciliation statement – as bank reconciliation statement is prepared to reconcile the difference in cash book and pass book. Similarly on the same ground a reconciliation statement is prepared to reconcile the difference between the profit as shown by financial books and cost books.

SPECIMEN OF RECONCILIATION STATEMENT

Profit as per Cost books		.....
Add:		
(i) Expenses overcharged in cost books	.....
(ii) Incomes not included in cost books	.....
(iii) Under valuation of closing stock in cost books	.....
(iv) Over valuation of opening stock in cost books	.....	.....
Less:		
(i) Expenses undercharged in cost books	.....
(ii) Expenses and losses shown in financial books but not in cost books	.....
(iii) Over valuation of closing stock in cost books	.....
(iv) Under valuation of opening stock in cost books	.....	.....
Profit as per Financial Books		.....

Note: If profit as per financial account is taken as the base, then items added should be deducted and those deducted should be added –

Reconciliation statement - at a glance

	Particular	Effect		In which column the amount of difference to be recorded?	
		On closing Profit	On Financial Profit	Cost Books*	Fin. Books*
	Stage I: Profit/Loss as per cost/Financial books			Profit (+)	Loss (-)
	stage II: To record the amount of the items of difference in 'plus' or 'minus' columns:				
1	overheads overcharged in cot books or under charged in financial books	Decreased (-)	Increased (+)	(+)	(-)
2	overheads uncharged in cost books or overcharged in financial books	Increased (+)	Decreased (-)	(-)	(+)
3	depreciation overcharged in cost books or undercharged in financial books	Decreased	Increased		



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4	depreciation undercharged in cost books or overcharged in financial books	(-) Increased	(+)	(+)	(-)
5	Opening stock overvalued in cost books or undervalued in financial books.	(+) Decreased	Decreased (-)	(-)	(+)
6	Opening stock undervalued in cost books or overvalued in financial books.	(-) Increased	(+)	(+)	(-)
7	Closing stock undervalued in cost books or overvalued in financial books.	(+) Decreased	Decreased (-)	(-)	(+)
8	Closing stock overvalued in cost books or undervalued in financial books.	(-) Increased	(+)	(+)	(-)
9	Purely financial expenses/losses: e.g. goodwill, preliminary exp., underwriting commission, discount on issue of shares/debentures written off, interest on debentures, provision for bad debts, transfer to reserves, loss on sale of fixed asset, abnormal losses, cash discount etc.	(+) Increased	Decreased (-)	(-)	(+)
10	Purely financial incomes/ gains: e.g. income from investments, bank interest and transfer fees received, dividend received, capital gain, casual incomes, profit on sale of fixed assets, commission/cash discount received etc.	(-) Decreased	Increased (+)	(+)	(-)
11	purely costing item i.e. notional/imaginary/opportunity cost e.g. interest on own capital, rent of own building used in business, owner's remuneration etc.	(-) Decreased	Increased (+)	(+)	(-)

1. By Preparing memorandum reconciliation statement – reconciliation statement can be prepared in the form of “memorandum account” as well. Preparation of this account is very simple and easy. Items of “plus” column will be credited and the items of “minus” column are debited. The difference of both the sides represent the profit/loss as per other set of books.
2. **Memorandum Reconciliation Account**



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To Loss as per books	By Profit as per books
To Direct expenses undercharged in cost books	By Direct expenses overcharged in cost books
To overheads undercharged in cost books	.....	By overheads overcharged or over recovered in cost books	.....
To expenses or losses not included in cost books	.....	By expenses or losses included only in cost books	.....
To Items of profit/gain/or income shown or included only in cost books	.....	By Items of profit/gain/or income not shown or recorded in cost books	.....
To over valuation of closing stock in cost books	.....	By over valuation of opening stock in cost books	.....
To Over valuation of closing stock in cost books	.....	By Under valuation of closing stock in cost books	.....
To profit as per financial books (Bal. Fig)	.....	By Loss as per financial books (Bal. Fig)	.....

Difference between reconciliation statement memorandum reconciliation statement

Basis	Reconciliation statement	Memorandum reconciliation statement
Nature	It is statement	It is an account
Sides	There are two sides plus and minus	There are two sides debit and credit
Items to be added	They are recorded in plus column	They are debited to the account
Items to be deducted	They are recorded in minus column	They are credited to the account
Total	Total of both sides are recorded	Only higher total is recorded



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<i>Difference of total</i>	<i>It is recorded below the total</i>	<i>It is recorded above the total</i>
<i>Side of difference</i>	<i>The difference is recorded in the column of higher total.</i>	<i>The difference is recorded in the column of lower total.</i>
<i>Popularity</i>	<i>It is more popular.</i>	<i>It is less popular</i>



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UNIT-V

MARGINAL COSTING –

MARGINAL COSTING FOR DECISION MAKING TOOLS

Marginal costing is a specific technique of cost analysis in which cost information's are presented in such a manner so that it may help the management in cost control and various managerial decisions.

Marginal Cost = Prime Cost + All Variable Overheads

"The ascertainment of marginal cost and the effect on profit of changes in volume or type of output by differentiating between fixed costs and variable costs is known as marginal costing."

Basic Characteristics of Marginal Costing

1. *Technique of Cost Analysis and Presentation*
2. *Division of Costs into Fixed and Variable*
3. *Period Cost and Product Cost*
4. *Valuation of Stock*
5. *Determination of Price*
6. *Calculation of Profit*
7. *Recovery of Costs*
8. *Break-even Analysis*

Assumptions of Marginal Costing

The technique of marginal costing is based on following assumptions:

1. *All the elements of cost, i.e., manufacturing, administrative and selling and distribution expenses can be divided into fixed and variable components.*
2. *Per unit variable cost of a product remains constant at all levels of output. In other words, total variable cost price varies in proportion to the volume of output.*
3. *Per unit selling price remains constant at all levels of operating activity.*
4. *Total fixed cost remains unchanged at all levels of output.*
5. *In case of production in addition to present level, only marginal or variable cost is incurred as additional cost.*



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Advantages of Marginal Costing

1. **Easy:** This method makes the process of cost accounting simple and easily understandable. In fact, it is very simple to understand and easy to operate because income statement is prepared allocating variable and fixed expenses separately.
2. **Proper Valuation of Closing Stock:** Under marginal costing the valuation of closing stock is done at marginal cost. This is considered proper and logical because fixed cost of one period is not carried over to the next period in the form of valuation of stock.
3. **Helpful in Profit Planning:** This technique helps in profit planning, particularly of short term nature. In short-term profit increases or decreases on account of changes in selling price and variable cost because fixed cost does not change during this period. Hence, planning of earning desired profit can be designed easily by making necessary adjustments in sales volume, price and variable cost. Moreover, knowledge of cost behaviour under various operational conditions is also necessary for profit planning. Marginal costing technique studies cost behaviour by segregating fixed and variable costs and helps profit planning on the basis of contribution and cost-volume relationship.
4. **Meaningful Managerial Reporting:** Marginal costing serves as a good basis for meaningful managerial reporting. In this method reporting is based on sales and not on production so as change in stock does not influence the comparison of efficiency. Moreover, treating all fixed expenses as period costs, their effect on profit is precisely and clearly reflects by this technique.
5. **Profitability Appraisal:** This technique also serves as a tool of profitability appraisal. Whenever there is problem relating to the comparative profitability of various lines, departments or divisions or profitability of various sales areas and channels, etc., this technique helps significantly.
6. **Useful to standard and Budgetary Costing:** This technique is very useful in adopting and implementing the system of standard and budgetary costing.
7. **Convenience in Computing Fixed Overheads:** Since fixed overheads are charged against the contribution in marginal costing, there is no problem of computing fixed overhead recovery rates and their under or over-recovery.

An important role of cost accounting is to assist in the process of managerial decisions. In this context profitability of two or more alternative options is compared and such option is selected which offers maximum profitability along with fulfillment of objectives of the enterprise.

Main Areas of Decision-Making and Applications of Marginal and Differential Costing

Marginal costing is a very useful technique in solving various managerial problems and contributing to various areas of decisions. In this chapter, the use of marginal costing in following important areas have been discusses:

1. Make or Buy Decision
2. Change in Product Mix
3. Pricing Decisions
4. Exploring a New Market
5. Shut-down Decisions

Make Or Buy Decision



'Make or Buy Decision' is a problem in respect of which management has to take decisions continuously. In this context, the management has to decide whether a certain product or a component should be made in the factory itself or bought from outside suppliers.

The nature of decision regarding make or buy may be of the following types:

- a. *Stopping the production of the part and buying it from the market: A business concern is already making a part or component which is used in the business. Now due to some reasons, a decision has to take whether this part or component should be bought from the market or additional requirement due to increase in production of main factory should be made in the factory or should be bought from the market.*
- b. *Stopping the purchase of a component and to produce it in own factory: Another aspect of the problem of 'make' or 'buy' may be that a component or part thus far being purchased from the market should be produced or made in the factory or not. In this case, normally some extra arrangements regarding space, labour, machines, etc. will be required. This may involve capital investments too. Some special overheads may also be necessary. If the decision for making requires the setting up of a new and separate factory, separate supervisory staff may also be needed. All these arrangements will require additional costs. As such, the price being paid to outsiders (suppliers of the component) should be compared with additional costs which will have to be incurred in the form of raw materials, wages, salaries of additional supervisors, interest on capital investments, depreciation on new machines, rent of premises, etc. If such additional costs are less than the buying price, the component should be manufactured and vice-versa.*

Change In Product Mix

Introducing a New Line or Department: The problem of introducing a new product or line involves decision in two respects – (i) whether a new product or line should be added to the existing production or not, and

(ii) If it should be introduced, then what should be the model or design or shape of the new product. In other words, if new product can be produced in more than one model, which model should be introduced?

A decision like above should not be based on contribution but other relevant factors should also be considered. The marginal cost of new product in all its possible models should be considered. The marginal cost of new product in all its possible models should be considered. It is also possible that a portion of the cost of facilities relating to the original production may be used for the purpose of producing new product. Some additional investments in the form of additional plant and machinery may be desired. This will likely increase the fixed overheads, which should also be considered along with marginal costs.

Pricing Decision

It is generally contended that price, in the long-run should be such as to cover total cost (Marginal Costs + Fixed Costs) as well as desired profit. In such a case, marginal costing will not play any significant role. Again, in a competitive market, price is not determined by the individual concern but is governed by the market forces. Thus, costing (particularly Marginal Costing) is helpful in price determination only in short-term and monopoly conditions. Here we shall confine our discussion only to the shortterm price policy. The various aspects of price policy may be enumerated as under:

- (1) Normal Price,
- (2) Minimum Price
- (3) Depression Price
- (4) Special Price including dumping
- (5) Price-changes.

Exploring a New Market



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Schemes of sales promotion as discussed earlier would aim at increasing the sales volume within the usual sales territories. Sales volume can also be increased by tapping new territories. This can be done either by extending its own marketing organization (such as opening a Branch/ Depot/ Shop) or through local distributors. It is also significant to note that some initial expenses will have to be incurred in organizing sales-channels in the new territories. A sort of competition may also be there due to the attachment of customers of that area to some other brand, removal of which will involve higher selling and distribution costs. Again, Marginal Costing will be helpful in providing adequate and relevant data for taking a decision in this regard.

If the firm finds opportunity to receive an export order the following additional points should also be considered:

- (i) Export order may result in some additional costs like special packing cost, freight and insurance charges, export duty etc. These costs should be deducted from contribution to determine profit from export order.
- (ii) There may be some additional benefits like export subsidy from government concession in excise duty etc. Such items should also be deducted from cost or added in contribution.

Shut-Down Decisions

Shut-down decisions may be of two types-

- (a) Closure of entire business,
- (b) Dropping a Line or product or Department.
 - a. Closure of entire Business' (Suspension of Activities): Sometimes, a business concern may not be in a position to carry out its trading activities (i.e., production and selling) in an adequate volume due to trade recession/ depression or cut-throat competition. As such, the management of such business concern may be faced with a problem of suspending the trading activities. Such suspension may be of the following nature:
 - i. Temporary closure or shut-down for a short period.
 - ii. Permanent closure.

Temporary Closure: When trading activity particularly plant operation is suspended for a short period; it is known as temporary closure. Such closure is necessitated either due to depression/ recession or due to ensuing off-season. In the former case, the period of closure will run over the period of recession/ depression, while in the latter case, it will cover the period of off-season.

Permanent Closure: Sometimes, management may have a problem, the solution of which will be the permanent closure of the factory or plant or liquidation of the whole show. If a business concern may not run profitably and reasonable or minimum return is not forthcoming on capital employed in the business in spite of possible efforts being taken to improve it, it may be wise as well as profitable to close the factory permanently. If it is not done immediately and time is allowed to pass on, there will be a number of financial problems due to erosion in capital day after day. Here the management of the concern should adopt the military rule followed by the General of Army, i.e., to retreat timely and gracefully, if it cannot be avoided.

Dropping a Line or Product or Department: Basically this problem is very much related to the profitability of a product or department. The best possible and maximum profitable utilization of limited resources of a business concern clearly demands the continuance of the production of that



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product/ line/ department, which will ensure the maximization of profit. This requires on the part of management to fix priorities for various products/ lines. Management will also have to decide whether the production of one or more product/ line should be dropped or curtailed. Such decision may be effective and judicious only, when it is based on the comparative study of contributions made by each product/ line or department. Here comes the role of marginal costing with the help of which Marginal cost and Contribution Statement is prepared and decision data are made available.

Earning of maximum profit in the ultimate goal of almost all business enterprises. The amount of profit on the sales of a product depends upon volume of production and its costs.

Cost-Volume-Profit Analysis is a logical extension of the concept of marginal costing, in which cost of production is divided into two parts, i.e. fixed cost and variable cost. Total amount of fixed cost remains constant upto a certain level of activity and change in production volume is associated with the change in variable (marginal) cost only.

Profit Volume Ratio, Break Even Point & Margin of Safety

Cost-volume-Profit analysis is an important tool in the process of managerial decisions and it is extremely helpful to management in a variety of problems involving planning and control. The main objectives of such analysis are as follows:

1. **Setting up Flexible Budget:** This analysis is helpful in setting up flexible budget which indicates that what trend of amount of sales and cost of production at different levels of activity will be.
2. **Determination of B.E.P.:** The most important objective of Cost-volume-Profit analysis is to find out break-even point, i.e., the point of no profit no loss.
3. **Profit Planning:** This analysis is useful in profit planning also because whereas, on the one hand, we can determine the amount of profits at different levels of activity we can also determine the volume of sales or production to earn desired profit on the other hand.
4. **Performance Evaluation for Control:** This analysis assists in evaluation of performance for the purpose of control. On the basis of profits achieved costs incurred it can be analyzed that what the role of volume of production and other factors was in effecting the amount of profit?
5. **Allocation of Overloaded Costs:** This analysis in finding out the amount of overhead costs to be rates is related to a selected volume of production.

Meaning of Break-Even Point (B.E.P)

Break-even point is that point of production or sales at which firm neither earns any profit nor incurs any loss. It is also known as 'No Profit Point' or Zero Loss Point'. Some of its definitions are as follows:

"The Break-even Point of a company or a unit of a company is that level of sales income which will equal the sum of its fixed cost and its variable costs." - **Keller and Ferrara**

Assumption of Break Even Analysis

The break-even analysis is based upon the following assumptions:

1. **Fixed and Variable Costs:** The basic assumption of Break-even analysis is that all elements of cost (i.e., production, administration, selling and distribution) can be divided into two parts, i.e., fixed cost and variable cost.



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2. **Proportionate Variable Cost:** It is assumed that variable cost remains constant per unit at all levels of production. In other words, variable cost fluctuates directly in proportion to changes in volume of production.
3. **Certain and Constant Fixed Cost:** Fixed cost remains certain and constant at any level of activity from zero production to full capacity.
4. **Unchanged Selling Price:** Selling price per unit remains constant or unchanged at all levels of production, i.e., there is no change in selling price despite increase or decrease in supply or demand of goods.
5. **Linear Behaviour:** Behaviour of different costs is linear, i.e., a straight line will be drawn if cost data are represented on a graph paper.
6. **Technological Stability:** It is assumed that during the period, for which break-even analysis is being made, there will be no change in production system, efficiency of machines or technology of production.
7. **No Role of Stock:** Production and sales both are taken as equal. In other words, whatever will be produced, all will be sold and there will be no role of stock of finished goods.
8. **No change in general Price Level:** It is assumed that during a specific period there will be no change in general price level, i.e., cost of material, labour and other overheads.
9. **Unchanged Sales-mix:** There is only one product. If several products are being produced and sold, the sales-mix will remain constant.
10. **Relationship between Volume and cost:** An important assumption of break-even analysis is that volume of production is the only factor which does affect the cost of production.

Calculation of Break-Even Point

Break-even point can be calculated in terms of amount (Rs.) as well as in terms of units. Hence, as per direction or information given in the question it is decided that in what term this point is to be calculated. In this context following guidelines may be helpful:

1. If there is clear-cut direction in the question, then amount or units should be calculated accordingly.
2. If per unit information's are available in the question and there is no specific direction, then B.E.P. should be calculated in both terms i.e., in Rs. And in units.
3. If per unit information's are not available, then B.E.P. will be calculated only in terms of Rs.
4. If the technique of P/V ratio is to be used, then also B.E.P. will be obtained in terms of Rs. a.B.E.P. (Rs.): It is also known as B.E.P. Sales

$$i. \quad B.E.P. (Rs.) = \frac{\text{fixed Cost} \times \text{Sales}}{\text{Contribution}} \text{ or } \frac{FC \times S}{C}$$

$$ii. \quad B.E.P. (Rs.) = \frac{\text{fixed Cost}}{P/V \text{ Ratio}}$$

$$iii. \quad B.E.P. (Rs.) = \text{Sales} - \text{Margin of Safety}$$

b.B.E.P. (In units): It is also known as 'Break-even Point in Quantity' or Output B.E.P.'

$$i. \quad B.E.P. (Units) = \frac{\text{fixed Cost}}{\text{Contribution per unit}} \text{ or } \frac{FC}{C_{pu}} \text{ or } \frac{FC \times S_{pu}}{C_{pu}}$$

$$ii. \quad B.E.P. (Units) = \frac{B.E.P. (Rs.)}{S_{pu}}$$

Margin of Safety

Margin of safety is the difference between actual total sales and B.E.P sales and may be calculated in rupees, unit or even in percentage form as explained below:

1. M.O.S. in Rupees:
 - i. $M.O.S. (Rs.) = \text{Sales} (Rs.) - B.E.P. (Rs.)$



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- ii. $M.O.S. (Rs.) = \frac{\text{Profit}}{P/V \text{ Ratio}}$
2. *M.O.S. in units:*
 - i. $M.O.S. (units) = \text{Sales (Units)} - B.E.P. (Units)$
 - ii. $M.O.S. (units) = \frac{\text{Profit}}{\text{Contribution per unit}}$
3. *M.O.S. in Percentage:*
It is also called as M.O.S. Ratio.
 $\% \text{ of margin of safety to sales (M.O.S. Ratio)} = \frac{\text{Margin of Safety}}{\text{Total Actual Sales}} \times 100$

Importance of Margin of Safety

Margin of safety is an indicator of the strength of the business. If the margin of safety is large, the position of the business will be sound and it can easily resist the situation of reduction in sales. Moreover, it will have more opportunities to earn profit. If the margin of safety is small, a small reduction in sales can be serious matter and may result even in loss. Thus, margin of safety serves as a cushion in between profit position and loss position.

Calculation of Sales for Desired Profit

Generally, it is considered in managerial decisions that what should be the target of sales in a particular period? In this context profit target is fixed and then attempt are made to attain that volume of sales which may yield the target of desired profit. A similar position may arise when a businessman is interested in maintaining the existing level of profit, even when the selling price is being reduced due to market situations. The following formulae may be applied for this purpose:

1. When total amount of desired profit is given in the question:

$$i. \text{ Sales (Rs.)} = \frac{\text{fixed Cost} + D.\text{Profit}}{S - V \text{ or Contribution}} \times \text{Sales OR } \frac{FC + Pt}{C} \times S$$

$$ii. \text{ Sales (Rs.)} = \frac{\text{fixed Cost} + D.\text{Profit}}{P/v \text{ Ratio}} \text{ OR } \frac{FC + Pt}{P/v \text{ Ratio}}$$

$$iii. \text{ Sales (Unit)} = \frac{\text{fixed Cost} + D.\text{Profit}}{C \text{ per unit}} \text{ OR } \frac{FC + Pt}{C_{pu}}$$

2. When desired profit per unit is given in the question:

$$i. \text{ Sales (Rs.)} = \frac{\text{Fixed Cost} \times \text{Selling Price per unit}}{\text{Contribution per unit} - \text{Profit per unit}}$$

$$= \frac{FC \times S_{pu}}{C_{pu} - P_{pu}}$$

$$ii. \text{ Sales (Unit)} = \frac{\text{Fixed Cost}}{C_{pu} - P_{pu}}$$

STANDARD COSTING AND VARIANCE ANALYSIS

MEANING OF STANDARD COST AND STANDARD COSTING:

The word 'standard' means a benchmark or gauge. The 'standard cost' is a predetermined cost which determines in advance what each product or service should cost under given circumstances. Backer and Jacobsen define "Standard cost is the amount the firm thinks a product or the operation of a process for a period of time should cost, based upon certain assumed conditions of efficiency, economic conditions and



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other factors". Chartered Institute of Management Accountants, London defines standard cost as "a predetermined cost which is calculated from management's standards of efficient operation and the relevant necessary expenditure". They are the predetermined costs based on technical estimate of material, labour and overhead for a selected period of time and for a prescribed set of working conditions.

The technique of using standard costs for the purposes of cost control is known as standard costing. Brown and Howard define "standard costing is a technique of cost accounting which compares the standard cost of each product or service with actual cost to determine the efficiency of the operation so that any remedial action may be taken immediately". The terminology of Cost Accountancy defines standard costing as "the preparation and use of standard costs, their comparison with actual costs, and the analysis of variance to their causes, and points of incidence". The London Institute of Cost and Works Accountants define it as "An estimate cost, prepared in advance of production or supply correlating a technical specification of material and labour to the price and wage rates estimated for a selected period of time, with an addition of the apportionment of overheads expenses estimated for the same period within a prescribed set of working conditions". Further, it is a system of cost accounting, which is designed to find out how much should be the cost of a product under the existing conditions. The actual cost can be ascertained only when production is undertaken. The predetermined cost is compared to the actual cost and a variance between the two enables the management to take necessary corrective measures.

STEPS INVOLVED IN STANDARD COSTING:

The technique of standard costing involves the determination of cost before occurring.

The standard cost is based on technical information after considering the impact of current conditions. With the change in condition, the cost also can be modified so as to make it more realistic. The standard cost is divided into standards for materials, labour and overheads. The actual cost is recorded when incurred. The standard cost is compared to the actual cost. The difference between the two costs is known as variance. The variances are calculated element wise. The management can take corrective measures to set the things right on the basis of different variances.

The basic purpose of standard costing is to determine efficiency or inefficiency in manufacturing a particular product. This will be possible only if both standard costs and actual costs are given side by side. Though standard costing system will be useful for all types of commercial and industrial undertakings but it will be more useful in those undertakings where production is standardized. It will be of less use in job costing system because every job has different specifications and it will be difficult to determine standard costs for every job.

STANDARD COSTING Vs. BUDGETARY CONTROL:

In budgetary control, budgets are used as a means of planning and control. The targets of various segments are set in advance and actual performance is compared with predetermined objects. In this way management can assess the performance of different departments. On the other hand, standard costing also set standards and enables to determine efficiency on the basis of standards and actual performance.

Budgetary control is essential to determine standard costs, whereas, the standard costing system is necessary for planning budgets. In budgetary control the budgets are prepared for the concern as a whole whereas in standard costing the standards are set for producing a product or for providing a service. In standard costing, unit concept is used while in budgetary control total concept is used. The budgets are fixed on the basis of past records and future expectations. Standard costs are fixed on the basis of technical information. Standard costs are planned costs and these are expected in future. As far as scope is concerned, in case of budgetary control it is much wider than standard costing. Budgets are prepared for incomes, expenditures and other functions of the departments such as purchase, sale, production, finance and personnel department. In contrary, standards are set up for expenditures only and, therefore, for manufacturing departments standards are set for different elements of cost i.e., material, labour and overheads.



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Further, in budgetary control, the targets of expenditure are set and these targets cannot be exceeded. In this system the emphasis is on keeping the expenditures within the budgeted figures. In standard costing the standards are set and an attempt is made to achieve these standards. The emphasis is on achieving the standards. Actual costs may be more than the standard costs and there can be no such thing in budgetary control. The budgetary control system can be applied partly or wholly. Budgets may be prepared for some departments and may not be prepared for all the departments. If a concern is interested in preparing production budget only, it is free to do so. Standard costing cannot be used partially; it will have to be used wholly. The standards will have to be set for all elements of cost. In fact, the systems operate in two different fields and both are complimentary in nature.

STANDARD COSTS AND ESTIMATED COSTS:

The standard costs and estimated costs both are used to determine price in advance. The purpose of both of them is to control cost. They follow the same accounting principles. Despite similarities, they differ in terms of objects and purpose. Estimated costs are based on historical accounting. It is an estimate of what the cost will be. It is a cost of guesswork or reasonable estimate for the costs in future. On the other hand standard costs are based on scientific analysis and engineering studies. Standard costing determines what the cost should be. Standard costs are used as a device for measuring efficiency. The standards are predetermined and a comparison of standards with actual costs enables to determine the efficiency of the concern. Estimated costs cannot be used to determine efficiency. It only determines the expected costs. An effort is made that estimated cost should almost be near to actual costs. The purpose of determining estimated costs is to find out selling price in advance to take a decision whether to produce or to make and also to prepare financial budgets. Estimated costs do not serve the purpose of cost control. On the other hand standard costs are helpful in cost control. The analysis of variance enables to take corrective measures, if necessary. Standard costs are not easily changed. The standards are set in such a way that small changes in conditions do not require a change in standards. Estimated costs are revised with the change in conditions. They are made more realistic by incorporating changes in prices. Standard costs are more static than estimated costs. Estimated costs are used by the concern using historical costing. Standard costing is used by those concerns which use standard costing system. Standard costing is a part of cost accounting process while estimated costs are statistical in nature and as such they may not become a part of accounting.

ADVANTAGES OF STANDARD COSTING:

Standard costing is not only helpful for cost control purposes but it is also useful in production planning and policy formulation. It derives following advantages:

1. Measurement of Efficiency: It is a tool for assessing the efficiency after comparing the actual costs with standard costs to enable the management to evaluate performance of various cost centres. By comparing actual costs with standard costs variances are determined and management is able to identify the place of inefficiencies. It can fix responsibility for deviation in performance. A regular check on various expenditures is also ensured by standard costing system. The standards are being constantly analyzed and an effort is made to improve efficiency. Whenever a variance occurs the reasons are studied and immediate corrective measures are undertaken.

2. Production and Price Policy Formulation: It becomes easy to formulate production plans by taking into account standard costs. It is also supportive for finding prices of various products. In case, tenders are to be submitted or prices are to be quoted in advance then standard costing produces necessary data for price fixation.

3. Reduction of Work: In this system, management is supplied with useful information and necessary information is recorded and redundant data are avoided. The report presentation is simplified and only required information is presented in such a form that management is able to interpret the information easily and usefully. Therefore, standard costing reduces clerical work to a considerable extent



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4. Management by Exception: Management by exception means that everybody is given a target to be achieved and management need not supervise each and everything. The responsibilities are fixed and everybody tries to achieve his targets. If the things are going as per targets then the management needs not to bother. Management devotes its time to other important things. So, management by exception is possible only when targets of work can be fixed. Standard costing enables the determination of targets.

LIMITATIONS OF STANDARD COSTING:

Besides all the above benefits derived from this system, it has a number of limitations, which are discussed as follows:

1. Standard costing cannot be used in those concerns where non-standard products are produced.
2. The time and motion study is required to be undertaken for the process of setting up standards. These studies require a lot of time and money. Further, the process of setting up standards is a difficult task, as it requires technical skill.
3. There are no inset circumstances to be considered for fixing standards. With the change in circumstances the standards are also to be revised. The revision of standard is a costly process.
4. This system is expensive and small concerns may not afford to bear the cost. For small concerns the utility from this system may be less than the cost involved in it.
5. The fixing of responsibility is not an easy task. The variances are to be classified into controllable and uncontrollable variances. The responsibility can be fixed only for controllable variances not in the case of uncontrollable.
6. The industries liable for frequent technological changes will not be suitable for standard costing system. The change in production process will require a revision of standard. A frequent revision of standard will be costly. So this system will not be useful for industries where methods and techniques of production are fast changing.

PRELIMINARIES FOR ESTABLISHING STANDARD COSTING SYSTEM:

The establishment of a standard costing system involves the following steps:

1. Determination of Cost Centre: A cost centre may be a department or part of a department or item of equipment or machinery or a person or a group of persons in respect of which costs are accumulated and one where control can be exercised. Cost centres are necessary for determining the costs.

2. Classification of Accounts: Classification of accounts is necessary to meet a required purpose i.e., function, asset or revenue item. Codes can be used to have a speedy collection of accounts. A standard is a predetermined measure of material, labour and overheads. It may be expressed in quantity and its monetary measurements in standard costs.

3. Types of Standards: The standards are classified into three categories:

(i) Current Standard: A current standard is a standard which is established for use over a short period of time and is related to current condition. It reflects the performance which should be accomplished during the current period. The period for current standard is normally one year. It is supposed that the conditions of production will remain unchanged. In case there is any change in price or manufacturing condition, the standards are also revised. Current standard may be ideal standard and expected standard.

(a) Ideal Standard: The standard represents a high level of efficiency. It is fixed on the assumption that favourable conditions will prevail and management will be at its best. The price paid for materials will be lowest and wastages cost of labour and overhead expenses will be minimum possible.

(b) Expected Standard: This standard is based on expected conditions. It is the target which can be achieved if expected conditions prevail. All existing facilities and expected changes are taken into consideration while fixing these standards. An allowance is given for human error and normal deficiencies. It is realistic and an attainable and it is used for fixing efficiency standard.

(ii) Basic Standard: A basic standard is established for use for an indefinite period or a long period. These standards are revised only on the changes in specification of material and technology production.



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(iii) Normal Standard: Normal standard is a standard which is anticipated can be attained over a future period of time, preferably long enough to cover one trade cycle. This standard is based on the conditions which will cover a future period, say 5 years, concerning one trade cycle. If a normal cycle of ups and downs in sales and production is 10 years then standard will be set on average sales and production which will cover all the years.

4. Organisation for Standard Costing: In a business concern a standard costing committee is formed for the purpose of setting standards. The committee includes production manager, purchase manager, sales manager, personnel manager, chief engineer and cost accountant. The Cost Accountant acts as a coordinator of this committee. He supplies all information for determining the standard and later on coordinates the costs of different departments. He also informs the committee about the change in price level, etc. The committee may revise the standards in the light of the changed circumstances.

5. Setting of Standards: The standard for direct material, direct labour and overhead expenses are fixed. The standards for direct material, direct labour and overheads should be set up in a systematic way so that they can be used as a tool for cost control easily.

ANALYSIS OF VARIANCES:

The divergence between standard costs, profits or sales and actual costs, profits or sales respectively will be known as variances. The variances may be favourable and unfavourable. If actual cost is less than the standard cost and actual profit and sales are more than the standard profits and sales, the variances will be favourable. On the contrary if actual cost is more than the standard cost and actual profit and sales are less than the standard profits and sales, the variances will be unfavourable. The variances are related to efficiency. If variances are favourable, it will show efficiency and if variances are unfavourable it will show inefficiency. The variances may be classified into four categories such as Direct Materials Variances, Direct Labour Variances, Overheads Cost Variances and Sales or Profit Variances.

DIRECT MATERIAL VARIANCES:

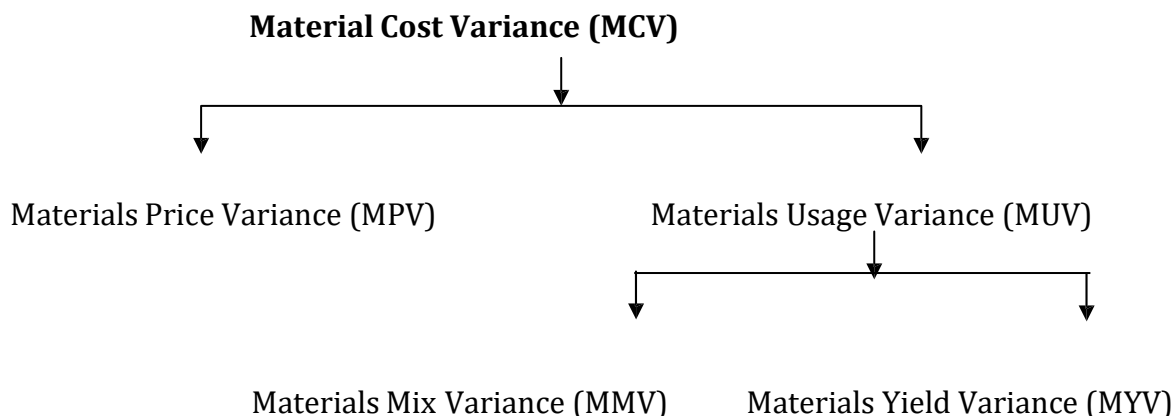
Direct material variances are also known as material cost variances. The material cost variance is the difference between the standard cost of materials that should have been incurred for manufacturing the actual output and the cost of materials that has been actually incurred. Material Cost Variance comprises of: (i) Material Price Variance and (ii) Material Usage Variance: Material usage variance may further be subdivided into material Mix Variance and Material Yield Variance.

The Chart depicts the divisions and subdivisions of material variances.



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The following equations may be used for verification of material cost variances.

- (i) $MCV = MPV + MUV$ or $MPV + MMV + MYV$
- (ii) $MUV = MMV + MYV$

(a) Materials Cost Variance: Material cost variance is the difference between standard materials cost and actual materials cost. Material cost variance arises due to change in price of materials and variations in use of quantity of materials. Material cost variance is ascertained as such:

Materials Cost Variance = Standard Material Cost – Actual Material Cost

Standard Material Cost = Standard Price per unit x Standard Quantity of materials

Actual Material Cost = Actual price per unit x Actual quantity of materials.

If the standard cost is more than the actual cost, the variance will be favourable and on the other hand, if the actual cost is more than the standard cost, the variance will be unfavourable or adverse.

(b) Materials Price Variance: Materials price variance arises due to the standard price specified and actual price paid. It may also arise due to: (i) Changes in basic prices of materials, (ii) failure to purchase the quantities anticipated at the time when standards were set, (iii) failure to secure discount on purchases, (iv) failure to make bulk purchases and incurring more on freight, etc., (v) failure to purchase materials at proper time, and (vi) Not taking cash discount when setting standards.

Materials Price Variance = Actual Quantity (Standard price – Actual price)

In this case actual quantity of materials used is taken. The price of materials is taken per unit. If the answer is in plus, the variance will be favourable and it will be unfavourable if the result is in negative.

(c) Material Usage Variance: Material usage (or quantity) variance arises due to the difference in standard quantity specified and actual quantity of materials used. This variance may also arise due to: (i) Negligence in use of materials, (ii) More wastage of materials by untrained workers or defective methods of production, (iii) Loss due to pilferage, (iv) Use of material mix other than the standard mix, (v) More or less yield from materials than the standard set, and (vi) Defective production necessitating the use of additional materials.

Materials usage variance = Standard Price (Standard Quantity – Actual Quantity)

The quantities of material specified and actually used are taken and standard price per unit is used. If the answer from the above mentioned formula is in plus, the variance will be a favourable variance but if the answer is in minus the variance will be unfavourable or adverse.

(d) Material Mix Variance: Materials mix variance is that part of material usage variance which arises due to changes in standard and actual composition of mix. Materials mix variance is the difference between standard price of standard mix and standard price of actual mix. The standard price is used in calculating this variance. The variance is calculated under two situations: (i) When actual weight of mix is equal to standard weight of mix, and (ii) When actual weight of mix is different from the standard mix.

(i) When Actual Weight and Standard Weight of Mix is Equal:

In this case the formula for calculating mix variance is:

Standard cost of standard mix – Standard cost of actual mix.



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(Standard Price x Standard Quantity) – (Standard Price x Actual Quantity) Or Standard unit cost (Standard Quantity – Actual Quantity)

In case standard quantity is revised due to shortage of one material, the formula will be equal to Standard unit cost (Revised Standard Quantity – Actual Quantity).

(ii) When Actual Weight and Standard Weight of Mix are Different:

When quantities of actual material mix and standard material mix are different, the formula will be:

$$\left\{ \frac{\text{Total weight of Actual Mix}}{\text{Total weight of Standard Mix}} \times \text{Standard cost of Standard Mix} \right\} - (\text{Standard cost of Actual Mix})$$

In case the standard is revised due to the shortage of one material then revised standard will be used instead of standard, the formula will become:

$$\left\{ \frac{\text{Total Weight of Actual Mix}}{\text{Total Weight of Revised Standard Mix}} \times \text{Standard cost of Revised Standard Mix} \right\} - (\text{Standard cost of Actual Mix})$$

(e) Materials Yield Variance: This is the sub-variance of material usage variance. It results from the difference between actual yield and standard yield. It may be defined as that portion of the direct materials usage variance which is due to the standard yield specified and the actual yield obtained. It may arise due to low quality of materials, defective methods of production, carelessness in handling materials, etc.

Material yield variance is calculated with the following formula:

Standard Rate (Actual yield – Standard yield)

Standard Rate is calculated as follows:

$$\text{Std. Rate} = \frac{\text{Standard Cost of Standard mix}}{\text{Net standard output i.e., Gross output – Standard Loss}}$$

There may be a situation where standard mix may be different from the actual mix. In this case the standard is revised in relation to actual mix and the question is solved with the revised standard and not with the original standard. The standard rate will be Calculated as follows:

$$\text{Std. Rate} = \frac{\text{Standard Cost of revised Standard mix}}{\text{Net standard output}}$$

In the earlier variances if the standard was more than the actual, the variance was favourable. But, in case of material yield variance the case is different. When actual yield is more than the standard yield, the variance will be favourable.

Chart showing the procedure for solving the question of material cost variances

Stage-1 : Basic Information

SQ = Standard quantity of materials for actual output.

AQ = Actual quantity of materials for actual output.

RSQ = Total AQ divided in SQ ratio.



Stage-2 : Analysis table

Material	Standard		Actual		RSQ
	SQ	SP	AQ	AP	
Total					

Stage-3 : Calculation of variances

MCV $= (SQ \times SP) - (AQ \times AP)$

$= (\quad) - (\quad) = \dots\dots\dots$

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$= (\quad) - (\quad) = \underline{\dots\dots\dots} \dots\dots\dots$

MPV $= (SP - AP) AQ$ $= \dots\dots\dots$

$= (\quad) - (\quad) = \dots\dots\dots$

$= (\quad) - (\quad) = \dots\dots\dots$

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MUV $= (SQ - AQ) SP$ $= \dots\dots\dots$

$= (\quad) - (\quad) = \dots\dots\dots$

$= (\quad) - (\quad) = \dots\dots\dots$

$= (\quad) - (\quad) = \underline{\dots\dots\dots} \dots\dots\dots$

MMV $= (RSQ - AQ) SP$ $= \dots\dots\dots$

$= (\quad) - (\quad) = \dots\dots\dots$

$= (\quad) - (\quad) = \dots\dots\dots$

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MYV $= (SQ - RSQ) SP$ $= \dots\dots\dots$

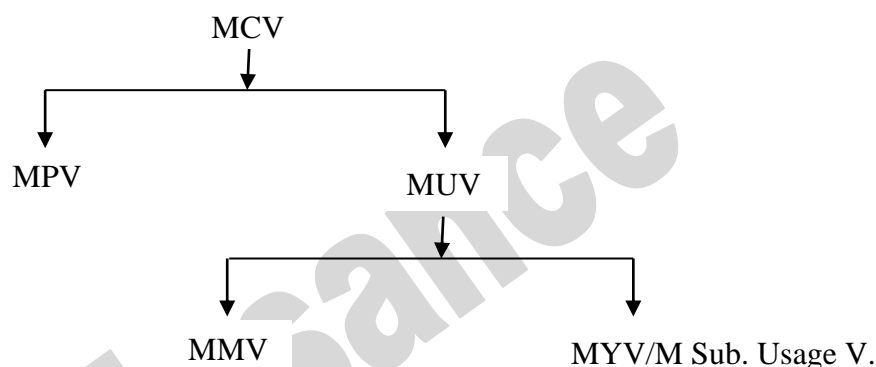
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Stage-3 : Verification :



When more than one type of labour is used. This variance may arise. It is that difference between the standard cost of standard mix and actual mix of various types of grades of labour.

This calculated as under –

Labour mix variance = (Revised standard hours-Actual hours) standard wage rate:

OR

LMV (RSH-AH) SR

RSH= Total of actual hours of various grades of workers divided in the standard hour ratio. This can be well illustrated by the following example –

To produce 300 units, labour requirement is as under: skilled labour-2,000 hours, semi skilled labour- 1,200 hours and unskilled labour- 800 hours. Actual labour: skilled - 3,000 hours, semi-skilled- 2,000 hours and unskilled- 1,000 hours. Now total of actual hours ie 3,000+2,000+ 1,000=6,000 will be divided in the standard ratio of 2,000:1,200: 800 or 5:3:2 which will come 3,000, 1,800 and 1,200. This is called revised standard hours i.e. RSH.

(5) Labour yield/sub-efficiency variance- This is the part of labour efficiency variance.

It is the difference between the standard cost of revised standard hours and actual hours. It is calculated as under

Labour yield variance (Standard hours-Revised standard hours) Standard wage rate

OR

LYV = (SH-RSH) SR.

Procedure for solving the questions related to labour cost variances

For this purpose, students are advised to study thoroughly the detailed discussion under the similar heading 'Procedure for solving the questions related to material cost variances' in the forgoing pages, because the same procedure will be adopted for labour variances also. For the convenience of students a chart is being given here -

DIRECT LABOUR VARIANCES

Labour Variances are discussed as follows:

(a) Labour Cost Variance:

Labour Cost Variance or Direct Wage Variance is the difference between the standard direct wages specified for the activity and the actual wages paid. It is the function of labour rate of pay and labour time variance. It arises due to a change in either a wage rate or in time or in both. It is calculated as follows:

Labour Cost Variance = Standard Labour Cost – Actual Labour Cost

Or (Standard time x Standard Wage Rate) – (Actual Time x Actual Wage Rate)



(b) Labour Rate of Pay or Wage Rate Variance:

It is that part of labour cost variance which arises due to a change in specified wage rate. Labour rate variance arises due to (i) change in basic wage rate or piece-work rate, (ii) employing persons of different grades than specified, (iii) payment of more overtime than fixed earlier, (iv) new workers being paid different rates than the standard rates, and (v) different rates being paid to workers employed for seasonal work or excessive work load.

The wage rates are determined by demand and supply conditions of labour conditions in labour market, wage board awards, etc. So, wage rate variance is generally uncontrollable except if it arises due to the development of wrong grade of labour for which production foreman will be responsible. This variance is calculated by the formula: Labour Rate of Pay Variance = Actual time (Standard Rate – Actual Rate) The variance will be favourable if actual rate is less than the standard rate and it will be unfavourable or adverse if actual rate is more than the standard rate.

(c) Labour Efficiency or Labour Time Variance:

It is that part of labour cost variance which arises due to the difference between standard labour hours specified and the actual labour hours spent. It helps in controlling efficiency of workers. The reasons for this variance are: (i) lack of proper supervision, (ii) defective machinery and equipment, (iii) insufficient training and incorrect instructions, (iv) increase in labour turnover, (v) bad working Conditions, (vi) discontentment along workers due to unsatisfactory personnel relations, and (vii) use of non-standard material requiring more time to complete work.

Labour efficiency variance is calculated as:

Labour efficiency variance = Standard Wage Rate (Standard Time–Actual Time).

If actual time taken for doing a work is more than the specified standard time, the variance will be unfavourable. On the other hand, if actual time taken for a job is less than the standard time, the variance will be favourable.

(d) Idle Time Variance:

This variance is the standard cost of actual time paid to workers for which they have not worked due to abnormal reasons. The Reasons for idle time may be power failure, defect in machinery, and non supply of materials, etc. Idle time variance should be segregated from the labour efficiency variance otherwise it will show inefficiency on the part of workers though they are not responsible for this. Idle time variance is always adverse and needs investigation for its causes. This variance is calculated as: Idle Time Variance=Idle Hours x Standard Rate

(e) Labour Mix or Gang Composition Variance:

This variance arises due to change in the actual gang composition than the standard gang composition. This variance shows to the management how much labour cost variance is due to the change in labour composition.

It may be calculated in two ways:

(i) When standard and actual times of the labour mix are same:

In this case the variance is calculated as follows:

Labour Mix Variance = Standard Cost of Standard Labour Mix – Standard Cost of Actual Labour Mix.

Due to the non-availability of one grade of labour, there may be a change in standard labour mix, and then revised standard will be used for standard mix. The formula will be: Labour Mix Variance = Standard cost of Revised Standard Labour Mix - Standard Cost of Actual Labour Mix.

(ii) When standard and actual time of labour mix are different:

In this case the variance will be calculated as follows:

$$\left\{ \frac{\text{Total Time of Actual Labour Mix}}{\text{Total Time of Standard Labour Mix}} \times \text{Standard cost of Standard Labour Mix} \right\} - (\text{Standard cost of Actual Labour Mix})$$



As in the earlier case, if labour composition is revised because of non-availability of one grade of labour then revised standard mix will be used instead of standard mix and the formula will become:

$$\left\{ \frac{\text{Total Time of Actual Labour Mix}}{\text{Total Time of Revised Standard Labour Mix}} \times \text{Standard cost of Revised Standard Labour Mix} \right\} - (\text{Standard cost of Actual Labour Mix})$$

Chart showing the procedure for solving the question of labour cost variances

Stage-1: Basic information

SH = Standard hours for actual output.

AH = Actual hours for actual output.

RSH = Total AH divided in SH ratio..

Stage - 2 : Analysis table

Labour	Standard		Actual		RSH
	SH	SR	AH	AR	
Total					

Stage - 3 : Calculation of variances

LCV = (SH X SR) - (AH X AR)

= () - () =

= () - () =

= () - () =

LRV = (SR - AR) AH

= () =

= () =

= () =

LEV = (SH - AH) SP

= () =

= () =

= () =

LMV = (RSH - AH) SR

= () =

= () =

= () =

LYV = (SH - RSH) SR

= () =

= () =

= () =



Stage-4 : Verification :

