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Subject – Cost & Works Accounting - I

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Topic 2 – Element of Cost & Cost Sheet

❖ Element of Cost –

A cost is composed of three elements i.e. material, labour and expenses. Each of these elements may be direct or indirect, as shown below:

Direct cost	Indirect Cost
Direct Material	Indirect Material
Direct labour	Indirect Labour
Direct Expenses	Indirect Expenses

➢ Material Cost –

According to CIMA, UK, material cost is "the cost of commodities supplied to an undertaking". Materials may be direct or indirect.

- **Direct Materials –**

  Direct Material cost is that which can be conveniently identified with and allocated to cost units. Direct materials generally become part of the finished product. For example cotton used in textile mill is a direct material. However in many cases though a material forms a part of the finished product, yet, it is not treated as direct material, e.g. nails used in furniture, thread used in stitching garments etc. This is because the value of such materials is so small that it is quite difficult and futile to measure it. Such materials are treated as indirect materials.

  Examples of Direct Material - Clay in Bricks, Leather in Shoes, Steel in machine, Cloth in Garment, Timber in Furniture

- **Indirect Materials –**

  These are those materials which cannot be conveniently identified with individual cost units. these are minor in importance, such as 1) small and relatively inexpensive items which may become a part of a finished product; e.g. pins, screws, nuts and bolts, thread etc., 2) Those items which do not physically become a part of the finished product; e.g. coal, lubricating oil and grease, sand paper used in polishing, soap etc.

Examples of Indirect Material - Lubricating Oil, Sand paper, Nuts & Bolts, Coal, Small tools, Office Stationary

- **Labour Cost -**

This is "the cost of remuneration (wages, salaries, commissions, bonuses etc), of the employees of an undertaking". (CIMA)

- **Direct Labour –**

  Direct labour cost consists of wages paid to workers directly engaged in converting raw materials into finished products. These wages can be conveniently identified with a particular product, job or process. Wages paid to a machine operator is a case of direct wages.

  Example of direct labour - Machine operator, Shoe-maker, Carpenter, Weaver, Tailor etc.

- **Indirect Labour –**

  It is of general character and cannot be conveniently identified with a particular cost unit. In other words, indirect labour is not directly engaged in the production operations but only to assist or help in production operations.

  Examples of indirect labour - Supervisor, Inspector, Cleaner, Clerk, Peon, Watchmen etc.

- **Expenses -**

All costs other than material and labour are termed as expenses. It is defined as "the cost of services provided to an undertaking and the notional cost of the use of owned assets". (CIMA)

- **Direct Expenses –**

  According to CIMA, UK, "direct expenses are those expenses which can be identified with and allocated to cost centres or cost units". These are those expenses which are specifically in curd in connection with a particular job or cost unit. Direct expenses are also known as chargeable expenses.

Examples of direct expenses –

Hire of special plant for a particular job

Travelling expenses in securing a particular contract

Cost of patent rights

Experimental costs

Cost of special drawings, designs and layouts

Carriage paid for materials purchased for specific job

Royalty paid in mining

Depreciation or hire of a plant used on a contract at site

- **Indirect Expenses –**

  All indirect costs, other than indirect materials and indirect labour costs are termed as indirect expenses. These cannot be directly identified with a particular job, process, work order and are common to cost units or cost centres.

  Examples of indirect expenses - Rent and rates, Depreciation, Lighting and power, Advertising, Insurance, Repairs

➢ **Prime Cost** –

This is the aggregate of direct material cost, direct labour cost and direct expenses. Thus,

Direct Material + Direct Labour + Direct Expenses = Prime Cost

➢ **Overhead** –

This is the aggregate of indirect material, indirect labour and indirect expenses. Thus,

Indirect Material + Indirect Labour + Indirect Expenses = Overhead

Overheads are divided into three groups as follows:

1. **Production overheads –**

   Also known as factory overheads, works overheads, manufacturing overheads. These are those overheads which are concerned with the production function. It includes indirect materials, indirect wages and indirect expenses in producing goods or services.

   a) Indirect Materials – e.g. Coal, oil, grease etc. Stationary in factory office, cotton waste, brush, sweeping broom etc.
   b) Indirect Labour – e.g. Works manager's salaries, salary of factory office staff, salary of inspectors and supervisor, wages of factory sweeper, wages of factory watchmen etc.
   c) Indirect Expenses - e.g. Factory rent, depreciation of plant, repairs and maintenance of plant, insurance of factory building, factory lighting & power, internal transport expenses etc.

2. **Office and Administrative Overheads –**

   This is the indirect expenditure incurred in general administrative function. These overheads are of general character and have no direct connection with production or sales activities.

   a) Indirect Material – e.g. stationary used in general administrative office, postage, sweeping broom and brush used in office etc.
   b) Indirect Labour – e.g. salary of office staff, salary of managing director, remuneration of directors of the company etc.
   c) Indirect Expenses – e.g. rent of office building, legal expenses, office lighting & power, telephone expenses, depreciation of office furniture and equipments, office air-conditioning, sundry office expenses.

3. **Selling and distribution overhead –**

Selling overhead is the cost of promoting sales and retaining customers. it is defined as “ the cost of seeking to create and stimulate demand and of securing orders”. Examples are advertising, samples and free gifts, salaries of salesman etc.

Distribution cost includes all expenditure incurred from the time the product is completed until it reaches its destination. It is defined as “the cost of sequence of operations which begins with making the packed product available for dispatch and ends with making the reconditioned returned empty packages, if any, available for re-use”. Examples are carriage outwards, Insurance of goods in transit, upkeep of delivery vans, warehousing etc.

Selling and distribution overheads also grouped into indirect material, indirect labour and indirect expenses.

a) Indirect Material - e.g. Packing material, Stationery used in sales office, cost of samples, price list, catalogues, oil, Grease for delivery vans etc.

b) Indirect Labour - e.g. Salary of sales manager, salary of sales office staff, salary of warehouse staff, salaries of drivers of delivery vans etc.

c) Indirect Expenses - e.g. Advertising, travelling expenses, showroom expenses, carriage outwards, rent of warehouse, bad debts, Insurance of goods in transit etc.

❖ Classification of Costs –

1. Direct and Indirect Costs –

- **Direct Costs –**

  These are those costs which are incurred for and conveniently identified with a particular cost unit, process or department. Cost of raw material used and wages of machine operator are common examples of direct costs. To be specific, cost of steel used in manufacturing a machine can be conveniently known. It is therefore, a direct cost. Similarly, wages paid to a tailor in a readymade garments company for stitching a piece of trouser is a direct cost because it can be easily identified in the cost of a trouser.

- **Indirect Costs –**

  These are general costs and are incurred for the benefit of a number of cost units, processes or departments. These costs cannot be conveniently identified with a particular cost unit or cost centre. Depreciation of machinery, insurance, lighting, power, rent, managerial salaries, materials used in repairs, etc. are common examples of indirect costs. For example, depreciation of machine for stitching a piece of trouser cannot be known and thus it is an indirect cost.

2. Fixed and Variable costs –

- **Fixed Costs –**

  These costs remain constant in 'total' amount over a wide range of activity for a specified period of time: i.e. these do not increase or decrease when the volume of production changes. For example, building rent, managerial salaries remain constant and do not change with change in output level and thus are fixed costs. But fixed cost 'per unit' decreases when volume of production increases and *vice versa*, fixed cost per unit increases when volume of production decreases.

- **Variable Costs –**

  These costs tend to vary in direct proportion to the volume of output. In other words, when volume of output increases, total variable cost also increases, and *vice versa,* when volume of output decreases, total variable cost also decreases. But, the variable cost per unit remains constant (fixed). For example, direct material, direct wages, power, royalties, normal spoilage, commission of salesmen, small tools etc.

- **Semi – Variable costs -**

  These costs include both a fixed and a variable component; i.e. these are partly fixed and partly variable. A semi-variable cost has often a fixed element below which it will not fall at any level of output. The variable element in semi-variable costs changes either at a constant rate or in lumps. For example, in the case of telephone, there is a minimum rent and after a specified number of calls, the charges are according to the number of calls made. Other examples are supervision, maintenance and repairs, compensation for accidents, light & power, depreciation etc.

3. Controllable and Non-controllable costs -

- **Controllable costs** -

  These are the cost which may be directly regulated at a given level of management authority. Costs are generally controllable by department heads. For example, cost of raw material may be controlled by purchasing in larger quantities.

- **Non-controllable costs -**

  These are those costs which cannot be influenced by the action of a specified member of an organisation. For example, it is very difficult to control costs like factory rent, managerial salaries, etc.

4. Product Cost and Period Costs -

- **Product Costs -**

  These are those costs which are necessary for production and which will not be incurred if there is no production. These consist of direct materials, direct labour and some of the factory overheads. Product costs are 'absorbed by' or 'attached to' the units produced.

- **Period Costs -**

  These are those costs which are not necessary for production and are written off as expenses in the period in which these are incurred. Such costs are incurred for a time period and are charged to profit and loss account of the period. rent, salary of company executives, travel expenses are examples of period costs.

5. Historical and Pre-determined costs -

- **Historical Costs -**

  These are the costs which are ascertained after these have been incurred. Historical costs are thus nothing but actual costs. These costs are not available until after the completion of the manufacturing operations

- **Pre-determined Costs -**

These are future costs which are ascertained in advance of production on the basis of a specification of all the factors affecting cost. These costs are extensively used for the purpose of planning and control

6. Committed and Discretionary Costs -

- **Committed Costs -**

These are those that are incurred in maintaining physical facilities and managerial setup. Such costs are committed in the sense that once the decision to incur them has been made, they are unavoidable and invariant in the short run. For example salary of the Managing Director represent a committed cost if by policy, the Managing Director is not be relieved unless the firm is liquidated. Similarly, depreciation of plant and equipment is committed because these facilities cannot be easily changed in short run.

- **Discretionary Costs -**

These are those which can be avoided by management decisions. Such costs are not permanent. Advertising, research and development cost, salaries of low level managers are examples of discretionary cost because these cost may be avoided or reduced in the short run

7. Normal or Abnormal Costs –

- **Normal Costs –**

  Normal costs may be defined as a cost which is normally incurred on expected lines at a given level of output. This cost is a part of cost of production.

- **Abnormal Costs –**

  Abnormal cost is that which is not normally incurred at a given level of output. Such cost is over and above the normal cost and is not treated as a part of the cost of production.

8. Special Costs for Managerial Decision-Making –

- **Sunk Costs –**

A sunk cost is an expenditure made in the past that cannot be changed and over which management has no control. These costs are not relevant for decision-making about the future. Thus, the book value of an asset currently being used is not relevant in making the decision to replace it. Similarly, the cost of land purchased in 1980 is not relevant in deciding whether to sell the land or hold it.

- **Differential (or Incremental) Costs –**

  Differential cost is the increase or decrease in total cost that result from an alternative course of action. It is ascertained by subtracting the cost of one alternative from the cost of another alternative. The alternative choice may arise because of change in method of production, in sales volume, change in product mix, make or buy decisions etc.

- **Marginal Costs –**

  Marginal cost is the additional cost of producing one additional unit. Marginal cost is the total of all variable/direct costs.

- **Imputed Costs –**

  These are hypothetical costs which are specially computed outside the accounting system for the purpose of decision-making. Interest on capital invested is a common type of imputed cost.

- **Opportunity Cost –**

  Opportunity cost is the sacrifice involved in accepting an alternative under consideration. In other words, it is a cost that measures the benefit that is lost or sacrificed when the choice of one course of action requires that other alternative course of action be given up.

- **Replacement Cost –**

  Replacement cost is the current market cost of replacing an asset. For example, a machine purchased in 1955 at Rs 10,000 is discarded in 2003 and a new machinery of the same type is purchased for Rs 15,000. So the replacement cost of the machinery is Rs 15,000.

- **Out-of –pocket Cost –**

  There are certain costs which require cash payment to be made (such as wages, rent) whereas many costs do not require cash outlay (such as depreciation). Out-of-pocket costs are those costs that involve cash outlays. Examples are wages, material cost, insurance, rent etc.

- **Cost Control and Cost Reduction –**
  - **Cost Control –**

    The cost control is the function of keeping costs within prescribed limits. According to CIMA, cost control is "the regulation by executive action of the cost of operating an undertaking, particularly where such action is guided by cost accounting". Cost control is based on the principle of predetermination of costs and achieving these cost levels so that inefficiencies and wastages may be reduced. This involves:

    a) Pre-determining or planning costs

    b) Comparing actual costs with planned costs

    c) Taking action to correct divergencies
  - **Cost Reduction –**

    Cost reduction is defined by CIMA as "the achievement of real and permanent reduction in the unit cost of goods manufactured or services rendered without impairing their suitability for use intended".

- **Format of Cost Sheet –**

Cost Sheet for the period.......

Particulars		Total Cost	Cost per unit
Opening stock of Raw Material	xxx		
Add – Purchases	xxx		
Add – Expenses on Purchases	xxx		
	xxx		
Less – Closing stock of Raw Material	xxx		
Cost of Material Consumed	xxx		
Direct Wages	xxx		
Direct Expenses	xxx		

A) Prime Cost	xxx	xxx	
Add - Factory Overheads			
Add – Opening stock of work-in-progress	xxx		
Less - Closing stock of work-in-progress	xxx		
B) Factory or Works Cost	xxx	xxx	
Add – Administrative Overheads	xxx		
C) Cost of Production	xxx	xxx	
Add – Opening stock of Finished Goods	xxx		
Less - Closing stock of Finished Goods	xxx		
D) Cost of Goods Sold	xxx	xxx	
Add – Selling & Distribution Overheads	xxx		
E) Cost of Sales	xxx	xxx	
Profit / Loss		xxx	
Sales		xxx	

Detailed Cost Sheet

Particulars	Total Cost	Cost per unit
Opening stock of Direct Raw Material		
Add – Purchases		
Add – Carriage Inward		
Add – Octroi and Customs Duty		
Less – Closing stock of Direct Raw Material		
Cost of Material Consumed		
Direct or productive Wages		
Direct Expenses		
A) Prime Cost		
Add - Factory/works/Manufacturing Overheads		
Indirect Material		
Indirect wages		
Leave wages		
Overtime premium		
Fuel & power		
Coal		
Factory rent and taxes		

Insurance Factory lighting Supervision Works stationary Canteen and welfare expenses Repairs Haulage works salaries Depreciation of plant and machinery Works expenses Gas and water Drawing office salaries Technical directors fees Laboratory expenses Works telephone expenses Internal transport expenses Less – Sale of Scrap Add – Opening stock of work-in-progress Less - Closing stock of work-in-progress		
B) Factory or Works Cost		
Add – Office and Administrative Overheads Office salaries Directors fees Office rent and rates Office stationery and printing Sundry office expenses Depreciation and repairs of office equipment Depreciation office furniture Subscription to trade journals Office lighting Establishment charges Directors travelling expenses Postage Legal charges Audit fees		
C) Cost of Production		
Add – Opening stock of Finished Goods Less - Closing stock of Finished Goods		
D) Cost of Goods Sold		
Add – Selling & Distribution Overheads Advertising Showroom expenses Bad debts Salesman salaries and expenses Packing expenses Carriage outward		

Commission of sales agents Counting house salaries Cost of catalogues Expenses of delivery van Collection charges Travelling expenses Cost of tenders Warehouse expenses Cost of mailing literature Sales Manager's salaries Sales directors fees Sales office expenses Depreciation and repairs of delivery van Expenses of sales branches		
E) Cost of Sales		
Profit / Loss **Sales**		