

Cost Control Techniques & Cost Audit

Unit I: Cost Concepts Analysis and Behavior:

Concept of Cost-Cost Accounting – Meaning - Definition -Objectives – Fundamental Principles-Relationship of Cost Accounting with Financial Accounting-Advantages and Limitations –Classification of Cost- Methods and Techniques of Costing – Preparation of Cost Sheet and Tender.

Cost accounting is a crucial aspect of financial management, primarily focused on the identification, measurement, and analysis of costs associated with various activities within an organization. It provides valuable insights into the cost structure of products or services, aiding in decision-making processes aimed at maximizing profitability and efficiency.

The concept of cost accounting revolves around the systematic recording and analysis of costs incurred during the production or provision of goods and services. It involves the classification of costs into various categories based on their nature, behavior, and relevance to decision-making.

1. **Meaning:** Cost accounting is the process of collecting, analyzing, and reporting information related to the costs incurred by an organization in its operations. It involves the identification and measurement of costs associated with different activities, such as production, distribution, and administration. The primary objective is to provide management with accurate cost data to facilitate planning, control, and decision-making.
2. **Definition:** Cost accounting can be defined as the systematic process of recording, classifying, allocating, and analyzing costs to determine the cost of producing goods or services and to provide useful information for managerial decision-making. It involves the use of various techniques and methods, such as job costing, process costing, activity-based costing (ABC), and standard costing, to track and manage costs effectively.

In essence, cost accounting serves as a vital tool for management in evaluating the performance of different departments, products, or processes, identifying cost-saving opportunities, setting prices, and formulating strategies to achieve organizational goals. It provides a detailed insight into the cost structure of an organization, enabling managers to make informed decisions to enhance efficiency and profitability.

Objectives of Cost Accounting:

1. **Cost Ascertainment:** The primary objective of cost accounting is to ascertain the cost incurred for producing a product or providing a service accurately. This involves identifying and recording all costs, both direct and indirect, associated with the production process.
2. **Cost Control:** Cost accounting aims to control and reduce costs wherever possible. By analyzing cost variances and identifying cost drivers, management can take corrective actions to eliminate wastage, improve efficiency, and optimize resource utilization.
3. **Cost Reduction:** Beyond control, cost accounting also focuses on reducing costs over time. By continually seeking opportunities to streamline processes, negotiate better deals

with suppliers, and improve productivity, organizations can lower their overall cost structure.

4. **Profit Planning and Decision Making:** Cost accounting provides crucial data for profit planning and decision-making processes. By understanding the cost structure of different products or services, management can make informed choices regarding pricing strategies, product mix, investment decisions, and resource allocation.
5. **Performance Evaluation:** Another objective is to evaluate the performance of various departments, units, or individuals within the organization. By comparing actual costs against standard costs or budgets, management can assess efficiency, identify areas of improvement, and reward or incentivize performance accordingly.
6. **Facilitating Budgeting:** Cost accounting plays a vital role in the budgeting process by providing estimates of future costs based on historical data and current trends. Budgets serve as financial roadmaps, guiding the allocation of resources and setting targets for performance evaluation.
7. **Optimum Resource Utilization:** By analyzing costs and resource utilization patterns, cost accounting helps in achieving optimum utilization of resources. This involves maximizing output while minimizing input costs, ensuring that resources are allocated efficiently across different activities.

Fundamental Principles of Cost Accounting:

1. **Cost Benefit Principle:** This principle states that the benefits derived from the information provided by cost accounting should outweigh the costs involved in implementing and maintaining the system.
2. **Causality Principle:** Costs should be attributed to the specific activities or cost objects that cause them. This principle ensures that costs are accurately allocated based on the factors that drive them, facilitating better decision-making.
3. **Materiality Principle:** Cost accounting focuses on material costs and significant cost drivers that have a substantial impact on the organization's overall cost structure. Trivial costs are often disregarded to avoid unnecessary complexity.
4. **Consistency Principle:** Consistency in cost accounting methods and procedures is crucial for comparability and reliability of cost data over time. Changes in methods should be made only when necessary and should be properly documented and explained.
5. **Accuracy Principle:** Cost accounting data should be accurate and reliable to serve as a basis for decision-making. This involves ensuring the integrity of data collection, recording, and analysis processes.
6. **Economic Reality Principle:** Cost accounting should reflect the economic reality of the organization's operations. It should consider not only financial costs but also non-financial factors that influence decision-making, such as environmental impact and social responsibility.

By adhering to these objectives and principles, organizations can effectively utilize cost accounting as a strategic tool for improving performance, maximizing profitability, and achieving long-term sustainability.

Relationship of Cost Accounting with Financial Accounting:

Cost accounting and financial accounting are two essential branches of accounting that serve different but complementary purposes within an organization. Understanding their relationship is crucial for effective financial management. Here's how they are related:

1. **Scope and Focus:**

- **Cost Accounting:** Focuses on the internal operations of an organization, primarily concerned with the ascertainment, allocation, and control of costs associated with production or service delivery.
- **Financial Accounting:** Primarily concerned with recording, summarizing, and reporting financial transactions to external stakeholders such as investors, creditors, regulators, and tax authorities.

2. **Data Utilization:**

- **Cost Accounting:** Utilizes detailed cost data to provide internal management with information for decision-making related to product costing, pricing, cost control, and performance evaluation.
- **Financial Accounting:** Summarizes financial information into standardized financial statements (income statement, balance sheet, cash flow statement) for external users to assess the financial health and performance of the organization.

3. **Timeframe:**

- **Cost Accounting:** Often involves the use of real-time or frequent reporting to provide timely information for managerial decision-making and control purposes.
- **Financial Accounting:** Typically follows a periodic reporting cycle (e.g., quarterly, annually) as required by accounting standards and regulatory requirements.

4. **Regulatory Compliance:**

- **Cost Accounting:** While there are generally accepted principles and standards for cost accounting, they are not as strictly regulated as financial accounting. Organizations have more flexibility in designing cost accounting systems tailored to their specific needs.
- **Financial Accounting:** Subject to stringent regulations and accounting standards (e.g., GAAP, IFRS) to ensure consistency, comparability, and transparency in financial reporting.

5. **Integration:**

- **Cost Accounting:** Provides valuable inputs to financial accounting by supplying detailed cost information needed for the preparation of financial statements, particularly for cost of goods sold (COGS) calculations and inventory valuation.
- **Financial Accounting:** Utilizes cost accounting data indirectly to allocate and report costs accurately in financial statements, ensuring compliance with accounting standards and regulatory requirements.

6. **Decision-Making Support:**

- **Cost Accounting:** Empowers internal management with cost data and analysis for making informed decisions related to pricing, product mix, budgeting, capital investment, and performance evaluation.
- **Financial Accounting:** Provides information to external stakeholders for investment decisions, credit assessments, and regulatory compliance, contributing to the overall transparency and accountability of the organization.

In summary, while cost accounting focuses on internal cost management and decision support, financial accounting serves external reporting and regulatory compliance purposes. Both disciplines are interconnected and complement each other in providing comprehensive financial information for effective management and stakeholder communication.

Advantages of Cost Accounting:

1. **Cost Ascertainment:** Cost accounting helps in accurately determining the cost of production or service delivery by systematically recording all costs incurred, including direct and indirect costs.
2. **Cost Control:** By identifying cost variances and analyzing cost drivers, cost accounting enables management to take proactive measures to control and reduce costs, leading to improved profitability.
3. **Decision Making:** Cost accounting provides valuable information for managerial decision-making, such as pricing, product mix, make-or-buy decisions, and resource allocation, by analyzing costs and their impact on profitability.
4. **Performance Evaluation:** It facilitates performance evaluation by comparing actual costs against standard costs or budgets, allowing management to assess efficiency, identify areas for improvement, and reward or incentivize performance accordingly.
5. **Budgeting and Planning:** Cost accounting aids in the budgeting process by providing estimates of future costs based on historical data and current trends, helping organizations to set realistic budgets and financial targets.
6. **Optimum Resource Utilization:** By analyzing costs and resource utilization patterns, cost accounting assists in achieving optimum utilization of resources, ensuring that resources are allocated efficiently across different activities.

Limitations of Cost Accounting:

1. **Complexity:** Cost accounting systems can be complex and costly to implement, especially for small and medium-sized enterprises (SMEs), requiring specialized knowledge and resources.
2. **Subjectivity:** Allocation of indirect costs and overheads involves subjective judgment, which can lead to biases and inaccuracies in cost determination, affecting decision-making.
3. **Focus on Historical Data:** Cost accounting primarily relies on historical cost data, which may not always reflect future costs accurately, leading to potential inaccuracies in budgeting and planning.
4. **Inflexibility:** Cost accounting systems may lack flexibility to adapt to changes in business environments, products, or processes, making it challenging to accommodate dynamic cost structures.
5. **Potential for Manipulation:** There is a risk of manipulation or distortion of cost data for managerial or incentive purposes, compromising the reliability and integrity of cost accounting information.
6. **Overemphasis on Cost Reduction:** A sole focus on cost reduction may lead to compromises in quality, innovation, and long-term sustainability, undermining the organization's competitive advantage and growth potential.

Despite these limitations, cost accounting remains a valuable tool for organizations to manage costs, enhance decision-making, and improve overall performance. By understanding its advantages and limitations, organizations can leverage cost accounting effectively to achieve their strategic objectives while mitigating potential challenges.

Classification of Cost:

Costs can be classified in various ways based on different criteria such as behavior, function, nature, variability, and controllability. Here's a breakdown of the common classifications of costs:

1. Based on Behavior:

- **Fixed Costs:** Costs that remain constant regardless of changes in the level of activity or production within a relevant range. Examples include rent, salaries of permanent staff, insurance premiums.
- **Variable Costs:** Costs that vary in direct proportion to changes in the level of activity or production. Examples include raw materials, direct labor, and sales commissions.
- **Semi-Variable Costs:** Costs that have both fixed and variable components. These costs increase with the level of activity but not in direct proportion. Examples include utilities (partly fixed and partly variable) and maintenance costs (which may have a fixed component and a variable component based on usage).

2. Based on Function:

- **Manufacturing Costs:** Costs directly associated with the production process, including direct materials, direct labor, and manufacturing overheads.
- **Non-Manufacturing Costs (Operating Expenses):** Costs incurred outside the production process, including selling expenses (e.g., advertising, sales commissions) and administrative expenses (e.g., salaries of administrative staff, office supplies).

3. Based on Nature:

- **Direct Costs:** Costs that can be directly traced to a specific cost object (such as a product, department, or activity) with a high degree of accuracy. Examples include direct materials and direct labor.
- **Indirect Costs:** Costs that cannot be directly traced to a specific cost object and are allocated or apportioned based on some reasonable basis. Examples include factory rent, supervisor salaries, and depreciation of machinery.

4. Based on Variability:

- **Short-Term Costs:** Costs that vary with changes in production or activity levels within a short time frame, such as raw materials or variable labor costs.
- **Long-Term Costs:** Costs that remain relatively fixed over the short term but may change significantly over the long term due to changes in capacity or technology. Examples include fixed asset depreciation, lease payments, and management salaries.

5. Based on Controllability:

- **Controllable Costs:** Costs that can be influenced or controlled by a specific manager or department within the organization. Examples include direct labor costs, materials costs, and some variable overhead costs.
- **Uncontrollable Costs:** Costs that cannot be influenced or controlled by a specific manager or department, typically determined by factors beyond their control, such as market conditions, government regulations, or corporate policies. Examples include rent, depreciation, and some fixed overhead costs.

Understanding these classifications helps organizations in cost analysis, decision-making, budgeting, and performance evaluation, allowing them to effectively manage and control their costs for optimal business outcomes.

Methods and Techniques of Costing:

Job Costing

Job costing is a type of accounting where the cost of each job is taken into account and calculated. This method is applied to the production units that don't involve more repetitive tasks.

The manufacturing units where the jobs are performed must be able to segregate each job or lot depending on the executed number of orders. Job costing is applied in commercial foundries, drop forging shops, and specialized industry equipment manufacturers.

2. Contract Costing

Based on the underlying principles job costing and contract costing are similar. However, the difference is that the contract costing task is big and the job costing is comparatively small. Both the costing methods are referred to as terminal costing.

3. Cost-plus Costing

This method is one component of contract costing. Cost-plus costing is implemented when, in a contract, the contractor receives both the predetermined contract price and an additional mutually agreed-upon amount.

4. Batch Costing

Batch costing is the practice of grouping orders or tasks into distinct batches, considering the efficient production of items as a primary factor. Here, the cost is determined based on the group of products.

This costing method is applicable for companies such as businesses producing general engineering goods where the components are arranged in appropriate economic batches. In

addition, batch costing is best utilised in pharmaceutical companies to determine the cost of goods effectively.

5. Process Costing

Process costing is applicable when a product undergoes various sequential phases, each of which is clearly defined, distinguishable, and easily separable from the others. In addition, process costing is beneficial to calculate the cost at each stage in the production process.

Process Costing is best suited for extractive industries and businesses such as chemicals, paints, food, soaps etc. All these companies find this method beneficial and effective.

6. Single Costing

Single costing involves determining the cost per unit of output or production. This costing method is also known as output costing or unit costing. Every component comprising this cost is individually calculated. Single costing method is suitable for industries such as paper mills, brick-making and flour mills.

7. Operating Costing

Operating costs are applicable to companies that provide bus, electricity and transport services. It helps in calculating the costs incurred in providing those services.

8. Multiple costing

In multiple costing, the costs incurred from multiple sections are combined after determining the expenses of each manufactured component. This costing method is very useful for the automotive industry and industries dealing with the production of assembly parts.

9. Departmental Costing

The main objective of departmental costing is to determine the cost of outputs separately for each department. If any company has multiple departments, departmental costing is the best solution to calculate and ascertain costs.

10. Operation Costing

Operation costing is an enhanced version of process costing. It is best applicable when a repetitive or mass production process is carried out. It is also used if the components are in a semi-finished stage.

Components of a Cost Sheet

1. Prime Costs

Under this header, you have to record all the expenses involved in the production process. This is also known as basic or first cost.

For example, if you have a textile store, your prime costs will be the costs of purchasing fabric from weavers, employee salaries, packaging, implements needed to measure and cut cloth, etc.

The formula for calculating prime costs is:

Prime Costs= Direct Labour + Direct Raw Material+Direct Expenses

2. Works Cost

Works cost is the sum of prime costs and overhead costs including factory expenses. Overhead costs are those costs that are not directly related to the production of a product but are required nevertheless. For example, you need to pay electricity bills to keep your production going. Similarly, there are several other taxes and utility costs that fall under the overhead costs category.

3. Cost of Production

Under this header, you should include all the expenses involved in business operations, including rents and work costs. The formula for calculating the cost of production is:

Cost of Production= (Work Costs)+(Administration Overhead Costs)-(Opening and Closing Stock of Finished Goods)

4. Cost of Sales

Cost of sales or total cost contains the details of all the expenses involved in the production and other costs involved in selling and distribution. This value will help you understand how much you spend on a product according to the resources used for producing it. You can decide your selling price according to the cost of sales and know how much profit you will earn from it.



