Management Accounting
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Lec 04
Statement of the Cost – An Introduction

Welcome students! So in the previous class we were talking about the cost sheet or statement of the cost and there we were learning about that why the total cost is divided over the different sub components of the cost and how the total cost of the product or service is calculated. So, the purpose as I discussed earlier was that to find out where the cost is going out of control, how to correct it and what action can be taken.

So, different components, four sub components of the cost and finally the cost of the product to be sold, here I would like to add one thing that the cost sheet or the statement of the cost of any manufacturing firm is very-very confidential document. It is very-very confidential document. They do not share it with anybody or any other side or any outside firm and outside does not know how the cost of the product is calculated because it is a very strategic decision.

Lot of efforts have to be put by the firm. The firm has to make lot of efforts to calculate the total cost of the product and find out those areas where the cost can be controlled, or if the cost is going out of control how to control it. This is a confidential statement. It is kept under a strict control and if any other company has to know about the costing process of the other company, then they use the spying.

They send their employees, as the employees of the say company whose cost sheet it is required they move up to the cost department of the costing department, they try to have this document and then they come back to their company. So, it means people go up to the extent of spying to know about the cost statement or the cost sheet of the companies. So it is a very-very confidential document but dividing the cost into the subcomponents the purpose behind it creating the sort of responsibility centres.

So, if at any time cost goes out of control we can find out how to control the cost. Now, quickly we will learn about the different types of the costs. We will be using them, means at the different points of time. In the further discussion, in the next coming lectures, we will be using different types of the cost. Though you know all these costs I think some time you have heard it in the past but let us quickly know about these costs so that when we use these costs later on in our discussion, you are aware about which type of the cost I am talking about.

So, there the different types of the cost. Cost can be classified under different names and the different say nomenclature. So, we have the different types (of). So, how many we have the different types of the costs here 1, 2, 3, 4, 5, 6, 7, 8, 9, 10, different types of the costs. When we refer them to in our discussion later on, we do not say that hat is this cost and what we are talking about, we know that. So, just quickly have a say review of this different types of the costs so that when we use them at the different places later on, we are clear about it.

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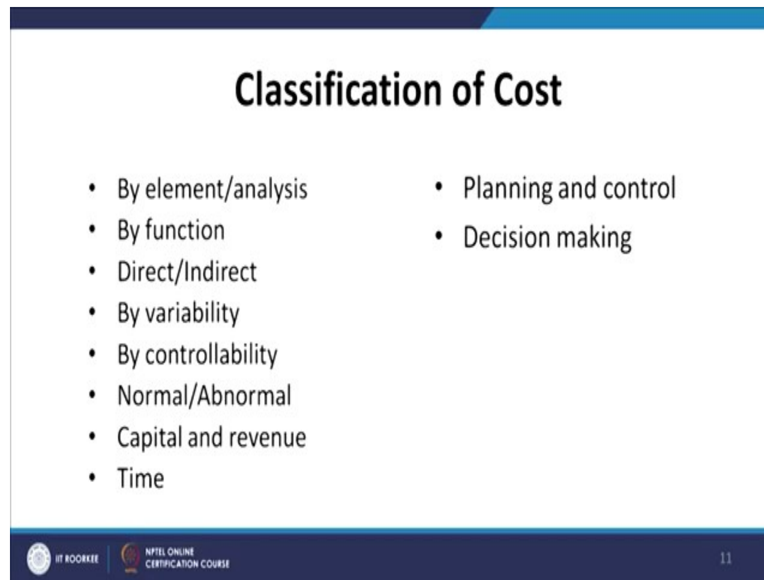

First one is the element or analysis cost, cost by elements. Elements are like your material labour and other overheads. These are the elements of the cost. So, material cost we are talking about, labour cost we are talking about, direct overheads cost we are talking about. So these costs are covered and under the elements cost. Then functions cost, functions cost means production cost, marketing cost, distribution cost, financial cost.

Different functions we perform in the firm, in the organization and the different cost occurring because of these functions is called as a functional cost. Then we have the direct and the indirect cost. Direct cost is the one which is you can say elements cost means elements of that say a production process that is material is one element. So, direct cost when you see, direct cost is here as I have discussed with you.

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COST SHEET OR STATEMENT OF COST

	Total Cost (Rs.)	Cost/unit
Direct Materials Direct Labour Direct Expenses **Prime cost**		
Add Works overheads **Works Cost**		
Add Administrative Overheads **Cost of Production**		
Add Selling and Distribution overheads		
Total Cost or Cost of Sales		

These three costs are the direct costs which make the prime cost. These three costs are the direct cost which makes the prime cost. So, it means in this case these three components, one is the material, then is the labour and then we have the direct expenses. These are the direct cost components. So, those costs which can be identified directly or which cause the product to be manufactured which are easily or directly identifiable cost they are called as direct cost.

And the cost which are supportive costs without which also the production process is not possible but those costs which are supportive costs those costs are indirect costs. For example, you talk about the factory overheads, that is a indirect cost. For example, we talk about the salaries of the employees, that is a indirect cost. People working in the office, people working in the factory, but not directly working on the plant, they are called as indirect cost. So, at the other major differentiation between them is that these costs are called as the fixed and the variable cost also.

Direct cost is generally variable and indirect cost is fixed. So, when employees working in the firm, his salary is fixed. He cannot be removed, he is a permanent employee, and he is a white-collar employee, so his cost is indirect cost, but the worker working on the plant, a blue-collar employee that cost is called as the direct cost because without that worker, the production is not possible.

If the employee is not in the office the production is possible, but if that worker is not there on the plant, production is not possible. So those costs which cause the production, they are direct costs, which are supportive behind the production process, they are indirect cost. Variability, variability means we have three costs as per the variability. They are fixed cost, variable cost and the semi-variable cost.

Fixed cost I just talked to you which is a period cost, which remains fixed over a period of time. Their cost does not change over a period of time. Say, for example, we have the plant capacity, now we have spent say 20 million rupees to buy a plant or to install a plant and the production capacity of that plant is how many, that is 10,000 units but we are not able to use that maximum capacity of 10,000 units. We can use this capacity maximum up to 5,000 units.

So, but you have to, means this plant and you have to shell out 20 million rupees, 2 crore rupees and that cost is, some cost once the plant is put in place. You manufacture 10,000 units, 5,000 units, 2,000 units, their cost one incurred it is incurred, it is a fixed cost. Variable cost is that if you are manufacturing 10,000 units, you are spending on the material accordingly. If you are manufacturing 5,000 units, you are spending on the material accordingly.

So, how much you want, that is a direct cost, how much you cannot control once it is fixed, it is incurred, it is a fixed cost and there is a partly, its variable partly fixed. For example, we talk about some expenses like your telephone expenses or the communication expenses. If it is a landline telephone, you pay the rent which is irrespective of the fact whether use the phone, or not use the phone; you have to pay the phone rent for that, right?

In case of the post-paid mobile telephones also it is like that. You use the phone, you do not use the phone you have to pay the minimum rent and the variable part is the calls which you make use of and you have to pay the amount or the bill for that also. Then we have the controllability, you call divided into two parts controllable cost and uncontrollable costs. Uncontrollable costs are, we say they are the abnormal costs.

Means controllable costs are which if the efforts are made and if the cause of costs going beyond control is identified, it can be checked, it can be controlled, but uncontrollable costs are the ones which are beyond the control of anybody as I was sharing with you that, for example, now the labour rates. Labour rates are not decided by the firm or anybody. They are decided by the labour market.

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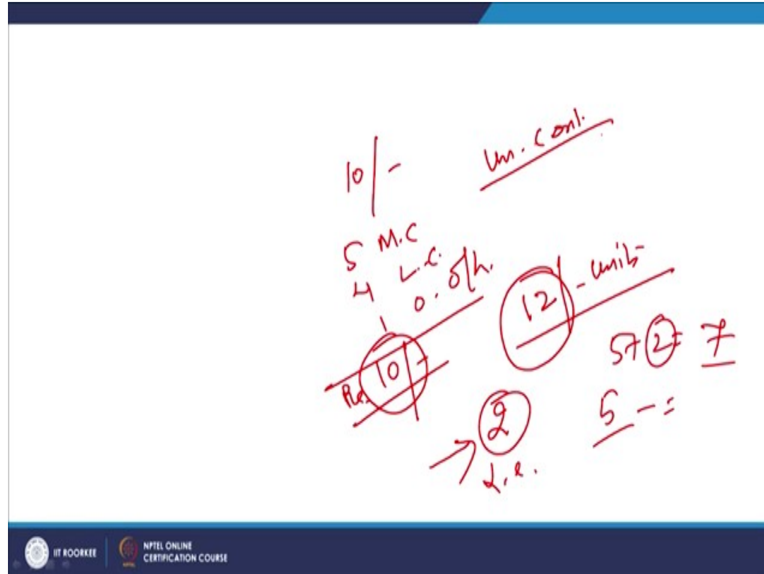

So for example, the labour rates have gone up in the market as a whole, so no worker will be ready to work for a price less than which is fixed by the market. So if the, may be had estimated that for manufacturing the product or 1 unit of the product, say the total cost of the production would be 10 rupees. Out of this 5 rupees is the material cost, out of this 4 rupees is the labour cost and out of this 1 rupee is the other overheads cost, other overheads cost, right?

Now, this makes the total is, how much is 10 rupees. This cost is 10 rupees, but when we manufacture the product we have found that the total cost of the production is 12 rupees per unit, 12 rupees per unit now. We have to make analysis that our standard cost was 10, our actual cost is 12. So, it means there is a difference of how much, 2 rupees. Now, why there is a difference of 2 rupees has come.

For example, if it is the material cost has gone up, material cost is that 5 plus 2 we have paid extra, 7 and normally the material was available in the market for 5 rupees per unit but the efforts were not made to buy this and we have paid 2 rupees extra, so this becomes the controllable cost. This was controllable, but it has not been controlled, right, so action will be taken against the purchase officials who have paid 2 rupees extra so that next time they take care of it.

But, for example, it is a labour cost, if it is a labour cost and 2 rupees extra have been paid and at that time the labour cost had gone off from rupees 4 per unit to rupees 6 per unit, it is beyond the control of anybody because labour is not available for 4 rupees per unit cost, but it has to be paid

6 rupees per unit, then it becomes the uncontrollable cost and if it is uncontrollable cost, it uncontrollable cost in that case what will be done that we will have to pay extra and nobody is held responsible.

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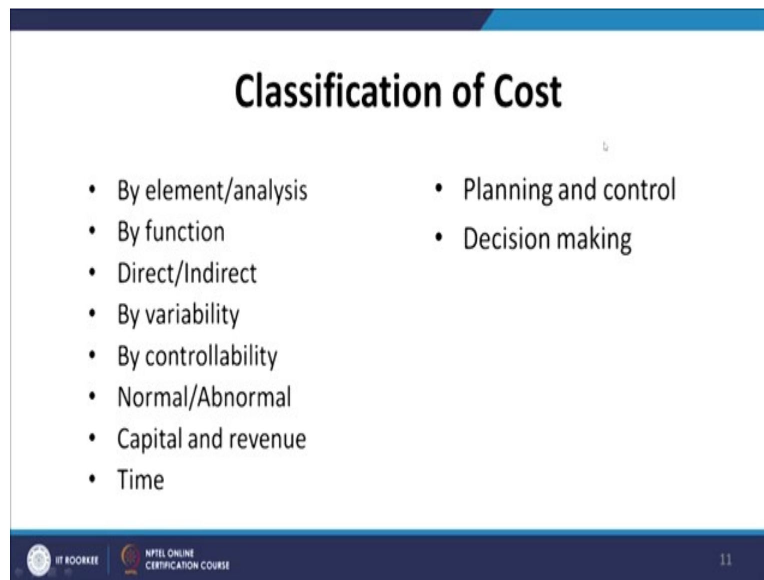

So in this case, the costs are bifurcated or known as controllable cost and the uncontrollable cost. Normal and abnormal cost. Normal circumstances, the cost will be something and abnormal circumstances the cost will be something. Now, for example, we are manufacturing the agriculture product, means any product which is based upon the agricultural inputs. We know that, if the crop is good and then if the normal price of the raw material has to be paid.

For example, we are manufacturing potato chips and we have to for that depend on the farmers for supplying us good quality potatoes. We are expecting that normal potato per kg available to the firm would be five rupees per kg, good quality potato, (but), and that is called as normal cost. But when the crop came, farmers asked a price say 8 rupees per kg or 9 rupees per kg because the crop was destroyed, the total output was not up to the mark, there is a shortage of the potatoes in the market, so prices have gone up.

So, this became the abnormal cost. It can happen once or maybe sometimes once in a while. So, if there is abnormal cost, we have to pay that and normal cost is that cost what is called as normal cost. But for example, if the product was available input was available at the normal cost but we have paid the abnormal cost then this is a cause of the variance and we have to find out that cause and take the corrective actions.

Capital revenue cost, capital is a long term cost means the benefit of which will be accruing to the firm for a period of more than one year that is called as the capital cost, or you can call it as a fixed cost. Revenue cost is the cost which is for fulfilling day-to-day expenses and short term cost you can say the benefit of which can be enjoyed by the firm maximum for a period of one year that is called as the revenue cost.

For example, revenue cost the cost of material is the revenue cost, cost of the labour is the revenue cost, cost of the overheads is the revenue cost but cost of the plant is the capital cost, cost of the building is the capital cost, cost of the furniture is the capital cost because it is a huge in size, large in size, large in amount and for the longer duration. So, it is normally related to the amount we are going to invest for increasing this cost and the period for which the benefit of this cost can be had.

Then is the time cost, so you can say that we have the historical cost and we have the standard cost, we have the historical cost and we had the standard cost. So, it means when you are talking about the historical cost, it means what was the cost incurred in the past, what was the cost incurred in the past, and what is the expected cost that is the standard cost, that is according to the time the standard cost and the historical cost and the actual cost or maybe the futuristic cost.

When you talk about the budgeted cost, it is the standard cost and that is expected to happen in future. Historical cost is the one is the actual cost which has already happened and it can be used as the guiding factor or the base level factor. Then is the planning and controlling, we have the planning cost and the controlling cost, so planning cost is the one which is the again the standard cost. Standard cost me is the budgeted cost. We prepare the budgets in every firm, budgets in every firm and then we go for the production that is the actual production.

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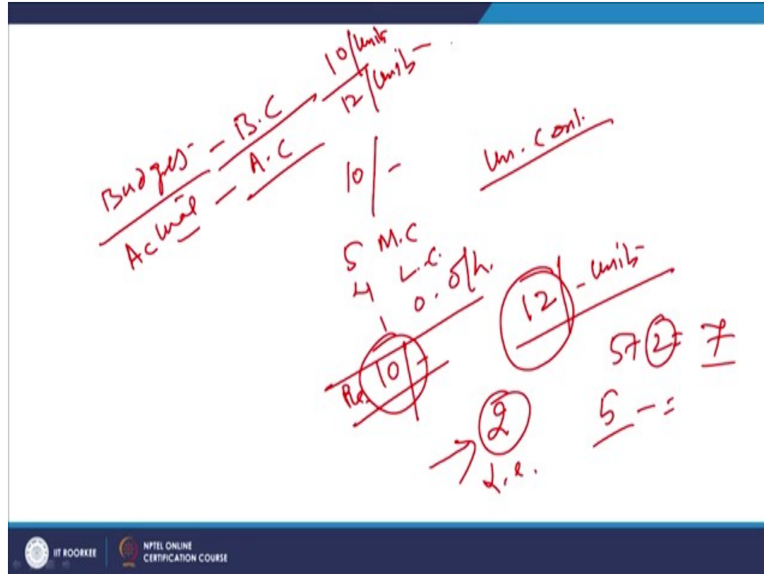

So, one cost is called as the budgeted cost and the one is the AC and then there is actual cost and then another is the BC that is the budgeted cost. So, now we have to see that budgeted costs of the product is 10 rupees per unit and then actual cost here is that is 12 rupees per unit. It means this is now the cause of concern, because what do we mean by planning, planning means deciding what is to be done in future, how is to be done in future and at what cost it is to be done in future.

Controlling means verifying that once you have taken the action actually gone for implementing the budgets then how are the actual results. So, when we compare the budgeted performance with the actual performance if the budgeted performance is equal to the actual performance and then there is no variance, but if the budgeted performance is less than the actual performance then it is the positive variance.

But if the budgeted performance was more than the actual performance a negative variance and in terms of the cost it is reverse. So, budgeted cost was less than the actual cost is more in that case there is a negative variance. We will have to find out the reasons for that and in case of the say cost itself if the actual cost is or the budgeted cost was more and the actual cost is less it is a negative variance. It is a positive variance so still we have to find out why there is a positive variance.

Our budget process was defective or actually we have become very-very effective while going for the actual production. So, it means when you plan you plan to do the things to be done in the future but when you control it means you compare the budgeted or standard with the actual, try to find out the performance compare it and if there is a positive variance even then and if it is negative variance even then it has to be analysed.

So that our objective is that in future there should not be kind of the variance or deviation between the budgeted cost and the actual cost. So, the purpose is to exercise the control and finally decision-making cost. Now, decision-making costs are we first of all we can include almost different kind of the costs here one cost is here is when you say the budgeting cost. Budgeting cost is helping us to serve as a guiding force.

Then we talk about the actual cost, when you see the planned or the controlled cost, so they are the decision-making cost also. In the decision making cost, say for example, you try to find out a cost that whether we should sell the product in the market at the full cost or at the variable cost. They are the variable cost. Normally we will be calling later on these cost under the different terminologies that is the variable cost and the total cost, right.

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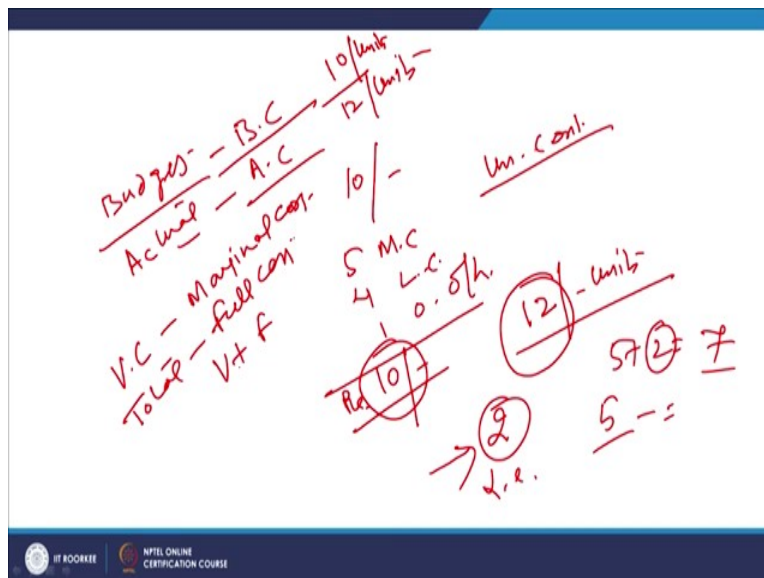

Variable cost is called as the marginal cost also. This is called as the marginal cost also and this is the total cost or the full cost and full cost is including what cost, variable cost plus the fixed cost. So, marginal cost means the variable cost. Sometimes what happens that we are not able to sell the product in the market at the full cost or at the total cost. It is a competitive scenario.

Many new suppliers have entered the market. Market has shrinked or maybe the competition has gone up.

There can be different factors. (So) but we want to sustain in the market. We do not want to go out of the market and we are expecting that this competitive phenomenon is a temporary phenomenon and we will regain our position and these things will improve in the market. So, what happens that for the time being firms start selling their products in the market and the variable cost. They do not include into that total costing of the product the fixed cost.

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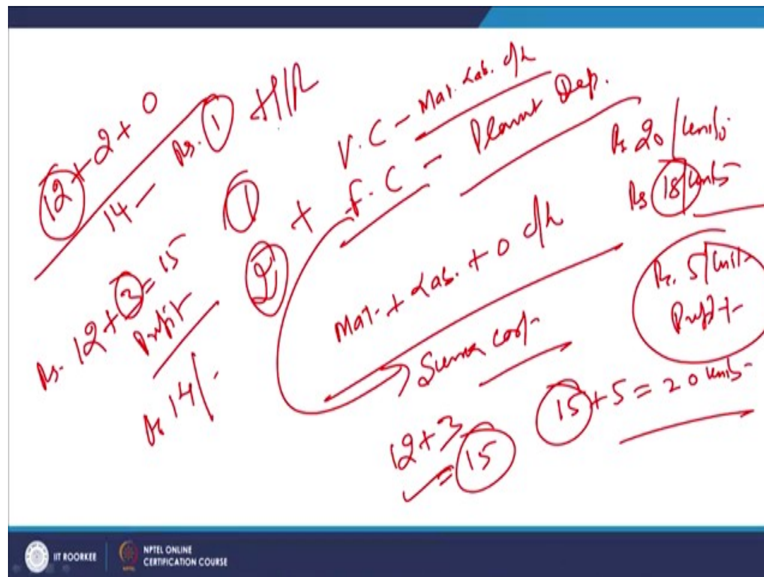

So, it means variable cost is only that we are able to recover only (the), actually there are two kind of the cost, variable cost and the fixed cost. Fixed cost as we know, that it is a plant depreciation or the plant caused of the labour costs or this employee cost or other kind of the cost. Variable cost is the cost of material. Then it is labour and then it is the overheads cost, right. These are the three cost we have.

Now, in this case when we are manufacturing a product we would like to sell it at the total cost this plus this, right. This one, this is two and the total cost. We would like to recover the fixed cost also; we would like to recover the variable cost also. But since the competition has increased in the market so what we are doing here, our objective now will be temporarily that whatever we are spending on material, plus on the labour, plus on the other overheads first we would like to recover that.

So that material cost does not go from our pocket, labour cost does not go from our pocket, other overheads do not go from our pocket. If you are able (to) because otherwise also the fixed cost is the sunk cost. This is the, this cost is the sunk cost. This has already happened. This has gone out of our hands. You use the plant you do not use the plant; you have to provide further depreciation. Anyway you have to provide for.

So if you are not able to recover the depreciation or the plant cost then at least you should be able to recover the material labour and the overhead the cost, so that we can postpone the recovery of the fixed cost. We can recover simply the variable cost and we can start selling the product at the variable cost. For example, now we are selling the product, earlier we were selling the product per unit in the market say for how much 20 rupees per unit. This is the 20 rupees per unit and now (the).

Say price of the product has come down to 18 rupees. Some of the people have started selling it at 18 to piece per unit. 18 rupees per unit, so it means in this 20 rupees we had a profit of how much 5 rupees per unit. Our profit was rupees 5 that is the profit. We were earning the profit of 5 rupees. So, it means in that case our cost of production was how much 15 rupees plus the profit or how much 5 rupees so that way that total price was 20 rupees per unit we were selling it in the market.

And out of this total cost of the 15 rupees our cost was say you can say that variable cost was 12 rupees and fixed cost is say 3 rupees. So, it means this became total 15 rupees as a total cost of the product. Now, when the market has become competitive and the product is selling for 18 rupees in the market so it means how much we are able to, we are able to recover how much out of the variable cost, total 12 rupees we are recovering.

Total this is coming rupees 12 we are able to recover it because we are selling at 18 rupees, not 20 rupees, and out of this say the fixed cost also we are recovering how much 3 rupees so over how much 15 rupees' cost is fully recovered. Only the loss of the something is there and that something is the profit, right, that something is the profit. We are safe at this point, there is no problem as such to worry about.

But, for example, now you talk about that your cost of the product further goes down missed the not cost but the price of the product in the market further goes down. It is now selling say not for 18 rupees in the market, further it has gone down may be the substitutes there in the market or suppliers are there in the market, some are more efficient in the production process and now, the

price has gone down in the market it is 18 rupees now, but it has come down to how much, it has come down to say slowly and steadily not immediately.

We were fighting the competition but now the competition has intensified, and now the price of the product in the market is how much that is say 14 rupees. This is selling at the 14 rupees per unit and now the firm is in a very difficult stage. So, what is happening now; firm is able to recover how much, again 12 rupees as a variable cost but fixed cost we are able to recover only how much, only 2 rupees and profit here is, if you talk about the profit that is 0.

So your cost becomes 14 rupees. So, it means actually we are at a loss of how much rupees 1 we are incurring a loss because our cost of production is 15 rupees and we have to sell the product at 14 rupees in the market, so we are able to recover the variable cost but we are not able to recover fixed cost fully. So, now we have to analyse the whole market process and the whole market situation.

We are expecting there still it is a temporary phenomenon and the market will again improve. These new players who are there in the market they will go out of the market means in the time to come, again the price will shoot up to 20 - 22 rupees. Then there is no harm we can keep on waiting and performing in the market. But see, now the situation is that we were selling at 20 rupees it came down to 18 rupees.

Now over the period of time it has come down to 14 rupees, will come down, comes down to 12 rupees and then 10 rupees. So, it means, decision-making cost says, that you can wait in the market you can fight the competition until unless price goes below 12 rupees. If it is up to 12 rupees you can sustain in the market because by selling the product at 12 rupees, you are able to recover the variable cost.

Whatever the raw material cost you are paying you are able to recover, whatever the labour cost you are paying you are able to recover, whatever other overheads cost power, water and other lubricants cost you are paying you are able to recover the cost but at this point the situation is very risky. You are not able to recover the fixed cost and profitability is zero. The rather we are at this state of loss. So, how long this is going to prevail.

We have to take a decision here whether we will be selling the product on the marginal cost, on the variable costs or on the total cost and if there is any untoward happening in the market, how long it is going to persist or sustain or pertain in the market, sustain in the market. If it is a short

term phenomenon, go ahead sustain in the market and try to say fight the competition. But, we are expecting that this is going to be a long term phenomenon. We will not be able to sell the product beyond 12 rupees in the market or 14 rupees in the market in that case.

If the 14 is going to be the permanent price in the market, then we have only a few alternatives. One alternative is, that you relook your costing process your cost sheet and try to bring out bring down your variable cost as well as the fixed cost. Fixed cost you cannot bring down but at least means the plant building you cannot change, but you can focus upon the human resources. You have to reduce your human resources.

If more employees are there, you make them understand the company's overall position and give them the VRS voluntary retirement and then they should be leaving the company going out. You reduce the human resources. You think about those fixed costs which can be controlled or which can be eliminated and seriously look at the variable cost because it is very easy to eliminate and minimize the variable cost.

We should buy the raw material from those sources where it is available at the cheaper price. You entered into a long term channelizing contracts for supply of the raw material, buy it from the markets or places or suppliers who are supplying it at a very competitive price. You have the labour and control the labour cost also. You try to control your inputs and the other overheads cost also. So, we have to sustain in the market.

So, we have to control the cost because price is not in our hands, but we only can sustain in the market if the situation improves in the time to come selling the product at 14 rupees also will be possible if the cost is reduced variable and the fixed cost is reduced and again the product of the firm, manufacturing and selling of the product of the firm in the market becomes profitable.

So decision-making cost that is why I had a very long discussion with you that decision-making costs are very-very important cost and in this case if you talk about these costs we all have to think about that these costs are very-very important, very-very useful and we will have to see that at what cost we have to, means what is the cost of manufacturing the product and what is the cost of selling the product, at what cost we have to sell the product in the market, that is the decision making cost whether it has to be a variable cost or it has to be a fixed cost.

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Uses of Accounting Information

Scorekeeping is the accumulation and classification of data.

Attention directing involves reporting and interpreting information.

Problem solving quantifies the likely results of possible courses of action.

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Use of accounting information, now why we used the accounting information, we use for the different purposes. Quickly this is all the general accounting information. It can be financial accounting information, it can be cost accounting information, or it can be may be any information which is generated under the any of the two branches of accounting and attention directing.

Say as I just told you that if the cost increases, when we are preparing the cost sheet and whatever the cost is suggested by the cost sheet and what is the actual cost available with us from the profit and loss account, trading account actually, then we will have to make a comparison that why the cost is going beyond the level where which we have calculated in the cost sheet and problem solving.

So, we have to find out the different problems happening in the firm and then we have to plug these with regard to financial problems accounting problems and even if it is a manufacturing and marketing or the distribution related problems we will have to and there the numbers help figures help and accounting information help to a larger extent.

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Accounting Systems

Generally accepted accounting principles (GAAP) include broad guidelines and detailed rules and procedures that make up accepted accounting practices at a given time.

Internal accounting reports need not be restricted by GAAP.

Accounting systems we know it. Accounting system is a formal mechanism of gathering, organizing, and communicating information about an organization's activities to internal as well as external shareholders. So, when if it is a financial accounting, it is useful to both internal and external but the total information generated under the cost accounting is useful only for the internal stakeholders. Nothing is with regard to the external stakeholders and same way this information can be used for the internal decision-making.

Similarly, when you talk about the accounting systems and financial accounting, especially, because this information has to be communicated to the external stakeholders. It has to go to the outside world so it has to be created in such a language which is understandable by all. So there we have created as you can call it as a system which is called as GAAP, Indian GAAP, American GAAP, UK GAAP.

Different countries they have their own GAAP. GAAP means generally accepted accounting principles generally accepted accounting principles and these accounting principles I think you have already gone through. You are well versed with the accounting principles. Accounting these systems which are called as generally agreed accounting principles, where we talk about the concepts of accounting, conventions of accounting, different types of accounts, rules of passing the journal entries.

This GAAP is created and that GAAP is (basically), these generally accepted accounting principles are known to all who are concerned with the accounting and financial information of the firm. So, we use the GAAP under the financial accounting but this GAAP is not required at all for the management accounting or the cost accounting because that information is generated or created for the internal use only and internally people understand their own internal language so no GAAP is required.

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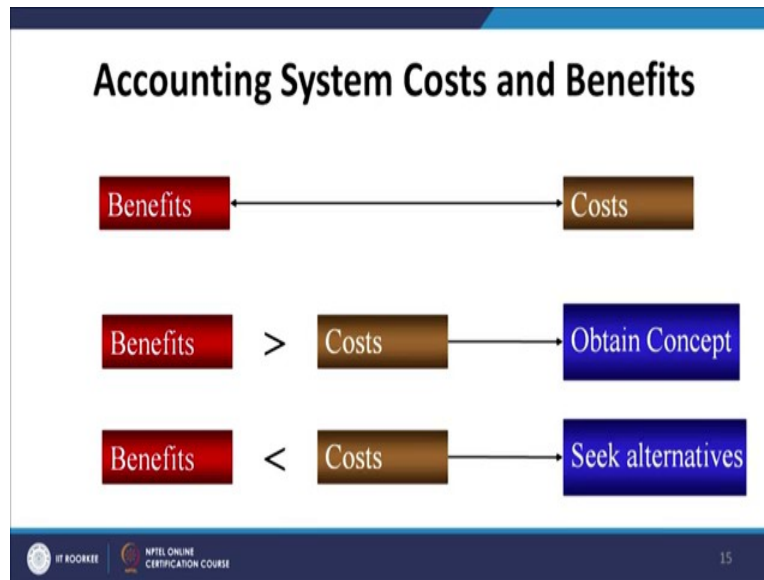

Now when we talk about the internal systems or the accounting systems we use this kind of the relationship under the management accounting. In the management accounting only those actions are taken where we have with us the information about benefits and cost. They are the basic decision-making factors in the management accounting. Whatever the actions we take in the management accounting, whatever the extra actions we take in the management accounting that is directly related to the benefits and cost.

No (other), say GAAP is required, no balance sheet is required, no profit and loss account is required. You draw that information from the financial accounting statements, cost accounting statements, but your decision-making under the management accounting will be largely based upon the two things, that is the benefits and cost. Whatever the action you want to take you always think about, that if I take this action what is my cost, what is my benefit.

If the cost is less than the benefit or if the benefit is more than greater than the cost, go for taking that action, but if the reverse happens you seek alternatives. You try to find out that I have to

look for the alternatives; I am not able to maximize the value of the firm. So, and for finding out the benefits and cost, cost accounting is helping you, financial accounting is helping you. So, your job under the management accounting is that translating those costs and revenues.

In terms of the cost and benefits for the firm and comparing it with the say material gains, the firm is going to have, say the financial gain the firm is going to have and every decision you are taking in the firm under the management accounting process that has to be based upon the cost and benefit. No other principles of accounting are required, only simple fundamentals of management accounting decision-making are benefits, and cost. So, always we will keep these cost and benefits in mind, and when you talk about the accounting systems, means here we say that all your decisions are based upon that part.

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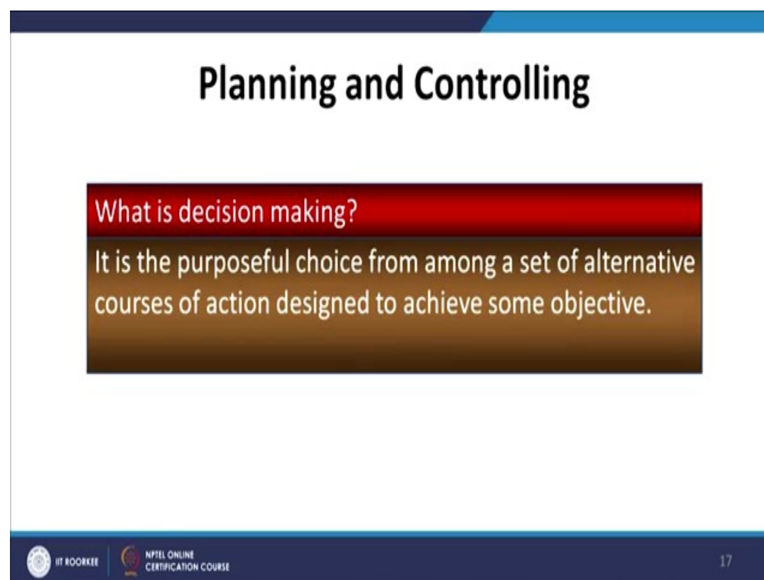

Now we will be further talking about that next part quickly that is the planning and controlling and we will be learning about that how we plan in the firms, how we control in the firms, what are the different tools and techniques are available for planning and controlling in the firms and how they can be made use of for the management decision-making. So that will be discussed in the next class.

So till date we have understood the different branches of accounting, their respective uses and how the information generated under the financial accounting and the cost accounting can be used for the decision making under the process of management accounting. The further discussion on this issue, that is the planning and controlling the process of planning and

controlling tools and techniques of planning and controlling, I will discuss with you in the next class. Thank you very much.