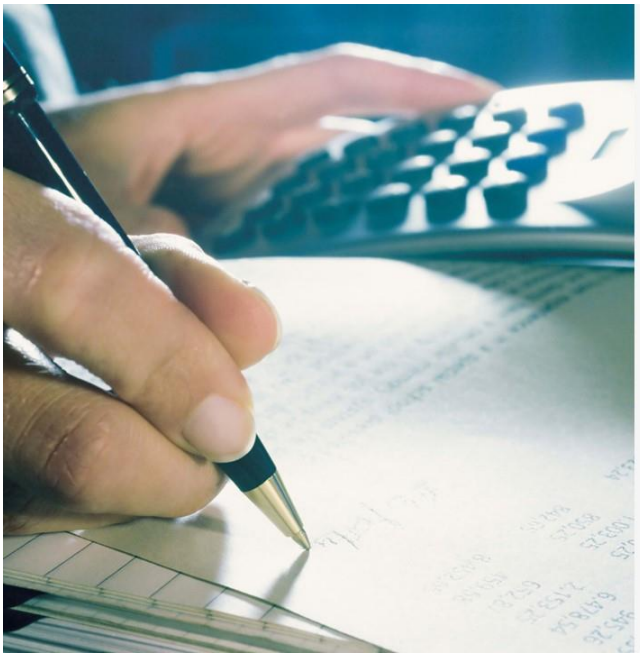
CA INTER

Costing Theory Smart Notes

CA Pranav Dedhia



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Dear Friends,

It is often noticed that most of us ignore the theory part in Paper 3 – Cost & Management Accounting. However, every examination paper always has conceptual theory questions to verify our understanding of the subject as a whole.

Theory portion plays a key role in Paper 3. Even in the toughest of C&MA Examination papers, if nothing works, then surely theory will work. Weightage of theory portion usually remains 20-25 marks, but generally we find at least **16-20 MARKS** of theory in every examination term.

It is true that we find it difficult to manage this part of the paper during our study time as it ends up becoming too time consuming and we lack confidence to be able to reproduce in examination; as a result of which it goes skipped. However, theory part is **VERY EASY** and **SCORING**. In fact, it acts as a **TIME SAVER** to complete the paper. Also, it leaves a good impression on the examiner that the candidate is well aware of key theory concepts that often are left unanswered by most candidates.

"Costing Theory Smart Notes" is an attempt to explain all the key theory concepts in this paper in a Summarized form in **JUST 16 PAGES**. It contains some memory techniques to retain these concepts and be able to reproduce them in the examination. The keys/codes/memory techniques may not make sense or appear funny, but TRUST ME, the funnier it gets, the more you will be able to recall.

Care has been taken to avoid mistakes while compiling this booklet. Students may post their suggestions and feedback by writing to me at **capranavdedhia@gmail.com**.

I hope this booklet helps you all to quickly revise and get a good hold over Costing Theory.

All the BEST for your Career

Happy Reading!!

CA Pranav Dedhia

Contents

Introduction to Cost and Management Accounting

Cost A/Cing & its Objectives

M'10, M'16 (4m)

"The process of A/Cing for cost which begins with recording of income & expenditure or basis on which they are calculated & ends with preparation of periodical statements & reports for ascertaining & controlling costs"

Objectives (Key : CARDS)

- **Cost Control**: Maintaining discipline in expenditure is an imp. obj. It ensures that expenditures are in consonance with predetermined standards & variation is reported.
- **Ascertainment of Cost**: Costs are accumulated, assigned & ascertained for each cost object.
- **Cost Reduction**: Achievement of real & permanent reduction in unit cost of goods manufactured or services rendered without impairing their suitability for intended use or diminution in quality.
- **Assisting mgmt. in Decision Making**: Assists mgmt. in planning, implementing, measuring, controlling & evaluation of various activities by providing relevant information.
- **Determination of Selling Price & Profitability**: Helps in determination of selling price & profitability of cost objects. Basis for price fixation & rate negotiation.

Scope of Cost A/Cing

(Key : C^2A^2RS)

- **Cost Comparisons**: Includes comparisons of cost from alternative courses of actions such as use of different technology for production, cost of making different products & activities & cost of same product / service over a period of time.
- **Cost Control**: *Same as Alongside*
- **Cost Accounting**: *Same as Alongside*
- **Cost Analysis**: Involves process of finding out factors responsible for variance in actual costs from budgeted costs & fixation of responsibility for cost differences.
- **Cost Reports**: Ultimate function of cost a/cing. Reports are primarily prepared for use by mgmt. at different levels. Cost Reports helps in managerial decision making.
- **Statutory Compliances** : Maintaining cost a/cing records relating to utilization of materials, labour & other items of cost as per rules prescribed by statute.

Role and Functions of C&MA

Role:

- **Provide relevant info.** to mgmt. for decision making.
- **Assist management** for planning, measurement, evaluation & control of business activities.
- **Help in allocation of cost** to products & inventories for both external & internal users.

Functions:

- **Collection & accumulation of cost** for each element of cost.
- **Assigning costs** to cost objects to ascertain cost.
- **Budgets & Standards** are set for particular period or activity beforehand which are compared with assigned costs. Deviations are reported.
- **Provision of relevant information** to mgmt. for decision making. Management Information System (MIS) provides relevant & timely information.
- Function of cost & mgmt. a/cing is to **gather data** like time taken, wastages, process idleness etc, analyse data, prepare reports & take necessary actions.

Essentials of a Good Cost A/Cing System

N'10, M'17 (4m)

(Key : I Am Ultra FIT)

- **Informative and simple**: Should be tailor-made, practical, simple & capable of meeting requirements of business.
- **Accurate and Authentic**: Data should be accurate & authenticated; otherwise it may distort system's output.
- **Uniformity & Consistency**: Uniformity & consistency in classification, treatment & reporting of cost data & related information is required for benchmarking & comparability of results.
- **Flexible & adaptive**: Should be flexible enough to make necessary amendments to incorporate changes in technological, reporting, regulatory & other requirements.
- **Integrated & inclusive**: Should be integrated with other systems like financial A/Cing, taxation, statistics & operational research etc. to have complete overview & clarity in results.
- **Trust on the system**: Mgmt. should have trust on system & its output. An active role of mgmt. is required for development of such system that reflects a strong conviction for decision making.

N'12 (4m)

Installation of Cost A/Cing System – Factors

(Key : SIMON IS Highly Powerful Personality)

- **Statutory compliances and audit**: Records are to be maintained to comply with statutory requirements & applicable cost accounting standards to be followed.
- **Information Attributes**: Information generated from Costing system should possess all attributes of information i.e. complete, accurate, timeliness, relevant etc.
- **Method of maintenance of cost records**: Manner in which Cost & Financial Accounts could be inter-locked into a single integral accounting system & how results of separate sets of accounts i.e. cost & financial, could be reconciled by means of control accounts.
- **Objective**: Objective of costing system, viz. whether it is being introduced for fixing prices or for insisting a system of cost control.
- **Nature of Business**: Every business has its own peculiarity & objectives. According to its info. Requirement, cost accounting methods are followed.
- **Information Synchronisation**: While drafting a costing system, information needs of various other departments should be taken into account.
- **Organisational Hierarchy**: Should fulfil info. requirements of different levels of mgmt.
- **Knowing the Product**: Nature of product determines type of costing system to be implemented.
- **Knowing the Production Process**: Cost apportionment can be done on most appropriate & scientific basis if a cost accountant can identify degree of effort or resources consumed in a particular process.

Notes

Introduction to Cost and Management Accounting

Responsibility Centres

M'15 (4m)

(i) **Cost Centres** are held accountable for incurrence of costs which are under its control. Performance is measured against **pre-determined standards or budgets**. Two types:

(a) Standard Cost Centre where output is measurable & input required for output can be specified.

(b) Discretionary Cost Centre whose output cannot be measured in financial terms, thus input-output ratio cannot be defined.

(ii) **Revenue Centres** are accountable for generation of revenue. Though revenue centre does not have control on expenditure, it incurs expenditures related with selling activities like commission to sales person etc

(iii) **Profit Centres** have both responsibility of generation of revenue & incurrence of expenditures. **Profitability** is the basis for measurement of performance.

(iv) **Investment Centres** Not only responsible for profitability but also have authority to make capital investment decisions. Performance is measured on basis of **ROI** besides profit.

Controllable Cost

- Cost that can be controlled, typically by a cost, profit or investment centre manager.
- Controllable costs incurred in a particular responsibility centre can be influenced by action of executive heading that centre.
- For eg., direct costs comprising direct labour, direct material, direct expenses & some overheads are generally controllable by shop level mgmt.

Differential Costs

- Represents change in total cost due to change in activity level, technology, process or method of production, etc. AKA Incremental & Decremental costs.
- Eg. If any change is proposed in existing level or method of production, increase or decrease in total cost will be known as incremental cost or decremental cost.

Out-of-Pocket Costs

- It is that portion of total cost, which involves cash outflow.
- Short-run concept used in decisions relating to fixation of selling price in recession, make/buy
- These costs can be avoided if a particular proposal under consideration is not accepted.

Shut Down Costs

- Costs which continue to be incurred even when a plant is temporarily shut-down, viz. Rent rates depreciation
- Cannot be eliminated with closure of plant i.e. all fixed costs, which cannot be avoided during temporary closure of plant

Absolute Costs

- Refer to cost of any product, process or unit in its totality.
- When costs are presented in a statement form, various cost components may be shown in absolute amount or as a percentage of total cost
- Such costs are base costs on which further analysis & decisions are based.

Uncontrollable Cost

- Costs which cannot be influenced by action of a specified member of an undertaking.
- For example, expenditure incurred by tool room is controllable by foreman in-charge of that section but share of tool-room expenditure which is apportioned to a machine shop is not to be controlled by machine shop foreman.

Imputed Costs

M'15 M'18 (2m)

- Notional costs which do not involve any cash outlay.
- Interest on capital, payment for which is not actually made, is an eg. of imputed cost.
- These costs are similar to opportunity costs.

N '09 (2m)

Opportunity Costs

M'15 (2m)

- Refers to value of sacrifice made or benefit of opportunity foregone in accepting an alternative course of action.
- Eg. Withdrawal of FD to finance expansion. Loss of interest on FD is opportunity cost for expansion

Sunk Costs

- Historical costs
- Play no role in decision making in current period.
- Eg. In case of decision relating to replacement of machine, WDV of existing machine is sunk cost

Capitalised Costs

- Costs which are initially recorded as assets and subsequently treated as expenses.

N '09 (2m)

Limitations of Cost A/Cing

- **Expensive :** It is expensive because analysis, allocation and absorption of overheads require considerable amount of additional work and thus, additional money.
- **Requirement of Reconciliation :** Results shown by cost accounts differ from those shown by financial accounts. Thus verification through Reco. is necessary.
- **Duplication of Work :** Involves duplication of work as organization has to maintain two sets of A/Cs viz. Financial A/C and Cost A/C.
- **Inefficiency :** Costing system itself does not control costs but its usage does.

Discretionary Costs

- Costs which are not tied to a clear cause & effect relationship b/w inputs & outputs.
- They usually arise from periodic decisions regarding maximum outlay to be incurred.
- Examples include advertising, public relations, executive training etc.

Explicit Costs

- AKA out of pocket costs & refer to costs involving immediate payment of cash.
- Salaries, wages, postage & telegram, printing & stationery, interest on loan etc. are some examples

M'14 (2m)

Implicit Costs

- Do not involve immediate cash payment
- They are not recorded in books of account
- AKA Economic costs

Engineered Costs

- Costs that result specifically from a clear cause & effect relationship b/w inputs & outputs
- The relationship is usually personally observable
- Examples:

Inputs : Direct Material Cost, Direct Labour Costs, etc.
Outputs : Cars, Computers, etc.

M'14 (2m)

Product Costs

- Costs which are associated with purchase & sale of goods (in case of merchandise inventory).
- In production scenario, such costs are associated with acquisition & conversion of materials & all other manufacturing inputs into finished products for sale

Conversion Costs

- It is the cost of transforming basic material into finished goods.
- Conversion Cost consists of direct wages, direct expenses and manufacturing overheads.
- So, Conversion Cost = Direct Labour Cost + Direct Expenses + Manufacturing Overhead
- Also, Conversion Cost = Factory Cost – Direct Materials Cost

N '16 (2m)

Introduction to Cost and Management Accounting

Cost Unit & its Typical Examples

M '17 (2m)

Unit of a Product or service or time (or combination of these) in relation to which costs may be ascertained or expressed.

Industry / Product / Activity	Cost Unit Basis
Automobile	Number
Cement	Ton / per bag
Chemicals	Litre, kilo, gallon, ton, etc.
Power / Electricity	Kilo watt hour (kWh)
Steel	Ton
Transport	Passenger-kilometre
Gas	Cubic feet
Brewing	Barrel
Brick making	1000 Bricks
Coal mining	Tonne/ton
Engineering	Contract / job
Oil	Barrel / tonne / litre
Hotel / Catering	Room / meal
Professional Services	Chargeable hour, job, contract
Education	Course, Enrolled Student
Hospital	Patient day
Credit Control	Accounts maintained
Material Storage	Requisitions issued / recd. Material movement, value issued
Personnel Administration	Personnel record

Methods of Costing

Identify the methods of costing:

a. Where all costs are directly charged to a specific job – **Job Costing**
b. Where all costs are directly charged to a group of products – **Batch Costing**
c. Where cost is ascertained for a single product – **Unit Costing or Single or Output Costing**
d. Where the nature of the product is complex and method can not be ascertained – **Multiple Costing**

Nature of Output	Method of Costing	Cost	Eg. of Industries
A Series of Processes	Process/Operation	For each Process	Sugar
Construction of Building	Contract	For each Contract	Real estate
Similar units of a Single Product, produced by Single Process	Unit or Output or Single Costing	For the entire activity, but averaged for the output	Cold Drinks
Rendering of Services	Operating Costing	For all services	Hospitals
Customer Specifications: Single Unit	Job Costing	For each order/assignment	Advertising
Multi-varieties of activities/processes	Multiple Costing	Combination of any method	Car Assembly

Industry	Method of Costing	Cost Unit
Hotel	Operation Costing	Room day/per Bed
Toy Making	Batch Costing	Units/Batch
Steel	Process Costing	Per Tonne/Per MT
Ship Building	Contract Costing	Project/Unit
Road Transport	Operation Costing	Passenger km or tonne km
Steel	Process Costing / Single/Unit Costing	Tonne / Metric Ton (MT)/ kg/ bar
Bicycles	Multiple Costing	Number / per piece
Bridge construction	Contract Costing	Project / Unit

Users of Cost and Management Accounting

M'18 (5m)

Internal Users

- **Managers** use information to :
  (i) know the cost of cost object & cost centre
  (ii) price for product or service
  (iii) Measure performance of resp. centres
  (iv) know product & customer-wise profitability
  (v) evaluate strategic options, make decisions
- **Operational Level staff** like supervisors, foremen, team leaders require information to know
  (i) Obj. & performance goals for them
  (ii) Product & service specifications like volume, quality & process
  (iii) Performance parameters against which their performance is measured and evaluated
  (iv) to know divisional (responsibility centre) profitability
- **Employees** are concerned with info. related with time, attendance, incentives for work, performance standards

External Users (Key : RASCAL)

- **Regulatory Authorities** are concerned with cost accounting data & info. for tariff determination, providing subsidies, rate fixation etc.
- **Shareholders** are concerned with info. that effect their investment in entity. Mgmt. communicate shareholders through periodic communique, annual reports
- **Creditors and Lenders** are concerned with data & info. which affects an entity's ability to serve lenders or creditors.
- **Auditors** while conducting audit of FS or for some other special audits like cost audit etc. requires info. related with costing reports reviewed by mgmt.

Introduction to Cost and Management Accounting

Key : Concept SPADES QC

N'11 N'14 (4m)

	Cost Reduction	Cost Control
Concept	♠ Achievement of real & permanent reduction in unit cost of products manufactured	♠ Cost Control involves a comparison of actual with the standards or budgets, to regulate the actual costs
Savings	♠ Realistic savings in cost	♠ There could be temporary savings in cost
Performance	♠ Not concerned with maintenance of performance according to standards	♠ The process involves setting up a target, investing variances and taking remedial measures to correct them
Applicability	♠ Universally applicable to all areas of business. Does not depend upon standards, though target amounts may be set	♠ Limited applicability to those items of cost for which standards can be set
Dynamism	♠ Fully dynamic approach	♠ Less dynamic than Cost Reduction
Emphasis	♠ Emphasis here is partly on present costs and largely on future costs	♠ Emphasis on present and past behaviour of costs
Standards	♠ Continuous process of critical examination includes analysis and challenge of standards	♠ Control is achieved through compliance with standards. Standards by themselves are not examined
Quality	♠ Product's Utility, Quality and Characteristics are retained	♠ Quality Maintenance is not a guarantee
Corrective / Preventive	♠ Cost reduction is a corrective measure	♠ Cost Control is a preventive measure

Key: ROAD (pe) No Divider

M'17 (4m)

	Cost Accounting	Management Accounting
Rules and Regulations	❖ It follows certain principles and procedures for recording costs of different products	❖ It does not follow any specific rules and regulations
Objective	❖ It records the cost of producing a product and providing a service	❖ Provides information to mgmt. for planning and co-ordination
Area	❖ It only deals with cost ascertainment	❖ Wider in scope as it includes financial accounting, budgeting, taxation, planning, etc
Development	❖ Development is related to industrial revolution	❖ Develops in accordance with the need of modern business
Nature	❖ Records quantitative aspects only	❖ Records both quantitative and qualitative aspects
Recording of Data	❖ Uses both past and present figures	❖ Focused on projection of figures for future

Key: AUNT (is a) PRO

	Financial Accounting	Cost Accounting
Analysis of Cost and Profit	❖ Shows profit or loss of the organization either segment wise or as a whole	❖ Provides cost details for each cost object i.e. product, process, job, contracts, etc
Users of Info.	❖ Shareholders, creditors, financial analysts and government and its agencies, etc	❖ Generally used by internal management, some time regulatory authorities
Nature	❖ It classifies records, present and interprets transactions in monetary terms	❖ It classifies costs, records, present, and interprets it in a significant manner
Time Period	❖ FS Prepared usually for a year	❖ Reports and statements prepared when required
Presentation of Info.	❖ Set format for presenting financial information	❖ No set formats
Recording of Data	❖ Records historical data	❖ Makes use of both historical and predetermined cost
Objective	❖ Providing info. on financial performance	❖ Ascertainment of cost for cost control & decision making

Marginal Costing	Absorption Costing
❖ Only Variable Costs are considered for product costing & inventory valuation	❖ Both Fixed & variable costs are considered for product costing & inventory valuation.
❖ Fixed costs are regarded as period costs. Profitability of different products is judged by their P/V ratio.	❖ Fixed costs are charged to cost of production. Each product bears a reasonable share of fixed cost & profitability of a product is influenced by apportionment of fixed costs.
❖ Cost data presented highlight total contribution of each product.	❖ Cost data are presented in conventional pattern. Net profit of each product is determined after subtracting fixed cost along with their variable costs.
❖ Difference in magnitude of opening & closing stock does not affect unit cost of production.	❖ Difference in magnitude of opening & closing stock affects unit cost of production due to impact of related fixed cost.
❖ In case of marginal costing, cost per unit remains same, irrespective of production as it is valued at variable cost.	❖ In case of absorption costing, cost per unit reduces, as production increases as it is fixed cost which reduces, whereas, variable cost remains the same per unit.

Material Cost

Importance of Proper Recording & Material Control

(Key : PQRS Wastage)

- **Price of final product**: Material constitutes a significant part of any product & cost of final product is directly related with cost of materials used to produce it.
- **Quality of final product**: Quality of output depends on quality of inputs.
- **Regular information about Resources** : Regular & Updated info. on availability & utilisation of materials are necessary for timely & informed decision making.
- **Cost of Stock holding & Stock-out**: An entity has to incur stock holding costs in form of interest and/or opportunity cost for fund used, stock handling losses like evaporation, obsolescence etc.
- **Wastage and other losses**: Based on nature of material & process, these are classified as normal & abnormal for efficient utilisation & control.

Objectives of System of Material control

(Key : ROMIO)

- **Reduction in Wastages**: Avoidance of unnecessary losses & wastages that may arise from deterioration in quality due to defective or long storage.
- **Optimisation of Material Cost**: Seeing to it that all materials & stores are acquired at lowest possible price considering quality that is required & considering other relevant factors like reliability in respect of delivery.
- **Minimising interruption in production process**: Ensuring that production does not suffer from interruption for want of materials & stores.
- **Adequate Information**: Maintenance of proper records to ensure that reliable info. is available for all items of materials.
- **Order Completion in time**: Proper material management is very necessary for fulfilling orders.

ABC Analysis – System of Inventory Control

N'11 (4m)

- A system of **inventory control** which exercises **discriminating control over different items** of stores classified on basis of investment involved.
- Usually, items are divided into 3 categories acc. to their importance, their value & frequency of replacement during a period.

Category	% of items	% of inventory
A	10%	70%
B	20%	20%
C	70%	10%

Advantages – ABC Analysis

(Key : [ABC can be learnt easily by an] Attentive Child through Continuous and Systematic Work)

- *Less Attention required* : **Management time is saved** since attention need be paid only to some items rather than all the items.
- *Lower Cost* : **Cost of placing orders, receiving goods & maintaining stocks** is minimised specially if system is coupled with determination of proper economic order quantities.
- *Continuity in production* : It ensures that **minimum investment** will be made in stocks of materials without there being any danger of interruption of production due to materials or stores.
- *Systematic Working* : **Much of the work** connected with purchases can be systematized on a routine basis to be handled **by subordinate staff**.

Bill of Material v/s Material Requisition Note

M'12 (4m)

Bill of Material

- Doc. prepared by **engineering** or **planning department**
- A **complete schedule** of component parts & raw materials required for a particular job or work order
- It **serves** the **purpose** of **material requisition** as it shows complete schedule of materials required for a particular job i.e. it can replace material requisition
- It can be **used for** purpose of **quotations**
- It helps in keeping a **quantitative control** on materials drawn through material requisition

Material Requisition Note

- It is prepared by **production** or other **consuming department**
- A **document** authorizing Store-keeper **to issue materials** to consuming dept
- It **cannot replace a bill of material**
- It is useful in **arriving historical cost** only
- It shows **material actually drawn** from stores

Stock Control Cards

- A quantitative record of inventory maintained by stores department for every item of material.
- Recording includes receipt, issue, return, in hand and orders given.

Advantages :

- Records are kept in a more **compact manner** so that **easy reference** is facilitated.
- Records can be kept in a **clean way** by men solely engaged in clerical work so that a **division of workers** b/w record keeping & actual material handling is **possible**.
- As records are at one place, it is possible to get an **overall idea of stock position** without necessity of going round stores.

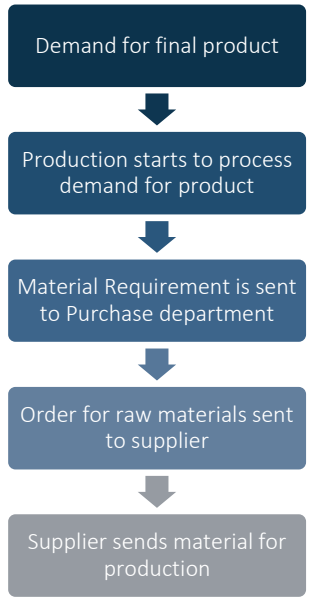
Disadvantages :

- **On the spot comparison** of physical stock of an item with its book balance is not **facilitated**.
- **Physical identification of materials** in stock may **not** be as **easy** as in case of bin cards, as Stock Control Cards are housed in cabinets or trays.

Just in Time (JIT) Inventory Management

M'18 (5m)

- JIT is a **system of inventory management** with an approach to have **zero inventory** in stores. As per JIT, material should **only** be **purchased when** it is **actually required** for production.
- JIT is based on two principles:
  - (i) **Produce goods only when** it is **required** and
  - (ii) The products should be **delivered to customers only when they want**.
- AKA '**Demand pull**' or '**Pull through**' system of production.
- In this system, **production** process actually **starts after order** for products is received.
- **Based on demand**, production process starts & requirement for raw materials is sent to purchase department for purchase.
- This can be understood with help of diagram alongside:



Material Cost

Bin Cards v/s Stores Ledger (N'17 (4m))

	Bin Cards	Stores Ledger
Individual/ Summarized	Each transaction is **individually** posted.	Transactions may be **summarized** & then posted.
Transfers	Inter-department transfers **do not appear** in Bin Card.	Material transfer from one job to another job **are recorded** for costing purposes.
Entries	Entries are made **when transaction takes place.**	It is always posted **after the transaction.**
(Who) Maintains	It is maintained by **storekeeper** in the store.	It is maintained in **Cost A/Cing department.**
Contains	It contains **only quantitative** details of material recd, issued & returned to stores.	It contains information **both** in **quantity** & **value**.

[Key : ITEM Contained (in Bin Cards and Stores Ledger)]

Advantages & Disadvantages of Bin Cards

Advantages :
- **Fewer mistakes** as entries are made as & when goods are received/issued by person actually handling materials.
- **Control over stock** can be **more effective**, as comparison of quantity in hand with book balance is possible anytime.
- **Identification** of different items of materials **is facilitated** by reference to Bin Card, bin or storage vessel.

Disadvantages :
- **Store records are dispersed** over a wide area.
- **Cards smear with dirt & grease** due to material handling.
- People handling materials are not ordinarily suitable for clerical work involved in writing Bin Cards.

Classification of Inventories

On the Basis of Frequency of Usage

Fast Moving, Slow Moving & Non Moving (FSN) Inventory:
Classification of items into 3 categories depends on **nature & managerial discretion**.
A threshold range on the basis of inventory turnover is decided & classified accordingly

(i) **Fast Moving**: These items are placed nearer to store issue point & stock is reviewed frequently for making of fresh order.

(ii) **Slow Moving**: These items are stored little far & stock is reviewed periodically for any obsolescence which may be then shifted to Non-moving category.

(iii) **Non Moving**: These items are kept for disposal. These items are reported to mgmt. & an appropriate provision for loss may be created.

On the Basis of Criticality

Vital, Essential & Desirable (VED) Inventory :
Under this system, inventories are classified on the basis of its **criticality for production function & final product**. Generally, this classification is done for spare parts which are used for production.

(i) **Vital** : Items are classified as vital when its unavailability can interrupt production process & cause a production loss.

(ii) **Essential** : Items under this category are essential but not vital. The unavailability may cause sub standardisation & loss of efficiency in production process.

(iii) **Desirable** : Items under this category are optional in nature, unavailability does not cause any production or efficiency loss.

FIFO Method (M'18 (5m))

- **Method of pricing** issues of materials, **in order of purchase**. Materials are issued in order of arrival or items longest in stock are issued first. Each **issue** recovers purchase price which **does not reflect market price.**
- FIFO is considered **suitable in falling price** as material cost charged to production will be high but replacement cost of materials will be low.
- In case of rising prices, if FIFO is adopted, charge to production will be low compared to replacement cost

"Perpetual inventory system comprises Bin Card & Stores Ledger, but efficacy of system depends on continuous stock taking." (M'13 (4m))

- Perpetual inventory represents system of records maintained by stores dept. It comprises: **Bin Cards & Stores Ledger.**
- **Bin Cards** maintain a quantitative record of receipts, issues & closing balances of each item of stores
- **Stores Ledger** is maintained to record all receipt & issue transactions for materials. It is filled up with help of goods received note & material requisitions.
- Perpetual Inventory system's efficacy depends on system of continuous stock taking. Continuous stock taking means physical checking of records i.e. Bin cards & stores ledger with actual physical stock.

Main advantages of perpetual inventory are as follows : (Key : PQRS + Discrepancies)

(1) **Physical stocks can be counted** & book balances adjusted when required w/o waiting for entire stock-taking.

(2) **Quick compilation of P&L A/c** due to prompt availability of stock figures.

(3) **Systematic Review of perpetual inventory** reveals existence of surplus, dormant, obsolete & slow-moving materials for further remedial measures.

(4) **Fixation of various Stock Levels & checking of actual balances** in hand with these levels assist Store keeper in maintaining stocks within limits & in initiating purchase requisitions for correct quantity at proper time.

(5) **Discrepancies are easily located** & corrective action can be promptly taken.

Continuous Stock Verification

Physical Checking of inventory is an essential feature of every sound system of material control. The system of continuous stock-taking consists of physical verification of items of inventory. Stock verification may be done without prior notice by internal audit dept. but are independent of store & production staff. The element of surprise is essential for effective control of system.

Advantages:

1. **Closure** of normal functioning is **not necessary**.
2. **Stock discrepancies** are likely to be brought to notice & **corrected much earlier than** under **annual stock-taking system**.
3. System generally has a **sobering influence on stores staff** because of surprise element.
4. **Movement of stores items** can be watched more closely by stores **auditor**.
5. **Final Accounts can be ready quickly**. Interim accounts are possible quite conveniently.

Advantages of FIFO Method

- Simple to understand & **easy to operate**
- Material cost charged to production represents actual cost with which cost of production should have been charged
- In case of **falling prices**, **use** of **FIFO** gives better results.
- **Closing stock** of material will be represented very closely at **current market price**.

Disadvantages of FIFO Method

- If **prices fluctuate** frequently, FIFO may lead to **clerical error**.
- Since each issue of material is related to a specific purchase price, **costs** charged to same job are likely to **show a variation between periods**
- In case of **rising prices**, real profits of concern being low, may not be adequate to meet materials purchase demand at market price.

Material Cost

	Waste	Scrap	Spoilage	Defectives	Obsolescence
Concept	❖ The portion of raw material which is **lost during storage or production and discarded**. The waste may or may not have any value.	❖ Materials which are **discarded & disposed-off without further treatment**. ❖ Generally, scrap has either **no value or insignificant value**. Some time it may be reintroduced into the process as raw material.	❖ It is the term used for **materials which are badly damaged in manufacturing operations**, and they cannot be rectified economically & hence taken out of process to be disposed of in some manner without further processing.	❖ It signifies **those units or portions of production which do not meet quality stds**. They arise due to sub-standard materials, bad supervision, bad planning, etc. ❖ Defectives which **can be re-made** as per quality std. by using additional materials are known as reworks. ❖ Defectives which cannot be brought up to quality standards are known as **rejects** which may either be disposed- off or re-cycled for production process.	Obsolescence is defined as "**the loss in the intrinsic value of an asset due to its supersession**". Materials may become obsolete under any of the following circumstances: (i) Where it is a spare part or component of m/c used in mfg. & that m/c becomes obsolete; (ii) where it is used in mfg. of product which has become obsolete; (iii) where material is replaced by another mat. due to improved quality or fall in price
Treatment-Normal	❖ Cost of normal waste is **absorbed by good production units.**	❖ The cost of scrap is **borne by good units** and income arising on account of **realisable value** is **deducted from cost**.	❖ Normal spoilage costs are **included in costs** either by charging it to production order or to production overhead. Salvage realised is credited to production order or production overhead account.	❖ The **cost less realisable value** on sale of defectives are charged to **material cost of good production**.	❖ In all 3 cases, value of obsolete material held in stock is **total loss** & immediate steps should be taken to **dispose it** off at best available price.
Treatment-Abnormal	❖ Cost of abnormal loss is **trfd. to Costing P&L A/c.**	❖ Scrap account should be charged with full cost. Credit is given to job or process concerned. Profit or loss in scrap account, on realisation, will be **trfd. to Costing P&L A/c**.	❖ The cost of abnormal spoilage is **charged to Costing P&L A/c**. When spoiled work is result of rigid specification, cost of spoiled work is absorbed by good production while cost of disposal is charged to production overhead.	❖ Material Cost of abnormal defectives are not included in material cost but treated as loss after giving credit to the realisable value of such defectives. Material cost of abnormal loss is **transferred to Costing P&L A/c.**	❖ The loss arising out of obsolete materials on abnormal loss **does not form part of cost of mfg.**

Waste vs Scrap

Waste	Scrap
❖ It is connected with **raw material or inputs** to production process.	❖ It is connected with **output**
❖ Waste of materials may be **visible or invisible**.	❖ Scraps are **generally identifiable** and has **physical substance**.
❖ Generally waste has **no recoverable value.**	❖ Scraps are termed as by-products & has **small recoverable value.**

Scrap vs Defectives

N'15 (2m)

Scrap	Defectives
❖ It is loss connected with **output**	❖ This type of loss connected with the **output but it can be in the input as well.**
❖ Scraps are **not intended** but **cannot be eliminated** due to nature of material or process itself.	❖ Defectives also are **not intended** but **can be eliminated** through proper control.
❖ Generally scraps are **not used or rectified.**	❖ Defectives can be **used after rectification**.
❖ Scraps have **insignificant recoverable value.**	❖ Defectives are sold at **lower value from that of good one.**

Reclamation of loss from defective units

In case of articles that have been spoiled, it is necessary to take steps to reclaim as much of loss as possible. For this :

(i) All defective units should be **sent to place fixed for purpose**;
(ii) These should be **dismantled**;
(iii) **Goods** & **serviceable parts** should be **separated** & taken into stock;
(iv) **Parts which can be made serviceable** by further work should be separated & sent to workshop for the purpose & taken into stock after defects have been removed;
(v) **Parts which cannot be made serviceable** should be collected in one place for being melted or sold.

LIFO Method

M'18 (5m)

❖ It is a **method of pricing** the issues of materials on the assumption that the **items of the last batch (lot) purchased are the first to be issued**.
❖ The prices of the last batch (lot) are used for pricing the issue, **until it Is exhausted**, and so on.
❖ Cost of **Materials Issued represents** the **cost of latest purchases**. Cost of **Closing Stock represents** the **cost of earlier purchases**.
❖ During **inflationary period**, the use of LIFO would help to ensure that the cost of production determined on the above basis is approximately the **current one**.

Employee Cost & Direct Expenses

Requisites of a Good Time Keeping System

1. System should **not allow proxy** for another employee.
2. A **provision of recording of time of piece employees** so that regular attendance and discipline may be maintained.
3. **Time of arrival & time of departure** of employees should be recorded for wages calculation.
4. **Method of recording of time should be mechanical** so that disputes regarding time may not arise between employees & time-keeper.
5. **Late-comers** should record late arrivals. Any relaxation by time-keeper in this regard will encourage indiscipline.
6. System should be **simple, smooth and quick**. Unnecessary queuing for marking attendance should be avoided.
7. System should be **reviewed & maintained periodically** to prevent any error.

Normal Idle Time

Causes

- **Time lost** between factory gate & place of work.
- The **interval** between one job & another
- **Setup time** for machine
- Normal rest time, **break** for lunch

Treatment

- Treated as **part of cost of production**. In case of direct workers, allowance for normal idle time is considered setting of std hours or std. rate.
- In case of indirect workers, normal idle time is **considered for computation of overhead rate.**

Abnormal Idle Time

Causes

- Idle time may also arise due to **abnormal factors** like lack of coordination, Power failure, Breakdown of machines, Non-availability of raw materials, strikes, lockouts, poor supervision, fire, flood etc.
- Causes for abnormal idle time should be further analysed into **controllable & uncontrollable.**

1. **Controllable abnormal idle time** refers to that time which could have been put to productive use had the mgmt. been more alert & efficient.
2. **Uncontrollable abnormal idle time** refers to time lost due to abnormal causes, over which management does not have any control e.g., breakdown of machines, flood etc.

Treatment

- Abnormal idle time cost is not included as a part of production cost & is shown as a separate item in **Costing P&L A/c**.
- Cost of abnormal idle time should be further categorised into **controllable & uncontrollable**. For each category, break-up of cost due to various factors should be separately shown. This would help mgmt. in fixing responsibility for controlling idle time.

1. Management should aim at **eliminating controllable idle time** & on a long-term basis reducing even normal idle time. This would require a detailed analysis of causes leading to such idle time.

Overtime Premium

Causes

- **Customer may agree to bear** entire charge of OT because urgency of work.
- OT may be called for to **make up any shortfall in production** due to some **unexpected development**.
- OT work may be necessary to **make up a shortfall in production** due to some **fault of management**.
- OT may be resorted to, to **secure out-turn in excess of normal output** to take advantage of expanding market or rising demand

Treatment

- If OT is resorted to at **desire of customer**, premium may be charged to job directly.
- If OT is required to cope with **general production programmes or for meeting urgent orders**, premium should be treated as overhead cost of particular dept. / cost centre which works OT.
- If OT is worked in a dept. due to **fault of another dept.**, premium should be charged to latter department.
- OT worked on account of **abnormal conditions** such as flood, earthquake etc., should be charged to Costing P&L A/c.

Halsey Premium Plan

Advantages

- **Time rate is guaranteed** while there is opportunity for increasing earnings by increasing production.
- The system is **equitable** in as much as **employer gets a direct return for his efforts** in improving production methods and providing better equipment.

Disadvantages

- **Incentive is not so strong** as with piece rate system. The harder the worker works, lesser he gets per piece.
- The **sharing principle may not be liked** by employees.

Time Rate System

Merits

1. **Simple** to understand and to calculate wages.
2. **Reduces temptation** on the part of workers to increase the output at the cost of quality.
3. **Unity in employee,** no distinction between efficient and inefficient employee due to quality of production.
4. **Stability in wages**

Demerits

1. **No monetary incentive** to raise the level of production.
2. **No distinction between** the **slow and** the **efficient worker**.
3. The **tendency** is **for the fall in output**; this raises cost per unit.
4. A **firm cannot be sure of employee costs per unit** under this method and, hence, may suffer a **loss on quotations** if already submitted.

Rowan Premium Plan

Advantages

- Claimed to be a **fool-proof system** in as much as a worker can never double his earnings even if there is bad rate setting.
- Admirably suitable for **encouraging moderately efficient workers** as it provides a better return for moderate efficiency than under Halsey Plan.
- **Sharing principle appeals** to employer **as being equitable**.

Disadvantages

- System is a **bit complicated**.
- **Incentive is weak** at a high production level where time saved is more than 50% of time allowed.
- **Sharing Principle not generally welcomed** by employees.

Employee Cost & Direct Expenses

Factors increasing Employee productivity

1. Employing only workers with **right type of skill.**
2. **Right Man for the right job**
3. **Train young & old workers** by providing them right types of opportunities
4. **Taking appropriate measures** to avoid situation of excess or shortage of employees
5. Carrying out **work study** for **fixation of wages** & for **simplification & standardisation of work**

Employee Turnover

Employee turnover or labour turnover in an organisation is the **rate of change in composition of employee force** during a specified period measured against a suitable index

Methods of Calculating Employee Turnover

N'10, N'14 (4m)

Replacement Method:

$$\frac{\text{Number of employees Replaced during the period}}{\text{Average number of employees on roll}} \times 100$$

Separation Method :

$$\frac{\text{Number of employees Separated during the period}}{\text{Average number of employees on roll}} \times 100$$

Flux Method :

$$\frac{\text{Number of employees Separated + Replaced}}{\text{Average number of employees on roll}} \times 100$$

Causes of Employee (Labour) Turnover

M'11 (4m)

Personal Causes:
- Change of jobs for betterment
- Premature retirement due to ill health or old age
- Domestic problems and family responsibilities
- Discontent over the jobs and working environment

Unavoidable Causes :
- Seasonal nature of business
- Shortage of raw material, power, slack market for the product etc.
- Change in the plant location
- Disability, making a worker unfit for work
- Disciplinary measures
- Marriage (generally in the case of women)

Avoidable Causes :
- Dissatisfaction with job, remuneration, hours of work, working conditions
- Strained relationship with mgmt, supervisors, fellow workers
- Lack of training facilities & promotional avenues, recreational medical facilities
- Low wages and allowances.

Cost Accounting System

M'10,M'12 M'15 (4m)

Integrated Accounting System & its advantages

System of A/cing where both costing & financial transactions are recorded in same set of books.

Advantages
- **No need for Reconciliation** - The question of reconciling costing profit & financial profit does not arise, as there is only one figure of profit.
- **Less efforts** - Due to use of one set of books, there is significant saving in efforts made.
- **Less time consuming** - No delay is caused in obtaining information provided in books of original entry.
- **Economical Process** - It is economical also as it is based on the concept of 'Centralization of Accounting Function'.

Motivational Factors for Adopting a Reconciliation Process

- When cost & financial accounts are kept separately, it is **imperative** that these should be **reconciled**, otherwise cost accounts would not be reliable.
- Reco. of two set of accounts can be made, if both sets contain **sufficient detail to enable causes of differences** to be located.
- In financial accounts, **expenses should be analysed** in same way as in cost accounts.

Motivation for reconciliation is :

N'17 (4m)

- To ensure **reliability** of cost data.
- To ensure **ascertainment of correct product cost.**
- To ensure **correct decision making** by the management based on Cost & Financial data.

Items included in Financial Accounts only

N'09 (2m)

Purely Financial Expenses
- Interest on loans or bank mortgages
- Expenses relating to issue & trf. of share & deb. viz. stamp duty expenses; discount on share & debentures etc.
- Losses on sales of fixed assets & investments
- Fines and penalties
- Damages payable under law
- Legal charges
- Goodwill, Preliminary Expenses written off
- Income tax, Donations, Subscriptions
- Expenses of Company's share transfer office

Purely Financial Income
- Interest recd. on bank deposits, loans & invst.
- Dividends recd
- Profits on sale of FA & invst.
- Transfer fee recd
- Rent receivable

Cost Accounts only

Notional Expenses
- Charges in lieu of rent where premises are owned
- Interest on cap (though not incurred)
- Salary for proprietor (though not incurred)
- Notional dep. on fully dep asset (BV = Nil)
- Items whose treatment is diff in two sets of account
- Varying basis of valuation

Is reconciliation of cost & financial accounts necessary in case of integrated accounting system?

M'13 (4m)

- In **integrated** accounting system, cost and financial accounts are kept in the **same set** of books.
- Such a system will have to afford **full information** required for Costing as well as for Financial Accounts.
- In other words, information and data should be recorded such a way so as to **enable firm to ascertain cost** of each product, job, process, operation or any other identifiable activity.
- It also ensures ascertainment of marginal cost, variances, abnormal losses & gains.
- In fact, all information that management requires from system of Costing for doing its work properly is made available.
- Integrated accounts give **full information** in a manner that P&L A/c & Balance sheet can be prepared according to requirements of law & mgmt. maintains full control over liabilities & assets of business.
- Since, **only one set of books** are kept for both cost accounting and financial accounting purpose so there is **no necessity of reconciliation** of cost and financial accounts

Overheads

Treatment of Over and Under Absorption in Cost Accounting

M'10, N'10 '14 '15 (4m)

Over/Under Absorption

Under-absorption has effect of understating cost while over-absorption has effect of overstating cost. Over or under-absorption of overheads may be disposed of in foll. ways:

Transfer to Costing P&L A/c	Amount of under-absorbed or over-absorbed overheads is trfd. (credited or debited) to **Costing P&L Account** when ❖ **amount is minor and insignificant** or ❖ it is **caused by abnormal circumstances** i.e., the factors beyond control of mgmt
Carry Forward to next year	Amount is carried over to subsequent years when **over absorption in current period will be neutralized by under-absorption in the next**. This method may be followed when: ❖ industry is seasonal with fluctuation in demand & production ❖ normal business cycle extends >1 year ❖ project is new & output is initially low but there will be more output in next year which will absorb more overheads.
Supplem-entary Rate Method	When **Amount is significant or large**, then cost of product needs to be adjusted by using supplementary rates. It is calculated by dividing amount of over absorption or under-absorption by equivalent units usually. Under this method, balance of under & over absorbed overheads may be **charged to cost of W.I.P., finished stock & cost of sales proportionately** with help of supplementary rate of overhead.

HOW TO DEAL WITH

M'11 (4m)

1. Packing Expenses

As Prime Cost	Cost of primary packing necessary for protecting product or for convenient handling - **Prime Cost**.
As Distrib-ution Cost	Cost of packing to facilitate transportation of product from factory to customer - **Distribution Cost**.
On Specific Job	If cost of special packing is at request of customer - **Specific Work Order or Job**.
As Selling Overhead	Cost of fancy packing necessary to attract customers is an advertising expenditure. Hence - **selling overhead.**

2. Fringe Benefits M'11 (4m)

- ❖ These are **additional payments/facilities provided to workers** apart from their salary and allowances like house rent, dearness allowances, etc. These are given in form of OT, extra shift duty allowance, holiday pay, pension facilities, etc.
- ❖ Such indirect benefits tend to **improve morale, loyalty & stability** towards organization.
- ❖ Expenditure on fringe benefits in respect of factory workers should be **apportioned among all production & service depts**. on basis of no. of workers in each dept.
- ❖ If amount of fringe benefit is considerably **large**, it'll be **recovered as direct charge** by a **supplementary wage rate** otherwise collected as part of production overheads.

N'15 (4m)

3. Idle Capacity Costs

- ❖ It is that **part of capacity of a plant**, machine or equipment which **cannot be effectively utilised** in production.
- ❖ It may **arise due to lack of product demand, no availability of raw-material, shortage of skilled labour, shortage of power**, etc.
- ❖ **Costs** associated with idle capacity are mostly **fixed in nature**. These costs remain **unabsorbed or unrecovered** due to under-utilisation of plant and service capacity.

Treatment

- ❖ If idle capacity cost is due to **unavoidable reasons**, a **supplementary overhead rate** may be used to recover idle capacity cost. In this case, costs are charged to production capacity utilised.
- ❖ If idle capacity cost is due to **avoidable reasons** such as faulty planning, etc. cost should be charged to **Costing Profit & Loss Account.**
- ❖ If idle capacity cost is due to **trade depression**, etc., - being abnormal in nature, cost should also be charged to **Costing Profit & Loss Account**.

Cost Allocation v/s Cost Absorption

M'13 (4m)

	Cost Allocation	Cost Absorption
❖ Meaning	❖ Cost allocation is the **allotment of whole item of cost** to a cost centre or a cost unit	❖ Cost absorption is the process of **absorbing all indirect costs or overhead costs** allocated or apportioned over particular cost centre or production department by the units produced.
❖ Sequence	❖ **Allocation** of overheads **occurs before absorption** in the process of distribution of overheads	❖ **Absorption** of overheads is the **last step** in the entire process of distribution of overheads and result in an ultimate charge to products, jobs or orders etc

Cost Allocation v/s Cost Apportionment

M'14 (4m)

	Cost Allocation	Cost Apportionment
❖ Meaning	❖ Allocation is a **direct process** of charging expenses to different cost centres	❖ Apportionment is an **indirect process** because there is a need for the identification of the appropriate portion of an expense to be borne by the different departments benefited.
❖ Deals with	❖ Deals with **whole items of cost**, which are identifiable with any 1 department.	❖ Deals with **proportions of an item of cost**.
❖ Nature of Expense	❖ Possible when nature of expenses is such that it can be **easily identified with a particular cost centre**	❖ Done in case of those overhead items which **can't be allocated to a particular department.**
❖ Example	❖ **Salary paid to foreman** of particular production dept. can be directly identified with that dept. & it will be directly charged to that department.	❖ **Salary paid to works manager** of factory cannot be charged wholly to particular production dept. but will have to be charged to all departments of factory on equitable basis.
❖ Basis for Distribution	❖ **No basis** is required for allocation.	❖ Apportionment is made on some **basis** which may **be area, assets value, number of workers** etc.

Activity Based Costing, Activity Based Budgeting and Activity Based Cost Management

ABC

- An **accounting methodology**
- Assigns **costs to activities** rather than products & services. Enables **resources** & **overhead costs** to be accurately **assigned** to **products & services** that consume them
- Resources are assigned to activities & activities are assigned to cost objects based on consumption estimate

ABB

- Activity Based Budgeting is a process of **planning** & **controlling** expected activities for organisation to derive a **cost-effective budget** that meets forecasted workload & agreed strategic goals.
- Key Elements (TQC)
  - **Type** of activity
  - **Quantity** of activity
  - **Cost** of activity

Value Added Activities

- An activity that customers perceive as **adding usefulness** to product or service they purchase.
- An activity that, **if eliminated**, will **reduce actual utility** which customers obtain from using product or service.
- **Enhance value** of products & services in eyes of organisation's customers while meeting its own goals.
- **Example**:
  - Painting a car in a company manufacturing cars; or
  - A computer manufacturing company making computers with preloaded software.

Non Value Added Activities

- An activity where there is an **opportunity of cost reduction** without reducing the product's service potential to customer.
- Activity that, **if eliminated**, will **NOT reduce actual or perceived value** that customers obtain by using product or service.
- **Do not contribute** to customer-perceived value
- **Example**:
  - Storage & moving of raw materials, reworking or repairing of products

Categories in ABC

- **Unit Level Activities :**
  - Use of indirect materials, Inspection / Testing, Indirect Consumables
- **Product Level Activities :**
  - Product Design, Customized Production of Parts, Advertising Costs
- **Facility Level Activities :**
  - Maintenance of Buildings, Plant Security
- **Batch Level Activities :**

The cost of some activities is driven by the number of batches of units produced. Examples of this are:

- **Material Ordering** – An order is placed for every batch of production.
- **Machine Set-up Costs** – M/c need reset b/w different production batch
- **Inspection of Products** – 1sti item in every batch is inspected rather than every 100th item

Business Applications of ABM

(Key: ABC uses Benchmarking for Performance Measurement)

- Activity Based Budgeting : SAME AS ABOVE
- Business Process Re-Engineering :

Involves **examining** business processes & making **substantial changes** in day to day operation of organisation.

- Cost Reduction :

ABCM helps in identification of costs against activities & to find opportunities to achieve **reduction in unit cost of products** manufactured. It continuously attempts to achieve genuine savings in cost

- Benchmarking :

Benchmarking is process of **identifying** & **learning** from **best practices**. It is a powerful tool for continuous improvement.

- Performance Measurement :

Organizations are now focussing on **activity performance** as a means of facing competitors & managing costs by **monitoring** the **effectiveness** & **efficiency of activities**

ABC : A Decision Making Tool

(Key: Wholesalers TAP Market for Facilities and Human Resources)

- WHOLESALE DISTRIBUTORS can gain significant advantage in decision-making process through implementation of ABC concepts.
- ABC is a **complement to** TQM.
- Using Traditional ABSORPTION costing, overheads may get distributed equally across all product lines. ABC traces costs back to activity and consumption of resources by each product.
- Companies who wish to determine PRICE based on cost plus mark-up basis find ABC method of costing very relevant to determine competitive prices.
- Other areas where ABC system can be relevant include MARKET, MAKE OR BUY decisions, TRANSFER PRICING, SHUT DOWN decisions, etc.
- Other decisions that can be assisted by ABC include FACILITY **and resource expansion**. Often, the basis for relocation or opening of a new distribution centre is based on cost associations.
- Decision support for HUMAN RESOURCES can be augmented by ABC. Where activity & cost can be associated to an individual, new levels of financial performance can be determined.

Activity Based Costing vs Traditional Absorption Costing

Key : CAR ka Driver CAR mein hai

	Activity Based Costing	Traditional Absorption Costing
Classification	Activities are classified as – (i) Unit Level, (ii) Batch Level, (iii) Product Level and (iv) Facility Level activities	Activities are classified as – (i) Unit Level (Variable) and (ii) Facility Level (Fixed) activities
Allocation	Overheads are related to activities and grouped into **activity cost pools**	Overheads are related to **cost centers / departments**
Realistic / Non Realistic	Costs are related to activities and hence are **more realistic**	Costs are related to cost centers and hence **not realistic** of cost behaviour
Driver	**Activity–wise** cost drivers are determined	**Time** (**Hours**) are assumed to be the **only cost driver**
Cost Control	ABC **aids** cost control	**Not suitable** for cost control
Assigned to	Cost are assigned to **cost objects**, e.g. customers, products, services, departments	Costs are assigned to **Cost Units** i.e. to products, or jobs or hours
Recovery Rate	**Activity–wise recovery rates** are determined & there is no concept of a single overhead recovery rate	Either **multiple overhead recovery rate** (for each department) **OR** a **single overhead recovery rate** may be determined for absorbing overheads

Unit Costing, Batch Costing & Job Costing

Unit Costing

- A method of costing used where **output** produced by an entity is **identical** & each unit of output require **identical cost**.
- AKA **Single or Output Costing** but these are sub-divisions of unit costing method.
- Followed by industries which produce single output or few variants of a single output.

Cost per unit = Total Cost of Production / No. of Units produced

M'18 (5m)

Batch Costing

- A **form of specific order costing** where articles are manufactured in predetermined lots, known as **batch**.
- Cost object for cost determination is a **batch for production rather than output** as seen in unit costing.
- Each batch consists of a number of **like units**. Each batch is treated as a cost unit. All costs are accumulated & ascertained for each batch.
- A **separate Batch Cost Sheet** is used for each batch and is assigned a certain number by which the batch is identified.

Cost per unit = Total Cost of batch / No. of items produced

N'16 (4m)

Job Costing

- Method of costing used when work is undertaken as per **customer's special requirement**.
- When an inquiry is received from customer, costs expected to be incurred on job are estimated & on basis of this estimate, a **price is quoted to customer**.
- Actual cost of materials, labour & overheads are accumulated & on completion of job, these **actual costs are compared with quoted price & profit or loss is determined**.

Job Costing v/s Batch Costing

- Method of costing used for **non-standard & non-repetitive products** produced as per customer specification against specific orders.
- Cost determined for **each Job**
- Jobs are **different** from each other and **independent** of each other. Each Job is **unique**

- **Homogeneous products produced** in a continuous production flow in lots
- Cost determined **in aggregate** for the entire Batch and then arrived at on per unit basis.
- Products produced in a batch are **homogeneous** and **lack of individuality**

Job Costing - Advantages and Disadvantages

Advantages

- **Details of Cost of material, labour & overhead** for all job is available to control
- **Profitability** of each job can be derived
- It facilitates **production planning**
- **Budgetary control & Standard Costing** can be applied in job costing
- **Spoilage & detective can be identified** & responsibilities can be fixed accordingly

Disadvantages

- Job Costing is **costly** and **laborious** method
- As lot of **clerical process** is involved, **chance of error** is more
- Not suitable in **inflationary condition**
- **Previous records** of costs will be **meaningless** if there is any **change in market condition**

Job costing v/s Process Costing

Job costing	Process Costing
A Job is carried out or a product is produced by **specific orders**	The process of producing the product has a **continuous flow** and the product produced is **homogeneous**
Costs are determined for **each job**	Costs are compiled on **time basis** i.e., for production of a given accounting period for each process or department
Each job is **separate** and **independent** of other jobs	Products lose their **individual identity** as they are manufactured in a continuous flow
Each job or order has a **number** and costs are collected against the same job number	The unit cost of process is an **average cost** for the period
Costs are computed when a **job is completed**. The cost of a job may be determined by adding all costs against the job	Costs are calculated @ **end of cost** period. Unit cost of process may be computed by dividing total cost by output of process
As **production is not continuous** & **each job** may be different, **managerial attention** is reqd. for effective control	Process of production is usually **standardized** and is therefore, quite stable. **Control** is **comparatively easier**

Joint Products & By Products

Methods of Apportionment of Joint Costs amongst Joint Products

1. Market value after further processing :

- Basis of apportionment of joint cost is total sales value of finished products

2. Average Unit Cost Method :

- *Average unit cost = Total process cost (upto point of separation) ÷ Total units of joint product produced.*

3. Physical Unit Method :

- Based on assumption that joint products are capable of being measured in same units. Accordingly, joint costs are apportioned on the basis of some physical base, viz. weight, numbers.
- Basis used for apportioning joint cost over joint products is physical volume of material present in joint products at point of separation. Any loss arises during joint production process is also apportioned over products on same basis.
- This method cannot be applied if physical units of two joint products are different. Main defect of this method is that it gives equal importance and value to all joint products.

4. Net Realisable Value at Split-off Point :

- NRV of each joint product is found out & Joint Costs are apportioned in ratio of such NRV.
- NRV is found out by deducting foll. from sales value of joint products (at finished stage i.e. after further processing):
  - estimated profit margins
  - selling and distribution expenses, and
  - post-split off costs

N'10 (4m)

5. Market value at point of separation :

- Used for apportionment of joint costs to joint products upto split off point. It is difficult to apply this method if MV of products at point of separation is not available.
- To determine apportionment of joint costs over joint products, a factor known as multiplying factor is determined.

Multiplying factor : Joint Cost / Total Sales Revenue X 100

6. Contribution Margin Method :

- Joint costs are segregated into 2 parts-variable & fixed.
- Variable costs are apportioned over joint products on basis of units produced (average method). In case products are further processed after point of separation, all variable cost incurred be added to variable costs determined earlier.
- Thus, total variable cost is arrived which is deducted from their respective sales values to ascertain their contribution.
- Fixed costs are then apportioned over joint products on the basis of contribution ratios.

Contract Costing

Cost Plus Contracts & its Advantages

M'16 (4m)

- Contract Price is ascertained by adding a percentage of profit to total cost of work.
- Such types of contracts are entered into when it is **not possible to estimate contract cost** with reasonable accuracy due to unstable condition of material, labour, services, etc.

Advantages

- Contractor is assured of **fixed percentage of profit**. There is **no risk of** incurring any **loss** on contract.
- It is useful specially when **work to be done is not definitely fixed** at the time of making estimate.
- Contractee can ensure himself about **'cost of contract'** as he is empowered to examine books & documents of contractor to ascertain veracity of cost of contract.

Process of estimating profit / loss on incomplete contracts

M'11 M'17 (4m)

- **<25% complete** : *No profit should be taken into account*
- **25% or more but <50% complete** : $1/3 \times \text{Notional Profit} \times \frac{\text{Cash Received}}{\text{Work certified}}$
- **50% or more but <90% complete** : $2/3 \times \text{Notional Profit} \times \frac{\text{Cash Received}}{\text{Work certified}}$
- **Contract nearing completion, i.e. b/w 90% and 100% complete** :

$$\text{Est. Profit} \times \frac{\text{Work Certified}}{\text{Contract price}}$$

$$\text{Est. Profit} \times \frac{\text{Cash Received}}{\text{Contract price}}$$

$$\text{Est. Profit} \times \frac{\text{Cost of work to date}}{\text{Estimated total cost}}$$

$$\text{Est. Profit} \times \frac{\text{Cost of work to date}}{\text{Est. total cost}} \times \frac{\text{Cash Recd.}}{\text{Work Cert.}}$$

$$\text{Notional Profit} \times \frac{\text{Work Certified}}{\text{Contract price}}$$

Notional Profit

N'14 (4m)

- Is the **balancing figure of contract account** prepared by contractor if the total of credit side exceeds the total of debit side.
- Represents the **diff. b/w value of work certified & cost of work certified.**
- It is determined as follows:

Notional profit = Value of work certified – (Cost of work to date – Cost of work not yet certified)

Retention Money

N'13 M'15 (2m)

- Contractor **does not receive full payment** of work certified by Surveyor.
- **Contractee retains some amount** (say 10% to 20%) to be paid, after sometime, when it is ensured that there is no fault in work carried out by contractor.
- Any deficiency or defect noticed in work, is to be rectified by contractor before release of retention money.
- Retention money provides a **safeguard against risk of loss** due to faulty workmanship.
- It is determined as follows :

Retention Money = Value of work certified – Payment actually made/ cash paid

Escalation Clause

- This clause is usually provided in contracts as a **safeguard against any likely changes in price or utilization of material & labour**.
- If during execution of contract, prices of materials/labour rise beyond certain limit, **contract price will be increased** by agreed amount.
- Such Escalation Clause usually relates to **change in price of inputs**, it may also be extended to **increased consumption/ utilization** of quantities of materials, labour etc.
- Contractor has to satisfy contractee that increased utilization is not due to his inefficiency.

Progress Payment

N'17 (4m)

- It **refers to amount received by contractor from contractee** for a particular period.

Computation

Value of Work Certified – Retention money – Payment to date

Cash Received Vs. Progress Payment

- Total amount received by contractor on a **particular date** is referred to as **Cash received** whereas the amount received by contractor from contractee for a **particular period** is called **Retention money.**
- Thus, Cash received is for all the collective periods whereas retention money is not.

Process Costing

N'12 (4m) N'13 (4m)

Inter Process Profit - Advantages & Disadvantages

- In some process industries, output of one process is transferred to next process **not at cost** but **at market value** or **cost plus a percentage of profit**.
- **Difference b/w cost & transfer price** is known as inter-process profits.

Advantages

- **Comparison between cost** of output **&** its **market price** at stage of completion is facilitated.
- **Each process is made to stand by itself** as to profitability.

Disadvantages

- Use of inter-process profits involves **complication**.
- System shows **profits which are not realised** because of stock not sold out.

Equivalent Production

- When opening & closing stocks of work-in-process exist, unit costs cannot be computed by simply dividing total cost by total number of units still in process.
- We can convert work-in-process units into finished units called equivalent production units so that unit cost of these uncompleted (W-I-P) units can be obtained.
- ***Equivalent Production units = Actual number of units in production × Percentage of work completed***
- It consists of -
  - balance of work done on opening work-in-process
  - current production done fully and
  - part of work done on closing WIP with regard to different elements of costs viz., material, labour and overhead.

OperaTION Costing *(Don't Confuse with OperaTING Costing)*

- This product costing system is used when an **entity produces more than one variant of final product** using different materials but with similar conversion activities. Which means conversion activities are similar for all product variants but materials differ significantly.
- Operation Costing method is AKA **Hybrid product costing system** as material costs are accumulated by **job order or batch wise** but conversion costs i.e. labour & overhead costs are accumulated by **department** & process costing methods are used to assign these costs to products. Under operation costing, conversion costs are applied to products using **predetermined application rate** based on **budgeted conversion costs.**
- Eg. A company is manufacturing two grades of products, Product - Deluxe & Product-Regular. Both products pass through similar production process but require different quality & quantities of raw materials. Cost of raw material is accumulated on basis of job or batches or units of two variants of products. But, costs for conversion activities need not be identified with product variants as both Products requires similar activities for conversion. Hence, conversion activity costs are accumulated on basis of departments or processes only.

Standard Costing

Steps involved in adopting standard costing system

N'15 (4m)

- **Setting of Standards** : 1st step is to set standards which are to be achieved.
- **Ascertainment of actual costs** : Actual cost for each component of cost is ascertained from books of account, material invoices, wage sheet, charge slip.
- **Comparison of actual cost & standard cost** : Actual costs are compared with the standards costs and variances are determined.
- **Investigation of variances** : Variances arising are investigated for further action. Based on this, performance is evaluated and appropriate actions are taken.
- **Disposition of variances** : Variances arising are disposed off by transferring to relevant accounts (costing P&L A/c) as per accounting method (plan) adopted

Advantages of Standard Costing

- It serves as a basis for **MEASURING OPERATING PERFORMANCE & COST CONTROL**. By setting standards, proper classification and determination of variances is possible.
- It aids **PRICE FIXING**. Standard costing can be used to predict costs.
- Introduction of standard costing facilitates **EVALUATION OF JOBS** & **INTRODUCTION OF INCENTIVES.**
- Standard costing facilitates the **ESTIMATION OF COST OF NEW PRODUCTS** with greater accuracy.
- It serves as a basis for **INVENTORY VALUATION**.
- Standard costing greatly aids **BUSINESS PLANNING, BUDGETING & MANAGERIAL DECISION MAKING.**
- Standard costing aids in **STANDARDISATION OF PRODUCTS, OPERATIONS & PROCESSES.**

Criticism of Standard Costing

- **Variation in price** : One of the chief problem faced in operation of standard costing system is precise estimation of likely prices or rate to be paid. The variability of prices is so great that even actual prices are not necessarily adequately representative of cost.
- **Varying levels of output** : If standard level of output set for pre-determination of standard costs is not achieved, standard costs are said to be not realised.
- **Changing standard of technology** : Not suitable for industries having frequent technological changes affecting production.
- **Attitude of technical people** : Technical people are accustomed to think of standards as physical standards and therefore, they will be misled by standard costs.
- **Fixation of standards may be costly** : May require higher skill & competency.

Marginal Costing

Key Factor

- A factor which at a particular time or over a period **limits activities of an undertaking.**
- It may be the **level of demand for products or service or it may be shortage of one or more of productive resources.**

M'10 (2m)

Angle of Incidence

M'12 (2m)

- This angle is formed by **intersection of sales line & total cost line at break-even point.**
- This angle shows **rate at which profits are being earned** once break-even point has been reached.
- **Wider** the angle, **the greater** is rate of earning profits.
- A **large angle of incidence with a high margin of safety** indicates extremely favourable position.

Marginal Costing

- Costing System where products and services are valued at **variable costs only**. It does not take consideration of fixed costs.
- This system of costing is **AKA direct costing** as only direct costs forms part of product costs.
- Costs are classified **on the basis of behaviour rather than functions** as done in absorption costing.

CVP Analysis - Basic assumptions

M'12 (4m)

- *Changes in levels of revenues & costs arise only because of changes in number of products (or service) units produced & sold.*
- *Total cost can be separated into 2 components - Fixed & variable.*
- *Graphically, behaviour of total revenues & total cost are linear in relation to output level within a relevant range.*
- *Selling price, variable cost per unit & total fixed costs are known & constant.*
- *All revenues & costs can be added, subtracted & compared without taking into account time value of money.*

Practical Application of Marginal Costing

N'13 (4m)

- **Pricing Policy** : Since marginal cost per unit is constant from period to period, firm decisions on pricing policy can be taken particularly in short term.
- **Decision Making** : MC helps mgmt. in taking business decisions like make or buy, discontinuance of a particular product, machine replacement, etc.
- **Ascertaining Realistic Profit** : Stock of finished goods & WIP are carried on marginal cost basis & fixed exp. are written off to P&L A/c as period cost.
- **Determination of production level :** MC helps in preparation of break-even analysis which shows effect of increasing or decreasing production activity on profitability.

Margin of Safety & Relationship b/w Op. Leverage & MOS Ratio

N'13 (4m)

- Margin of Safety (MoS) is the **EXCESS OF TOTAL SALES OVER THE BREAK EVEN SALES**. MoS defines the amount upto which level sales can decline before occurring loss. A **greater MoS** reflects **soundness of business**. If MoS is small, any fall in sales value may even result in loss.

Margin of safety = Actual sales or output – Break even sales or productions

$$\text{Margin of Safety Ratio} = \frac{\text{Sales} - \text{Break Even Sales}}{\text{Sales}}$$

Relationship between Operating Leverage and Margin of Safety

- Op. leverage is calculated as **Contribution ÷ Operating profit** wherein contribution margin plays an important role.
- If **sales** are expected to **increase**, **higher operating leverage** will result in **higher profit**. When **sales** are expected to **decrease**, **lower operating leverage** will result in **higher profit**.
- **Higher variable cost & lower fixed cost** will result into **higher MoS** & **risk will be lower** & vice versa.
- So, like Operating leverage, **MoS is a measure of risk as to what extent an organisation is exposed to change in sales volume.**

Budget & Budgetary Control

Important Formulae

1.	**Efficiency Ratio**	(Standard Hours / Actual Hours) × 100
2.	**Activity Ratio**	(Standard Hours / Budgeted Hours) × 100
3.	**Calendar Ratio**	(Avail. Working Days / Budg. Working Days) × 100
4.	**Standard Capacity Usage Ratio**	(Budgeted Hours / Max. Possible Hours in Budgeted Period) × 100
5.	**Actual Capacity Usage Ratio**	(Actual Hours Worked / Maximum Possible Working Hours in a Period) × 100
6.	**Actual Usage of Budgeted Capacity Ratio**	(Actual Working Hours / Budgeted Hours) × 100

M'14 (4m)

Budget Manual

Collection of documents that contains key information. Typical contents :

- **Introductory explanation** of budgetary planning & control process, including **statement of budgetary objective** & **desired results**.
- **Org. chart** to show who is responsible for preparation of each functional budget & way in which budgets are interrelated.
- Timetable for preparation of each budget prevents formation of '**bottleneck**' with late preparation of 1 budget holding up preparation of others.
- **Copies of all forms** to be completed by those responsible for preparing budgets, with explanations concerning their completion.
- A list of **organization's account codes**, with full explanations to use them.
- Info. concerning **key assumptions** to be made by managers in their budgets, viz rate of inflation, exch. rates, etc.

N'11 M'16 (4m)

Fixed Budget v/s Flexible Budget

Fixed Budget	Flexible Budget
It is **inflexible** & does **not change** with actual volume of output.	It **can be re-casted** according to the level of activity.
Operates under **1 level of activity & 1 set of conditions**. It assumes that conditions would remain **static**.	It consists of **various budgets for different levels of activity**.
Costs are **not classified** according to their variability i.e., fixed, variable and semi variable.	Costs are **classified** according to their variability i.e., fixed, variable and semi variable.
If budgeted & actual activity levels differ significantly, aspects like **cost ascertainment & price fixation do not give correct picture.**	Flexible budgeting at different levels of activity facilitates **ascertainment of cost, fixation of selling price & tendering of quotations.**

Zero Based Budgeting

Advantage of ZBB

1. Provides a **systematic approach for evaluation** of different activities & ranks them in order of preference for allocation of scarce resource.
2. Ensures that various **functions** of organisation are **critical** for achievement of its objectives & are being performed in best way.
3. Provides an **opportunity** to mgmt. **to allocate resources** for various activities after having a thorough **cost-benefit analysis**.
4. **Area of wasteful expenditure** can be easily identified & eliminated.
5. Departmental budgets are closely linked with **corporate objectives**.
6. The technique can also be used for introduction & implementation of system of '**management by objective'.**

Limitations of ZBB (Key : OT_3)

1. Various **OPERATIONAL PROBLEMS** are likely to be faced in implementing the technique.
2. The full SUPPORT of **TOP MANAGEMENT** is required.
3. It is **TIME CONSUMING** as well as **COSTLY**.
4. It requires proper **TRAINED MANAGERIAL STAFF**

Steps involved in the process of Zero Based Budgeting (Key : DEAD Body)

1. **DETERMINATION** of a **SET OF OBJECTS** is the pre-requisite and essential step in the direction of ZBB technique.
2. Deciding about the **EXTENT** to which the technique of ZBB is to be applied whether in all areas of organization activities or only in few selected areas on trial basis.
3. Identify the **AREAS** where decisions are required to be taken.
4. Developing **DECISION PACKAGES** and ranking them in order of performance.
5. Preparation of **BUDGET** that is translating decision packages into practicable units/items and allocating financial resources.

ZBB is an extension of cost benefit analysis method to area of corporate planning & budgeting.

ZBB Superior to Traditional Budgeting – How ?

M'18 (5m)

Zero based budgeting is superior to traditional budgeting in following manner:

- It provides a **systematic approach for evaluation** of different activities.
- It ensures that **function** undertaken **are critical** for achievement of objectives.
- It provides an **opportunity for management to allocate resources** to various activities after a thorough – cost benefit analysis.
- It helps in **identification of wasteful expenditure** & then their elimination.
- It facilitates **close linkage of departmental budgets with corporate objectives**.
- It helps in introduction of system of **Management by Objectives.**

Traditional Budgeting v/s Zero Based Budgeting

Traditional Budgeting	Zero-Based Budgeting
Traditional budgeting is **accounting oriented**. Main stress happens to be on previous level of expenditure.	Zero-based budgeting makes a **decision oriented** approach. It is very rational in nature and requires all programmes, old and new, to compete for scarce resources.
In traditional budgeting, **first reference** is made to **past level of spending** and **then demand for inflation** and **new programmes**	In zero- based budgeting, **management focuses attention to only on decision packages**, which enjoy priority to others.
In tradition budgeting, some managers **deliberately inflate** their **budget request** so that after the cuts they still get what they want	In zero-based budgeting, a **rationale analysis of budget proposals** is attempted. The managers, who unnecessarily try to inflate the budget request, are likely to be caught and exposed. Management accords its approval only to a carefully devised result-oriented package
In traditional budgeting, it is for **top management** to **decide** why a particular amount should be spent on a particular decision unit.	In Zero-based budgeting, this responsibility is shifted from top management to the **manager of decision unit**.

Budget & Budgetary Control

N'09 (3m) Functional Budgets

Budgets which relate to individual functions in an org. are known as Functional Budgets.

Commonly used Functional budgets:

- *Sales Budget*
- *Production Budget*
- *Plant Utilisation Budget*
- *Direct Material Usage Budget*
- *Direct Material Purchase Budget*
- *Direct Labour (Personnel) Budget*
- *Factory Overhead Budget*
- *Production Cost Budget*

N'11 (2m) Essentials of Budget

- **Org. structure** must be clearly defined & responsibility should be assigned to identifiable units. Setting of clear obj & reasonable targets. Obj. should be in consonance with org's **long term plan**.
- **Obj & degree of responsibility** should be clearly communicated to mgmt./ responsible person.
- **Budgets are prepared for future periods** based on expected course of actions. Entire org. must be committed to budgeting
- **Budgets are updated for events** that were not kept into mind while establishing budgets. Hence, budgets should be flexible enough for mid-term revision.
- Budgets should be **quantifiable & master budget** should be broken down into various functional budgets.
- Budgets should be **monitored periodically**. Variances from set standards should be analysed & responsibility should be fixed

N'12 (4m) Capital Exp. Budget - Considerations

- **Overhead on production facilities** of certain departments as indicated by plant utilisation budget.
- **Replacement requests** from concerned departments.
- **Future development plans** to increase output by expansion of plant facilities.
- Factors like :
  - **sales potential** to absorb the increased output,
  - possibility of **price reductions**,
  - increased **costs of advertising and sales promotion** to absorb increased output, etc.

N'13 (4m) Preparation of Budget – Steps involved

- **Definition of objectives** : A budget is a plan for achievement of certain operational objectives, so these should be defined precisely.
- **Location of key factor** : Factor(s) which sets a limit to total activity is known as key factor. For proper budgeting, it must be located & estimated properly.
- **Appointment of controller** : Formulation of budget usually requires whole time services of senior executive known as budget controller.
- **Budget Manual** : Effective budgetary planning relies on provision of adequate information which are contained in budget manual.
- **Budget period** : Period covered by budget is known as budget period. It may be months/quarters/such periods as coincide with period of trading activity.
- **Standard of activity or output** : Results of past should only be applied when similar conditions are like to repeat in future.

Advantages of Budgetary Control System

1. **Efficiency**: Use of budgetary control system enables mgmt. to conduct its business activities efficiently.
2. **Control on expenditure**: It is a powerful instrument used by business houses for expenditure control.
3. **Finding deviations**: It reveals deviations to mgmt., from budgeted figures after making a comparison with actual figures.
4. **Effective utilisation of resources**: Effective utilisation of various resources like—men, material, machinery & money—is made possible, as production is planned after taking them into account.
5. **Implementation of Standard Costing system** : It creates suitable conditions for implementation of standard costing system in a business organisation.
6. **Cost Consciousness**: Budgets are studied by outside fund providers also such as banking & financial institutions, realising that mgmt. encourages cost consciousness & maximum utilisation of available resources.
7. **Credit Rating**: Mgmt. which have developed a well ordered budget plan & which operate accordingly, receive greater favour from credit agencies.

Limitations of Budgetary Control System

1. **Based on Estimates**: Budgets are based on series of estimates which are based on conditions prevailed when budget is established.
2. **Time factor** : Some preliminary steps are required to be accomplished before budgets are implemented.
3. **Co-operation:** Required Staff co-operation is usually not available during budgetary control exercise. In a decentralised organisation each unit has its own objective and these units enjoy some degree of discretion.
4. **Expensive** : Its implementation is quite expensive.
5. **Not a substitute for management**: Budget is only a managerial tool & must be applied correctly for management to get benefited.
6. **Rigid document** : Budgets are considered as rigid document. But in reality, an organisation is exposed to various uncertain internal & external factors.

Advantages of Capital Exp. Budget

1. It **outlines capital development program & estimated capital exp** during budget period.
2. It enables co. to **establish system of priorities.** When there is shortage of funds, capital rationing becomes necessary.
3. Serves as tool for **expenditure control.**
4. It provides amount of exp. to be incorporated in future budget summaries for calculation of **estimated return on capital employed.**
5. Enables **cash budget** to be completed. With other cash commitments, capital expenditure commitment should also be considered for completion of budget.
6. It facilitates **cost reduction programme**, particularly when modernisation is covered by this budget.

Operating Costing / Service Costing

N'09, N'14 (4m) How to compute composite units?

- Operating Costing is a method of **ascertaining costs of providing or operating a SERVICE**.
- It is usually used by ***transport companies, gas & water works departments, electricity supply companies, canteens, hospitals, theatres, schools etc.***

Computation of Composite Units :

When two units are merged into one, it is called Composite units. Composite units i.e. tonnes kms., quintal kms. etc. may be computed in two ways :

1. **Absolute (weighted average) tonnes-kms** : Absolute tonnes-kms., are the sum total of tonnes-kms., arrived at by multiplying various distances by respective load quantities carried.
2. **Commercial (simple average) tonnes-kms** : Commercial tonnes-kms., are arrived at by multiplying total distance kms., by average load quantity.

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