

K.T.S.P.Mandal's

**SAHEBRAOJI BUTTEPATIL**  
**MAHAVIDYALAYA**

Rajgurunagar, Tal-Khed, Dist- Pune,410505

**Department Of Commerce**

**F.Y.B.COM**

**SEM-I**

**Subject**

**Basics of Cost and Management Accounting and Material Accounting-I**

**Chapter- 2**

**Elements and Classification of Cost**

## **2.1 Cost Accounting Standard:**

Cost Accounting Standards (CAS) were established in the 1970s in the United States to regulate cost accounting practices for government contractors. Their primary objective is to ensure consistency and fairness in allocating costs and reporting expenses incurred in federal contracts. CAS promote transparency, accountability, and accuracy in cost estimation, aiding the government in assessing the true cost of goods and services procured through contracts.

### **2.1.1 Meaning:**

Cost Accounting Standards (CAS) refer to regulatory guidelines established to ensure consistency and fairness in the allocation, measurement, and reporting of costs incurred by government contractors. These standards are designed to promote uniformity and transparency in cost accounting practices among entities involved in federal contracts. CAS provide a framework for identifying, measuring, and allocating costs to contracts, aiming to facilitate accurate cost estimation, control, and accountability. Compliance with CAS is typically mandatory for contractors receiving federal awards exceeding specified thresholds.

### **2.1.2 Definition:**

Definition of Cost Accounting Standard are as follows:

#### **1) Hansen and Mowen:**

"Cost Accounting Standards are regulatory measures instituted to promote uniformity and transparency in cost accounting practices among entities engaged in government contracts."

#### **2) Hilton :**

"Cost Accounting Standards refer to rules and principles designed to standardize cost allocation methods and reporting procedures for government contractors."

## **2.2 Importance of Cost Accounting Standards**

Cost Accounting Standards (CAS) play a crucial role in ensuring transparency, accuracy, and fairness in cost allocation and reporting, particularly for government contractors. Their importance can be understood through the following points:

### **1) Uniformity:**

CAS promote consistency in cost accounting practices among contractors, ensuring that similar costs are treated alike across different contracts. This uniformity enhances comparability and facilitates effective decision-making by contractors and government agencies alike.

### **2) Transparency:**

By mandating specific methodologies and principles for cost allocation and reporting, CAS enhance transparency in financial reporting for government contracts. This transparency is essential for stakeholders to assess the true cost of goods and services procured through federal contracts.

### **3) Fair Competition:**

CAS help level the playing field among contractors by establishing standardized cost accounting practices. This fosters fair competition based on the quality and efficiency of goods and services rather than on differing accounting methods.

### **4) Cost Control:**

Compliance with CAS enables contractors to better control costs by providing clear guidelines for cost allocation and reporting. This helps prevent cost overruns and ensures that government funds are used efficiently.

### **5) Accurate Cost Estimation:**

CAS provide a framework for accurately estimating costs associated with government contracts. By following standardized cost accounting practices, contractors can more reliably forecast project expenses, enabling better contract pricing and budgeting.

### **6) Compliance Requirements:**

Contractors receiving federal awards above specified thresholds are required to comply with CAS. Failure to adhere to these standards can result in penalties, contract termination, or disqualification from future government contracts.

### **7) Taxpayer Protection:**

CAS safeguard taxpayer interests by ensuring that government funds are spent wisely and transparently. By promoting accurate cost allocation and reporting, CAS help prevent fraud, waste, and abuse of taxpayer dollars.

#### **8) Legal Compliance:**

Compliance with CAS is not only a contractual requirement but also a legal obligation for government contractors. Adhering to these standards helps contractors avoid legal liabilities and ensures they remain eligible for government contracts.

#### **9) Auditing and Oversight:**

CAS provide a framework for auditors and government agencies to evaluate the adequacy and reliability of cost accounting practices employed by contractors. This oversight helps maintain the integrity of government procurement processes.

#### **10) International Comparability:**

While CAS are specific to the United States, their principles align with international accounting standards. This facilitates comparability between U.S. government contractors and their international counterparts, promoting consistency in global procurement practices.

#### **11) Improved Decision-making:**

Standardized cost accounting practices prescribed by CAS enable contractors and government agencies to make more informed decisions regarding resource allocation, pricing strategies, and contract negotiations.

#### **12) Enhanced Public Trust:**

Compliance with CAS enhances public trust in government contracting processes by demonstrating a commitment to accountability, fairness, and integrity. This trust is essential for maintaining public confidence in government procurement activities.

### **2.3 Elements of Cost:**

Elements of cost are considered to arrive at a total project cost estimate. The elements of cost are generic in nature. They are not considered as definitive examples since the accounting practices of different firms and organisations may vary greatly. The definition of the cost parameters is usually not the responsibility of one department of the organization. The main aim is to give an idea of the various components that are included in the total project cost. The elements of cost include direct materials, direct labour and expenses.

Cost is made up of three elements i.e. Material, Labour and Expenses. Each of these can be direct or indirect. This is shown below:

Direct	Indirect	Material	Material	Labour	Labour	Expenses	Expenses	Elements of Cost	
Direct	Material	Direct	Labour	Direct	Expenses	Overheads	Factory	Overheads	Office
Overheads	Selling & Distribution	Overheads	Indirect	Material	Indirect	Labour	Indirect		
Expenses									

### **2.3.1 Material :**

The substance from which the product is made is known as material. It may be in a raw or a manufactured state. It can be direct as well as indirect.

#### **a) Direct Material :**

All material which becomes an integral part of the finished product and which can be conveniently assigned to specific physical units is termed as "Direct Material".

Following are some of the examples of direct material:

- i) All material or components specifically purchased, produced or requisitioned from stores.
- ii) Primary packing material (e.g. carton, wrapping, cardboard, boxes etc.).
- iii) Purchased or partly produced components.

Direct material is also described as raw material, process material, prime material, production material, stores material constructional material etc.

#### **b) Indirect Material:**

All material which is used for purposes ancillary to the business and which cannot be conveniently assigned to specific physical units is termed as "indirect Material".

Consumable stores, oil and waste, printing stationery etc. are a few examples of indirect material. Indirect material may be used in the factory, the office or the selling and distribution divisions

### **2.3.2. Labour**

#### **a) Direct Labour:**

Labour which takes an active and direct part in the production of a particular commodity is called direct labour. Direct labour costs are, therefore, specifically and conveniently

traceable to specific products. Direct labour is also described as process labour, productive labour, operating labour, manufacturing labour, direct wages etc.

**b) Indirect Labour :**

Labour employed for the purpose of carrying out tasks incidental to goods or services provided, is indirect labour. Such labour does not alter the construction, composition or condition of the product. It cannot be practically traced to specific units of output. Wages of store-keepers, foremen, time-keepers, director's fees, salaries of salesmen, etc. are all examples of indirect labour costs. Indirect labour may relate to the factory, "the office or the selling and, distribution divisions.

**2.3.3 Expenses :**

Expenses may be direct or indirect.

**a) Direct Expenses :**

These are expenses which can be directly, conveniently and wholly allocated to specific cost centre's or cost units. Examples of such expenses are: hire of some special machinery required for a particular contract, cost of defective work incurred in connection with a particular job or contract etc. Direct expenses are sometimes also described as "chargeable expenses".

**b) Indirect Expenses:**

These are expenses which cannot be directly, conveniently and wholly allocated to cost Centre's of cost units.

**2.3.4 Overhead :**

The term overhead includes indirect material, indirect labour and indirect expenses. Thus, all indirect costs are overhead. A manufacturing organisation can broadly be divided into the following three divisions:

- a) Factory or works, where production is done.
  - b) Office and administration, where routine as well as policy matters are decided.
  - c) Selling and distribution, where products are sold and finally dispatched to customers
- Overhead may be incurred in a factory or office or selling and distribution divisions. Thus, overhead may be of three types:

**1) Factory Overhead :**

They include the following things:

- a) Indirect material used in a factory such as lubricants, oil, consumable stores etc.
- b) Indirect labour such as gatekeeper, timekeeper, works manager's salary etc.
- c) Indirect expenses such as factory rent, factory insurance, factory lighting etc.

## **2) Office and Administration Overhead :**

They include the following things:

- a) Indirect materials used in an office such as printing and stationery material, brooms and dusters etc.
- b) Indirect labour such as salaries payable to office manager, office accountant, clerks, etc.
- c) Indirect expenses such as rent, insurance, lighting of the office.

## **3) Selling and Distribution Overhead :**

They include the following things:

- a) Indirect materials used such as packing material, printing and stationery material etc
- b) Indirect labour such as salaries of salesmen and sales manager etc.
- c) Indirect expenses such as rent, insurance, advertising expenses etc.

## **2.4 Classification of Cost:**

The process of grouping costs according to their common characteristics is called classification of cost. It is a systematic placement of like items together according to their common features. The followings are the important ways of classifying costs.

### **2.4.1 Definition :**

Cost classification is the logical process of categorising the different costs involved in a business process according to their type, nature, frequency and other features to fulfil accounting objectives and facilitate economic analysis. Cost refers to the value sacrificed with the aim of gaining something in return. Every business process involves some cost. It is the basis of profit determination for an organisation.

### **2.4.2 Need/Importance of Classification of Cost:**

Need/Importance of Classification of Cost as follows:

### **1) Preparation of Budget:**

Classification of cost helps in preparation of the budget of the organization. For preparing the budget of an organization one must know how and where exactly the expenses have been incurred in relation to manufacturing the product. On the basis of this classification of the cost an organization accordingly prepares its budget.

### **2) Helps in Measuring Efficiency:**

Classification of cost helps in measuring the efficiency of the organization. On the basis of the places where the costs have been incurred and the amount of cost that has been incurred the efficiency of the organization can be judged.

### **3) Controlling Cost:**

#### **a) Labour Cost:**

With the help of classification of cost an organization can control its labour cost as well. If the labour complete their task well in time and with much efficiency then the organization would be able to reduce its labour cost.

#### **b) Material Cost:**

Material cost can be controlled if material wastage is avoided and proper standardization of materials is used. Thus with the help of classification of cost an organization is able to reduce the cost incurred on materials and thus able to control material cost.

#### **c) Overhead Cost:**

Overhead comprises indirect expenditure incurred in manufacturing. By knowing the amount that has been incurred under various heads an organization can device ways to reduce the cost. Thus with the help of classification of cost an organization is able to control overhead cost.

### **4) Expansion of the Organization :**

If an organization knows where exactly it incurs expenditure then it can device ways to control these costs. Once an organization is able to control its cost then it can concentrate on its expansion. Thus with the help of classification of cost an organization is able to device ways for its expansion.

### **2.4.3 Classification According to Functions:**

This is a traditional classification. A business has to perform a number of functions like manufacturing, administration, selling, distribution and research. Cost may have to be ascertained for each of these functions. On this basis, costs are classified into the following groups:

#### **Functional Classification of Costs**

**Manufacturing Costs:** Materials , Labour, Factory rent, Depreciation, Power & Lighting, Insurance, Stores Keeping, Packing Costs.

**Administration Costs:** Accounts Office Expenses , Audit Fees , Legal Expenses, Office Rent, Director's remuneration, Postage

**Selling Costs:** Advertising, Salaries & Commission of Salesman , Showroom Expenses, Samples, Travel Expenses

**Distribution Costs:** Carriage Outward, Warehousing costs , Upkeep and running costs of delivery vans .

#### **a) Manufacturing Cost**

This is the cost of the sequence of operations which begins with supplying materials, labour and services and ends with completion of production.

#### **b) Administration Cost:**

This is general administrative cost and includes all expenditure incurred in formulating the policy, directing the organization and controlling the operations of an undertaking, which is not directly related to production, selling and distribution, research and development activity or function.

#### **c) Selling and Distribution Cost:**

Selling cost is the cost of seeking to create and stimulating demand and of securing orders. Distribution cost is the cost of sequence of operations which begins with making the packed product available for dispatch and ends with making the reconditioned returned empty package for re-use.

#### **d) Research and Development Cost:**

Research cost is the cost of searching new or improved products or methods. It comprises wages and salaries of research staff, payments to outside research organisations,

materials used in laboratories and research departments, etc. After completion of research, the management may decide to produce a new improved product or to employ a new or improved method. Development cost is the cost of the process which begins with the implementation of the decision to produce a new product or to employ a new or improved method and ends with the commencement of formal production of that product or by that method. Pre-production cost is that part of the development cost which is incurred in making in trial production run preliminary to formal production.

#### **2.4.4 Classification Based on Cost Behaviour:**

Depending on the variability behaviour costs can be classified into variable and fixed costs.

##### **a) Variable Cost:**

The variable cost is a cost that tends to vary in accordance with level of activity within the relevant range and within a given period of time. The Prime product costs i.e., direct material, direct labour and direct expenses tend to vary in direct proportion to the level of activity. An increase in the volume means a proportionate increase in the total variable costs and a decrease in volume will lead to a proportionate decline in the total variable costs.

##### **b) Fixed Cost:**

The fixed cost is a cost that tends to be unaffected by changes in the level of activity during a given period of time. The fixed costs remain constant in the total regardless of changes in volume up to a certain level of output. They are not affected by changes in the volume of production. There is an inverse relationship between volume and fixed cost per unit. Fixed costs tend to remain constant for all levels of activity within a certain range. For example salaries bill may go up because of annual increments or due to change in the pay rates and due to pay structure.

##### **c) Semi-variable Cost or Semi-fixed Cost:**

Many costs fall between these two extremes. They are called as semi-variable cost or semi-fixed costs. They are neither perfectly variable nor absolutely fixed in relation to changes in volume. They change in the same direction as volume but not in direct proportion thereto. An example is found in telephone charges. The rental element is a fixed cost whereas charges for call made are a variable cost

#### **2.4.5 Committed and Discretionary Costs:**

It is shown above 'the costs may be classified into fixed and variable.' Fixed costs may be further classified as committed costs and discretionary (or programmed) costs. This classification is based on the degree to which firm is locked into the asset or service that is generating the fixed cost. Fixed cost is committed if it is incurred in maintaining physical facilities and management set up. Committed costs cannot be avoided in the short run. For example, salary of the managing director may represent a committed cost if, by policy, the managing director is not to be released unless the firm is liquidated. Similarly, depreciation of plant and equipment is committed because these facilities cannot be easily changed in the short run. Discretionary fixed costs are those which can be avoided by management. Such costs are not permanent. Advertising, research and development cost, salaries of low level managers are examples of discretionary costs because these costs may be avoided or reduced in the short run if so desired by the managements. This classification into committed and discretionary costs is important from the point of view of cost control and decision making.

#### **2.4.6 Financial Costs & Non-Financial Costs:**

##### **a) Financial Cost:**

##### **1) Cash Costs :**

Cash costs are those sacrifices that are reflected in actual cash outflows. Business transactions usually involve both reward (and revenue) and sacrifice (or cost) with the difference between the two being gain (or profit). Thus,

Reward-Sacrifice = Gain

Revenue Cost = Profit

##### **2) Non-cash Costs:**

Non-cash costs are financial sacrifices that do not involve cash outlays at the time when the cost is recognised. These costs are found in depreciation, opportunity costs etc.

##### **b) Non-Financial Costs :**

Non financial costs are those costs that are not directly traceable through a company's cash flow. While such costs (e.g., low morale of employees) certainly involve scarifies and they may lead eventually, in complex ways to a reduced cash flow in the future. They do not represent an immediate cash outlays. The above cost concepts are based on several

factors like controllability, period, situation, input-output relationship, opportunity, urgency, historical, product, etc. The clear understanding of costs concepts will help the management in analysis of costs, reporting, cost control and decision making.

#### **2.4.7 Product Costs and Period Costs:**

Product costs are those costs which are necessary for production and which will not be incurred if there is not production. These consist of direct materials, direct labour and some of the factory overhead. Product costs are 'absorbed by' or 'attached to' the units produced. Period costs are those which are not necessary for production and are written off as expenses in the period in which these are incurred. Such cost are incurred for a time period and are charged to Profit and Loss Account of the period, rent, salary of company executives, travel expenses are examples of period costs. These costs are not inventoried i.e. these are not included in the value of closing stocks. Classification into product-and period cost is important from the point of view of profit determination.

#### **2.4.8 Classification According to Identifiability with Cost Units:**

Costs are classified into direct and indirect on the basis of their identifiability with cost units or jobs or processes:

##### **a) Direct Costs :**

These are those costs which are incurred for and may be conveniently identified with a particular cost unit, process or department.

##### **b) Indirect Costs:**

These costs cannot be conveniently identified with a particular cost unit, process or department. These are general costs and are incurred for the benefit of a number of cost units or cost centres. Cost of raw materials used, wages of machine operators are common examples of direct costs. Examples of indirect costs are rent, repairs, depreciation, managerial salaries, coal, lubricating oil, wages of foreman, etc. Costs are not traced or identified directly to a product for one of the three reasons.

- i) It is impossible to do so e.g., rent of building etc.
- ii) It is not convenient or feasible to do, so e.g., nails used in furniture, sewing thread, etc.
- iii) Management chooses not to do so i.e. many companies classify certain items of cost as indirect because it is customary in the industry to do so e.g., carriage inward etc.

#### **2.4.9 Classification According to Controllability:**

The costs can also be classified into controllable and uncontrollable:

##### **a) Controllable Costs:**

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

##### **b) Uncontrollable Costs :**

These are those costs which cannot be influenced by the action of a specified member of an enterprise. Fixed costs are generally uncontrollable. For example, it is very difficult to control costs like factory rent, managerial salaries, etc. Two important points should be noted regarding this classification. First, controllable costs cannot be distinguished from uncontrollable costs without specifying the level and scope of management authority. In other words, a cost which is uncontrollable at one level of management may be controllable at another level of management. Secondly, in the long-run all costs are controllable.

#### **2.5. Segregation of Cost into Elements**

Segregation of costs into elements is a fundamental aspect of cost accounting. This process involves classifying and analyzing costs to understand their behaviour and impact on a business. Segregating costs helps in budgeting, cost control, and decision-making.

##### **A) Different Elements into which Costs can be Segregated:**

Here's a detailed explanation of the different elements into which costs can be segregated

##### **1) Direct Materials:**

Direct materials are the raw materials and components that can be directly traced to the production of specific goods or services. These materials form an integral part of the finished product and their costs can be easily attributed to specific products. For instance, wood used in furniture manufacturing, steel used in car production, and fabric used in garment production are all examples of direct materials. Accurate tracking of direct materials helps in determining the true cost of producing a product and is essential for effective pricing strategies.

## **2) Indirect Materials**

Indirect materials are those materials used in the production process that cannot be directly traced to specific products. Although necessary for production, they do not form part of the finished product, and their costs are not easily attributable to specific products. Examples include lubricants for machinery, cleaning supplies for a factory, and office supplies used in production management. The costs of indirect materials are usually allocated to overheads and subsequently distributed across products, making it essential for cost control and accurate product costing.

## **3) Direct Labour:**

Direct labour refers to the wages paid to workers who are directly involved in the production of goods or services. These labour costs can be directly attributed to specific products, as they involve hands-on or physical work on the production line. Examples include the wages of assembly line workers, salaries of machinists, and payments to seamstresses in a garment factory. Accurate tracking of direct labour costs is crucial for determining the cost of production and ensuring fair compensation for workers based on their contribution to the production process.

## **4) Indirect Labour:**

Indirect labour refers to wages paid to workers who support the production process but do not directly work on the product. These costs are not easily attributable to specific products and involve roles such as supervision, maintenance, and administration. Examples include salaries of factory supervisors, wages of maintenance staff, and payments to quality control inspectors. Indirect labour costs are typically included in overheads and allocated across products, making it important for overall cost management and operational efficiency.

## **5) Direct Expenses:**

Direct expenses are costs that can be directly traced to the production of specific goods or services, other than direct materials and direct labour. These expenses are directly attributable to specific products or jobs and vary with the level of production. Examples include royalties paid for the use of patents, the cost of special tools or equipment for a specific job, and hire charges for specialized machinery used in production. Tracking direct expenses accurately is important for precise product costing and profitability analysis.

## **6) Indirect Expenses:**

Indirect expenses are costs incurred in the production process that cannot be directly traced to specific products. These expenses are necessary for the overall production process and their costs are allocated based on reasonable estimates or apportionments. Examples include factory rent, utility bills for the production facility, and depreciation on production equipment. Indirect expenses are usually classified under overheads and their accurate allocation is vital for comprehensive cost control and financial planning.

## **7) Overheads:**

Overheads are the aggregate of indirect materials, indirect labour, and indirect expenses. They are divided into manufacturing, administrative, and selling and distribution overheads. Manufacturing overheads include costs related to the production process but not directly tied to specific products, such as depreciation of factory equipment, factory maintenance costs, and factory utilities. Administrative overheads cover costs related to the general administration of the business, like salaries of administrative staff, office rent, and office supplies. Selling and distribution overheads include costs incurred to market, sell, and distribute the product, such as salaries of sales staff, advertising expenses, and shipping costs.

## **B) Importance of Segregating Costs into Elements:**

### **Importance of segregating costs into elements explains with following points:**

#### **1) Accurate Product Costing:**

Segregating costs into elements is crucial for determining the accurate cost of producing a product. By identifying and tracking direct and indirect costs separately, businesses can precisely calculate the total production cost. This precision is essential for setting appropriate selling prices that cover costs and generate profit. Accurate product costing also aids in comparing the cost-efficiency of different products, leading to informed decision-making about product lines.

#### **2) Cost Control and Reduction:**

Identifying and segregating costs into their elements allows businesses to pinpoint areas where cost control and reduction are possible. By analyzing each cost element, managers can identify inefficiencies and implement measures to reduce unnecessary expenses. This systematic approach to cost control helps in maintaining profitability and competitiveness

in the market. Regular monitoring of cost elements also ensures that cost-saving measures are effective and sustainable over time.

### **3) Budgeting and Forecasting:**

Segregating costs into elements facilitates the preparation of detailed and accurate budgets. By understanding the specific costs associated with materials, labour, and overheads, businesses can create more realistic budgets that reflect their operational needs. This detailed cost information also aids in forecasting future expenses based on historical data. Accurate budgeting and forecasting are essential for financial planning, resource allocation, and achieving long-term business objectives.

### **4) Decision Making:**

Detailed cost information derived from segregating costs into elements supports managerial decision-making. With a clear understanding of the cost structure, managers can make informed decisions regarding pricing, outsourcing, production planning, and investment in new projects. This granular cost information helps in evaluating the financial implications of various strategic options and selecting the most cost-effective alternatives. Effective decision-making based on accurate cost data enhances overall business performance.

### **5) Profitability Analysis:**

Segregating costs into elements enables a thorough analysis of the profitability of different products or departments. By attributing costs accurately, businesses can determine the true profitability of each product line or business unit. This analysis helps in identifying the most and least profitable segments, allowing managers to focus on areas that contribute the most to the bottom line. Profitability analysis also supports strategic decisions such as product development, market expansion, and discontinuation of unprofitable lines.