

UNIT TWO

NATURE, SCOPE AND FUNCTIONS OF COST ACCOUNTING.

Objectives

At the end of this chapter, students should be able to understand:

- The objectives of cost accounting.
- Different classification of cost.
- The cost coding system
- How to install cost accounting system.

Learning Outcome:

At the end of this chapter, students should be able to:

- Explain the objectives of cost accounting.
- Analyze different classification of cost.
- Explain the cost coding system.
- Itemize the process of installing cost accounting system.

M1.2:1. Objectives of Cost Accounting.

Every branch of accounting (financial, Costing, Management etc.) has its purpose or objectives. The objectives of cost accounting include but not limited to the following:

- i. The establishment of a sound cost accounting department
- ii. Identification of cost center
- iii. Collection of cost accounting in various centers
- iv. Classifying cost in an appropriate manner so as to facilitate ascertainment of cost and facilitate product pricing
- v. Preparation of timely cost accounting information that will facilitate short term decision making and planning
- vi. Ensure that established format for data compilation are correctly followed at various levels

- vii. Monitor the regularity of entry of data to ensure timeliness
- viii. Prepare summaries of raw data collected showing the results from various perspective to give a total picture.
- ix. Check the accuracy of figures supplied through reasonable checks

M1:2.2. Cost classification.

There are various classifications of cost. It could be based on behavior, functions, purpose, nature, traceability and other numerous ways depending on the objective of such classification. We will limit our discussion in this book on the three first mentioned classifications.

Cost Classification by Behavior.

Cost behavior simply refers to the relationship between total costs and activity level. Costs are classified into fixed, variable and mixed cost.

Fixed Cost.

Fixed costs do not change or vary with the level of activity within the relevant range. This is a cost that tend to be unaffected by changes in the level of activity during a given period of time. The total fixed cost remains constant regardless of changes in volume up to a certain range of activity. There is inverse relationship between volume and fixed cost per unit. In a production sector, fixed cost is incurred whether there are productions or not. It decreases with increase in production. Fixed cost is the cost that does not vary with changes in output within a range and it accrues even when there is no output. E.g. rent. It should be noted that fixed cost only remains fixed only within a relevant range. At a range beyond the relevant range the fixed cost can vary with the output. This occurs when there is need to expand the firm capacity for an increased output.

Variable Cost.

Variable costs change or vary proportionately with the output or level of production. The total variable cost increases when more units are produced. It decreases when production reduces while variable cost per unit remains constant. There is a linear relationship between volume and variable cost. They are constant per unit.

The prime product costs, direct material, direct labour and direct expenses are all variable in nature.

Mixed Cost.

Mixed cost can also be referred to as semi-variable or semi-fixed cost. Such cost is neither perfectly variable or nor fixed in behavior. Mixed cost change in the same direction as volume but not in direct proportion. Example is electricity or telephone charge of those days where there is a fixed element of charges and the variable element portion.

Cost Classification by Functions.

Cost classification by functions is not rigid but influenced by the business model of the organization.

Cost if classified by functions or activities in an organization is normally categorized into activities such as product cost, administration cost, distribution cost, Marketing and selling cost, finance cost, and research and development cost. Basically, it is grouped into the primary activities of the business.

Production Cost.

Production cost which is further subdivided into direct and indirect production cost involves all the costs relating to the production of goods and services. The direct production or manufacturing costs includes the three elements of prime cost: Direct material, direct labour and other direct expenses while the indirect production cost otherwise known as production overheads includes all costs not directly traceable to volume of production such as salaries of Supervisors, store expenses, Security expenses, Insurance etc.

Administration Cost.

Administration costs also known as administrative overhead are cost incurred in the general management of the business. They are usually indirect in nature and typical examples include salaries of staff in general management, Audit & legal fees, Rent, rates, taxes etc. these costs are not related to production but they are unavoidable in the overall administration

of the organization. It is always difficult to directly link the administrative costs to the profits of the organization hence organizations try to keep this cost as low as possible inspite the fact that it supports the primary activity of production.

Distribution Cost.

All the costs incurred in the distribution of products from the point of production to its customers are grouped under the distribution cost. Example include transportation cost, warehouse rents etc.

Marketing or Selling Cost.

This category of cost includes all kinds of expenses incurred to achieve marketing or sales of the product or services. This equally referred to as marketing or selling overheads. Examples include salaries of selling staff, Commission and discount, product market research etc.

Research and Development Cost.

These are cost incurred for the improvement of existing products or for the development of new products. This type of cost is always critical and unavoidable for the success of the organization. Failure to invest on research and development cost can force the organization to a halt due to technological developments.

M1.2.3. Cost Coding System.

A code is a system of symbols designed to be applied to a classified set of items, to give a brief accurate reference facilitating entry, collation and analysis Terry (2009).

Coding in accounting is simply the process of assigning numbers or letters to data. This is to aid a fast location of cost items in a database. Such codes are not universal as every accountant, or entities may create its own coding system in accounting to achieve its own organizational requirements.

CIMA defines coding as *“a system of symbols designed to be applied to a classified set of items, to give a brief accurate reference facilitating entry, collation and analysis”*.

Cost codes consist of numeric characters with a suitable account title. It is a series of *alphabetical or numerical* symbols each of which represents a particular labour, material or overhead cost item. Cost codes facilitate the classification and recording of costs for cost control purposes.

Codification of costs is therefore a system of assigning code numbers to each head, subhead and category of expense to facilitate the systematic and easy recording, accounting, summarization of cost data for ascertainment of cost, profitability and managerial decision making (Wikipedia).

Objectives of Cost Codification

There are different purposes/benefits of cost codification which includes:

1. It helps in apportionment of similar items of expenses on one suitable basis of apportionment.
2. Codification systematizes the recording and accounting of cost data and control of expenses.
3. it makes the application of computerized Cost Accounting a lot easier.
4. It enables automatic and prompt allocation, apportionment and absorption of costs to different cost units or cost centers.

Requirements of Efficient Coding System.

- a) The codes should be as brief as possible, taking into account the necessity of details of item.
- (b) As far as possible, all codes should be of same length. This helps in computerization of costs and location of errors.
- (c) The code should be comprehensive and elastic and should be capable of accommodating new items.
- (d) To minimize errors, the code should incorporate check digits so that computerized system can detect coding errors.
- (e) There should be a centralized authority in maintenance of coding system. Every individual should not be allowed to allocate code numbers.
- (f) The code should be unique and certain. Each item should have only one possible code number and should be able to be identified from the structure of code.

Features of a Good Coding System:

- i. Uniqueness: This implies that every item of cost must have one and only one symbol attached to it.
- ii. Distinctiveness: Every item should have its own peculiar code for the purpose of identification.
- iii. Clear Symbolization: There should be an effective coding system based on either numeric or alphabetic character. In most computer
- iv. Brevity: A good coding system must not be too lengthy i.e. every code must be short.
- v. Non-ambiguity: Every element of confusion and mix-up of items should be avoided.
- vi. Uniformity: Codes should be made to be of equal length and of the same structure in order to facilitate effective recognition.
- vii. Exhaustively. The code must be such that accommodates the full range of groupings as it exists and also be able to accommodate new items as they arise.
- viii. Mnemonic: Some of the familiar words could be derived from the descriptions given to certain items or activities that are to be used, such that the structure is not too lengthy.
- ix. It must be simple for the organization to use i.e simplicity
- x. It must be flexible in nature i.e. flexibility
- xi. It must be concise in nature.

M1.2.4. Installation of a Costing System

Installation of cost accounting system for an organization is usually independently done depending on cost information need of the entity. Basic factors to be considered while installing the system are as follows:

- i. Information needs: what level of information do the management need. Considering the fact that costing is expensive, it will be an economic waste if costing information that will not be required by the management is developed. It is therefore necessary that top management ought to specify the depth of their information need to aid the cost installation system.
- ii. Frequency of the information. It is equally important to determine how frequent certain information will be needed. This could then be embedded

into the costing system to be developed particularly if it is an on line-real time costing system.

Other factors necessary for consideration includes:

- i. The information needs of the management and the level of details needed.
- ii. The frequency of the information to be provided
- iii. The factory layout and production process, method of production and type of processes
- iv. The level of control to be exercised over production & cost centers'
- v. The nature of raw material and labour used in the process
- vi. The organization structure and degree of decentralization
- vii. The speed and accuracy in requirement of information
- viii. The information needs of different cost centres
- ix. The relative size of the cost units and cost centres.
- x. The level of integration of cost and financial accounts desired
- xi. The expenses of the costing should commensurate with the benefits of installation i.e cost versus benefits

Problems in the Installation of a Cost Accounting System.

b. Problems inherent in the installation of a Cost Accounting System:

- i. Size of the organisation
- ii. Type of product/service rendered
- iii. The production process
- iv. The methods of manufacturing
- v. Availability of staff
- vi. Definition of responsibility
- vii. Definition or designation of cost centres
- viii. Compilation of a comprehensive cost system
- ix. Labour hours worked
- x. Machine utilization time
- xi. Treatment of scrap products or materials
- xii. The difficulty of accurate classification of cost

Effectiveness of Cost Accounting System.

For the Cost Accounting System to be effective, the following are the principles that must be observed:

- i. The system must be appropriate to the organization and its processes or business.
- ii. Reports, statements and analyses produced by the system should contain relevant information for intended purpose;
- iii. Reports, statements and analyses should be produced at appropriate time for it to be relevant;
- iv. Reports should be addressed to the appropriate responsible persons who have the capacity to act on the subject matter of the report;
- v. Information generated from the system must be sufficiently accurate to make them reliable.
- vi. Reports should be so presented as to make them simple and understandable;
- vii. The benefits from generating information should outweigh the cost before such information is generated;