

# SCHOOL OF MANAGEMENT STUDIES

UNIT – I – COST ACCOUNTING AND BANKING – SBAA1308

# UNIT 1 INTRODUCTION TO COST ACCOUNTING

Cost Accounting – Meaning, Scope, Objectives - Advantages and Limitations – Difference between Cost Accounting and Financial Accounting – Elements of Cost – preparation of Cost Sheet.

# Introduction

Cost Accounting is a branch of accounting and has been developed due to limitations of financial accounting. Financial accounting is primarily concerned with record keeping directed towards the preparation of Profit and Loss Account and Balance Sheet. It provides information regarding the profit and loss that the business enterprise is making and also its financial position on a particular date. The financial accounting reports help the management to control in a general way the various functions of the business but it fails to give detailed reports on the efficiency of various divisions. The limitations of Financial Accounting which led to the development of cost accounting are as follows.

#### **1.1 Limitations of Financial Accounting**

1. No clear idea of operating efficiency: Sometimes profits in an organization may be less or more because of inflation or trade depression and not due to efficiency or inefficiency. But financial accounting does not give a clear reason for profit or loss.

2. Weakness not spotted out by collective results: Financial Accounting shows the net result of an organization. When the profit and loss account of an organization, shows less profit or a loss, it does not give the reason for it or it does not show where the weakness lies.

3. Does not help in fixing the price: In Financial Accounting, we get the total cost of production but it does not aid in determining prices of the products, services, production order and lines of products.

4. No classification of expense sand accounts: In Financial Accounting, we don't get data relating to costs incurred by departments, processes separately or per unit cost of product lines, or cost incurred in various sales territories. Further expenses are not classified as direct or indirect, controllable and uncontrollable overheads and the value added in each process is not reported.

5. No data for comparison and decision making: It does not supply useful data to management for comparison with previous period and for taking various financial decisions as introduction of

new products, replacement of labour by machines, price in normal or special circumstances, producing a part in the factory or buying it from outside market, production of a product to be continued or given up, priority accorded to different products, investment to be made in new products or not etc.

6. No control on cost: Financial Accounting does not help to control materials, supplies, wages, labour and overhead costs.

7. Does not provide standards to assess the performance: Financial Accounting does not help in developing standards to assess the performance of various persons departments. It also does not help in checking that costs do not exceed a reasonable limit for a given quantum of work of the requisite equality.

8. Provides only historical information: Financial Accounting records only the historical costs incurred. It does not provide day-to-day cost information to the management for making effective plans for the future.

#### 1.2 Features and Need of Accounting.

It is the Practice and body of knowledge concerned primarily with

- 1. methods for recording transactions,
- 2. Keeping financial records,
- 3. Performing internal audits,
- 4. reporting and analyzing financial information to the management, and
- 5. Advising on taxation matters.

It is a systematic process of identifying, recording, measuring, classifying, verifying, summarizing, interpreting and communicating financial information. It reveals profit or loss for a given period, and the value and nature of a firm's assets, liabilities and owners' equity.

Accounting provides information on the

- 1. resources available to a firm,
- 2. The means employed to finance those resources ,and
- 3. The results achieved through their use.

#### **1.3 Types of accounting**

1.Financial Accounting

- 2.Management Accounting
- 3.CostAccounting

#### **1.4 Cost Accounting**

It is the recording of all the costs incurred in a business in a way that can be used to improve its management.

Cost accounting is a type of accounting process that aims to capture a company's costs of production by assessing the input costs of each step of production as well as fixed costs such as depreciation of capital equipment. Cost accounting will first measure and record these costs individually, then compare input results to output or actual results to aid company management measuring financial performance.

#### **1.4 Definition:**

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Cost Accounting: Cost accounting is the method of accounting for cost. The I C W A defines Cost Accounting as the technique and process of ascertainment of costs. Cost accounting begins with the recording of all income and expenditure, and ends with the presentation of statistical data.

#### **Costing and Cost Accounting**

The costing terminology of C.I.M.A ., London defines costing as the "the techniques and processes of ascertaining costs". These techniques consist of principles and rules which govern the procedure of ascertaining cost of products or services. The techniques to be followed for the analysis of expenses and the processes by which such an analysis should be related to different products or services differ from industry to industry. These techniques are also dynamic and they change with time.

The main object of traditional cost accounts is the analysis of financial records, so as to subdivide expenditure and to allocate it carefully to selected cost centers, and hence to build up a total cost for the departments, processes or jobs or contracts of the undertaking. The extent to which the analysis of expenditure should be carried will depend upon the nature of business and degree of accuracy desired. The other important objective of costing are cost control and cost reduction.

Cost Accounting may be regarded as "a specialized branch of accounting which involves classification, accumulation, assignment and control of costs." The costing terminology of C.I.M.A, London defines cost accounting as "the process of accounting for costs from the point at which expenditure is incurred or committed to the establishment of its ultimate relationship with cost centers and cost units. In its widest usage, it embraces the preparation of statistical

data, the application of cost control methods and the ascertainment of profitability of activities carried out or planned".

We defines cost accounting as "classifying, recording and appropriate allocation of expenditure for determination of costs of products or services and for the presentation of suitably arranged data purposes of control and guidance of management". It is thus a formal mechanism by means of which costs of products or services are ascertained and controlled.

#### **1.5 Objectives of Cost Accounting**

Cost accounting aims at systematic recording of expenses and analysis of the same so as to ascertain the cost of each product manufactured or service rendered by an organization. Information regarding cost of each product or service would enable the management to know where to economize on costs, how to fix prices, how to maximize profits and so on. Thus, the main objectives of cost accounting are the following.

1. To analyse and classify all expenditure with reference to the cost of products and operations.

2. To arrive at the cost of production of every unit, job, operation, process, department or service and to develop cost standard.

3. To indicate to the management any inefficiencies and the extent of various forms of waste, whether of materials, time, expenses or in the use of machinery, equipment and tools. Analysis of the causes of unsatisfactory results may indicate remedial measures.

4. Toprovidedataforperiodicalprofitandlossaccountsandbalancesheetsatsuchintervals,

e.g. weekly, monthly or quarterly as may be desired by the management during the financial [School of Distance Education] Cost Accounting Page 8 year, not only for the whole business but also by departments or individual products. Also, to explain in detail the exact reasons for profit or loss revealed in total in the profit and loss accounts.

5. To reveal sources of economies in production having regard to methods, types of equipment, design, output and layout. Daily, Weekly, Monthly or Quarterly information may be necessary to ensure prompt constructive action.

6. To provide actual figures of costs for comparison with estimates and to serve as a guide for future estimates or quotations and to assist the management in their price fixing policy.

7. To show, where Standard Costs are prepared, what the cost of production ought to be and with which the actual costs which are eventually recorded may be compared.

8. To present comparative cost data for different periods and various volume of output and to provide guidance in the development of business. This is also helpful in budgetary control.

9. To record the relative production results of each unit of plant and machinery in use as a basis for examining its efficiency. A comparison with the performance of other types of machines may suggest the necessity for replacement.

10. To provide a perpetual inventory of stores and other materials so that interim Profit and Loss Account and Balance Sheet can be prepared without stock taking and checks on stores and adjustments are made at frequent intervals.

Also to provide the basis for production planning and for avoiding unnecessary wastages or losses of materials and stores. Last but not the least, to provide information to enable management to make short term decisions of various types, such as quotation of price to special customers or during a slump, make or buy decision, assigning priorities to various products, etc

## Difference between Cost Accounting and Financial Accounting-

Both financial accounting and cost accounting are concerned with systematic recording and presentation of financial data. Financial accounting reveals profits and losses of the business as a whole during a particular period, while cost accounting shows, by analysis and localization, the unit costs and profits and losses of different product lines. The main difference between financial accounting and cost accounting are summarized below.

1. Financial accounting aims at safeguarding the interests of the business and its proprietors and others connected with it. This is done by providing suitable information to various parties, such as shareholders or partners, present or prospective creditors etc. Cost accounting on the other hand, renders information for the guidance of the management for proper planning, operation, control and decision making.

2. Financial accounts are kept in such a way as to meet the requirements of the Companies Act, Income Tax Act and other statues. On the other hand cost accounts are generally kept voluntarily to meet the requirements of the management. But now the Companies Act has made it obligatory to keep cost records in some manufacturing industries.

3. Financial accounting emphasizes the measurement of profitability, while cost accounting aims at ascertainment of costs and accumulates data for this very purpose.

4. Financial accounts disclose the net profit and loss of the business as a whole, whereas cost accounts disclose profit or loss of each product, job or service. This enables the management to eliminate less profitable product lines and maximize the profits by concentrating on more

profitable ones.

5. Financial accounting provides operating results and financial position usually gives information through cost reports to the management as and when desired.

6. Financial accounts deal mainly with actual facts and figures, but cost accounts deal partly with facts and figures, but cost accounts deal with facts and figures and partly with estimates.

7.In case of financial accounts stress is on the ascertainment and exhibition of profits earned or losses incurred in the business. On account of this reason in financial accounts, the transactions are recorded, classified and analyzed in a subjective manner i.e. according to the nature of expenditure. In cost accounts the emphasis is more on aspects of planning and control and therefore transactions are recorded in an objective manner. Financial accounts are concerned with external transactions i.e. transactions between the business concern on one side and third parties on the other. These transactions form the basis for payment or receipt of cash. While cost accounts are concerned with internal transactions which do not form the basis of payment or receipt of cash.

8. The costs are reported in aggregate in financial accounts but costs are broken into unit basis in cost accounts.

9. Financial accounts do not provide information on the relative efficiencies of various workers, plants and machinery while cost accounts provide valuable information on the relative efficiencies of various plants and machinery.

10. In financial accounts stocks are valued at cost or market price whichever is less, whereas stocks are valued at cost price in cost accounts.

#### **1.6** Difference between Management Accounting and Cost Accounting.

#### Objective:

The objective of cost accounting is the ascertainment and control of costs of products or services. But the objective of management accounting is to help the management in the decision-making.

#### <u>Scope:</u>

Cost accounting deals with cost data. But management accounting deals with both cost and revenue. It includes financial accounting, cost accounting, budgeting, reporting to management and interpretation of financial data. Thus, the scope of management accounting is wider than that of cost accounting,

## Data used:

In cost accounting only those transactions, which can be expressed in figures are taken. But management accounting uses both quantitative and qualitative information.

#### <u>Nature:</u>

Cost accounting uses both Past and recent figures. But management accounting is concerned with the projection of figures as guidelines.

#### Parties:

The facts and data, provided by cost accounting, are Preferred by both internal as well as external parties whereas the furnished by management accounting is useful only the management . Cost Analysis

#### **1.7 Importance of Cost Accounting**

The limitations of financial accounting have made the management to realize the importance of cost accounting. Whatever may be the type of business, it involves expenditure on labour, materials and other items required for manufacturing and disposing of the product. The management has to avoid the possibility of waste at each stage. It has to ensure that no machine remains idle, efficient labour gets due incentive, by-products are properly utilized and costs are properly ascertained. Besides the management, the creditors and employees are also benefited in numerous ways by installation of a good costing system. Cost accounting increases the overall productivity of an organization and serves as an important tool, in bringing prosperity to the nation, thus, the importance of cost accounting can be discussed under the following headings:

a) Costing as an aid to management:-Cost accounting provides invaluable aid to management. It provides detailed costing information to the management to enable them to maintain effective control over stores and inventory, to increase efficiency of the organization and to check wastage and losses. It facilitates delegation of responsibility for important tasks and rating of employees. For all these the management should be capable of using the information provided by cost accounts in a proper way. The various advantages derived by the management from a good system of costing are as follows:

1.Cost accounting helps in periods of trade depression and trade competition. In periods of trade depression, the organization cannot afford to have wastages which pass unchecked. The management must know areas where economies may be sought, waste eliminated and efficiency increased. The organization must wage a war not only for its survival but also continued growth. The management should know the actual cost of their products before embarking on any scheme

of price reduction. Adequate system of costing facilitates this.

2. Cost accounting aids price fixation. Although the law of supply and demand determines the price of the product, cost to the producer does play an important role. The producer can take necessary guidance from his costing records in case he is in a position to fix or change the price charged.

3. Cost accounting helps in making estimates. Adequate costing records provide a reliable basis for making estimates and quoting tenders.

4. Cost accounting helps in channelizing production on right lines. Proper costing information makes it possible for the management to distinguish between profitable and non-profitable activities; profits can be maximized by concentrating on profitable operations and eliminating non-profitable ones.

5. Cost accounting eliminates wastages. As cost accounting is concerned with detailed breakup of costs, it is possible to check various forms of wastages or losses.

6. Cost accounting makes comparisons possible. Proper maintenance of costing records provides various costing data for comparisons which in turn helps the management in formulating future lines of action.

7. Cost accounting provides data for periodical Profit and Loss Account. Adequate costing records provide the management with such data as may be necessary for preparation of Profit and Loss Account and Balance Sheet at such intervals as may be desired by the management.

8. Cost accounting helps in determining and enhancing efficiency. Losses due to wastage of materials, idle time of workers, poor supervision etc will be disclosed if the various operations involved in the production are studied carefully. Efficiency can be measured, cost controlled and various steps can be taken to increase the efficiency.

9. Cost accounting helps in inventory control. Cost accounting furnishes control which management requires, in respect of stock of materials, work in progress and finished goods.

**b**) **Costing as an aid to Creditors**. Investors, banks and other money lending institutions have a stake in the success of the business concern are therefore benefitted immensely by the installation of an efficient system of costing. They can base their judgment about the profitability and future prospects of the enterprise on the costing records.

c) Costingasanaidtoemployees.Employeeshaveavitalinterestintheiremployer"senterprise in which they are employed. They are benefited by a number of ways by the installation of an efficient system of costing. They are benefited, through continuous employment and higher remuneration

by way of incentives, bonus plans, etc

d) Costing as an aid to National Economy An efficient system of costing brings prosperity to the business enterprise which in turn brings prosperity to the business enterprise which in turn results in stepping up of the government revenue. The overall economic development of a country takes place as a consequence of increase in efficiency of production.Control of costs, elimination of wastages and inefficiencies led to the progress of the industry and, in consequence of the nation as a whole.

#### **1.8 Classification of Cost**

Costs can be classified or grouped according to their common characteristics. Proper classification of costs is very important for identifying the costs with the cost centers or cost units. The same costs are classified according to different ways of costing depending upon the purpose to be achieved and requirements of a particular concern. The important ways of classification are:

**1.** By Nature or Elements. According to this classification the costs are classified into three categories i.e., Materials, Labour and Expenses. Materials can further be sub-classified as raw materials components, spare parts, consumable stores, packing materials etc. This helps in finding the total cost of production and the percentage of materials (labour or other expenses) constituted in the total cost. It also helps in valuation of work-in-progress.

**2** By Functions: This classification is on the basis of costs incurred in various functions of an organization ie. Production, administration, selling and distribution. According to this classification, costs are divided into Manufacturing and Production Costs and Commercial costs. Manufacturing and Production Costs are costs involved in manufacture, construction and fabrication of products. Commercial Costsare

(a) Administration costs

(b) Selling and distribution costs.

**3** By Degree of Traceability to the Product : According to this, costs are divided indirect costs and indirect costs. Direct Costs are those costs which are incurred for a particular product and can be identified with a particular cost center or cost unit. Eg:- Materials, Labour. Indirect Costs are those costs which are incurred for the benefit of a number of cost centre or cost units and cannot be conveniently identified with a particular cost center or cost center or cost unit. Eg:- Rent of Building, electricity charges, salary of staff etc.

**4** By Changes in Activity or Volume: According to this costs are classified according to their behavior in relation to changes in the level of activity or volume of production. They are fixed, variable and semi-variable. Fixed Costs are those costs which remain fixed in total amount with increase or decrease in the volume of the output or productive activity for a given period of time.

Fixed Costs per unit decreases as production increases and vice versa. Eg:- rent, insurance of factory building, factory manager's salary etc. Variable Costs are those costs which vary in direct proportion to the volume of output. These costs fluctuate in total but remain constant per unit as production activity changes. Eg:- direct material costs, direct labour costs, power, repairs etc. **Semi-variable Costs** are those which are partly fixed and partly variable. For example; Depreciation, for two shifts working the total depreciation may be only 50% more than that for single shift working. They may change with comparatively small changes in output but not in the same proportion.

**5 Association with the Product:** Cost can be classified as product costs and period costs. Product costs are those which are traceable to the product and included in inventory cost, thus product cost is full factory cost. Period costs are incurred on the basis of time such as rent, salaries etc. thus it includes all selling and administration costs. These costs are incurred for a period and are treated as expenses.

**6** By Controllability: The CIMA defines controllable cost as "a cost which can be influenced by the action of a specified member of an undertaking" and a non-controllable cost as "a cost which cannot be influenced by the action of a specified member of an undertaking".

**7.** By Normality: There are normal costs and abnormal costs. Normal costs are the costs which are normally incurred at a given level of output under normal conditions. Abnormal costs are costs incurred under abnormal conditions which are not normally incurred in the normal course of production .Eg:- damaged goods due to machine break down, extra expenses due to disruption of electricity, inefficiency of workers etc.

**8** By Relationship with Accounting Period: There are capital and revenue expenses depending on the length of the period for which it is incurred. The cost which is incurred in purchasing an asset either to earn income or increasing the earning capacity of the business is called capital cost, for example, the cost of a machine in a factory. Such cost is incurred at one point of time but the benefits accruing from it are spread over a number of accounting years. The cost which is incurred for maintaining an asset or running a business is revenue expenditure. Eg:- cost of materials, salary and wages paid, depreciation, repairs and maintenance, selling andistribution.

- 9. By Time..Costs can be classified as
- 1) Historical cost and
- 2) Predetermined Costs
- 3) The costs which are ascertained and recorded after it has been incurred is called historical costs. They are based on recorded facts hence they can be verified and are always supported by evidences. Predetermined costs are also known as estimated costs as they are computed in advance of production taking into consideration the previous periods "costs and the factors affecting such costs. Predetermined costs when calculated scientifically become standard costs. Standard costs are used to prepare budgets and then the actual cost incurred is later-on compared with such predetermined cost and the variance is studied for future correction.

#### 1.9 Types, Methods and Techniques of Costing

The general fundamental principles of ascertaining costs are the same in every system of cost accounting, but the methods of analysis and presenting the costs vary from industry to industry. Different methods are used because business enterprises vary in their nature and in the type of products or services they produce or render. Basically, there are two principal methods of costing, namely (i) Job Costing, and (ii) Process costing.

1. **Job costing**: It refers to a system of costing in which costs are ascertained in terms of specific jobs or orders which are not comparable with each other. Industries where this method of costing is generally applied are Printing Process, Automobile Garages, Repair Shops, Shipbuilding, House building, Engine and Machine construction, etc. Job Costing includes the following methods of costing:

(a) <u>*Contract Costing*</u>: Although contract costing does not differ in principle from job costing, it is convenient to treat contract cost accounts separately. The term is usually applied to the costing method adopted where large scale contracts at different sites are carried out, as in the case of building construction.

(b) <u>Bach Costing</u>: This method is also a type of job costing. A batch of similar products is regarded as one job and the cost of this complete batch is ascertained. It is then used to determine the unit cost of the articles produced. It should, however, be noted that the articles produced should not lose their identity in manufacturing operations.

(c) <u>*Terminal Costing*</u>: This method is also a type of job costing. This method emphasizes the essential nature of job costing, ie, the cost can be properly terminated at some point and related to a particular job.

(d) <u>Operation Costing</u>: This method is adopted when it is desired to ascertain the cost of carrying out an operation in a department, for example, welding. For large undertaking, it is frequently necessary to ascertain the cost of various operations.

2. **Process Costing**: Where a product passes through distinct stages or processes, the output of one process being the input of the subsequent process, it is frequently desired to ascertain the cost of each stage or process of production. This is known as process costing. This method is used where it is difficult to trace the item of prime cost to a particular order because its identity is lost in volume of continuous production. Process costing is generally adopted in textile industries, chemical industries, oil refineries, soap manufacturing, paper manufacturing, tanneries, etc.

3. <u>Unit or single or output or single output costing</u>: This method is used where a single article is produced or service is rendered by continuous manufacturing activity. The cost of the whole production cycle is ascertained as a process or series of processes and the cost per unit is arrived at by dividing the total cost by the number of units produced. The unit of costing is chosen according to the nature of the product. Cost statements or cost sheets are prepared under which various items of expenses are classified and the total expenditure is divided by total quantity produced in order to arrive at unit cost of production. This method is suitable in industries like brick-making, collieries, flour mills, cement manufacturing, etc. this method is useful for the assembly department in a factory producing a mechanical article eg.Bicycle.

4. **Operating Costing**: This method is applicable where services are rendered rather than goods produced. The procedure is same as in the case of single output costing. The total expenses of the operation are divided by the units and cost per unit of services is arrived at. This method is employed in Railways, Road Transport, Water supply undertakings, Telephone services, Electricity companies, Hospital services, Municipal services, etc.

5. <u>Multiple or Complete Costing</u>: Some products are so complex that no single system of costing is applicable. It is used where there are a variety of components separately produced and

subsequently assembled in a complex production. Total cost is ascertained by computing component costs which are collected by job or process costing and then aggregating the costs through use of the single or output costing system. This method is applicable to manufacturing concerns producing Motor Cars, Aeroplanes, Machine tools, Type-writers, Radios, Cycles, Sewing Machines, etc.

6. <u>Uniform Costing</u>: It is not a distinct method of costing by itself. It is the name given to a common system of costing followed by a number of firms in the same industry. This helps in comparing performance of one firm with that of another.

7. **Departmental Costing**: When costs are ascertained department by department, the method is called "Departmental Costing". Usually, for ascertaining the cost of various goods or services produced by the department, the total costs will have to be analyzed, say, by the use of job costing or unit costing.

In addition to the above methods of costing, mention can be made of the following techniques of costing which can be applied to any one of the above method of costing for special purposes of cost control and policymaking:

- a) Standard or Predetermined Costs.
- b) Margina lCosts

#### **1.10** Installation of Costing System

While installing a cost system, the cost accountant should consider the following factors:

(1) <u>Objectives of Costing System</u>: While installing a cost accounting system, it should be ensured that it will aid in ascertainment of cost, determination of selling price, cost control and cost reduction etc.

(2) <u>Nature of Business</u>: Cost Accounting system should be suited to the nature of products and business. The nature of product and business is essential to determine proper method of costing on the basis of types of product, methods and product life cycle, quantity, qualityetc.

(3) <u>Nature of Organization</u>: It is essential to examine existing organization structure of the company before introducing the costing system. Since the system is to be designed to suit the organization it is necessary to ascertain the layout, nature and size of the organization, scope of authority and responsibility.

(4) <u>Methods and Procedures:</u> Before introducing the costing system, the Cost

Accountant should carefully study the existing manufacturing procedures, processes, methods, system of wage payments, receipts and issue of materials. This will help him to select the proper method of costing.

(5) <u>Communication:</u> A good system of cost accounting will provide information which helps in decision making. Cost information should be made available promptly and regularly. It is necessary to examine the prompt reporting system.

(6) <u>Standardization</u>: The system should be introduced after a detailed study of the standardization. Standard Forms should be used in order to reduce clerical work to the minimum.

(7) <u>Simplicity</u>: The system to be adopted should be simple and easy to adopt to the changing requirement. The costing system should be capable of being understood by the operating personnel.

(8) <u>Co-operation</u>: There is need for co-operation and support of the various departments involved in the cost accounting process for being successfully implemented.

(9) <u>Reconciliation:</u> Emphasis should be on whether separate set of cost and financial books are required or an integrated system has to be followed. This depends upon the nature and size of the industry. Where cost books are maintained independently of financial records there must be provision for reconciliation between the cost and financial records.

## Practical Difficulties in Installing Costing System

The following are the practical difficulties confronted in installing a costing system : (1) Lack of top management support.

(2) Resistance from accounting departmental staff.(3) Non co-operation from user departments.

(4) Shortage of trained staff in costing department.

(5) Heavy cost of installing the system.

## Steps to Overcome Practical Difficulties

To overcome these difficulties, the steps required are given below:

(1) To sell the idea to top management to convince them of the utility of the system.

(2) Resistance and non co-operation can be overcome by behavioural approach to deal with the staff concerned effectively.

(3) Proper training should be given to the staff at each level.

(4) Regular meetings should beheld with the cost accounting staff, user departments staff and top management to clarify points.

## 1.11 Characteristics of an Ideal Costing System (or) Requisites' of good costing system

An ideal system of costing is that which achieves the objectives of a costing system and brings all advantages of costing to the business. Following are the main characteristics which an ideal system of costing should possess or the points which should be taken into consideration before installing a costing system.

## (i) Suitability to the Business:

A costing system should be tailor-made, practical and must be devised according to the nature, conditions, requirements and size of the business. Any system which serves the purposes of the business and supplies necessary information for running the business efficiently is an ideal system.

## (ii) Simplicity:

The system of costing should be simple and plain so that it may be easily understood even by a person of average intelligence. The facts, figures and other information"s provided by cost accounting must be presented in the right form at the right time to the right person in order to make it more meaningful.

# (iii) Flexibility:

The system of costing must be flexible so that it may be changed according to changed conditions and circumstances. The system without such flexibility will be outmoded because of fast changes in business and industry. Thus, the system must have the capacity of expansion or contraction without much change.

## (iv) Economical:

A costing system is like other economic goods. It costs money just like economic goods. If the system is too expensive, management may be unwilling to pay as buyers are not willing to pay for the goods if these are expensive as compared to their utility. A costing system should not be expensive and must be adapted according to the financial capacity of the business.

The benefits to be derived from the system must be more than its costs as management will be willing to install the system when it's perceived expected benefits exceed its perceived expected costs. In short, the system must be economical taking into consideration the requirements of the business. The cost of installing and operating the system should justify the results.

#### (v) Comparability:

The costing system must be such so that it may provide facts and figures necessary to management for evaluating the performance by comparing it with the past figures, or figures of other concerns or against the industry as a whole or other department of the same concern.

#### (vi) Capability of Presenting Information at the Desired Time:

The system must provide accurate and timely information so that it may be helpful to management for taking decisions and suitable action for the purpose of cost control.

(vii) Necessary cooperation and participation of executives from various departments of the concern is essential for development of a good system of cost accounting. Moreover, management should have faith in the costing system and should also provide a helping hand for its development and success.

(viii) The system of costing should not sacrifice the utility by introducing meticulous and unnecessary details.

(ix) A carefully phased programme should be prepared by using network analysis for the introduction of the system.

## (x) Minimum Changes in the Existing SetUp:

The existing system of delegation and division of authority and responsibility must not be disturbed with the costing system. As far as possible the system must be such so that it may least disturb the existing organisational set up.

#### (xi) Uniformity of Forms:

All forms and proformas etc necessary to the system should be uniform in size and quality of paper. Higher efficiency can be obtained by using colour of the paper to distinguish different forms. Printed forms should contain instructions as to their use and disposal. Forms should be suitably designed for collection and dissemination of cost data.

## (xii) Minimum Clerical Work:

The filling of the forms by foremen and workers should involve as little clerical work as possible as most of workers are not well educated. To ensure reliable statistics, every original entry should be supported by an examiner's signatures.

## (xiii) Efficient System of Material Control:

There should be an efficient system of stores and stock control as materials usually account for a greater proportion of the total cost. A good method of pricing material issued to production should be followed.

## (xiv) Adequate Wage Procedure:

There should be a well defined wage procedure for recording the time spent by workers on different jobs, for preparing the wage sheets and for the payment of wages. Thus the introduction of well defined wage system will help to control the cost of labour.

## (xv) Departmentalization of Expenses:

A sound plan should be devised for the collection, allocation, apportionment and absorption of overheads in order to ascertain the cost accurately.

# (xvi) Reconciliation of Cost Accounts and Financial Accounts:

If possible the Cost accounts and financial accounts should be interlocked into one integral accounting scheme. If this is not possible the systems should be so devised that the two sets of accounts are capable of easy reconciliation.

# (xvii) External Factors:

The installation of a costing system mainly depends on internal factors of a firm, but external factors may also affect the structure of the system. For example, cost accounting rules applicable to certain industries as notified by the Central Government require certain cost information to be developed and included in the books of accounts. Therefore, an ideal system of costing should take care of internal as well as external factors.

# (xviii) Duties and Responsibilities of the Cost Accountant:

Under a good system of cost accounting the duties and responsibilities of the cost accountant should be clearly defined. The cost accountant should have access to all works and departments

**1.12** Cost analysis (CA), sometimes called benefit–cost analysis (BCA), is a systematic approach to estimating the strengths and weaknesses of alternatives that satisfy transactions, activities or functional requirements for a business.

## **Importance of Cost analysis**

#### Evaluate Projects

A cost-benefit analysis is used to evaluate the risks and rewards of projects under consideration. It can be used to project the potential benefits of investing in marketing ideas, product development, infrastructure enhancements and operational changes. If all potential costs are tallied accurately and the benefits outweigh the costs, the considered investment may be a good choice.

## Prepare Budgets and Sales Projections

The information obtained during a cost-benefit analysis makes budgeting easier. If you have all the possible costs listed, you can project the budget needed to undertake the project. The anticipated benefits can also be used to project sales if they can be quantified into financial goals. Both of these considerations are useful when preparing budgets and sales projections.

## Prioritize Investments

Cost-benefit analysis is useful for business owners who must choose among several potential projects. After examining profitable projects for potential benefits, you can prioritize investments, choosing the projects with the greatest benefit and lowest cost to invest in first. In this way, you can achieve the fastest return on your investment and use remaining capital to fuel additional projects.

## Establish Goals

Once the benefits of possible projects are understood, they can be used to set benchmarks and goals for the project itself. Quantifiable benefits can be used to set concrete revenue goals. Other benefits can be used to set productivity, time or other management goals. Goals can be set for various types of projects, including marketing, finance, management and human resources.

#### 1.13 Cost center

According to Chartered Institute of Management Accountants, London, cost centre means "a location, person or item of equipment (or group of these) for which costs may be ascertained and used for the purpose of cost control". Cost centre is the smallest organizational sub- unit for which separate cost collection is attempted. Thus cost centre refers to one of the convenient unit into which the whole factory organization has been appropriately divided for costing purposes. Each such unit consists of a department or a sub-department or item of equipment or , machinery or a person or a group of persons.

For example, although an assembly department may be supervised by one foreman, it may contain several assembly lines. Some times each assembly line is regarded as a separate cost centre with its own assistant foreman.

The selection of suitable cost centers or cost units for which costs are to be ascertained in an undertaking depends upon a number of factors which are listed as follows.

- 1. Organization of the factory
- 2. Conditions of incidence of cost
- 3. Requirements of the costing system ie. Suitability of the units or centers for cost purposes.
- 4. Availability of information
- 5. Management policy regarding making a particular choice from several alternatives

**Cost units**- The Chartered Institute of Management Accountants, London, defines a unit of cost as "a unit of quantity of product, service or time in relation to which costs may be ascertained or expressed".

The forms of measurement used as cost units are usually the units of physical measurements like number, weight, area, length, value, time etc.

Following are some examples of cost unit.

#### Industry/product

Automobile Brickworks Cement Chemicals Steel Sugar Transport <u>Cost unitbasis</u> Numbers per 1000bricks perTonne Litre, gallon, kilogram,ton Tonne Tonne Passenger-kilometre, tonnekilometer

## 1.14 Profitcenter

A profit centre is that segment of activity of a business which is responsible for both revenue and expenses and discloses the profit of a particular segment of activity. Profit centers are created to delegate responsibility to individuals and measure their performance.

Difference between Profit centre and Cost centre

The various points of difference between Profit centre and cost centre are as follows. Cost centre is the smallest unit of activity or area of responsibility for which costs are collected whereas a profit centre is that segment of activity of a business which is responsible for both revenue and expenses.

(i) Cost centers are created for accounting conveniences of costs and their control whereas as a profit centre centre because of decentralization of operations i.e., to delegate responsibility to individuals who have greater knowledge of local conditions etc.

(ii) Cost centers are not autonomous whereas profit centers are autonomous.

(iii) A cost centre does not have target cost but efforts are made to minimize costs, but each profit centre has a profit target and enjoys authority to adopt such policies as are necessary to achieve it s targets.

(iv) There may be a number of cost centers in a profit centre in a profit centre as production or service cost centers or personal or impersonal but a profit centre may be a subsidiary company within a group or division in a company.

## 2. Cost Sheet

Cost sheet is a statement, which shows various components of total cost of a product. It classifies and analyses the components of cost of a product. Previous period's data is given in the cost sheet for comparative study. It is a statement which shows per unit cost in addition to Total Cost. Selling price is ascertained with the help of cost sheet. The detail of total cost presented in the form of a statement is termed as Cost sheet. Cost sheet is prepared on the basis of

- 1. Historical Cost
- 2. Estimated Cost.

## **Historical Cost**

Historical Cost sheet is prepared on the basis of actual cost incurred. A statement of cost prepared after incurring the actual cost is called Historical Cost Sheet.

## **Estimated Cost**

Estimated cost sheet is prepared on the basis of estimated cost. The statement prepared before the commencement of production is called estimated cost sheet. Such cost sheet is useful in quoting the tender price of a job or a contract.

## **Importance of Cost Sheet**

#### **Cost ascertainment**

The main objective of the cost sheet is to ascertain the cost of a product. Cost sheet helps in ascertainment of cost for the purpose of determining cost after they are incurred. It also helps to ascertain the actual cost or estimated cost of a Job.

## **Fixation of selling price**

To fix the selling price of a product or service, it is essential to prepare the cost sheet. It helps in fixing selling price of a product or service by providing detailed information of the cost.

## Help in cost control

For controlling the cost of a product it is necessary for every manufacturing unit to prepare a cost sheet. Estimated cost sheet helps in the control of material cost, labour cost and overheads cost at every point of production.

## **Facilitates managerial decisions**

It helps in taking important decisions by the management such as: whether to produce or buy a

component, what prices of goods are to be quoted in the tender, whether to retain or replace an existing machine etc.

#### **Elements of Cost**

The management of an organization needs necessary data to analyze and classify costs for proper control and for taking decisions for future course of action. Hence the total cost is analyzed by



elements of costs ie by the nature of expenses. The elements of costs are three and they are

By grouping the above elements of cost, the following divisions of cost are obtained.

1. Prime cost = Direct Materials + Direct Labour+ Direct Expenses

2. Works or Factory Cost = Prime Cost + Works or Factory Overheads

3. Cost of Production = Works Cost + Administration Overheads

4. Total Cost or Cost of Sales = Cost of Production + Selling and Distribution Overheads The difference between the cost of sales and selling price represents profit or loss.

**Working Problem 1**.Find the Prime Cost, Works Cost, Cost of production, total Cost and profit from the following:- Direct Materials Rs.20000; Direct Labour Rs. 10000; Factory Expenses Rs. 7000; Administration Expenses Rs. 5000; Selling Expenses Rs. 7000 and Sales Rs.60,000. Solution:

Prime Cost = Direct Materials + Direct Labour = Rs.20,000 + Rs.10,000 = Rs.30,000. Works Cost = Prime Cost + Factory Expenses = Rs.30,000 + Rs.7,000 = Rs.37,000. Cost of Production = Works Cost + Administration Expenses=Rs.37000+ Rs.5, 000 = Rs.42, 000. Total Cost or Cost of sales= Cost of Production + Selling Expenses = Rs.42, 000+ Rs.7, 000 = Rs.49, 000. Profit = Sales - Total Cost = Rs.60,000 - Rs.49,000=Rs.11, 000.

These terms can be explained as follows

1. **Direct Materials** are those materials which can be identified in the product and can be conveniently measured and directly charged to the product. For example, bricks in houses, wood in furniture etc. Hence all raw materials, materials purchased specifically for a job or process like glue for book making, parts or components purchased or produced like batteries for radios and tires for cycles, and primary packing materials are direct materials.

2. **Indirect Materials** are those materials which cannot be classified as direct materials. Examples are consumables like cotton waste, lubricants, brooms, rags, cleaning materials, materials for repairs and maintenance of fixed assets, high speed diesel used in power generators etc.

3.

4. **Direct Labour** is all labour expended in altering the construction, composition, confirmation or condition of the product. Thus direct wages means the wages of labour which can be conveniently identified or attributed wholly to a particular job, product or process or expended in converting raw materials into finished goods. Thus payment made to groups of labourers engaged in actual production, or carrying out of an operation or process, or supervision, maintenance, tools setting, transportation of materials, inspection, analysis direct labour.

5. **Direct Expenses** are expenses directly identified to a particular cost centre. Hence expenses incurred for a particular product, job, department etc are direct expenses. Example royalty, excise duty, hire charges of a specific plant and equipment, cost of any experimental work carried out especially for a particular job, travelling expenses incurred in connection with a particular contract or job etc.

6. **Overheads** may be defined as the aggregate of the cost of indirect materials, indirect labour and such other expenses including services as cannot conveniently be charged direct or specific cost units. Overheads may be sub-divided into (i) Manufacturing Overheads; (ii) Administration Overheads; (iii) Selling Overheads; (iv) Distribution Overheads; (v) Research and Development Overheads.

# **Types of Overheads**

According to functions, classification of overhead expenses may be done as follows:

# (i) Factory or Works Overhead

Factory or works overhead refers to all indirect expenses of a factory. It includes the following:

- □ Wages of all factory staff excluding those of direct workers
- Indirect material
- Rent for factory
- Rates for factory
- Taxes of factory
- Depreciation of factory assets
- E Excise duty
- Canteen expenses
- Labor welfare expenses

# (ii) Administration Overhead

It refers to all the expenses incurred in connection with general administration. In administrative building, following things are included:

- □ Salary of administrative staff
- Rent for office
- Rates for office
- Taxes of administrative accommodation
- Postage
- Telegram and telephone
- **Stationery**
- Lighting of administrative building
- Depreciation of office appliances

# (iii) Selling Overhead

Selling overhead refers to all expenses incurred in connection with sales. In selling overhead, following things are included:

- Salary of sales staff
- Traveler's commission
- Advertisement
- Rent for showroom

- Rates for showroom or sales shop
- Taxes of sales office
- Depreciation of sales office appliances
- Cost of participation in industrial fares and exhibitions
- Cost of free gifts
- Cost of free after sales service
- Normal bad debt

## (iv) Distribution Overhead

Distribution overhead refers to all the expenses incurred in connection with the delivery of a product after the sale is affected. In distribution overhead, following things are included:

- Delivery van expenses
- Fright and insurance
- □ Packing for delivery loading and unloading
- Salary of the deliverymen
- Customs duty

According to behavior, classification of overhead expenses may be done as follows:

## a. Variable Overhead

The overhead expenses that vary proportionately with the output are variable overhead.

## b. Semi-Variable or Semi-Fixed Overhead

The overhead expenses that vary with the output but not proportionately are semi- variable or semi-fixed overhead.

It should be always kept in mind that in this connection direct materials, direct wages and direct expenses are variable items of direct cost. Therefore, if we classify cost according to behavior, we get the following classification:

## a. Fixed Costs

Fixed costs include only those overhead expenses which remain fixed irrespective of the level of output. Some of the items of fixed costs are as follows:

- Rent and rate of building
- □ Salary of work mangers, administrative manager, sales managers
- Depreciation of buildings

## Insurance

## **b.** Variable costs

Variable costs include prime cost and variable overheads. These costs vary proportionately with the output. Some of the items of variable costs are as follows:

- Direct material
- Direct wages
- Direct expenses
- Consumable stores
- Power
- 🖸 Fuel

## c. Semi-Variable Costs

Semi-variable costs include overhead expenses that vary according to output but not proportionately, so these costs are partly fixed and partly variable. Some of the items of semi-variable costs are as follows:

- Normal repairs and maintenance of building and plant
- Salary of supervisors
- Charge men
- Foremen
- Service department expenses
- Depreciation of plant and machinery

Consider the element repairs. Normal repair is mostly fixed in nature because within a certain degree of capacity, utilization is beyond that degree. More frequent repairs will be necessary involving further cost. But still, such an increase in cost will not be proportionate to an increase in output. This is why the element is semi-fixed or semi-variable.

**Preparation of Cost sheet or Statement of Cost**: When costing information is set out in the form of a statement, it is called "Cost Sheet". It is usually adopted when there is only one main product and all costs almost are incurred for that product only. The information incorporated in a cost sheet would depend upon the requirement of management for the purpose of control.

Raw materials are converted into finished products by a manufacturing concern with the help of labor, plants etc. The elements that constitute the cost of manufacturing are known as

Direct material, direct labor and direct expenses are those which can be traced in relationship

with a particular process, job, operation or product. Indirect material, indirect labor and indirect expenses are those which are of general nature and cannot be traced in relationship with a particular process, operation, job or product.

# 2.2 Specimen of Cost Sheet

	Total Cost Rs	Cost per Unit Rs.
Direct Materials		xx
Direct Labour	XX	Х
Prime cost	х	XX
	XX	Х
Add: Works Overheads	Х	
	XXX	XXX
Works Cost		
	XXX	XXX
Add: Administrative Overheads	XXX	XXX
Cost of Production		
	xxx	xxx
Add: Selling and Distribution Overheads Total Cost or Cost of Sales	XXX	XXX
	xxx	ххх
	ххх	xxx

## Working Problem : 2

A manufacturer has shown an amount of Rs. 16190 in his books as "establishment" which includes the following expenses:

- Agents commission-- Rs.5750
- □ Warehouse wages-- Rs.1800
- Warehouse repairs-- Rs.510
- Lighting of office-- Rs.70
- Office salaries-- Rs.1130
- Director's remuneration-- Rs.1400
- Traveling expenses-- Rs.760
- Rent, rates and insurance of warehouse-- Rs.310
- Rent, rates and insurance of office-- Rs.230
- Lighting of warehouse-- Rs.270
- Printing and stationery-- Rs.1500
- Trade magazines-- Rs.70
- Donations-- Rs.150
- Bank charges-- Rs.100
- Discount allowed-- Rs.1970
- Bad debts-- Rs.170

From the above information, prepare a statement showing the following (in separate totals):

- Selling expenses
- Distribution expenses
- Administration expenses
- Expenses which you will exclude form total cost

# Solution:

Statement of Cost			
		Rs.	Rs.
Selling expenses:			
Agents' commission		5,750	
Traveling expenses		760	
Bad debts		170	
			6,680
Distribution expenses:			
Warehouse wages		1,800	
Warehouse repairs		510	
Rent, rates and insurance of warehouse		310	
Lighting of warehouse		270	
			2,890
Administration expenses:			
Lighting of office		70	
Office salaries		1.130	
Directors' remuneration		1.400	
Rent, rates and insurance of office		230	
Printing and stationery		1,500	
Trade magazines		70	
Bank charges		100	
			- 4,500
Total expenses to be considered in estimation costs			1,4,070
Expenses to be excluded form costs:			
Donations		150	
Discount allowed		1 970	2,120
	Total	1,770	1,6,190

# Working Problem: 3

ABC Ltd., a manufacturing company, incurred the following expenses during a certain period. You are required to prepare a statement showing the subdivision of total cost.

	Rs.		Rs.
Materials used on jobs	1,20,540	Depreciation of plant	3,800
Wages traceable to jobs	86,650	Depreciation of delivery vans	1,600
Wages paid to men for		Insurance on finished goods	2,500
maintenance work	1.26.00	Lubrication oil	250
Salaries of sales men	15 100	Bad debts	300
Directors' fees	10,000	Commission to salesmen	2,850
Carriage inwards on raw	10,000	Cost of idle time in factory	510
materials	860	Auditors fees	3,800
Carriage outwards	2 800	Dividends paid	6,800
Factory rent and rates	2,000 8 300	Lighting of showroom	1,500
Works salaries	20,400	Office salaries and expenses	7,000
Hire of crane for work	1 300	Income tax	8,600
Consumable stores	340		
	540		

# Solution:

## **Statement of Cost**

	Rs.	Rs.
Direct materials	120540	
Add: carriage inwards	860	121400
Direct wages		86650
Direct expenses (hire of crane for work )		1300
Prime Cost		209350
Works overhead		
Wages paid to men on maintenance work	12600	
Factory rent and rates	8300	
Works salaries	20400	
Consumable stores	340	
Depreciation of plant	3800	
Lubricating oil	250	
Cost of idle time in factory	510	46200
Works cost		255550
Administration overhead		
Directory fees	10000	
Auditors fees	3800	
Office salaries and expenses	7000	20800
Cost of production		276350
Selling and distribution overhead		
Salaries of salesmen	15100	

Carriage outwards	2800	
Depreciation of delivery vans	1600	
Insurance of finished goods	2500	
Commission to sales men	2850	
Lighting of showroom	1500	
Bad debts	300	26650
Total Cost		303000

# **Tender and Quotation**

It is usually refers to the process whereby governments and financial institutions invite bids for large projects that must be submitted within a finite deadline. The term also refers to the process whereby shareholders submit their shares or securities to a takeover offer.

## **Definition:**

A **quotation** is a document that offers to sell goods or services at a stated price, under specified conditions. **Quotations** are used to let a potential buyer know how many your goods or services will cost before committing to purchase them.

To invite bids for a project, or to accept a formal offer such as a takeover bid. **Tender** usually refers to the process whereby governments and financial institutions invite bids for large projects that must be submitted within a finite deadline.

In order to prepare the tender the following items to be analyzed

1.Raw materials,

2.Direct Labour3.Chargable expenses4.Work overheads

5.Office overheads

6.Selling overheads

7.Estimatedprofit

# **PREPARTION OF A PRICE LIST**

Most businesses will need to draw up a price list at some stage. If you sell a fixed range of products, this may be the only form of pricing you need. This type of standard price list can also be used as the basis for pricing your non-standard orders.

It's a good idea to **date your price lists** - particularly if your customer is likely to keep it for a long time. You should make it clear when any special offers expire. It can also be useful to include a clause at the end of the price list stating that prices are subject to change.

We should make clear whether any **delivery**, **packing** or **postage** costs are included in your prices. Additionally, although you don't have to indicate discounts for bulk purchases on your price list, it might attract more business.

We may be able to use **software** packages such as Sage Simply Accounting to help you draw up complex price lists.

# THE DIFFERENCE BETWEEN A QUOTATION AND AN ESTIMATE

It's impossible for some businesses to give standard prices for goods and services. This may be because the skills, time and materials required for each job vary depending on different customers' needs.

This situation is more common in some trades than others - decorators or builders, for example, rarely do exactly the same job twice. When it's not possible to work from a standard price list, you have to give a quotation or an estimate instead.

A **quotation** is a fixed price offer that can't be changed once accepted by the customer. This holds true even if you have to carry out much more work than you expected.

An **estimate** is an educated guess at what a job may cost - but it isn't binding. To take account of possible unforeseen developments, you should provide several estimates based on various circumstances, including the worst-case scenario. This will prevent your customer from being surprised by the costs.

# PREPARATION OF A WRITTEN ESTIMATE

When you prepare an estimate it's good practice to give the customer a **written copy**, including a full **breakdown** of costs.

Our estimate should include the:

- Overall price
- Breakdown, listing the components of the price, schedule, detailing when work will be done or products delivered
- Terms and conditions
- Time period the estimate is valid for

• Payment terms or schedule

We must include our full business contact details in our estimates. If we have letterhead, it's a good idea to put our estimates on this.

Include a disclaimer stating clearly that the estimate's price is **subject to change**. Agree in advance how any variations will be costed. These can arise if the client changes their requirements or if a job turns out to be more complicated than expected.

# PREPARATION OF A WRITTEN QUOTATION

Quotations commit you to the price you specify, so they are usually used when:

• The work you're quoting for has clear requirements - in terms of time, labour, materials, etc. our costs are stable and our confident in the work won't turn out to be more complicated than expected.

It's good practice to give your customers a **written quotation**. This should include the:

- Overall price
- Breakdown of the components of the price, indicating what is covered and what is not
- Period the quotation is valid for
- Schedule for when the work will be done or products delivered
- Full contact details of your business
- Payment terms or schedule

It's also advisable to get your customer's **written confirmation** that they're happy with the price you have quoted and the work that this includes. This should be done before you carry out the work, or provide the goods or services.

Computer **software** can be used to help you determine the costs involved in any work for which you're drawing up a quotation. Many accounting and spreadsheet packages can be used for this.

# Process of Inviting or preparing aTender

Invitations to tender should normally consist of the following sections; it will however depend upon the complexity of the requirement.

Part 1 - Defines the contract, giving details of timescales for commencement and completion

Part 2 - Contains the "Conditions of Contract" wherein the commercial details are explained in simple language; where appropriate the draft contract can be included.

Part 3 - Should be a pricing schedule

Part 4 - Will give details of the scope of the work or services or the quantity and frequency of requirements of goods or services to be supplied.

Part 5 - Depending on the size of the contract, should highlight all procedural requirements, such as third party inspection, variations if any, the communication route and names of people involved in discharging contractual requirements and so on.

Part 6 - The specification; if a "Technical" specification this should give full details of the work, supply or service to be undertaken; current preference is for this to be a "performance" or "functional" specification, which allows freedom of choice to the bidder as to how best to meet the requirement.

Part 7 - Any drawings and/or plans required to allow bidders to ensure their offered goods or service comply, not only to the specification, but also to those drawings originally issued as part of the Technical Specification.

Part 8 - Should contain details of free issue goods, if any, and the arrangement for such free issue.

Part 9 - Gives details of submission of bids, such as time and precise location, that late bids will not be accepted, the date of bid opening and whether it will be open or closed. Open bidding is where all bidders have the option of being present to view and note total prices submitted by all bidders. Often used overseas as a means of avoiding accusations of corrupt practices as only those bids opened, registered, and with their total cost announced, will be considered in the evaluation process. Where appropriate, information should be included on the tender evaluation methods that should be adopted.

Part 10 - Will detail the terms and conditions anticipated in any resultant contract, so that bidders may take any "special" conditions into consideration when compiling their tender. All invitations to tender for a specific product or service must be identical onissue.

# **Tender opening**

The Tender Board can be a standing group. It might consist of a board member as chairman, the purchasing director, probably a technical expert, and a non-aligned person to act as secretary.

To ensure equality of treatment of all tenders, the Tender Board meets on the nominated day, at the nominated time, in a location suitable to accommodate all interested parties, if a public opening. If not, in a closed office. All bids are date and time stamped and recorded, with total costs noted.

Late tenders or bids should preferably not be opened but should be date and time stamped and returned to the bidder with a letter of explanation. It may be that in some companies ALL tenders

are opened and those which were late, annotated as such, and kept separate from valid bids, submitted within the timescale stipulated.

# **Tender evaluation**

The bid analysis team, as identified in the introduction to this guide (as the Procurement Project Team), have now to assess all components of all bids. Firstly to ensure the bid is compliant, and that all parts are complete, then to compare and assess all parts, to identify the best value for money bid overall. It is most important to ensure that the necessary skills are included in the team. For example, a financial expert, a technical expert, a purchasing expert and, if necessary, a commercial or legal expert.

The process must follow a defined pattern to which all participants subscribe, to ensure all bids are dealt with in exactly the same way. The methods for comparison have to be fair, thorough and demonstrably so, should inspection take place.

# **Components of a tender**

The following is a check list of some of the aspects which, depending on the nature of the requirement, might need to be considered for inclusion in an invitation to tender:

- The scope and/or functions of the work or service required
- The output required
- The quality expected
- Estimated maintenance requirements when appropriate
- The number or amount
- Any standards required to be achieved, or applied
- Timescales start date required
- Finish date if "time is of the essence"
- A schedule of deliveries
- Any inspection required and at what stages
- Details of free issue materials
- Accommodation details for installation
- Insurance cover required for contractors
- Costs in use of components or complete product where appropriate
- Response times
- Details of measurement of the work

# **Reconciliation of Cost and Financial Accounts**

## Meaning

In business concern where Non-integrated Accounting System is followed. cost and financial accounts are maintained separately, the difference between the end result of these two are required to be reconciled. Reconciliation of cost and financial accounts mean tallying the profit or loss revealed by both set of accounts. The chief aim is to find out the reasons for the difference between the results shown by Cost Accounts and Financial Accounts.

## **Reasons for the Difference**

The various reasons which create difference between cost and financial profit or loss shown by the two set of books may be listed under the following heads:

- (1) Items shown only in Financial Accounts
- (2) Items shown only in Cost Accounts
- (3) Absorption of Overheads
- (4) Methods of Stock Valuation
- (5) Abnormal Loss and Gains

(1) Items shown only in Financial Accounts: Some items of income and expenses which are included only in financial accounts but are not shown in cost accounts and vice versa. The following items are shown in financial accounts but not in cost accounts:

## (A) Income:

- (1) Profit on sale of fixed assets
- (2) Interest received on investment
- (3) Dividend received on investment
- (4) Rent, brokerage and commission received
- (5) Premium on issue of shares
- (6) Transfer fees received.

#### (B). Expenditure:

- (1) Loss on sale of fixed assets, e.g., Plant, Machinery, Building
- (2) Interest paid
- (3) Discount paid
- (4) Dividend paid
- (5) Losses due to scrapping of plant and machinery
- (6) Penalties and fines
- (7) Expenses of shares' transfer fees
- (8) Preliminary expenses written off
- (9) Damages payable at law.

(2) Items shown only in Cost Accounts: There are some items which are recorded only in Cost Accounts but are not included in financial accounts, national interest on capital, notional rent of premises owned, salary to proprietor etc. are not recorded in financial account because the amount is not actually spent or paid. These expenses reduced the profit in cost account while in financial account it may be the reverse effect.

(3) Absorption of Overheads : In financial accounts actual amount of expenses paid are recorded while in cost accounts overheads are charged at predetermined rates. If overhead charged are not equal to the amount of overhead incurred the under or over absorption of overhead leads to difference in profits of two accounts.

(4) Methods of Stock Valuation: The term stock refers to opening or closing stock of raw materials, work in progress and finished goods. In financial accounts stocks are valued at cost price or market price whichever is lower. In Cost Account; stock of raw materials can be valued on the basis of FIFO, LIFO and Simple Average Method etc., and work in progress may be valued at Prime Cost or Work Cost. Finished stocks are generally valued on the basis of cost of production. Thus, the adaptation of different method of valuation of stock leads to difference in profits of two sets of accounts.

(5) Abnormal Losses and Gains: Different items of abnormal wastages, losses or gains which are included in financial accounts but are not recorded in cost accounts. Thus, the figures of abnormal losses and gains may affect the results in financial accounts alone.

### **Importance of Reconciliation**

Reconciliation of cost and financial a c c o u n t is necessary f o r the following reasons:

- (1) To ensure arithmetical accuracy of both set of accounts for effective cost ascertainment and cost control.
- (2) To identify t he reasons for different r esults .
- (3) To evaluate the reasons f o r variations
- (4)To enable the smooth co-operation and co-ordination between the activities of cost and financial accounting departments.
- (5) To ensure the standardization of policies relating to stock valuation, depreciation and absorption of overheads.

Format of Reconciliation	n Statement
--------------------------	-------------

Particulars	Amt.Rs.	Amt.
Profit/Loss as per Cost Sheet (A)		XXXX
ADD: (I) Financial Income which are ignored in Cost		
Account		
Interest received	XXXX	
Dividend received	XXXX	
Share transfer fee	XXXX	
Rent received	XXXX	
Profit of asset sold	XXXX	
(II) Over valuation of Overhead Expenses in Cost Account		
Factory overheads	XXXX	
Administrative overheads	XXXX	
Selling & Distribution overheads	XXXX	
(III) Over valuation of closing stock in Cost Account(B)	XXXX	XXXX
Grand Total (A+B)=C		XXXX
LESS : (I) Financial expenditure which are ignored in Cost Acc.		
Income Tax	XXXX	
Penalty	XXXX	
Donation	XXXX	
Goodwill written off	XXXX	
Preliminary expenses written off	XXXX	
Debenture discount written off	XXXX	
Bad debt reserve	XXXX	
Loss of Assets sold	XXXX	
(II) Under valuation of overhead expenses in Cost Account		
Factory overheads	XXXX	
Administrative overheads	XXXX	
Selling & Distribution overheads	XXXX	
(III) Under valuation of closing stock in Cost Account (D)	XXXX	XXXX
Profit/Loss as per Financial Account(C-D)		XXXX

# Working problem: 4

From the following particulars, prepare a Cost Sheet showing (1) Cost of Materials Consumed (2) Prime Cost (3) Factory Cost (4) Cost of Production and (5)Profit

Opening stock of raw materials	20,000
Opening stock of work in progress	10,000
Opening stock of finished goods	50,000
Raw materials purchased	5,00,000

Direct wages	3,80,000
Sales for the year	12,00,000
Closing stock of raw materials	75,000
Closing stock of work in progress	15,000
Factory overhead	80,000
Direct expenses	50,000
Office and Administrative overhead	60,000
Selling and Distribution expenses	30,000

Solution:

Opening Stock of Raw Materials	20,000	
Purchases	5,00,000	
	5,20,000	
Less : Closing Stock of Raw Materials	75,000	
Cost of Raw Materials Consumed (1)		4,45,000
Add : Direct Wages	3,80,000	
Direct Expenses	50,000	4,30,000
Prime Cost (2)		8,75,000
Add : Factory overheads	80,000	
Add: Opening stock of work in progress	10,000	
	90,000	
Less: Closing stock of Work in Progress	15 000	75 000
Less. Clusing slock of Work in Frugress	15,000	75,000
	13,000	75,000
Works Cost (or) Factory Cost (3)	13,000	9,50,000
Works Cost (or) Factory Cost (3)     Add: Office & Administrative Overhead	13,000	<b>9,50,000</b> 60,000
Works Cost (or) Factory Cost (3)     Add: Office & Administrative Overhead     Cost of Production (4)	13,000	9,50,000 60,000 10,10,000
Works Cost (or) Factory Cost (3)     Add: Office & Administrative Overhead     Cost of Production (4)     Add: Opening Stock of Finished Goods		<b>9,50,000</b> 60,000 <b>10,10,000</b> 50,000
Works Cost (or) Factory Cost (3)     Add: Office & Administrative Overhead     Cost of Production (4)     Add: Opening Stock of Finished Goods		<b>9,50,000</b> 60,000 <b>10,10,000</b> 50,000 <b>10,60,000</b>
Works Cost (or) Factory Cost (3)     Add: Office & Administrative Overhead     Cost of Production (4)     Add: Opening Stock of Finished Goods     Less: Closing Stock of Finished Goods		<b>9,50,000</b> 60,000 <b>10,10,000</b> 50,000 <b>10,60,000</b> 50,000
Works Cost (or) Factory Cost (3)     Add: Office & Administrative Overhead     Cost of Production (4)     Add: Opening Stock of Finished Goods     Less: Closing Stock of Finished Goods     Cost of Goods Sold (5)		9,50,000 60,000 10,10,000 50,000 10,60,000 50,000 10,10,000
Works Cost (or) Factory Cost (3)     Add: Office & Administrative Overhead     Cost of Production (4)     Add: Opening Stock of Finished Goods     Less: Closing Stock of Finished Goods     Cost of Goods Sold (5)     Add : Selling and Distribution Overhead		<b>9,50,000</b> 60,000 <b>10,10,000</b> 50,000 <b>10,60,000</b> 50,000 <b>10,10,000</b> 30,000
Works Cost (or) Factory Cost (3)     Add: Office & Administrative Overhead     Cost of Production (4)     Add: Opening Stock of Finished Goods     Less: Closing Stock of Finished Goods     Cost of Goods Sold (5)     Add : Selling and Distribution Overhead     Cost of Sales (6)		9,50,000 60,000 10,10,000 50,000 10,60,000 50,000 10,10,000 30,000 10,40,000
Works Cost (or) Factory Cost (3)     Add: Office & Administrative Overhead     Cost of Production (4)     Add: Opening Stock of Finished Goods     Less: Closing Stock of Finished Goods     Cost of Goods Sold (5)     Add : Selling and Distribution Overhead     Cost of Sales (6)     Profit (7)		9,50,000 60,000 10,10,000 50,000 10,60,000 10,10,000 30,000 10,40,000 1,60,000

# **Methods of Reconciliation**

For reconciling the profit or loss as disclosed by the financial accounting with that shown by the cost accounting. A Reconciliation Statement or Memorandum of Reconciliation Account is prepared.

The following steps have to be taken for preparation of Reconciliation Statement :

- (I) Ascertain the extent of difference between the profit or loss disclosed by two set of book of accounts.
- (2) Take the base profit or loss as per any set of books (either cost or financial) of accounts as the starting point.
- (3) Prepare a statement by making suitable adjustment of items either added or subtracted included in one set of accounts but not in the other set.
- (4) In other words. balances as per cost account has been taken as the starting point, then balance as per financial account is to be adjusted according to the transaction recorded in the financial accounts and vice versa.

## **Book References:**

1. Jain. S.P, Narang , K.L&Simmi Agarwal, (2011) , Cost Accounting (2nd Ed.) Delhi, India, Kalyani Publishes.

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# SCHOOL OF MANAGEMENT STUDIES

UNIT – II – COST ACCOUNTING AND BANKING – SBAA1308

#### **UNIT 2 MATERIAL COST**

Material cost – Purchase Procedure – Material controlling techniques – Economic Order Quantity – Stores Ledger – Pricing of Issues – FIFO, LIFO, Simple Average and Weighted Average Methods

## Meaning of Materials

Materials cost is one of the important element s of cost of product or unit. It constitutes a substantial proportion of the total cost of production. For material cost control purposes, it is very essential to know the important aspects of material, material control and material purchase control.

**Materials:** The term ' materials' refers to all commodities or components which are consumed in the process of manufacture. The materials m a y be classified into Direct Materials and Indirect Materials.

**Direct Materials :**Direct Materials for m part of the finished products. They can be easily identified with a particular cost unit. For example, cotton used in textile mills, timber used in furniture industries.

**Indirect Materials :** Indirect materials indirectly used for conversion from raw materials into finished p r o d u c t s . They cannot be easily identified with a particular cost unit. For example, spare parts, tools, nails, lubrications etc.

Materials are further classified on the basis of the nature which have to be used such as:

- (a) Raw Materials, e.g., rubber, timber, steeletc.
- (b) Components, e.g., instruments
- (c) Consumable stores, e.g., cottonwaste, brushes
- (d) Maintenance Materials, e.g., spare parts
- (e) Tools, e.g., jigs and fixtures

#### Materials Control

Materials control may be defined as the systematic control over the procurement, storage and usage of materials so as to maintain an even flow of materials and at the same time avoiding excessive investment in inventories.

From the above definition we can derive the following important **Objectives:** 

- (1) To ensure the smooth flow of production with out interruptions.
- (2) Prevention of excessive investments in materials stock.

## **Functions of Materials Control**

- 1. Purchasing of Materials
- 2. Receiving of Materials
- 3. Inspection of Materials
- 4. Storage of Materials
- 5. Issue of Materials
- 6. Maintenance of Stores Records
- 7. Stock Audit.

## **Methods of Purchasing**

Purchasing can be broadly classified as centralized and localized purchasing.

(a) <u>*Centralized Purchasing*</u>: In a large organization, manufacturing units are many. In such cases centralized purchasing is beneficial. The advantages of centralized purchasing are:

- 1. Specialized and expert knowledge is available.
- 2. Advantages arise due to bulk purchases
- 3. The cost of purchasing can be reduced and selling price can be lowered.
- 4. As there is good knowledge of market conditions, greater control can be exercised.
- 5. When materials have to be imported, it is advantageous to centralize the buying.
- 6. Economy and ease in compilation and consultation of results.
- 7. It can take advantage of market changes.
- 8. Investment in inventories can be reduced.

9. Other advantages include undivided responsibility, consistent buying policies.

Factors to be considered when decision regarding centralization has to be taken are geographical separation of plants, homogeneity of products, type of material bought, location of supplies etc.

(b) *Decentralization of Purchases:* The advantages of localized purchasing or decentralization of purchases are:-

- 1. Each plant may have its own particular need. This can be given special attention.
- 2. Direct contact can be established with suppliers.
- 3. The time lag between indenting and receiving materials can be reduced.
- 4. Technical requirements of each plant can be ascertained

### **Advantages of Materials Control**

- (1) It ensures continuous flow of production.
- (2) There is maximum utilization of stores resources.
- (3) It facilitates economy of buying.
- (4) It ensures optimum investments in inventories.
- (5) There is possibility of reduction of loss of theft, leakage, obsolescence etc.
- (6) It minimizes cost of materials during purchase, storage and issue of materials.
- (7) It facilitates effective information system to management.

#### **Materials Purchase Control**

Materials Purchase is one of the important functions of stores department. The basic objectives of the material purchasing is to ensure continuous supply of raw materials to production and maximum reduction of cost product. In other words, the chief aim of purchasing is to ensure, not only to procure the raw materials at the lowest price but to reduce the cost of the finished product. In order to achieve the above said objectives the following aspects and procedure should be adapted:

#### **Organization of Purchasing**

Materials may be purchased based on the size of the concern ,nature of materials to be used, nature of operations a n d management polices etc. A large company will have a separate purchase department while a small firm on the other hand may have all functions including purchasing, carried out by the owner himself. Materials maybe purchased through Centralized Organization or Decentralized Organization.

#### **Qualities of the Purchasing Manager**

(1) **Integrity:** Personal integrity is the important quality of the purchase manager because purchasing involves huge sums of company money.

(2) **Dependability:** He must have this personality trait because continuous operations d e p e n d on the reliability of the supplies.

- (3) **Initiative:** He must have the ability of initiative to continuous search for alternative sources of supply or alternative materials.
- (4) **Co-operation:** Purchasing Manager must possess an unusual ability y to co- operate.

(5) **Tact:** To maintain a sound and friendly relationship with suppliers is considered to be an important characteristic of the purchasing manager.

(6) Ability to Learn: A Purchasing personnel must have an inquiring mind. He must always be seeking information about company's products, materials and process.

(7) Ability to Work on Details: He must have ability to work on details even though it is routine In nature.

(8) He must have the technical knowledge of materials and sources acquired.

## Need and essentials of material control

1. Proper co-ordination of all departments involved viz., finance, purchasing, receiving, inspection, storage, accounting and payment.

2. Determining purchase procedure to see that purchases are made, after making suitable enquiries, at the most favorable terms to the firm.

3. Use of standard forms for placing the order, noting receipt of goods, authorizing issue of the materials etc.

4. Preparation of budgets concerning materials, supplies and equipment to ensure economy in purchasing and use of materials.

5. Operation of a system of internal check so that all transactions involving materials, supplies and equipment purchases are properly approved and automatically checked.

6. Storage of all materials and supplies in a well designated location with proper safeguards.

7. Operation of a system of perpetual inventory together with continuous stock checking so that it is possible to determine at any time the amount and value of each kind of material in stock.

8. Operation of a system of stores control and issue so that there will be delivery of materials upon requisition to departments in the right amount at the time they are needed.

9. Development of system of controlling accounts and subsidiary records which exhibit summary and detailed material costs at the stage of material receipt and consumption.

# **Economic Ordering Quantity**

Economic order quantity (EOQ) is the ideal order quantity a company should purchase to minimize inventory costs such as holding costs, shortage costs, and order costs. This production-scheduling model was developed in 1913 by Ford W. Harris and has been refined over time.<sup>1</sup>

The formula assumes that demand, ordering, and holding costs all remain constant.

# Formula : EOQ= 2AB/CS

Whereas EOQ = Economic order quantity,

А	=	Annual Consumption usage of materials in units
В	=	Buying cost per order
С	=	Cost per unit
S	=	Storage cost and carrying cost percentage per annum.

*Carrying cost:* it is the cost of holding the materials in the store and includes:

- 1. Cost of storage pace which could have been utilized for some other purpose.
- 2. Cost of bins and racks
- 3. Cost of maintaining the materials to avoid deterioration.
- 4. Amount of interest pay able on the amount of money locked up in the materials.
- 5. Cos to spoilage in stores and handling.
- 6. Transportation cost in relation to stock.
- 7. Cost of obsolescence of materials due to change in process or product.
- 8. Insurance cost
- 9. Clerical cost etc.

*Ordering cost:* it is the cost of placing orders for the purchase of materials and includes:

- 1. Cost of staff posted in the purchasing department, inspection section and stores accounts department.
- 2. Cost of stationary postage and telephone charges.

# c) Minimum Level or Safety Stock level

The minimum level is the minimum quantity of the material which must be maintained in hand at all times. The quantity is fixed so that the production is not held up due to shortage of the materials. In fixing this level, the following factors should be considered:

- 1. Lead time i.e. time lag between indenting and receiving of the material. It is the time required to replenish the supply.
- 2. Rate of consumption of the material during the lead time.

3. Nature of the material. Minimum level is not required in case of a special material which is required against customer's specific order.

Formula for calculating minimum level or safety stock level given by Wheldon is as follows: Minimum Stock Level = Re-ordering level – (Normal consumption x Normal e-order period)

#### d) Maximum Level

It is the maximum of stock which should be held in stock at any time during the year. The quantity is fixed so as to avoid overstocking as it leads to the following disadvantages.

- 1. Overstocking leads to increase in working capital requirement which could be profitable used some where else.
- 2. Overstocking will need more go down space, so more rent will have to be paid.
- 3. It may also lead to obsolescence on account of over stocking.
- 4. There are chances that the quality of materials will deteriorate because large stock will require more time before they are consumed.

5. There may be fear of depreciation in market values of the over stocked materials. According to Wheldon,

Maximum Stock level = Reordering level + Re-ordering Quantity– (Minimum consumption x Minimum reordering period)

#### e) Danger Level

This level means that level of stock at which normal issues of the material are stopped and issues are made only under specific instructions. The purchase officer will make special arrangements to get the materials which reach at their danger levels so that the production may not stop due to shortage of materials.

Danger Level = Average consumption x Max.re-order period for emergency purchases.

# f) Average Stock Level

The average stock level is calculated by the following formula: Average Stock Level = Minimum Stock Level + ½ of Re-order Quantity. Or ½ (Minimum Stock Level + Maximum Stock Level)

## **Inventory Control and its technique**

- Economic order quantity
- ABC analysis
- VED analysis
- Perpetual inventory system
- Just in time(JIT)
- FNSD analysis
- Automatic ordering system
- Ordering cycle method
- Min-max method
- Inventory turn over ratio
- Input-Output ratio analysis
- Inventory cost reports

# The ABC Analysis

In materials management, **ABC analysis** is an inventory categorization technique. ... The **ABC analysis** suggests that inventories of an organization are not of equal value. Thus, the inventory is grouped into three categories (A, B, and C) in order of their estimated importance.

ABC analysis may be seen to share similar ideas as the Pareto principle, which states that 80% of overall consumption value comes from only 20% of items. Plainly, it means that 20% of your products will bring in 80% of your revenues.

ABC analysis works by breaking it down in the following ways:

- A-items: 20% of all goods contribute to 70-80% of the annual consumption value of the items
- B-items: 30% of all goods contribute to 15-25% of the annual consumption value of the items
- C-items: 50% of all goods contribute only 5% of the annual consumption value of the items

In order to calculate the annual consumption value of any item or items:

Annual consumption value = annual demand x item cost per unit

#### The VED Analysis

The VED criticality analysis of all the listed items was performed by classifying the items into vital (V), essential (E) and desirable (D) categories. The items critically needed for the survival of the patients and those that must be available at all times were included in the V category. The items with a lower criticality need and those that may be available in the hospital were included in the E group. The remaining items with lowest criticality, the shortage of which would not be detrimental to the health of the patients, were included in the D group. The VED status of each item was discussed with justification by a group comprising of physician, surgeon, pediatrician and pharmacist.

### **Material costing**

Material costing is the process of determining the costs at which inventory items are recorded into stock, as well as their subsequent valuation in the accounting records. We deal with these concept separately.

# JUST IN TIME (JIT)

Just-in-time (JIT) is an inventory strategy companies employ to increase efficiency and decrease waste by receiving goods only as they are needed in the production process, thereby reducing inventory costs.

## Methods of pricing material issues.

The most important being: FIFO, LIFO, simple and weighed average methods.

## 1) First in First Out (FIFO)

Under this method material is first issued from the earliest consignment on hand and priced at the cost at which that consignment was placed in the stores. In other words, materials received first are issued first. The units in the opening stock of materials are treated as if they are issued first, the units from the first purchase issued next, and so on until the units left in the closing stock of materials are valued at the latest cost of purchases.

### 2) Last in First Out (LIFO)

Under this method, issues are priced in the reverse order of purchase i.e., the prices of the latest available consignment is taken. This method is suitable in times of rising prices because material will be issued from the latest consignment at a price which is closely related to the current price levels. Valuing material issues at the price of the latest available consignment will help the management in fixing the competitive selling prices of the products.

#### 3) Highest In, First Out(HIFO)

**HIFO** is an acronym of the words Highest In, First Out. Requirements / material are serviced in order, from the most expensive items regardless of date of entry or acquisition. **HIFO** is an acronym of the words Highest In, First Out.

### 4).SAM (Simple average method)

In this method, price is calculated by dividing the total of the prices of the materials in the stock from which the material to be priced could be drawn by the number of the prices used in that total. This method may lead to over-recovery or under-recovery of cost of materials from production because quantity purchased in each lot is ignored.

# 5)Weighted Average Methods

In this method, price is calculated by dividing the total cost of materials in the stock from which the materials to be priced could be drawn by the total quantity of materials in that stock.

## Market price

The current price at which an asset or service can be bought or sold. Economic theory contends that the market price converges at a point where the forces of supply and demand meet. Shocks to either the supply side and/or demand side can cause the market price for a good or service to be re-evaluated.

In cost accounting, *market-based pricing* sets the product price based on customer expectations and demand. You take a look at the customer's perceived value of the product. Based on the customer view, you estimate how much he or she would be willing to pay.

### **Base stock method**

An **accounting method** of valuing inventories by carrying on the books a minimum quantity of a commodity at the same low fixed **price** from year to year and valuing the quantity in excess of the minimum at a separate **price** which is usually the lower of **cost** or market value

### Standard price method

Under this method, all factors by which price may be effected are considered & before the actual price, standard material price for the materials is generally fixed. At that standard price materials issued are valued. For establishing standard price, the factors usually considered are-

(a) Due to possible changes in market conditions, apprehended changes in price. (b) Depending upon the quantity to be ordered, the amount of discount that may be available from the suppliers.(c) Expenses which are related to purchases i.e. freights & carriage, customs duty, godown expenses, packing, handling etc.

Difference, if any, between the standard price & the actual purchase price, is known as material variance. However, the variance which arises due to the difference between standard rate of purchase & the actual rate of purchase is known as rate variance. On the other hand, variance due to difference between total actual material cost & total standard material cost, there being no difference in rates, the variance is called usage variance. Either at the time of actual purchase or at the end of accounting period, the variance may be worked out. The variance is analyzed into causative reasons & by taking suitable measures its recurrence is prevented.

#### Advantages:

(a) Efficiency of the purchase department can be revealed. (b) As all the issues are charged at a standard price, the method is easy

to apply. (c) Even if standard costing method is not applied in any industry, the method can be used there. (d) By setting the standard price, control on material cost may be exercised by the method, which may be called the price that should be.

#### Disadvantages:

(a) At actual cost, the issues are not charged.

(b) Profit or loss on materials may be there.

(c) The purpose for which it is set may be spoiled by a very low or high standard price.

(d) Fixing a reliable standard price is difficult, since upon a number of unknown variable factors, the price depends.

# **Working Problems**

# MATERIALS EOQ-Economic Ordering Quantity:

- Calculate economic ordering quantity from the following particulars: Annual requirement = 1,600units Cost of materials per unit = Rs. 40 Cost of placing and receiving one order = Rs. 50 Annual carrying cost of inventory.10% of inventory value.
- 2. Calculate economic

order quantity: Annual Consumption = 600units Order cost = Rs.12 per order Cost price per unit =Rs.20 Storage & carrying cost=20% Calculate the economic ordering quantity from the following particulars: Annual usage = 20,000units
Buying per order= Rs.10
Cost per unit =Rs.100

4.

rom the following information, determine the EOQ: Annual Consumption = 90,000units Cost per unit = Rs. 50 Buying Cost per order = Rs.10 Cost of carrying inventory = 10% of cost.

# EOQ- Where material usage is given in rupees:

5. Find out the economic ordering quantity from the following

Particulars: Annual usage = Rs.1,20,000 Cost of placing and receiving one order = Rs. 60 Annual carrying Cost: 10% of inventory value.

6. You are required to compute the economic ordering quantity with the help of the details given below:

Materials usage per month = Rs. 1,600. Buying Cost per order = Rs. 40.

Storage & carrying cost.15% of Inventory value.

7. Calculate the economic ordering quantity. Also state the number of orders to be placed in a year.

Consumption of materials per annum = 10,000 Kg. Cost of materials per Kg= Rs. 2 Order placing costs per order =Rs. 50 Storage costs 8% on Average Inventory.

## **Stock levels for one material:**

8. From the following information ,calculate:

- (a) Maximum Stock level
- (b) Minimum Stock level

F

- (c) Reorder level
- (d) Average stock level

Minimum Consumption= 240 units per day Maximum Consumption = 420 units per day Normal Consumption= 300 units per day Reorder quantity= 3,600 units, Reorder period = 10-15 days Normal Reorder period = 12 days.

## 9. Calculate Maximum Stock level, Minimum Stock level and Re-ordering level

- (1) Minimum Consumption= 100 units per day
- (2) Maximum Consumption = 150 units per day
- (3) Normal Consumption = 120 units per day
- (4) Reorder period = 10-15 days
- (5) Reorder quantity = 1,500 units
- (6) Normal Reorder period = 12 days.

10. Calculate Reorder level, Minimum Stock level, Maximum Stock level and Average Stock level from the following information:

Normal usage = 300 units per week Maximum usage= 450 units per week Minimum usage =150 units per week Reorder period = 4-6 weeks Reorder quantity = 2,400 units.

11. Two components X and Y are used as follows:

Normal usage = 600 units per week each Maximum usage = 900 units per week each Minimum usage =350 units per week each Reorder quantity:

> X= 4,800 units, Y= 7,200 units Reorder period: X= 4-6weeks Y= 2-4weeks

Calculate for each component: Reorder level (b) Maximum level (c) Minimum level (d) Average stock level

12. Two materials A and B are used as follows:

Normal Consumption = 50 units per week each Minimum Consumption = 25units per week each Maximum Consumption = 75units per week each

Reorder quantity:

A = 300 units

B= 500 units Reorder period:

A=4-6 weeks B=2-4 weeks

Calculate for each component:

(a) Reorder level (b) Maximum level (c) Minimum level (d) Average stock level

13. Two materials A and B are used as follows:

Normal usage = 3,000 units per week each Minimum usage = 1,500 units per week each Maximum usage = 4,500 units per week each Reorder quantity:

A=13,000units

B= 14,000units

Reorder period: A=4-6 weeks

B=2-4weeks

Calculate for each component:

(a) Reorder level (b) Maximum level (c) Minimum level (d) Average stock level

#### A) FIRST IN FIRST OUT (FIFO)METHOD

14. Prepare a store ledger on FIFO METHOD

DATE	RECEIPTS	ISSUES
2001-March 1	600 units at Rs.5 per unit	
16	400 units at Rs.6 per unit	

20		500 units
22	400 units at Rs.7 per unit	
23		600 units
25	200 units at Rs.8 per units	200 units

15. Prepare a store ledger on FIFO Method of pricing issues.

2002-January 1	Opening balance	50 units at Rs.30 per unit
5	Issued	20 units
7	Purchased	48 units at Rs.40 per unit
9	Issued	20 units
19	Purchased	36 units at Rs.35 per unit
24	Received back	10 units out of the units issued on 9 <sup>th</sup> January
27	Issued	15 units

16. Prepare a store ledger on LIFOMETHOD

DATE	RECEIPTS	ISSUES
2001-March 1	600 units at Rs.5 per unit	
16	400 units at Rs.6 per unit	
20		500 units
22	400 units at Rs.7 per unit	
23		600 units
25	200 units at Rs.8 per units	200 units

17. Prepare a store ledger on LIFO Method of pricing issues.

2012-January 1	Opening balance	50 units at Rs.30 per unit
5	Issued	20 units
7	Purchased	48 units at Rs.40 per unit
9	Issued	20 units
19	Purchased	36 units at Rs.35 per unit
24	Received back	10 units out of the units issued on 9 <sup>th</sup> January
27	Issued	15 units

## **Book References:**

1. Jain. S.P, Narang , K.L&Simmi Agarwal, (2011) , Cost Accounting (2nd Ed.) Delhi, India, Kalyani Publishes.

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# SCHOOL OF MANAGEMENT STUDIES

UNIT - III - COST ACCOUNTING AND BANKING - SBAA1308

#### UNIT 3 LABOUR COST

# Labour Cost – Importance – Various Methods of Labour Cost Control – Methods of Wage Payment – Various Incentive Schemes – Labour Turnover.

# Labor cost

The cost of labor is the sum of all wages paid to employees, as well as the cost of employee benefits and payroll taxes paid by an employer. The cost of labor is broken into direct and indirect (overhead)costs.

# Meaning

Labor cost covers one of the major portion of the total cost of a product or job. It may increase unnecessarily due to inefficiency of workers, wastage of materials by workers, idle time, unusual overtime work and high labor turnover. Hence, the management should devise effective techniques for controlling labor cost to ensure maximum outputs of better quality at low cost through proper utilization of the labor force.

Basically, management is concerned with controlling labor cost. Labor cost control involves such systems, procedures, techniques and tools used by the management in order to keep the labor cost of the product or job as minimum as possible. Labor cost control consists of a number of such regular activities which are carried on by various departments of the organization in a coordinated manner to ensure the availability of the best employees and their optimum utilization. It is the system followed by the management to maximize quality output at a minimum cost. Labor cost control includes the process of developing various forms, studying and recording the activities and performance of workers, calculating the correct amount of wages and making payment in time. It also includes the process of analyzing and reporting labor cost to the management for planning and decisionmaking.

# **Importance Or Needs Of Labor Cost Control**

- i. Labor cost control is important to make economic utilization of labor force in production process.
- ii. Labor cost control is important to obtain maximum quantity of output with the least amount of materials and otherresources.

- iii. Labor cost control helps to obtain better quality output with the least effort and time of workers.
- iv. Labor cost control reduces the cost of production of products manufactured orservices rendered.
- v. Labor cost control ensures the satisfaction of the workers by creating a good working environment in thefactory.
- vi. Labor cost control helps to adopt the fair system of wage payment and to minimize labor turnover.
- vii. Labor cost control is helpful in minimizing wastage of materials by workers ,idle time and unusual overtimework.
- viii. Labor cost control is helpful to maintain safety workingenvironment.
- ix. Labor cost control is important to keep complete records of the employees and to supply information to the management regarding availability, efficiency, utilization and absenteeism of theworkers.
- x. Labor costcontrolis veryusefultoincreasetheprofitabilityandcompetitivenessofthe organization.

#### **Types of Labour Cost**

The labour cost can be classified into

(1) Direct Labour Cost: Any labour cost that is specially incurred for or can be readily charged to or identified with a specific job, contract, work order or any other unit of cost is termed as direct labour cost. Wages for supervision, wages for foremen, wages for labours who are actually engaged in operation or process are the examples of direct labour cost.

(2) Indirect Labour Cost: Indirect 1 a b o u r is for work in general. The importance of the distinction lies in the fact that whereas direct labour can be identified with and charged to the job, indirect labour cannot be so charged and has, therefore to be treated as part of the factory overheads to be included in the cost of production. For example, salaries and wages of supervisors, storekeepers and maintence labour etc.

# **Control of Labour Cost**

Control of labour costis a significant influence on the growth, profitability and cost of production. Labour cost may become unduly high rate due to inefficiency of labour, ineffective supervision, ideal time, unusual overtime work etc. The primary objectives of the management therefore is to efficiently utilize the labour as economically as possible.

# **Techniques of Labour Cost Control**

In order to achieve the effective utilization of manpower resources, the management has to apply proper system of labour cost control.

- (1) Scientific method of productionplanning.
- (2) Use of labour budgets.
- (3) Establishment of labour standards.
- (4) Proper system of labour performance report.
- (5) Effective system of job evaluation and jobanalysis.
- (6) Devise a proper system of control over idealtime
- (7) Establish a fairandequitable remuneration system.
- (8) Effective cost accountingsystem.

# The Department that using Labour cost

The objectives of proper control on labour cost is effectively achieved through the functions of various departments responsible for controlling labour cost in an organisation. The following are the important departments for control over labour costs:

- (1) PersonnelDepartments.
- (2) Engineering and Works StudyDepartment.
- (3) Time KeepingDepartments.
- (4) Pay RollDepartment.
- (5) Cost Accounting Department.

# (1) PersonnelDepartment

Personnel department plays a very important role in control of labour costs. It is primarily concerned with the recruitment of labours on the basis of employee placement requisition and imparting training to them. And thereafter placing them to the job for which they are best suited. In order to achieve the efficient utilization of manpower resources, this department is responsible to execution of labour policies which have been laid down by topmanagement.

# (2) Engineering and Works StudyDepartment

Engineering department isprimarily concerned with maintaining control over working conditions and production methods for each job, process, operation or departments. It is performed by undertaking the following functions:

- (I) Preparation of planand specification of eachjob.
- (2) Maintaining required safety and efficient workingconditions.
- (3) Making time and motionstudies.
- (4) Conducting job analysis, job evaluation and meritrating.
- (5) Setting fair and equitable piece rate or time wagesystem.
- (6) Conducting research and experimentalwork.
- (7)

# Methods to control the labor cost

(a) Method Study: It is one of the important components of work study. The chief aims of this study isto find a scheme of least wastage. Method Study is defined as "a systematic and scientific evaluation of existing and proposed plans and performance of any work system and the evaluation of improvement, through analytical process of critical examination."

(b) Motion Study: Frank Gilbreth, who is the real founder of Motion Study. According to him motion study may be defined as the "science of eliminating wastefulness resulting from ill-directed and inefficient motions. The following are the important objectives of the motionstudy:

- (1) Effective utilisation of material, machine and labours.
- (2) Elimination of wastage of time and labours.
- (3) Maintaining higher standards of safety andhealth.
- (4) Reducing unnecessary movements in order to minimizewastages.
- (5) Better design of work place layout for effective productionprocess.

(6) Ensure fair remuneration with jobsatisfaction.

(c) **Time Study**: Time study is also called work measurement. Time study may be defined as "the art of observing and recording the time required to do each detailed element of an industrial operation."

(e) Job Evaluation: Job evaluation may be defined as "a process of analyzing and describing positions, grouping them and determining their relative value by comparing the duties of different positions in terms of their different responsibilities and other requirements." Job evaluation is determined on the basis of job description and job analysis. The primary purpose of job evaluation is developing appropriate wage and salary structure with internal pay equity between jobs.

(f) Merit Rating: Merit rating may be defined as "a systematic evaluation of an employee's performance on the job in terms of the requirement of the job." Merit rating is a system of measuring both qualitatively and quantitatively of an employee's capacity in relation to hisjob.

# **Computation of Labor Cost**

#### Step1

Calculate an average wage rate per hour for your manufacturing workforce. To do so, add all the hourly wages together and average them. Then, add all the payroll tax you pay for these employees and average this figure. Next, average the benefits you pay for your manufacturing labors. Add these figures -- the hourly wage average, the payroll tax average and the benefits average -- together to determine your workforce's average wage rate per hour .

#### Step2

Calculate average labor hours per unit. This is best done by observation. Find the average amount of time it takes a laborer to produce a unit. Add an allowance for breaks and personal needs. Add in some time for machine setup and machine downtime. The resulting figure is your average labor hours perunit.

# Step3

Multiply your average labor hours per unit by the average wage rate per hour. This is your average labor cost per unit. Note that it is an average, and actual unit labor costs may be above and below the average.

# Step4

To make a standard labor cost card for each unit, write down your calculations in detail. That way, if machine downtime increases, or average wages increase, you can make adjustments and recalculate.

#### Methods of wage payment

Labourcost isone of the important elements of production. Wage, salaries and other incentives of employee remuneration constitute a very large component of operating costs. Remuneration of employees is a vital factor not only affecting the cost of production but also industrial relations of the organization. No organization can expect to attract and attain qualified and motivated employees unless it pays them fair remuneration. Employee remuneration, therefore, influences vitally the growth and profitability of the company.

### **Objectives of an IdealWageSystem**

An ideal wage system is required to achieve the following objectives:

- (1) The wage system should establish a fair and equitableremuneration.
- (2) Asound wage system helps toattract qualified and efficient worker by ensuring an adequatepayment.
- (3) It assists to improve the motivation and moral of employees which in turn lead to higherproductivity.
- (4) It enables effective control of labourcost.
- (5) An Ideal wage system helps to improve union-management relations.It should reducegrievances arising out of wageinequities.

(6) It should facilitate job sequences and lines of promotion wherever applicable.

(7) An ideal system seeks to project the image of aprogressive employer and to

comply with legalrequirements relating to wages and salaries

# Principles of an Ideal Wage System

The following principles should be adopted for an ideal wage system

- (1) Differences in pay should be based on differences in jobrequirements.
- (2) Follow the principle of equal pay for equalwork.
- (3) The scheme should be based on work study, and the work contents of various jobs should bestabilized.
- (4) Recognize individual differences in ability and contributions.
- (5) The scheme should not be very costly inoperation.
- (6) The scheme should beflexible.
- (7) The scheme should encourageproductivity.
- .(8) The scheme should notundermine co-operation amongst theworkers.
- (9) The scheme should be sufficient to ensure for the worker and his family reasonable standard ofliving.

# Types of wags payment

The following aretheimportant methods of remuneration

which may be groupedinto

- : (1) Time Rate Systems
  - (2) Piece Rate Systems
  - (3) Bonus System (or) Incentives Schemes.
  - (4) Indirect Monetary Incentives.
  - (5) Non-Monetary Incentives

These may be further classified as under:

# (1) Time RateSystems:

- (a) At OrdinaryLevels
- (b) At High WageLevels
- (c) Guaranteed TimeRates.

# (2) Piece RateSystems:

- (a) Straight PieceRate
- (b) Piece Rates with Guaranteed TimeRate
- (c) Differential PieceRates:
  - (i) Taylor's Differential Piece RateSystem
  - (ii) Merrick Differential Piece RateSystem
  - (iii) Gantt Task and BonusPlan

## (3) Bonus System or Incentive Schemes:

- (1) Halsey PremiumPlan
- (2) Halsey-Weir PremiumPlan
- (3) RowanPlan
- (4) Barth Variable SharingPlan
- (5) Emerson EfficiencyPlan
- (6) Bedaux Point Premium System
- (7) Accelerating PremiumPlan
- (8) Group or Collective Bonus Plans.

## (4) Indirect Monetary Incentives

(5) Non-Monetary Incentives

# (1)Time rate System

### (a) Time Rate at OrdinaryLevels:

This is also termed as "Day Wage System" or "Flat Rate System." Under this system, wages are paid to the workers on the basis of time spent on the job irrespective of the quantity of work produced by the workers. Payment can be made at a rate per day or a week, a fortnight or amonth.

The formula for calculation of payment of time rate of ordinary levels is as follows:

# **Remuneration** or Earnings = Hours Worked X Rate PerHour

Time rate system is suitable under the following conditions:

(1) Where the units of output are difficult to measurable, e.g., watchman.

(2) Where the quality of work is more important, e.g., furniture, finejewellery.

(3) Where machinery and materials used areverysophisticated and expensive.

(4) Where supervision is effective and close supervision is possible.

(5) Where the workers are new and learning the job.

(6) Where the work is of a highly varied nature and standard of performance cannot beestablished.

### Advantages

- (1) It is simple and easy tocalculate.
- (2) Earning of workers are regular and fixed.
- (3) Time rate system is accepted by tradeunions.
- (4) Quality of the work is notaffected.
- (5) This method also avoids inefficient handling of materials andtools.

## Disadvantages

 No distinction between efficient and inefficient worker is made and hence they get the same remuneration.

(2) Cost of supervision are high due to strict supervision used for high productivity of labour.

(3) Labour cost is difficult to control due to more payment may be made for the lesser amount ofwork.

(4) No incentive given to efficient workers. It will depress the efficient workers.

(5) There is no specific standards for evaluating the merit of different employees forpromotions.

## (b) Time Rat e at HighLevels:

Under this system, efficient workers are paid higher wages in order to increase production. The main object of this method designed to remove the drawbacks of time rate at ordinary levels. This systemis simple and easily understandable. When higher rate of wages are paid, it not only reduces labour turnover but also increases production and efficiency.

## (c) Guaranteed TimeRates:

Under this method, the wage rate is calculated by considering to changes in cost of living index. Accordingly, the wage rate is varied for eachworker

according to the change in cost of living index. This system is suitable during the period of raising prices.

#### (2) Piece RateSystem

This is also known as "Piece Wage System" or "Payment By Result." Under this system, wages of a worker are calculated on the basis of amount of work done or output of a worker. Accordingly, a worker is paid in direct proportion to hisoutput.

Piece Rate System is suitable under the following conditions:

- (1) Quality andworkmanship are notimportant.
- (2) Work can be measured accurately.
- (3) Quantity of output directly depends upon the efforts of theworker.
- (4) Production of standardized goods in a factory.
- (5) Job is of a repetitivenature.

### **Advantages**

- (2) This encourages the efficient workers to increase
- (3) Under this system efficient workers are recognized andrewarded.
- (4) It helps to reduce the cost of supervision and idletime.
- (5) Tenders or quotations can be prepared confidently and accurately.

### Disadvantages

(1) Where a concern is producing large quantities, it is difficult to fix a piece rate.

(2) In order to maximize their earnings, workers working with high speed may affect theirhealth.

(3) The quality of output cannot bemaintained.

(4) This systemis notencouraging to the inefficientworkers.

(5) Temporary delays or difficulties may affect the earnings of theworkers. There are three important methods of paying labour remuneration falling under thistype:

(a) Straight Piece Rate

(2) Piece Rates with Guaranteed Time Rates and

(c) Differential PieceRates.

(a) Straight Piece Rate: Under this system, workers are paidaccording to the number of units produced at a given rate per unit. Thus, total earnings of each worker is calculated on the basis of his output irrespective of the time taken by him. The following formula is used for measuring piece workearning:

## Straight Piece Work Earnings = Units Produced x Rate Per Hour

(b) Piece Rates with Guaranteed Time Rates: Under this method, the worker earning from piece work less than the guaranteed minimum wage, will get the fixed amount of guaranteed time rate. A guaranteed rate would be paid per hour rate or day rate or weekrate.

(c) Differential Piece Rates: This system is designed to provide for variation of piece rates at different levels of output. Accordingly increase in wages is proportionate to increase inoutput. Under thissystem, efficient workers get ample reward and at the same timeinefficientworkersaremotivatedtoearnmore. The following are the three important types of differential piece rates:

- (a) Taylor's Differential Piece RatesSystem.
- (b) Merrick's Differential Piece RatesSystem.
- (c) Gantt Task BonusPlan.

# (a) Taylor's Differential Piece RatesSystem

FW.Taylor, who is the father of scientific management introduced this plan. Under this system, two piece rates are applicable on the basis of standard of performance established. Accordingly one is high rate and the other one is lower rate. Thus high piece rate is applicable for standard and above the standard performance. Lower piecerate for those workers with below the standard performance.

### (b) Merrick Differential Piece RateSystem

This is also termed as Multiple Piece Rate system. This planis 'designed to overcome the drawback of Taylor's Differential Piece Rate System. Under this method, three piece rates are applied with different levels of performance.

## (c) Gantt's Task BonusPlan

This system is designed by Henry L. Gantt. Under this system, standard time for every task is fixed through time and motion study. The mainfeature of this system is a good combination of time rate, differential piece rate and bonus. In this system day wages are guaranteed to allworkers.

# Differences Between Piece Rate System And Time Rate System Of Wage Payment

#### 1. Meaning

Piece rate system is a method of wage payment to workers based on the quantity of output they have produced. Time rate system is a method of wage payment to workers based on time spent by them for the production of output.

#### 2. Nature OfPayment

Piece rate system pays the workers according to the units of output produced. Time rate system pays the workers according to the time spent in the factory.

#### 3. Emphasis

Piece rate system gives emphasis on larger quantity of output. Time rate system emphasis on better quality of output.
#### 4. Discrimination

Piece rate system discriminates the workers and pays more wages to efficient and skilled workers. Time rate system does not discriminate the workers and pays the same wages to efficient and inefficientworkers.

#### 5. Supervision

Piece rate system requires strict supervision to get the required quality output. Time rate system requires strict supervision to get required quantity of output.

#### 6. Determination Of LaborCost

Piece rate system helps to fix per unit labor cost in advance. Time rate system does not help to fix labor cost per unit inadvance.

#### 7. Flow OfProduction

Piece rate system does not bring uniformity in the flow of production and causes an excessive wastage of inputs. Time rate system helps maintain a uniform flow of production and ensures an efficient use of materials, tools and equipments.

#### (3) Bonus or IncentivesSchemes

Incentive schemes of wage payment are also known as Premium Bonus Plans. introduced in order to increase production with ensuring proper industrial climate. Wage incentive plans may be of two types : (1) Individual Incentive Plans and (2) Group Incentive Plans. Under individualincentive plans, remuneration can be measured on the performance of the individualworker.

(1) Halsey Premium Plan: This Plan was developed by F. A. Halsey. This system alsotermed as Split Bonus Plan or Fifty-Fifty Plan. Under this plan, standard time is fixed for each job or operation on the basis of past performance. If a worker completes his job within or more than the standard time then the worker is paid a guaranteed time wage. If a worker completes his job within or less than the standard time, then he gets a bonus of 50% of the

time saved plus normalearnings.

(2) **The Halsey- Weir Scheme:** Under this system, the worker gets the bonus of 30% of thetime saved instead of 50% of time saved under Halsey Plan. Except for this, Halsey Plan and Halsey-Weir Systems are similar in all other respects

(3) **Rowan Plan:** This plan was introduced by James Rowan of England. It was similar to the Halsey Plan in many respects except that it differs in calculation of bonus. Under this system. bonusis determined as the proportion of the time taken which the time saved bears to the standard timeallowed.

(4) Emerson's Efficiency Sharing Plan: Under this plan, earning of a worker is by combining guaranteed day wages with a differential piece rate. Accordingly the level of efficiency is determined on the basis of establishment of standard task for a unit of time. If the level of worker's efficiency reaches 67% the bonus is paid to him at a normal rate. The rate of bonus increases in a given rate as the output increases from 67% to 100% efficiency. Above 100% efficiency, the bonus increases to 20% of the wage earned plus additional bonus of 1% is added for each increase of 1% inefficiency.

(5) **Barth Variable Sharing Plan**: This scheme introduced to attract newly recruited and skilled employees who are motivated to learn work, It provides sufficient incentives to inefficient workers who are motivated to increaseproductivity.

6) Bedaux Point Premium System: This plan was introduced by Charles E.Bedauxin 1911. Under this plan, standard time fixed for each operation or job is expressed in terms of Bedaux point or'S.' For example, a standard time of 360 B means the operation or job should be completed within 360 minutes. The chief advantage of this plan is that it can be applied to any kind of a job. Under this system, worker is paid at the time for actual hours worked, and 75% of the wages for the time saved are paid as bonus to the worker and 25% to the foremen, supervisors etc

(7) Accelerating Premium Bonus Plan: Under this plan, bonus is determined on the basis of time saved unlike a fixed percentage under Halsey Plan and as a decreasing percentage under Rowan Plan. The bonusis paid to workers at an increased rate according to more and more time saved. This provides increasing incentives to efficient workers.

#### Merits

- (1) It is simple tounderstand.
- (2) Total earnings of each worker can be easy tocalculate.
- (3) Bothemployer and employee get equal benefit of times aved.
- (4) This system not onlybenefits efficient worker but also provides average worker to get guaranteed minimumwages.
- (5) This system is based on time saved and it can reduce the labour cost.

#### Demerits

- (1) Lack of co-operation among the employees.
- (2) Under thissystem establishment of standard is very difficult.
- (3) Earning are reduced at high level of efficiency.

#### **Group or Collective Bonus Plan**

The incentive schemes explained so far are applicable to individual performance depending directly on production. However, it is not the individual worker who produce the goods or services (operation) alone but group of several other workers are required to jointly perform a single operation. It is, therefore, essential that a group incentive scheme be introduced. Bonus is calculated for a group incentivescheme.

The bonus is calculated for a group of workers and the total amount is distributed among the group of workers on anyone of the following basis:

- (a) Equally by all the workers of the group.
- (b) Pro rata on the time ratebasis.
- (c) Pre determined percentage basis.
- (d) Specified proportionbasis.

#### **Types ofGroup IncentivePlans**

The following are the important types of group incentive bonus plans:

- (1) Budgeted Expenses BonusPlan
- (2) Priest Man BonusPlan
- (3) Towne's Gain-sharing Plan
- (4) ScanlonPlan

(1) Budgeted Expenses Bonus Plan: Under this method, bonus is determined on the basis of savings in actual expenditure compared with total budgeted expenditure.

(2) **Priest Man Bonus Plan:** Under this plan, standard performance is fixed by the management and committee of workers. The group of workers get bonus when actual performance exceeds the standard performance irrespective of individual's efficiency orinefficiency.

(3) Towne's Gain-sharing Plan: Under this plan, bonus is calculated on the basis of savings in labour cost. The group of workers get bonus when actual costs is less than the standard costs, one-half of the savings is distributed among workers including foremen in proportion with the wagesearned.

(4) Scanlon Plan: Scanlon Plan is designed with the chief aim of reducing the cost of operations in order to increase the production efficiency. This plan is generally applicable in industries where the operation cost ishigh.

#### (4)Indirect Monetary Incentives

Incentive schemes are regarded beneficial to both employers and workers. In this regard, under indirect monetary incentives by giving them a share of profit and introducing co-partnership schemes or as they have become partners in the business in order to make a very profitable enterprise.

**Profit Sharing:** Profit sharing and bonus is also known as Profit sharing bonus. Under this scheme, there is an agreement between the employer and employee by which employee receives a share, fixedin advance of the profits. Accordingly profit sharing bonus refers to the distribution of profit on the basis of a certain percentage of one's monthly earnings. The amount to be distributed depends on the profits earned by an enterprise. The proportion of the profits to be distributed amongthe employees is determined inadvance.

**Co-partnership:** This system provides not only a worker to become partner in the business but also to share in the profits of the concern. There are different degrees of partnership and share of responsibilities allowed to the workers to take part in its control.

**Non-Monetary** Incentive Schemes: Under this system, employees are provided better facilities, instead of additional monetary payments. Some of the examples of non-monetary incentives are free education for children, rent free accommodation. medical facilities. canteen facilities. welfare facilities. and entertainment facilitiesetc.

#### **Idle Time**

Idle Time is that time during which the workers spend their time without giving any production or benefit to the employer and concern. The idletime may arise due to non-availability of raw materials, shortage of power, machine breakdownetc.

# **Types of Idle Time:**

It refers that any loss of time is inherent in every situation which cannot be avoided. Any cost associated with the normal idle time are mostly fixed in nature. The normal idle time arises due to the following reasons:

- (1) Time taken for personal affairs.
- (2) Time taken for lunch and teabreak.
- (3) Time taken for obtainingwork.
- (4) Time taken for changing from one job toanother.
- (5) Waiting time for getting instructions, tools and or rawmaterials.

(6) Time taken by the workers towalk between factory gate and place of work.

## **Abnormal IdleTime**

Abnormal idle time refers that any loss of time which may occur due to some abnormal reasons. Abnormal idle time can be prevented through effective planning and control. The abnormal idle time may arise due to the following avoidable reasons:

- (1) Faultyplanning.
- (2) Lack of co-operation and co-ordination.
- (3) Powerfailure.
- (4) Time lost due to delayedinstructions.
- (5) Time lost due to inefficiency ofworkers.
- (6) Time lostduetonon-availability of raw materials, spare parts, toolsetc.
- (7) Time lost due to strikes, lock outs andlay-off.

**Over Time**: The term "over time" refers to when a worker works beyond the normal working hours or scheduled time is known as 'overtime.' According to Factories Act, the wage rate of overtime work to be paid at double the normal rate of wages. The extra amount of remuneration is paid to the worker in addition to normal rate of wages is said to be overtimepremium.

**Effect of Over Time Payment on Productivity:** The following are the effects of over time payment onproductivity:

(I) Overtime premium is anextra payment over normal wages and hence will increase the productioncost.

(2) The efficiency of workers during overtime work mayfall and hence output may bereduced.

- (3) To earn more, workers may notconcentrate on work during normal hours, and thus the output during normal hours mayfall.
- (4) Reduced output and increased premium will increase the cost of production.

**Control of Overtime:** Control of overtimeis essential to minimize the cost of production and increase the overall performance of the efficiency. Effective control of overtime can be possible through the following ways:

- (1) Effective sound planning of production
- (2) Adequatesupervision
- (3) Ensuring availability of raw materials, spareparts
- (4) Encouraging productivity
- (5) Reducing labour turnover
- (6) Ensuring effective system of repairs and maintenance, material handling and smooth flow of production
- (7) Fair and equitable remuneration to efficient and inefficient workers.

**Casual Workers:** Casual workers are those who are engaged casually whenever there is extra load of work or due to planned maintenance duringoff season.

**System of Control:** In order to achieve the effective control of casual workers the following system to beadopted:

- (1) Assess work load, forexample, planned maintenance during offseason.
- (2) Assesmanpowerrequirement.
- (3) Obtain prior sanction for number of workers giving the period for which engagement is to bedone.
- (4) Obtain periodical report onperformance and compare with the plan to ensure that there is no laggingbehind.

(5) Provide for automatic termination after the period for which sanction is givenexpenses.

**Out Workers:** Out workers are those who are engaged in production operations outside the factory. For example, works carried on construction and electricity.

**Control ofOut Workers** : The following are the important aspects to be considered for effective control of out workers:

- (1) Keep a log book atreception.
- (2) Record complaint specifying date and time of receipt of complaint.
- (3) Keep proper complaint slips and send the same to technical department.
- (4) Prepare duty sheets in duplicate to note down time on and timeoff.
- (5) Summarise time spent by each service mandaily.
- (6) Summarise chargeable amount and non-chargeable amount.
- (7) Adviseaccounts department forbilling.

**Labour Turnover:** Labour Turnover may be defined as "the rate of changes in labour force, i.e., the percentage of changes in the labour force of an organization during aspecific period. Higher rate of labour turnover indicates that labouris not stable and there are frequent changes in the labour force in the organization. It will affect the efficiency of the workers and overall profitability of the firm. The determinant result oflabour turnover is expressed in terms of percentage.

## Types of labor turn over

#### (1) Labour turnover according to separationmethod:

= Number of employees left during a period Average number of employees during a period × 100

This definition does not take into consideration the fact of surplus labour. This definition will give incorrect result when the surplus workers are discharged because labour turnover calculated in this way will be high.

## (2) Labour turnover according to fluxmethod:

 $= \frac{\text{Number of additions + Separations during a period}}{\text{Average number of employees during a period}} \times 100$ 

This definition will not be applicable when the organisation expanding. In such a case, many new workers are engaged and there may be no separation; even then labour turnover calculated will be high.

(3) Labour Turnover = Average number of employees during a period × 100

This definition will misguide when an organisation has reached its optimum size and does not require expansion at all. In such a case, labour turnover, as per this definition, will show half the actual percentage of labour turnover.

## (4) Labour turnover according to replacementmethod:

```
= \frac{\text{Number of workers replaced during a period}}{\text{Average number of workers during the period}} \times 100.
```

This definition takes into account the surplus labour. This definition will also give correct labour turnover when the factory is expanding because all additions are not to be taken only workers

replaced due to leavers are to be taken. Therefore, this definition can be taken to be the most reliable definition out of all the definitions given above.

Causes for Labour Turnover:

- (1) AvoidableCauses
- (2) Unavoidable Causes

## (1) AvoidableCauses

- (1) Lack of jobinvolvement
- (2) Lack of co-operation among the employees
- (3) Lack of smooth relationship between employer and employees
- (4) Dissatisfaction with wages and incentives
- (5) Bias attitude of Management
- (6) Poor workingconditions
- (7) Dissatisfaction with promotion, recognition, transferetc.
- (8) Lack of Co-ordination
- (9) Non-availability of adequate protection, proper instructions, accommodationetc.

## (2) UnavoidableCauses

- (1) Retirement or Death of employer
- (2) Marriage in the case of femaleworkers
- (3) Permanent disability due to accident or illness
- (4) Dismissal or discharged due to inefficiency or disciplinaryground
- (5) Dissatisfaction with job
- (6) Shortage of power, raw materialsetc.
- (7) Personalresponsibilities
- (8) Personal betterment with regard to newjob
- (9) Changeinnatureofbusinessandplantlocation.

## **Effect of Labour Turnover:**

- (1) Increased cost of recruitment, training and placement
- (2) Increased cost of production
- (3) Decrease in output due to inefficient or newly recruitedworkers
- (4) Higher accident rate due to negligence or mishandlingof machines

(5) Lowteamspiritduetolackofco-operationandco-ordinationbetweentheworkersand employers.

## **Cost of Labour Turnover:**

The chief aim of the preventive costs which are incurred in order to keep the workers satisfied and reduce the labour turnover rate as much as possible. These preventive costs which include the following:

- (a) Cost of providing medical facilities, canteen and other welfarefacilities
- (b) Cost of administration
- (c) Cost of providing better workingconditions
- (d) Cost of pension, gratuity, provident fund and other retirementbenefits.

# **Working Problem**

#### LABOUR COST

1. From the following data given by the Personnel department, calculate the labour turn overrate by applying:

a) Separation method b) Replacement Method c)
Fluxmethod No of workers in thepayroll:
At the beginning of the month
900 At the end ofthemonth
1,

During the month 10 workers left; 40 workers were discharged and 150 workers were recruited. Of these, 25 workers are recruited in the vacancies of those leaving while rests were

engaged for an expansion scheme.

Days	Hours worked
Monday	8
Tuesday	12
Wednesday	10
Thursday	10
Friday	9
Saturday	4
Total	53

2. Calculate the normal and overtime wages payable to a workman from the followingdata:

Normal working hours-8 hours per day: on Saturday-4 hours. Normal rate Rs.2 per hour.Overtime rate up to 9 hours in a day at single rate and over 9 hours in a day at double rate. Or up to 48 hours in a week at single rate and over 48 hours at double rate, whichever is more beneficial to theworkers.

- 3. From the following data prepare statement showing the cost per day of 8 hours of engaging particular type of labour:
  - a) Monthly salary (Basic plus dearness allowance)Rs.400
  - b) Leave salary payable to a workman 15% of basic and dearnessallowance.
  - c) Employee's contribution to provident fund 8% of salary (items a andb)
  - d) Employer's contribution to E.S.I 5% of salary (items a andb)
  - e) Pro rata expenditure an amenities to labour Rs25 per head permonth.
  - f) No. of working hours in a month200
- 4. Mr. A, a worker in a factory is paid on time basis. During the month of October, 2009 he has worked for 200 hours. His hourly wage rate is Rs.10 perhour.

Mr. B, another employee of the company is paid on the basis of piece wages. During the month of January 99 his output was 1,000 units. Rate of wages per piece is Rs.3. Calculate the wages of respective workers for the month of October, 2009.

- 5. Calculate the earnings of workers X and Y under (A) straight piece rate system
  - and(B) Taylors differential piece rate system from thedetails:

Standard time per unit =12 minutes Standard rate per hour =Rs.60 Differentials to be used 80% and 120%

In a particular day of 8 hours, workers 'X' produced 30 units and worker 'Y' produced 50 units.

6. Calculate the earnings of 3 workers A, B, and C under 'Merrick's multiple piece ratesystem', given thefollowing:

Standard production per day: 150 units Normal piece rate: Rs.0.50 per unit Production of workers on a particular day: A-120 units B-140units C-160 units

 The following are the particulars applicable to a workprocess: Time Rate Rs.5 perhour High task 40 units per week

Piece rate above the high task Rs.605 per unit

In a 40 hour week, the production of the workers was as follows: A 35 units B 52 units Calculate the wages of the workers under Gantt's task bonus plan.

- 8. A worker is paid at 25 paiseper hour for completing a work within 8 hours. If he completes the work within 6 hours, calculate his wages under Halsey plan when the rate of premium is 50%. Also ascertains the effective hourly rate of earning by theworker.
- 9. Calculate the total earnings from the following data under Halsey Plan and Halsey-

Weirplan. StandardTime : 10hours

Timetaken	: 8hours

Timerate Rs.2.5 perhour

10. Calculatetheearningsofaworkerunder(A) HalseyPremiumplanand (B) Rowanscheme.

Time allowed= 48hoursTimetaken= 40hoursRateperhour=Re.1

11. Asertain wages of a worker under Bedeaux's point premium system from the following details:

Standard output per day of 8 hours =160 units Actual output during a day of 8 hours 200 units Rate per hour is Rs.5.00

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# SCHOOL OF MANAGEMENT STUDIES

**UNIT – IV– COST ACCOUNTING AND BANKING – SBAA1308** 

#### UNIT 4 OVERHEADS

**Overheads** – Classification – Apportionment Of Overheads – Redistribution Of Overheads – Absorption Of Overheads – Calculation of Machine Hour Rate

## **Overhead**

**Overhead** expenses are all **costs** on the income statement except for direct labour, direct materials, and direct expenses. **Overhead** expenses include **accounting** fees, advertising, insurance, interest, legal fees, labor burden, rent, repairs, supplies, taxes, telephone bills, travel expenditures, and utilities.

Cost pertaining to a cost centre or cost unit may be divided into two portions direct and indirect. The indirect portion of the total cost constitutes the overhead cost which is the aggregate of indirect material cost, indirect wages and indirect expenses. CIMA defines indirect cost as "expenditure on labour, materials or services which cannot be conveniently identified with a specific saleable cost per unit."

Indirect costs are those costs which are incurred for the benefit of a number of cost centers or costs units. Indirect cost, therefore, cannot be conveniently identified with a particular cost centre or cost unit but it can be apportioned to or absorbed by cost centers or cost units.

#### **Importance of Overhead Costs:**

In various five-year plans, industrialization was given due importance. The result is that a large number of establishments have grown up both in the public and private sectors for mass production for which use of improved and costlier and special type of machines has become absolutely necessary. With the increasing trend towards plant automation, heavy expenditure is being incurred which cannot be charged directly to any particular unit and can be called as cost common to all units of production. Overhead expenses being a significant proportion of the total cost have assumed an added importance and require analysis for purposes of cost ascertainment and control by function and for guidance in certain managerial decisions by the extent of the variability with production.

Overhead costs cannot be allocated but have to be suitably apportioned and then absorbed by suitable methods. The cost accountant is required to pay so much attention to the accounting of overhead cost as prudence choice of various bases used for apportionment and absorbing the overheads in the cost of products has to be made by him.

# **Classification of Overhead Costs:**

Cost classification is the process of grouping costs according to their common characteristics and establishing a series of special groups according to which costs are classified.

# Thus, it involves two steps:

(i) The determination of the class or groups in which the overhead costs are subdivided,

(ii) The actual process of classification of the various items of expenses into one or the other of the groups.

The method to be adopted for the classification of overhead costs depends upon the type and size of the business, nature of the product or services rendered and policy of the management.

# **Classification Of Overheads**

# 1. Classification Of Overheads Based On Function

- (a) Manufacturing Overhead,
- (b) Administration Overhead,
- (c) Selling & Distribution Overhead,

## (d) Research and Development Expenses

## 2. Classification Of Overheads Based On Behavior

- \* Fixed Overheads
- \*Variable Overheads
- \* Semi-variable Overheads
- \* Semi-fixed Overhead

# 3. Classification Of Overheads Based On Elements

- \* Indirect Materials
- \* Indirect labor (Wages)

# 4. Classification Of Overheads Based On Control & Nature

- \* Controllable Overheads
- \* Uncontrollable Overheads

A concern may adopt one or more of the above classifications. For example, the overhead expenses in a concern may be first divided according to functions i.e. manufacturing, administration, selling and distribution groups. The expenses pertaining to one group say manufacturing may further be classified into fixed, variable and semi-variable.

Each of these groups may then be grouped into the elements i.e. indirect material, indirect labour and indirect expenses and under each element, the expenses may be further subdivided according to their nature i.e. depreciation, salary, repairs and maintenance etc.

# I. Functional Classification of Overheads

When overhead expenses are classified with reference to major activity divisions of a concern, it is called functional classification of overhead. This classification is necessary for the segregation of the cost of each of the principal functional division of the concern and for having separate methods of accounting and control for the diverse nature of expenses in

each division.

# The main groups forming the basis of the classification are

(a) Manufacturing Overhead: (also referred to as factory overhead, factory burden, and manufacturing support costs) refers to *indirect* factory-related costs that are incurred when a product is manufactured. Along with costs such as direct material and direct labor, the cost of manufacturing overhead must be assigned to each unit produced so that Inventory and Cost of Goods Sold are valued and reported according to generally accepted accounting principles (GAAP).

# (b) Administration Overheads

The overheads incurred for the overall administrative work of the organisation. They include:

- Indirect Materials such as office supplies, stationery and printing items, brooms etc.

Indirect Labour such as salaries payable to manager, clerk etc.
 Indirect Expenses such as lighting, bank charges, legal/audit charges, rent/insurance of office.

# (C) Selling Overheads

The overheads incurred from the stage of final manufacturing of finished goods till the stage of goods sold in the market and collection of dues from the customers. They include:

-Indirect Materials such as samples, packing materials, etc.
- Indirect Labour such as salaries and commission payable to sales manager, salesmen etc.

- Indirect Expenses such as rent, carriage outwards, warehouse charges, discount offered to

customers, advertising expenses, bad debts etc

## (d) Research and Development Expenses:

Research and development (R&D) describes activity or expense associated with the research and development of a company's goods or services. R&D expenses are a type of operating expense and can be deducted as such on a business tax return. This type of expense is incurred in the process of finding and creating new products or services.

#### **II.** Classification with Regard to Behaviour of Expenditure:

Under this overheads are classified with reference to their tendency to vary with production/sales volume or activity level. Some expenses vary directly with the rise and fall in output, some remain constant in spite of change in the level of activity of the concern whereas there are some other items which are constant only upto a certain level and then change their character to become variable or which vary with volume of output but less than proportionately.

## Based on this behaviour, the expenses may be classified into

### 1. Fixed Overheads

Fixed overheads are also called period costs or capacity costs. Fixed overheads are incurred for creating an output capacity of the concern for a fixed period of time. They are the costs which remain fixed or constant in total despite changes in the volume of production or sales. Fixed overheads remain fixed in total up to a certain level of activity which is known as *relevant range of activity* but fixed overheads per unit always vary with the production or sales volume in an opposite direction. For example, per unit fixed overheads decrease with an increase in the production or sales volume and vice verse. Examples of fixed overheads are rent, salaries, depreciation, interest and legal expenses.

### 2. Variable Overheads

Variable overheads are those type of overheads which vary positively with the production and sales volume. Hence, they vary directly in proportion to the volume. Variable overheads increase in total with the increase in volume and vice versa. They, however, remain constant in per unit. Examples of variable overheads are indirect materials, indirect wages and power expenses.

#### 3. Semi-variable overheads

Semi-variable overheads are neither completely fixed nor variable. Therefore, they are also called semi-fixed costs. Semi-variable overheads comprise the quality of both the fixed and variable costs. They vary disproportionately with the change in the volume of output. They do not vary directly proportion to the volume. They are the mixed type of overheads. The semi- variable overheads increase with the increase in output units but not at the same rate. Telephone

, electricity, repair and maintenance, heating, lighting, supervision and inspection, salesmen remuneration are some of the examples of semi-variable or semi-fixed overheads.

#### 4. Step Fixed Overheads

Step fixed overheads remain fixed within a certain range of output level and jump up once the range of output level exceeds. Step fixed overheads remain constant for a given volume, but increase by another fixed amount the moment there is addition of volume, and keep on increasing by a fixed amount with the addition of volume. Hence, such overheads increase step by step according to the relevant range of output level. For example, a college bus driver is paid salary of \$ 2500 a month which will remain constant until another bus is bought or hired. But as soon as the number of college bus increases, the salary cost will be increase by \$2500 with every addition of such buses.

#### **Overhead Allocation**

The allocation of certain overhead costs to produced goods is required under the rules of various accounting frameworks. In many businesses, the amount of overhead to be allocated is substantially greater than the direct cost of goods, so the overhead allocation method can be of some importance.

There are two types of overhead, which are administrative overhead and manufacturing overhead. Administrative overhead includes those costs not involved in the development or production of goods or services, such as the costs of front office administration and sales; this is essentially all overhead that is not included in manufacturing overhead. Manufacturing overhead is all of the costs that a factory incurs, other than direct costs.

## Advantages of Overhead Classification

- 1. It ensures effective cost control.
- 2. It helps the management for effective decision making.
- 3. The application of marginal costing is essentially for profit planning, cost control, decision making etc. are based on the classification of overheads.
- On the basis of classification of fixed and variable cost, flexible budgets are prepared at different levels of activity.
- 5. It facilitates fixing of selling price.
- 6. Cost classification is useful for break-even analysis. Break-even analysis mainly depends on overall. cost and profit which can be useful for making or buying decision.
- 7. It helps to find out the unit cost of production.

## **Codification of Overhead**

Codification is a process of representing each item by a number, the digits of which indicate the group, the subgroup, the type and the dimension of the item.

## Advantages of Codification

- It enables systematic grouping of similar items and avoids confusion caused by long description of the items.
- (2) It serves as the starting point of implication and standardization.
- (3) It helps in avoiding duplication of items and results in the minimisation of number of items,
- (4) It helps in allocation and apportionment of overheads to different cost centers.
- (5) It assists the grouping of overheads for cost control.
- (6) It helps in reducing clerical efforts to the minimum

## Methods of Codification

- (1) Numerical Codes Method.
- (2) Decimal Codes Method.
- (3) Codes with a Combination of Numbers and Alphabets.

1) Numerical Method: Under this method, numerical codes are assigned to each item of expenses.

(2) Decimal Codes: Under this method, the whole numbers are allotted to indicate master group and the decimals indicate the sub-group

(3) Codes with a Combination of Numbers and Alphabet: Under this method the alphabet indicates the main group and the type of expenses is indicated by the numerical

#### **Procedure or Steps in overhead**

Overheads are incurred for work in general. Overhead is added to the prime cost in order to measure the total cost of production or cost of goods sold. For allocation and apportionment of overhead in the cost of production or cost of goods sold the following procedures are involved: (1) Classification Overhead: We have already discussed the classification of overhead in the preceding pages, and the discussion on other procedures would follow in this chapter and the subsequent one.

(2) Collection of Overhead: The production overheads or factory overheads are collected and identified under separate overhead code numbers or standing order numbers. These overheads are collected from different sources and documents. The following are the important sources and documents .

#### (3) Overhead Analysis :

#### (a) Allocation and Apportionment of Overhead to Cost Centers

The first step of overhead analysis is distribution of overhead to production department and service department. Before analysing overhead, we should know the concept of Allocation, Absorption and Apportionment.

Allocation: Cost allocation refers to the allotment of whole item of cost to cost centers. The technique of charging the entire overhead expenses to a cost centre is known as cost allocation.

**Absorption:** Cost absorption refers to the process of absorbing all overhead costs allocated to apportioned over particular cost centre or production department by the unit produced.

**Apportionment:** Apportionment is the process of distribution factory overheads to cost centers or cost units on an equitable basis. The term apportionment refers to the allotment of expenses which cannot be identified wholly with a particular department. Such expenses require division and apportionment over two or more cost centers in proportion to estimated benefits received.

### Allocation Vs Apportionment

(1) Allocation deals with whole amount of factory overheads while apportionmer

(2) The item of factory overhead directly allocated and identified with specific cost centers. Whereas apportionment requires suitable and equitable basis. For example, factory rent may be allocated to the factory and has to be apportioned among the producing and service departments on an equitable basis.

### (b) Re-apportionment (Re-distribution):

Re-distribution of overhead from various service departments to production departments is known as Re-apportionment or Secondary distribution. Accordingly, allocation and apportionment of overheads from service departments or centers to production centers or departments.

#### Methods of Re-apportionment or Re-distribution

The following are the important methods of re-distribution of service department overheads to production department :

- (1) Direct Re-distribution Method
- (2) Step Distribution Method
- (3) Reciprocal Service Method this method further grouped into:
  - (a) Repeated Distribution Method
  - (b) Simultaneous Equitation Method
  - (c) Trial and Error Method

(1) **Direct Re-distribution Method:** Under this method, the cost of service department is directed to re-distribution to the production departments without considering the services rendered by one service department to another service department.

(2) Step Method: Under this method the cost of most serviceable department is first

distributed to production departments and other service departments. Thereafter, the next service department is distributed and later the last service department until the cost of all the service departments are redistributed to the production department

(3) **Reciprocal Service Method :** This method recognizes the fact that if a service department receives services from other department, the services should be charged in the receiving department. Thus, the cost of inter departmental services is taken into account on reciprocal basis. The following are the three important methods available for dealing with reciprocal distribution :

(a) Simultaneous Equation Method: Under this method, the true cost of total overhead of each

service department is ascertained with the help of Simultaneous or Algebraic Equation. The obtained result reapportioned to production department on the basis of given percentage.

(b) Repeated Distribution Method: Under this method, the total overhead costs of the service departments are distributed to service and production departments according to given percentage of the service departments are exhausted, in tum repeatedly until the figures become too small to matter.

(c) Trial and Error Method: In this method, the cost of a service centre is apportioned to another service centre. Then, the cost of another service centre along with the apportioned cost from the first centre is again apportioned back to the first service centre. This process is repeated till the amount to be apportioned becomes zero or negligible.

## **Overhead Calculation**

The typical procedure for allocating overhead is to accumulate all manufacturing overhead costs into one or more cost pools, and to then use an activity measure to apportion the overhead costs in the cost pools to inventory. Thus, the overhead allocation formula is:

Cost pool / Total activity measure = Overhead allocation per unit

#### **Absorption of Overhead Meaning**

Absorption of overhead is also termed as levy, recovery, or application of overhead. Cost absorption refers to the process of absorbing all overhead costs allocated to apportioned over particular cost centre or production department by the unit produced. Accordingly, the distribution of the overhead cost 10 the cost centres or cost units is known as Overhead Absorption.

### **Overhead Rate**

The apportionment of overhead expenses is done by adopting suitable basis such as output, materials, prime cost, labour hours, machine hours etc. In order to determine the absorption of overhead in costs of jobs, products or process, a rate is calculated and it is called as "Overhead Absorption Rate" or "Overhead Rate."

Types of overhead rate

**Different overhead rates** are applied based on the features and objectives of the business organization.

(1) Actual Overhead Rate

(2) Predetermined Overhead Rate

- (3) Blanket Overhead Rate
- (4) Multiple Overhead Rate
- (5) Normal Overhead Rate
- (6) Supplementary Overhead Rate

(1) Actual Overhead Rate: Actual overhead rate as otherwise called the historical rate. This rate is calculated by dividing the actual overhead absorbed by the actual quantity or value of the base selected for a particular period.

(2) **Predetermined Overhead Rate:** Predetermined overhead rate is determined in advance of actual production and the rate is computed by dividing the budgeted overhead for the accounting period by the budgeted base for the period.

(3) Blanket Overhead Rate: Blanket overhead rate is also termed as Single

Overhead Rate. A single overhead rate when computed for the entire factory is known as Blanket Rate.

(4) Multiple Overhead Rate: Multiple overhead rates involve computation of separate rates for each production department, service department, cost centre, each product or line and for each production factor.

(5) Normal Overhead Rate: Normal Overhead Rate is a predetermined rate calculated with reference to normal capacity.

(6) Supplementary Overhead Rates: These rates used to carry out adjustment between overhead absorbed and overhead incurred.

#### Methods of Absorption of Overhead

There are number of methods applicable for computing overhead absorption rate. The following are the various methods of absorbing "Manufacturing Overhead" depending upon the suitable basis selected for the purpose :

- (1) Direct Material Cost Method
- (2) Direct Labour Cost Method
- (3) Direct Labour Hours Method
- (4) Prime Cost Method
- (5) Unit of Output Method
- (6) Machine Hour Rate Method

(1) **Direct Material Cost Method:** Under this method, the rate of absorption is calculated on the basis of direct material cost method. The rate of manufacturing overhead absorption is determined by dividing the manufacturing overhead by the direct material cost. The result obtained the rate of absorption is expressed as percentage.

(2) Direct Labour Cost Method: Direct Labour Cost Method is also termed as Direct Wages Method. Under this method direct wage rate can be determined by dividing the estimated factory overhead cost apportioned by the predetermined direct wages, and the result obtained is expressed as a percentage.

(3) **Direct Labour Hours Method:** Under this method the rate is determined by dividing the production overheads by direct labour hours of each department. This

method is designed to overcome the objections of direct labour cost method. This method is most suitable in such industries where the production is carried out manually or by skilled labours.

(4) **Prime Cost Method:** Under this method, both direct material cost and direct labour cost are taken into account for determination of recovery rate. The actual or predetermined rate of factory absorption is computed by dividing actual or budgeted overhead expenses by the aggregate of direct material or direct labour cost of the department.

(5) Unit of Output Method: This method is also termed as Production Unit Method or Cost Unit Rate Method. Under this method absorption rate is determined on the basis of number of units produced is known as Cost Unit Rate. The recovery rate is calculated by dividing the actual or budgeted factory overheads by the number of cost units produced.

(6) Machine Hour Rate: Machine hour rate means the cost or expenses incurred in running a machine for one hour. It is one of the scientific methods of absorbing factory expenses where the process of manufacturing are carried out by machines. Under this method overhead costs are allocated on the basis of the number of hours a machine or machines are used for a particular job.

According to the Institute of Cost and Management Accountants, England a **machine hour rate** is "an actual or predetermined rate of cost apportionment or overhead absorption, which is calculated by dividing the cost to be apportioned or absorbed by the number of machine hours expended or to be expended."

### Calculation Machine Hour Rate:

The following steps are required for computing the machine hour

(1) Identify the overhead expenses relating to a specific machine or group of machine in order to require for computing machine hour rate

(2) Each machine or group of machine treated as a cost centre.

(3) Manufacturing overhead or machine expenses are grouped into two types:

(a) *Fixed or Standing Charges:* Fixed or Standing Charges which remain constant irrespective of the use of machine. For example, rent, insurance charges, rates, supervision etc.

(b) Variable Machine Expenses: These expenses are variable with use of the machine. For example, power, depreciation, repairs etc.

(4) An hourly rate of fixed or standing charges will be calculated by totaling of fixed charges and dividing by the number of normal hours worked by machine.

- (5) Normal working hours are calculated by adding the cost relating to non-productive time, i.e., normal ideal time for maintenance and setting up etc.
- (6) Separate hourly rate for each machine expenses will be calculated.
- (7) The total of the standing charges rate and the machine expenses rates per hour will give the machine hour rate.

#### Advantages

(1) It helps to measure the relative efficiency of different machines.

(2) It facilitates comparison of cost of operating different machines.

(3) It helps to ascertain idle time of machines relating to non-productive time.

(4) It is the most desirable scientific method, where the time factor is taken into account.

#### Disadvantages

(1) It involves more clerical labour in determining the number of machine hours worked.

(2) It does not consider where the expenses not proportional to the working hours of machines.

(3) It is very difficult to measure the machine hours where the works are completed without operating any machinery.

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## SCHOOL OF MANAGEMENT STUDIES

# UNIT – IV – COST ACCOUNTING AND BANKING – SBAA1308

### UNIT 5 INTRODUCTION TO BANKING

Banking – Meaning, objectives - Role of banking, Classification of Banks - functions of Commercial Banks- functions of RBI - E-Banking and Internet Banking - Meanings, scope, advantages and disadvantages.

#### **INTRODUCTION**

Banking is an integral part of the modern economy. But the nature and functions of modern banks have evolved over a long period of time. The idea of banking evolved with the idea of money. Banking business is mainly linked to lending. Moneylender is to be found in every societyancient or modern; advanced or backward. The priests in temples took advantage of the sanctity of the temples, collected people's savings and did lending business. In the middle ages, banking business was carried by the individuals. Then came partnership and today in all countries banking is carried out by joint stock companies and is regulated by the Government.

#### **ORIGIN OF BANKING**

It is seen that banking transactions have been taking place since last number of years. Even it is evidenced that the banking system was prevailing at the time of Babilon culture. The banks were in existence in Rome also. It was said that in the year 1171, the authorities of Venice had taken loan from the people for meeting the expenses of war and the arrangements for repayment were also made by them. Such loan was called as Mot' in Italian language. The meaning of mot in German language is bank'. In those days, there was German rule in many parts of Italy. Afterwards, in Italian language it was called as banco. The German word bank means a joint stock fund. This word bank was Italianized into banco when the Germans were masters of a great part of Italy.

#### Bank :

A bank is a financial institution which deals with deposits and advances and other related services. It receives money from those who want to save in the form of deposits and it lends money to those who need it. A bank is a financial institution and a financial intermediary that accepts deposits and channels those deposits into lending activities, either directly by loaning or indirectly through capital markets. A bank is the connection between customers that have capital deficits and customers with capital surpluses.

### **Definitions:**

### 1) F.E. Perry:

The bank is an establishment which deals in money, receiving it on deposit from customers, honoring customer's drawings against such deposits on demand, collecting cheques for customs and lending or investing surplus deposits until they are required for repayment.

2) Walter Leaf:

A banker is an institution or individual who is always ready to receive money on deposits to be returned against the cheques of their depositors.

## MAIN FUNCTIONS OF COMMERCIAL BANKS

The main functions of commercial banks are accepting deposits from the public and advancing them loans. However, besides these functions there are many other functions which these banks perform. All these functions can be divided under the following heads:

- 1. Accepting deposits
- 2. Giving loans
- 3. Overdraft
- 4. Discounting of Bills of Exchange
- 5. Investment of Funds

#### 6. Agency Functions

7. Miscellaneous Functions

### **1. Accepting Deposits:**

The most important function of commercial banks is to accept deposits from the public. Various sections of society, according to their needs and economic condition, deposit their savings with the banks.

For example, fixed and low income group people deposit their savings in small amounts from the points of view of security, income and saving promotion. On the other hand, traders and businessmen deposit their savings in the banks for the convenience of payment.

Therefore, keeping the needs and interests of various sections of society, banks formulate various deposit schemes. Generally, there are three types of deposits which are as follows:

#### (i) Current Deposits:

The depositors of such deposits can withdraw and deposit money whenever they desire. Since banks have to keep the deposited amount of such accounts in cash always, they carry either no interest or very low rate of interest. These deposits are called as Demand Deposits because these can be demanded or withdrawn by the depositors at any time they want.

Such deposit accounts are highly useful for traders and big business firms because they have to make payments and accept payments many times in a day.

### (ii) Fixed Deposits:

These are the deposits which are deposited for a definite period of time. This period is generally not less than one year and, therefore, these are called as long term deposits. These deposits cannot be withdrawn before the expiry of the stipulated time and, therefore, these are also called as time deposits..
### (iii) Saving Deposits:

In such deposits, money up to a certain limit can be deposited and withdrawn once or twice in a week. On such deposits, the rate of interest is very less. As is evident from the name of such deposits their main objective is to mobilize small savings in the form of deposits. These deposits are generally done by salaried people and the people who have fixed and less income.

# 2. Giving Loans:

The second important function of commercial banks is to advance loans to its customers. Banks charge interest from the borrowers and this is the main source of their income.

Banks advance loans not only on the basis of the deposits of the public rather they also advance loans on the basis of depositing the money in the accounts of borrowers. In other words, they create loans out of deposits and deposits out of loans. This is called as credit creation by commercial banks..

### (i) Cash Credit:

In this type of credit scheme, banks advance loans to its customers on the basis of bonds, inventories and other approved securities. Under this scheme, banks enter into an agreement with its customers to which money can be withdrawn many times during a year. Under thisset up banks open accounts of their customers and deposit the loan money. With this type of loan, credit is created.

#### (iii) Demand loans:

These are such loans that can be recalled on demand by the banks. The entire loan amount is paid in lump sum by crediting it to the loan account of the borrower, and thus entire loan becomes chargeable to interest with immediate effect.

### (iv) Short-term loan:

These loans may be given as personal loans, loans to finance working capital or as priority sector advances. These are made against some security and entire loan amount is transferred to the loan account of the borrower

# 3. Over-Draft:

Banks advance loans to its customer's up to a certain amount through over-drafts, if there are no deposits in the current account. For this banks demand a security from the customers and charge very high rate of interest.

# 4. Discounting of Bills of Exchange:

This is the most prevalent and important method of advancing loans to the traders for short- term purposes. Under this system, banks advance loans to the traders and business firms by discounting their bills. In this way, businessmen get loans on the basis of their bills of exchange before the time of their maturity.

# 5. Investment of Funds:

The banks invest their surplus funds in three types of securities—Government securities, other approved securities and other securities. Government securities include both, central and state governments, such as treasury bills, national savings certificate etc.

Other securities include securities of state associated bodies like electricity boards, housing boards, debentures of Land Development Banks units of UTI, shares of Regional Rural banks etc.

# 6. Agency Functions:

Banks function in the form of agents and representatives of their customers. Customers give their consent for performing such functions. The important functions of these types are as follows:

(i) Banks collect cheques, drafts, bills of exchange and dividends of the shares for their customers.

(ii) Banks make payment for their clients and at times accept the bills of exchange: of their customers for which payment is made at the fixed time.

# 7. Miscellaneous Functions:

Besides the functions mentioned above, banks perform many other functions of general utility which are as follows:

(i) Banks make arrangement of lockers for the safe custody of valuable assets of their customers such as gold, silver, legal documents etc.

(ii) Banks give reference for their customers.

(iii) Banks collect necessary and useful statistics relating to trade and industry.

(iv) For facilitating foreign trade, banks undertake to sell and purchase foreign exchange.

(v) Banks advise their clients relating to investment decisions as specialist

(vi) Bank does the under-writing of shares and debentures also.

(vii) Banks issue letters of credit.

(viii) During natural calamities, banks are highly useful in mobilizing funds and donations.

(ix) Banks provide loans for consumer durables like Car, Air-conditioner, and Fridge etc.

### **ROLE OF COMMERCIAL BANKS**

Agency Services or Agency functions of commercial banks are elaborated in detail below

1. Collection of Cheques, Dividends, Interests etc.: Collecting cheques, drafts, bill of exchange, dividends, interests etc. on behalf of its customers and credit the amount in their account is one of the most important agency services rendered by the banks. Banker accepts standing instructions from the customers and arranges to collect dividend, interest, pension, salaries, bills etc. on behalf of his customers.

**2. Payment of Subscription,** Rent, Insurance Premium etc.: Banks undertake the payment of subscriptions, rent, insurance premium etc. on behalf of the customers and debit the account with the amount. It accepts the standing instructions of the customer and arranges for. The payment of such expenses on their behalf. It charges a small amount by way of commission for these services.

**3. Conduct of Stock Exchange** Transactions: Banks purchase and sell various securities such as shares, debentures, bonds etc. of joint stock companies both private and Government on behalf of their customers.

**4.** Acting as Executor, Trustees, Attorneys etc.: Banks act as executors of will, trustees, attorneys and administrators. As an executor it preserves the Wills of the customers and executes them after their death. As a trustee, it takes care of the funds of the customers. As an attorney, it signs

transfer forms and documents on behalf of the customer.

5. Preparation of Income Tax Returns: Banks prepare income tax returns for their customers through their tax service departments.

**6.** Conducting Foreign Exchange Transactions: Commercial banks purchase and sell foreign exchange for their customers.

**7. Banker acts as an agent to the customer**. When a customer deposits cheques, drafts, bills or any other promissory notes, the banker collects them and on realization credits the account of the customer. For this activity, the banker is given commission. Banks also act as a correspondent, representative of their customers. Some banks may even get the travelers' tickets, passport etc. for their customers.

#### FUNCTIONS OF A CENTRAL BANK:

A central bank performs the following functions, as given by De Kock and accepted by the majority of economists.

#### **1. Regulator of Currency:**

The central bank is the bank of issue. It has the monopoly of note issue. Notes issued by it circulate as legal tender money. It has its issue department which issues notes and coins to commercial banks. Coins are manufactured in the government mint but they are put into circulation through the central bank. Central banks have been following different methods of note issue in different countries. The central bank is required by law to keep a certain amount of gold and foreign securities against the issue of notes.

### 2. Banker, Fiscal Agent and Adviser to the Government:

Central banks everywhere act as bankers, fiscal agents and advisers to their respective governments. As banker to the government, the central bank keeps the deposits of the central and state governments and makes payments on behalf of governments. But it does not pay interest on governments deposits. It buys and sells foreign currencies on behalf of the government.

It keeps the stock of gold of the government. Thus it is the custodian of government money and

wealth. As a fiscal agent, the central bank makes short-term loans to the government for a period not exceeding 90 days. It floats loans, pays interest on them, and finally repays them on behalf of the government. Thus it manages the entire public debt. The central bank also advises the government on such economic and money matters as controlling inflation or deflation, devaluation or revaluation of the currency, deficit financing, balance of payments, etc.

#### 3. Custodian of Cash Reserves of Commercial Banks:

Commercial banks are required by law to keep reserves equal to a certain percentage of both time and demand deposits liabilities with the central banks. It is on the basis of these reserves that the central bank transfers funds from one bank to another to facilitate the clearing of cheques.

Thus the central bank acts as the custodian of the cash reserves of commercial banks and helps in facilitating their transactions. There are many advantages of keeping the cash reserves of the commercial banks with the central bank, according to De Kock.

In the first place, the centralization of cash reserves in the central bank is a source of great strength to the banking system of a country. Secondly, centralized cash reserves can serve as the basis of a large and more elastic credit structure than if the same amount were scattered among the individual banks.

#### 4. Custody and Management of Foreign Exchange Serves:

The central bank keeps and manages the foreign exchange reserves of the country. It is an official reservoir of gold and foreign currencies. It sells gold at fixed prices to the monetary authorities of other countries. It also buys and sells foreign currencies at international prices. Further, it fixes the exchange rates of the domestic currency in terms of foreign currencies.

# 5. Lender of the Last Resort:

De Kock regards this function as a sine qua non of central banking. By granting accommodation in the form of re-discounts and collateral advances to commercial banks, bill brokers and dealers,

or other financial institutions, the central bank acts as the lender of the last resort. The central bank lends to such institutions in order to help them in times of stress so as to save the financial structure of the country from collapse. It acts as lender of the last resort through discount house on the basis of treasury bills, government securities and bonds at the front door.

The other method is to give temporary accommodation to the commercial banks or discount houses directly through the back door. The difference between the two methods is that lending at the front door is at the bank rate and in the second case at the market rate. Thus the central bank as lender of the last resort is a big source of cash and also influences prices and market rates.

### 6. Clearing House for Transfer and Settlement:

As bankers' bank, the central bank acts as a clearing house for transfer and settlement of mutual claims of commercial banks. Since the central bank holds reserves of commercial banks, it transfers funds from one bank to other banks to facilitate clearing of cheques. This is done by making transfer entries in their accounts on the principle of book-keeping. To transfer and settle claims of one bank upon others, the central bank operates a separate department in big cities and trade centers. This department is known as the clearing house and it renders the service free to commercial banks.

# 7. Controller of Credit:

The most important function of the central bank is to control the credit creation power of commercial bank in order to control inflationary and deflationary pressures within this economy. For this purpose, it adopts quantitative methods and qualitative methods. Quantitative methods aim at controlling the cost and quantity of credit by adopting bank rate policy, open market operations, and by variations in reserve ratios of commercial banks.

#### The Reserve Bank of India

The Reserve Bank of India is India's central bank, responsible for the issue and supply of the Indian rupee and the regulation of the Indian banking system. It also manages the country's main payment systems and works to promote its economic development.

### **TRADITIONAL FUNCTIONS OF RBI**

The traditional functions of Reserve Bank of India includes Issue of Currency, Banker to Govt, Bankers Bank, Credit control Measures, lender of lost resort, exchange control, clearing house etc.

**1. Issue of Currency:** RBI undertakes issue of currency and the system adopted in India is the minimum reserve system. All the currency notes from Rs. 2, Rs 5, Rs. 10, Rs. 50, Rs.

100, Rs. 500 and Rs. 1,000 are issued by RBI and they carry the signature of Reserve Bank of India Governor. They are called unlimited legal tender and any amount of payment can be made with these currencies subject to the regulations of Income Tax Act, 1961.

The one rupee note and smaller coins are issued by the government and they are called limited legal tender which means that they can be demanded as a medium of payment only to a limited extent. The one rupee note carries the signature of secretary to the Ministry of Finance.

**2. Banker to Government:** Reserve Bank of India acts as a banker to the government by maintaining the account of Central government and also that of the State government. It also provides overdraft facility to both State and Central governments. The public borrowings of government are done through Reserve Bank of India. Payments to the government such as income tax are also accepted by Reserve Bank of India.

**3. Bankers' Bank:** The other traditional function of RBI consisting of bankers' bank is done in the following manner:

1. Issuing license to banks and allowing them to open branches under the provisions of Banking Regulation Act.

2. RBI also controls the working of commercial banks and undertakes periodical inspection of these banks.

3. In case of violation of the Banking Regulation Act by any of the commercial banks, RBI will order for the closure of these banks.

4. The management of the commercial banks will also be controlled by Reserve Bank of India. All the top level management appointments of commercial banks require prior approval of RBI. 5. The credit requirements of commercial banks are met by discounting and re- discounting eligible securities at the bank rate.

4. Credit Control functions: RBI exercise the following credit control measures

• The quantitative weapons of bank rate, open market operation and variable reserve ratio are exercised by Reserve Bank of India.

• The modern weapon of selective credit control is also being exercised by RBI particularly on agricultural commodities.

• The seasonal fluctuations in the money market is balanced by Reserve Bank of India through adequate finance during a period of financial stringency.

**5. RBI acts as lender of last resort**: The commercial banks have to maintain as a part of statutory requirements certain percentage of their deposits with RBI which is called cash reserve ratio. By increasing or decreasing this percentage of cash reserve ratio, RBI allows adequate funds for lending purpose by commercial banks. When all the commercial banks are depositing with Reserve Bank of India in the form of cash reserve ratio, a sizable amount of fund is available with RBI. This fund will be extended by RBI to any commercial bank which is facing crisis.

**6. Exchange control function:** In India, we have the exchange control since independence and RBI is given enough powers to exercise exchange control. Without the license of Reserve Bank of India no one can deal in foreign exchange. The exchange rate with different foreign currencies is provided by RBI to its authorized dealers consisting of nationalized and other private commercial banks.

All the foreign exchange earnings in the country are kept by RBI in the form of foreign exchange reserve. RBI also has the responsibility of maintaining the value of domestic currency and take adequate measures so that its value does not depreciate abnormally in relation to foreign currencies.

7.Clearing house: In all big cities Reserve Bank of India has its branches and clearing house

operations are undertaken. Where RBI does not have its branch, the clearing house operations are undertaken by State Bank of India and its subsidiary banks. All the commercial banks in India are members in clearing house and they take part in the clearing of cheques.

#### **PROMOTIONAL FUNCTIONS OF RBI**

Various promotional functions performed by the Reserve Bank of India are given below

**1. Promotion of Banking Habit**: The Reserve Bank of India helps in mobilizing the savings of the people for investment. It expanded banking system throughout the nation by setting up of various institutions like UTI, IDBI, IRCI, NABARD etc. Thereby it promoted banking habit among the people.

**2. Providing Refinance for Exports:** The Reserve Bank of India is providing refinance for export promotion. The Export Credit and Guarantee Corporation (ECGC) and Export Import Bank were established initially by the Reserve Bank of India to finance the foreign trade of India. They finance foreign trade in the form of insurance cover, long-term finance and foreign currency credit. However, they are now functioning separately.

**3. Providing Credit to Agriculture:** The Reserve Bank of India makes institutional arrangements for rural or agricultural finance. For example, the bank has set up special agricultural credit cells. It has promoted regional rural banks with the help of commercial banks. It has also promoted NABARD.

**4. Providing Credit to Small Scale Industrial Unit:** Commercial banks lend loans to smallscale industrial units as per the directives issued by the Reserve Bank of India time to time. The Reserve Bank of India encourages commercial banks to render guarantee services also to smallscale industrial sector. The Reserve Bank of India considers advances given to small- scale sector as priority sector advances. It also directed commercial banks to open specialized branches to provide adequate financial and technical assistance to small-scale industrial branches.

**5. Providing Indirect finance to Cooperative Sector:** The RBI has directed NABARD to give loans to State Cooperative Banks, which in turn lend loans to cooperative sector. Hence, the Reserve Bank of India provides indirect finance to cooperative sector in India.

**6. Exercising Control over Monetary and Banking system of the Country:** The Reserve Bank of India is vested with enormous and extensive powers regarding supervision and control over commercial banks, cooperative banks and also non-banking institutions receiving deposits. The Banking Regulation Act prescribes extensive requirements as minimum regarding the paid-up capital, reserves, cash reserves and liquid assets.

The operation of the bank, the management, amalgamation, reconstruction and liquidation etc. are thoroughly supervised by the officials of the Reserve Bank of India. Every scheduled bank is required to furnish to the Reserve Bank a weekly statement showing the principal items of its liabilities and assets in India.

**7. Making Industrial arrangement for Industrial Finance:** The Reserve Bank of India makes institutional arrangement for industrial finance. For instance, it has brought into existence several development banks such as the Industrial Finance Corporation of India, the Industrial Development Bank of India, which provide long-term finance to industries.

**Classification of Banks** 



# **Commercial Bank**

Commercial Bank are regulated under the Banking Regulation Act, 1949 and their business model is designed to make profit. Their primary function is to accept deposits and grant loans to the general public, corporate and government. Commercial banks can be divided into- Public Bank, Private Bank, Foreign Bank and Regional Rural Banks.

# **Regional Rural Banks.**

These are also scheduled commercial banks but they are established with the main objective of providing credit to weaker sections of the society like agricultural labourers, marginal farmers and small enterprises. They usually operate at regional levels in different states of India and may have branches in selected urban areas as well.

- Providing banking and financial services to rural and semi-urban areas
- Government operations like disbursement of wages of MGNREGA workers, distribution of pensions, etc.
- Para-Banking facilities like debit cards, credit cards and locker facilities

# Foreign bank

A foreign bank is one that has its headquarters in a foreign country but operates in India as a private entity. These banks are under the obligation to follow the regulations of its home country as well as the country in which they are operating. Ex: AMN Ambro, BNY Milon, RBS and BNP Paribas

# Nationalised banks

These are the nationalised banks and account for more than 75 per cent of the total banking business in the country. Majority of stakes in these banks are held by the government. In terms of volume, SBI is the largest public sector bank in India and after its merger with its 5 associate banks (as on 1<sup>st</sup> April 2017) it has got a position among the top 50 banks of the world.

Ex: SBI, Indian Bank, BOI, IOB, Canara bank and Punjab National Bank.

# **Private Sector bank**

These include banks in which major stake or equity is held by private shareholders. All the banking rules and regulations laid down by the RBI will be applicable on private sector banks as well. Given below is the list of private-sector banks in India.

Ex: ICICI Bank, Axis Bank, Tamilnadu Mercantile Bank, HDFC Bank and Yes Bank

# **Payment bank**

This is a relatively new model of bank in the Indian Banking industry. It was conceptualised by the RBI and is allowed to accept a restricted deposit. The amount is currently limited to Rs. 1 Lakh per customer. They also offer services like ATM cards, debit cards, net-banking and mobile-banking.

# **Co-operative banks**

Co-operative banks are registered under the Cooperative Societies Act, 1912 and they are run by

an elected managing committee. These work on no-profit no-loss basis and mainly serve entrepreneurs, small businesses, industries and self-employment in urban areas. In rural areas, they mainly finance agriculture-based activities like farming, livestock and hatcheries.

### Scheduled banks

Scheduled banks are covered under the 2nd Schedule of the Reserve Bank of India Act, 1934. To qualify as a scheduled bank, the bank should conform to the following conditions:

- A bank that has a paid-up capital of Rs. 5 Lakh and above qualifies for the schedule bank category
- A bank requires to satisfy the central bank that its affairs are not carried out in a way that causes harm to the interest of the depositors
- A bank should be a corporation rather than a sole-proprietorship or partnership firm

# Non-scheduled banks

Non-scheduled banks refer to the local area banks which are not listed in the Second Schedule of Reserve Bank of India. Non-Scheduled Banks are also required to maintain the cash reserve requirement, not with the RBI, but with them.

# **INTERNET BANKING**

Internet banking and online banking is an outgrowth of PC banking. PC banking enables Customers to execute bank transactions from their personal computer via a modern through financial software of the bank. Internet banking has become a strategic necessity for most of the banking transactions. Internet banking is the ability to use one's personal computer to communicate with one's bank. It is being used as a distribution channel to build up customer contracts in a systematic way in order to inform counsel sell product and services.

As observed early customer behavior has changed drastically due to technological advancement and changes in life style. The use of financial services is today characterized by individuality, mobility, independence of time and place and flexibility. Internet is being viewed as a new distribution channel to provide complex product at lower cost to more and more potential customers who can consume them at anytime from anywhere in world. The internet has helped banks to enlarge their market area without building new offices and to increase their market share and profits.

All banks which propose to offer internet services suit obtain prior approval from RBI. Only those banks which are licensed and supervised in India and have physical presence in India will be permitted to offer internet banking product to residence of India. Thus both banks and virtual banks incorporated outside the country and having no physical present in India will not present be permitted to offer internet banking services to Indian residents.

A number of routine issues which are simple in nature but time-consuming can be handled through the internet, e.g. customer's request for opening an account, balance enquiries, FD renewals, request for cheque books, foreign exchange rates, on line bill payments, stop payment request, request for debit cards, transfer of funds on-line and monthly statement by e-mail. No staff intervention is required in all these cases and the bank can provide all these service to their customer at a fraction of the cost. Internet banking not only ensures saving in the salary of staff, but also enhances the bank's ability to increase their customer base without having to invest in exorbitantly priced real estate for opening more physical branches. According to some estimates, the cost per transaction over the internet is one- eighth of the cost to the bank if performed through branch banking.

#### ADVANTAGES

- Internet banking provides
- Anywhere and anytime banking as services are provided round the clock
- Worldwide connectivity as it transcends geographical boundaries
- Easy access to recent and historical data
- Direct customer control of international movement of funds
- Greater processing speed and accuracy

### **ONLINE BANKING**

Online banking allows a user to execute financial transactions via the internet. Online banking is also known as "internet banking" or "web banking." An online bank offers customers just about every service traditionally available through a local branch, including deposits, which is done online or through the mail, and online bill payment.

#### **Advantages of Online Banking**

Convenience is a major advantage of online banking. Basic banking transactions such as paying bills and transferring funds between accounts can easily be performed at times convenient to consumers. In effect, consumers can perform banking transactions 24 hours-a- day, seven-days a week. Online banking is fast and efficient. Funds can be transferred between accounts almost instantly, especially if the two accounts are held at the same banking institution. Banking accounts can be monitored more closely thanks to online banking. This allows consumers to keep their accounts safe. Around-the-clock access to banking information provides early detection of fraudulent activity that has the potential to cause financial or damage loss. Online banking allows for the opening and closing of fixed deposit and recurring deposit accounts that typically offer higher rates of interest.

#### **Disadvantages of Online Banking**

For a novice online banking customer, using systems for the first time may present challenges that prevent transactions from being processed. Although online banking security is continually improving, such accounts are still vulnerable when it comes to hacking. Consumers are advised to use their data plans, rather than public Wi-Fi networks when using online banking, to prevent unauthorized access. Additionally, online banking is dependent on a reliable internet connection. Connectivity issues from time-to-time may make it difficult to determine if banking

transactions have been successfully processed.

# **OFF-LINE BANKING**

An offline transaction, also known as a signature debit transaction, is a payment method that uses a debit card

Today, business moves faster, and most commercial activities are dependent on banks. The need, therefore, is being felt for continuous availability of operations. Uninterrupted banking services are absolutely necessary for customer satisfaction and brand protection. Interruptions in business can occur anywhere, anytime, due to any of the following reasons:

- Natural Calamities, like earth quakes, tsunamis etc.
- Terrorist attacks
- Power failures
- Loss of data-connectivity

Whenever, there is interruption in connectivity, it requires some time to get it restored. During this period of dis-connectivity bank's are required to provide some essential services to its customers. Off-line data capturing ensures uninterrupted basic customer services.

Features:

- Data Capturing from Finacle and RBI
- Handling Transactions and Clearing services
- Uploading of data to Finacle after restoration of connectivity

# **MOBILE BANKING**

It is a system that allows customers of a financial institution to conduct a number of financial transactions through a mobile device such as a mobile phone or personal digital assistant.

# FEATURES & BENEFITS OF MOBILE BANKING

# a) Simplicity:

The m-payment application must be user friendly with little or no learning curve to the customer.

The customer must also be able to personalize the application to suit his or her convenience.

### **b) Universality:**

M-payments service must provide for transactions between one customer to another customer (C2C), or from a business to a customer(B2C) or between businesses (B2B). The coverage should include domestic, regional and global environments. Payments must be possible in terms of both low value micro-payments and high value macro payments.

# c) Security, Privacy and Trust:

A customer must be able to trust a mobile payment application provider that his or her credit or debit card information may not be misused. Secondly, when these transactions become recorded customer privacy should not be lost in the sense that the credit histories and spending patterns of the customer should not be openly available for public scrutiny. Mobile payments have to be as anonymous as cash transactions.

### **COMPUTERIZED BANKING SYSTEM**

(CBS) is a banking establishment to manage customer data. Computerized banking system is for creating customer account of whole world. Also known as computerized banking management system (CBMS), customer account records management, customer transaction control or customer data report's system

**Computerized Banking System** means how to manage the database of customers that how the customers are merged in different fields. In this project we admit the new registration of customer. We can update customer's records. We can retrieve customer's data such as their balance, withdrawals, deposits, modifying etc. In this project we can delete customer's records. This project is connected through data base access.

A Computerized Banking System (CBS) is designed to help banks for manage the data base. Extensive information is available at your fingertips through this System. Viewing customer data, account open and deletion, managing transaction, with drawls, balance inquiry, modify account, customer information, data environment and data reports and related issues are made simple and easy. There are custom search capabilities to aid in finding customer information and working on customer records. This can make the system easier to navigate and to use maximizing the effectiveness of time and other resources.

### **BENEFITS OF E-BANKING**

#### NATIONAL ELECTRONIC FUNDS TRANSFER (NEFT)

NEFT is a system similar to RTGS with certain differences. RTGS handles big ticket transactions, whereas NEFT handles smaller size transactions. Most branches are using this facility to transfer funds in an efficient manner. Once the applicant for the transfer of funds furnishes full and correct details (correct account details means correct name of the beneficiary, the correct account number, the branch and bank of the beneficiary, and the correct IFS code, etc.) funds can be transferred to the beneficiary's account by the remitting bank. Transfer of funds through NEFT is safe, quick. It reduces the paper work and is cost effective.

NEFT is an innovative electronic media for effecting transfer of funds. Special features of NEFT are:

- NEFT is a funds transfer system which enables a customer of a bank to transfer funds to another customer of another bank having account with any participating bank
- NEFT allows both intra and inter-bank funds transfer within a city and across cities
- Since it is in the form of e transfer, without any physical movement of instruments, funds can be transferred quickly
- The beneficiary customer gets funds in his account on the same day or at the earliest on the next day depending upon the time of settlement
- Both the originating and destination bank branches should be on NEFT platform
- The correct details of IFSC, beneficiary's name, account numbers, etc., should be furnished to the originating bank.
- The originating bank branch can keep track of the status of the NEFT transaction.
- In case for any reason the destination branch is not able to afford credit to the beneficiary's account, destination branch/bank have to return the funds to the originating bank within two

hours of completion of the batch

• It is not only easy method of transfer of funds, but also enables the remitters to have user friendly and cost effective transfer of funds

# **AUTOMATED TELLER MACHINE (ATM)**

An automated teller machine or automatic teller machine (ATM) is computerized telecommunications device that provides a financial institution's customers a secure method of performing financial transactions in a public space without a human clerk or bank teller.

An earlier version of an ATM was developed in 1939 in York, by the than city bank of New York, but removed only after 6 months of installation due to the lack of customer acceptance. This status quo was maintained for nearly 25 years till Barclays bank of UK installed an ATM in 1967 in London. ATMs first came into wide use during the early eighties to mid- eighties in the west and picked up later in the 1990s in india.

ATMs can be interior (i.e., located in the branch premises) or exterior (located anywhere outside the branch premises, e.g. at railway stations, airports, shopping malls, etc.,) banks need not obtain permission of the RBI for installation of ATMs at branches and extension counters for which they hold licences issued by the reserve bank.

They can also install offsite ATMs without RBI approval. However, they should obtain a licence from the regional office

of DBOD (department of banking operations and development) of RBI, before operational zing the ATM, so as to be in conformity with section 23 of the banking regulation act.

### DEBIT CARDS

Like the credit card a debit card too is a payment mechanism which allows the holder to make purchase without making any immediate cash payment. It appears that plastic money seems to be the preferred mode of payment for more and more and more people. While the use of credit cards and debit cards has increased manifold both in terms of value and volume of transactions yet the growth in use of debit cards has been at a much faster rate than in the case of credit cards.

#### **SMART CARDS**

As the name suggests this plastic card is smarter than the credit card and debit card. A smart card is a magnetic strip card that is embedded with a computer microchip and designed with a far greater capacity. The microchip provides the smart card intelligence and memory. It is small enough to be conveniently carried around, and has manifold application. In fact, it is almost like carrying a portable computer in one's pocket.

#### **CREDIT CARDS**

There are various ways of making payment through the banking system. These include cheques, direct debits, bank drafts, electronic transfer, international money orders, letters of credit etc. since, the beginning of 1980s, the banks introduced a new facility for making payments, i.e., the credit cart. The use of credit card is essentially a method of postponing payment. When the customer makes a purchase, the actual payment is made later when he issues a cheque for the payment on his bank.

These cards are made of plastic, he nce they are referred to plastic money plastic money refers to substitution of currency at the time when a payment is taking place by using a card. It has become the best alternative to cash and made life simpler, easier and faster than before. Plastic money has increasingly become an alternative payment system in most developed and developing countries. There are myriad factors responsible for this. First and foremost the technical revolution in the banking sector has eliminated physical and geographical banking and replaced it with anytime anywhere banking. This has played a crucial role in the payment card industries. Secondly, there has been a sea change in consumer behavior .They want the convenience and safety in making payments. With the use of credit card there is no need to stand in queues in the bank branch, where they have an account during banking hours on a working day. The use of hard cash and thus provides safety to the cardholder.

### **DEFINITION OF 'E-CASH'**

An Internet-based system allows funds to be transferred anonymously. Similar to credit cards, eCash was free to users, while sellers paid a fee. Because of security concerns, eCash remains more of an idea and less of an actual payment system.

### SWIFT

Society for Worldwide Inter-bank Financial Telecommunications (SWIFT) is a co-operative nonprofit making organization established under Belgian law with its head quarters at Brussels. SWIFT is wholly owned by its member banks. SWIFT is a paperless message transmission system.

SWIFT – important features:

- Operates on 24x7 basis throughout the year
- All messages are transmitted to any part of the world immediately
- Message formats are standardized
- Information is confidential and is protected against unauthorized disclosure
- SWIFT assumes financial responsibility for the accuracy and timely delivery
- SWIFT and banks
  - SWIFT transmit authenticated financial and non financial messages

• SWIFT with its well-standardized and structured message formats have been offering a reliable system of message transmission

• Banks use SWIFT platform to for transmission of financial and non financial messages covering international finance (settlement of forex deals), international trade (advising of LCs, amendments to LCs etc,)

# **REAL TIME GROSS SETTLEMENT (RTGS)**

One of the important IT revolutions in Indian Banking Scenario was the implementation of the Real Time Gross Settlement (RTGS) system by the Reserve Bank of India. With the changing

scenario from manual environment to electronic mode, banks started to use faster, safer and efficient methods to transfer funds.

In this regard, two important and popular electronic funds transfer systems are Real Time Gross System (RTGS) and National Electronic Funds Transfer System (NEFT) RTGS is an electronic payment system, where payment instructions are processed on a

#### **RTGS: Special features:**

(a) Real Time Gross Settlement helps banks to settle interbank and forex settlements

(b) It also helps banks in handling big ticket funds transfers

(c) Since RTGS it is routed through RBI platform, the credit risk is minimized (this is one of the main advantages in settlement of funds)

(d) Unlike in case of cheque clearance, the drawer of the cheque cannot enjoy the float time (the date of issuance of cheque and the date on which it is received in inward clearing and debited by his banker) However, in the case of RTGS, the remitter's account is debited first and then only the funds are transferred

(e) If all relevant details such as the beneficiary's name, account number, IFSC code of the receiving branch, name of the beneficiary bank, etc., are correctly furnished it would assist the remitting bank to effect the transfer quickly

(f) As the name RTGS suggests, the transfer mechanism works on real time and, therefore, the beneficiary branch/bank should receive the funds immediately. The beneficiary's branch/bank should give credit to the beneficiary's account immediately or latest within 2 hours of receiving the funds transfer message.

However, in case the funds cannot be credited for any reason, such funds should be returned to the originating branch within two hours. In such a situation, as soon as the money is returned, the remitting bank should reverse the original debit entry in the client's (remitter's) account. This system is applicable between banks/branches who are on Core Banking Solutions (CBS)

### IMPACT OF TECHNOLOGY IN BANKING

Development of Computerized Banking Software:

With the development of Banking Applications, the banks process becomes faster and more reliable and the record keeping and retrieval becomes much easier.

Development of Core Banking Solution:

However, the Computerized Banking offers great and reliable service but with the expansion of the Internet the concept of core banking comes into picture and whoa! There comes the new Core Banking System. With implementing the CBS, the bank's branches are getting interconnected to common centralized database and hence, were able to provide Multi-City Banking.

# **Development of MICR Cheque Processing:**

With the use of Magnetic Ink - the MICR Cheque Processing System has been developed and strategically implemented. This technology revolutionizes the cheque clearing process from over the counter to a more systematic procedure which is fast and efficient.

Development of Credit/Debit Cards (Plastic Money):

**The magnetic data** recording technology was used with the magnetic strips on the plastic cards and hence, the ATM/Debit/Credit Cards are used along with the ATM Machines which reduces the account holder's requirement to visit the branch within the banking hours to withdraw the money from his/her account.

# **Development of Internet Banking Solution:**

With data being centralized, and increasing internet reach, the Internet Banking Solution was developed and now it is offered by almost every bank. The Internet Banking offers you many transactions and inquires to be performed online without visiting the branch. The various banking automation systems also facilitated the users with ease of automated banking services like cash deposit machine, cheque deposit machine, passbook printing machine, automated inquiry machine, etc.

**Development of Mobile Banking Solution:** With the introduction of Mobile Internet and Mobile Application Development, the Mobile Banking Applications were developed and it makes your life easy just banking on your mobile which is truly anywhere - anytime.

**Development of Cheque Truncation System (CTS):** With the refinement in imaging and internet technology, the Cheque Truncation System came into existence. The CTS removes the movement of physical instruments (cheques, demand drafts, warrants, etc.) which was required in old MICR Clearing System. With this the clearing process becomes more fast and secure.

**Development of Online Loan Processing:** The development of very intelligent a system which process the pre-approved online loan applications of the customers and disburses the amount online. It is a great facility with ease of availing the loan within seconds and that to at any time. Well, this is the technology which is transforming everything and there are lot more developments which are going on towards the customer service, process improvement, etc. an in the near future we will see the completely transformed banking. Thanks to the Technology. Current Scenario of E-Banking in India

**Internet Banking** has become an integral part of banking system in India. The concept of ebanking is of fairly recent origin in India. Till the early 90's traditional model of banking i.e. branch based banking was prevalent, but after that non-branch banking services were started. The Indian government enacted the IT Act, 2000, with effect from the 17th October 2000. To examine different aspects of Internet banking RBI set up a committee on Internet Banking. The committee had focused on three major areas of Internet banking, Technology and security issues, legal issues and regulatory and supervisory issues. RBI had accepted the suggestions and recommendations of the working committee and accordingly issued guidelines to banks to implement internet banking in India. The old manual systems which were prevalent in Indian banking for centuries seem to replaced by modern technologies.

### **Challenges in adoption of E-banking**

E-banking is facing following challenges in Indian banking industry:

• Not safe and secure: The most serious threat faced by ebanking is that it is not safe and secures all the time. There may be loss of data due to technical defaults.

• **High start up cost:** E-banking requires high initial start up cost. It includes internet installation cost, cost of advanced hardware, software, modem, computers, cost of maintenance of all computer equipments, and cost of reorganizational structure.

• Lack of Professional: There is shortage of web developers' content providers and knowledgeable professionals to perform banking activities through internet.

• **Restricted Business:** All banking transactions cannot be performed electronically. Many banking activities require personal visit of customers.

• **Improper infrastructure:** There is lack of proper infrastructure for the installation of edelivery channels.

• Not techno savvy: A majority of customers are not computer savvy.

### **Recommendations to overcome the challenges**

The following are certain recommendations to popularise ebanking services/ products:

• Create awareness about e-banking: Banks should create awareness among people about ebanking products and services. Customers should be made literate about the use of e-banking products and services.

• Special arrangements by banks: Special arrangements should be made by banks to ensure full security of customer funds. Technical defaults should be avoided by employing well trained and expert technicians in field of computers, so that loss of data can be avoided. Banks should use latest technologies with timely updates to secure customers valuable money from the hands of hackers.

• Specialised training: Employees of banks should be given special technical training for the use

of e-banking, so that they can further encourage customers to use the same.

- Organising seminars and workshops: Seminars and workshops should be organised on the healthy usage of ebanking especially for those who are ATM or computer illiterate.
- Cater to need of customers: E-banking services should be customised on basis of age, gender, occupation etc so that needs and requirements of people are met accordingly.

#### Need of e Banking In India

E-banking is need of the hour. Though there are lots of hurdles in the way of smooth implementation of E-banking in India but at the same time E-banking has bright future in India. It is golden path for banking sector in India to maximize its profits and also the customer base. That's why E-banking can never be neglected. Moreover the recommendations provided in this research are useful for the banks and also for the customers for better service and satisfaction respectively. Thus only those banks will survive in the future which will manage the changes as per technological developments and customer requirements because future of the banks ultimately stays in the hands of customers. They should be satisfied at any cost.

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