KISM AND KASNEB

CPSP PART 2

PROCUREMENT COSTING AND BUDGETING

TABLE OF CONTENT

CONTENTS

TOPIC 1

NATURE AND PURPOSE OF COSTING AND SUPPLY

Definition of and Scope of Cost Accounting

Cost accounting (commonly) termed "costing" may be defined as:

"The establishment of budgets, standard costs and actual costs of operations, activities or products; and the analysis of variances, profitability, or the social use of funds"

The accounting system of any organization is the foundation of the internal financial information system. Management needs a variety of information to plan, to control and to make decisions. Information regarding the financial aspects of performance is provided by the costing system. Examples of information provided by a typical costing system and how it is used are given in the following table and the following paragraphs.

Example of costing information and uses

Information provided by costing system	**Possible uses by management**
Cost per unit of production or service or for a Process	As a factor in pricing decisions, production planning and cost control
Cost of running a section, department of Factory	Organization planning, decisions on alternative methods, wages cost control
Wages costs for unit of production or per period of production.	Production planning, decisions on alternative methods, wages cost control
Scrap/rectification costs	Material cost control, production planning
Cost behaviour with varying levels of activity	Profit planning, make or buy decisions, cost Control

Cost accounting and control

An important part of the management task is to ensure that operations, departments, processes and costs are under control and that the organization and its constituent parts are working efficiently towards agreed objectives. Although there are numerous other control systems within an organization, for examples production control, quality control, inventory control, the costing system is the key financial control system and monitors and the results of all activities and all other control systems. The detailed analysis and location of all expenditures, the calculation of job and product costs, the analysis of losses and scrap, the monitoring of labour and departmental efficiency and output of the costing provide a sound basis of information for financial control.

Cost accounting and financial accounting

Financial accounting can be defined as:

"The classification and recording of the monetary transactions of an activity in accordance with established concepts, principles, accounting standards and legal requirements and their presentation, by means of profit and loss account, balance sheets and cash flow statements, during and at the end of accounting period"

Financial accounting originated to fulfill the stewardship function of businesses and this is still an important feature. Most of the external financial aspects of the organization, e.g., dealing with accounts payable and receivables, preparation of final accounts etc., are dealt with by the financial accounting system. Of course internal information is also prepared, but in general it can be said that financial accounting presents a broader, more overall view of the organization with primary emphasis upon classification according to type of transaction rather than the cost and management accounting emphasis on the function, activities, products and processes and on internal planning and control information.

Difference between financial accounting and cost accounting

Financial accounting	Cost accounting
Provides information to external users	Provides information to internal users
Produces general purpose financial statements	Produces special statements and reports
Must confirm to generally accepted accounting principles	Must conform to information needs of Management
Provides accounting data in monetary terms	Provides accounting data in monetary and non-monetary terms
Financial statements are prepared on yearly or half yearly basis	Cost statements and reports are prepared ,ore frequently i.e. weekly and daily basis

Management Accounting

Management accounting is defined as:

"The application of professional knowledge and skill in the preparation and presentation of accounting information in such a way as to assist management in the formulation of policies and in the planning and control of operations of the undertaking".

The provision of information required by management for such purposes such as:

a) Formulation of policies
b) Planning and controlling the activities of the enterprise
c) Decision taking on alternative courses of action
d) Disclosure to those external to the entity
e) Disclosure to employees
f) Safeguarding assets

Management accounting uses both financial and cost information to advice management in planning and controlling the organization.

The objectives of the various facets of accounting have been given above and differences. And the differences discussed. However, it must be realized that all form part of the financial information system of an organization and in many organizations the various facets are totally integrated with no artificial divisions between them.

Purpose of Cost Accounting

The main purpose or advantages of cost accounting are:

(i) **Cost ascertainment:** The costs of producing different goods or services must be ascertained accurately. These costs consist of material cost, labour costs and overheads.

(ii) **Controlling.** This is the process by which management makes sure that intended and desired results are consistently and continuously achieved. This consists of; establishing of standards, comparison of results against standards and correction of deviations.

(iii) **Disclosure of waste***:* Costs incurred for the production of any commodity can be determined in advance in view of the past experience. If actual costs are higher than the expected or standard costs then this excessive costs can be analyzed. These excessive costs may be due to wastage of raw materials or idle labour time.

(iv) **Decision making:** management is responsible for decisions regarding what goods/services should be produced and in which quantity. Cost accounting information provides information for making these decisions.

(v) **Cost control** this is an important function of management. Material cost, labour cost and overheads must be maintained at desirable levels. Cost accounting principles are used to eliminate unnecessary costs.

(vi) **Evaluation of alternatives:** Management is frequently confronted with decisions involving choice from different alternative courses of action e.g., whether to make or buy a product, whether to continue or discontinue a product/service etc. Cost accounting provides information as to how future costs and revenues will be affected under each alternative thus assisting management in taking an appropriate selection.

(vii) **Planning:** is the process of setting objectives and then determining the steps required to attain them. It is the activity by which managers analyze present conditions to determine ways of reaching the desired future. Planning requires appropriate information and cost accountants makes analysis of costs of past operations. These costs are adjusted to reflect changes in products, technology, volume, production efficiency, input cost etc.

(viii) **Pricing of products and projects:** This involves determination of prices of new products adjustment in prices of existing products as well as determination of bid prices for contracts. The decision of setting prices is based on cost data collected.

(ix) **Measurement of efficiency:** Cost data are used to measure the efficiency of an organization in utilization of resources employed in production process.

(x) **Inventory management:** costing assists in inventory management by keeping accurate and complete records of materials from time they enter into premises till the time they are used in production process.

(xi) **Evaluation of profitability:** Costing provides information for evaluating the profitability of an activity, department or the entire organization.

Conditions for Effective Costing System

A costing system is designed in accordance to the requirements of the organization. The system should simple, economical and practicable. The main conditions are:

(i) There must be a proper system of store and stock control

(ii) There must co-operation and co-ordination among the staff members of the organization.

(iii) The wages procedure must be proper and satisfactory. Labour costs should be charged to respective jobs accurately.

(iv) Standard printed forms must be used for recording the receipts of materials and issues, recording labour hours worked and calculations and other activities of the organization.

(v) The overheads must be recorded accurately and these must be charged to respective production departments

(vi) The costing department must be established. The responsibilities and duties of cost accountant should be clearly stated.

(vii) The cost accounts and financial accounts should be maintained in a way that results can be reconciled easily.

TOPIC 2

COST CONCEPT AND CLASSIFICATION

Cost

This may be defined as:

"The amount of expenditure (actual or notional) incurred on, or attributable to, a specified thing or activity."
At the simplest level, cost includes two components, quantity used and price, i.e.

Cost = quantity used x price

Cost units

The cost unit to be used in any given situation is that which is most relevant to the purpose of the cost ascertainment exercise. This means that in any one organization numerous cost units may be used for particular parts of the organization or for differing purposes.

The main elements of costs are:

a) Raw material this usually form a high proportion of the total cost of production

b) Labour

c) Overheads

Classification of Costs

Classification is the process of grouping costs recording to their common characteristics. Classification of cost is done in order to be concise of every cost incurred in the process of manufacture so that such costs can be accurately recorded, monitored and controlled. They are various ways of grouping cost:-

1. **Function classification:** A business has to perform a number of functions e.g. manufacture, administration, selling, distribution and research. On this basis costs are classified into the following;

a) **Manufacturing/production/factory cost:** These are costs related to the manufacturing process e.g. material cost, labour, cost and factory cost such as rent, depreciation of machinery, power and lighting etc.

b) Adminstrative costs include all expenditure incurred in formulating policies, directing the organizations and controlling the operation of an undertaking such as audit fee, office rent, salaries etc.

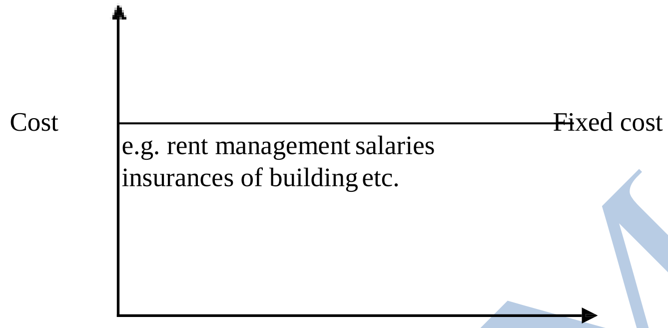
c) **Selling cost** are costs of seeking to create and stimulate demand and to serve orders e.g. advertising, salaries and commission of salesmen etc.

d) **Distribution expenses** are cost incurred to avail the product to the final consumer. E.g. packing cost, carriage outward, warehousing cost etc.

e) **Research and development cost** this is the cost of searching new and improved products and methods. E.g. wages and salaries of research staff, payment to outside research organizations etc.

2. Classification according to behaviour or variability

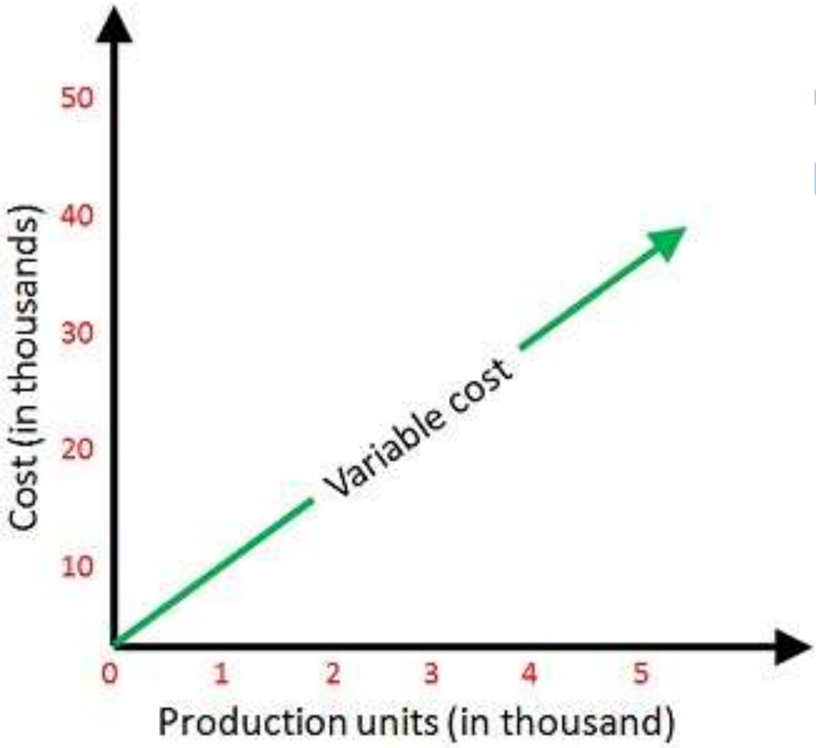
a) **Fixed cost** – This is a cost which does not vary with activities or output. It remains constant within the relevant range as shown in Figure 2.1. A relevant range is range within which relationship between cost and activity hold.



Activity

Fixed costs

b) **Variable cost** is costs that vary in direct proportion to the volume of output. When volume of output increases variable cost also increases and vice versa as indicated below.



c) **Semi variance cost:** These are costs that are partially fixed and partially variable. A semi-variable cost has often a fixed element below which it will not fall at any level of output. The variable element is a semi-variable cost changes either at a constant rate or in lumps. E.g. electricity bill which has a fixed element in it below which it cannot follow and a variable element that changes based on the power consumptions as shown below