
Unit 2 □ Cost Concepts and Cost Objects

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2.1 Introduction

Since cost accounting deals with the analyses of costs for various decision making purposes, a clear conception about 'cost' and its distinction from other similar terms are pre-requisite for cost accounting. With these ends in view, this unit discusses the following aspects in different sections apart from the present *introductory* section : Concept of Cost, Cost vs. Expense, Cost Object, Cost Objective, and Types of Costs.

2.2 Concept of Cost

In common parlance, cost is 'the amount of money, effort, etc. required to achieve an end.' (one of the meanings given in Webster's New World Dictionary, ed. by David B. Guralink, Oxford & IBH Publishing Co., 1976). In business parlance too, similar meaning has been expressed in the following two definitions of cost. The first definition has been given in the terminology published by ICMA; it reads as 'the amount of expenditure (actual or notional) incurred on or attributable to a specified thing or activity.' The other definition given by the Committee on Cost Concepts and Standards of the American Accounting Association goes on saying cost as 'a foregoing, measured in monetary terms incurred or potentially to be incurred to achieve a specific objective.' So, cost is essentially a sacrifice measurable in money value, made for acquisition or creation of some economic resources necessary for achievement of some objective. For example, in case of purchasing materials, cost

is the *sacrifice* of the amount of money paid or to be paid for *acquisition* of materials (economic resource) necessary for *manufacturing* (objective) goods.

2.3 Cost vs. Expenses

The two terms 'cost' and 'expense' connote more or less the same meaning as we find in the definitions of cost given above. Cost is sometimes referred to as 'the sum of the expenditures' or 'the measure of the expenditure'. However, some authors have made minute distinction between the two terms. According to them, costs may be either *deferred* for which benefits are receivable in future period of time or *expired* for which benefits have already been received. Since the benefit-period has not expired in case of deferred costs, these are also called *unexpired* costs; these are, therefore, capitalized and shown in the balance sheet as assets (for example, building, plant, equipment, inventory etc.). On the other hand, expired costs like rent, salary, wages, etc. are charged against (deducted from) revenues (sales) and are naturally shown in the Trading and Profit & Loss A/c. Expired costs are referred to as *expenses*. It may so happen that benefits out of deferred costs are gradually received in future period. In such cases, the extent to which benefits are received, are converted from 'deferred cost' to 'expense'. Depreciation (expired cost) charged on assets (unexpired or deferred cost) is an example on the dot.

2.4 Cost Object

Object is any person or thing to which an action or thinking is directed. Cost object is therefore, the thing or activity for which cost is incurred and for which we want to have a separate measurement for cost so incurred. Any activity operation, product, service, department, project or programme may be referred to as a cost object. The term 'cost' does not carry any sense unless it is tied to a cost object.

2.5 Cost Objective

Objective means purpose or goal. So, cost objective/s is/are the purpose/s for which costs are incurred. Some of the important purposes for which cost data may be used are :

- i) Determining cost of a product or service,
- ii) Determining periodic profit,
- iii) Determining prices of products or services,
- iv) Planning and budgeting,
- v) Controlling costs.

To make a distinction between *cost object* and *cost objective*, an example may be useful. For the purpose of controlling cost, an old machine may be planned to be replaced by a newer and more sophisticated one. In this case, while cost control is the *cost objective*, the new machine is the *cost object*.

2.6 Types of Costs

There may be different types of cost based on the process or period of measurement, purpose, controllability, relevance, etc. Some such important and commonly used cost types are discussed below in brief :

- a) *Historical Cost* : It is the cost measured on the basis of the actual amount of outlay involved.
- b) *Estimated Cost* : It is the cost determined beforehand by estimation.
- c) *Standard Cost* : It is a scientifically predetermined cost based on specification of the conditions or elements.
- d) *Replacement Cost* : It is the cost to be incurred at present for replacing an asset.
- e) *Total Cost* : It is the aggregate amount of all costs attributable to a given volume of output.
- f) *Marginal Cost* : It is the additional cost for additional one unit of production.
- g) *Differential Cost* : It is the difference in total cost between two levels of activity.
- h) *Opportunity Cost* : It is the cost of the opportunity for alternative use foregone for choosing a particular use of any resource. It is not an actual cost since it does not involve any outlay of cash or cash-equivalent. It is only the probable cost but is very useful in managerial decision making.
- i) *Imputed Cost* : It is the cost attributable to any notional exchange of resources. Notional transaction is an incomplete transaction in the sense that in such cases one party receives/gives something (of value) from/to the other party without giving to/receiving from the corresponding party. The capital invested in the business by the owner without charging any interest, family members working in the family-farm without any wages, etc. are examples of notional transactions. The notional cost of such transactions as may be imputed hypothetically is very much important in decision making; ignoring such cost, being not an actual cost, may lead to a wrong decision.

- j) *Relevant Cost* : These are future costs which vary depending upon different alternatives. On the contrary, those future costs which remain unchanged under alternative situations do not merit for consideration in decision making and are known as irrelevant costs. So, relevant costs are affected or changed by a decision while irrelevant costs are not so affected.
- k) *Sunk Cost* : It is that part of the historical cost which has already been incurred on the basis of a decision taken in the past and is now beyond recovery by any other decision. For example, the depreciated value of an existing asset is a sunk cost which is irrecoverable and hence irrelevant in making decision as to whether the asset is to be replaced or not.
- l) *Discretionary Costs* : These are a kind of fixed costs occurrence—which depends on the discretion of the management. Such discretion is usually guided by the management policies. Costs for employees' training programme, advertising, donation, research and development cost, etc. are common examples of discretionary costs.
- m) *Controllable Costs* : These can be defined as the costs which can be influenced by the action of a single responsible person in an organization within a defined period of time. On the contrary, the costs which are beyond the control of any person of an organization are known as uncontrollable costs. There may be a few items of costs which are controllable in the short run; moreover, most of the costs which are uncontrollable in the short run may be turned into controllable ones in a wider time span.

2.7 Questions

(a) *Long answer type*

1. Explain fully the concept of cost. How does this concept differ from that of expense?
2. What do you mean by Cost Objective? Is it different from Cost Object? Explain with the help of an example.

(b) *Short answer type*

3. Explain in brief the meaning of the following types of costs :
 - (i) Estimated cost
 - (ii) Relevant cost
 - (iii) Opportunity cost
 - (iv) Uncontrollable cost
4. What is imputed cost? How is it ascertained?

(c) **Objective type**

5. Explain the validity of the following statements by indicating 'true' or 'false' :
- (i) Cost essentially involves a sacrifice.
 - (ii) Discretionary cost is essentially a fixed cost.
 - (iii) Notional cost is arbitrary and has got no basis.
 - (iv) Standard cost of an item may be different under different conditions.
 - (v) A controllable cost always remains controllable.
6. Fill up the blanks :
- (i) Sunk cost is not _____ for decision making.
 - (ii) Differential cost is the difference in total costs between _____.
 - (iii) Opportunity cost is relevant even if it is not _____ cost.
 - (iv) Cost must be measurable in _____ term.
 - (v) Cost is a _____ of the expenditure.

2.8 Select Readings

Banerjee, B., *Cost Accounting*, World Press Pvt. Ltd.

Prasad, N. K., *Cost Accounting*, Book Syndicate

Wheldon's *Cost Accounting*, ELBS

Horngren, T., *Cost Accounting—A Managerial Emphasis*, Prentice Hall.

2.9 Hints for Solution (for some question)

5. (i) True (ii) True (iii) False (iv) True (v) False.
6. (i) relevant (ii) two levels of activity (iii) an actual (iv) monetary (v) measure.