



**ICMA**  
Pakistan

Institute of Cost and Management  
Accountants of Pakistan

a chartered institute of professional accountants and business leaders

# Cost Accounting Standards

Classification of  
Cost

Capacity  
Determination

Direct Material Cost

Direct Labour Cost

Production  
Overheads

Administrative  
Overheads

Selling and Distribution  
Overheads

Direct Expenses

Packing Material Cost

Cost of Production for  
Captive Consumption

Cost of Power & Energy

Cost of Service  
Cost Centre

## Vision

To be the Preference in Value Optimization for Business.

## Mission

To develop Business Leaders through imparting quality education and training in financial and non-financial areas to bring value-addition in the economy.

## Core Values



# Message

President and Chief Executive  
ICMA Pakistan

In today's competitive world, the cost efficiency has major impact on achieving competitiveness, profitability and global penetration. The Cost Accounting Standards issued by ICMA Pakistan help the organizations to achieve cost efficiency by ensuring optimum utilization of resources.

The standardization in the application of cost accounting practices helps in cost classification, cost allocation, price setting of products and services. These standards would also helpful in capacity determination and decision making.

The Cost Accounting Standards developed and issued by ICMA Pakistan help the government in project planning, monitoring and control. On the basis of such standards, the regulators may determine the tariff of various services based on cost efficiency model. These standards facilitate financial accounting systems to systematically accumulate and report expenditures incurred and ensure proper allocation of direct and indirect costs to product and services. These standards will facilitate the industry, trade and businesses in the preparation of business feasibilities and cost management.

In order to regulate, promote and continuous updation of these standards, the Institute with the representation of government, regulators and industry has formed a

## **'Cost Accounting Standards Board'**

I, on behalf of the Council of the Institute, appreciate the efforts of Technical Support Committee of the Institute for developing these standards and also acknowledge the inputs of members.

**Zia ul Mustafa, FCMA**

# Preface

Vice President and Chairman Technical Support  
and Practice Development Committee  
ICMA Pakistan

I am delighted to present the first ever edition of Cost Accounting Standards in a shape of booklet. The development of Cost Accounting Standards for the benefit of professional accountants in particular and other professionals in general was long awaited desire of our members, both in practice and in employment.

In today's stringent business environment, achieving efficiency through cost reduction becomes a major competitive edge which can help businesses enhance local market share and penetrate into global market. The cost accounting techniques and practices will also help the businesses in ensuring optimum utilization of resources and operational efficiency. We believe that adoption of these standards will ensure cost efficiency and through a built-in cost reporting mechanism, the management will have better understanding of business performance.

In addition to industry at large, the standard will specially facilitate following sectors which in accordance with Companies Ordinance, 1984 are required to maintain Cost Accounting Records:

- Cement
- Sugar
- Vegetable Ghee/ Cooking Oil
- Natural Gas
- Polyester Fiber
- Fertilizer
- Petroleum Refining
- Thermal Energy

The Securities and Exchange Commission of Pakistan has issued the 'Companies Cost Accounting Rules (General Orders), 2008', requiring these industries to maintain cost accounting records and comply with the provisions of Companies (Audit of Cost Accountants) Rules, 1988. We believe that all industries should be required to maintain their cost records and get them audited by qualified Cost and Management Accountants to control costs, eliminate inefficiencies, achieve competitiveness and increase profitability.

Being an active member of International Federation of Accountants (IFAC), the Institute is committed to promote the profession of Cost and Management Accounting. We hope that these standards will enhance the efficiency of industry by maintaining a Cost Accounting System in accordance with laid down principles.

We expect from the industry and professionals to continue providing their inputs to improve these standards. The development of these standards is a beginning towards gigantic objective to make Pakistani organizations globally competitive and their products and services universally acceptable.

The Institute while striving hard to help Corporate Pakistan achieve this objective, the availability of new cost accounting standards and updation in existing standards in line with the international benchmarks will be a continuous process.

### **Acknowledgement**

I am thankful to members of the Technical Support and Practice Development Committee for their support in developing the Cost Accounting Standards. I am also thankful to President and Council Members of ICMA Pakistan who extended their full support during the process. I specially appreciate the efforts of Mr. Muhammad Yousaf Khan, FCMA for developing the draft Cost Accounting Standards, which laid a foundation for our further work. I especially acknowledge the valuable time spent by members of the CAS review Committee for reviewing and finalizing the Cost Accounting Standards. Finally, I appreciate the efforts by Mr. Tariq Javed Kamboh, FCMA, Director Technical Support and Practice Development and his team for untiring efforts in giving it a booklet shape.

**Ghulam Mustafa Qazi, FCMA**

November 29, 2014



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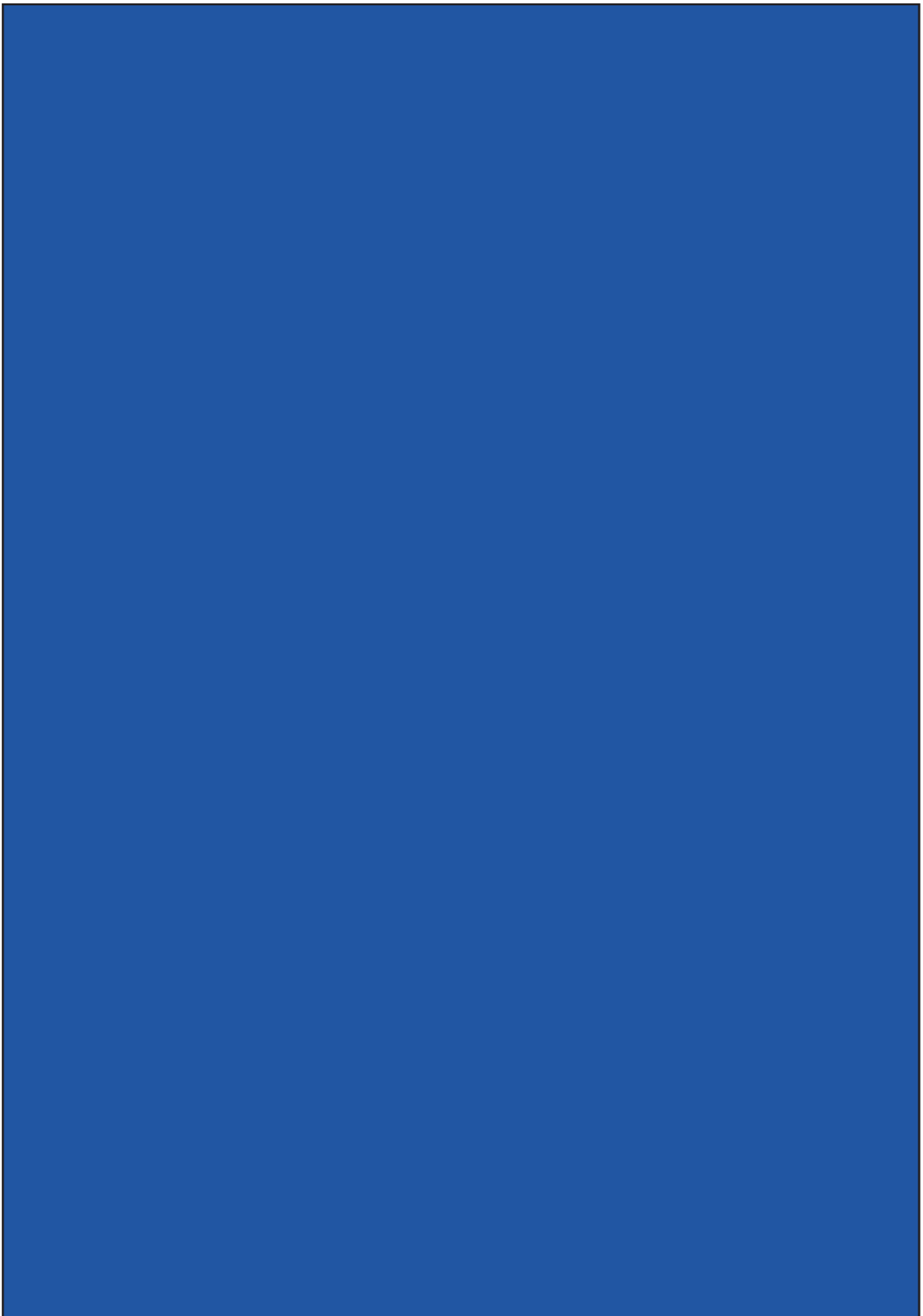


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*Cost Accounting Standard-1*

# **Classification of Cost**



## **1.1 Introduction**

This standard deals with the basis of classification of costs and the practice to be adopted for classification of cost elements with regard to its nature and management objective. The standard aims at providing better understanding on classification of cost for preparation of various cost statements required for statutory obligations or cost control measures.

## **1.2 Objectives**

The objectives of this standard include:

1.2.1 The objective of this standard is to prescribe the application of classification of costs for ascertainment of cost of a product or service and preparation of cost statements on a consistent and uniform basis with a view to effect the comparability of such statements among various reporting units with that of previous periods.

1.2.2 The classification and its disclosures are aimed at providing better transparency in the cost statements.

1.2.3 The standard is also for better adoption of uniform costing and inter-firm comparison.

## **1.3 Scope**

1.3.1 The standard on classification of cost shall be applied in assessment of cost of a product or service, application of costing technique and for management decision making by the reporting entity.

1.3.2 The cost statement (See Annexure "A") prepared, based on this standard shall be used for assessment of cost of production or valuation of product/ service or the valuation of stock to be certified for calculation of duties and taxes, tariffs, anti-dumping measures, transfer pricing and carbon credit etc. and other purposes, as the case may be.

## **1.4 Definitions**

### **1.4.1 Activity**

Activity is the actual work, task or steps performed in producing and delivering products and services. It includes an aggregation of actions performed within

an organization that is useful for the purpose of activity-based costing.

#### 1.4.2 Activity Analysis

Activity analysis is the identification and description of activities in an organization. Activity analysis involves determining what activities are done within a department, how many people perform the activities, how much time they spend in performing the activities, what resources are required to perform the activities and what customer value the activity has for the organization. Activity analysis is accomplished with interviews, questionnaires, observations and reviews of physical records of work.

#### 1.4.3 Activity Based Costing

Activity based costing is the cost accounting method that measures the cost and performance of process related activities and cost objects. It assigns costs to cost objects, such as products or customers, based on their use of activities. It recognizes the casual relationship of cost drivers to activities.

#### 1.4.4 Cost

Cost is a forgoing, measured in monetary terms, incurred or potentially to be incurred to achieve a specific objective.

#### 1.4.5 Cost Center

Cost center means any unit of cost accounting selected with a view to accumulating all cost under that unit. The unit may be a product, service, division, department, section, group of plant and machinery, group of employees or combination of several units. This may also be a budget center.

Cost centers may be divided into broad types i.e. Production Cost Centers and Service Cost Centers. Production Cost Centers are those which are engaged in production like Machine Shop, Welding Shop, and Assembly Shop etc. Service Cost Centers are for rendering service to production cost center like Power House, Maintenance, Stores and Purchase Office etc.

#### 1.4.6 Cost Accounting System

Cost accounting system is a process and procedures that accumulates and reports, consistent and reliable cost information and performance data from various cost centers. The accumulated and reported data enable management

and other stake holders to measure and make decisions about the organization's/ segment's ability to improve operations, safeguard assets, control its resources, comply with relevant reporting requirements and determine if objectives are being met.

#### 1.4.7 Cost Driver

Cost drivers are the structural determinants of the cost of an activity, reflecting any linkages or inter relationships that affect it. Therefore, we could assume that the cost drivers determine the cost behavior within the activities, reflecting the links that these have with other activities and relationships that affect them.

#### 1.4.8 Absorption Costing

Absorption costing is a method of inventory costing in which all variable manufacturing costs and all fixed manufacturing costs are included as inventoriable costs.

#### 1.4.9 Variable Costing

Variable costing is a method of inventory costing in which only variable manufacturing costs are included in inventoriable costs. It is also called direct costing.

#### 1.4.10 Full Cost

Full cost is the sum of all variable and fixed costs in all business functions in the value chain including R & D, design, production, marketing, distribution and customer services.

#### 1.4.11 Statement of Cost

Statement of cost is a statement which is made for calculating total cost, per unit cost and budget cost of product. All elements of cost in statement of cost are taken from financial accounting's historical records. This statement is also known as cost sheet.

### 1.5 Classification of Cost

Classification of cost is grouping of the components of cost under a common designation on the basis of similarities of nature, attributes or relations. Classification of cost is the arrangement of items of costs in logical groups

having regard to their nature (subjective classification) or purpose (objective classification). Items grouped together under common heads may be further classified according to their fundamental differences. Furthermore, the same costs may appear in several different classifications depending on the purpose of classification. Therefore, costs are classified as under:

- (a) By the nature of item (Natural classification).
- (b) By their tendency to vary with volume or activity.
- (c) By relation to accounting period to which they apply.
- (d) By their relation to departments.
- (e) By their relation to the product.
- (f) By their relation to function or activity.
- (g) By their nature as common and/ or joint costs.
- (h) By relationship to management decision making.
- (i) By nature of production process.
- (j) By relation to time.

## **1.6 Basis of Classification of Cost**

### **1.6.1 By the Nature of Item (Natural Classification)**

The process of classifying costs and expenses can begin with total cost, which may be considered as all costs or deductions from sales revenue before income tax. The sum of all costs is termed as cost to make and sell. Typically, total operating cost is divided into following categories:

- (a) Manufacturing cost
- (b) Commercial expenses

#### **1.6.1.1 Manufacturing Cost**

It is the sum of the following:

- i. Direct Material
- ii. Direct Labour
- iii. Other Direct Cost
- vi. Factory Overhead

##### **1.6.1.1.1 Direct Material Cost**

Direct material cost includes cost of procurement, freight inward, taxes & duties, insurance etc. directly attributable to the acquisition. Trade discounts,



rebates, duty draw backs, refunds on account of sale tax and other similar items are deducted in determining the cost of material.

#### 1.6.1.1.2 Direct Labour

Direct labour cost is the labour applied directly to the material comprising the finished product. The cost of wages paid to skilled or un-skilled workers and assignable to a particular unit produced or service rendered, is termed as direct labour cost. Direct labour cost comprises wages of those workers who are conveniently and economically identified with a cost object or cost center.

#### 1.6.1.1.3 Other Direct Cost

Other direct cost is the cost of resources directly consumed by an activity. Direct costs are assigned to activities by direct tracing of unit of resources consumed by individual products, services or activities. Any cost that is specifically identified with a single cost object.

#### 1.6.1.1.4 Factory Overhead

Factory overhead is the indirect cost involved in the production process. Simply all production cost other than direct material, direct labour and other direct cost is factory overhead. Factory overhead is also termed as production overhead, factory burden or manufacturing overhead.

#### 1.6.1.2 Commercial Expenses

Commercial expenses fall in two broad classifications:

- (a) Marketing Cost (Distribution and Selling)
- (b) Administrative Cost (General and Admin)

##### 1.6.1.2.1 Marketing Cost

Marketing cost is the cost incurred in promoting and selling products or services to customers and prospective customers. It includes advertising, selling, distribution, sales promotion and other selling costs etc.

##### 1.6.1.2.2 Administrative Cost

Administrative cost is expense incurred for general management of an organization. These are in the nature of indirect costs and are also termed as administrative overhead.

## 1.6.2 Cost in their tendency to vary with Volume or Activity

Some costs vary directly in relation to changes in the volume of output, while others remain fixed in amount. Direct material and direct labour are generally listed among the variable costs. Factory overhead and non-manufacturing costs, however, must be examined with regard to items of a variable and fixed nature. The division is a necessary prerequisite to successful budgeting and intelligent cost planning and analysis. Under this classification cost may be classified as variable cost, fixed cost, semi variable cost and step fixed cost.

### 1.6.2.1 Variable Cost

Variable costs show the following four characteristics:

- (a) Variability of total amount in direct proportion to volume.
- (b) Comparatively constant cost per unit within a relevant range.
- (c) Easy and reasonably accurate assignment to operating departments or cost centers.
- (d) Control of their incurrence and consumption by the responsible departmental/ cost center head.

### 1.6.2.2 Fixed Cost

The characteristics of fixed cost are:

- (a) Remain unchanged in total over the relevant range.
- (b) Change per unit with change in volume of output.
- (c) Assignment to departments/ cost centers is often made on arbitrary managerial decisions or cost allocation methods.
- (d) Control of incurrence mostly rests with executive management rather than operating supervisors.

### 1.6.2.3 Semi Variable Cost

Semi variable cost is a cost that contain both the elements, fixed as well as variable; hence such costs are termed as semi variable cost. Semi variable cost is often characterized by a fixed rupee amount, below which, it will not fall at all relevant level of output. Whereas the variable element changes with changes in volume of output. They are partly affected by fluctuation in the level of activity.

#### 1.6.2.4 Step Fixed Cost

Step fixed cost is a cost function in which the cost remains the same over various ranges of the level of activity, but the cost increases by discrete amounts (that increases in steps) as the level of activity changes from one range to the next.

#### 1.6.3 Cost with respect to accounting period to which they apply

Expenditure can be divided into two broad classes:

- (a) Capital Expenditure
- (b) Revenue Expenditure

#### 1.6.3.1 Capital Expenditure

Capital expenditure is intended to benefit future periods and is classified as an asset.

#### 1.6.3.2 Revenue Expenditure

Revenue expenditure benefits current periods and is classified as an expense.

#### 1.6.4 By their Relation to Departments

A business may be organized along departmental lines or cost centers for management and control purposes. This departmentalization is the basis for the important classification and subsequent accumulation of costs by departments/ cost centers to achieve, (1) Cost budgeting by cost centers with responsibility accounting and control and (2) A greater degree of reliable costing. Following classification is used in this connection:

- (a) Production Department Cost.
- (b) Service Department Cost.

#### 1.6.4.1 Production Department Cost

Production department cost relates to the cost associated with producing departments in which manual and machine operations are performed directly upon any part of the product manufactured. More specifically, producing departments are those, whose costs may be charged to the product because they have contributed to its production. Such as, machining, forming, upholstering, cutting, assembling etc. In many cases, producing departments

are further sub-divided into cost pools. Where two or more different types of machines perform operations on a product within the same department. Such breakdown into cost center's or cost pools increases the accuracy of the product cost. For example in the manufacturing of cotton yarn and cloth, the producing department, carding may be broken down into cost centers or cost pools such as, opening cotton bales, picking, carding and drawing.

#### 1.6.4.2 Service Department Cost

Service department cost is a cost incurred in the operation of service departments, represents a part of total factory overhead and must be absorbed in the cost of the product by means of the factory overhead rate. Service department is one that is not directly engaged in production, but renders a particular type of service for the benefit of other departments. In some industries, service departments benefit other service departments as well as the producing departments. Common service departments are administration, HR, Internal audit, receiving, inspection, storeroom, maintenance, timekeeping, cost accounting, budgeting, MIS & data processing, general office, cafeteria and plant protection. Service department cost is prorated to producing departments and/ or service departments. These prorated costs are also termed as indirect departmental charges.

#### 1.6.5 By their relation to the Product

The elements of manufacturing costs are direct material, direct labour, other direct costs and factory overhead. Cost may be classified as follows:

- (a) Prime Cost
- (b) Conversion cost

##### 1.6.5.1 Prime Cost

Prime cost is combination of direct material, direct labour and other direct costs associated with the product or service.

##### 1.6.5.2 Conversion Cost

Conversion cost is the combination of direct labour cost and factory overhead.

#### 1.6.6 By their relationship to Function/ Activity

Cost shall be classified according to the following major functions:

- (a) Production

- (b) Administration
- (c) Marketing
- (d) Distribution
- (e) Research & Development

#### 1.6.6.1 Production Cost

Production cost is the cost of all items involved in the production of a product or rendering a service. It includes all direct and indirect costs related to the production.

#### 1.6.6.2 Administration cost

Administration cost is expense incurred for general management of an organization. These are in the nature of indirect costs and are also termed as administrative overhead.

#### 1.6.6.3 Marketing cost

Marketing cost is the cost incurred in promoting and selling products or services to customers and prospective customers. It includes advertising, selling, distribution, sales promotion and other selling costs etc.

#### 1.6.6.4 Distribution Cost

Distribution cost is the cost incurred in handling a product from the time it is completed in the work premises until it reaches the ultimate consumer. It can be divided in two parts:

- (a) Primary Distribution Cost
- (b) Secondary Distribution Cost

##### 1.6.6.4.1 Primary Distribution Cost

Primary distribution cost is the cost incurred on basic material that contains the product and is included in the cost of direct material. For example, in pharmaceutical industry, cost incurred on the strip which contains the tablets is primary distribution cost. The cost incurred on the strip is to be included in product cost.

##### 1.6.6.4.2 Secondary Distribution Cost

Secondary distribution cost incurred in handling of product from the time

it is completed in the work premises until it reaches the ultimate consumer.

#### 1.6.6.5 Research & Development Cost

Research & development cost is the cost for undertaking research to improve quality of a present product or improve manufacturing process, develop a new product, market research etc. and commercialization thereof. While research cost comprises of cost incurred on development of new product/ process and improvement of existing product/ process, Development cost includes the cost incurred for commercialization/ implementation of research findings.

#### 1.6.7 By their Nature as Common and/ or Joint cost

Joint costs are the common cost of facilities or services employed in the output of two or more simultaneously produced or otherwise closely related operations, products or services.

When a production process is such that from a set of same input, two or more distinguishably different products are produced together, products of greater importance are termed as joint products and products of minor importance are termed as by-products. The costs incurred prior to the point of separation of the products are termed as joint costs. For example, in a petroleum refinery industry, petrol, diesel oil, kerosene oil, tar coal etc. are produced jointly in the refinery process. The Joint or common costs are allocated to main or by- products on appropriate basis.

#### 1.6.8 By Relationship to Management Decision Making

For the purpose of management decision making, costs are classified as under:

- (a) Marginal Cost
- (b) Differential Cost
- (c) Opportunity Cost
- (d) Replacement Cost
- (e) Relevant Cost
- (f) Imputed Cost
- (g) Sunk Cost
- (h) Normal Cost
- (i) Abnormal Cost

- (j) Avoidable Cost
- (k) Unavoidable Cost

#### 1.6.8.1 Marginal cost

Marginal cost is the aggregate of variable costs, i.e. prime cost plus variable overhead. Marginal cost per unit is the change in the amount at any given volume of output by which the aggregate cost changes if the volume of output is increased or decreased by one unit. The part of the cost of one unit of product or service that would be avoided if that unit was not produced, or that would increase if one extra unit were produced.

#### 1.6.8.2 Differential Cost

Differential cost is the change in cost due to change in activity from one level to another. Differential Cost is found by using the principle which highlights the points of differences in costs by adoption of different alternatives. When the level of activity is increased, the differential cost is known as incremental cost and when the level of activity is decreased, the decrease in cost is known as decremental cost.

#### 1.6.8.3 Opportunity Cost

Opportunity cost is the value of the alternatives foregone by adopting a particular strategy or employing resources in specific manner.

#### 1.6.8.4 Replacement Cost

Replacement Cost is the cost of replacing an asset in the current market. Replacement cost is generally used for determining the optimum time for replacement of an equipment or machine in consideration of maintenance cost of the existing one and its productive capacity.

#### 1.6.8.5 Relevant Cost

Relevant cost is expected future cost that differs among the alternative courses of action, being considered. They must occur in future decision deals with selecting a course of action based on its expected future results and differ among the alternative course of action. Cost that does not differ will not matter and hence will have no bearing on the decision being made.

#### 1.6.8.6 Imputed Cost

Imputed cost is hypothetical or notional cost, not involving cash outlay, computed only for the purpose of decision making.

#### 1.6.8.7 Sunk Cost

Sunk cost is cost which has been irreversibly incurred or committed prior to a decision point, and cannot therefore be considered relevant to subsequent decisions.

#### 1.6.8.8 Normal Cost

Normal cost includes those items of cost which occur in the normal situation of production process or in the normal environment of the business. The normal idle time is to be included in the ascertainment of normal cost.

#### 1.6.8.9 Abnormal Cost

Abnormal cost is an unusual or a typical cost whose occurrence is usually irregular, unexpected and due to some abnormal situation.

#### 1.6.8.10 Avoidable Costs

Avoidable costs are those cost which, under given conditions of performance efficiency, shall not have been incurred. Avoidable costs are logically associated with some activity or situation and are ascertained by the difference of actual cost with the happening of the situation and the normal cost.

#### 1.6.8.11 Unavoidable Costs

Unavoidable costs are inescapable costs which are essentially to be incurred, within the limits or norms provided for.

### 1.6.9 By nature of Production Process

Costs under this classification are categorized as follows:

- (a) Batch Cost.
- (b) Process Cost.
- (c) Operation Cost.
- (d) Contract Cost



#### 1.6.9.1 Batch Cost

Batch cost is the cost associated with a batch of similar articles which maintain their identity throughout the production but is not traceable to an individual item within the batch. The unit cost of the batch of goods can be calculated by dividing batch cost by the number of units produced in that batch.

#### 1.6.9.2 Process Cost

Process cost is a method of costing something that is manufactured from a series of continuous processes, where the total costs of those processes are divided by the number of units produced.

#### 1.6.9.3 Operation Cost

Operation cost is the cost of a specific operation involved in a production process or business activity. When there are distinctly separate operations involved in a process, cost for each operation is found out for effective control mechanism.

#### 1.6.9.4 Contract Cost

Contract cost is a form of specific order costing in which costs are attributed to individual contracts.

#### 1.6.10 Classification by Time

A cost item related to a specific period of time and cost can be classified as follows:

- (a) Historical
- (b) Pre-determined
- (c) Standard
- (d) Estimated

#### 1.6.10.1 Historical Cost

Historical cost are the actual costs of acquiring assets or producing goods or services. These are costs ascertained after they have been incurred and they represent the cost of actual operational performance.

### **1.6.10.2 Pre-determined Cost**

The pre-determined cost for a product is computed in advance of production on the basis of a specification of all the factors affecting cost and cost data. Pre-determined costs may be either standard or estimated.

(a) **Standard Cost** - Standard cost is a predetermined norm applied as a scale of reference for assessing actual cost, whether these are more or less. The standard cost serves as a basis of cost control and as a measure of productive efficiency when ultimately posed with an actual cost. It provides management with a medium by which the effectiveness of current results is measured and responsibility of deviation placed. Standard costs are used to compare the actual costs with the standard cost with a view to determine the variances, if any, and analyze the causes of variances and take proper measure to control them.

(b) **Estimated Cost** - Estimated cost of a product is prepared in advance prior to the performance of operations or even before the acceptance of sale orders. Estimated cost is found with specific reference to product in question, and activity level. It has no link with actual and hence it is assumed to be less accurate than the standard cost.

## **1.7 Presentation and Disclosure**

1.7.1 The classification of cost item shall be done on the "Basis of classification" chosen with predetermined objective.

1.7.2 The classification of cost item shall be followed consistently from one period to next and preparation of cost statements shall be made with reference to a period of time.

1.7.3 A change in classification shall be made only if it is required by law or for compliance with a cost accounting standard or if the change would result in a more appropriate preparation or presentation of cost statements.

1.7.4 Any change in classification of cost which has a material effect on the cost of the product shall be disclosed in the notes to the cost statements. Where the effect of such change is not ascertainable, the fact shall be indicated in the cost statement.

**Annexure-"A"**

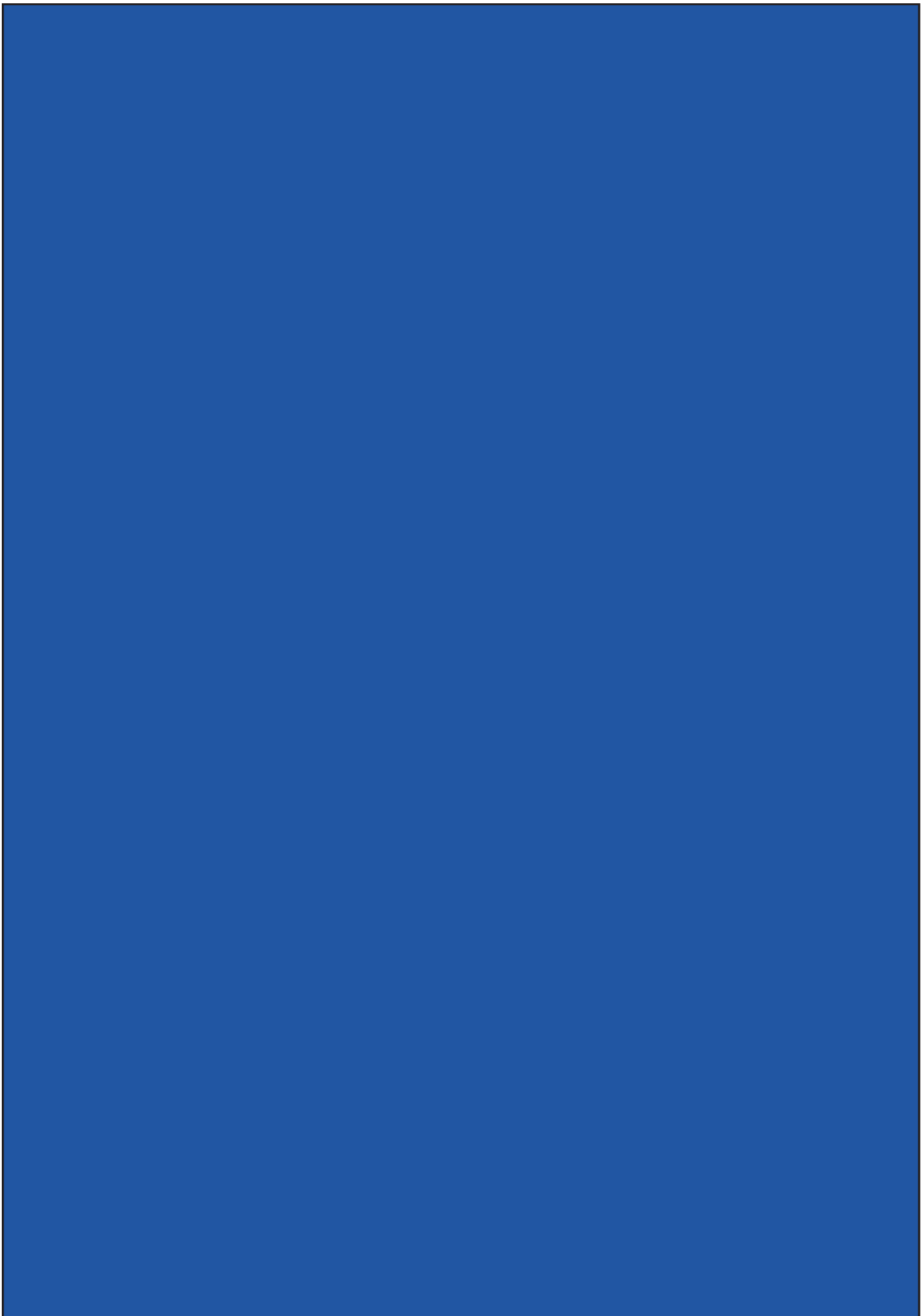
**Analysis of Total Operating Cost**

<b>Direct Material Cost</b>	+	<b>Direct Labour Cost</b>	+	<b>Other Direct Costs</b>	=	<b>Prime Cost</b>
						+
<b>Indirect Material</b>		<b>Indirect Labour</b>		<b>Other Indirect Costs</b>		<b>Factory Overhead</b>
Factory Supplies		Supervision		Rent		
Lubricants		Superintendence		Insurance		
		Inspection		Property Tax		
		Factory Clerks Salaries		Depreciation		
	+	Defective Work	+	Maintenance & Repair	=	
		Experimental Work		Power Light		
				Heat		
				Employer Payroll Taxes		
				Misc Overhead		
				Small Tools		
						<b>Manufacturing Cost</b>
						+
<b>Marketing Cost</b>		<b>Administrative Cost</b>		<b>Distribution Cost</b>		<b>Commercial Expenses</b>
Sales Salaries		Admin Staff Salaries		Distribution Staff Salaries		
Sales Staff Commission		Employer Payroll Taxes		Secondary Packaging		
Employer Payroll Taxes		Rent		Misc		
Advertising		Depreciation				
Samples		Property Tax				
Entertainment		Auditing Expenses				
Travel Expenses	+	Legal Expenses	+		=	
Rent		Uncollectable Accounts				
Depreciation		Telephone & Telegraph				
Property Tax		Stationery & Printing				
Telephone & Telegraph		Postage				
Stationery & Printing		Misc				
Postage						
Freight & Carriage out						
Misc						=
						<b>Total Cost to make and sell</b>



*Cost Accounting Standard-2*

# Capacity Determination



## **2.1 Introduction**

Capacity is that fixed amount of plant & machinery along with the number of personnel combined with critical factors of production like power etc, with which management has committed itself to carry out the business. Thus, capacity of a reporting unit is its limiting capability to produce an output over a period of time. Most of the fixed overheads are associated with the level of capacity installed by an organization. The concept of capacity is utilized for setting sales price, controlling cost, preparation of budgets, overhead application rates, determining the standard cost of each product, production planning, inventory valuation and measurement of effects of changes in volume of production. Better utilization of capacity means better utilization of resources. It is an important consideration for cost determination and cost reduction. Therefore, it is essential to establish, understand and manage capacity of the reporting unit effectively.

## **2.2 Objectives**

The objectives of this standard include:

2.2.1 The standard prescribes the methods of determination of various types of capacities, their uniform and consistent application by the reporting units.

2.2.2 It shall help the management to identify the bottlenecks, imbalances and idle capacity for effective use of various resources.

2.2.3 The standard shall help in proper allocation, apportionment and absorption of cost.

## **2.3 Scope**

2.3.1 The standard shall be followed for capacity determination required to be carried out for any purpose or under provisions of any act, rule or regulation except where prescribed otherwise by law.

2.3.2 The standard shall be followed for maintaining cost records under the Companies (Audit of the Cost Accounts) Rules, 1998 or the Special/ General Orders/ SROs on Cost Account Orders issued by SECP from time to time for furnishing information on capacity utilization to the regulator.

2.3.3 The standard is to help in proper allocation, apportionment and absorption of cost.

## 2.4 Definitions

### 2.4.1 Licensed Capacity

Licensed capacity is the production capacity of the plant for which license has been issued by Government/ concerned authority.

### 2.4.2 Theoretical or Installed Capacity

Theoretical or installed capacity is the maximum productive capacity according to the manufacturer's specification of machines/ equipment. It is the capacity to produce at 100 percent of its rated capacity without any interruption.

### 2.4.3 Practical Capacity

Practical capacity is the theoretical capacity adjusted for allowances for unavoidable interruptions such as time lost for repairs, inefficiencies, breakdowns, setups, failures, unsatisfactory materials, delays in material supplies, holidays, vacations, stock taking and pattern and model changes. In short, reduction in capacity is only due to internal influences results in practical capacity.

### 2.4.4 Normal Capacity

Normal capacity is the production achieved or achievable on an average over a longer period of time to level out seasonal or cyclical variations. This is the most widely used concept of capacity. In determining normal capacity, physical plant capacity and sales potential must be considered together.

$$\text{Normal Capacity} = \text{Installed Capacity} - \text{Capacity loss} \\ \text{(Internal \& External factors)}$$

OR

$$\text{Normal Capacity} = \text{Practical Capacity} - \text{Capacity loss by} \\ \text{External factors}$$

### 2.4.5 Actual Capacity Utilization

Actual capacity utilization is the volume of production achieved in relation



to installed capacity.

#### 2.4.6 Idle Capacity

Idle capacity is a results from the temporary idleness of production facilities due to internal and external factors. As these factors are removed, the production capacity restores to normal capacity. Its cost is usually part of the total expense used in setting up the overhead rate and is a part of the product cost.

#### 2.4.7 Abnormal Idle Capacity

Abnormal idle capacity is the difference between practical capacity and the normal capacity or actual capacity, whichever is higher.

Abnormal Idle Capacity= Practical Capacity-{(Normal Capacity or Actual Capacity) whichever is higher}

Example is illustrated at Annexure "A".

#### 2.4.8 Excess Capacity

Excess capacity is the result either from greater productive capacity than organization could ever hope to use, or from an imbalance in equipment or machinery. This imbalance involves the excess capacity of one machine in contrast with the output of other machines. Any expense arising from excess capacity shall be excluded from the factory overhead rate and from the product cost. The expense shall be treated as a deduction in the income statement.

### 2.5 Determination of Installed Capacity

2.5.1 Installed capacity of a reporting unit is determined on the following factors:

- (a) Manufacturer's technical specifications.
- (b) Capacities of individual or interrelated production centers.
- (c) Operational constraints/ capacity of critical machines.
- (d) Number of shifts.
- (e) Any other factor.

2.5.2 In case, manufacturer's technical specifications are not available, the estimates by technical experts on capacity under ideal conditions may be considered for determination of installed capacity.

2.5.3 In case a product passes through different production processes and each process is having different capacity then the process which brings control or core process shall be considered for deciding installed capacity.

## **2.6 Determination of Normal Capacity**

2.6.1 Normal capacity is determined based on the average productive capacity achieved over a period of three normal years out of preceding five years.

2.6.2 This capacity is determined after adjustment of external factors with practical capacity.

2.6.3 Normal capacity of production process involved in the production of a product or the normal capacity of the plant as a whole shall be taken into account to arrive at normal capacity for a product or plant, as the case may be.

2.6.4 The periods influenced by abnormalities shall be excluded for this purpose.

### **Explanation:**

(a) In case the same products with different specifications and of different ranges in terms of size, type, variety etc. are manufactured, then there is a need to determine equivalence among them, in order to determine the capacity.

(b) In case some intermediate products/ components etc. are also produced, they shall be taken into consideration for determining equivalent capacity.

(c) In case some machines are leased out/ let out or some machines are taken on lease, resulting decrease/ increase in capacity shall also be considered.

## **2.7 Disclosure**

2.7.1 The details of basis for arriving at the capacity, variables used and assumptions made shall be disclosed.

2.7.2 Any change in the installed capacity due to modifications in the machines/ equipment or addition of balancing equipment or disposal or impairment of machines/ equipment shall be disclosed.

2.7.3 The licensed capacity and installed capacity shall be disclosed in absolute term of production.

2.7.4 The normal capacity and actual capacity utilized shall also be disclosed in absolute term as well as in percentage of installed capacity.

2.7.5 In case the same products are manufactured with different specifications and of different ranges in terms of size, type, variety etc., there is a need to disclose capacity in terms of equivalent units.

2.7.6 Idle capacity during the period shall be disclosed along with the reasons.

2.7.7 Any excess capacity shall also be disclosed in absolute terms and in percentage with reasons.

2.7.8 In case of any deviation from normal capacity, the reasons for the same shall be disclosed specifying controllable and uncontrollable in short term or in long term.

2.7.9 Comparison of actual capacity utilized and the installed capacity shall be disclose along with such comparison with last year.

**Annexure-"A"**

<b>CASE 1</b>		
<b>Statement</b>	<b>Units</b>	<b>Remarks</b>
Theoretical / Installed Capacity	100,000	
Practical Capacity	80,000	(Theoretical - Internal Factors)
Normal Capacity	75,000	(Practical - External Factors)
Actual Capacity	60,000	
Idle Capacity	40,000	(Theoretical -Actual)
Abnormal Idle Capacity	5,000	(Practical - Actual or Normal, Whichever is high)
In this case the normal capacity is higher than the actual capacity.		

<b>CASE 2</b>		
<b>Statement</b>	<b>Units</b>	<b>Remarks</b>
Theoretical / Installed Capacity	100,000	
Practical Capacity	80,000	(Theoretical - Internal Factors)
Normal Capacity	75,000	(Practical - External Factors)
Actual Capacity	78,000	
Idle Capacity	40,000	(Theoretical - Actual)
Abnormal Idle Capacity	2,000	(Practical - Actual or Normal, Whichever is high)
In this case the normal capacity is more than the normal capacity.		

*Cost Accounting Standard-3*

# **Direct Material Cost**



### **3.1 Introduction**

3.1.1 This standard describe the principles and methods to determine the direct material cost, its classification, measurement and assignment to cost object.

3.1.2 Direct Material includes raw materials, in-house manufactured or bought out components, assemblies and sub-assemblies.

3.1.3 This standard does not cover indirect and packing materials.

### **3.2 Objective**

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the direct material cost with reasonable accuracy.

### **3.3 Scope**

This standard shall be applied for classification, measurement, assignment, presentation and disclosure of direct material cost for preparation of cost statements.

### **3.4 Definitions**

#### **3.4.1 Abnormal Cost**

Abnormal cost is a typical cost whose occurrence is unusual, irregular, and unexpected or due to some abnormal situation of the production or operation.

#### **3.4.2 Administrative Overheads**

Administrative overheads is expense incurred for general management of an organization. These are in the nature of indirect costs and are also termed as administrative overhead.

#### **3.4.3 Cost Object**

Cost object includes a product, service, cost center, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained.

#### 3.4.4 Defectives

Defectives means end product or intermediate product that does not meet quality standards. This may include reworks or rejects.

#### 3.4.5 Reworks

Reworks means defective materials which can be brought up to the standard by putting in additional resources. Rework includes repairs, reconditioning and refurbishing.

#### 3.4.6 Rejects

Rejects means defective materials which cannot meet the quality standards prescribed by the management.

#### 3.4.7 Direct Materials

Direct Materials are all materials that form an integral part of the finished product and that are included directly in calculating the cost of the product. It is the cost which can be attributed to a cost object in an economically feasible way.

#### 3.4.8 Scrap

Scrap means discarded material having some value and which is usually either disposed off without further treatment (other than reclamation and handling) or reintroduced into the production process.

#### 3.4.9 Standard Cost

Standard cost is the predetermined cost of manufacturing a single product or a number of product units during a specific period in the immediate future. It is the planned cost of product under current and/ or anticipated conditions.

#### 3.4.10 Wastage

Wastage is a material loss during production or storage due to various factors such as evaporation, chemical reaction, contamination, unrecoverable residue, shrinkage etc. and discarded material which may or may not have value.



### 3.4.11 Spoilage

Spoilage material is that material which does not meet with dimensional or quality standards in such a way that it cannot be rectified economically and is sold for a disposal value. Net spoilage is the difference between costs accumulated up to the point of rejection and the salvage value.

## 3.5 Principles of Measurement

### 3.5.1 Valuation of Direct Materials

3.5.1.1 The direct material shall be valued at purchase price including duties and taxes, freight inwards, insurance, and other expenditure directly attributable to procurement (net of trade discounts, rebates, taxes and duties refundable) that can be quantified with reasonable accuracy at the time of acquisition.

3.5.1.2 Finance costs incurred in connection with the acquisition of direct materials shall not form part of direct material cost.

3.5.1.3 Normal loss or spoilage of material prior to reaching the factory or at places where the services are provided shall be absorbed in the cost of remaining direct materials, net of amounts recoverable from suppliers, insurers, carriers or recoveries from disposal.

3.5.1.4 Losses due to shrinkage or evaporation and gain due to elongation or absorption of moisture etc., before the material is received shall be absorbed in material cost to the extent they are normal, with corresponding adjustment in the quantity.

3.5.1.5 The forex component of imported material cost shall be converted at the rate on the date of the transaction. Any subsequent change in the exchange rate till payment or otherwise shall not form part of the material cost. The foreign exchange gain/ loss shall not become the part of the material cost.

3.5.1.6 Any demurrage or detention charges, or penalty levied by transport or other authorities shall not form part of the cost of direct materials.

3.5.1.7 Subsidy/ grant/ incentive and any such payment received/ receivable with respect to any material shall be reduced from cost of the cost object to which such amounts are related.

### 3.5.2 Valuation of Issuance of Material

3.5.2.1 Material issued shall be valued using appropriate assumptions on cost flow, i.e. First In First Out or Weighted Average method. The method of valuation shall be followed on a consistent basis. Only these two valuation methods are applicable in line with the IAS-2.

3.5.2.2 Where direct materials are accounted at standard cost, the price variances related to direct materials shall be adjusted in the material cost.

3.5.2.3 Any abnormal cost shall be excluded from the material cost.

### 3.5.3 Self-manufactured Components and Sub-assemblies

Self-manufactured components and sub-assemblies shall be valued including direct material cost, direct employee cost, direct expenses, factory overheads, share of administrative overheads relating to production but excluding share of other administrative overheads, finance cost and marketing overheads.

### 3.5.4 Normal Scrap and Defective Items

The material cost of scrap/ defectives, not exceeding the normal limit, shall be adjusted in the material cost of good production. Material cost of abnormal scrap/ defectives should not be included in material cost but treated as loss after giving credit to the realizable value of such scrap/ defectives.

## 3.6 Assignment of Costs

### 3.6.1 Direct Material

#### 3.6.1.1 Direct Material Cost to Cost Objects

Material cost shall be directly traced to a cost object to the extent it is economically feasible and/ or shall be assigned to the cost object on the basis of material quantity consumed or similar identifiable measure and valued as per the principles laid under Paragraph 3.5.

3.6.1.2 Where the material costs are not directly traceable to the cost object, these may be assigned on a suitable basis like technical estimates, such material will become the part of the indirect material.

### 3.6.2 Direct Expenses

Direct expenses are the expenses related to material which is processed or part manufactured by a third party according to specifications provided by the buyer, the processing/ manufacturing charges payable to the third party shall be treated as part of the material cost.

### 3.7 Presentation

Cost statements governed by this standard, shall present direct material costs as stated below:

3.7.1 Direct Materials shall be suitably classified in the cost statement under relevant heads which may include:

- (a) Raw materials
- (b) Components
- (c) Sub components
- (d) Assemblies
- (e) Sub-assemblies
- (f) Any other material which can be directly and conveniently identified with the cost object.

Note: The above classifications may further be bifurcated into local, imported, self-manufactured and outsourced components.

### 3.8 Disclosures

The following information shall be disclosed in the cost statements dealing with determination of material cost:

3.8.1 The basis of valuation of direct materials.

3.8.2 Any change in the cost accounting principles and methods applied for the determination of the direct material cost during the period covered by the cost statement. Where the effect of such change is not ascertainable wholly or partly, the fact shall be indicated.

3.8.3 Any abnormal cost excluded from the material cost.

3.8.4 Any demurrage or detention charges, penalty levied by any authority excluded from the material cost.

3.8.5 Any subsidy/ grant/ incentive or any such payment reduced from material cost.

3.8.6 Cost of direct materials procured from related parties.

3.8.7 Disclosures shall be made as footnote or separate schedule.

*Cost Accounting Standard 4*

# **Direct Labour Cost**



## **4.1 Introduction**

This standard deals with the principles and methods of classification, measurement and assignment of direct labour cost, for determination of the cost of product or service and the presentation and disclosure in cost statements.

## **4.2 Objective**

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the direct labour cost with reasonable accuracy.

## **4.3 Scope**

This standard shall be applied to cost statements which require classification, measurement, assignment, presentation and disclosure of direct labour cost including those requiring attestation.

## **4.4 Definitions**

### **4.4.1 Abnormal Cost**

Abnormal cost is a typical cost whose occurrence is unusual, irregular, and unexpected or due to some abnormal situation of the production or operation.

### **4.4.2 Abnormal Idle Time**

Abnormal idle time means an unusual direct labour idle time, occurrence of which is usually irregular and unexpected or due to some abnormal situations e.g. strike, lockout or an accident etc.

### **4.4.3 Cost Object**

Cost object includes a product, service, cost center, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained.

### **4.4.4 Direct Labour Cost**

Direct labour cost is an aggregate of all kinds of consideration paid, payable and provisions made for the services rendered by direct labourers of an enterprise (including temporary, part time and contract direct labours).

Consideration includes wages, salary, contractual payments and benefits, as applicable or any payment made on behalf of direct labour. Direct labour is labour directly involved upon material comprising the finished product. The cost of wages paid to skilled or unskilled workers and assignable to particular unit is termed as direct labour.

Contract direct labours include direct labours directly engaged by the employer on contract basis but does not include direct labours of any contractor engaged in the organization.

Compensation paid to direct labours for the past period on account of any dispute/ court orders shall not form part of direct labour Cost.

#### 4.4.5 Idle Time

Idle time is the difference between the time for which the direct labours are paid and the direct labours' time booked against the cost object. The time for which the direct labours are paid includes holidays, paid leave and other allowable time offs such as lunch, tea breaks etc.

#### 4.4.6 Imputed Costs

Imputed cost is the hypothetical or notional costs, not involving cash outlay, computed for any purpose.

#### 4.4.7 Indirect Labour Cost

Indirect labour cost is a cost which cannot be directly attributable to a particular cost object.

#### 4.4.8 Overtime Premium

Overtime premium is the time spent beyond the normal working hours which is usually paid at a higher rate than the normal time rate. The extra amount beyond the normal wages and salaries paid is called overtime premium.

### 4.5 Principles of Measurement

4.5.1 Direct labour cost is ascertained by taking in to account the labour directly involved upon material comprising the finished product. Wages, over time bonuses etc. other benefits including subsidized food, subsidized



housing, subsidized conveyance, statutory provisions for insurance against accident or health scheme shall not become part of the direct labour cost.

4.5.2 Bonus whether payable as a statutory, or on a sharing of surplus shall be treated as part of direct labour cost. Ex gratia payable in lieu of or in addition to bonus shall also be treated as part of the direct labour cost.

4.5.3 Remuneration payable to managerial personnel including Executive Directors on the Board and other officers of a corporate body under a statute will not be considered as part of the direct labour cost of the year under reference whether the whole or part of the remuneration is computed as a percentage of profits.

4.5.4 Separation costs related to voluntary retirement, retrenchment, termination etc. shall be amortized over the period benefitting from such costs. It shall not become the part of the direct labour cost.

4.5.5 Cost of idle time (Normal or abnormal) is ascertained by the idle hours multiplied by the hourly rate applicable to the idle direct labour.

4.5.6 Where direct labour cost is accounted at standard cost, variances due to normal reasons related to direct labour cost shall be treated as part of direct labour cost. Variances due to abnormal reasons shall be treated as part of overheads.

4.5.7 Any payment received or receivable by the entity on account of subsidy, grant and incentive etc. for the period with respect to direct labour cost shall be reduced for ascertainment of cost of the cost object to which such amounts are related.

4.5.8 Any abnormal cost shall not form part of the direct labour cost.

4.5.9 Penalties, damages paid to statutory authorities or other third parties shall not form part of the direct labour cost.

## **4.6 Assignment of Costs**

4.6.1 Where the labour services are traceable to a cost object, such direct labour cost shall be assigned to the cost object on the basis such as time

consumed or number of direct workers engaged etc. or similar identifiable measure.

4.6.2 While determining whether a particular direct labour cost is chargeable to a separate cost object, the principle of materiality shall be adhered to.

4.6.3 Where the direct labour costs are not directly traceable to the cost object, these may be assigned on suitable basis like estimates of time based on time study, such labour cost shall not form the part of the direct labour.

4.6.4 Overtime premium shall be assigned directly to the cost object or treated as overheads depending on the economic feasibility and the specific circumstance requiring such overtime.

4.6.5 Idle time cost shall be assigned directly to the cost object or treated as overheads depending on the economic feasibility and the specific circumstances causing such idle time. Cost of idle time for reasons anticipated like normal lunchtime, holidays etc. is normally included in the direct labour cost while arriving at the cost per hour of a direct labour/ a group of direct labourers whose time is attributed direct to cost objects.

#### **4.7 Presentations**

4.7.1 Direct labour costs shall be presented as a separate cost head in the cost statement.

4.7.2 The cost statement shall furnish the resources consumed on account of direct labour cost, category wise such as wage to permanent, temporary, part time and contract labourers piece rate payments, overtime payments etc.

#### **4.8 Disclosures**

4.8.1 The cost statements shall disclose the following:

4.8.1.1 Direct labour cost attributable to capital works or jobs in the nature of deferred revenue expenditure indicating the method followed in determining the cost of such capital work.

4.8.1.2 Separation costs payable to labour.

- 4.8.1.3 Any abnormal cost excluded from direct labour cost.
- 4.8.1.4 Penalties and damages paid etc. excluded from direct labour cost.
- 4.8.1.5 Any subsidy, grant, incentive and any such payment reduced from direct labour cost.
- 4.8.1.6 The direct labour cost paid to related parties.
- 4.8.1.7 Direct labour cost incurred in foreign exchange.
- 4.8.2 Any change in the cost accounting methods applied for the measurement and assignment of the direct labour cost during the period covered by the cost statement which has a material effect on the direct labour cost. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.
- 4.8.3 Disclosures shall be made only where material, significant and quantifiable.
- 4.8.4 Disclosures shall be made in the body of the cost statement or as a foot note or as a separate schedule.







## **5.1 Introduction**

Production overheads are indirect costs involved in the production process or in rendering services. Production overheads include administration cost relating to production, factory works or manufacturing. Production related expenses incurred at corporate office e.g. design office expenses, materials management and industrial relations will also be covered under production overheads. A system of better distribution of overheads will ensure greater accuracy in determination of cost of products or services. Therefore, standard practices for allocation, apportionment and absorption of overheads shall be followed for preparation of cost statements.

## **5.2 Objectives**

The objectives of this standard include:

5.2.1 To prescribe the methods of collection, allocation, apportionment of overheads to different cost centers and absorption thereof to cost objects on a consistent and uniform basis in the preparation of cost statements.

5.2.2 To facilitate inter organizational and intra-organizational comparison.

5.2.3 To standardize collection, allocation, apportionment and absorption of overheads, in order to provide a basis for determination of cost of different cost objects.

5.2.4 To facilitate commercial and strategic management decision making to ensure compliance with disclosure requirements and transparency in the cost statement.

## **5.3 Scope**

This standard shall be applied to cost statements which require classification, measurement, assignment, presentation and disclosure of production overheads.

## **5.4 Definitions**

### **5.4.1 Production Overheads**

Production overheads means all the elements of cost other than direct

material, direct labour and other direct costs shall be termed as production overheads.

#### **5.4.2 Variable Overheads**

Variable production overheads, which vary in proportion to the change of volume of production shall be termed as variable overheads.

#### **5.4.3 Fixed Overheads**

Fixed production overheads which do not change with the change in volume of production shall be termed as fixed overheads.

#### **5.4.4 Semi-variable Overheads**

Semi-variable overheads are partly affected by change in the production volume. They are further segregated into variable overheads and fixed overheads.

#### **5.4.5 Allocation of Overheads**

Allocation of overheads is assigning an item of cost to a cost object, which can be directly identified to that cost object.

### **5.5 Collection of Overheads**

5.5.1 Collection of overheads means the pooling of indirect items of expenses from books of accounts and supportive records in logical groups having regards to their nature and purpose.

5.5.2 Overheads are collected on the basis of pre-planned groupings, called cost pools. Homogeneity of the cost components in respect of their behavior and character is to be considered in developing the cost pool. Variable and fixed overheads should be collected in separate cost pools under a cost centre. A great degree of homogeneity in the cost pools is to be maintained to make the apportionment of overheads more rational and scientific. A cost pool for maintenance expenses will help in apportioning them to different cost centers, which use the maintenance service.

### **5.6 Allocation of Overheads**

Allocation of overheads is assigning an item of cost to a cost object, which



can be directly identified to that cost object.

## 5.7 Apportionment of Overheads

Apportionment of overhead is distribution of overheads to more than one cost objects on an equitable basis. When the indirect costs are common to different cost objects, these shall be apportioned to these cost objects.

### 5.7.1 Primary and Secondary Distribution of Overheads

In multi-product environment, common service cost centers provide services to the various production cost centers and other service cost centers. The costs of such services shall be apportioned to the relevant cost centers in two steps. Firstly, it shall be apportioned to all cost centers and then the costs of service cost centers to production cost centers. The first step is termed as primary distribution and the second step is termed as secondary distribution of overheads.

## 5.8 Absorption of overheads

Absorption of overheads is charging of overheads from cost centers to products or services by means of absorption rates for each cost center. Overhead rate is calculated as follows:

$$\text{Overhead absorption rate} = \frac{\text{Total estimated overhead of the cost centre}}{\text{Normal Capacity}}$$

The denominator is selected on the basis of type of the cost centre and its contribution to the products or services, such as, machine hours, labour hours, quantity produced etc.

The numerator and the denominator are based on the normal capacity in arriving at the overhead absorption rate, whereas overheads would be applied or absorbed on the basis of actual capacity utilized as depicted below:

$$\text{Overhead absorbed} = \text{Overhead absorption rate} \times \text{Actual capacity utilized.}$$

## 5.9 Basis of Apportionment of Production Overheads

Overheads shall be apportioned to different cost centers based on any of the following two principles:

- (a) **Cause and Effect** - Cause is the process or operation or activity and effect is the incurrence of cost.
- (b) **Benefits received** - Overheads are to be apportioned to the various cost objects in proportion to the benefits received by them.

## **5.10 Distribution of Overheads**

### **5.10.1 Primary Distribution of Overheads**

Basis of primary apportionment of items of production overheads is to be selected to distribute them among the cost centers following any of the two principles as given above at para 5.9. Basis of apportionment must be rational to distribute overheads. Once the base is selected, the same is to be followed consistently and uniformly. However, change in basis for apportionment can be adopted only when it is considered necessary due to change in circumstances.

### **5.10.2 Secondary Distribution of Overheads**

Secondary distribution of overheads may be done by following either reciprocal basis or non-reciprocal basis.

#### **5.10.2.1 Secondary Apportionment of Overheads on Reciprocal Basis**

The services rendered by certain service cost centers are also utilized by other service cost centers. In reciprocal secondary distribution, the cost of service cost centers are apportioned to production cost centers as well as other service cost centers. In such case, any one of the following two methods may be followed:

- (a) Repeated Distribution Method
- (b) Simultaneous Equation Method

##### **5.10.2.1.1 Repeated Distribution Method**

Steps to be followed under repeated distribution method are:

- (a) The proportion at which the costs of a service cost centers are to be distributed to production cost centers and other service cost centers are determined.
- (b) Cost of first service cost center shall be apportioned to production

cost centers and service cost centers in the proportion as determined in step (a).

- (c) The cost of other service cost centers is to be apportioned, accordingly.

The process stated above shall continue till the figures remaining undistributed in the service cost centers are negligibly small. The negligibly small amount left with service centre may be distributed to production cost centers.

#### 5.10.2.1.2 Simultaneous Equation Method

The simultaneous equations method is to be adopted to take care of secondary distribution of cost of service cost centers to production cost centers with the help of mathematical formulation and solution. (Refer Exhibit 1 & 2).

#### 5.10.2.2 Secondary Apportionment of Overheads on Non-Reciprocal Basis

In non-reciprocal secondary distribution, the cost of service cost centers shall be apportioned to the production cost centers. Steps involved are:

- (a) The cost of first service cost centre shall be apportioned on a suitable basis to production cost centers.
- (b) The second step is to apportion the cost of next service centre to the production cost centers as indicated in step (a).
- (c) The process is to be continued till the costs of all service cost centers are apportioned. (Refer Exhibit 3).

#### 5.10.3 Common bases for Absorption of Production Overheads

Following are the common basis for absorption of production overheads:

<b>Bases of Denominator</b>	<b>Applicability</b>
Unit of Production	When single product is produced or various products are similar in specification.
Direct Labour Cost	When conversion process is labour intensive and wage rates are substantially uniform.
Direct Labour Hour	When conversion process is labour intensive
Machine Hour or Vessel Occupancy or Reaction Hour or Crushing Hour	When production mainly depends on performance of the Base.

#### 5.10.4 Absorption of Production Overheads and Production Capacity

Overheads shall be categorized into variable overheads and fixed overheads. The production overheads shall be absorbed to products or services based on actual capacity utilization. In case actual production varies from normal production, over or under absorption of overheads shall be adjusted in costing profit & loss account.

#### 5.10.5 Determination of Overheads Absorption Rate

Production overheads absorption rate for each cost centre is to be determined with the help of normal capacity as indicated below:

$$\text{Overhead absorption rate} = \frac{\text{Estimated Total Production Overheads}}{\text{Normal Capacity}}$$

$$\text{Fixed overheads absorption rate} = \frac{\text{Fixed Production overheads}}{\text{Normal Capacity}}$$

These rates may also be calculated for each cost centre or each department for a particular period with the following formula:

$$\text{Variable overheads absorption rate} = \text{Variable Production overheads}$$

The amount of total overheads absorbed by a product, service or activity will be the sum total of the overheads absorbed from individual cost centers on pre-determined basis.

$$\text{Departmental overhead Rate} = \frac{\text{Estimated Departmental Overhead for the Period}}{\text{Normal capacity of the department}}$$

### 5.11 Presentation and Disclosure

5.11.1 Once the basis of collection, allocation, apportionment and absorption for different production cost centers is selected, the same shall be followed consistently and uniformly.

5.11.2 Change in the basis for collection, allocation, apportionment and absorption can be adopted only when it is compelled by the change

in circumstances such as change in technology, refinement and improvement in the basis etc. In case of such changes, proper disclosure in cost records is essential.

5.11.3 Any change in basis for collection, allocation, apportionment and absorption which has a material effect on the cost of the product, should be disclosed in the cost statements. Where the effect of such change is not ascertainable wholly or partly, the fact should be indicated in the cost statement.

**Exhibit 1**

Servicing departments Y & Z whose costs are to be allocated to producing departments A & B, using reciprocal method of distribution on the basis of simultaneous equation:-

Departments:	Departmental Overhead	Service Department	
	Before Distribution of Service department cost (Rs)	Dept. Y	Dept. Z
Producing –A	6,000	40%	50%
Producing –B	8,000	-	30%
Service-Y	3,630	20%	0%
Service-Z	2,000	100%	100%
Total departmental overhead	19,630		

Following are the equation to calculate the value of Y & Z.

$$Y = \text{Rs. } 3,630 + 0.30Z \quad (\text{Equation 1})$$

$$Z = \text{Rs. } 2,000 + 0.20Y \quad (\text{Equation 2})$$

By putting value of (Z) in equation 1

$$Y = \text{Rs. } 3,630 + 0.30 (\text{Rs } 2,000 + 0.20Y)$$

$$Y = \text{Rs. } 3,630 + \text{Rs } 600 + 0.06Y$$

$$0.94Y = \text{Rs } 4,230$$

$$Y = \text{Rs } 4,500$$

Substituting Z:

$$Z = \text{Rs. } 2,000 + 0.20 (\text{Rs.}4,500)$$

$$Z = \text{Rs.}2,000+ \text{Rs.}900$$

$$Z = \text{Rs. } 2,900$$

Distribution of factory overhead on the basis of equation solved above

DISTRIBUTION OF FACTORY OVERHAED	PRODUCING DEPARTMENTS		SERVICE DEPARTMENTS		TOTAL
	A	B	Y	Z	
Departmental overhead before distribution of service departments	6,000	8,000	3,630	2,000	19,630
Distribution of FOH:					
Department Y	1,800	1,800	(4,500)	900	0
Department Z	580	1,450	870	(2,900)	0
Total departmental overhead	8,380	11,250	0	0	19,630

### Exhibit2

#### Reciprocal Overheads Apportionment : Repeated Method

	Production Department			Service Department	
	Machine	Assembly	Finishing	Stores	Repair
Ratio of apportionment from Stores	50%	20%	15%		15%
Ratio apportionment from Repair	40%	35%	15%	10%	
Distribution from :					
Primary Distribution	35,500.00	31,900.00	14,800.00	5,000.00	6,000.00
Stores Dept.	2,500.00	1,000.00	750.00	(5,000.00)	750.00
Total	38,000.00	32,900.00	15,550.00	-	6,750.00
Repairs & Maintenance Dept	2,700.00	2,362.50	1,012.50	675.00	(6,750.00)
Total	40,700.00	35,262.50	16,562.50	675.00	-
Stores Dept.	337.50	135.00	101.25	(675.00)	101.25
Total	41,037.50	35,397.50	16,663.75	-	101.25
Repairs & Maintenance Dept	40.50	35.44	15.19	10.13	(101.25)
Total	41,078.00	35,432.94	16,678.94	10.13	-
Stores Dept.	5.06	2.03	1.52	(10.13)	1.52
Total	41,083.06	35,434.96	16,680.46	-	1.52
Repairs & Maintenance Dept	0.61	0.53	0.23	0.15	(1.52)
Total	41,083.67	35,435.49	16,680.68	0.15	-
Stores Dept.	0.10	0.03	0.02	(0.15)	-
Total	41,083.77	35,435.52	16,680.71	-	-

<b>Exhibit 3</b>							
Primary Distribution							
	Production Departments					Service Departments	
Expenses	Basis of allocation / apportionment	Total (Rs.)	Machine Shop	Assembly Shop	Finishing Dept	Stores	Repairs & Maint
Consumable stores	Direct Materials	15,400	5,200	6,000	2,000	600	1,600
Supervision	Direct Wages	22,800	7,900	5,100	6,100	2,200	1,500
Rent & Rates	Area	10,000	3,000	2,000	2,500	1,000	1,500
Insurance	Asset Value	2,000	800	900	200	50	50
Depreciation	Asset Value	30,000	12,000	13,500	3,000	750	750
Power	H.PxHoursx L.F	9,000	5,400	3,600	-	-	-
Light & Heat	Area	4,0	1,200	800	1,000	400	600
<b>Total</b>		<b>93,200</b>	<b>35,500</b>	<b>31,900</b>	<b>14,800</b>	<b>5,000</b>	<b>6,000</b>

Secondary Distribution							
	Production Departments					Service Departments	
Expenses	Basis of allocation / apportionment	Total (Rs.)	Machine Shop	Assembly Shop	Finishing Dept	Stores	Repairs & Maint
Primary dist. (earlier table)		93,200	35,500	31,900	14,800	5,000	6,000
Stores	Direct Material ( 9 : 6 :5)		2,250	1,500	1,250	(5,000)	
Repairs & Maint	Direct labour ( 2 : 3 : 1)		2,000	3,000	1,000		(6,000)
<b>Total</b>		<b>93,200</b>	<b>39, 750</b>	<b>36,400</b>	<b>17,050</b>	<b>-</b>	<b>-</b>

**NOTE:** Exhibits does not form part of the standard. These are only for guidelines



*Cost Accounting Standard-6*

# **Administrative Overheads**



## 6.1 Introduction

This standard deals with the principles and methods of classification, measurement and assignment of administrative overheads, for determination of the cost of cost objects, and the presentation and disclosure in cost statements.

## 6.2 Objectives

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the administrative overheads with reasonable accuracy.

This standard helps management in analyzing the impact of administrative expenses incurred on each cost object and relative benefit received against such expenses incurred.

## 6.3 Scope

This standard shall apply to cost statements which require classification, measurement, assignment, presentation and disclosure of administrative overheads.

## 6.4 Definitions

The following terms are being used in this standard with the meaning specified:

### 6.4.1 Abnormal Cost

Abnormal cost is a typical cost, whose occurrence is unusual, irregular, and unexpected or due to some abnormal situation of the production or operation.

### 6.4.2 Absorption of Overheads

Absorption of overheads is charging of overheads to cost objects using appropriate absorption rate.

### 6.4.3 Administrative Overheads

Administrative overheads are the costs of all activities relating to general management and administration of an organization.

Expenses in the nature of indirect costs, incurred for general management of an organization.

#### 6.4.4 Cost object

Cost object includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in relation to which costs are ascertained.

#### 6.4.5 Finance Cost

Finance cost is a cost incurred by an enterprise in connection with the borrowing of funds. This will include interest and commitment charges on bank borrowings, other short term and long term borrowings, amortization of discounts or premium related to borrowings, amortization of ancillary cost incurred in connection with the arrangements of borrowings, finance charges in respect of finance leases, other similar arrangements and exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs. The term finance costs and borrowing costs are used interchangeably.

#### 6.4.6 Imputed Cost

Imputed costs are the hypothetical or notional costs, not involving cash outlay, computed for any purpose.

#### 6.4.7 Normal Capacity

Normal capacity is the production achieved or achievable on an average over a long period of time to level out seasonal or cyclical variations. This is the most widely used concept of capacity. In determining normal capacity, physical plant capacity and sales potential must be considered together.

$$\text{Normal Capacity} = \text{Installed Capacity} - \text{Capacity loss (Internal \& External factors)}$$

OR

$$\text{Normal Capacity} = \text{Practical Capacity} - \text{Capacity loss by External factors}$$

#### 6.4.8 Overheads

Overheads comprise of costs of indirect material, indirect labour and other

indirect expenses, which are not directly identifiable or allocable to a cost object.

#### 6.4.9 Absorption of Administrative Overheads

Absorption of administrative overheads is charging of overheads to cost objects by means of appropriate absorption rate.

$$\text{Overhead absorption rate} = \frac{\text{Estimated total admin overheads}}{\text{Estimated Activity}}$$

(Estimated total admin overheads and activity shall be based on the normal capacity)

### 6.5 Principles of Measurement

6.5.1 Administrative overheads shall be the aggregate of cost of resources consumed in activities relating to general management and administration of an organization.

6.5.2 In case of leased assets, if the lease is an operating lease, the entire rentals shall be included in the administrative overheads. If the lease is a finance lease, the finance cost portion shall be segregated and treated as part of finance costs.

6.5.3 The cost of software (developed in house, purchased, licensed or customized), including up-gradation cost shall be amortized over its estimated useful life. It shall become part of administrative overheads.

6.5.4 The cost of administrative services procured from outside shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto net of discounts (other than cash discount), taxes and duties refundable or to be credited.

6.5.5 Any subsidy, grant, incentive or any amount of similar nature received/receivable with respect to administrative overheads shall be reduced for ascertainment of the cost of object to which such amounts are related.

6.5.6 Administrative overheads shall not include any abnormal administrative cost.

6.5.7 Any change in the cost accounting principles applied for the measurement of the administrative overheads shall be made only if it is required by law or for compliance with the requirements of a cost accounting standard or a change would rest in a more appropriate preparation or presentation of cost statements of an entity.

## 6.6 Assignment of Cost

While assigning administrative overheads, traceability to a cost object in an economically feasible manner shall be the guidance principle. Assignment of administrative overheads to the cost objects shall be based on either of the following two principles:

- (a) **Cause and Effect** - Cause is the process or operation or activity and effect is the incurrence of cost.
- (b) **Benefits received** - Overheads are to be apportioned to the various cost objects in proportion to the benefits received by them.

The costs of shared services should be assigned to user activities on the basis of actual usage.

## 6.7 Presentation

6.7.1 Administrative overheads shall be presented as a separate cost head in the cost statement.

6.7.2 Element wise details of the administrative overheads based on materiality shall be presented.

## 6.8 Disclosures

Cost statement shall disclose the following:

6.8.1 The basis of assignment of administrative overheads to the cost objects.

6.8.2 Foreign exchange component of administrative overheads.

6.8.3 Cost of activities, credits and recoveries relating to the administrative

overheads received from or supplied to related parties.

6.8.4 Any abnormal portion of the administrative overheads.

6.8.5 Penalties and damages excluded from the administrative overheads.

6.8.6 Change in basis for collection, allocation, apportionment and absorption can be adopted only when it is compelled by the change in circumstances like change in technology, refinement and improvement in the basis etc. and the change would provide more scientific approach.

6.8.7 Any change in basis for collection, allocation, apportionment and absorption which has a material effect on the cost of the product should be disclosed in the cost statements. Where the effect of such change is not ascertainable wholly or partly, the fact should be indicated in the cost statement.





*Cost Accounting Standard-7*

# **Selling and Distribution Overheads**



## 7.1 Introduction

This standard deals with the principles and methods of classification, measurement and assignment of selling and distribution overheads, for determination of the cost of cost object and for the presentation and disclosure in cost statements.

## 7.2 Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the selling and distribution overheads with reasonable accuracy.

## 7.3 Scope

This standard shall be applied to cost statements, which require classification, measurement, assignment, presentation and disclosure of selling and distribution overheads.

This standard helps management analyze the impact of marketing expenses incurred on each cost object and relative benefit received against such expenses incurred.

## 7.4 Definitions

The following terms are being used in this standard with the meaning specified:

### 7.4.1 Abnormal cost

Abnormal cost is the atypical cost whose occurrence is unusual, irregular, and unexpected or due to some abnormal situation of the production or operation.

### 7.4.2 Absorption of Overheads

Absorption of overheads is charging of overheads to cost objects using appropriate absorption rate.

### 7.4.3 Cost object

Cost object includes a product, service, cost centre, activity, sub-activity, project, contract, customer or distribution channel or any other unit in

relation to which costs are ascertained.

#### 7.4.4 Imputed Costs

Imputed cost are hypothetical or notional costs, not involving cash outlay, computed for any purpose.

#### 7.4.5 Indirect Expenses

Indirect expenses are the expenses which are not directly attributable to a particular cost object.

#### 7.4.6 Overheads

Overheads comprise of costs of indirect material, indirect labour and other indirect expenses, which are not directly identifiable or allocable to a cost object.

#### 7.4.7 Distribution Overheads

Distribution overheads are the costs incurred in handling a product or service from the time it is ready for delivery until it reaches the ultimate consumer.

The cost such as packing, repacking, labeling, transportation and warehousing etc. at an intermediate storage location will be part of distribution cost.

#### 7.4.8 Selling Overheads

Selling overheads are the expenses related to sale of products or services and include all indirect expenses related to sales management.

#### 7.4.9 Marketing Overheads

Marketing overheads comprise selling overheads and distribution overheads.

### 7.5 Principles of Measurement

7.5.1 Selling and distribution overheads shall be the costs consumed in the selling and distribution activities of the entity. The cost of resources procured from outside shall be determined at invoice value or agreed price including duties and taxes, and other expenditure directly attributable thereto, net of discounts (other than cash discounts), taxes and duties refundable or to be credited by the Tax Authorities.

7.5.2 Post sales costs such as warranty cost, product liability cost, after sales service shall be estimated on a reasonable basis.

7.5.3 Selling and distribution overheads, the benefits of which are expected to be derived over a long period, shall be amortized on a rational basis.

7.5.4 Imputed costs shall not be included in selling and distribution overheads.

7.5.5 The costs under after sales service contracts shall be determined on appropriate basis, net of any recovery on the service.

7.5.6 A subsidy, grant, incentive or any other such payment received or receivable with respect to selling and distribution overheads shall be reduced from the cost of the relevant overhead.

7.5.7 Any abnormal cost relating to selling and distribution activity shall be excluded from the selling and distribution overheads.

7.5.8 Any demurrage or detention charges or penalty levied by transportation or other authorities in respect of distribution activity shall not form part of the selling and distribution overhead.

7.5.9 Penalties and damages paid to statutory authorities or other third parties shall not form part of the selling and distribution overheads.

7.5.10 Credits or recoveries relating to the selling and distribution overheads including those rendered without any consideration, material and quantifiable, shall be deducted from selling and distribution overheads.

7.5.11 Any change in the cost accounting principles applied for the measurement of the selling and distribution overheads shall be made only if it is required by law or for compliance with the requirements of a cost accounting standard or a change would result in a more appropriate preparation or presentation of cost statements of an entity.

## **7.6 Assignment of Cost**

7.6.1 Selling and distribution overheads directly traceable shall be assigned to the relevant product sold or services rendered.

7.6.2 Transportation cost relating to distribution shall be assigned, where relevant and applicable.

7.6.3 Assignment of selling and distribution overheads to the cost objects shall be based on either of the following two principles:

(a) **Cause and Effect** - Cause is the process or operation or activity and effect is the incurrence of cost.

(b) **Benefits received** - overheads are to be apportioned to the various cost objects in proportion to the benefits received by them.

## 7.7 Presentation

7.7.1 Selling & distribution overheads shall be presented as a separate cost head in the cost statement.

7.7.2 A cost benefit analysis of marketing expenses incurred for each product or service may be carried out for evaluating the impact of such expenses and measuring the efficiency of resources consumed by each cost object.

7.3 A reporting entity may use the term marketing overheads in place of selling and distribution overheads.

## 7.8 Disclosures

Cost statement shall disclose the following:

7.8.1 The basis of assignment of selling and distribution overheads to the cost objects.

7.8.2 Foreign exchange component of selling or distribution overheads.

7.8.3 Cost of selling and distribution activities received from or supplied to related parties.

7.8.4 Credits or recoveries relating to the selling or distribution overheads.

7.8.5 Any abnormal portion of the selling or distribution overheads.

7.8.6 Penalties and damages excluded from the selling or distribution overheads.

7.8.7 Any change in basis for collection, allocation, apportionment and absorption which has a material effect on the cost of the product. Where the effect of such change is not ascertainable wholly or partly, the fact should be indicated in the cost statement.





*Cost Accounting Standard-8*  
**Direct Expenses**



## **8.1 Introduction**

This standard deals with the principles and methods of classification, measurement and assignment of direct expenses, for determination of the cost of product or service, and the presentation and disclosure in cost statements.

## **8.2 Objective**

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the direct expenses with reasonable accuracy.

## **8.3 Scope**

This standard should be applied to cost statements, which require classification, measurement, assignment, presentation and disclosure of direct expenses including those requiring attestation.

## **8.4 Definitions**

The following terms are being used in this standard with the meaning specified as below:

### **8.4.1 Direct expenses**

Direct expenses are expenses relating to manufacture of a product or rendering a service, this can be identified or linked with the cost object other than direct material cost (CAS-2) and direct labour cost (CAS-3). Examples of direct expenses are royalties charged on production, job charges, hire charges for use of specific equipment for a specific job, cost of special designs or drawings for a job, software services specifically required for a job, travelling expenses for a specific job.

### **8.4.2 Finance Cost**

Finance cost is a cost incurred by an enterprise in connection with the borrowing of funds. This will include interest and commitment charges on bank borrowings, other short term and long term borrowings, amortization of discounts or premium related to borrowings, amortization of ancillary cost incurred in connection with the arrangements of borrowings, finance charges in respect of finance leases, other similar arrangements and exchange

differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to the interest costs. The term finance costs and borrowing costs are used interchangeably.

### 8.4.3 Standard Cost

Standard cost is the predetermined cost of manufacturing a single product or a number of product units during a specific period in the immediate future. It is the planned cost of product under current and/ or anticipated conditions.

## 8.5 Principles of Measurement

8.5.1 Identification of direct expenses shall be based on traceability in an economically feasible manner.

8.5.2 Direct expenses incurred for the use of bought out resources shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto, net of trade discounts, rebates, taxes and duties refundable or to be credited.

8.5.3 Direct expenses other than those referred to in paragraph 8.5.2 shall be determined on the basis of amount incurred in connection therewith.

Examples: In case of dies and tools produced internally, the cost of such dies and tools shall include direct material cost, direct labour cost, direct expenses, and factory overheads including share of administrative overheads relating to production comprising factory management and administration.

8.5.4 In the case of research and development cost, the amount traceable to the cost object for development and improvement of the process for the existing product shall be included in direct expenses.

8.5.5 Direct expenses paid or incurred in lump-sum or which are in the nature of 'one time' payment, shall be amortized on the basis of the estimated output or benefit to be derived from such direct expenses.

Examples: Royalty or technical know-how fees, or drawing designing fees, are paid for which the benefit is ensued in the future period. In such case, the production/ service volumes shall be estimated for the effective period

and based on volume achieved during the cost accounting period, the charge for amortization is determined.

8.5.6 If an item of direct expenses does not meet the test of materiality, it can be treated as part of overheads.

8.5.7 Finance costs incurred in connection with the self-generated or procured resources shall not form part of direct expenses.

8.5.8 Where direct expenses are accounted for at standard cost, variances due to normal reasons shall be treated as part of the direct expenses. Variances due to abnormal reasons shall not form part of the direct expenses.

8.5.9 Any Subsidy/ grant/ incentive or any such payment received/ receivable with respect to any direct expenses shall be reduced for ascertainment of the cost of the cost object to which such amounts are related.

8.5.10 Any abnormal portion of the direct expenses where it is material and quantifiable shall not form part of the direct expenses.

8.5.11 Penalties, damages paid to statutory authorities or other third parties shall not form part of the direct expenses.

8.5.12 Credits/ recoveries relating to the direct expenses, material and quantifiable, shall be deducted to arrive at the net direct expenses.

8.5.13 Any change in the cost accounting principles applied for the measurement of the direct expenses should be made only if, it is required by law or for compliance with the requirements of a cost accounting standard, or a change would result in a more appropriate preparation or presentation of cost statements of an organization.

## **8.6 Assignment of costs**

Direct expenses that are directly traceable to the cost object shall be assigned to that cost object.

## **8.7 Presentation**

Direct expenses, if material, shall be presented as a separate cost head with suitable classification, e.g. subcontract charges or royalty on production.

## 8.8 Disclosures

The cost statements shall disclose the following:

8.8.1 The basis of distribution of direct expenses to the cost objects/ cost units.

8.8.2 Quantity and rates of items of direct expenses, as applicable.

8.8.3 Where direct expenses are accounted at standard cost, the price and usage variances.

8.8.4 Direct expenses representing procurement of resources and expenses incurred in connection with resources generated.

8.8.5 Direct expenses paid/ payable to related parties.

8.8.6 Direct expenses incurred in foreign exchange.

8.8.7 Any Subsidy/ Grant/ Incentive and any such payment reduced from direct expenses.

8.8.8 Credits/ recoveries relating to the direct expenses.

8.8.9 Any abnormal portion of the direct expenses.

8.8.10 Penalties and damages excluded from the direct expenses.

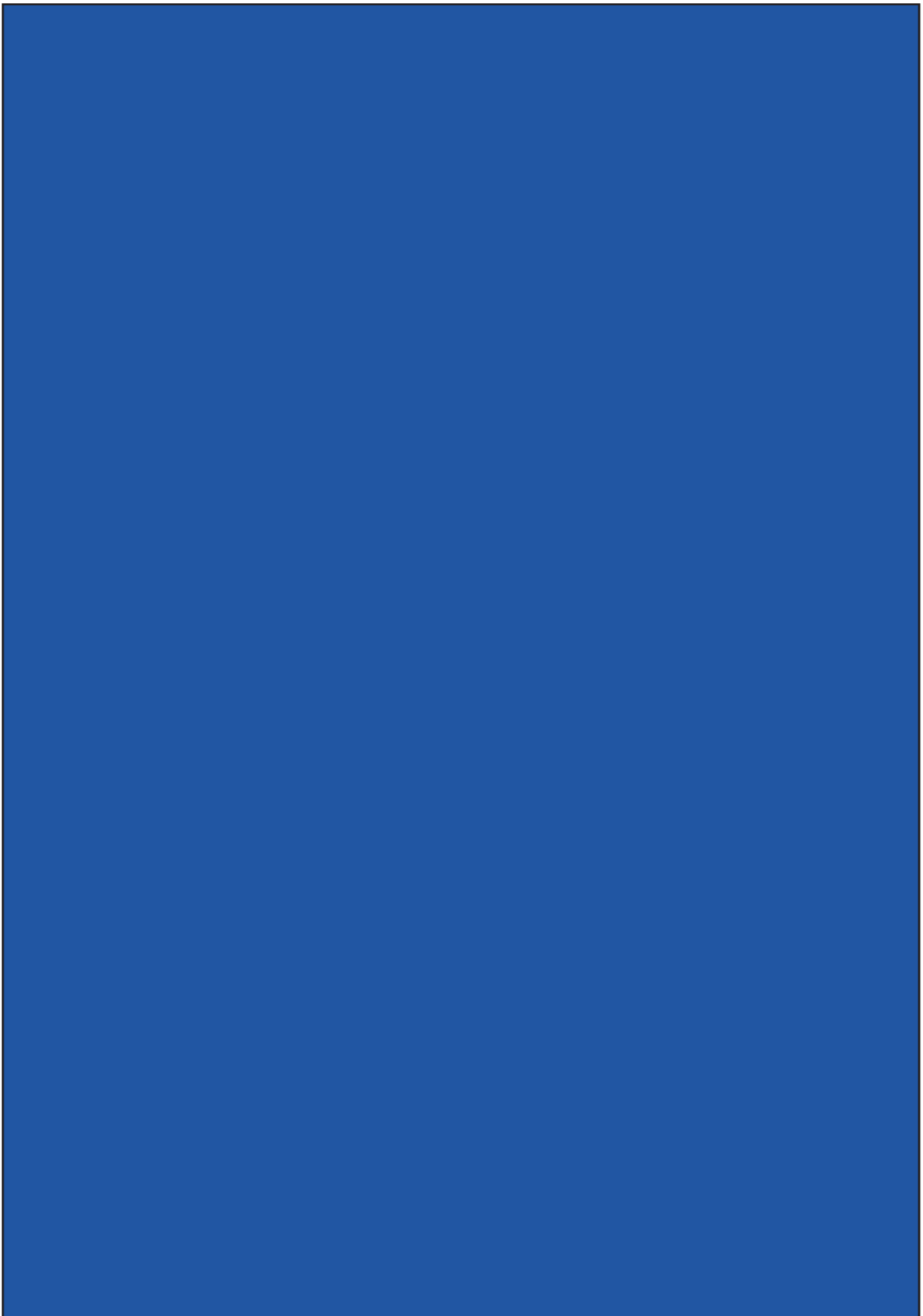
8.8.11 Disclosures shall be made only where material significant and quantifiable.

8.8.12 Disclosures shall be made in the body of the cost statement or as a foot note or as a separate schedule.

8.8.13 Any change in the cost accounting principles and methods applied for the measurement and assignment of the direct expenses during the period covered by the cost statement which has a material effect on the direct expenses. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.

*Cost Accounting Standard-9*

# **Packing Material Cost**





## **9.1 Introduction**

This standard deals with the principles and methods of classification, measurement and assignment of packing material cost for determination of the cost of product and its presentation and disclosure in cost statements.

## **9.2 Objective**

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the packing material cost with reasonable accuracy.

## **9.3 Scope**

This standard shall be applied to cost statements requiring classification, measurement, assignment, presentation and disclosure of packing material cost.

## **9.4 Definitions**

### **9.4.1 Direct expenses**

Direct expenses means expenses relating to manufacture of a product or rendering a service, this can be identified or linked with the cost object other than direct material cost and direct labour cost. Examples of direct expenses are royalties charged on production, job charges, hire charges for use of specific equipment for a specific job, cost of special designs or drawings for a job, software services specifically required for a job, travelling expenses for a specific job.

### **9.4.2 Packing Material**

Packing material means material used to hold, identify, describe, store, protect, display, transport, promote and make the product marketable and communicate with the consumer.

### **9.4.3 Packing Material Cost**

Packing material cost is the cost of material of any nature used for the purpose of packing a product.

### **9.4.4 Primary Packing Material**

Primary packing material means the packing material which is essential to

hold the product and bring it to a condition in which it can be used by or sold to a customer.

#### **9.4.5 Secondary Packing Material**

Secondary packing material is the packing material that enables to store, transport, inform the customer, promote and otherwise make the product marketable.

#### **9.4.6 Reusable Packing Material**

Reusable packing materials are the packing materials which are used more than once to pack the product.

#### **9.4.7 Scrap**

Scrap means the discarded packing material having some value in a few cases and which is usually either disposed of without further treatment or reintroduced into the production of packing material.

### **9.5 Principles of Measurement**

9.5.1 Identification of packing material cost shall be based on traceability in an economically feasible manner.

9.5.2 Packing material cost incurred for the use of bought out resources shall be determined at invoice or agreed price including duties and taxes, and other expenditure directly attributable thereto, net of trade discounts, rebates, taxes and duties refundable or to be credited.

9.5.3 Packing material cost other than those referred to in paragraph 9.5.2 shall be determined on the basis of cost incurred in connection therewith.

9.5.4 Normal loss or spoilage of packing material prior to receipt in the factory shall be absorbed in the cost of balance materials net of amounts recoverable from suppliers, insurers, carriers or recoveries from disposal.

9.5.5 The forex component of imported packing material cost shall be converted at the rate on the date of the transaction. Any subsequent change in the exchange rate till payment or otherwise shall not form part of the packing material cost.

9.5.6 Any demurrage, detention charges or penalty levied by the transport agency or any authority shall not form part of the cost of packing materials.

9.5.7 Any Subsidy/ grant/ incentive or any such payment received/ receivable with respect to packing material shall be reduced for ascertainment of the cost to which such amounts are related.

9.5.8 Issues shall be valued using appropriate method of cost valuation. The method of valuation shall be followed on a consistent basis.

9.5.9 Packing material costs shall not include imputed costs. However in case of cost of production of excisable goods for captive consumption. The cost shall be computed as per relevant cost accounting standard.

9.5.10 Where packing materials are accounted at standard cost, the price variances related to such materials shall be treated as part of packing material cost and the portion of usage variances due to normal reasons shall be treated as part of packing material cost. Usage variances due to abnormal reasons shall be treated as part of abnormal cost.

9.5.11 The normal loss arising from the issue or consumption of packing materials shall be included in the packing materials cost.

9.5.12 Any abnormal cost, which is material and quantifiable, shall be excluded from the packing material cost.

9.5.13 To arrive at the net cost of packing material, the credits/ recoveries of normal scrap arising from packing materials if any, should be deducted from the total cost of packing materials.

## **9.6 Assignment of Cost**

Assignment of packing material costs to cost objects:

9.6.1 Packing material costs shall be directly traced to a cost object where it is economically feasible.

9.6.2 Where the packing material costs are not directly traceable to the cost object, these may be assigned on appropriate basis.

9.6.3 Cost of primary packing materials shall form part of the cost of production.

9.6.4 Cost of secondary packing materials shall form part of distribution overheads.

## **9.7 Presentation**

9.7.1 Packing materials shall be classified as primary and secondary and within this classification as purchased, imported and self-manufactured.

9.7.2 Where separate cost statements are prepared for packing costs, the cost of packing materials consumed shall be prepared for each type of packing material used.

## **9.8 Disclosures**

The cost statements shall disclose the following:

9.8.1 The basis of valuation of packing materials are as under:

9.8.1.1 Where packing materials cost is disclosed at standard cost, the price and usage variances.

9.8.1.2 The cost and price of packing materials received from/ supplied to related parties.

9.8.1.3 Packing materials cost incurred in foreign exchange.

9.8.1.4 Any subsidy/ Grant/ Incentive and any such payment reduced from packing materials costs.

9.8.1.5 Credits/ recoveries relating to the packing materials costs.

9.8.1.6 Any abnormal cost excluded from packing materials costs.

9.8.1.7 Penalties and damages paid etc. excluded from packing materials costs.

9.8.2 Any change in the cost accounting principles and methods applied

for the measurement and assignment of the packing materials costs during the period covered by the cost statement which has a material effect on the packing materials cost shall be disclosed. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.

9.8.3 Disclosures shall be made only where it is material, significant and quantifiable.

9.8.4 Disclosures shall be made in the body of the cost statement or as a foot note or as a separate schedule.



*Cost Accounting Standard-10*

# **Cost of Production for Captive Consumption**





## **10.1 Introduction**

This standard deals with the principles and methods of determination of cost for captive consumption.

## **10.2 Objective**

To bring uniformity in the principles and methods used for determining the cost of production used for captive consumption.

To determine assessable value of excisable goods used for captive consumption.

## **10.3 Scope**

The standard shall be followed for determining the cost of production to arrive at an assessable value goods used for captive consumption.

## **10.4 Definitions**

### **10.4.1 Cost of Production**

Aggregate of direct material, direct labour, direct expenses and production overhead costs is termed as cost of production.

### **10.4.2 Captive Consumption**

Captive consumption means the consumption of goods manufactured by one division, department or unit and consumed by another division, department or unit of the same organization or related undertaking for manufacturing another product(s) or component.

### **10.4.3 Normal Capacity**

Normal capacity is the production achieved or achievable on an average over a longer period of time to level out seasonal or cyclical variations. In determining normal capacity, physical plant capacity and sales potential must be considered together.

$$\text{Normal Capacity} = \text{Installed Capacity} - \text{Capacity loss (Internal \& External factors)}$$

OR

$$\text{Normal Capacity} = \text{Practical Capacity} - \text{Capacity loss by External factors}$$

## **10.5 Determination of Cost of Production for Captive Consumption**

### **10.5.1 Material Consumed**

10.5.1.1 Material consumed shall include materials directly identified for production of goods such as:

- (a) Indigenous materials
- (b) Imported materials
- (c) Purchased materials
- (d) Self manufactured items
- (e) Process materials and other items

10.5.1.2 Cost of material consumed shall include cost of material, duties and taxes, freight inwards, insurance, and other directly attributable expenses net of trade discount, rebates and other similar items. Customs duty, Sales Tax adjustments, VAT, duty drawback and other similar duties subsequently recovered or recoverable by the entity shall also be deducted.

### **10.5.2 Direct Labour**

Direct labour shall include salaries and wages, house rent allowance, overtime and incentive payments made to employees directly engaged in the manufacturing activities.

Direct labour includes fringe benefits such as:

- (a) Contribution to provident fund
- (b) Bonus to employees
- (c) Provision for retirement benefits such as gratuity
- (d) Medical benefits
- (e) Subsidized food
- (f) Paid leave
- (g) Leave encashment
- (h) Other allowances

### **10.5.3 Direct Expenses**

Direct expenses are the expenses other than direct material cost and direct labour costs which can be directly identified with the cost object.

Direct expenses include:

- (a) Cost of utilities such as fuel, power, water, steam etc.

- (b) Royalty based on production.
- (c) Technical Assistance/ know-how fees.
- (d) Amortized cost of moulds, patterns, patents etc.
- (e) Job charges.
- (f) Hire charges for tools and equipment.
- (g) Charges for a particular product designing etc.

#### 10.5.4 Overheads

Overheads are the indirect costs incurred in the production process such as:

- (a) Consumable stores and spares.
- (b) Depreciation of plant and machinery, factory building etc.
- (c) Lease rent of production assets.
- (d) Repair and maintenance of plant and machinery, factory building etc.
- (e) Indirect employees cost connected with production activities
- (f) Drawing and Designing Department cost.
- (g) Insurance of plant and machinery, factory building, stock of raw material & WIP etc.
- (h) Amortized cost of jigs, fixtures, tooling etc.
- (i) Service Department cost such as Tool Room, Engineering & Maintenance, Pollution Control etc.

#### 10.5.5 Quality Control Cost

The quality control cost is the expense incurred in relation to quality control activities for adhering to quality standards.

#### 10.5.6 Research and Development Cost

The research and development cost incurred for development and improvement of the process or the existing product shall be included in the cost of production.

#### 10.5.7 Administrative Overheads

Administrative overheads shall be analyzed in relation to production and other activities. Administrative overheads in relation to production activities shall be included in the cost of production. Administrative overheads in relation to activities other than manufacturing activities such as marketing, corporate office expenses etc. shall be excluded from the cost of production.