Budgeting and Budgetary Control

Budgeting: Basics

Core concept: **Quantitative plan** of **future** activities and objectives for a specified period.

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Budgeting: Basics (cont)

Main focus: Planning, coordination, resource allocation and performance targets.

Budgeting: Basics (cont)

Objectives: **Planning → Coordination → Communication → Resource allocation → Cost control → Performance evaluation → Corrective action**.

Budgeting: Basics (cont)

Major advantages: Better planning, cost control, efficiency, accountability and coordination.

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Budgeting: Basics (cont)

Major limitations: Estimates may be inaccurate; preparation is time-consuming; rigidity and budgetary slack may arise.

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Budgeting: Basics (cont)

Key distinction: Budgeting = preparation of plans; Budgetary Control = comparison, variance analysis and corrective action.

Budgeting: Basics (cont)

Key distinction: Budget = planned target; Forecast = expected future outcome.

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Budgetary Control Process

Core concept: System of controlling operations through budgets, **actual-performance comparison** and **corrective action**.

Budgetary Control Process (cont)

Key process: **Objectives → Budget Centres → Key Budget Factor → Budget Policies → Functional Budgets → Master Budget → Approval → Actual Results → Variance Analysis → Corrective Action**.

Budgetary Control Process (cont)

Budget Centre: Organisational unit for which a separate budget is prepared.

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Budgetary Control Process (cont)

Key Budget Factor: Limiting factor governing activity; may be sales, material, labour or capacity.

Budgetary Control Process (cont)

Management by Exception: Focus on significant deviations.

Budgetary Control Process (cont)

Prerequisites: Management support, clear responsibilities, realistic budgets, reliable accounting, coordination and timely reporting.

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Budgetary Control Process (cont)

Key distinction: Budgeting prepares the plan; budgetary control monitors and acts on performance.

Budget Committee and Budget Manual

Budget Committee: Group of senior executives responsible for overall coordination, review and supervision of budgeting.

Budget Committee and Budget Manual (cont)

Composition: CEO/MD, Finance Director, Budget Officer and departmental heads.

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Budget Committee and Budget Manual (cont)

Main functions: **Budget policies → Coordination → Review → Conflict resolution → Monitoring → Revision**.

Budget Committee and Budget Manual (cont)

Budget Officer: Administrative and technical coordinator who collects, checks and consolidates budget estimates.

Budget Committee and Budget Manual (cont)

Budget Manual: Written document containing budgeting procedures, responsibilities, formats, timetables and reporting guidelines.

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Budget Committee and Budget Manual (cont)

Major distinction: Committee = People who oversee budgeting; Manual = Document explaining how budgeting is conducted.

Fixed and Flexible Budgets

Fixed Budget: Prepared for **one predetermined activity level**; does not change with actual output.

Fixed and Flexible Budgets (cont)

Flexible Budget: **Adjusted** according to **actual or expected activity levels**.

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Fixed and Flexible Budgets (cont)

Main focus: Understanding how costs behave as activity changes.

Fixed and Flexible Budgets (cont)

Major strength of flexible budgeting: Meaningful cost control and performance evaluation at different activity levels.

Fixed and Flexible Budgets (cont)

Major weakness: Requires reliable cost classification and more preparation.

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Fixed and Flexible Budgets (cont)

Key distinction: Fixed = one activity level; Flexible = multiple activity levels.

Cost behaviour:
- **Fixed** → Total constant; per-unit cost decreases.
- **Variable** → Total changes proportionately; per-unit cost constant.
- **Semi-variable** → Contains fixed and variable components.

Key formulas:
- Total variable cost = Variable cost per unit × Output.
- Total cost = Fixed cost + Variable cost.
- Semi-variable cost = **(a+bX)**.
- **High-Low variable cost per unit = Change in cost ÷ Change in activity**.

Functional Budgets

Core concept: **Separate budgets** prepared for **individual organisational functions** and **consolidated into the Master Budget**.

Functional Budgets (cont)

Key sequence: **Sales → Production → Materials, Labour and Overheads → Master Budget**.

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Functional Budgets (cont)

Main purpose: Coordination of departmental activities, resource planning and cost control.

Functional Budgets (cont)

Key principle: Functional budgets are **interdependent**; the output or estimates of one budget provide inputs for others.

Functional Budgets (cont)

Principal Budget Factor: The limiting factor governing operations. **Sales** is commonly the starting point, but material availability, labour or production capacity may be the constraint.

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Functional Budgets (cont)

Key distinction: Functional Budgets = Individual departmental plans; **Master Budget** = Consolidated organisational plan.

Main types:

1. **Sales Budget** → Expected sales quantity and revenue.
2. **Production Budget** → Units to be manufactured.
3. **Material Budget** → Materials required and purchases.
4. **Labour Budget** → Labour hours and labour cost.
5. **Overhead Budget** → Indirect production expenses.

Sales Budget

Core concept: **Estimates expected sales quantity** and revenue for a specified period.

Sales Budget (cont)

Main focus: How much can the organisation sell, and at what price?

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Sales Budget (cont)

Formula: **Sales Revenue = Budgeted Units × Selling Price per Unit**.

Sales Budget (cont)

Methods: Market research, sales force composite, trend analysis, statistical methods, expert opinion and test marketing.

Sales Budget (cont)

Major strength: Provides the basis for production and other functional budgets.

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Sales Budget (cont)

Major limitation: Accuracy depends on demand forecasts and market conditions.

Production Budget

Core concept: **Estimates units to be manufactured** to meet expected sales and desired inventory.

Production Budget (cont)

Main focus: How much should the organisation produce?

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Production Budget (cont)

Formula: **Production = Sales + Desired Closing Stock − Opening Stock**.

Production Budget (cont)

Key inputs: Sales forecast, opening inventory, desired closing inventory and production capacity.

Production Budget (cont)

Major strength: Coordinates production, sales, inventory and resource requirements.

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Production Budget (cont)

Major weakness: Depends on accurate sales forecasts and availability of production resources.

Production Budget (cont)

Key distinction: Sales Budget = Units expected to be sold; Production Budget = Units required to be manufactured.

Production Budget (cont)

Numerical trap: **Higher closing stock increases production; higher opening stock reduces production**.

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Material Budget

Core concept: Estimates raw material quantity and cost required for production and the purchases needed to maintain desired inventory.

Material Budget (cont)

Types: **Material Consumption Budget** and **Material Purchase Budget**.

Material Budget (cont)

Main focus: How much material will be consumed, and how much must be purchased?

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Material Budget (cont)

Key inputs: Production, material consumption per unit, opening stock, desired closing stock and purchase price.

Material Budget (cont)

Major strength: Ensures material availability and supports purchase planning and cost control.

Material Budget (cont)

Major weakness: Depends on accurate production estimates, consumption standards and supply availability.

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Material Budget (cont)

Key distinction: **Consumption** = Material needed for production; **Purchases** = Consumption **adjusted for inventory**.

Material Budget (cont)

Numerical trap: If wastage is expressed as a percentage of input, **Required Input = Good Output ÷ (1 − Wastage Rate)**.

Formulas:

- **Material Required** = Production Units × Material per Unit.
- **Material Purchases** = Material Required + Desired Closing Stock − Opening Stock.
- **Purchase Cost** = Purchase Quantity × Purchase Price.

Labour Budget

Core concept: Estimates **labour hours, workforce requirements and labour cost** for **planned production**.

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Labour Budget (cont)

Main focus: How many workers and labour hours are required, and what will they cost?

Labour Budget (cont)

Key inputs: Production, labour time standards, wage rates, workforce availability and productivity.

Labour Budget (cont)

Major strength: Helps plan workforce requirements and control labour costs.

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Labour Budget (cont)

Major weakness: Productivity, absenteeism, labour turnover and overtime can make estimates inaccurate.

Labour Budget (cont)

Key distinction: Labour Hours Budget = Time required; Labour Cost Budget = Wages required.

Labour Budget (cont)

Keyword associations: **Idle Time** → Paid but unproductive time; **Overtime** → Work beyond normal hours; **Labour Turnover** → Employees leaving and being replaced.

Formulas:

- **Labour Hours** = Production Units × Labour Hours per Unit.
- **Labour Cost** = Labour Hours × Wage Rate.
- **Workers Required** = Total Labour Hours ÷ Working Hours per Worker.
- **Labour Productivity** = Output ÷ Labour Hours.

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Overhead Budget

Core concept: Estimates **indirect expenses** expected to be incurred during a specified period.

Overhead Budget (cont)

Functional classification: Production / Factory → Administration → Selling → Distribution.

Overhead Budget (cont)

Cost behaviour: Fixed → Variable → Semi-variable.

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Overhead Budget (cont)

Key process: Identify overheads → Classify by function → Classify by behaviour → Estimate → Consolidate → Monitor.

Overhead Budget (cont)

Formula: **OAR = Budgeted Overheads ÷ Budgeted Activity**.

Overhead Budget (cont)

Allocation: Charging an overhead directly to **one cost centre**.

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Overhead Budget (cont)

Apportionment: Distributing common overhead among **multiple cost centres**.

Overhead Budget (cont)

Major strength: Helps control indirect costs and estimate total production expenditure.

Overhead Budget (cont)

Major weakness: Estimation and allocation of indirect costs can involve judgement.

Keyword associations:
- Factory rent → Production overhead.
- Advertising → Selling overhead.
- Delivery → Distribution overhead.
- Office rent → Administration overhead.
- Machine hours → Common overhead absorption base.

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Cash Budget

Core concept: Estimates **future cash receipts and payments** to determine **cash surplus** or **deficit**.

Cash Budget (cont)

Main focus: When will cash actually come in and go out?

Cash Budget (cont)

Formula: **Closing Cash = Opening Cash + Cash Receipts − Cash Payments**.

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Cash Budget (cont)

Methods: **Receipts and Payments Method; Adjusted Profit and Loss Method; Balance Sheet Method**.

Cash Budget (cont)

Cash receipts: Cash sales, debtor collections, loans received, sale of assets and other cash inflows.

Cash Budget (cont)

Cash payments: Supplier payments, wages, overheads, taxes, capital expenditure, loan repayments and interest.

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Cash Budget (cont)

Non-cash items: Depreciation, provisions and bad debts are excluded as cash movements.

Cash Budget (cont)

Major strength: Helps manage liquidity and anticipate financing requirements.

Cash Budget (cont)

Major weakness: Depends on accurate forecasts of receipts, payments and their timing.

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Cash Budget (cont)

Key distinction: Cash Budget = Future cash forecast; Cash Flow Statement = Actual historical cash flows.

Cash Budget Methods

- **Receipts & Payments**: Opening cash + cash receipts − cash payments.
- **Adjusted P&L**: Start with estimated profit; add non-cash expenses, adjust working capital changes and other cash items.
- **Balance Sheet**: Prepare estimated closing balance sheet; cash/bank is the balancing figure.

Closing Cash = Total Liabilities + Capital - Other Assets

Note:
- Profit does not necessarily mean positive cash flow.

Receipts and Payments Method

Concept: Prepare a period-wise statement of all expected cash receipts and cash payments.

Receipts and Payments Method (cont)

1. **Cash receipts — ADD (+)**

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Receipts and Payments Method (cont)

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Receipts and Payments Method (cont)

> Cash sales Add

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Receipts and Payments Method (cont)

> Collection from debtors Add

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Receipts and Payments Method (cont)

> Sale of fixed assets Add

Receipts and Payments Method (cont)

> New loan received Add

Receipts and Payments Method (cont)

> Issue of shares/debentures Add

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Receipts and Payments Method (cont)

> Interest/dividend received Add

Receipts and Payments Method (cont)

> Other cash income Add

Receipts and Payments Method (cont)

> Opening cash/bank balance Add

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Receipts and Payments Method (cont)

2. **Cash payments — SUBTRACT (−)**

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Receipts and Payments Method (cont)

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Receipts and Payments Method (cont)

> Cash purchases Subtract

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Receipts and Payments Method (cont)

> Payment to creditors Subtract

Receipts and Payments Method (cont)

> Wages and salaries Subtract

Receipts and Payments Method (cont)

> Rent and other expenses paid Subtract

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Receipts and Payments Method (cont)

> Purchase of fixed assets Subtract

Receipts and Payments Method (cont)

> Loan principal repaid Subtract

Receipts and Payments Method (cont)

> Interest paid Subtract

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Receipts and Payments Method (cont)

> Tax paid Subtract

Receipts and Payments Method (cont)

> Dividend paid Subtract

Receipts and Payments Method (cont)

> Other cash expenses Subtract

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Receipts and Payments Method (cont)

3. Important adjustments in numerical questions

Receipts and Payments Method (cont)

A. Credit sales and debtor collections

Receipts and Payments Method (cont)

If sales are on credit, don't include the entire sales amount as cash received. Calculate collections based on the given credit terms.

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Receipts and Payments Method (cont)

Example:

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Receipts and Payments Method (cont)

- January credit sales = ₹1,00,000

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Receipts and Payments Method (cont)

- 60% collected in January

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Receipts and Payments Method (cont)

- 40% collected in February

Receipts and Payments Method (cont)

January receipt = ₹60,000; February receipt = ₹40,000.

Receipts and Payments Method (cont)

B. Credit purchases and creditor payments

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Receipts and Payments Method (cont)

Similarly, purchases are not cash payments until suppliers are paid.

Receipts and Payments Method (cont)

Example:

Receipts and Payments Method (cont)

- January credit purchases = ₹80,000

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Receipts and Payments Method (cont)

- 70% paid in January

Receipts and Payments Method (cont)

- 30% paid in February

Receipts and Payments Method (cont)

January payment = ₹56,000; February payment = ₹24,000.

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Receipts and Payments Method (cont)

C. Outstanding and prepaid expenses

Receipts and Payments Method (cont)

- Outstanding expense: Include when actually paid.

Receipts and Payments Method (cont)

- Prepaid expense: Include when cash is paid, even if it relates to a future period.

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Receipts and Payments Method (cont)

D. Non-cash items

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Receipts and Payments Method (cont)

Exclude:

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Receipts and Payments Method (cont)

- Depreciation

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Receipts and Payments Method (cont)

- Amortisation

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Receipts and Payments Method (cont)

- Goodwill written off

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Receipts and Payments Method (cont)

- Provision for doubtful debts

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Receipts and Payments Method (cont)

- Credit purchases/sales not yet settled in cash

Adjusted Profit and Loss Method

The objective is to convert accounting profit into estimated cash.

Adjusted Profit and Loss Method (cont)

Step 1. **Start with Net Profit**

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Adjusted Profit and Loss Method (cont)

Take the estimated net profit as given in the question.

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Adjusted Profit and Loss Method (cont)

Step 2. **Adjust non-cash and non-operating items**

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Adjusted Profit and Loss Method (cont)

Item Treatment Shortcut

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Adjusted Profit and Loss Method (cont)

> Depreciation: Add (+) Expense, but no cash paid

Adjusted Profit and Loss Method (cont)

> Amortisation: Add (+) Non-cash expense

Adjusted Profit and Loss Method (cont)

> Provision for doubtful debts: Add (+) No immediate cash outflow

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Adjusted Profit and Loss Method (cont)

> Goodwill written off: Add (+) Non-cash expense

Adjusted Profit and Loss Method (cont)

> Loss on sale of fixed asset: Add (+) Accounting loss, not operating cash

Adjusted Profit and Loss Method (cont)

> Profit on sale of fixed asset: Subtract (−) Accounting gain, not operating cash

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Adjusted Profit and Loss Method (cont)

> Interest income credited to P&L: Subtract (−) Remove if separately treated as cash inflow

Adjusted Profit and Loss Method (cont)

> Dividend income credited to P&L: Subtract (−) Remove if separately treated as cash inflow

Adjusted Profit and Loss Method (cont)

Shortcut: Non-cash expenses → ADD. Non-cash gains → SUBTRACT.

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Adjusted Profit and Loss Method (cont)

Step 3. **Adjust working capital changes**

Adjusted Profit and Loss Method (cont)

This is where MCQs can test whether you understand the direction of adjustment.

Adjusted Profit and Loss Method (cont)

Working capital item Increase Decrease

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Adjusted Profit and Loss Method (cont)

> Debtors / Receivables − +

Adjusted Profit and Loss Method (cont)

> Stock / Inventory − +

Adjusted Profit and Loss Method (cont)

> Prepaid expenses − +

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Adjusted Profit and Loss Method (cont)

> Creditors / Payables + −

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Adjusted Profit and Loss Method (cont)

> Outstanding expenses + −

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Adjusted Profit and Loss Method (cont)

> Income received in advance + −

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Adjusted Profit and Loss Method (cont)

> Accrued income − +

Adjusted Profit and Loss Method (cont)

Two powerful shortcuts:

Adjusted Profit and Loss Method (cont)

- **Current assets: Increase → subtract; decrease → add.**

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Adjusted Profit and Loss Method (cont)

- **Current liabilities: Increase → add; decrease → subtract.**

Adjusted Profit and Loss Method (cont)

Why? More current assets generally tie up cash; more current liabilities generally preserve cash by delaying payment.

Adjusted Profit and Loss Method (cont)

Step 4. **Account for other cash items separately**

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Adjusted Profit and Loss Method (cont)

Once you have calculated cash generated from operations, account for other cash flows.

Adjusted Profit and Loss Method (cont)

Transaction Treatment Reason

Adjusted Profit and Loss Method (cont)

> Purchase of machinery / building − Cash paid

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Adjusted Profit and Loss Method (cont)

> Sale of machinery / building + Cash received

Adjusted Profit and Loss Method (cont)

> Purchase of investments − Cash paid

Adjusted Profit and Loss Method (cont)

> Sale of investments + Cash received

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Adjusted Profit and Loss Method (cont)

> New loan raised + Cash received

Adjusted Profit and Loss Method (cont)

> Loan principal repaid − Cash paid

Adjusted Profit and Loss Method (cont)

>Issue of shares + Cash received

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Adjusted Profit and Loss Method (cont)

> Redemption / buyback of shares − Cash paid

Adjusted Profit and Loss Method (cont)

> Interest paid − Cash outflow

Adjusted Profit and Loss Method (cont)

> Tax paid − Cash outflow

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Adjusted Profit and Loss Method (cont)

> Dividend paid − Cash outflow

Adjusted Profit and Loss Method (cont)

> Opening cash balance + Already available cash

Adjusted Profit and Loss Method (cont)

Shortcut:

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Adjusted Profit and Loss Method (cont)

- Money coming IN → ADD.

Adjusted Profit and Loss Method (cont)

- Money going OUT → SUBTRACT.

Adjusted Profit and Loss Method (cont)

- Ignore non-cash transactions.

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Adjusted Profit and Loss Method (cont)

Step 5. Calculate closing cash

Adjusted Profit and Loss Method (cont)

Closing Cash=Opening Cash+Net Cash Movement

Master Budget

Core concept: **Consolidated overall budget** combining functional budgets.

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Master Budget (cont)

Operating Budget: Sales, production, material, labour, overheads and budgeted P&L.

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Master Budget (cont)

Financial Budget: Cash budget, capital expenditure, financing and budgeted balance sheet.

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Master Budget (cont)

Key process: **Functional budgets → Operating and financial plans → Master Budget**.

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Master Budget (cont)

Major purpose: Coordination, resource allocation, planning and control.

Master Budget (cont)

Key distinction: Functional = individual department; Master = organisation-wide.

Master Budget (cont)

Keyword association: Master Budget = Integrated plan; **Pro forma = Budgeted financial statements**.

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Budgeted Income Statement and Balance Sheet

Budgeted Income Statement: Forecasts revenue, expenses and profit.

Budgeted Income Statement and Balance Sheet (cont)

Format: **Sales − COGS = Gross Profit − Operating Expenses = EBIT − Interest − Tax = PAT**.

Budgeted Income Statement and Balance Sheet (cont)

COGS: Opening Stock + Purchases + Direct Expenses − Closing Stock.

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Budgeted Income Statement and Balance Sheet (cont)

Budgeted Balance Sheet: Forecasts assets, liabilities and equity.

Budgeted Income Statement and Balance Sheet (cont)

Key calculations: **Debtors** = Opening + Credit Sales − Collections − Bad Debts; **Creditors** = Opening + Credit Purchases − Payments.

Budgeted Income Statement and Balance Sheet (cont)

Fixed assets: Opening net assets + Purchases − Book Value Sold − Depreciation.

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Budgeted Income Statement and Balance Sheet (cont)

Key equation: **Assets = Liabilities + Equity**.

Budgeted Income Statement and Balance Sheet (cont)

Connection: **PAT retained increases reserves/retained earnings**.

Budgeted Income Statement and Balance Sheet (cont)

Key distinction: **Income Statement = performance over a period; Balance Sheet = financial position on a date**.

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Budgeted Income Statement and Balance Sheet (cont)

A. Format of Budgeted Income Statement

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Budgeted Income Statement and Balance Sheet (cont)

Sales Revenue

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Budgeted Income Statement and Balance Sheet (cont)

Less: Cost of Goods Sold

Budgeted Income Statement and Balance Sheet (cont)

Gross Profit

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Budgeted Income Statement and Balance Sheet (cont)

Less: Operating Expenses

Budgeted Income Statement and Balance Sheet (cont)

Selling expenses

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Budgeted Income Statement and Balance Sheet (cont)

Administrative expenses

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Budgeted Income Statement and Balance Sheet (cont)

Operating Profit (EBIT)

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Budgeted Income Statement and Balance Sheet (cont)

Add: Non-operating income

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Budgeted Income Statement and Balance Sheet (cont)

Less: Finance cost / Interest

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Budgeted Income Statement and Balance Sheet (cont)

Profit Before Tax (PBT)

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Budgeted Income Statement and Balance Sheet (cont)

Less: Tax

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Budgeted Income Statement and Balance Sheet (cont)

Profit After Tax (PAT)

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Budgeted Income Statement and Balance Sheet (cont)

B. Format of Budgeted Balance Sheet

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Budgeted Income Statement and Balance Sheet (cont)

Liabilities and Equity

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Budgeted Income Statement and Balance Sheet (cont)

Share capital

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Budgeted Income Statement and Balance Sheet (cont)

Reserves and surplus

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Budgeted Income Statement and Balance Sheet (cont)

Long-term borrowings

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Budgeted Income Statement and Balance Sheet (cont)

Trade payables / Creditors

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Budgeted Income Statement and Balance Sheet (cont)

Outstanding expenses

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Budgeted Income Statement and Balance Sheet (cont)

Other liabilities

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Budgeted Income Statement and Balance Sheet (cont)

Total

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Budgeted Income Statement and Balance Sheet (cont)

Assets

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Budgeted Income Statement and Balance Sheet (cont)

Fixed assets

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Budgeted Income Statement and Balance Sheet (cont)

Less: Accumulated depreciation

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Budgeted Income Statement and Balance Sheet (cont)

Inventory / Closing stock

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Budgeted Income Statement and Balance Sheet (cont)

Trade receivables / Debtors

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Budgeted Income Statement and Balance Sheet (cont)	Budgeted Income Statement and Balance Sheet (cont)	Budgeted Income Statement and Balance Sheet (cont)
Cash and bank	Prepaid expenses	Total

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Budgeted Income Statement and Balance Sheet (cont)

The fundamental accounting equation: **Assets = Liabilities + Equity**.

Types and Modern Approaches to Budgeting

Zero-based budgeting.

Associated with: **Peter A. Pyhrr**.

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Zero-based budgeting. (cont)

Origin of the modern approach: Developed and popularised at **Texas Instruments**.

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Zero-based budgeting. (cont)

Starting point: **Zero base**.

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Zero-based budgeting. (cont)

Core requirement: Fresh justification of expenditure.

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Zero-based budgeting. (cont)

Key terminology: **Decision unit, decision package, ranking**.

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Zero-based budgeting. (cont)

Resource allocation: Based on evaluated priorities and available resources.

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Zero-based budgeting. (cont)

Application: Both existing and new activities can be evaluated.

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Zero-based budgeting. (cont)

Major weakness: Time-consuming and costly preparation.

Zero-based budgeting. (cont)

Major strength: Identification and elimination of unnecessary expenditure.

ZBB in six words/steps

Zero → Identify → Justify → Evaluate → Rank → Allocate

Start afresh → identify activities → prepare packages → evaluate proposals → rank priorities → distribute funds.

- **Decision unit** = where expenditure is examined.
- **Decision package** = why the activity deserves funding.
- **Ranking** = which package gets priority.

Performance Budgeting

Core concept: Links financial allocations with physical performance and results.

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Performance Budgeting (cont)

Main focus: What was achieved with the money spent.

Performance Budgeting (cont)

Key components: **Inputs (resources), Outputs (goods/services delivered), Outcomes (broader results)**.

Performance Budgeting (cont)

Three Es: **Economy (cost of resources), Efficiency (input-output relationship), Effectiveness (achievement of objectives)**.

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Performance Budgeting (cont)

Major strength: Better accountability and result-oriented resource allocation.

Performance Budgeting (cont)

Major weakness: Difficult to measure outcomes; requires reliable data and monitoring.

Performance Budgeting (cont)

India: First ARC recommended it in 1966; introduced in selected ministries in 1968–69.

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Performance Budgeting (cont)

Outcome Budget: Introduced in 2005–06; focuses on measurable outcomes and impact.

Performance Budgeting in six steps **Objectives → Activities → Targets → Resource allocation → Performance measurement → Review**.

- **Input** = resources used.
- **Output** = direct goods/services delivered.
- **Outcome** = broader result achieved.
- Performance vs Outcome Budget = work and performance vs results and impact.

Programme Budgeting

Core concept: Organises and allocates expenditure around programmes and organisational objectives.

Programme Budgeting (cont)

Main focus: What programmes should be undertaken to achieve desired objectives.

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Programme Budgeting (cont)

Key structure: **Programme → Sub-programme → Activity**.

Programme Budgeting (cont)

Resource allocation: Based on programme objectives, priorities and requirements.

Programme Budgeting (cont)

Major strength: Better coordination, planning and objective-oriented allocation.

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Programme Budgeting (cont)

Major weakness: Complex classification, overlapping activities and coordination difficulties.

Programme Budgeting (cont)

PPBS → **Planning–Programming–Budgeting System**. Connection: Programme Budgeting is one important element within the broader PPBS approach. **Robert McNamara** → Associated with the introduction/popularisation of PPBS in the US Department of Defense in the 1960s.

Programme Budgeting in six steps **Objectives** → **Programmes** → **Sub-programmes** → **Activities** → **Resource allocation** → **Review**.

- **Programme** = broad objective-oriented grouping of activities.
- **Sub-programme** = component of a programme.
- **Activity** = specific task undertaken.

Incremental Budgeting

Core concept: Uses the previous period's budget as the base and adjusts it for expected changes.

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Incremental Budgeting (cont)

Main focus: What changes are required to the existing budget?

Incremental Budgeting (cont)

Key process: **Previous Budget → Adjustments (+/−) → Revised Budget → Approval → Control**

Incremental Budgeting (cont)

Formula: **New Budget = Previous Budget + Net Adjustments**.

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Incremental Budgeting (cont)

Adjustments: May include **both increases and reductions**.

Incremental Budgeting (cont)

Major strength: Simple, economical, less time-consuming and predictable.

Incremental Budgeting (cont)

Major weakness: Perpetuates historical inefficiencies; limited scrutiny of existing expenditure.

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Incremental Budgeting (cont)

Budgetary slack: Deliberate overestimation of costs or underestimation of revenues.

Incremental Budgeting (cont)

Numerical trap: Consecutive percentage increases are **compounded**.

Incremental Budgeting (cont)

Suitability: Relatively **stable operating environments**.

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Incremental Budgeting (cont)

Keyword association: **Use-it-or-lose-it** → Incremental Budgeting.

Rolling / Continuous Budgeting

Core concept: A budget that is **continuously updated** by adding a new future period as the current period ends.

Rolling / Continuous Budgeting (cont)

Main focus: Maintaining a continuously updated, fixed future planning horizon.

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Rolling / Continuous Budgeting (cont)

Key process: **Set Planning Horizon → Prepare Budget → Monitor Actuals → Revise Estimates → Drop Completed Period → Add New Period**.

Rolling / Continuous Budgeting (cont)

Example: A 12-month budget is continuously rolled forward by dropping the completed month and adding a new month.

Rolling / Continuous Budgeting (cont)

Frequency: **Monthly, quarterly or other periodic intervals**.

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Rolling / Continuous Budgeting (cont)

Major strength: Continuous planning, adaptability and improved forecasting.

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Rolling / Continuous Budgeting (cont)

Major weakness: Time-consuming, costly and administratively demanding.

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Rolling / Continuous Budgeting (cont)

Suitability: **Dynamic and uncertain business environments**.

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Rolling / Continuous Budgeting (cont)

Key distinction: Rolling Budget = Updates the time horizon; Flexible Budget = Adjusts for activity levels.

Rolling / Continuous Budgeting (cont)

Keyword association: **Fixed planning horizon + continuous updating** → Rolling Budgeting.

Activity-Based Budgeting (ABB)

Core concept: Estimates budget requirements based on expected activities and the resources needed to perform them.

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Activity-Based Budgeting (ABB) (cont)

Main focus: What activities are required, in what quantity, and what resources will they consume?

Activity-Based Budgeting (ABB) (cont)

Key process: **Forecast Demand → Identify Activities → Estimate Activity Quantities → Identify Cost Drivers → Estimate Resources → Prepare Budget → Monitor**.

Activity-Based Budgeting (ABB) (cont)

Cost driver: Factor that causes or influences the cost of an activity.

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Activity-Based Budgeting (ABB) (cont)

Activity cost pool: Collection of costs associated with a particular activity.

Activity-Based Budgeting (ABB) (cont)

Major strength: Better cost estimation, resource allocation and identification of inefficient activities.

Activity-Based Budgeting (ABB) (cont)

Major weakness: Complex, time-consuming, costly and data-intensive.

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Activity-Based Budgeting (ABB) (cont)

Suitability: Organisations with **diverse activities** and **significant overhead costs**.

Activity-Based Budgeting (ABB) (cont)

Key distinction: ABC calculates product/service costs using activities; ABB estimates future resource requirements using expected activities.

Activity-Based Budgeting (ABB) (cont)

Keyword association: **Cost drivers + Expected activities → Activity-Based Budgeting**

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Participative Budgeting

Core concept: Budget prepared with the involvement of managers and employees at different organisational levels.

Participative Budgeting (cont)

Main focus: Who participates in budget preparation?

Participative Budgeting (cont)

Alternative name: **Bottom-Up Budgeting**.

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Participative Budgeting (cont)

Key process: **Top Management Guidelines → Departmental Estimates → Discussion & Negotiation → Consolidation → Approval → Implementation**.

Participative Budgeting (cont)

Major strength: Better estimates, motivation, ownership, commitment and coordination.

Participative Budgeting (cont)

Major weakness: Time-consuming; risk of budgetary slack and departmental conflicts.

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Participative Budgeting (cont)

Budgetary slack: Deliberate overestimation of costs or underestimation of revenues.

Participative Budgeting (cont)

Key distinction: Participative budgeting focuses on involvement in preparation; Responsibility Budgeting focuses on accountability.

Participative Budgeting (cont)

Keyword association: Bottom-up approach → Participative Budgeting.

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Responsibility Budgeting

Core concept: Budgets are prepared for different **responsibility centres**, and managers are held **accountable** for their respective performance.

Responsibility Budgeting (cont)

Main focus: Who is responsible for costs, revenue, profit and investment?

Responsibility Budgeting (cont)

Key structure: **Cost Centre → Revenue Centre → Profit Centre → Investment Centre**.

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Responsibility Budgeting (cont)

Performance measures: **Cost Centre** → Cost control. **Revenue Centre** → Revenue generation. **Profit Centre** → Profit (Revenue and costs). **Investment Centre** → ROI / Residual Income (Revenue, costs and assets/investment).

Responsibility Budgeting (cont)

Key principle: **Controllability Principle** — managers should be evaluated primarily on factors within their control.

Responsibility Budgeting (cont)

Major strength: Clear accountability, cost control, performance evaluation and decentralisation.

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Responsibility Budgeting (cont)

Major weakness: Departmental conflicts, uncontrollable factors and difficulty allocating common costs.

Responsibility Budgeting (cont)

Key distinction: Responsibility Budgeting focuses on **accountability**; Participative Budgeting focuses on employee involvement in budget preparation.

Responsibility Budgeting (cont)

Keyword association: Responsibility Centres → Responsibility Budgeting.

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Cost Sheet and Cost Ascertainment

Other cost types

Relevant, Irrelevant, Sunk, Opportunity, Differential, Marginal and Replacement Costs

Other cost types (cont)

1. Relevant Cost

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Other cost types (cont)

- A future cost that differs between alternative courses of action and affects a decision.

Other cost types (cont)

- Used in decision-making such as make-or-buy, product discontinuation and special-order pricing.

Other cost types (cont)

- Must be both future-oriented and different between alternatives.

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Other cost types (cont)

- Example: Additional raw material cost incurred only if an order is accepted.

Other cost types (cont)

2. Irrelevant Cost

Other cost types (cont)

- A cost that does not change between alternatives and therefore does not affect the decision.

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Other cost types (cont)

- Example: Existing factory rent when deciding whether to accept an additional order, if rent remains unchanged.

Other cost types (cont)

- Irrelevant costs should be excluded from decision analysis.

Other cost types (cont)

3. Sunk Cost

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Other cost types (cont)

- A cost already incurred in the past that cannot be recovered or changed by a current decision.

Other cost types (cont)

- It is irrelevant to future decision-making.

Other cost types (cont)

- Example: Money already spent on research and development or an old machine's historical purchase price.

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Other cost types (cont)

- MCQ trap: Sunk cost is always historical; not every fixed cost is a sunk cost.

Other cost types (cont)

4. Opportunity Cost

Other cost types (cont)

- The benefit sacrificed by choosing one alternative instead of the next-best alternative.

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Other cost types (cont)

- It represents the value of the foregone opportunity.

Other cost types (cont)

- Example: Using owned premises for a business means sacrificing the rental income that could have been earned.

Other cost types (cont)

- Important in resource allocation and make-or-buy decisions.

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Other cost types (cont)

- Usually not recorded as an accounting expense but is relevant for managerial decisions.

Other cost types (cont)

5. Differential Cost

Other cost types (cont)

- Difference in total cost between two alternative courses of action.

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Other cost types (cont)

- May be positive (incremental cost) or negative (cost saving).

Other cost types (cont)

- Formula:

Other cost types (cont)

- Differential Cost = Cost under Alternative A − Cost under Alternative B (using a consistent comparison order).

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Other cost types (cont)

- Example: If manufacturing costs ₹5 lakh and outsourcing costs ₹4.2 lakh, outsourcing provides a differential cost saving of ₹80,000.

Other cost types (cont)

6. Incremental Cost

Other cost types (cont)

- Additional cost arising from an increase in activity, output or adoption of an alternative.

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Other cost types (cont)

- Example: Additional cost incurred to produce 1,000 extra units.

Other cost types (cont)

- Incremental cost is a type of differential cost when comparing an increased level of activity with the existing level.

Other cost types (cont)

7. Marginal Cost

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Other cost types (cont)

- Additional cost of producing one additional unit of output.

Other cost types (cont)

- Under conventional marginal costing, it generally consists of variable production costs.

Other cost types (cont)

- Formula:

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Other cost types (cont)

- Marginal Cost = Change in Total Cost / Change in Output

Other cost types (cont)

- For one additional unit: Marginal Cost = Additional Total Cost.

Other cost types (cont)

- Fixed costs are generally treated as period costs under marginal costing.

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Other cost types (cont)

- Used in pricing, output and contribution decisions.

Other cost types (cont)

8. Replacement Cost

Other cost types (cont)

- Cost of replacing an existing asset or material with a similar asset or material at current prices.

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Other cost types (cont)

- Reflects the current cost of replacement rather than historical purchase cost.

Other cost types (cont)

- Example: Current market price of replacing raw material already held in inventory.

Other cost types (cont)

- Useful in replacement decisions, inventory valuation analysis and pricing decisions.

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Other cost types (cont)

Important MCQ Distinctions

Other cost types (cont)

- Relevant cost = Future cost that differs between alternatives.

Other cost types (cont)

- Irrelevant cost = Does not affect the decision.

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Other cost types (cont)

- Sunk cost = Already incurred and unrecoverable.

Other cost types (cont)

- Opportunity cost = Benefit sacrificed from the next-best alternative.

Other cost types (cont)

- Differential cost = Difference in total cost between alternatives.

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Other cost types (cont)

- Incremental cost = Additional cost due to increased activity or a changed decision.

Other cost types (cont)

- Marginal cost = Cost of one additional unit.

Other cost types (cont)

- Replacement cost = Current cost of replacing an asset or material.

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Other cost types (cont)

- A cost can be relevant in one decision and irrelevant in another.

Other cost types (cont)

- Opportunity cost is relevant even if it is not recorded in financial accounts.

Product Costs and Period Costs

Product Costs

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Product Costs and Period Costs (cont)

- Costs directly associated with acquiring or producing goods.

Product Costs and Period Costs (cont)

- Initially treated as inventory costs and recorded as assets.

Product Costs and Period Costs (cont)

- Become expenses (Cost of Goods Sold) when the goods are sold.

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Product Costs and Period Costs (cont)

- Include:

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Product Costs and Period Costs (cont)

- Direct material.

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Product Costs and Period Costs (cont)

- Direct labour.

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Product Costs and Period Costs (cont)

- Direct expenses.

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Product Costs and Period Costs (cont)

- Production/factory overheads.

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Product Costs and Period Costs (cont)

- Also called inventoriable costs.

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Product Costs and Period Costs (cont)

- Examples: Raw materials, factory wages, factory rent and machinery depreciation used in production.

Product Costs and Period Costs (cont)

Period Costs

Product Costs and Period Costs (cont)

- Costs that are not included in the cost of inventory.

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Product Costs and Period Costs (cont)

- Charged to the Income Statement as expenses in the period in which they are incurred.

Product Costs and Period Costs (cont)

- Generally include:

Product Costs and Period Costs (cont)

- Selling expenses.

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Product Costs and Period Costs (cont)

- Distribution expenses.

Product Costs and Period Costs (cont)

- General administration expenses not related to production.

Product Costs and Period Costs (cont)

- Examples: Advertising, sales commission, office rent and head-office administrative salaries.

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Product Costs and Period Costs (cont)

Important Distinctions

Product Costs and Period Costs (cont)

- Product cost is initially recognised as inventory; period cost is expensed in the period incurred.

Product Costs and Period Costs (cont)

- Product cost is recognised as an expense when the related goods are sold.

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Product Costs and Period Costs (cont)

- Unsold finished goods and work-in-p-rogress retain their product costs as inventory.

Product Costs and Period Costs (cont)

- Selling and distribution costs are generally period costs.

Product Costs and Period Costs (cont)

- Factory overheads are generally product costs, even though they are indirect costs.

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Product Costs and Period Costs (cont)

Inventory Cost Flow

Product Costs and Period Costs (cont)

- Raw Material → Work-in-Progress (WIP) → Finished Goods → Cost of Goods Sold (COGS).

Product Costs and Period Costs (cont)

- Product costs move through inventory accounts until the goods are sold.

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Product Costs and Period Costs (cont)

- When sold, the product cost is transferred to COGS.

Product Costs and Period Costs (cont)

MCQ Traps

Product Costs and Period Costs (cont)

- Product cost does not mean only direct cost; it includes production overheads too.

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Product Costs and Period Costs (cont)

- Period cost does not mean an expense paid periodically; it means a cost charged to the accounting period.

Product Costs and Period Costs (cont)

- Unsold inventory carries product costs forward to the next accounting period.

Product Costs and Period Costs (cont)

- Advertising is generally a period cost, not a product cost.

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Product Costs and Period Costs (cont)

- Factory depreciation is generally a product cost; office-building depreciation is generally a period cost.

Fixed, Variable and Semi-Variable Costs

Fixed Costs

Fixed, Variable and Semi-Variable Costs (cont)

- Costs that remain constant in total within a specified relevant range of activity, irrespective of changes in output.

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Fixed, Variable and Semi-Variable Costs (cont)

- Fixed cost per unit decreases as output increases and increases as output decreases.

Fixed, Variable and Semi-Variable Costs (cont)

- Examples: Factory rent, fixed salaries, insurance and straight-line depreciation.

Fixed, Variable and Semi-Variable Costs (cont)

Variable Costs

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Fixed, Variable and Semi-Variable Costs (cont)

- Costs that change in total in direct proportion to changes in output or activity, within the relevant range.

Fixed, Variable and Semi-Variable Costs (cont)

- Variable cost per unit remains constant.

Fixed, Variable and Semi-Variable Costs (cont)

- Examples: Direct raw materials, piece-rate wages and production-linked consumables.

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Fixed, Variable and Semi-Variable Costs (cont)

Semi-Variable Costs (Mixed Costs)

Fixed, Variable and Semi-Variable Costs (cont)

- Costs containing both fixed and variable components.

Fixed, Variable and Semi-Variable Costs (cont)

- Total cost changes with activity, but not in direct proportion because a fixed component exists.

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Fixed, Variable and Semi-Variable Costs (cont)

- Examples: Electricity bills with a fixed charge plus usage charges; telephone bills with rental plus usage charges.

Fixed, Variable and Semi-Variable Costs (cont)

Important Formulas

Fixed, Variable and Semi-Variable Costs (cont)

- Total Cost = Fixed Cost + Variable Cost

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Fixed, Variable and Semi-Variable Costs (cont)

- Variable Cost = Variable Cost per Unit × Units Produced

Fixed, Variable and Semi-Variable Costs (cont)

- Total Cost = Fixed Cost + (Variable Cost per Unit × Output)

Fixed, Variable and Semi-Variable Costs (cont)

- Fixed Cost per Unit = Total Fixed Cost / Units Produced

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Fixed, Variable and Semi-Variable Costs (cont)

- Average Total Cost = Total Cost / Units Produced

Fixed, Variable and Semi-Variable Costs (cont)

Cost Behaviour Example

Fixed, Variable and Semi-Variable Costs (cont)

- Fixed cost = ₹10,000.

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Fixed, Variable and Semi-Variable Costs (cont)

- Variable cost = ₹20 per unit.

Fixed, Variable and Semi-Variable Costs (cont)

- At 100 units:

Fixed, Variable and Semi-Variable Costs (cont)

- Total cost = ₹10,000 + (₹20 × 100) = ₹12,000.

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Fixed, Variable and Semi-Variable Costs (cont)

- Fixed cost per unit = ₹100.

Fixed, Variable and Semi-Variable Costs (cont)

- At 200 units:

Fixed, Variable and Semi-Variable Costs (cont)

- Total cost = ₹10,000 + (₹20 × 200) = ₹14,000.

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Fixed, Variable and Semi-Variable Costs (cont)

- Fixed cost per unit = ₹50.

Fixed, Variable and Semi-Variable Costs (cont)

- Total fixed cost remains ₹10,000, but fixed cost per unit falls as output rises.

Fixed, Variable and Semi-Variable Costs (cont)

Semi-Variable Cost Separation

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Fixed, Variable and Semi-Variable Costs (cont)

- High-Low Method: Separates fixed and variable components using the highest and lowest activity levels.

Fixed, Variable and Semi-Variable Costs (cont)

- Variable Cost per Unit = (Cost at Highest Activity − Cost at Lowest Activity) / (Highest Activity − Lowest Activity)

Fixed, Variable and Semi-Variable Costs (cont)

- Fixed Cost = Total Cost − (Variable Cost per Unit × Activity)

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Fixed, Variable and Semi-Variable Costs (cont)

Other Cost Behaviour Concepts

Fixed, Variable and Semi-Variable Costs (cont)

- Step Fixed Cost: Remains fixed over a range but increases when activity crosses a threshold.

Fixed, Variable and Semi-Variable Costs (cont)

- Example: Additional supervisor required after a production capacity limit.

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Fixed, Variable and Semi-Variable Costs (cont)

- Curvilinear Variable Cost: Variable cost changes non-linearly with output due to efficiency changes or capacity constraints.

Fixed, Variable and Semi-Variable Costs (cont)

MCQ Traps

Fixed, Variable and Semi-Variable Costs (cont)

- Fixed cost is fixed in total, not per unit.

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Fixed, Variable and Semi-Variable Costs (cont)

- Variable cost is variable in total, but constant per unit.

Fixed, Variable and Semi-Variable Costs (cont)

- Semi-variable cost has both fixed and variable components.

Fixed, Variable and Semi-Variable Costs (cont)

- Fixed costs are constant only within the relevant range and specified time period.

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Fixed, Variable and Semi-Variable Costs (cont)

- A step-fixed cost is not the same as a semi-variable cost.

Fixed, Variable and Semi-Variable Costs (cont)

- Total cost generally increases with output when variable cost per unit is positive.

Direct and Indirect Costs

Direct Costs

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Direct and Indirect Costs (cont)

- Costs that can be conveniently and economically identified with a specific cost object (product, job, service, department or process).

Direct and Indirect Costs (cont)

- Directly attributable to a particular unit or activity.

Direct and Indirect Costs (cont)

- Examples:

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Direct and Indirect Costs (cont)

- Direct material: Timber used in a table.

Direct and Indirect Costs (cont)

- Direct labour: Wages of workers assembling a specific product.

Direct and Indirect Costs (cont)

- Direct expenses: Royalty paid per unit produced.

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Direct and Indirect Costs (cont)

- Direct costs generally form part of prime cost.

Direct and Indirect Costs (cont)

Indirect Costs

Direct and Indirect Costs (cont)

- Costs that cannot be conveniently or economically traced to a specific cost object.

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Direct and Indirect Costs (cont)

- Incurred for the benefit of multiple products, departments or activities.

Direct and Indirect Costs (cont)

- Examples:

Direct and Indirect Costs (cont)

- Indirect material: Factory lubricants and cleaning supplies.

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Direct and Indirect Costs (cont)

- Indirect labour: Factory supervisor salary.

Direct and Indirect Costs (cont)

- Indirect expenses: Factory rent, common electricity and insurance.

Direct and Indirect Costs (cont)

- Indirect costs are collectively called overheads.

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Direct and Indirect Costs (cont)

Classification of Indirect Costs

Direct and Indirect Costs (cont)

- Factory/production overheads: Factory rent, machinery depreciation, indirect wages.

Direct and Indirect Costs (cont)

- Administration overheads: Office rent, office salaries, stationery.

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Direct and Indirect Costs (cont)

- Selling overheads: Advertising, sales commission, sales staff salaries.

Direct and Indirect Costs (cont)

- Distribution overheads: Warehousing, delivery, transportation and packing for distribution.

Direct and Indirect Costs (cont)

Important Distinctions

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Direct and Indirect Costs (cont)

- Direct/indirect classification depends on the cost object being considered.

Direct and Indirect Costs (cont)

- The same expense can be direct for one cost object and indirect for another.

Direct and Indirect Costs (cont)

- Example: Salary of a department manager is direct to that department but may be indirect to individual products manufactured there.

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Direct and Indirect Costs (cont)

- Direct does not necessarily mean variable; indirect does not necessarily mean fixed.

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Direct and Indirect Costs (cont)

- A cost can be direct and fixed, or indirect and variable, depending on circumstances.

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Direct and Indirect Costs (cont)

Allocation and Apportionment

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Direct and Indirect Costs (cont)

- Cost allocation: Charging an entire cost directly to a particular cost centre or cost object.

Direct and Indirect Costs (cont)

- Cost apportionment: Distributing a common cost among multiple cost centres on a reasonable basis.

Direct and Indirect Costs (cont)

- Absorption: Charging overheads to cost units/products using an appropriate absorption rate.

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Direct and Indirect Costs (cont)

- Examples of apportionment bases:

Direct and Indirect Costs (cont)

- Factory rent: Floor area.

Direct and Indirect Costs (cont)

- Electricity: Meter readings or machine hours.

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Direct and Indirect Costs (cont)

- Canteen expenses: Number of employees.

Direct and Indirect Costs (cont)

- Depreciation: Asset value or usage, depending on the cost.

Direct and Indirect Costs (cont)

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Direct and Indirect Costs (cont)

- Direct cost is identified with a specific cost object; it need not be physically incorporated into the product.

Direct and Indirect Costs (cont)

- Indirect costs are not necessarily fixed.

Direct and Indirect Costs (cont)

- Direct costs are not necessarily variable.

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Direct and Indirect Costs (cont)

- Allocation relates to charging a whole cost to a cost centre; apportionment distributes common costs.

Direct and Indirect Costs (cont)

- Overheads consist of indirect material, indirect labour and indirect expenses.

Elements of Cost: Material, Labour and Expenses

Basic Classification

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Elements of Cost: Material, Labour and Expenses (cont)

- The three elements of cost are:

Elements of Cost: Material, Labour and Expenses (cont)

- Material: Physical inputs used in producing goods or providing services.

Elements of Cost: Material, Labour and Expenses (cont)

- Labour: Human effort used in production or service delivery.

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Elements of Cost: Material, Labour and Expenses (cont)

- Expenses: Other costs incurred for production or services, excluding material and labour.

Elements of Cost: Material, Labour and Expenses (cont)

- These elements are further classified into direct and indirect costs.

Elements of Cost: Material, Labour and Expenses (cont)

1. Material Cost

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Elements of Cost: Material, Labour and Expenses (cont)

- Cost of materials consumed in production or service delivery.

Elements of Cost: Material, Labour and Expenses (cont)

- Direct material: Material that can be conveniently and economically traced to a specific product.

Elements of Cost: Material, Labour and Expenses (cont)

- Examples: Wood in furniture, steel in machinery, flour in bread.

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Elements of Cost: Material, Labour and Expenses (cont)

- Indirect material: Material that cannot be conveniently traced to a specific product or is insignificant in value.

Elements of Cost: Material, Labour and Expenses (cont)

- Examples: Lubricants, cleaning supplies, small tools and factory consumables.

Elements of Cost: Material, Labour and Expenses (cont)

- Material consumed = Opening stock + Purchases + Direct expenses on purchases − Closing stock.

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Elements of Cost: Material, Labour and Expenses (cont)

2. Labour Cost

Elements of Cost: Material, Labour and Expenses (cont)

- Remuneration paid to employees for their work.

Elements of Cost: Material, Labour and Expenses (cont)

- Direct labour: Labour directly involved in manufacturing a product or providing a service.

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Elements of Cost: Material, Labour and Expenses (cont)

- Examples: Machine operators, assembly workers, construction workers.

Elements of Cost: Material, Labour and Expenses (cont)

- Indirect labour: Labour that supports production but cannot be economically traced to a specific product.

Elements of Cost: Material, Labour and Expenses (cont)

- Examples: Factory supervisors, maintenance staff, security personnel.

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Elements of Cost: Material, Labour and Expenses (cont)

- Labour cost may include wages, salaries, overtime, bonuses and employer contributions, depending on the applicable costing treatment.

Elements of Cost: Material, Labour and Expenses (cont)

3. Expenses

Elements of Cost: Material, Labour and Expenses (cont)

- Costs other than direct material and direct labour incurred for production or services.

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Elements of Cost: Material, Labour and Expenses (cont)

- Direct expenses: Expenses specifically attributable to a particular product, job or contract.

Elements of Cost: Material, Labour and Expenses (cont)

- Examples: Royalty paid per unit produced, special design charges, hire of special equipment for a specific job.

Elements of Cost: Material, Labour and Expenses (cont)

- Indirect expenses: Expenses that cannot be directly attributed to a specific product or job.

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Elements of Cost: Material, Labour and Expenses (cont)

- Examples: Factory rent, electricity for common facilities, insurance and depreciation of factory buildings.

Elements of Cost: Material, Labour and Expenses (cont)

Important Cost Aggregates

Elements of Cost: Material, Labour and Expenses (cont)

- Prime Cost = Direct Material + Direct Labour + Direct Expenses

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Elements of Cost: Material, Labour and Expenses (cont)

- Factory/Works Cost = Prime Cost + Factory Overheads

Elements of Cost: Material, Labour and Expenses (cont)

- Cost of Production = Factory Cost + Production Administration Overheads

Elements of Cost: Material, Labour and Expenses (cont)

- Cost of Sales = Cost of Production + Selling and Distribution Overheads

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Elements of Cost: Material, Labour and Expenses (cont)

Overheads

Elements of Cost: Material, Labour and Expenses (cont)

- Overheads = Aggregate of indirect material, indirect labour and indirect expenses.

Elements of Cost: Material, Labour and Expenses (cont)

- Major classifications:

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Elements of Cost: Material, Labour and Expenses (cont)

- Factory/production overheads.

Elements of Cost: Material, Labour and Expenses (cont)

- Administration overheads.

Elements of Cost: Material, Labour and Expenses (cont)

- Selling overheads.

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Elements of Cost: Material, Labour and Expenses (cont)

- Distribution overheads.

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Elements of Cost: Material, Labour and Expenses (cont)

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Elements of Cost: Material, Labour and Expenses (cont)

- Prime cost includes only direct costs.

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Elements of Cost: Material, Labour and Expenses (cont)

- Direct expenses are included in prime cost; indirect expenses form part of overheads.

Elements of Cost: Material, Labour and Expenses (cont)

- Factory rent is generally an indirect expense.

Elements of Cost: Material, Labour and Expenses (cont)

- Factory supervisor salary is indirect labour.

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Elements of Cost: Material, Labour and Expenses (cont)

- Lubricants used across machines are generally indirect material.

Elements of Cost: Material, Labour and Expenses (cont)

- Overheads are not limited to factory expenses; they also include administration, selling and distribution costs.

Cost Centre, Cost Unit and Profit Centre

Cost Centre

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Cost Centre, Cost Unit and Profit Centre (cont)

- A cost centre is a location, person, department, activity or item of equipment for which costs are separately accumulated and analysed.

Cost Centre, Cost Unit and Profit Centre (cont)

- It is used to identify, allocate and control costs.

Cost Centre, Cost Unit and Profit Centre (cont)

- Examples: Production department, maintenance department, machine shop, quality-control department.

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Cost Centre, Cost Unit and Profit Centre (cont)

- A cost centre is not necessarily a physical location; it can also be a function or activity.

Cost Centre, Cost Unit and Profit Centre (cont)

Types of Cost Centres

Cost Centre, Cost Unit and Profit Centre (cont)

- Production cost centre: Directly involved in manufacturing or providing the main service.

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Cost Centre, Cost Unit and Profit Centre (cont)

- Examples: Assembly, machining and processing departments.

Cost Centre, Cost Unit and Profit Centre (cont)

- Service cost centre: Provides support to production or other departments.

Cost Centre, Cost Unit and Profit Centre (cont)

- Examples: Maintenance, stores, personnel and administration.

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Cost Centre, Cost Unit and Profit Centre (cont)

- Personal cost centre: Associated with an individual or group of individuals.

Cost Centre, Cost Unit and Profit Centre (cont)

- Impersonal cost centre: Associated with a location, machine or equipment.

Cost Centre, Cost Unit and Profit Centre (cont)

Cost Unit

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Cost Centre, Cost Unit and Profit Centre (cont)

- A cost unit is the unit of product or service in relation to which cost is measured or expressed.

Cost Centre, Cost Unit and Profit Centre (cont)

- It answers: Cost per what?

Cost Centre, Cost Unit and Profit Centre (cont)

- Examples:

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Cost Centre, Cost Unit and Profit Centre (cont)

- Electricity: Per kilowatt-hour (kWh).

Cost Centre, Cost Unit and Profit Centre (cont)

- Transport: Per passenger-kilometre or tonne-kilometre.

Cost Centre, Cost Unit and Profit Centre (cont)

- Cement: Per tonne.

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Cost Centre, Cost Unit and Profit Centre (cont)

- Hotel: Per room-day.

Cost Centre, Cost Unit and Profit Centre (cont)

- Hospital: Per patient-day.

Cost Centre, Cost Unit and Profit Centre (cont)

- A composite cost unit combines two measurements, e.g. tonne-kilometre.

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Cost Centre, Cost Unit and Profit Centre (cont)

Profit Centre

Cost Centre, Cost Unit and Profit Centre (cont)

- A profit centre is a segment or department whose revenues and costs are separately identified to determine its profit or loss.

Cost Centre, Cost Unit and Profit Centre (cont)

- The manager is responsible for both revenue generation and cost management.

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Cost Centre, Cost Unit and Profit Centre (cont)

- Examples: A retail store branch, regional business division or product division.

Cost Centre, Cost Unit and Profit Centre (cont)

- Performance is evaluated using the profit earned by that segment.

Cost Centre, Cost Unit and Profit Centre (cont)

Important Distinctions

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Cost Centre, Cost Unit and Profit Centre (cont)

- Cost centre: Focuses on costs.

Cost Centre, Cost Unit and Profit Centre (cont)

- Cost unit: Measures the cost of a product or service.

Cost Centre, Cost Unit and Profit Centre (cont)

- Profit centre: Focuses on both revenue and costs to determine profit.

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Cost Centre, Cost Unit and Profit Centre (cont)

- A production department may be a cost centre; the product manufactured is measured using a cost unit.

Cost Centre, Cost Unit and Profit Centre (cont)

- A profit centre has broader responsibility than a cost centre because it is evaluated on revenue as well as expenditure.

Cost Centre, Cost Unit and Profit Centre (cont)

Related Concept: Investment Centre

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Cost Centre, Cost Unit and Profit Centre (cont)

- An investment centre is a responsibility centre where the manager is accountable for revenues, costs and investments/assets employed.

Cost Centre, Cost Unit and Profit Centre (cont)

- Performance may be measured using Return on Investment (ROI) or Residual Income (RI).

Cost Centre, Cost Unit and Profit Centre (cont)

- Example: An autonomous business division with control over its operating assets and investment decisions.

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Cost Centre, Cost Unit and Profit Centre (cont)

MCQ Traps

Cost Centre, Cost Unit and Profit Centre (cont)

- Cost centre does not necessarily generate revenue.

Cost Centre, Cost Unit and Profit Centre (cont)

- Cost unit is a measurement unit, not a department.

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Cost Centre, Cost Unit and Profit Centre (cont)

- Profit centre is accountable for both revenues and costs.

Cost Centre, Cost Unit and Profit Centre (cont)

- Investment centre has wider responsibility than a profit centre because it also controls investment decisions.

Cost Control and Cost Reduction

Cost Control

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Cost Control and Cost Reduction (cont)

- Cost control = process of regulating costs by setting standards/budgets, measuring actual performance and correcting deviat-ions.

Cost Control and Cost Reduction (cont)

- Objective: Ensure actual costs do not exceed predetermined cost limits without compromising required quality.

Cost Control and Cost Reduction (cont)

- Focuses on maintaining costs within established standards.

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Cost Control and Cost Reduction (cont)

Process of Cost Control

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Cost Control and Cost Reduction (cont)

- Establish cost standards and budgets.

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Cost Control and Cost Reduction (cont)

- Measure actual costs.

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Cost Control and Cost Reduction (cont)

- Compare actual costs with standards/budgets.

Cost Control and Cost Reduction (cont)

- Identify and analyse variances.

Cost Control and Cost Reduction (cont)

- Take corrective action.

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Cost Control and Cost Reduction (cont)

- Monitor results and revise standards when necessary.

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Cost Control and Cost Reduction (cont)

Techniques of Cost Control

Cost Control and Cost Reduction (cont)

- Budgetary control: Comparing actual performance with budgets.

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Cost Control and Cost Reduction (cont)

- Standard costing: Comparing actual costs with predetermined standard costs.

Cost Control and Cost Reduction (cont)

- Variance analysis: Analysing differences between actual and standard costs.

Cost Control and Cost Reduction (cont)

- Inventory control: Techniques such as Economic Order Quantity (EOQ), ABC analysis and stock-level controls.

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Cost Control and Cost Reduction (cont)

- Responsibility accounting: Assigning cost responsibility to departments or managers.

Cost Control and Cost Reduction (cont)

Cost Reduction

Cost Control and Cost Reduction (cont)

- Cost reduction = permanent and genuine reduction in the unit cost of a product or service without reducing its quality, suitability or performance.

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Cost Control and Cost Reduction (cont)

- Focuses on continuously improving efficiency and eliminating unnecessary expenditure.

Cost Control and Cost Reduction (cont)

- Challenges existing methods and seeks better ways of operating.

Cost Control and Cost Reduction (cont)

Techniques of Cost Reduction

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Cost Control and Cost Reduction (cont)

- Value analysis and value engineering.

Cost Control and Cost Reduction (cont)

- Process improvement and automation.

Cost Control and Cost Reduction (cont)

- Reducing material wastage and labour idle time.

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Cost Control and Cost Reduction (cont)

- Better procurement and supplier management.

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Cost Control and Cost Reduction (cont)

- Improved capacity utilisation.

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Cost Control and Cost Reduction (cont)

- Product and process redesign.

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Cost Control and Cost Reduction (cont)

- Energy conservation and efficient resource utilisation.

Cost Control and Cost Reduction (cont)

Cost Control vs Cost Reduction

Cost Control and Cost Reduction (cont)

- Cost control aims to keep costs within predetermined limits; cost reduction aims to bring costs down permanently.

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Cost Control and Cost Reduction (cont)

- Cost control is standards-oriented; cost reduction challenges existing standards and methods.

Cost Control and Cost Reduction (cont)

- Cost control is preventive and corrective; cost reduction is improvement-oriented.

Cost Control and Cost Reduction (cont)

- Cost control may maintain the existing cost level; cost reduction seeks a lower cost level.

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Cost Control and Cost Reduction (cont)

- Both aim to improve operational efficiency and profitability.

Cost Control and Cost Reduction (cont)

MCQ Traps

Cost Control and Cost Reduction (cont)

- Cost reduction must not compromise quality or performance.

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Cost Control and Cost Reduction (cont)

- Cost control does not necessarily mean reducing expenditure; it may simply keep expenditure within budget.

Cost Control and Cost Reduction (cont)

- Cost reduction is a continuous process, not a one-time exercise.

Cost Control and Cost Reduction (cont)

- Cutting essential maintenance or quality expenditure may reduce immediate costs but is not genuine cost reduction if it harms long-term efficiency.

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Cost Control and Cost Reduction (cont)

- Variance analysis is a major tool of cost control; value engineering is a major cost-r-eduction technique.

Cost vs Financial vs Management Accounting

Financial Accounting

Cost vs Financial vs Management Accounting (cont)

- Records financial transactions of the organisation and prepares financial statem-ents.

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Cost vs Financial vs Management Accounting (cont)

- Main users: External stakeholders such as investors, lenders, creditors, regulators and shareholders.

Cost vs Financial vs Management Accounting (cont)

- Focus: Overall financial performance and position of the entity.

Cost vs Financial vs Management Accounting (cont)

- Primarily historical in nature.

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Cost vs Financial vs Management Accounting (cont)

- Follows prescribed accounting standards and statutory requirements.

Cost vs Financial vs Management Accounting (cont)

- Outputs: Income Statement, Balance Sheet and Cash Flow Statement.

Cost vs Financial vs Management Accounting (cont)

Cost Accounting

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Cost vs Financial vs Management Accounting (cont)

- Determines and analyses the cost of products, services, processes and activities.

Cost vs Financial vs Management Accounting (cont)

- Main users: Internal management.

Cost vs Financial vs Management Accounting (cont)

- Focus: Cost ascertainment, allocation, control and reduction.

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Cost vs Financial vs Management Accounting (cont)

- Uses both historical and predetermined costs.

Cost vs Financial vs Management Accounting (cont)

- Provides detailed cost information by product, department, job or process.

Cost vs Financial vs Management Accounting (cont)

- Outputs: Cost sheets, cost statements, cost reports and variance reports.

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Cost vs Financial vs Management Accounting (cont)

Management Accounting

Cost vs Financial vs Management Accounting (cont)

- Provides financial and non-financial information to management for planning, decision-making and control.

Cost vs Financial vs Management Accounting (cont)

- Main users: Internal managers at different organisational levels.

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Cost vs Financial vs Management Accounting (cont)

- Focus: Future planning, strategy, performance evaluation and managerial decisions.

Cost vs Financial vs Management Accounting (cont)

- Uses information from financial accounting, cost accounting and other operational sources.

Cost vs Financial vs Management Accounting (cont)

- Includes budgeting, forecasting, ratio analysis, marginal costing and capital budgeting.

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Cost vs Financial vs Management Accounting (cont)

- No single universally prescribed format; reports are designed according to management needs.

Cost vs Financial vs Management Accounting (cont)

Key Distinctions

Cost vs Financial vs Management Accounting (cont)

- Financial accounting = overall financial reporting.

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Cost vs Financial vs Management Accounting (cont)

- Cost accounting = determining and controlling costs.

Cost vs Financial vs Management Accounting (cont)

- Management accounting = using information for managerial decisions.

Cost vs Financial vs Management Accounting (cont)

- Cost accounting is an important source of information for management accounting.

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Cost vs Financial vs Management Accounting (cont)

- Financial accounting is generally mandatory for companies; cost accounting and cost audit are mandatory only for specified classes of companies under applicable law.

Cost vs Financial vs Management Accounting (cont)

- Management accounting is generally voluntary and internally designed.

Cost vs Financial vs Management Accounting (cont)

Relationship

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Cost vs Financial vs Management Accounting (cont)

- Financial accounting provides the overall financial data.

Cost vs Financial vs Management Accounting (cont)

- Cost accounting provides detailed cost information.

Cost vs Financial vs Management Accounting (cont)

- Management accounting integrates these and other sources to support planning, control and decisions.

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Cost vs Financial vs Management Accounting (cont)

MCQ Traps

Cost vs Financial vs Management Accounting (cont)

- Cost accounting is narrower than management accounting in terms of its primary focus.

Cost vs Financial vs Management Accounting (cont)

- Management accounting includes both financial and non-financial information.

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Cost vs Financial vs Management Accounting (cont)

- Financial accounting is primarily external--facing; cost and management accounting are primarily internal-facing.

Cost vs Financial vs Management Accounting (cont)

- Cost accounting is not synonymous with management accounting.

Meaning, Objectives, Nature and Scope

Meaning

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Meaning, Objectives, Nature and Scope (cont)

- Cost accounting = systematic process of recording, classifying, analysing and allocating costs to determine the cost of a product, service, process or activity.

Meaning, Objectives, Nature and Scope (cont)

- It helps management understand where, why and how much an organisation spends.

Meaning, Objectives, Nature and Scope (cont)

- Cost = monetary value of resources sacrificed to achieve a specific objective.

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Meaning, Objectives, Nature and Scope (cont)

Objectives

Meaning, Objectives, Nature and Scope (cont)

- Cost ascertainment: Determine the cost per unit, job, process or service.

Meaning, Objectives, Nature and Scope (cont)

- Cost control: Monitor actual costs against budgets or standards and identify deviat-ions.

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Meaning, Objectives, Nature and Scope (cont)

- Cost reduction: Achieve sustainable reduction in unit cost without compromising quality or performance.

Meaning, Objectives, Nature and Scope (cont)

- Pricing decisions: Provide cost information for fixing selling prices and quotations.

Meaning, Objectives, Nature and Scope (cont)

- Profitability analysis: Identify profitable products, services, departments and customers.

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Meaning, Objectives, Nature and Scope (cont)

- Decision-making: Support make-or-buy, product mix, outsourcing and shutdown decisions.

Meaning, Objectives, Nature and Scope (cont)

- Efficiency measurement: Identify wastage, idle time and underutilisation of resources.

Meaning, Objectives, Nature and Scope (cont)

- Inventory valuation: Help determine material, work-in-progress and finished--goods costs.

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Meaning, Objectives, Nature and Scope (cont)

Nature and Characteristics

Meaning, Objectives, Nature and Scope (cont)

- Analytical and systematic accounting process.

Meaning, Objectives, Nature and Scope (cont)

- Focuses on cost classification, allocation, measurement and control.

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Meaning, Objectives, Nature and Scope (cont)

- Can use historical costs as well as predetermined costs (standard costs and budgets).

Meaning, Objectives, Nature and Scope (cont)

- Provides detailed information by product, department, process, job or activity.

Meaning, Objectives, Nature and Scope (cont)

- Primarily serves internal management, although cost records and audits may be legally required for specified companies.

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Meaning, Objectives, Nature and Scope (cont)

Scope

Meaning, Objectives, Nature and Scope (cont)

- Material, labour and overhead costing.

Meaning, Objectives, Nature and Scope (cont)

- Job, batch, contract, process and service costing.

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Meaning, Objectives, Nature and Scope (cont)

- Standard costing and variance analysis.

Meaning, Objectives, Nature and Scope (cont)

- Marginal costing and break-even analysis.

Meaning, Objectives, Nature and Scope (cont)

- Budgetary control.

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Meaning, Objectives, Nature and Scope (cont)

- Inventory and cost-of-production analysis.

Meaning, Objectives, Nature and Scope (cont)

- Cost audit and cost reporting, where applicable.

Meaning, Objectives, Nature and Scope (cont)

MCQ Traps

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Meaning, Objectives, Nature and Scope (cont)

- Cost accounting is not limited to recording expenditure; it also analyses and controls costs.

Meaning, Objectives, Nature and Scope (cont)

- It is primarily an internal management tool.

Meaning, Objectives, Nature and Scope (cont)

- Cost accounting can use both actual and predetermined costs.

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Meaning, Objectives, Nature and Scope (cont)

- Cost ascertainment determines cost; cost control regulates it; cost reduction seeks lasting improvement.

Fundamentals of Cost Accounting

Prime Cost

Meaning

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Prime Cost (cont)

- Prime Cost = Total of all direct costs incurred in manufacturing a product or completing a job.

Prime Cost (cont)

- It represents the basic cost directly attributable to production.

Prime Cost (cont)

Components

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Prime Cost (cont)

- Direct Material.

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Prime Cost (cont)

- Direct Labour.

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Prime Cost (cont)

- Direct Expenses.

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Prime Cost (cont)

Formula

Prime Cost (cont)

Prime Cost = Direct Material + Direct Labour + Direct Expenses

Prime Cost (cont)

Direct Material Consumed

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Prime Cost (cont)

- Direct Material Consumed = Opening Raw Material Stock + Net Purchases + Direct Purchase Expenses − Closing Raw Material Stock.

Prime Cost (cont)

- Net Purchases = Purchases − Purchase Returns.

Prime Cost (cont)

Important Points

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Prime Cost (cont)

- Prime cost excludes all indirect costs and overheads.

Prime Cost (cont)

- Factory rent, factory supervisor salary and machinery depreciation are not part of prime cost.

Prime Cost (cont)

- Direct expenses such as job-specific royalty and special equipment hire are included.

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Prime Cost (cont)

- Prime cost is the starting point for calculating factory/manufacturing cost.

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Prime Cost (cont)

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Prime Cost (cont)

- Prime cost = Direct Material + Direct Labour + Direct Expenses.

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Prime Cost (cont)

- Factory overheads are added after prime cost to arrive at factory cost.

Prime Cost (cont)

- Direct expenses must not be confused with indirect expenses.

Prime Cost (cont)

- Closing raw material stock is deducted while calculating material consumed.

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Treatment of Stock, WIP and Finished Goods

1. Raw Material Stock

Treatment of Stock, WIP and Finished Goods (cont)

- Opening Raw Material Stock: Added while calculating material consumed.

Treatment of Stock, WIP and Finished Goods (cont)

- Purchases: Added to opening stock.

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Treatment of Stock, WIP and Finished Goods (cont)

- Purchase Returns: Deducted from purchases.

Treatment of Stock, WIP and Finished Goods (cont)

- Carriage/Freight Inward: Added if directly attributable to bringing materials to the premises.

Treatment of Stock, WIP and Finished Goods (cont)

- Closing Raw Material Stock: Deducted.

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Treatment of Stock, WIP and Finished Goods (cont)

Formula

Treatment of Stock, WIP and Finished Goods (cont)

Material Consumed = Opening Stock + Net Purchases + Direct Purchase Expenses - Closing Stock

Treatment of Stock, WIP and Finished Goods (cont)

2. Work-in-Progress (WIP)

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Treatment of Stock, WIP and Finished Goods (cont)

- WIP = Goods that have entered production but are not yet completed.

Treatment of Stock, WIP and Finished Goods (cont)

- Opening WIP: Added to current-period production costs.

Treatment of Stock, WIP and Finished Goods (cont)

- Closing WIP: Deducted from current-p-eriod production costs.

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Treatment of Stock, WIP and Finished Goods (cont)

- WIP is adjusted while calculating factory/works cost.

Treatment of Stock, WIP and Finished Goods (cont)

- Closing WIP is carried forward as opening WIP of the next period.

Treatment of Stock, WIP and Finished Goods (cont)

Formula

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Treatment of Stock, WIP and Finished Goods (cont)

Factory Cost =Prime Cost+Factory Overheads

Treatment of Stock, WIP and Finished Goods (cont)

+Opening WIP-Closing WIP

Treatment of Stock, WIP and Finished Goods (cont)

3. Finished Goods Stock

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Treatment of Stock, WIP and Finished Goods (cont)

- Finished Goods = Goods fully manufactured and ready for sale.

Treatment of Stock, WIP and Finished Goods (cont)

- Opening Finished Goods: Added to cost of production to determine goods available for sale.

Treatment of Stock, WIP and Finished Goods (cont)

- Closing Finished Goods: Deducted because these goods remain unsold.

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Treatment of Stock, WIP and Finished Goods (cont)

- Adjusted while calculating Cost of Goods Sold (COGS).

Treatment of Stock, WIP and Finished Goods (cont)

Formula

Treatment of Stock, WIP and Finished Goods (cont)

COGS = Cost of Production+Opening Finished Goods - Closing Finished Goods

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Treatment of Stock, WIP and Finished Goods (cont)

4. Inventory Cost Flow

Treatment of Stock, WIP and Finished Goods (cont)

- Raw Material → Work-in-Progress → Finished Goods → Cost of Goods Sold.

Treatment of Stock, WIP and Finished Goods (cont)

- Raw materials are consumed in production.

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Treatment of Stock, WIP and Finished Goods (cont)

- Production costs accumulate in WIP.

Treatment of Stock, WIP and Finished Goods (cont)

- Completed goods move into finished goods inventory.

Treatment of Stock, WIP and Finished Goods (cont)

- When goods are sold, their cost moves to COGS.

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Treatment of Stock, WIP and Finished Goods (cont)

5. Numerical Illustration

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Treatment of Stock, WIP and Finished Goods (cont)

Given:

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Treatment of Stock, WIP and Finished Goods (cont)

- Opening Raw Material = ₹10,000.

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Treatment of Stock, WIP and Finished Goods (cont)

- Purchases = ₹50,000.

Treatment of Stock, WIP and Finished Goods (cont)

- Closing Raw Material = ₹8,000.

Treatment of Stock, WIP and Finished Goods (cont)

- Direct Labour = ₹20,000.

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Treatment of Stock, WIP and Finished Goods (cont)

- Direct Expenses = ₹2,000.

Treatment of Stock, WIP and Finished Goods (cont)

- Factory Overheads = ₹10,000.

Treatment of Stock, WIP and Finished Goods (cont)

- Opening WIP = ₹5,000.

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Treatment of Stock, WIP and Finished Goods (cont)

- Closing WIP = ₹3,000.

Treatment of Stock, WIP and Finished Goods (cont)

- Production Administration Overheads = ₹4,000.

Treatment of Stock, WIP and Finished Goods (cont)

- Opening Finished Goods = ₹7,000.

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Treatment of Stock, WIP and Finished Goods (cont)

- Closing Finished Goods = ₹9,000.

Treatment of Stock, WIP and Finished Goods (cont)

Calculation:

Treatment of Stock, WIP and Finished Goods (cont)

- Material Consumed = ₹10,000 + ₹50,000 − ₹8,000 = ₹52,000.

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Treatment of Stock, WIP and Finished Goods (cont)

- Prime Cost = ₹52,000 + ₹20,000 + ₹2,000 = ₹74,000.

Treatment of Stock, WIP and Finished Goods (cont)

- Factory Cost = ₹74,000 + ₹10,000 + ₹5,000 − ₹3,000 = ₹86,000.

Treatment of Stock, WIP and Finished Goods (cont)

- Cost of Production = ₹86,000 + ₹4,000 = ₹90,000.

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Treatment of Stock, WIP and Finished Goods (cont)

- COGS = ₹90,000 + ₹7,000 − ₹9,000 = ₹88,000.

Treatment of Stock, WIP and Finished Goods (cont)

MCQ Traps

Treatment of Stock, WIP and Finished Goods (cont)

- Opening stock is added; closing stock is deducted at the relevant stage.

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Treatment of Stock, WIP and Finished Goods (cont)

- Opening WIP and closing WIP affect factory cost, not finished-goods adjustment.

Treatment of Stock, WIP and Finished Goods (cont)

- Opening and closing finished goods affect COGS, not prime cost.

Treatment of Stock, WIP and Finished Goods (cont)

- Raw material closing stock is deducted while calculating material consumed.

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Treatment of Stock, WIP and Finished Goods (cont)

- WIP means partially completed goods; finished goods are fully completed but may remain unsold.

Treatment of Stock, WIP and Finished Goods (cont)

- Closing inventory is carried forward as opening inventory of the next accounting period.

Preparation of Cost Sheets and Numerical Problems

Meaning

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Preparation of Cost Sheets and Numerical Problems (cont)

- A Cost Sheet is a statement showing the total cost and cost per unit of a product or service for a specified period.

Preparation of Cost Sheets and Numerical Problems (cont)

- It classifies costs under different elements and cost stages to determine the total cost of production and sales.

Preparation of Cost Sheets and Numerical Problems (cont)

- Used for cost ascertainment, pricing, cost comparison and cost control.

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Preparation of Cost Sheets and Numerical Problems (cont)

Standard Cost Sheet Format

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Preparation of Cost Sheets and Numerical Problems (cont)

1. Prime Cost

Preparation of Cost Sheets and Numerical Problems (cont)

- Direct Material Consumed

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Preparation of Cost Sheets and Numerical Problems (cont)

- Add: Direct Labour

Preparation of Cost Sheets and Numerical Problems (cont)

- Add: Direct Expenses

Preparation of Cost Sheets and Numerical Problems (cont)

- Prime Cost

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Preparation of Cost Sheets and Numerical Problems (cont)

2. Factory / Works Cost

Preparation of Cost Sheets and Numerical Problems (cont)

- Prime Cost

Preparation of Cost Sheets and Numerical Problems (cont)

- Add: Factory Overheads

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Preparation of Cost Sheets and Numerical Problems (cont)

- Add: Opening WIP

Preparation of Cost Sheets and Numerical Problems (cont)

- Less: Closing WIP

Preparation of Cost Sheets and Numerical Problems (cont)

- Factory Cost

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Preparation of Cost Sheets and Numerical Problems (cont)

3. Cost of Production

Preparation of Cost Sheets and Numerical Problems (cont)

- Factory Cost

Preparation of Cost Sheets and Numerical Problems (cont)

- Add: Production Administration Overheads

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Preparation of Cost Sheets and Numerical Problems (cont)

- Cost of Production

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Preparation of Cost Sheets and Numerical Problems (cont)

4. Cost of Goods Sold

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Preparation of Cost Sheets and Numerical Problems (cont)

- Cost of Production

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Preparation of Cost Sheets and Numerical Problems (cont)

- Add: Opening Finished Goods

Preparation of Cost Sheets and Numerical Problems (cont)

- Less: Closing Finished Goods

Preparation of Cost Sheets and Numerical Problems (cont)

- COGS

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Preparation of Cost Sheets and Numerical Problems (cont)

5. Cost of Sales / Total Cost

Preparation of Cost Sheets and Numerical Problems (cont)

- COGS

Preparation of Cost Sheets and Numerical Problems (cont)

- Add: Administration Overheads not already included

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Preparation of Cost Sheets and Numerical Problems (cont)

- Add: Selling and Distribution Overheads

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Preparation of Cost Sheets and Numerical Problems (cont)

- Cost of Sales / Total Cost

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Preparation of Cost Sheets and Numerical Problems (cont)

6. Profit and Selling Price

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Preparation of Cost Sheets and Numerical Problems (cont)

- Cost of Sales

Preparation of Cost Sheets and Numerical Problems (cont)

- Add: Profit

Preparation of Cost Sheets and Numerical Problems (cont)

- Sales / Selling Price

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Preparation of Cost Sheets and Numerical Problems (cont)

Important Formulas

Preparation of Cost Sheets and Numerical Problems (cont)

- Material Consumed = Opening Raw Material + Purchases + Direct Purchase Expenses − Purchase Returns − Closing Raw Material.

Preparation of Cost Sheets and Numerical Problems (cont)

- Prime Cost = Direct Material + Direct Labour + Direct Expenses.

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Preparation of Cost Sheets and Numerical Problems (cont)

- Factory Cost = Prime Cost + Factory Overheads + Opening WIP − Closing WIP.

Preparation of Cost Sheets and Numerical Problems (cont)

- Cost of Production = Factory Cost + Production Administration Overheads.

Preparation of Cost Sheets and Numerical Problems (cont)

- COGS = Cost of Production + Opening Finished Goods − Closing Finished Goods.

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Preparation of Cost Sheets and Numerical Problems (cont)

- Cost of Sales = COGS + Administration Overheads not included earlier + Selling and Distribution Overheads.

Preparation of Cost Sheets and Numerical Problems (cont)

- Profit = Sales − Cost of Sales.

Preparation of Cost Sheets and Numerical Problems (cont)

- Cost per Unit = Total Cost / Number of Units.

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Preparation of Cost Sheets and Numerical Problems (cont)

- Selling Price per Unit = Total Selling Price / Units Sold.

Preparation of Cost Sheets and Numerical Problems (cont)

Numerical Example

Preparation of Cost Sheets and Numerical Problems (cont)

Given:

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Preparation of Cost Sheets and Numerical Problems (cont)

- Opening Raw Material = ₹20,000.

Preparation of Cost Sheets and Numerical Problems (cont)

- Purchases = ₹1,00,000.

Preparation of Cost Sheets and Numerical Problems (cont)

- Closing Raw Material = ₹10,000.

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Preparation of Cost Sheets and Numerical Problems (cont)

- Direct Labour = ₹40,000.

Preparation of Cost Sheets and Numerical Problems (cont)

- Direct Expenses = ₹5,000.

Preparation of Cost Sheets and Numerical Problems (cont)

- Factory Overheads = ₹25,000.

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Preparation of Cost Sheets and Numerical Problems (cont)

- Opening WIP = ₹8,000.

Preparation of Cost Sheets and Numerical Problems (cont)

- Closing WIP = ₹3,000.

Preparation of Cost Sheets and Numerical Problems (cont)

- Production Administration Overheads = ₹10,000.

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Preparation of Cost Sheets and Numerical Problems (cont)

- Opening Finished Goods = ₹15,000.

Preparation of Cost Sheets and Numerical Problems (cont)

- Closing Finished Goods = ₹20,000.

Preparation of Cost Sheets and Numerical Problems (cont)

- Selling and Distribution Overheads = ₹12,000.

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Preparation of Cost Sheets and Numerical Problems (cont)

Calculation:

Preparation of Cost Sheets and Numerical Problems (cont)

- Material Consumed = ₹20,000 + ₹1,00,000 − ₹10,000 = ₹1,10,000.

Preparation of Cost Sheets and Numerical Problems (cont)

- Prime Cost = ₹1,10,000 + ₹40,000 + ₹5,000 = ₹1,55,000.

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Preparation of Cost Sheets and Numerical Problems (cont)

- Factory Cost = ₹1,55,000 + ₹25,000 + ₹8,000 − ₹3,000 = ₹1,85,000.

Preparation of Cost Sheets and Numerical Problems (cont)

- Cost of Production = ₹1,85,000 + ₹10,000 = ₹1,95,000.

Preparation of Cost Sheets and Numerical Problems (cont)

- COGS = ₹1,95,000 + ₹15,000 − ₹20,000 = ₹1,90,000.

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Preparation of Cost Sheets and Numerical Problems (cont)

- Cost of Sales = ₹1,90,000 + ₹12,000 = ₹2,02,000.

Preparation of Cost Sheets and Numerical Problems (cont)

- If profit is ₹48,000, Sales = ₹2,02,000 + ₹48,000 = ₹2,50,000.

Preparation of Cost Sheets and Numerical Problems (cont)

Common Adjustments

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Preparation of Cost Sheets and Numerical Problems (cont)

- Purchase returns: Deduct from purchases.

Preparation of Cost Sheets and Numerical Problems (cont)

- Carriage inward/freight inward: Add to material purchase cost when directly attributable.

Preparation of Cost Sheets and Numerical Problems (cont)

- Carriage outward: Selling/distribution overhead.

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Preparation of Cost Sheets and Numerical Problems (cont)

- Factory power: Factory overhead unless directly traceable and treated otherwise.

Preparation of Cost Sheets and Numerical Problems (cont)

- Office administration: Administration overhead.

Preparation of Cost Sheets and Numerical Problems (cont)

- Advertising: Selling overhead.

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Preparation of Cost Sheets and Numerical Problems (cont)

- Opening stock: Add at the relevant inventory stage.

Preparation of Cost Sheets and Numerical Problems (cont)

- Closing stock: Deduct at the relevant inventory stage.

Preparation of Cost Sheets and Numerical Problems (cont)

MCQ and Numerical Traps

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Preparation of Cost Sheets and Numerical Problems (cont)

- Do not confuse material purchased with material consumed.

Preparation of Cost Sheets and Numerical Problems (cont)

- Opening stock is added; closing stock is deducted.

Preparation of Cost Sheets and Numerical Problems (cont)

- Opening WIP and opening finished goods are added at their respective stages.

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Preparation of Cost Sheets and Numerical Problems (cont)

- Closing WIP and closing finished goods are deducted at their respective stages.

Preparation of Cost Sheets and Numerical Problems (cont)

- Carriage inward is generally part of material cost; carriage outward is a distribution cost.

Preparation of Cost Sheets and Numerical Problems (cont)

- Ensure overheads are not counted twice.

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Preparation of Cost Sheets and Numerical Problems (cont)

- Cost per unit must use the correct output quantity; cost per unit produced and cost per unit sold may differ when inventory changes.

Total Cost and Selling Price

Meaning

Total Cost and Selling Price (cont)

- Total Cost (Cost of Sales) = Complete cost incurred to manufacture and sell a product or provide a service.

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Total Cost and Selling Price (cont)

- It includes production cost as well as administration, selling and distribution overheads.

Total Cost and Selling Price (cont)

Components

Total Cost and Selling Price (cont)

- Cost of Goods Sold (COGS).

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Total Cost and Selling Price (cont)

- Add: Administration Overheads (not already included in production cost).

Total Cost and Selling Price (cont)

- Add: Selling and Distribution Overheads.

Total Cost and Selling Price (cont)

Formula

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Total Cost and Selling Price (cont)

Total Cost = COGS + Administration Overheads + Selling Overheads + Distribution Overheads

Total Cost and Selling Price (cont)

Selling Price

Total Cost and Selling Price (cont)

- Selling Price = Total Cost + Profit.

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Total Cost and Selling Price (cont)

- Profit is added to total cost to determine the selling price.

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Total Cost and Selling Price (cont)

Important Formulas

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Total Cost and Selling Price (cont)

- Profit = Sales − Total Cost.

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Total Cost and Selling Price (cont)

- Selling Price per Unit = Cost per Unit + Profit per Unit.

Total Cost and Selling Price (cont)

- Profit Percentage on Cost = (Profit / Cost) × 100.

Total Cost and Selling Price (cont)

- Profit Percentage on Sales = (Profit / Sales) × 100.

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Total Cost and Selling Price (cont)

- If profit is (p%) on cost:

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Total Cost and Selling Price (cont)

Selling Price = Cost x (1+p/100)

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Total Cost and Selling Price (cont)

- If profit is (p%) on sales:

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Total Cost and Selling Price (cont)

Selling Price = Cost / (1-p/100)

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Total Cost and Selling Price (cont)

Example

Total Cost and Selling Price (cont)

- Total Cost = ₹800.

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Total Cost and Selling Price (cont)

- Profit = 20% on cost = ₹160.

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Total Cost and Selling Price (cont)

- Selling Price = ₹960.

Total Cost and Selling Price (cont)

- If profit is 20% on sales instead:

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Total Cost and Selling Price (cont)

- Selling Price = ₹800 / 0.80 = ₹1,000.

Total Cost and Selling Price (cont)

Important Distinctions

Total Cost and Selling Price (cont)

- Profit on cost and profit on sales are different percentages.

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Total Cost and Selling Price (cont)

- Total Cost includes production, administration, selling and distribution costs.

Total Cost and Selling Price (cont)

- Selling price may also be influenced by market demand, competition and pricing strategy; cost-plus pricing is not the only pricing method.

Total Cost and Selling Price (cont)

MCQ Traps

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Total Cost and Selling Price (cont)

- Profit on cost = Profit / Cost × 100.

Total Cost and Selling Price (cont)

- Profit margin on sales = Profit / Sales × 100.

Total Cost and Selling Price (cont)

- A 20% profit on cost is equivalent to a 16.67% profit on sales.

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Total Cost and Selling Price (cont)

- Selling and distribution overheads are added after COGS in the conventional cost sheet.

Total Cost and Selling Price (cont)

- Avoid adding an overhead twice if it has already been included in an earlier cost figure.

Cost of Goods Sold (COGS)

Meaning

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Cost of Goods Sold (COGS) (cont)

- Cost of Goods Sold (COGS) = Cost attributable to finished goods actually sold during an accounting period.

Cost of Goods Sold (COGS) (cont)

- It represents the production cost of goods sold, excluding unsold finished goods.

Cost of Goods Sold (COGS) (cont)

Components

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Cost of Goods Sold (COGS) (cont)

- Opening Finished Goods Stock.

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Cost of Goods Sold (COGS) (cont)

- Add: Cost of Production.

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Cost of Goods Sold (COGS) (cont)

- Less: Closing Finished Goods Stock.

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Cost of Goods Sold (COGS) (cont)

Formula

Cost of Goods Sold (COGS) (cont)

COGS = Opening Finished Goods + Cost of Production - Closing Finished Goods

Cost of Goods Sold (COGS) (cont)

Important Distinctions

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Cost of Goods Sold (COGS) (cont)

- Cost of Production = Cost of goods manufactured during the period.

Cost of Goods Sold (COGS) (cont)

- COGS = Cost of goods actually sold during the period.

Cost of Goods Sold (COGS) (cont)

- Opening finished goods are added because they were manufactured earlier but are available for sale now.

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Cost of Goods Sold (COGS) (cont)

- Closing finished goods are deducted because they remain unsold and are carried forward as inventory.

Cost of Goods Sold (COGS) (cont)

- COGS excludes selling and distribution overheads under the conventional cost-sheet format.

Cost of Goods Sold (COGS) (cont)

Example

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Cost of Goods Sold (COGS) (cont)

- Opening Finished Goods = ₹1,00,000.

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Cost of Goods Sold (COGS) (cont)

- Cost of Production = ₹8,50,000.

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Cost of Goods Sold (COGS) (cont)

- Closing Finished Goods = ₹1,50,000.

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Cost of Goods Sold (COGS) (cont)

- COGS = ₹1,00,000 + ₹8,50,000 − ₹1,50,000 = ₹8,00,000.

Cost of Goods Sold (COGS) (cont)

MCQ Traps

Cost of Goods Sold (COGS) (cont)

- Cost of production and COGS are not interchangeable.

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Cost of Goods Sold (COGS) (cont)

- Closing finished goods reduce COGS.

Cost of Goods Sold (COGS) (cont)

- Opening finished goods increase COGS.

Cost of Goods Sold (COGS) (cont)

- COGS relates to goods sold, whereas cost of production relates to goods manufactured.

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Cost of Production

Meaning

Cost of Production (cont)

- Cost of Production = Total cost incurred to manufacture finished goods, including factory costs and production-related administration overheads.

Cost of Production (cont)

- It represents the cost of goods manufactured during the accounting period.

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Cost of Production (cont)

Components

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Cost of Production (cont)

- Factory/Manufacturing Cost.

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Cost of Production (cont)

- Add: Production Administration Overheads.

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Cost of Production (cont)

- Factory-related administrative salaries.

Cost of Production (cont)

- Production planning and supervision administration.

Cost of Production (cont)

- Office expenses specifically related to production.

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Cost of Production (cont)

- Adjust for any relevant production-related adjustments, where applicable.

Cost of Production (cont)

Formula

Cost of Production (cont)

Cost of Production = Factory Cost + Production Administration Overheads

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Cost of Production (cont)

Important Distinction

Cost of Production (cont)

- Factory Cost covers manufacturing operations and factory overheads.

Cost of Production (cont)

- Cost of Production additionally includes production administration overheads.

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Cost of Production (cont)

- General corporate administration expenses are not automatically production administration overheads.

Cost of Production (cont)

- Selling and distribution expenses are excluded.

Cost of Production (cont)

Example

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Cost of Production (cont)

- Factory Cost = ₹8,00,000.

Cost of Production (cont)

- Production Administration Overheads = ₹50,000.

Cost of Production (cont)

- Cost of Production = ₹8,50,000.

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Cost of Production (cont)

MCQ Traps

Cost of Production (cont)

- Cost of production is the cost of goods manufactured, not necessarily goods sold.

Cost of Production (cont)

- Closing WIP is adjusted while calculating factory cost.

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Cost of Production (cont)

- Production administration overheads are added after factory cost.

Cost of Production (cont)

- Selling and distribution overheads are not included in cost of production.

Factory / Manufacturing Cost

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Factory / Manufacturing Cost (cont)

- Factory Cost (Works Cost) = Total cost incurred in converting raw materials into finished goods within the factory.

Factory / Manufacturing Cost (cont)

- It includes prime cost and factory/production overheads, adjusted for work-in-progress (WIP).

Factory / Manufacturing Cost (cont)

Components

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Factory / Manufacturing Cost (cont)

- Prime Cost.

Factory / Manufacturing Cost (cont)

- Add: Factory/Production Overheads:

Factory / Manufacturing Cost (cont)

- Indirect material.

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Factory / Manufacturing Cost (cont)

- Indirect labour.

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Factory / Manufacturing Cost (cont)

- Indirect factory expenses.

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Factory / Manufacturing Cost (cont)

- Add: Opening Work-in-Progress.

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Factory / Manufacturing Cost (cont)

- Less: Closing Work-in-Progress.

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Factory / Manufacturing Cost (cont)

Formula

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Factory / Manufacturing Cost (cont)

Factory Cost = Prime Cost + Factory Overheads

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Factory / Manufacturing Cost (cont)

+ Opening WIP - Closing WIP

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Factory / Manufacturing Cost (cont)

Examples of Factory Overheads

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Factory / Manufacturing Cost (cont)

- Factory rent and insurance.

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Factory / Manufacturing Cost (cont)

- Depreciation of factory machinery.

Factory / Manufacturing Cost (cont)

- Salary of factory supervisors.

Factory / Manufacturing Cost (cont)

- Repairs and maintenance of production equipment.

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Factory / Manufacturing Cost (cont)

- Indirect materials such as lubricants and cleaning supplies.

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Factory / Manufacturing Cost (cont)

- Factory electricity and lighting.

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Factory / Manufacturing Cost (cont)

Important Points

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Factory / Manufacturing Cost (cont)

- Factory cost is also called works cost or manufacturing cost.

Factory / Manufacturing Cost (cont)

- WIP represents partially completed goods at the beginning or end of an accounting period.

Factory / Manufacturing Cost (cont)

- Opening WIP is added because it represents production costs carried forward from the previous period.

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Factory / Manufacturing Cost (cont)

- Closing WIP is deducted because it represents incomplete production carried forward to the next period.

Factory / Manufacturing Cost (cont)

- Administration, selling and distribution overheads are not included in factory cost.

Factory / Manufacturing Cost (cont)

MCQ Traps

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Factory / Manufacturing Cost (cont)

- Factory Cost = Prime Cost + Factory Overheads + Opening WIP − Closing WIP.

Factory / Manufacturing Cost (cont)

- Factory overheads are indirect production costs.

Factory / Manufacturing Cost (cont)

- Closing WIP is deducted; opening WIP is added.

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Factory / Manufacturing Cost (cont)

- Factory cost and cost of production are not necessarily identical: production administration overheads may be added after factory cost.

Contract Costing

Work-in-Progress and Balance-Sheet Treatment

1. Meaning of Contract WIP

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Work-in-Progress and Balance-Sheet Treatment (cont)

- Work-in-Progress (WIP) represents the value of work performed on an incomplete contract at the reporting date.

Work-in-Progress and Balance-Sheet Treatment (cont)

- It generally consists of:

Work-in-Progress and Balance-Sheet Treatment (cont)

- Work certified.

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Work-in-Progress and Balance-Sheet Treatment (cont)

- Work uncertified.

Work-in-Progress and Balance-Sheet Treatment (cont)

- Materials and plant lying unused at the site are generally shown separately and excluded from cost of work performed.

Work-in-Progress and Balance-Sheet Treatment (cont)

2. Traditional Balance-Sheet Presentation

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Work-in-Progress and Balance-Sheet Treatment (cont)

- Work certified + Work uncertified = Gross Work-in-Progress.

Work-in-Progress and Balance-Sheet Treatment (cont)

- Retention money represents the portion of certified work value not yet received.

Work-in-Progress and Balance-Sheet Treatment (cont)

- Cash received is deducted from the gross work-in-progress to determine the net amount generally presented as an asset.

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Work-in-Progress and Balance-Sheet Treatment (cont)

Formula

Work-in-Progress and Balance-Sheet Treatment (cont)

Net Contract WIP = Work Certified + Work Uncertified - Cash Received

Work-in-Progress and Balance-Sheet Treatment (cont)

3. Treatment of Profit Reserve

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Work-in-Progress and Balance-Sheet Treatment (cont)

- For incomplete contracts, the profit not yet recognised is generally retained as a reserve.

Work-in-Progress and Balance-Sheet Treatment (cont)

- Traditional presentation:

Work-in-Progress and Balance-Sheet Treatment (cont)

Reserve Profit = Notional Profit - Profit Transferred to P&L

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Work-in-Progress and Balance-Sheet Treatment (cont)

Net WIP after profit reserve: WIP (Net) = Work Certified + Work Uncertified - Cash Received - Reserve Profit

Work-in-Progress and Balance-Sheet Treatment (cont)

4. Balance-Sheet Classification

Work-in-Progress and Balance-Sheet Treatment (cont)

- Net WIP/debtor balance: Generally shown as an asset.

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Work-in-Progress and Balance-Sheet Treatment (cont)

- Retention money: Included in amounts receivable, subject to contractual terms.

Work-in-Progress and Balance-Sheet Treatment (cont)

- Materials and plant at site: Shown separately as assets where applicable.

Work-in-Progress and Balance-Sheet Treatment (cont)

- If cash received exceeds the relevant WIP balance, the excess may represent a liability/advance from the contractee, depending on the accounting treatment.

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Work-in-Progress and Balance-Sheet Treatment (cont)

5. Important Distinctions

Work-in-Progress and Balance-Sheet Treatment (cont)

- Work certified: Approved work, generally valued at contract price.

Work-in-Progress and Balance-Sheet Treatment (cont)

- Work uncertified: Completed but unapproved work, generally valued at cost.

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Work-in-Progress and Balance-Sheet Treatment (cont)

- Retention money: Certified value not yet paid.

Work-in-Progress and Balance-Sheet Treatment (cont)

- Reserve profit: Notional profit not yet transferred to P&L.

Work-in-Progress and Balance-Sheet Treatment (cont)

- Materials at site: Not the same as work-in-progress; they have not necessarily been incorporated into the work.

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Work-in-Progress and Balance-Sheet Treatment (cont)

MCQ Traps

Work-in-Progress and Balance-Sheet Treatment (cont)

- Gross WIP = Work Certified + Work Uncertified.

Work-in-Progress and Balance-Sheet Treatment (cont)

- Cash received is deducted when calculating the traditional net WIP/debtor balance.

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Work-in-Progress and Balance-Sheet Treatment (cont)

- Retention money is not deducted separately if cash received has already been deducted; doing so would double-count it.

Work-in-Progress and Balance-Sheet Treatment (cont)

- Reserve profit is deducted to arrive at WIP after provision for unrealised profit.

Work-in-Progress and Balance-Sheet Treatment (cont)

- Balance-sheet presentation under modern financial reporting may differ from the traditional textbook contract-account format.

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Profit Recognition on Incomplete Contracts

Meaning

Profit Recognition on Incomplete Contracts (cont)

- Contract costing often involves projects extending over multiple accounting periods.

Profit Recognition on Incomplete Contracts (cont)

- Recognising the entire profit only on completion may not reflect performance during the contract period.

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Profit Recognition on Incomplete Contracts (cont)

- Therefore, a reasonable portion of profit may be recognised on incomplete contracts, subject to prudence.

Profit Recognition on Incomplete Contracts (cont)

Traditional Cost Accounting Treatment

Profit Recognition on Incomplete Contracts (cont)

- Contract less than 25% complete: Generally, no profit is transferred to Profit and Loss Account (P&L).

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Profit Recognition on Incomplete Contracts (cont)

- Contract between 25% and 50% complete: A portion of notional profit may be transferred.

Profit Recognition on Incomplete Contracts (cont)

Profit Transferred = Notional Profit x (1 / 3) x

Profit Recognition on Incomplete Contracts (cont)

(Cash Received / Work Certified)

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Profit Recognition on Incomplete Contracts (cont)

- Contract 50% or more complete: A larger portion may be transferred.

Profit Recognition on Incomplete Contracts (cont)

Profit Transferred = Notional Profit x (2 / 3) x

Profit Recognition on Incomplete Contracts (cont)

(Cash Received / Work Certified)

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Profit Recognition on Incomplete Contracts (cont)

- Contract nearing completion: Estimated total profit may be recognised using a prudent proportion based on work completed.

Profit Recognition on Incomplete Contracts (cont)

Important Conditions

Profit Recognition on Incomplete Contracts (cont)

- These are traditional textbook conventions, not universal statutory percentages.

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Profit Recognition on Incomplete Contracts (cont)

- The fraction of notional profit (1/3 or 2/3) depends on the convention prescribed in the question.

Profit Recognition on Incomplete Contracts (cont)

- Cash received relative to work certified is used as a prudence adjustment.

Profit Recognition on Incomplete Contracts (cont)

- If cash received equals work certified, the cash adjustment factor is 1.

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Profit Recognition on Incomplete Contracts (cont)

- If the contract is expected to incur an overall loss, the entire expected loss is generally recognised immediately.

Profit Recognition on Incomplete Contracts (cont)

Modern Financial Reporting Perspective

Profit Recognition on Incomplete Contracts (cont)

- Under Ind AS 115, Revenue from Contracts with Customers, revenue is recognised over time when specified criteria are satisfied, with progress measured using an appropriate method.

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Profit Recognition on Incomplete Contracts (cont)

- Profit recognition is not governed by the traditional 25%/50% textbook formula.

Profit Recognition on Incomplete Contracts (cont)

- The accounting treatment depends on the applicable reporting framework and the nature of the contract.

Profit Recognition on Incomplete Contracts (cont)

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Profit Recognition on Incomplete Contracts (cont)

- Notional profit is not automatically transferred entirely to P&L.

Profit Recognition on Incomplete Contracts (cont)

- Traditional 1/3 and 2/3 rules are conventional cost-accounting treatments, not universal legal requirements.

Profit Recognition on Incomplete Contracts (cont)

- Cash received / work certified is a fraction, not a percentage to be multiplied again by 100.

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Profit Recognition on Incomplete Contracts (cont)

- Expected contract loss: recognise the full expected loss, not merely the proportionate loss.

Profit Recognition on Incomplete Contracts (cont)

- Distinguish traditional contract-costing questions from Ind AS 115 revenue-recognition questions.

Notional Profit and Estimated Profit

1. Notional Profit

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Notional Profit and Estimated Profit (cont)

- Notional profit is the excess of the value of work completed (certified and uncertified) over the cost of work performed up to a particular date.

Notional Profit and Estimated Profit (cont)

- It is an interim measure of profit on an incomplete contract.

Notional Profit and Estimated Profit (cont)

Formula

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Notional Profit and Estimated Profit (cont)

Notional Profit =Work Certified+ Work Uncertified

Notional Profit and Estimated Profit (cont)

- Cost of Work to Date

Notional Profit and Estimated Profit (cont)

- Cost of Work to Date = Total contract expenditure incurred − Cost of materials/plant lying unused or transferred, as applicable.

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Notional Profit and Estimated Profit (cont)

- Work certified is generally valued at contract price; work uncertified is generally valued at cost.

Notional Profit and Estimated Profit (cont)

2. Estimated Profit

Notional Profit and Estimated Profit (cont)

- Estimated profit is the anticipated total profit on completion of the entire contract.

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Notional Profit and Estimated Profit (cont)

- It is calculated using the estimated total contract cost.

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Notional Profit and Estimated Profit (cont)

Formula

Notional Profit and Estimated Profit (cont)

Estimated Profit = Contract Price - Estimated Total Contract Cost

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Notional Profit and Estimated Profit (cont)

- Estimated Total Contract Cost = Cost incurred to date + Estimated Cost to Complete.

Notional Profit and Estimated Profit (cont)

- It considers both expenditure already incurred and future expenditure expected.

Notional Profit and Estimated Profit (cont)

3. Key Differences

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Notional Profit and Estimated Profit (cont)

- Notional profit: Profit earned on work performed up to the reporting date.

Notional Profit and Estimated Profit (cont)

- Estimated profit: Expected profit on the entire contract upon completion.

Notional Profit and Estimated Profit (cont)

- Notional profit: Based on work completed to date.

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Notional Profit and Estimated Profit (cont)

- Estimated profit: Based on total contract price and estimated total cost.

Notional Profit and Estimated Profit (cont)

- Notional profit: Used in determining profit recognised on incomplete contracts.

Notional Profit and Estimated Profit (cont)

- Estimated profit: Used to assess overall expected contract profitability.

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Notional Profit and Estimated Profit (cont)

4. Example

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Notional Profit and Estimated Profit (cont)

- Contract price = ₹100 lakh.

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Notional Profit and Estimated Profit (cont)

- Work certified = ₹40 lakh.

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Notional Profit and Estimated Profit (cont)

- Work uncertified = ₹5 lakh.

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Notional Profit and Estimated Profit (cont)

- Cost of work to date = ₹35 lakh.

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Notional Profit and Estimated Profit (cont)

- Estimated cost to complete = ₹45 lakh.

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Notional Profit and Estimated Profit (cont)

Calculations:

Notional Profit and Estimated Profit (cont)

- Notional Profit = ₹40 + ₹5 − ₹35 = ₹10 lakh.

Notional Profit and Estimated Profit (cont)

- Estimated Total Contract Cost = ₹35 + ₹45 = ₹80 lakh.

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Notional Profit and Estimated Profit (cont)

- Estimated Profit = ₹100 − ₹80 = ₹20 lakh.

Notional Profit and Estimated Profit (cont)

MCQ Traps

Notional Profit and Estimated Profit (cont)

- Notional profit is not the same as estimated profit.

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Notional Profit and Estimated Profit (cont)

- Notional profit considers work certified plus work uncertified.

Notional Profit and Estimated Profit (cont)

- Estimated profit considers the entire contract, including future costs.

Notional Profit and Estimated Profit (cont)

- A contract may show notional profit currently but have an expected overall loss if future costs are high.

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Notional Profit and Estimated Profit (cont)

- Expected total contract losses should not be deferred merely because the contract is incomplete.

Escalation Clause

Meaning

Escalation Clause (cont)

- An escalation clause is a contractual provision that allows the contract price to be revised when specified input costs increase or decrease beyond an agreed limit.

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Escalation Clause (cont)

- It protects the contractor against significant fluctuations in material prices, labour wages and other input costs during long-duration contracts.

Escalation Clause (cont)

Key Features

Escalation Clause (cont)

- Usually included in long-term contracts where prices may fluctuate substantially.

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Escalation Clause (cont)

- Specifies the items eligible for price adjustment.

Escalation Clause (cont)

- Defines the base prices or wages against which changes are measured.

Escalation Clause (cont)

- May specify a threshold beyond which price adjustment becomes applicable.

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Escalation Clause (cont)

- Can provide for both upward and downward price adjustments.

Escalation Clause (cont)

- Adjustment is made according to the formula or mechanism specified in the contract.

Escalation Clause (cont)

Example

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Escalation Clause (cont)

- A construction contract provides for adjustment in steel prices if the market price increases by more than 5% over the agreed base price.

Escalation Clause (cont)

- If the specified threshold is crossed, the contract price is revised according to the contractual formula.

Escalation Clause (cont)

De-escalation

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Escalation Clause (cont)

- If input prices fall, the contract price may also be reduced where the clause provides for downward adjustment.

Escalation Clause (cont)

- This prevents the contractor from receiving an unintended windfall from falling input costs.

Escalation Clause (cont)

Purpose

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Escalation Clause (cont)

- Protects against inflation and unexpected cost increases.

Escalation Clause (cont)

- Reduces disputes arising from price fluctuations.

Escalation Clause (cont)

- Makes long-term contracts more commercially viable.

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Escalation Clause (cont)

MCQ Traps

Escalation Clause (cont)

- Escalation clause adjusts contract price; it does not automatically guarantee a particular profit.

Escalation Clause (cont)

- It may cover material, labour or other specified costs.

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Escalation Clause (cont)

- Both upward and downward adjustments may be provided.

Escalation Clause (cont)

- Thresholds and adjustment formulas are contract-specific, not universally prescribed.

Escalation Clause (cont)

- It is particularly relevant in long-duration construction and infrastructure contracts

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Retention Money

Meaning

Retention Money (cont)

- Retention money is the portion of the value of work certified that the contractee withholds from payments due to the contractor.

Retention Money (cont)

- It acts as security against defective work, non-compliance or failure to fulfil contractual obligations.

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Retention Money (cont)

- Released after completion, inspection, expiry of the defect-liability period or fulfilment of specified contractual conditions.

Retention Money (cont)

Calculation

Retention Money (cont)

- Cash Received = Value of Work Certified × (Cash Payment Percentage / 100).

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Retention Money (cont)

- Retention Money = Value of Work Certified − Cash Received.

Retention Money (cont)

Example

Retention Money (cont)

- Work certified = ₹20 lakh.

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Retention Money (cont)

- Payment released = 80%.

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Retention Money (cont)

- Cash received = ₹16 lakh.

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Retention Money (cont)

- Retention money = ₹4 lakh.

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Retention Money (cont)

Accounting Treatment

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Retention Money (cont)

- Retention money is part of the amount due to the contractor but not yet received.

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Retention Money (cont)

- It is not an expense or deduction from the contract's certified value.

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Retention Money (cont)

- It is generally included in the contractee's outstanding amount/receivable, subject to contractual terms.

Retention Money (cont)

- On release, it is received as cash/bank.

Retention Money (cont)

Purpose

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Retention Money (cont)

- Ensures quality and completion as per specifications.

Retention Money (cont)

- Protects the contractee against defects and contractual non-performance.

Retention Money (cont)

- Encourages the contractor to fulfil post-c-ompletion obligations.

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Retention Money (cont)

MCQ Traps

Retention Money (cont)

- Retention money is withheld from the contractor's payment, not deducted from the value of work certified.

Retention Money (cont)

- It is not automatically forfeited; it is normally released when contractual conditions are met.

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Retention Money (cont)

- Retention percentage is contract-specific; there is no single universal percentage applicable to all contracts.

Retention Money (cont)

- Retention money is different from a security deposit, although both may serve as contractual security.

Work Certified and Work Uncertified

1. Work Certified

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Work Certified and Work Uncertified (cont)

- Work completed by the contractor and formally approved by the architect, engineer or authorised representative of the contractee.

Work Certified and Work Uncertified (cont)

- Certification confirms the value of work completed according to contractual requirements.

Work Certified and Work Uncertified (cont)

- Recorded on the credit side of the Contract Account.

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Work Certified and Work Uncertified (cont)

- Usually valued at the contract rate or agreed valuation basis, not necessarily at actual cost.

Work Certified and Work Uncertified (cont)

- Forms the basis for progress payments.

Work Certified and Work Uncertified (cont)

2. Work Uncertified

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Work Certified and Work Uncertified (cont)

- Work completed but not yet certified by the authorised representative.

Work Certified and Work Uncertified (cont)

- Generally valued at cost, not at contract price.

Work Certified and Work Uncertified (cont)

- Recorded on the credit side of the Contract Account.

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Work Certified and Work Uncertified (cont)

- Included in closing Work-in-Progress (WIP).

Work Certified and Work Uncertified (cont)

- May become certified in a subsequent period.

Work Certified and Work Uncertified (cont)

3. Key Differences

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Work Certified and Work Uncertified (cont)

- Work certified: Approved by the architect/engineer; generally valued at contract price.

Work Certified and Work Uncertified (cont)

- Work uncertified: Not yet approved; generally valued at cost.

Work Certified and Work Uncertified (cont)

- Work certified: Eligible for progress billing subject to contractual terms.

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Work Certified and Work Uncertified (cont)

- Work uncertified: Normally not eligible for payment until certification.

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Work Certified and Work Uncertified (cont)

4. Important Formulas

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Work Certified and Work Uncertified (cont)

- Notional Profit = Value of Work Certified + Work Uncertified − Cost of Work to Date.

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Work Certified and Work Uncertified (cont)

- Work-in-Progress = Work Certified + Work Uncertified.

Work Certified and Work Uncertified (cont)

- Cash Received = Work Certified × Cash Percentage / 100.

Work Certified and Work Uncertified (cont)

- Retention Money = Work Certified − Cash Received.

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Work Certified and Work Uncertified (cont)

MCQ Traps

Work Certified and Work Uncertified (cont)

- Work uncertified is not the same as work not yet performed; it represents completed but uncertified work.

Work Certified and Work Uncertified (cont)

- Work certified is generally valued at contract price; uncertified work is generally valued at cost.

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Work Certified and Work Uncertified (cont)

- Both are credited to the Contract Account.

Work Certified and Work Uncertified (cont)

- Work certified and cash received are different because of retention money.

Work Certified and Work Uncertified (cont)

- Certification does not necessarily mean the entire certified amount has been paid.

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Meaning and Features of Contract Costing

Meaning

Meaning and Features of Contract Costing (cont)

- Contract costing is a form of job costing used for large-scale, long-duration projects executed under a specific contract.

Meaning and Features of Contract Costing (cont)

- Each contract is treated as a separate cost unit.

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Meaning and Features of Contract Costing (cont)

- Costs and revenues are accumulated separately for every contract.

Meaning and Features of Contract Costing (cont)

Industries

Meaning and Features of Contract Costing (cont)

- Construction of roads, bridges, dams, buildings, tunnels.

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Meaning and Features of Contract Costing (cont)

- Shipbuilding, railway projects and large engineering works.

Meaning and Features of Contract Costing (cont)

Key Features

Meaning and Features of Contract Costing (cont)

- Large-scale work: Each contract generally involves substantial expenditure.

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Meaning and Features of Contract Costing (cont)

- Long duration: Contracts may extend over several accounting periods.

Meaning and Features of Contract Costing (cont)

- Site-specific execution: Work is usually performed at the contract site.

Meaning and Features of Contract Costing (cont)

- Separate cost records: A separate Contract Account is maintained for each contract.

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Meaning and Features of Contract Costing (cont)

- Direct costs: Materials, wages, plant and site expenses are charged to the specific contract.

Meaning and Features of Contract Costing (cont)

- Indirect costs: Common expenses are apportioned on a reasonable basis.

Meaning and Features of Contract Costing (cont)

- Progress payments: Payments are received in stages as work progresses.

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Meaning and Features of Contract Costing (cont)

- Work certification: An architect, engineer or authorised representative certifies completed work.

Meaning and Features of Contract Costing (cont)

- Retention money: A portion of certified work value may be withheld until contractual conditions are fulfilled.

Meaning and Features of Contract Costing (cont)

Important Terms

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Meaning and Features of Contract Costing (cont)

- Contractee: Customer/employer who awards the contract.

Meaning and Features of Contract Costing (cont)

- Contractor: Person or organisation undertaking the work.

Meaning and Features of Contract Costing (cont)

- Contract Price: Amount payable by the contractee upon fulfilment of contractual obligations.

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Meaning and Features of Contract Costing (cont)

- Contract Cost: Total expenditure incurred on executing the contract.

Meaning and Features of Contract Costing (cont)

- Work-in-Progress (WIP): Work performed but not yet completed or finally settled.

Meaning and Features of Contract Costing (cont)

Contract Account — Debit Side

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Meaning and Features of Contract Costing (cont)

- Materials consumed.

Meaning and Features of Contract Costing (cont)

- Wages and labour.

Meaning and Features of Contract Costing (cont)

- Direct expenses and subcontracting charges.

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Meaning and Features of Contract Costing (cont)

- Plant and machinery costs/depreciation.

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Meaning and Features of Contract Costing (cont)

- Allocated indirect expenses.

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Meaning and Features of Contract Costing (cont)

Contract Account — Credit Side

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Meaning and Features of Contract Costing (cont)

- Materials returned or transferred.

Meaning and Features of Contract Costing (cont)

- Plant transferred back or sale proceeds, as applicable.

Meaning and Features of Contract Costing (cont)

- Work certified.

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Meaning and Features of Contract Costing (cont)

- Work uncertified.

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Meaning and Features of Contract Costing (cont)

- Any other relevant recoveries.

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Meaning and Features of Contract Costing (cont)

MCQ Traps

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Meaning and Features of Contract Costing (cont)

- Contract costing is a specialised form of job costing.

Meaning and Features of Contract Costing (cont)

- Contract is the cost unit.

Meaning and Features of Contract Costing (cont)

- Contractee awards the contract; contractor executes it.

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Meaning and Features of Contract Costing (cont)

- A separate Contract Account is maintained for each contract.

Meaning and Features of Contract Costing (cont)

- Work certified is not necessarily equal to cash received because retention money may be withheld.

Methods of Costing

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Unit / Output Costing

Meaning

Unit / Output Costing (cont)

- Used when identical or homogeneous units are produced continuously in large quantities.

Unit / Output Costing (cont)

- Cost is accumulated for the entire output during a period and expressed per unit.

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Unit / Output Costing (cont)

- Also called single or output costing.

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Unit / Output Costing (cont)

Industries

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Unit / Output Costing (cont)

- Cement, sugar, bricks, paper, mining, steel, flour mills.

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Unit / Output Costing (cont)

Cost Calculation

Unit / Output Costing (cont)

- Cost per Unit = Total Cost of Production / Units Produced.

Unit / Output Costing (cont)

- Total Cost includes direct material, direct labour, direct expenses and production overheads.

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Unit / Output Costing (cont)

- If opening and closing WIP or finished goods exist, adjust them at the relevant stages of the cost sheet

Unit / Output Costing (cont)

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Unit / Output Costing (cont)

Key Characteristics

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Unit / Output Costing (cont)

- Production is standardised and units are uniform.

Unit / Output Costing (cont)

- Costs are collected for a period rather than separately for each customer order.

Unit / Output Costing (cont)

- Unit cost helps in pricing, cost control and efficiency comparison.

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Unit / Output Costing (cont)

MCQ Traps

Unit / Output Costing (cont)

- Suitable for homogeneous, identical output.

Unit / Output Costing (cont)

- Not suitable where every job or product is significantly different.

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Unit / Output Costing (cont)

- Unit cost is an average cost; it does not necessarily represent the marginal cost of producing one additional unit.

Job Costing

Meaning

Job Costing (cont)

- A method in which costs are accumulated separately for each specific job, order or contract.

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Job Costing (cont)

- Each job is treated as a separate cost unit.

Job Costing (cont)

- Used when production is based on specific customer requirements rather than continuous standardised output.

Job Costing (cont)

Industries

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Job Costing (cont)

- Printing, furniture manufacturing, repair workshops, shipbuilding, specialised machinery, interior design.

Job Costing (cont)

Cost Ascertainment

Job Costing (cont)

- Each job receives a unique job number.

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Job Costing (cont)

- Direct material, direct labour and direct expenses are charged specifically to that job.

Job Costing (cont)

- Overheads are allocated or absorbed using an appropriate predetermined rate.

Job Costing (cont)

- A separate Job Cost Sheet records the total cost of each job.

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Job Costing (cont)

Formula

Job Costing (cont)

- Total Job Cost = Direct Material + Direct Labour + Direct Expenses + Absorbed Overheads.

Job Costing (cont)

- Cost per Unit = Total Job Cost / Units Produced in the Job.

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Job Costing (cont)

Key Characteristics

Job Costing (cont)

- Production is undertaken against specific orders.

Job Costing (cont)

- Jobs may differ in design, specifications, size and cost.

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Job Costing (cont)

- Each job's profitability can be determined separately.

Job Costing (cont)

- Work may be completed in one accounting period or extend across periods.

Job Costing (cont)

MCQ Traps

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Job Costing (cont)

- Job costing is order-specific; unit costing is suitable for homogeneous mass production.

Job Costing (cont)

- A job is the cost unit.

Job Costing (cont)

- Direct costs are traced to individual jobs; common overheads are absorbed.

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Job Costing (cont)

- Job costing is suitable for customised production, not necessarily only one-unit production.

Selection of an Appropriate Costing Method

Basis of Selection

Selection of an Appropriate Costing Method (cont)

- Nature of Production: Continuous, repetitive or customised production.

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Selection of an Appropriate Costing Method (cont)

- Type of Output: Homogeneous products or products differing in specifications.

Selection of an Appropriate Costing Method (cont)

- Production Process: Single-stage, multi--stage, batch-based or project-based.

Selection of an Appropriate Costing Method (cont)

- Industry Requirements: Manufacturing, construction or service delivery.

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Selection of an Appropriate Costing Method (cont)

- Cost Information Needed: Product-wise, job-wise, batch-wise, process-wise or service-unit cost.

Selection of an Appropriate Costing Method (cont)

- Practicality: Cost of maintaining detailed records should be justified by the usefulness of information.

Selection of an Appropriate Costing Method (cont)

Method Selection — Quick Recall

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Selection of an Appropriate Costing Method (cont)

- Unit / Output Costing: Homogeneous mass production — cement, sugar, bricks.

Selection of an Appropriate Costing Method (cont)

- Job Costing: Individual customer orders — printing, repair work, customised furniture.

Selection of an Appropriate Costing Method (cont)

- Batch Costing: Identical products manufactured in lots — medicines, garments, footwear.

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Selection of an Appropriate Costing Method (cont)

- Contract Costing: Large, long-term projects — roads, bridges, buildings.

Selection of an Appropriate Costing Method (cont)

- Process Costing: Continuous production through processes — chemicals, oil refining, paper.

Selection of an Appropriate Costing Method (cont)

- Operation Costing: Repetitive individual operations — engineering components, metalworking.

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Selection of an Appropriate Costing Method (cont)

- Service / Operating Costing: Services delivered — transport, hospitals, hotels, electricity.

Selection of an Appropriate Costing Method (cont)

- Multiple / Composite Costing: Complex products made of several components — automobiles, aircraft, machinery.

Selection of an Appropriate Costing Method (cont)

Important Relationships

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Selection of an Appropriate Costing Method (cont)

- Job costing and batch costing are closely related; a batch is treated as a job.

Selection of an Appropriate Costing Method (cont)

- Contract costing is a specialised form of job costing for large projects.

Selection of an Appropriate Costing Method (cont)

- Process costing suits continuous, homogeneous production.

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Selection of an Appropriate Costing Method (cont)

- Operation costing provides cost information at individual-operation level.

Selection of an Appropriate Costing Method (cont)

- Multiple costing combines methods where different components or stages require different approaches.

Selection of an Appropriate Costing Method (cont)

- Service costing measures the cost of delivering services rather than manufacturing goods.

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Selection of an Appropriate Costing Method (cont)

MCQ Traps

Selection of an Appropriate Costing Method (cont)

- The method is selected based on the production or service environment, not merely the industry name.

Selection of an Appropriate Costing Method (cont)

- One organisation may use more than one costing method.

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Selection of an Appropriate Costing Method (cont)

- A customised product generally favours job costing; identical products produced in lots favour batch costing.

Selection of an Appropriate Costing Method (cont)

- Contract costing is appropriate for large projects with separate contractual arrangements.

Selection of an Appropriate Costing Method (cont)

- Multiple costing does not mean simply maintaining multiple cost sheets; it means combining costing methods.

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Multiple / Composite Costing

Meaning

Multiple / Composite Costing (cont)

- A method used when a product consists of several components or sub-assemblies manufactured through different processes.

Multiple / Composite Costing (cont)

- Combines two or more costing methods to ascertain the total cost of the finished product.

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Multiple / Composite Costing (cont)

- Also called composite costing.

Multiple / Composite Costing (cont)

Industries

Multiple / Composite Costing (cont)

- Automobiles, aircraft, ships, machinery, electronics and other complex manufactured products.

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Multiple / Composite Costing (cont)

Cost Ascertainment

Multiple / Composite Costing (cont)

- Different components may be costed using different methods.

Multiple / Composite Costing (cont)

- Individual component costs are accumulated separately.

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Multiple / Composite Costing (cont)

- Assembly and finishing costs are added.

Multiple / Composite Costing (cont)

- Total cost of the finished product is determined by combining component and assembly costs.

Multiple / Composite Costing (cont)

Example: Automobile Manufacturing

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Multiple / Composite Costing (cont)

- Tyres and standard components: Batch costing.

Multiple / Composite Costing (cont)

- Engine components: Process or operation costing.

Multiple / Composite Costing (cont)

- Customised bodywork: Job costing.

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Multiple / Composite Costing (cont)

- Final assembly: Assembly costing.

Multiple / Composite Costing (cont)

- Total automobile cost = Component Costs + Assembly Costs + Other Production Costs.

Multiple / Composite Costing (cont)

Key Characteristics

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Multiple / Composite Costing (cont)

- Suitable for complex products made up of multiple components.

Multiple / Composite Costing (cont)

- Different departments or production stages may use different costing methods.

Multiple / Composite Costing (cont)

- Provides component-wise as well as total product cost.

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Multiple / Composite Costing (cont)

- Requires coordination of cost records across production stages.

Multiple / Composite Costing (cont)

MCQ Traps

Multiple / Composite Costing (cont)

- Multiple/composite costing is a combination of costing methods.

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Multiple / Composite Costing (cont)

- It is particularly suitable for complex products with multiple components.

Multiple / Composite Costing (cont)

- It is not a separate method based on one uniform production pattern.

Multiple / Composite Costing (cont)

- Do not confuse composite costing with service costing, which determines the cost of providing services.

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Service / Operating Costing

Meaning

Service / Operating Costing (cont)

- A method used to determine the cost of providing services rather than manufacturing tangible products.

Service / Operating Costing (cont)

- Costs are accumulated for a service, department or operating unit.

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Service / Operating Costing (cont)

- Cost per service unit is calculated to measure efficiency and support pricing.

Service / Operating Costing (cont)

Industries

Service / Operating Costing (cont)

- Transport, hospitals, hotels, electricity, water supply, airlines, educational institutions and telecommunications.

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Service / Operating Costing (cont)

Cost Classification

Service / Operating Costing (cont)

- Fixed Costs: Rent, insurance, depreciation, fixed salaries.

Service / Operating Costing (cont)

- Variable Costs: Fuel, consumables, food ingredients, usage-based supplies.

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Service / Operating Costing (cont)

- Semi-variable Costs: Electricity, maintenance and certain operating expenses.

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Service / Operating Costing (cont)

Common Cost Units

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Service / Operating Costing (cont)

- Transport: Passenger-kilometre, tonne-kilometre, vehicle-kilometre.

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Service / Operating Costing (cont)

- Hospitals: Patient-day, bed-day, operation performed.

Service / Operating Costing (cont)

- Hotels: Room-day, guest-day.

Service / Operating Costing (cont)

- Electricity: Kilowatt-hour (kWh) / unit.

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Service / Operating Costing (cont)

- Water supply: Kilolitre.

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Service / Operating Costing (cont)

- Canteens: Meal served.

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Service / Operating Costing (cont)

- Education: Student-year.

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Service / Operating Costing (cont)

Important Composite Cost Units

Service / Operating Costing (cont)

- Passenger-kilometre = Number of passengers × Distance travelled.

Service / Operating Costing (cont)

- Tonne-kilometre = Tonnes of goods × Distance travelled.

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Service / Operating Costing (cont)

- Bed-day = Number of occupied beds × Number of days.

Service / Operating Costing (cont)

- Room-day = Number of rooms occupied × Number of days.

Service / Operating Costing (cont)

Cost Ascertainment

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Service / Operating Costing (cont)

- Collect operating costs for the relevant period.

Service / Operating Costing (cont)

- Classify costs into fixed, variable and semi-variable categories.

Service / Operating Costing (cont)

- Determine total service units delivered.

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Service / Operating Costing (cont)

- Calculate cost per service unit.

Service / Operating Costing (cont)

Formula

Service / Operating Costing (cont)

Cost per Service Unit = Total Operating Cost / Total Service Units

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Service / Operating Costing (cont)

Key Characteristics

Service / Operating Costing (cont)

- Suitable for service organisations.

Service / Operating Costing (cont)

- Cost unit is often composite because service output involves both quantity and distance/time.

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Service / Operating Costing (cont)

- Helps assess cost efficiency, utilisation and pricing.

Service / Operating Costing (cont)

- Service capacity utilisation affects cost per unit, particularly where fixed costs are significant.

Service / Operating Costing (cont)

MCQ Traps

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Service / Operating Costing (cont)

- Service costing is also called operating costing.

Service / Operating Costing (cont)

- Passenger-kilometre and tonne-kilometre are composite cost units.

Service / Operating Costing (cont)

- Hospital bed-day is not the same as number of patients.

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Service / Operating Costing (cont)

- Electricity is commonly measured in kWh, not kW: kW measures power; kWh measures energy consumed.

Operation Costing

Meaning

Operation Costing (cont)

> - A method that determines cost for individual operations within a production process.

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Operation Costing (cont)

> - Each operation is treated as a cost-accumulation unit.

Operation Costing (cont)

> - Combines features of job costing and process costing.

Operation Costing (cont)

> - Particularly useful where products undergo repetitive, standardised operations but may differ in the combination or sequence of operations.

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Operation Costing (cont)

> Industries

Operation Costing (cont)

> - Engineering, automobile components, garments, footwear, metalworking and electronics manufacturing.

Operation Costing (cont)

> Cost Ascertainment

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Operation Costing (cont)

> - Costs are collected operation-wise.

Operation Costing (cont)

> - Direct material is traced to the product or batch.

Operation Costing (cont)

> - Labour and overheads are accumulated for each operation.

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Operation Costing (cont)

> - Operation-wise costs are assigned to products based on the operations performed.

Operation Costing (cont)

> Key Characteristics

Operation Costing (cont)

> - Focuses on the cost of individual operations rather than only the final product or department.

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Operation Costing (cont)

> - Helps identify costly operations and production inefficiencies.

Operation Costing (cont)

> - Useful for comparing efficiency and cost across operations.

Operation Costing (cont)

> - Products may pass through several operations.

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Operation Costing (cont)

> Operation Costing vs Process Costing

Operation Costing (cont)

> - Process costing accumulates costs for broad production processes or depart-ments.

Operation Costing (cont)

> - Operation costing accumulates costs at a more detailed individual-operation level.

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Operation Costing (cont)

> - Both are suitable for repetitive manufacturing; operation costing provides more detailed cost information.

Operation Costing (cont)

> MCQ Traps

Operation Costing (cont)

> - Operation is the cost-accumulation unit.

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Operation Costing (cont)

> - Operation costing is not the same as operating/service costing.

Operation Costing (cont)

> - It is useful where standard operations are repeated across products or batches.

Operation Costing (cont)

> - Do not confuse it with job costing, where each customised job is separately costed.

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Costing Cheat Sheet

by keersri05 via cheatography.com/217923/cs/48568/

Process Costing

Meaning

Process Costing (cont)

- A method used where production passes through a series of continuous or repetitive processes.

Process Costing (cont)

- Costs are accumulated process-wise or department-wise for a period.

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Process Costing (cont)

- Output of one process may become the input of the next process.

Process Costing (cont)

- Average cost per unit is calculated for each process.

Process Costing (cont)

Industries

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Process Costing (cont)

- Oil refining, chemicals, textiles, paper, sugar, cement, paints, fertilisers and food processing.

Process Costing (cont)

Cost Ascertainment

Process Costing (cont)

- Separate Process Accounts are maintained for each process.

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Process Costing (cont)

- Direct material, labour and overheads are charged to the relevant process.

Process Costing (cont)

- Cost per unit = Total Process Cost / Equivalent Units of Production, where output is not fully completed.

Process Costing (cont)

- Normal process loss, abnormal loss and abnormal gain are treated separately.

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Process Costing (cont)

Important Concepts

Process Costing (cont)

- Normal Loss: Expected loss under efficient operating conditions; generally unavoidable. Its cost is absorbed by good output.

Process Costing (cont)

- Abnormal Loss: Actual loss exceeding normal loss; arises due to inefficiency or unexpected events. It is generally transferred to Costing Profit and Loss Account.

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Process Costing (cont)

- Abnormal Gain: Actual loss is lower than expected normal loss; the gain is generally transferred to Costing Profit and Loss Account.

Process Costing (cont)

- Equivalent Production: Incomplete units expressed as an equivalent number of fully completed units.

Process Costing (cont)

- Inter-process Transfer: Output of one process transferred to the next process, usually at cost or a predetermined transfer price.

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Process Costing (cont)

Key Characteristics

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Process Costing (cont)

- Continuous and standardised production.

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Process Costing (cont)

- Products are generally homogeneous.

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Process Costing (cont)

- Costs are averaged over units produced.

Process Costing (cont)

- Closing WIP requires equivalent-production calculations.

Process Costing (cont)

- Sequential processes may involve transfer of output and accumulated cost.

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Process Costing (cont)

Basic Formula

Process Costing (cont)

Cost per Unit = Total Process Cost / Equivalent Units

Process Costing (cont)

MCQ Traps

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Process Costing (cont)

- Process = cost accumulation point; output unit = cost unit.

Process Costing (cont)

- Normal loss is expected; abnormal loss is unexpected/excess loss.

Process Costing (cont)

- Abnormal gain occurs when actual loss is less than normal loss.

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Process Costing (cont)

- Equivalent units account for incomplete production; physical units alone may give misleading unit costs.

Process Costing (cont)

- Process costing is suitable for continuous homogeneous production, unlike job costing for customised orders.

Contract Costing

Meaning

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Contract Costing (cont)

- A form of job costing used for large, long-term projects undertaken according to specific customer contracts.

Contract Costing (cont)

- Each contract is treated as a separate cost unit.

Contract Costing (cont)

- Commonly used in construction and infrastructure projects.

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Contract Costing (cont)

Industries

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Contract Costing (cont)

- Buildings, bridges, roads, dams, tunnels, shipbuilding and large engineering projects.

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Contract Costing (cont)

Cost Ascertainment

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Contract Costing (cont)

- Costs are accumulated separately for each contract.

Contract Costing (cont)

- Direct material, labour, plant, site expenses and other attributable costs are charged to the contract.

Contract Costing (cont)

- Site-specific indirect expenses are apportioned appropriately.

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Contract Costing (cont)

- A separate Contract Account is maintained for each contract.

Contract Costing (cont)

Important Terms

Contract Costing (cont)

- Work Certified: Work completed and approved by the architect, engineer or other authorised certifier.

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Contract Costing (cont)

- Work Uncertified: Work completed but not yet certified; generally valued at cost.

Contract Costing (cont)

- Progress Payments: Payments made by the contractee as work progresses.

Contract Costing (cont)

- Retention Money: Portion of the certified value withheld by the contractee until specified contractual conditions are met.

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Contract Costing (cont)

- Notional Profit: Value of work certified and uncertified (as valued) less cost incurred to date.

Contract Costing (cont)

- Estimated Total Profit: Contract price minus estimated total contract cost.

Contract Costing (cont)

Profit Recognition

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Contract Costing (cont)

- Contracts often extend across accounting periods, so profit recognition requires special treatment.

Contract Costing (cont)

- For incomplete contracts, profit is recognised cautiously, depending on the stage of completion and applicable accounting rules.

Contract Costing (cont)

- Expected losses on a contract are generally recognised immediately in full.

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Contract Costing (cont)

Key Characteristics

Contract Costing (cont)

- Large value, long duration and site-s-pecific execution.

Contract Costing (cont)

- Costs are accumulated contract-wise.

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Contract Costing (cont)

- Contractee usually makes progress payments.

Contract Costing (cont)

- Plant and materials may be supplied or used specifically for a contract.

Contract Costing (cont)

- Contract costing helps track project costs, work progress and profitability.

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Contract Costing (cont)

MCQ Traps

Contract Costing (cont)

- Contract = cost unit; it is a specialised form of job costing.

Contract Costing (cont)

- Work certified is approved; work uncertified is completed but not approved.

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Contract Costing (cont)

- Retention money is withheld from progress payments; it is not an additional cost.

Contract Costing (cont)

- Notional profit is not necessarily the same as profit recognised in financial statements.

Contract Costing (cont)

- Expected contract loss is not deferred until contract completion.

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Batch Costing

Meaning

Batch Costing (cont)

- A method in which a group of identical or similar products is manufactured together as a batch.

Batch Costing (cont)

- Each batch is treated as a separate cost unit.

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Batch Costing (cont)

- It is essentially a form of job costing where the job consists of a batch of units.

Batch Costing (cont)

Industries

Batch Costing (cont)

- Pharmaceuticals, garments, footwear, bakeries, component manufacturing, toys.

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Batch Costing (cont)

Cost Ascertainment

Batch Costing (cont)

- Each batch is assigned a unique batch number.

Batch Costing (cont)

- Material, labour and overheads are accumulated for the entire batch.

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Batch Costing (cont)

- Total batch cost is divided by the number of acceptable units produced.

Batch Costing (cont)

Formulas

Batch Costing (cont)

- Total Batch Cost = Direct Material + Direct Labour + Direct Expenses + Absorbed Overheads.

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Batch Costing (cont)

- Cost per Unit = Total Batch Cost / Number of Good Units Produced.

Batch Costing (cont)

Economic Batch Quantity (EBQ)

Batch Costing (cont)

- EBQ = optimum batch size that minimises total set-up and inventory carrying costs.

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Batch Costing (cont)

- Formula:

Batch Costing (cont)

EBQ = sqrt(2DS/H)

Batch Costing (cont)

Where:

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Batch Costing (cont)

- D = Annual demand in units.

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Batch Costing (cont)

- S = Set-up cost per batch.

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Batch Costing (cont)

- H = Annual holding cost per unit.

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Batch Costing (cont)

Key Characteristics

Batch Costing (cont)

- Products within a batch are generally identical.

Batch Costing (cont)

- Production takes place in identifiable lots rather than continuously.

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Batch Costing (cont)

- Set-up costs are incurred for each batch.

Batch Costing (cont)

- Larger batches reduce set-up cost per unit but increase average inventory and holding cost.\

Batch Costing (cont)

MCQ Traps

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Batch Costing (cont)

- Batch costing is a variation of job costing.

Batch Costing (cont)

- Batch = cost unit; individual item = unit of measurement for per-unit cost.

Batch Costing (cont)

- EBQ balances set-up cost and inventory carrying cost.

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Batch Costing (cont)

- Do not confuse EBQ (Economic Batch Quantity) with EOQ (Economic Order Quantity): EBQ concerns production batches; EOQ concerns purchase order quantities.

Contract Account Numericals

1. Standard Contract Account Format

Contract Account Numericals (cont)

Debit Side

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Contract Account Numericals (cont)

- Materials consumed.

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Contract Account Numericals (cont)

- Direct wages and labour.

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Contract Account Numericals (cont)

- Direct expenses.

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Contract Account Numericals (cont)

- Plant and machinery (less depreciation, where applicable).

Contract Account Numericals (cont)

- Subcontracting charges.

Contract Account Numericals (cont)

- Allocated indirect expenses.

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Contract Account Numericals (cont)

Credit Side

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Contract Account Numericals (cont)

- Materials returned/transferred.

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Contract Account Numericals (cont)

- Plant transferred or sold.

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Contract Account Numericals (cont)

- Work certified.

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Contract Account Numericals (cont)

- Work uncertified.

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Contract Account Numericals (cont)

2. Important Numerical Formulas

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Contract Account Numericals (cont)

- Material Consumed = Opening Materials + Materials Purchased − Materials Returned − Closing Materials.

Contract Account Numericals (cont)

- Plant Value at Closing = Original Cost − Depreciation.

Contract Account Numericals (cont)

- Cost of Work to Date = Total Contract Expenditure − Cost of Materials/Plant lying unused or transferred, where relevant.

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Contract Account Numericals (cont)

- Notional Profit = Work Certified + Work Uncertified − Cost of Work to Date.

Contract Account Numericals (cont)

- Estimated Profit = Contract Price − Estimated Total Contract Cost.

Contract Account Numericals (cont)

- Retention Money = Work Certified − Cash Received.

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Contract Account Numericals (cont)

3. Complete Numerical Illustration

Contract Account Numericals (cont)

A contractor provides the following information:

Contract Account Numericals (cont)

- Contract Price = ₹100 lakh.

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Contract Account Numericals (cont)

- Materials purchased = ₹30 lakh.

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Contract Account Numericals (cont)

- Wages = ₹20 lakh.

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Contract Account Numericals (cont)

- Direct expenses = ₹5 lakh.

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Contract Account Numericals (cont)

- Plant purchased = ₹10 lakh.

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Contract Account Numericals (cont)

- Depreciation on plant = ₹2 lakh.

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Contract Account Numericals (cont)

- Work Certified = ₹50 lakh.

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Contract Account Numericals (cont)

- Work Uncertified = ₹3 lakh.

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Contract Account Numericals (cont)

- Cash received = 80% of work certified.

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Contract Account Numericals (cont)

- Estimated Cost to Complete = ₹25 lakh.

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Contract Account Numericals (cont)

Step 1: Calculate Contract Cost

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Contract Account Numericals (cont)

- Materials = ₹30 lakh.

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Contract Account Numericals (cont)

- Wages = ₹20 lakh.

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Contract Account Numericals (cont)

- Direct Expenses = ₹5 lakh.

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Contract Account Numericals (cont)

- Plant Depreciation = ₹2 lakh.

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Contract Account Numericals (cont)

Total Cost to Date = ₹57 lakh.

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Contract Account Numericals (cont)

Step 2: Calculate Notional Profit

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Contract Account Numericals (cont)

NP = 50+3-57

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Contract Account Numericals (cont)

Notional Profit = ₹0 lakh

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Contract Account Numericals (cont)

Step 3: Calculate Retention Money

Contract Account Numericals (cont)

- Cash Received = 80% × ₹50 lakh = ₹40 lakh.

Contract Account Numericals (cont)

- Retention Money = ₹50 − ₹40 = ₹10 lakh.

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Contract Account Numericals (cont)

Step 4: Calculate Estimated Profit

Contract Account Numericals (cont)

- Estimated Total Cost = ₹57 + ₹25 = ₹82 lakh.

Contract Account Numericals (cont)

- Estimated Profit = ₹100 − ₹82 = ₹18 lakh.

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Contract Account Numericals (cont)

4. Numerical on Profit Transfer

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Contract Account Numericals (cont)

Suppose:

Contract Account Numericals (cont)

- Notional Profit = ₹12 lakh.

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Contract Account Numericals (cont)

- Work Certified = ₹60 lakh.

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Contract Account Numericals (cont)

- Cash Received = ₹48 lakh.

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Contract Account Numericals (cont)

- Contract is 60% complete.

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Contract Account Numericals (cont)

Using the traditional 2/3 notional-profit formula:

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Contract Account Numericals (cont)

Profit Transferred

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Contract Account Numericals (cont)

=12 x {2 / 3} x {48 / 60}

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Contract Account Numericals (cont)

=₹6.4 lakh

Contract Account Numericals (cont)

- Profit Reserve = ₹12 − ₹6.4 = ₹5.6 lakh.

Contract Account Numericals (cont)

5. Common Adjustments in Contract Numericals

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Contract Account Numericals (cont)

- Materials returned to suppliers: Deduct from material purchases/consumption.

Contract Account Numericals (cont)

- Materials lying unused at site: Exclude from cost of work performed.

Contract Account Numericals (cont)

- Materials transferred to another contract: Credit the relevant Contract Account.

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Contract Account Numericals (cont)

- Plant depreciation: Charge to contract cost.

Contract Account Numericals (cont)

- Plant sold: Credit sale proceeds to the Contract Account.

Contract Account Numericals (cont)

- Work uncertified: Add to work certified while calculating notional profit; generally value at cost.

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Contract Account Numericals (cont)

- Retention money: Deduct cash received from work certified to calculate the amount withheld.

Contract Account Numericals (cont)

- Escalation claims: Adjust contract revenue only when supported by the contractual clause and applicable recognition requirements.

Contract Account Numericals (cont)

- Expected overall contract loss: Recognise the entire expected loss.

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Contract Account Numericals (cont)

6. High-Value MCQ Traps

Contract Account Numericals (cont)

- Work certified is generally valued at contract price; work uncertified at cost.

Contract Account Numericals (cont)

- Notional profit uses both certified and uncertified work.

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Contract Account Numericals (cont)

- Plant depreciation is a contract expense; the full plant purchase price is not necessarily consumed in one period.

Contract Account Numericals (cont)

- Materials at site are not automatically treated as work performed.

Contract Account Numericals (cont)

- Retention money is not an expense or loss.

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Contract Account Numericals (cont)

- Traditional profit-transfer formulas are textbook conventions, not universal statutory rules.

Material Costing and Inventory Control

Material Losses, Wastage, Scrap and Spoilage

1. Normal Loss

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Material Losses, Wastage, Scrap and Spoilage (cont)

- Unavoidable loss arising under efficient and normal operating conditions.

Material Losses, Wastage, Scrap and Spoilage (cont)

- Examples: evaporation, shrinkage, unavoidable handling loss.

Material Losses, Wastage, Scrap and Spoilage (cont)

- Expected and considered while determining material/product cost.

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Material Losses, Wastage, Scrap and Spoilage (cont)

- Cost of normal loss is generally absorbed by good production.

Material Losses, Wastage, Scrap and Spoilage (cont)

- No separate abnormal-loss treatment.

Material Losses, Wastage, Scrap and Spoilage (cont)

2. Abnormal Loss

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Material Losses, Wastage, Scrap and Spoilage (cont)

- Loss exceeding the normal expected level.

Material Losses, Wastage, Scrap and Spoilage (cont)

- Arises due to avoidable or unexpected events such as accidents, negligence, theft, fire or abnormal wastage.

Material Losses, Wastage, Scrap and Spoilage (cont)

- Not treated as part of normal production cost.

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Material Losses, Wastage, Scrap and Spoilage (cont)

- In process costing, abnormal loss is generally transferred to the Costing Profit and Loss Account.

Material Losses, Wastage, Scrap and Spoilage (cont)

- Insurance claims, scrap value or recoveries are adjusted separately where applicable.

Material Losses, Wastage, Scrap and Spoilage (cont)

3. Waste

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Material Losses, Wastage, Scrap and Spoilage (cont)

- Material lost during production with little or no recoverable value.

Material Losses, Wastage, Scrap and Spoilage (cont)

- Examples: evaporation, dust, fumes and unavoidable material residue.

Material Losses, Wastage, Scrap and Spoilage (cont)

- Normal waste cost is absorbed by good output; abnormal waste is separately identified and charged.

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Material Losses, Wastage, Scrap and Spoilage (cont)

4. Scrap

Material Losses, Wastage, Scrap and Spoilage (cont)

- Residual material arising from production, usually having a small recoverable value.

Material Losses, Wastage, Scrap and Spoilage (cont)

- Examples: metal cuttings, wood shavings and rejected material remnants.

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Material Losses, Wastage, Scrap and Spoilage (cont)

- Scrap may be sold or reused.

Material Losses, Wastage, Scrap and Spoilage (cont)

- Accounting treatment:

Material Losses, Wastage, Scrap and Spoilage (cont)

- Sale proceeds of scrap may be credited to the relevant process/job or factory overhead.

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Material Losses, Wastage, Scrap and Spoilage (cont)

- Scrap attributable to a specific job/process should generally be credited to that cost object.

Material Losses, Wastage, Scrap and Spoilage (cont)

- If scrap is insignificant and cannot be allocated economically, it may be credited to factory overhead.

Material Losses, Wastage, Scrap and Spoilage (cont)

5. Spoilage

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Material Losses, Wastage, Scrap and Spoilage (cont)

- Units or materials damaged during production and rendered unsuitable for their intended purpose.

Material Losses, Wastage, Scrap and Spoilage (cont)

- Examples: defective ceramic tiles, damaged castings or burnt products.

Material Losses, Wastage, Scrap and Spoilage (cont)

- Normal spoilage: expected under efficient operating conditions; cost absorbed by good production.

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Material Losses, Wastage, Scrap and Spoilage (cont)

- Abnormal spoilage: beyond normal limits; cost separately charged to Costing Profit and Loss Account.

Material Losses, Wastage, Scrap and Spoilage (cont)

6. Defectives and Rework

Material Losses, Wastage, Scrap and Spoilage (cont)

- Defectives: products that do not meet required quality standards but can be rectified or sold at a reduced price.

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Material Losses, Wastage, Scrap and Spoilage (cont)

- Rework: additional work required to bring defective products up to standard.

Material Losses, Wastage, Scrap and Spoilage (cont)

- Normal rework cost is generally included in production cost.

Material Losses, Wastage, Scrap and Spoilage (cont)

- Abnormal rework cost is separately identified and charged to Costing Profit and Loss Account.

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Material Losses, Wastage, Scrap and Spoilage (cont)

Important Distinctions

Material Losses, Wastage, Scrap and Spoilage (cont)

- Waste: material lost, usually without significant recovery value.

Material Losses, Wastage, Scrap and Spoilage (cont)

- Scrap: residual material with some recoverable value.

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Material Losses, Wastage, Scrap and Spoilage (cont)

- Spoilage: damaged output that cannot be economically brought to standard.

Material Losses, Wastage, Scrap and Spoilage (cont)

- Defectives: output that can be corrected or sold at a lower value.

Material Losses, Wastage, Scrap and Spoilage (cont)

- Normal loss: expected and absorbed into good output cost.

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Material Losses, Wastage, Scrap and Spoilage (cont)

- Abnormal loss: unexpected/excessive and separately charged.

Material Losses, Wastage, Scrap and Spoilage (cont)

Process Costing Formula

Material Losses, Wastage, Scrap and Spoilage (cont)

- Normal Loss = Input Units × Normal Loss Percentage.

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Material Losses, Wastage, Scrap and Spoilage (cont)

- Expected Good Output = Input Units − Normal Loss.

Material Losses, Wastage, Scrap and Spoilage (cont)

- Abnormal Loss = Actual Loss − Normal Loss.

Material Losses, Wastage, Scrap and Spoilage (cont)

- Abnormal Gain = Normal Loss − Actual Loss, when actual loss is below normal loss.

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Material Losses, Wastage, Scrap and Spoilage (cont)

- Cost per Good Unit = (Total Process Cost − Scrap Value of Normal Loss) ÷ Expected Good Output.

Material Losses, Wastage, Scrap and Spoilage (cont)

MCQ Traps

Material Losses, Wastage, Scrap and Spoilage (cont)

- Normal loss is not treated as abnormal loss merely because physical units are lost.

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Material Losses, Wastage, Scrap and Spoilage (cont)

- Scrap value of normal loss reduces the cost to be borne by good output.

Material Losses, Wastage, Scrap and Spoilage (cont)

- Abnormal loss is not loaded onto normal production cost.

Material Losses, Wastage, Scrap and Spoilage (cont)

- Normal rework is a production cost; abnormal rework is separately charged.

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Material Losses, Wastage, Scrap and Spoilage (cont)

- Scrap is not necessarily worthless; it has recoverable value.

FIFO, LIFO and Weighted-Average Pricing

1. FIFO — First In, First Out

FIFO, LIFO and Weighted-Average Pricing (cont)

- Assumes materials purchased first are issued first.

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FIFO, LIFO and Weighted-Average Pricing (cont)

- Closing inventory consists of the latest purchases.

FIFO, LIFO and Weighted-Average Pricing (cont)

- During rising prices:

FIFO, LIFO and Weighted-Average Pricing (cont)

- Issue cost is generally lower.

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FIFO, LIFO and Weighted-Average Pricing (cont)

- Closing inventory value is generally higher.

FIFO, LIFO and Weighted-Average Pricing (cont)

- Reported profit is generally higher, other things remaining equal.

FIFO, LIFO and Weighted-Average Pricing (cont)

- During falling prices, the reverse generally applies.

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FIFO, LIFO and Weighted-Average Pricing (cont)

- Suitable where materials are perishable or need to be used in order of receipt.

FIFO, LIFO and Weighted-Average Pricing (cont)

- Physical flow need not necessarily follow FIFO in every accounting system.

FIFO, LIFO and Weighted-Average Pricing (cont)

2. LIFO — Last In, First Out

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FIFO, LIFO and Weighted-Average Pricing (cont)

- Assumes the latest materials purchased are issued first.

FIFO, LIFO and Weighted-Average Pricing (cont)

- Closing inventory consists of older purchase layers.

FIFO, LIFO and Weighted-Average Pricing (cont)

- During rising prices:

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FIFO, LIFO and Weighted-Average Pricing (cont)

- Issue cost is generally higher.

FIFO, LIFO and Weighted-Average Pricing (cont)

- Closing inventory value is generally lower.

FIFO, LIFO and Weighted-Average Pricing (cont)

- Reported profit is generally lower, other things remaining equal.

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FIFO, LIFO and Weighted-Average Pricing (cont)

- During falling prices, the reverse generally applies.

FIFO, LIFO and Weighted-Average Pricing (cont)

- LIFO is not permitted under Ind AS 2 / Indian Accounting Standards for inventory valuation and is also prohibited under International Accounting Standard (IAS) 2.

FIFO, LIFO and Weighted-Average Pricing (cont)

- It may still appear in traditional cost-accounting questions as a material issue-pricing method.

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FIFO, LIFO and Weighted-Average Pricing (cont)

3. Weighted-Average Price Method

FIFO, LIFO and Weighted-Average Pricing (cont)

- Materials issued are priced using the weighted-average cost of available inventory.

FIFO, LIFO and Weighted-Average Pricing (cont)

- Formula:

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FIFO, LIFO and Weighted-Average Pricing (cont)

Weighted Average Price per Unit = Total Cost of Materials Available ÷ Total Quantity of Materials Available.

FIFO, LIFO and Weighted-Average Pricing (cont)

- Weighted average is based on both quantity and cost; it is not a simple arithmetic average of purchase prices.

FIFO, LIFO and Weighted-Average Pricing (cont)

- Two common approaches:

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FIFO, LIFO and Weighted-Average Pricing (cont)

- Periodic Weighted Average: average calculated over a specified period.

FIFO, LIFO and Weighted-Average Pricing (cont)

- Moving Weighted Average: average recalculated after each new receipt.

FIFO, LIFO and Weighted-Average Pricing (cont)

- Smooths the impact of price fluctuations.

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FIFO, LIFO and Weighted-Average Pricing (cont)

- Issue prices and closing inventory values are generally between the relevant purchase prices.

FIFO, LIFO and Weighted-Average Pricing (cont)

Comparison and Key Effects

FIFO, LIFO and Weighted-Average Pricing (cont)

- FIFO: oldest costs issued first; newest costs remain in closing stock.

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FIFO, LIFO and Weighted-Average Pricing (cont)

- LIFO: newest costs issued first; oldest costs remain in closing stock.

FIFO, LIFO and Weighted-Average Pricing (cont)

- Weighted average: blends costs of available inventory.

FIFO, LIFO and Weighted-Average Pricing (cont)

- When prices are rising, FIFO generally gives the highest closing stock value and profit; LIFO generally gives the lowest; weighted average lies between them, assuming comparable quantities and no other complications.

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FIFO, LIFO and Weighted-Average Pricing (cont)

MCQ Traps

FIFO, LIFO and Weighted-Average Pricing (cont)

- FIFO and LIFO are cost-flow assumptions, not necessarily descriptions of actual physical movement.

FIFO, LIFO and Weighted-Average Pricing (cont)

- Under FIFO, closing stock reflects recent purchase prices.

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FIFO, LIFO and Weighted-Average Pricing (cont)

- Under LIFO, closing stock reflects older purchase prices.

FIFO, LIFO and Weighted-Average Pricing (cont)

- Moving average is recalculated after each receipt; periodic average is calculated for the period.

FIFO, LIFO and Weighted-Average Pricing (cont)

- Weighted average must be quantity-weighted.

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FIFO, LIFO and Weighted-Average Pricing (cont)

- Under Ind AS 2, permitted cost formulas include FIFO and weighted average; LIFO is not permitted.

FIFO, LIFO and Weighted-Average Pricing (cont)

- Specific identification is appropriate for inventory items that are not ordinarily interc-hangeable or are segregated for specific projects.

ABC, VED, HML, FSN and XYZ Analysis

1. ABC Analysis — Always Better Control

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ABC, VED, HML, FSN and XYZ Analysis (cont)

- Classifies inventory based on annual consumption value.

ABC, VED, HML, FSN and XYZ Analysis (cont)

- Annual Consumption Value = Annual Quantity Consumed × Unit Price.

ABC, VED, HML, FSN and XYZ Analysis (cont)

- Based on the Pareto principle (80:20 concept): a small proportion of items often accounts for a large proportion of inventory value.

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ABC, VED, HML, FSN and XYZ Analysis (cont)

- Typical classification:

ABC, VED, HML, FSN and XYZ Analysis (cont)

- A items: about 10% of items account for 70% of consumption value; very strict control, frequent review and accurate records.

ABC, VED, HML, FSN and XYZ Analysis (cont)

- B items: about 20% of items account for 20% of value; moderate control.

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ABC, VED, HML, FSN and XYZ Analysis (cont)

- C items: about 70% of items account for 10% of value; simpler controls and bulk ordering may be suitable.

ABC, VED, HML, FSN and XYZ Analysis (cont)

- Percentages are indicative, not universal.

ABC, VED, HML, FSN and XYZ Analysis (cont)

- Focus: financial value of consumption.

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ABC, VED, HML, FSN and XYZ Analysis (cont)

2. VED Analysis — Vital, Essential, Desirable

ABC, VED, HML, FSN and XYZ Analysis (cont)

- Classifies inventory based on criticality to operations.

ABC, VED, HML, FSN and XYZ Analysis (cont)

- Vital: absence may stop production or seriously disrupt operations; no stock-out should be permitted.

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ABC, VED, HML, FSN and XYZ Analysis (cont)

- Essential: shortage can be tolerated for a limited period but causes operational difficulty.

ABC, VED, HML, FSN and XYZ Analysis (cont)

- Desirable: shortage has relatively minor consequences; lower stocking priority.

ABC, VED, HML, FSN and XYZ Analysis (cont)

- Commonly used for spare parts, maintenance inventory and hospital supplies.

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ABC, VED, HML, FSN and XYZ Analysis (cont)

- Focus: criticality, not monetary value.

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ABC, VED, HML, FSN and XYZ Analysis (cont)

3. HML Analysis — High, Medium, Low

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ABC, VED, HML, FSN and XYZ Analysis (cont)

- Classifies inventory based on unit price.

ABC, VED, HML, FSN and XYZ Analysis (cont)

- High-cost items: strict purchasing and issue authorisation.

ABC, VED, HML, FSN and XYZ Analysis (cont)

- Medium-cost items: normal control.

ABC, VED, HML, FSN and XYZ Analysis (cont)

- Low-cost items: relatively simple control.

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ABC, VED, HML, FSN and XYZ Analysis (cont)

- Focus: price per individual item, unlike ABC, which uses annual consumption value.

ABC, VED, HML, FSN and XYZ Analysis (cont)

4. FSN Analysis — Fast-moving, Slow-moving, Non-moving

ABC, VED, HML, FSN and XYZ Analysis (cont)

- Classifies inventory based on rate/frequency of issue or consumption.

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ABC, VED, HML, FSN and XYZ Analysis (cont)

- Fast-moving: issued frequently; requires regular replenishment.

ABC, VED, HML, FSN and XYZ Analysis (cont)

- Slow-moving: issued infrequently; monitor stock levels.

ABC, VED, HML, FSN and XYZ Analysis (cont)

- Non-moving: no issue/consumption for a specified period; investigate surplus, obsolescence or disposal.

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ABC, VED, HML, FSN and XYZ Analysis (cont)

- Helps identify dead stock and improve inventory turnover.

ABC, VED, HML, FSN and XYZ Analysis (cont)

- Focus: movement of inventory over time.

ABC, VED, HML, FSN and XYZ Analysis (cont)

5. XYZ Analysis

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ABC, VED, HML, FSN and XYZ Analysis (cont)

- Common inventory-control convention: classifies inventory based on value of stock held at a particular point in time.

ABC, VED, HML, FSN and XYZ Analysis (cont)

- X items: high inventory value; close monitoring and accurate forecasting.

ABC, VED, HML, FSN and XYZ Analysis (cont)

- Y items: medium inventory value; moderate control.

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ABC, VED, HML, FSN and XYZ Analysis (cont)

- Z items: low inventory value; relatively simple control.

ABC, VED, HML, FSN and XYZ Analysis (cont)

- Focus: closing/inventory holding value, unlike ABC's annual consumption value.

ABC, VED, HML, FSN and XYZ Analysis (cont)

- Note: XYZ terminology can vary across organisations and textbooks; follow the definition specified in the question.

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ABC, VED, HML, FSN and XYZ Analysis (cont)

Important Distinctions

ABC, VED, HML, FSN and XYZ Analysis (cont)

- ABC = annual consumption value.

ABC, VED, HML, FSN and XYZ Analysis (cont)

- VED = operational criticality.

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ABC, VED, HML, FSN and XYZ Analysis (cont)

- HML = unit price.

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ABC, VED, HML, FSN and XYZ Analysis (cont)

- FSN = rate of movement/issue.

ABC, VED, HML, FSN and XYZ Analysis (cont)

- XYZ = value of stock held.

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ABC, VED, HML, FSN and XYZ Analysis (cont)

- These techniques can be combined. For example, ABC–VED analysis helps prioritise items that are both financially significant and operationally critical.

ABC, VED, HML, FSN and XYZ Analysis (cont)

MCQ Traps

ABC, VED, HML, FSN and XYZ Analysis (cont)

- ABC and HML are not the same: annual consumption value vs unit price.

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ABC, VED, HML, FSN and XYZ Analysis (cont)

- ABC and XYZ are not the same: annual consumption value vs value of stock held.

ABC, VED, HML, FSN and XYZ Analysis (cont)

- VED is based on criticality, not cost.

ABC, VED, HML, FSN and XYZ Analysis (cont)

- FSN identifies non-moving/dead stock; it does not classify by value.

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ABC, VED, HML, FSN and XYZ Analysis (cont)

- A low-value item can still be VITAL under VED.

ABC, VED, HML, FSN and XYZ Analysis (cont)

- Classification percentages and cut-offs are indicative and may vary by organi-sation.

Safety Stock and Lead Time

Safety Stock

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Safety Stock and Lead Time (cont)

- Safety stock = additional inventory maintained above expected consumption to protect against uncertainty in demand or replenishment.

Safety Stock and Lead Time (cont)

- Also called buffer stock.

Safety Stock and Lead Time (cont)

- Prevents stock-outs caused by:

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Safety Stock and Lead Time (cont)

- Unexpected increase in demand.

Safety Stock and Lead Time (cont)

- Supplier delays or longer-than-expected lead time.

Safety Stock and Lead Time (cont)

- Supply disruptions or quality rejection.

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Safety Stock and Lead Time (cont)

- Higher safety stock improves availability but increases carrying cost and inventory investment.

Safety Stock and Lead Time (cont)

Lead Time

Safety Stock and Lead Time (cont)

- Lead time = time between placing an order and receiving the materials.

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Safety Stock and Lead Time (cont)

- Includes supplier processing, dispatch, transportation, receipt and inspection, depending on the organisation's definition.

Safety Stock and Lead Time (cont)

- Longer lead time generally requires a higher reorder point and potentially more safety stock.

Safety Stock and Lead Time (cont)

- Lead time may be:

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Safety Stock and Lead Time (cont)

- Fixed: remains relatively constant.

Safety Stock and Lead Time (cont)

- Variable: fluctuates due to supplier, transport or operational uncertainty.

Safety Stock and Lead Time (cont)

Key Formulas

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Safety Stock and Lead Time (cont)

- Reorder Point = Demand during Lead Time + Safety Stock.

Safety Stock and Lead Time (cont)

- If daily demand and lead time are constant: Reorder Point = Average Daily Consumption × Lead Time + Safety Stock.

Safety Stock and Lead Time (cont)

- Safety Stock = Reorder Point − Expected Demand during Lead Time.

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Safety Stock and Lead Time (cont)

- Under a simple uncertainty approach: Safety Stock = Maximum Usage during Maximum Lead Time − Average Usage during Average Lead Time.

Safety Stock and Lead Time (cont)

- These are alternative calculation approaches; use the formula specified by the question.

Safety Stock and Lead Time (cont)

Factors Determining Safety Stock

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Safety Stock and Lead Time (cont)

- Variability in demand.

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Safety Stock and Lead Time (cont)

- Variability in supplier lead time.

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Safety Stock and Lead Time (cont)

- Reliability of suppliers.

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Safety Stock and Lead Time (cont)

- Criticality of the material.

Safety Stock and Lead Time (cont)

- Cost of stock-out and production interr-uption.

Safety Stock and Lead Time (cont)

- Availability of substitutes and storage/c-arrying costs.

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Safety Stock and Lead Time (cont)

MCQ Traps

Safety Stock and Lead Time (cont)

- Safety stock is a buffer; it is not the normal working stock or reorder quantity.

Safety Stock and Lead Time (cont)

- Reorder point includes expected lead-time demand plus safety stock.

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Safety Stock and Lead Time (cont)

- Higher demand uncertainty or longer/less predictable lead time generally increases required safety stock.

Safety Stock and Lead Time (cont)

- Safety stock reduces stock-out risk but does not eliminate it.

Safety Stock and Lead Time (cont)

- Lead time is the replenishment period, not the time between two successive orders.

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Reorder, Minimum, Maximum and Danger Levels

1. Reorder Level

Reorder, Minimum, Maximum and Danger Levels (cont)

- Stock level at which a fresh purchase order must be placed to replenish inventory before existing stock is exhausted.

Reorder, Minimum, Maximum and Danger Levels (cont)

- Also called ordering level or reorder point.

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Reorder, Minimum, Maximum and Danger Levels (cont)

Formula

Reorder, Minimum, Maximum and Danger Levels (cont)

Reorder Level = Maximum Consumption x Maximum Lead Time

Reorder, Minimum, Maximum and Danger Levels (cont)

- In systems using average demand and fixed lead time, reorder point may instead be calculated as average consumption × lead time + safety stock.

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Reorder, Minimum, Maximum and Danger Levels (cont)

2. Minimum Stock Level

Reorder, Minimum, Maximum and Danger Levels (cont)

- Lowest stock level that should normally be maintained to avoid interruption of production.

Reorder, Minimum, Maximum and Danger Levels (cont)

Minimum Level = Reorder Level -

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Reorder, Minimum, Maximum and Danger Levels (cont)

(Normal Consumption x Normal Lead Time)

Reorder, Minimum, Maximum and Danger Levels (cont)

3. Maximum Stock Level

Reorder, Minimum, Maximum and Danger Levels (cont)

- Highest stock level that should normally be maintained to prevent excessive inventory investment and carrying costs.

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Reorder, Minimum, Maximum and Danger Levels (cont)

Maximum Level= Reorder Level+ Reorder Quantity

Reorder, Minimum, Maximum and Danger Levels (cont)

- (Minimum Consumption x Minimum Lead Time)

Reorder, Minimum, Maximum and Danger Levels (cont)

4. Danger Level

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Reorder, Minimum, Maximum and Danger Levels (cont)

- Stock level at which urgent action is required to prevent a stock-out.

Reorder, Minimum, Maximum and Danger Levels (cont)

- Emergency purchases or special arrangements may be necessary.

Reorder, Minimum, Maximum and Danger Levels (cont)

Danger Level = Average Consumption x Emergency Lead Time

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Reorder, Minimum, Maximum and Danger Levels (cont)

- Emergency lead time is the time required to obtain fresh supplies under urgent arrangements.

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Reorder, Minimum, Maximum and Danger Levels (cont)

5. Relationship Between Stock Levels

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Reorder, Minimum, Maximum and Danger Levels (cont)

- Maximum Level > Reorder Level > Minimum Level > Danger Level (normally).

Reorder, Minimum, Maximum and Danger Levels (cont)

- Reorder Level triggers fresh ordering.

Reorder, Minimum, Maximum and Danger Levels (cont)

- Minimum Level represents the normal lower stock limit.

Reorder, Minimum, Maximum and Danger Levels (cont)

- Maximum Level prevents excessive stocking.

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Reorder, Minimum, Maximum and Danger Levels (cont)

- Danger Level triggers emergency procurement.

Reorder, Minimum, Maximum and Danger Levels (cont)

6. Numerical Illustration

Reorder, Minimum, Maximum and Danger Levels (cont)

Given:

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Reorder, Minimum, Maximum and Danger Levels (cont)

- Maximum consumption = 200 units/week.

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Reorder, Minimum, Maximum and Danger Levels (cont)

- Normal consumption = 150 units/week.

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Reorder, Minimum, Maximum and Danger Levels (cont)

- Minimum consumption = 100 units/week.

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Reorder, Minimum, Maximum and Danger Levels (cont)

- Maximum reorder period = 4 weeks.

Reorder, Minimum, Maximum and Danger Levels (cont)

- Normal reorder period = 3 weeks.

Reorder, Minimum, Maximum and Danger Levels (cont)

- Minimum reorder period = 2 weeks.

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Reorder, Minimum, Maximum and Danger Levels (cont)

- Reorder quantity = 1,000 units.

Reorder, Minimum, Maximum and Danger Levels (cont)

- Average consumption = 150 units/week.

Reorder, Minimum, Maximum and Danger Levels (cont)

- Emergency lead time = 1 week.

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Reorder, Minimum, Maximum and Danger Levels (cont)

Calculations:

Reorder, Minimum, Maximum and Danger Levels (cont)

- Reorder Level = 200 × 4 = 800 units.

Reorder, Minimum, Maximum and Danger Levels (cont)

- Minimum Level = 800 − (150 × 3) = 350 units.

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Reorder, Minimum, Maximum and Danger Levels (cont)

- Maximum Level = 800 + 1,000 − (100 × 2) = 1,600 units.

Reorder, Minimum, Maximum and Danger Levels (cont)

- Danger Level = 150 × 1 = 150 units.

Reorder, Minimum, Maximum and Danger Levels (cont)

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Reorder, Minimum, Maximum and Danger Levels (cont)

- Reorder level is based on maximum consumption × maximum lead time in the traditional formula.

Reorder, Minimum, Maximum and Danger Levels (cont)

- Minimum level uses normal consumption and normal lead time.

Reorder, Minimum, Maximum and Danger Levels (cont)

- Maximum level uses minimum consumption and minimum lead time.

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Reorder, Minimum, Maximum and Danger Levels (cont)

- Danger level is based on emergency lead time.

Reorder, Minimum, Maximum and Danger Levels (cont)

- Reorder quantity and reorder level are different: one is a quantity ordered, the other is a stock threshold.

Reorder, Minimum, Maximum and Danger Levels (cont)

- These are traditional inventory-control formulas; where a question provides a different convention, follow the data and formula specified.

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Economic Order Quantity (EOQ)

Meaning

Economic Order Quantity (EOQ) (cont)

- Economic Order Quantity (EOQ) is the optimal quantity of material to order at one time that minimises total inventory ordering and carrying costs.

Economic Order Quantity (EOQ) (cont)

- It balances the cost of placing frequent orders against the cost of holding large inventories.

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Economic Order Quantity (EOQ) (cont)

Formula

Economic Order Quantity (EOQ) (cont)

EOQ = sqrt (2DS / H)

Economic Order Quantity (EOQ) (cont)

Where:

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Economic Order Quantity (EOQ) (cont)

- D = Annual demand/consumption in units.

Economic Order Quantity (EOQ) (cont)

- S = Ordering cost per order.

Economic Order Quantity (EOQ) (cont)

- H = Annual holding/carrying cost per unit.

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Economic Order Quantity (EOQ) (cont)

Important Cost Relationships

Economic Order Quantity (EOQ) (cont)

- Annual Ordering Cost = (Annual Demand / Order Quantity) × Ordering Cost per Order.

Economic Order Quantity (EOQ) (cont)

- Average Inventory = Order Quantity / 2 (assuming no safety stock and instantaneous replenishment).

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Economic Order Quantity (EOQ) (cont)

- Annual Carrying Cost = (Order Quantity / 2) × Holding Cost per Unit.

Economic Order Quantity (EOQ) (cont)

- Total Relevant Inventory Cost = Annual Ordering Cost + Annual Carrying Cost.

Economic Order Quantity (EOQ) (cont)

- Total Purchase Cost = Annual Demand × Purchase Price per Unit.

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Economic Order Quantity (EOQ) (cont)

At EOQ

Economic Order Quantity (EOQ) (cont)

- Annual Ordering Cost = Annual Carrying Cost.

Economic Order Quantity (EOQ) (cont)

- Total relevant inventory cost is minimum.

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Economic Order Quantity (EOQ) (cont)

- EOQ does not necessarily minimise total purchase cost.

Economic Order Quantity (EOQ) (cont)

- If purchase price changes with quantity discounts, total cost must be evaluated separately.

Economic Order Quantity (EOQ) (cont)

Assumptions of Basic EOQ Model

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Economic Order Quantity (EOQ) (cont)

- Demand and consumption are known and constant.

Economic Order Quantity (EOQ) (cont)

- Ordering cost per order remains constant.

Economic Order Quantity (EOQ) (cont)

- Holding cost per unit per year remains constant.

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Economic Order Quantity (EOQ) (cont)

- Lead time is known and constant.

Economic Order Quantity (EOQ) (cont)

- Replenishment is assumed to be instantaneous.

Economic Order Quantity (EOQ) (cont)

- No stock-outs or shortages are permitted.

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Economic Order Quantity (EOQ) (cont)

- Purchase price per unit remains constant; quantity discounts are excluded.

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Economic Order Quantity (EOQ) (cont)

Factors Affecting EOQ

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Economic Order Quantity (EOQ) (cont)

- Higher annual demand → Higher EOQ.

Economic Order Quantity (EOQ) (cont)

- Higher ordering cost → Higher EOQ.

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Economic Order Quantity (EOQ) (cont)

- Higher holding cost → Lower EOQ.

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Economic Order Quantity (EOQ) (cont)

- Lower ordering cost → Lower EOQ.

Economic Order Quantity (EOQ) (cont)

- Lower holding cost → Higher EOQ.

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Economic Order Quantity (EOQ) (cont)

Useful Additional Formulas

Economic Order Quantity (EOQ) (cont)

- Number of Orders per Year = Annual Demand / EOQ.

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Economic Order Quantity (EOQ) (cont)

- Time Between Orders = Working Days per Year / Number of Orders.

Economic Order Quantity (EOQ) (cont)

- Reorder Point (without safety stock) = Average Daily Consumption × Lead Time.

Economic Order Quantity (EOQ) (cont)

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Economic Order Quantity (EOQ) (cont)

- EOQ minimises ordering + carrying costs, not necessarily total expenditure including purchase price.

Economic Order Quantity (EOQ) (cont)

- At EOQ, annual ordering cost equals annual carrying cost under the basic model.

Economic Order Quantity (EOQ) (cont)

- Average inventory is EOQ/2 only when safety stock is excluded.

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Economic Order Quantity (EOQ) (cont)

- EOQ is expressed in units, not rupees.

Economic Order Quantity (EOQ) (cont)

- EOQ is an optimum order quantity, not the reorder level.

Economic Order Quantity (EOQ) (cont)

- EOQ and Economic Batch Quantity (EBQ) are related concepts but apply to purchasing and production batches respectively.

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Stores Management and Inventory Control

Meaning

Stores Management and Inventory Control (cont)

- Stores Management: Systematic receipt, storage, preservation, issue and recording of materials.

Stores Management and Inventory Control (cont)

- Inventory Control: Ensuring optimum stock levels by balancing material availability against ordering, carrying and shortage costs.

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Stores Management and Inventory Control (cont)

Objectives

Stores Management and Inventory Control (cont)

- Ensure uninterrupted production.

Stores Management and Inventory Control (cont)

- Prevent overstocking, understocking and stock-outs.

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Stores Management and Inventory Control (cont)

- Minimise inventory investment and carrying costs.

Stores Management and Inventory Control (cont)

- Prevent theft, deterioration, damage and obsolescence.

Stores Management and Inventory Control (cont)

- Maintain accurate stock records and accountability.

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Stores Management and Inventory Control (cont)

Functions of Stores Department

Stores Management and Inventory Control (cont)

- Receive and inspect incoming materials.

Stores Management and Inventory Control (cont)

- Verify materials against Purchase Orders and Goods Received Notes (GRNs).

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Stores Management and Inventory Control (cont)

- Classify, codify and store materials systematically.

Stores Management and Inventory Control (cont)

- Preserve materials and prevent deterioration.

Stores Management and Inventory Control (cont)

- Issue materials against authorised requisitions.

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Stores Management and Inventory Control (cont)

- Maintain Bin Cards and coordinate with Stores Ledger.

Stores Management and Inventory Control (cont)

- Conduct physical stock verification and reconcile discrepancies.

Stores Management and Inventory Control (cont)

- Identify slow-moving, obsolete and surplus inventory.

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Stores Management and Inventory Control (cont)

Important Inventory Control Techniques

Stores Management and Inventory Control (cont)

1. Perpetual Inventory System

Stores Management and Inventory Control (cont)

- Continuous recording of receipts, issues and balances.

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Stores Management and Inventory Control (cont)

- Provides up-to-date stock information.

Stores Management and Inventory Control (cont)

- Supported by continuous or periodic physical verification.

Stores Management and Inventory Control (cont)

- Helps detect shortages, pilferage and recording errors.

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Stores Management and Inventory Control (cont)

2. Continuous Stock Verification

Stores Management and Inventory Control (cont)

- Physical counting of selected inventory items throughout the year.

Stores Management and Inventory Control (cont)

- Different items are verified at different times.

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Stores Management and Inventory Control (cont)

- Helps identify discrepancies without waiting for annual stocktaking.

Stores Management and Inventory Control (cont)

3. Periodic Stock Verification

Stores Management and Inventory Control (cont)

- Physical counting of inventory at specified intervals, often at year-end.

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Stores Management and Inventory Control (cont)

- Actual quantities are compared with book balances.

Stores Management and Inventory Control (cont)

4. Two-Bin System

Stores Management and Inventory Control (cont)

- Inventory is divided into two bins.

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Stores Management and Inventory Control (cont)

- First bin supplies regular consumption.

Stores Management and Inventory Control (cont)

- Second bin acts as reserve stock during replenishment lead time.

Stores Management and Inventory Control (cont)

- Reordering is triggered when the first bin is exhausted.

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Stores Management and Inventory Control (cont)

5. Just-in-Time (JIT) Inventory

Stores Management and Inventory Control (cont)

- Materials are procured close to the time they are required for production.

Stores Management and Inventory Control (cont)

- Aims to minimise inventory holding and storage costs.

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Stores Management and Inventory Control (cont)

- Requires reliable suppliers, accurate planning and dependable logistics.

Stores Management and Inventory Control (cont)

- Supply disruptions can interrupt production because buffer stock is low.

Stores Management and Inventory Control (cont)

6. Inventory Codification

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Stores Management and Inventory Control (cont)

- Assigning unique codes to materials for easy identification and classification.

Stores Management and Inventory Control (cont)

- Reduces confusion caused by similar material names.

Stores Management and Inventory Control (cont)

- Facilitates purchasing, storage, accounting and stock verification.

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Stores Management and Inventory Control (cont)

7. Standardisation and Simplification

Stores Management and Inventory Control (cont)

- Standardisation: Establishing uniform specifications and quality standards.

Stores Management and Inventory Control (cont)

- Simplification: Reducing unnecessary varieties and types of materials.

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Stores Management and Inventory Control (cont)

- Helps bulk purchasing, reduces storage complexity and improves control.

Stores Management and Inventory Control (cont)

Important Inventory Costs

Stores Management and Inventory Control (cont)

- Ordering Cost: Cost of placing and processing purchase orders.

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Stores Management and Inventory Control (cont)

- Carrying/Holding Cost: Storage, insurance, interest on capital, handling, deterioration and obsolescence.

Stores Management and Inventory Control (cont)

- Stock-out Cost: Losses arising from unavailable materials, production stoppages and delayed deliveries.

Stores Management and Inventory Control (cont)

- Purchase Cost: Price paid for acquiring materials.

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Stores Management and Inventory Control (cont)

MCQ Traps

Stores Management and Inventory Control (cont)

- Perpetual inventory is continuous record maintenance; continuous stock verification is physical checking.

Stores Management and Inventory Control (cont)

- Bin Card is maintained by the storekeeper; Stores Ledger is generally maintained by the cost/accounts department.

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Stores Management and Inventory Control (cont)

- JIT reduces inventory holding but increases dependence on reliable suppliers.

Stores Management and Inventory Control (cont)

- Two-bin system uses the second bin as reserve during replenishment.

Stores Management and Inventory Control (cont)

- Inventory control aims at optimum stock, not zero stock in every situation.

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Material Procurement and Purchasing Procedure

Meaning

Material Procurement and Purchasing Procedure (cont)

- Material procurement is the process of obtaining the right quality and quantity of materials at the right time, from the right source and at the right price.

Material Procurement and Purchasing Procedure (cont)

- Purchasing is one part of materials management; procurement also includes planning, supplier selection, receipt, inspection and follow-up.

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Material Procurement and Purchasing Procedure (cont)

Objectives

Material Procurement and Purchasing Procedure (cont)

- Ensure uninterrupted production through timely availability.

Material Procurement and Purchasing Procedure (cont)

- Purchase materials at competitive prices without compromising quality.

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Material Procurement and Purchasing Procedure (cont)

- Maintain optimum inventory and minimise carrying and ordering costs.

Material Procurement and Purchasing Procedure (cont)

- Avoid overstocking, stock-outs, wastage and obsolete inventory.

Material Procurement and Purchasing Procedure (cont)

- Ensure reliable suppliers and proper documentation.

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Material Procurement and Purchasing Procedure (cont)

Purchasing Procedure — Sequence

Material Procurement and Purchasing Procedure (cont)

1. Purchase Requisition: Stores or user department raises a formal request specifying material, quantity, quality and required date.

Material Procurement and Purchasing Procedure (cont)

2. Supplier Enquiry: Obtain quotations, catalogues and terms from potential suppliers.

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Material Procurement and Purchasing Procedure (cont)

3. Quotation Evaluation: Compare price, quality, delivery time, credit terms, reliability and after-sales service.

Material Procurement and Purchasing Procedure (cont)

4. Supplier Selection: Choose the most suitable supplier, not necessarily the lowest-price supplier.

Material Procurement and Purchasing Procedure (cont)

5. Purchase Order (PO): Formal order specifying description, quantity, price, delivery schedule, quality specifications and terms.

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Material Procurement and Purchasing Procedure (cont)

6. Receipt of Materials: Goods Receiving Note (GRN) prepared when materials arrive.

Material Procurement and Purchasing Procedure (cont)

7. Inspection: Verify quantity and quality against the purchase order.

Material Procurement and Purchasing Procedure (cont)

8. Invoice Verification: Match supplier invoice with purchase order and GRN (three-way matching).

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Material Procurement and Purchasing Procedure (cont)

9. Payment: Accounts department processes payment according to agreed terms.

Material Procurement and Purchasing Procedure (cont)

10. Record Maintenance: Update inventory records, supplier records and purchase documentation.

Material Procurement and Purchasing Procedure (cont)

Important Documents

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Material Procurement and Purchasing Procedure (cont)

- Purchase Requisition: Internal request to purchase materials.

Material Procurement and Purchasing Procedure (cont)

- Request for Quotation (RFQ): Invitation to suppliers to submit prices and terms.

Material Procurement and Purchasing Procedure (cont)

- Purchase Order: Authorised order placed with supplier.

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Material Procurement and Purchasing Procedure (cont)

- Goods Received Note (GRN): Record of materials received.

Material Procurement and Purchasing Procedure (cont)

- Inspection Report: Records quality and quantity inspection.

Material Procurement and Purchasing Procedure (cont)

- Material Requisition Note: Authorises issue of materials from stores to production.

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Material Procurement and Purchasing Procedure (cont)

- Material Return Note: Records unused materials returned to stores.

Material Procurement and Purchasing Procedure (cont)

- Bin Card: Quantity-wise record of receipts, issues and balance maintained by the storekeeper.

Material Procurement and Purchasing Procedure (cont)

- Stores Ledger: Quantity and monetary value of material receipts, issues and balances, generally maintained by the cost/accounts department.

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Material Procurement and Purchasing Procedure (cont)

Centralised vs Decentralised Purchasing

Material Procurement and Purchasing Procedure (cont)

- Centralised: Purchases handled by one central department; better bargaining power, standardisation and control.

Material Procurement and Purchasing Procedure (cont)

- Decentralised: Individual departments/locations purchase independently; faster response to local requirements but potentially less purchasing leverage.

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Material Procurement and Purchasing Procedure (cont)

MCQ Traps

Material Procurement and Purchasing Procedure (cont)

- Purchase requisition is an internal document; purchase order is sent to the supplier.

Material Procurement and Purchasing Procedure (cont)

- GRN confirms receipt, not necessarily acceptance after quality inspection.

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Material Procurement and Purchasing Procedure (cont)

- Bin Card records quantities; Stores Ledger records both quantity and value.

Material Procurement and Purchasing Procedure (cont)

- Lowest quotation does not automatically mean the best supplier.

Material Procurement and Purchasing Procedure (cont)

- Three-way matching = Purchase Order + GRN + Supplier Invoice.

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Labour Costing

Time-Rate and Piece-Rate Systems

1. Time-Rate System

Time-Rate and Piece-Rate Systems (cont)

- Wages are paid according to the time spent working, irrespective of the quantity of output produced.

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Time-Rate and Piece-Rate Systems (cont)

- Formula:

Time-Rate and Piece-Rate Systems (cont)

Wages = Time Worked × Wage Rate per Unit of Time.

Time-Rate and Piece-Rate Systems (cont)

- Example: 8 hours × ₹100/hour = ₹800.

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Time-Rate and Piece-Rate Systems (cont)

- Common forms: hourly, daily, weekly and monthly wages.

Time-Rate and Piece-Rate Systems (cont)

- Suitable when:

Time-Rate and Piece-Rate Systems (cont)

- Quality is more important than quantity.

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Time-Rate and Piece-Rate Systems (cont)

- Output cannot be measured accurately.

Time-Rate and Piece-Rate Systems (cont)

- Work requires supervision, precision or teamwork.

Time-Rate and Piece-Rate Systems (cont)

- Advantages:

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Time-Rate and Piece-Rate Systems (cont)

- Stable and predictable earnings.

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Time-Rate and Piece-Rate Systems (cont)

- Better quality focus.

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Time-Rate and Piece-Rate Systems (cont)

- Simple wage calculation.

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Time-Rate and Piece-Rate Systems (cont)

- Limitations:

Time-Rate and Piece-Rate Systems (cont)

- No direct incentive for higher output.

Time-Rate and Piece-Rate Systems (cont)

- Requires supervision to maintain productivity.

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Time-Rate and Piece-Rate Systems (cont)

- Efficient and inefficient workers may receive similar wages for equal time.

Time-Rate and Piece-Rate Systems (cont)

2. Piece-Rate System

Time-Rate and Piece-Rate Systems (cont)

- Wages are paid according to the number of units produced, irrespective of the time taken, subject to applicable wage and labour-law requirements.

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Time-Rate and Piece-Rate Systems (cont)

- Formula:

Time-Rate and Piece-Rate Systems (cont)

Wages = Units Produced × Wage Rate per Unit.

Time-Rate and Piece-Rate Systems (cont)

- Example: 100 units × ₹10/unit = ₹1,000.

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Time-Rate and Piece-Rate Systems (cont)

- Suitable when:

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Time-Rate and Piece-Rate Systems (cont)

- Output is measurable and standardised.

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Time-Rate and Piece-Rate Systems (cont)

- Quality can be checked.

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Time-Rate and Piece-Rate Systems (cont)

- Workers can influence their production rate.

Time-Rate and Piece-Rate Systems (cont)

- Advantages:

Time-Rate and Piece-Rate Systems (cont)

- Direct incentive for higher production.

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Time-Rate and Piece-Rate Systems (cont)

- Encourages productivity.

Time-Rate and Piece-Rate Systems (cont)

- Labour cost per unit is relatively predictable.

Time-Rate and Piece-Rate Systems (cont)

- Limitations:

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Time-Rate and Piece-Rate Systems (cont)

- May compromise quality if poorly designed.

Time-Rate and Piece-Rate Systems (cont)

- Earnings may fluctuate.

Time-Rate and Piece-Rate Systems (cont)

- Less suitable for team-based or complex work.

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Time-Rate and Piece-Rate Systems (cont)

3. Types of Piece-Rate Systems

Time-Rate and Piece-Rate Systems (cont)

- Straight Piece Rate: Fixed payment per unit produced.

Time-Rate and Piece-Rate Systems (cont)

- Differential Piece Rate: Different rates apply depending on whether output reaches or exceeds specified efficiency standards.

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Time-Rate and Piece-Rate Systems (cont)

- Taylor Differential Piece-Rate System: Higher rate for workers meeting or exceeding the standard; lower rate for workers below standard.

Time-Rate and Piece-Rate Systems (cont)

- Merrick Differential Piece-Rate System: Uses multiple efficiency slabs, commonly three rates, to provide a graduated incentive.

Time-Rate and Piece-Rate Systems (cont)

4. Important Differences

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Time-Rate and Piece-Rate Systems (cont)

- Time rate rewards time worked; piece rate rewards output produced.

Time-Rate and Piece-Rate Systems (cont)

- Time rate places more emphasis on quality and stability; piece rate places more emphasis on productivity.

Time-Rate and Piece-Rate Systems (cont)

- Under time rate, total wages generally increase with hours worked.

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Time-Rate and Piece-Rate Systems (cont)

- Under piece rate, total wages generally increase with units produced.

Time-Rate and Piece-Rate Systems (cont)

- Under both systems, employers must comply with applicable minimum-wage and other labour-law requirements.

Time-Rate and Piece-Rate Systems (cont)

MCQ Traps

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Time-Rate and Piece-Rate Systems (cont)

- Time rate does not directly reward additional output.

Time-Rate and Piece-Rate Systems (cont)

- Piece rate does not mean payment is made only for overtime or extra production.

Time-Rate and Piece-Rate Systems (cont)

- Straight piece rate uses one fixed rate per unit.

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Time-Rate and Piece-Rate Systems (cont)

- Differential piece rate uses different rates based on performance/efficiency.

Time-Rate and Piece-Rate Systems (cont)

- Piece-rate workers are not exempt from statutory wage protections.

Time-Rate and Piece-Rate Systems (cont)

- Time-rate wages = time × rate; piece-rate wages = output × rate.

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Incentive Schemes: Halsey, Rowan and Other Plans

Meaning of Wage Incentive Schemes

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Incentive schemes link workers' earnings to productivity or efficiency.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Aim to increase output, reduce production time and improve labour productivity while maintaining quality.

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Commonly involve a guaranteed time wage plus an additional bonus for time saved.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

1. Halsey Premium Plan

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Worker receives guaranteed time wages plus a fixed percentage of the wages corresponding to time saved.

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Common bonus percentage: 50% (Halsey 50% plan).

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

Formula

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Time Saved = Time Allowed − Actual Time Taken.

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Time Wages = Actual Time Taken × Hourly Rate.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Bonus = Time Saved × Hourly Rate × Bonus Percentage.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Total Earnings = Time Wages + Bonus.

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

Example

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Time allowed = 10 hours.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Actual time = 8 hours.

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Wage rate = ₹100/hour.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Bonus percentage = 50%.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Time wages = 8 × ₹100 = ₹800.

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Bonus = 2 × ₹100 × 50% = ₹100.

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Total earnings = ₹900.

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

2. Rowan Premium Plan

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Worker receives time wages plus a bonus based on the proportion of time saved to time allowed.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Bonus increases with time saved but is subject to a ceiling as time saved approaches time allowed.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

Formula

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Bonus = (Time Saved ÷ Time Allowed) × Actual Time Taken × Hourly Rate.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Total Earnings = Time Wages + Bonus.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

Example

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Time allowed = 10 hours.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Actual time = 8 hours.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Wage rate = ₹100/hour.

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Time saved = 2 hours.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Time wages = ₹800.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Bonus = (2 ÷ 10) × 8 × ₹100 = ₹160.

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Total earnings = ₹960.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

3. Halsey vs Rowan

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Halsey bonus depends on a fixed percentage of the wages for time saved.

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Rowan bonus depends on the proportion of time saved to time allowed, multiplied by actual time wages.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- At low levels of time saved, Halsey may provide a higher bonus depending on the agreed Halsey percentage.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Rowan discourages excessive rushing because its bonus is limited by the formula.

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Both guarantee time wages for actual time worked.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

4. Taylor Differential Piece-Rate System

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Two different piece rates are prescribed:

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Lower rate for output below standard.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Higher rate for output at or above standard.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Designed to encourage workers to achieve the production standard.

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- No separate time-saving bonus; incentive comes through differential piece rates.

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

5. Merrick Differential Piece-Rate System

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Uses graduated efficiency slabs rather than only two rates.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Traditional textbook structure:

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Below 83% efficiency: ordinary piece rate.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- 83% to below 100% efficiency: 110% of ordinary piece rate.

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- 100% efficiency and above: 120% of ordinary piece rate.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Exact slab conventions should be followed as stated in the question.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

6. Gantt Task and Bonus Plan

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Combines guaranteed time wages with task-based incentives.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Traditional structure:

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Below standard: guaranteed time wages.

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- At standard: time wages plus a specified bonus.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Above standard: higher earnings through a higher piece rate.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Encourages achievement and surpassing of standard output.

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

7. Emerson Efficiency Plan

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Bonus is linked to the percentage of efficiency achieved.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Guaranteed time wages are generally provided.

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Bonus increases progressively as efficiency improves.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Traditional textbook schedules often begin bonus payments around 66⅔% efficiency, with higher bonus percentages at higher efficiency levels; the exact schedule varies.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

Key Formulas for Numericals

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Efficiency (%) = (Standard Time ÷ Actual Time) × 100.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Time Saved = Standard Time − Actual Time.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Halsey Bonus = Time Saved × Hourly Rate × Bonus Percentage.

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Rowan Bonus = (Time Saved ÷ Standard Time) × Actual Time × Hourly Rate.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Total Earnings under Halsey/Rowan = Actual Time Wages + Bonus.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Halsey: fixed percentage of time saved.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Rowan: time saved as a proportion of time allowed.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Taylor: two differential piece rates.

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Merrick: graduated differential piece rates.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Gantt: guaranteed time wages plus task/bonus and higher piece rate above standard.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Emerson: progressive efficiency-based bonus.

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Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- Efficiency is standard time divided by actual time, not the reverse.

Incentive Schemes: Halsey, Rowan and Other Plans (cont)

- If actual time equals standard time, time saved is zero; Halsey and Rowan time-s-aving bonuses are zero.

Machine-Hour Rate and Departmental Overhead Rates

1. Machine-Hour Rate

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Machine-Hour Rate and Departmental Overhead Rates (cont)

- Machine-Hour Rate = Overhead cost attributable to a machine or group of machines per hour of operation.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Particularly suitable for mechanised industries where machine usage is the major driver of production overhead.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Formula:

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Machine-Hour Rate and Departmental Overhead Rates (cont)

Machine-Hour Rate = Total Machine-R-elated Overheads ÷ Effective Machine Hours.

Machine-Hour Rate and Departmental Overhead Rates (cont)

2. Components of Machine-Hour Rate

Machine-Hour Rate and Departmental Overhead Rates (cont)

Standing Charges / Fixed Charges

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Machine-Hour Rate and Departmental Overhead Rates (cont)

- Rent and rates.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Insurance of machinery.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Depreciation of factory buildings and machinery (where treated as a standing charge).

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Machine-Hour Rate and Departmental Overhead Rates (cont)

- Lighting and supervision costs attributable to the machine.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- These costs generally do not vary directly with machine operating hours.

Machine-Hour Rate and Departmental Overhead Rates (cont)

Machine Expenses / Variable Charges

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Machine-Hour Rate and Departmental Overhead Rates (cont)

- Power consumed.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Lubricants and consumables.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Repairs and maintenance linked to machine operation.

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Machine-Hour Rate and Departmental Overhead Rates (cont)

- Other operating expenses that vary with usage.

Machine-Hour Rate and Departmental Overhead Rates (cont)

3. Important Machine-Hour Rate Calculations

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Effective Machine Hours = Available Working Hours − Normal Idle/Setup Time, as defined in the question.

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Machine-Hour Rate and Departmental Overhead Rates (cont)

- Standing Charge Rate per Hour = Total Standing Charges ÷ Effective Machine Hours.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Variable Machine Expense Rate = Variable Machine Expenses ÷ Machine Hours.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Total Machine-Hour Rate = Standing Charge Rate + Variable Machine Expense Rate.

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Machine-Hour Rate and Departmental Overhead Rates (cont)

- Machine Overhead Absorbed = Machine Hours Worked × Machine-Hour Rate.

Machine-Hour Rate and Departmental Overhead Rates (cont)

4. Comprehensive Machine-Hour Rate — Illustration

Machine-Hour Rate and Departmental Overhead Rates (cont)

Given:

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Machine-Hour Rate and Departmental Overhead Rates (cont)

- Annual standing charges = ₹1,20,000.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Annual machine operating expenses = ₹60,000.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Effective machine hours = 3,000 hours.

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Machine-Hour Rate and Departmental Overhead Rates (cont)

Calculations:

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Standing charge rate = ₹1,20,000 ÷ 3,000 = ₹40/hour.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Variable expense rate = ₹60,000 ÷ 3,000 = ₹20/hour.

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Machine-Hour Rate and Departmental Overhead Rates (cont)

- Total machine-hour rate = ₹60/hour.

Machine-Hour Rate and Departmental Overhead Rates (cont)

If a job uses the machine for 25 hours:

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Machine overhead absorbed = 25 × ₹60 = ₹1,500.

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Machine-Hour Rate and Departmental Overhead Rates (cont)

5. Departmental Overhead Rates

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Departmental Overhead Rate = Separate overhead absorption rate calculated for each department.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Used when departments differ in production methods, machinery, labour intensity or overhead consumption.

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Machine-Hour Rate and Departmental Overhead Rates (cont)

- More accurate than a single blanket rate when overhead patterns differ significantly.

Machine-Hour Rate and Departmental Overhead Rates (cont)

Common Bases

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Machine-intensive department → Machine hours.

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Machine-Hour Rate and Departmental Overhead Rates (cont)

- Labour-intensive department → Direct labour hours.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Department where output is homogeneous → Units produced.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Labour-related overhead → Direct labour cost.

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Machine-Hour Rate and Departmental Overhead Rates (cont)

- Material-related overhead → Direct material cost, where appropriate.

Machine-Hour Rate and Departmental Overhead Rates (cont)

6. Blanket Rate vs Departmental Rate

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Blanket Rate: One absorption rate for the entire factory.

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Machine-Hour Rate and Departmental Overhead Rates (cont)

- Departmental Rate: Different rates for different departments.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Blanket rate is simpler but may distort costs where departments have different cost structures.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Departmental rates improve cost allocation and product-cost accuracy.

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Machine-Hour Rate and Departmental Overhead Rates (cont)

7. Advantages of Machine-Hour Rate

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Suitable for mechanised production.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Reflects machine utilisation.

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Machine-Hour Rate and Departmental Overhead Rates (cont)

- Helps compare machine operating costs.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Supports production planning, pricing and cost control.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Helps identify expensive or underutilised machines.

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Machine-Hour Rate and Departmental Overhead Rates (cont)

8. Limitations

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Calculation can be complex.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Accurate machine-hour records are essential.

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Machine-Hour Rate and Departmental Overhead Rates (cont)

- Idle time and machine breakdown treatment can affect the rate.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Not suitable as the only basis in labour-intensive production.

Machine-Hour Rate and Departmental Overhead Rates (cont)

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Machine-Hour Rate and Departmental Overhead Rates (cont)

- Machine-hour rate = machine overhead per operating hour.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Use effective machine hours, not automatically total calendar hours.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Depreciation and insurance are generally standing charges; power and lubricants are generally machine expenses.

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Machine-Hour Rate and Departmental Overhead Rates (cont)

- A departmental rate is not necessarily a machine-hour rate; the appropriate base depends on the department.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Blanket rate = one factory-wide rate; departmental rate = separate rate for each department.

Machine-Hour Rate and Departmental Overhead Rates (cont)

- Do not double-count machine expenses already included in the departmental overhead pool.

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Under- and Over-Absorption of Overheads

1. Meaning of Overhead Absorption

Under- and Over-Absorption of Overheads (cont)

- Overhead Absorption = Charging overhead costs to products/jobs using a predetermined absorption rate.

Under- and Over-Absorption of Overheads (cont)

- Difference between actual overhead incurred and overhead absorbed results in under-absorption or over-absorption.

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Under- and Over-Absorption of Overheads (cont)

2. Under-Absorption of Overheads

Under- and Over-Absorption of Overheads (cont)

- Under-absorption occurs when overheads absorbed are less than actual overheads incurred.

Under- and Over-Absorption of Overheads (cont)

- Formula:

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Under- and Over-Absorption of Overheads (cont)

Under-Absorption = Actual Overheads − Absorbed Overheads.

Under- and Over-Absorption of Overheads (cont)

- Example:

Under- and Over-Absorption of Overheads (cont)

- Actual overheads = ₹5,00,000.

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Under- and Over-Absorption of Overheads (cont)

- Absorbed overheads = ₹4,50,000.

Under- and Over-Absorption of Overheads (cont)

- Under-absorption = ₹50,000.

Under- and Over-Absorption of Overheads (cont)

Causes

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Under- and Over-Absorption of Overheads (cont)

- Actual overhead expenditure exceeds budget.

Under- and Over-Absorption of Overheads (cont)

- Actual production/activity is lower than budgeted.

Under- and Over-Absorption of Overheads (cont)

- Unexpected increases in electricity, rent, repairs or indirect wages.

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Under- and Over-Absorption of Overheads (cont)

- Inefficient utilisation of production capacity.

Under- and Over-Absorption of Overheads (cont)

- Incorrect estimation of overheads or activity levels.

Under- and Over-Absorption of Overheads (cont)

3. Over-Absorption of Overheads

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Under- and Over-Absorption of Overheads (cont)

- Over-absorption occurs when overheads absorbed exceed actual overheads incurred.

Under- and Over-Absorption of Overheads (cont)

- Formula:

Under- and Over-Absorption of Overheads (cont)

Over-Absorption = Absorbed Overheads − Actual Overheads.

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Under- and Over-Absorption of Overheads (cont)

- Example:

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Under- and Over-Absorption of Overheads (cont)

- Actual overheads = ₹4,50,000.

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Under- and Over-Absorption of Overheads (cont)

- Absorbed overheads = ₹5,00,000.

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Under- and Over-Absorption of Overheads (cont)

- Over-absorption = ₹50,000.

Under- and Over-Absorption of Overheads (cont)

Causes

Under- and Over-Absorption of Overheads (cont)

- Actual overhead expenditure is lower than budgeted.

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Under- and Over-Absorption of Overheads (cont)

- Actual production/activity exceeds budgeted levels.

Under- and Over-Absorption of Overheads (cont)

- Better cost control and operational efficiency.

Under- and Over-Absorption of Overheads (cont)

- Overestimation of overhead expenditure.

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Under- and Over-Absorption of Overheads (cont)

- Underestimation of activity levels.

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Under- and Over-Absorption of Overheads (cont)

4. Accounting Treatment

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Under- and Over-Absorption of Overheads (cont)

A. Supplementary Rate Method

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Under- and Over-Absorption of Overheads (cont)

- Under- or over-absorbed overheads are adjusted against the cost of production, Work-in-Progress (WIP), Finished Goods and Cost of Goods Sold.

Under- and Over-Absorption of Overheads (cont)

- A supplementary rate is calculated to correct the difference.

Under- and Over-Absorption of Overheads (cont)

- Suitable where the difference is material and inventory/cost balances require adjustment.

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Under- and Over-Absorption of Overheads (cont)

B. Costing Profit and Loss Account

Under- and Over-Absorption of Overheads (cont)

- Small or immaterial under-absorption may be written off to the Costing Profit and Loss Account.

Under- and Over-Absorption of Overheads (cont)

- Over-absorption may be credited to the Costing Profit and Loss Account when not adjusted through a supplementary rate.

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Under- and Over-Absorption of Overheads (cont)

- Abnormal or avoidable overheads are generally charged separately to Costing Profit and Loss Account.

Under- and Over-Absorption of Overheads (cont)

C. Carry Forward

Under- and Over-Absorption of Overheads (cont)

- In certain circumstances, under- or over-absorbed overheads may be carried forward to the next accounting period.

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Under- and Over-Absorption of Overheads (cont)

- This is generally appropriate where the difference is temporary and expected to be corrected in the following period.

Under- and Over-Absorption of Overheads (cont)

5. Supplementary Rate

Under- and Over-Absorption of Overheads (cont)

- Supplementary Rate = Under-/Over-Absorbed Overheads ÷ Relevant Actual Activity or Cost Base.

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Under- and Over-Absorption of Overheads (cont)

- For under-absorption, the supplementary rate increases the cost.

Under- and Over-Absorption of Overheads (cont)

- For over-absorption, the supplementary rate reduces the cost.

Under- and Over-Absorption of Overheads (cont)

- The adjustment is distributed among WIP, Finished Goods and Cost of Goods Sold as appropriate.

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Under- and Over-Absorption of Overheads (cont)

6. Important Distinctions

Under- and Over-Absorption of Overheads (cont)

- Under-absorption: actual overheads > absorbed overheads.

Under- and Over-Absorption of Overheads (cont)

- Over-absorption: absorbed overheads > actual overheads.

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Under- and Over-Absorption of Overheads (cont)

- Under-absorption increases the cost of production if adjusted.

Under- and Over-Absorption of Overheads (cont)

- Over-absorption decreases the cost of production if adjusted.

Under- and Over-Absorption of Overheads (cont)

- Under-absorption is not automatically evidence of inefficiency; it may result from lower production or unexpected costs.

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Under- and Over-Absorption of Overheads (cont)

- Over-absorption is not automatically evidence of efficiency; it may result from estimation errors or higher-than-budgeted activity.

Under- and Over-Absorption of Overheads (cont)

MCQ Traps

Under- and Over-Absorption of Overheads (cont)

- Always compare actual overheads with absorbed overheads.

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Under- and Over-Absorption of Overheads (cont)

- Under-absorption = Actual − Absorbed.

Under- and Over-Absorption of Overheads (cont)

- Over-absorption = Absorbed − Actual.

Under- and Over-Absorption of Overheads (cont)

- Supplementary rate corrects the difference in product/job costs.

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Under- and Over-Absorption of Overheads (cont)

- Abnormal idle capacity and abnormal overhead expenditure should not automatically be loaded onto normal production.

Under- and Over-Absorption of Overheads (cont)

- Carry-forward treatment is not a universal default; it depends on the nature of the variance and costing policy.

Absorption of Overheads

1. Meaning

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Absorption of Overheads (cont)

- Overhead Absorption = Charging production overheads to individual products, jobs, processes or cost units.

Absorption of Overheads (cont)

- It takes place after overhead allocation, apportionment and departmental distribution.

Absorption of Overheads (cont)

- Objective: include an appropriate share of indirect production costs in product cost.

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Absorption of Overheads (cont)

- Also called overhead recovery.

Absorption of Overheads (cont)

2. Overhead Absorption Rate (OAR)

Absorption of Overheads (cont)

- Overhead Absorption Rate = Budgeted/-Allocated Overheads ÷ Budgeted Activity.

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Absorption of Overheads (cont)

- The activity base may be labour hours, machine hours, direct labour cost, direct material cost or units produced.

Absorption of Overheads (cont)

- Overhead Absorbed = Actual Activity × Predetermined Overhead Absorption Rate.

Absorption of Overheads (cont)

3. Methods of Overhead Absorption

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Absorption of Overheads (cont)

A. Direct Material Cost Percentage Method

Absorption of Overheads (cont)

- Rate = (Factory Overheads ÷ Direct Material Cost) × 100.

Absorption of Overheads (cont)

- Suitable where overheads are closely related to material value.

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Absorption of Overheads (cont)

- Limitation: material prices may fluctuate independently of overhead consumption.

Absorption of Overheads (cont)

B. Direct Labour Cost Percentage Method

Absorption of Overheads (cont)

- Rate = (Factory Overheads ÷ Direct Labour Cost) × 100.

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Absorption of Overheads (cont)

- Suitable where production is labour-intensive and overheads are related to labour expenditure.

Absorption of Overheads (cont)

- Limitation: differences in wage rates can distort overhead absorption.

Absorption of Overheads (cont)

C. Prime Cost Percentage Method

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Absorption of Overheads (cont)

- Rate = (Factory Overheads ÷ Prime Cost) × 100.

Absorption of Overheads (cont)

- Prime Cost = Direct Material + Direct Labour + Direct Expenses.

Absorption of Overheads (cont)

- Simple method but may not accurately reflect actual overhead consumption.

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Absorption of Overheads (cont)

D. Direct Labour Hour Rate Method

Absorption of Overheads (cont)

- Rate = Factory Overheads ÷ Budgeted Direct Labour Hours.

Absorption of Overheads (cont)

- Overhead absorbed = Actual Labour Hours × Rate.

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Absorption of Overheads (cont)

- Suitable for labour-intensive production.

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Absorption of Overheads (cont)

E. Machine Hour Rate Method

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Absorption of Overheads (cont)

- Rate = Machine-related Overheads ÷ Machine Hours.

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Absorption of Overheads (cont)

- Overhead absorbed = Actual Machine Hours × Machine Hour Rate.

Absorption of Overheads (cont)

- Suitable for mechanised production.

Absorption of Overheads (cont)

F. Unit of Production Method

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Absorption of Overheads (cont)

- Rate = Factory Overheads ÷ Budgeted Units Produced.

Absorption of Overheads (cont)

- Overhead absorbed = Units Produced × Rate.

Absorption of Overheads (cont)

- Suitable for homogeneous products produced in large quantities.

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Absorption of Overheads (cont)

4. Predetermined vs Actual Overhead Rate

Absorption of Overheads (cont)

- Predetermined Rate: Calculated before the accounting period using budgeted overhead and activity.

Absorption of Overheads (cont)

- Actual Rate: Calculated after the period using actual overhead and actual activity.

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Absorption of Overheads (cont)

- Predetermined rates enable timely costing and pricing.

Absorption of Overheads (cont)

- Actual rates reflect actual expenditure but are known only after the period.

Absorption of Overheads (cont)

5. Blanket Rate vs Departmental Rate

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Absorption of Overheads (cont)

- Blanket Rate: One overhead absorption rate for the entire factory.

Absorption of Overheads (cont)

- Departmental Rate: Separate absorption rates for different departments.

Absorption of Overheads (cont)

- Blanket rate is simpler but may distort product costs when departments have different processes or machinery.

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Absorption of Overheads (cont)

- Departmental rates generally provide more accurate product costing.

Absorption of Overheads (cont)

6. Important Formula Relationships

Absorption of Overheads (cont)

- Total Overhead Absorbed = Absorption Rate × Actual Activity.

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Absorption of Overheads (cont)

- Under a machine-hour rate system, activity = machine hours.

Absorption of Overheads (cont)

- Under a labour-hour rate system, activity = labour hours.

Absorption of Overheads (cont)

- Cost of Production = Prime Cost + Factory Overheads Absorbed + Relevant Production Administration Overheads.

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Absorption of Overheads (cont)

MCQ Traps

Absorption of Overheads (cont)

- Allocation and apportionment distribute overheads among cost centres; absorption charges overheads to cost units.

Absorption of Overheads (cont)

- Predetermined rates use budgeted overhead and budgeted activity.

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Absorption of Overheads (cont)

- Actual activity is multiplied by the predetermined rate to calculate overhead absorbed.

Absorption of Overheads (cont)

- Machine-hour rate is especially appropriate for mechanised production.

Absorption of Overheads (cont)

- Labour-hour rate is especially appropriate for labour-intensive production.

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Absorption of Overheads (cont)

- Blanket rate uses one factory-wide rate; departmental rates use separate rates.

Absorption of Overheads (cont)

- Do not confuse overhead incurred with overhead absorbed.

Primary and Secondary Distribution of Overheads

1. Primary Distribution

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Primary and Secondary Distribution of Overheads (cont)

- Primary Distribution = Initial allocation and apportionment of overheads among all production and service departments.

Primary and Secondary Distribution of Overheads (cont)

- Directly identifiable overheads are allocated to the relevant department.

Primary and Secondary Distribution of Overheads (cont)

- Common overheads are apportioned using suitable bases.

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Primary and Secondary Distribution of Overheads (cont)

- Objective: determine the total overhead cost of each department before redistributing service department costs.

Primary and Secondary Distribution of Overheads (cont)

Example

Primary and Secondary Distribution of Overheads (cont)

- Factory rent → apportioned based on floor area.

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Primary and Secondary Distribution of Overheads (cont)

- Canteen expenses → apportioned based on number of employees.

Primary and Secondary Distribution of Overheads (cont)

- Machinery depreciation → allocated to the department using the machinery, if exclusively identifiable.

Primary and Secondary Distribution of Overheads (cont)

2. Secondary Distribution

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Primary and Secondary Distribution of Overheads (cont)

- Secondary Distribution = Redistribution of service department overheads to production departments and, where applicable, other service departments.

Primary and Secondary Distribution of Overheads (cont)

- Objective: transfer service department costs to the departments ultimately benefiting from those services.

Primary and Secondary Distribution of Overheads (cont)

- After secondary distribution, production departments carry the overheads to be absorbed into products/jobs.

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Primary and Secondary Distribution of Overheads (cont)

Example

Primary and Secondary Distribution of Overheads (cont)

- Maintenance Department provides services to Production Departments A and B.

Primary and Secondary Distribution of Overheads (cont)

- Its overheads are redistributed between A and B based on maintenance hours consumed.

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Primary and Secondary Distribution of Overheads (cont)

- Canteen expenses may be redistributed based on the number of employees in each department.

Primary and Secondary Distribution of Overheads (cont)

3. Methods of Secondary Distribution

Primary and Secondary Distribution of Overheads (cont)

A. Direct Redistribution Method

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Primary and Secondary Distribution of Overheads (cont)

- Service department costs are distributed directly to production departments.

Primary and Secondary Distribution of Overheads (cont)

- Ignores services provided by one service department to another.

Primary and Secondary Distribution of Overheads (cont)

- Simple and easy to apply.

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Primary and Secondary Distribution of Overheads (cont)

- Suitable when inter-service department services are insignificant.

Primary and Secondary Distribution of Overheads (cont)

B. Step-Down Method / Sequential Distribution Method

Primary and Secondary Distribution of Overheads (cont)

- Service department costs are redistributed sequentially.

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Primary and Secondary Distribution of Overheads (cont)

- Recognises some services provided by one service department to another.

Primary and Secondary Distribution of Overheads (cont)

- Once a service department's cost has been fully distributed, it is not reopened for further allocation.

Primary and Secondary Distribution of Overheads (cont)

- The sequence of distribution affects the result.

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Primary and Secondary Distribution of Overheads (cont)

- Suitable when reciprocal services exist but a simpler method is preferred.

Primary and Secondary Distribution of Overheads (cont)

C. Reciprocal Service Methods

Primary and Secondary Distribution of Overheads (cont)

- Recognise services exchanged between service departments.

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Primary and Secondary Distribution of Overheads (cont)

- Two major methods:

Primary and Secondary Distribution of Overheads (cont)

- Repeated Distribution Method: Repeatedly distributes service department costs among other service and production departments until the remaining balance becomes negligible.

Primary and Secondary Distribution of Overheads (cont)

- Simultaneous Equation Method: Uses simultaneous equations to determine the fully loaded costs of service departments after considering reciprocal services.

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Primary and Secondary Distribution of Overheads (cont)

4. Simultaneous Equation Method — Basic Illustration

Primary and Secondary Distribution of Overheads (cont)

- Service Department S1 has its own overhead of ₹10,000.

Primary and Secondary Distribution of Overheads (cont)

- Service Department S2 has its own overhead of ₹8,000.

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Primary and Secondary Distribution of Overheads (cont)

- S1 receives 20% of services from S2.

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Primary and Secondary Distribution of Overheads (cont)

- S2 receives 10% of services from S1.

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Primary and Secondary Distribution of Overheads (cont)

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Primary and Secondary Distribution of Overheads (cont)

- S1 = Total cost of S1 after receiving reciprocal services.

Primary and Secondary Distribution of Overheads (cont)

- S2 = Total cost of S2 after receiving reciprocal services.

Primary and Secondary Distribution of Overheads (cont)

Equations:

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Primary and Secondary Distribution of Overheads (cont)

- S1 = ₹10,000 + 10% of S2.

Primary and Secondary Distribution of Overheads (cont)

- S2 = ₹8,000 + 20% of S1.

Primary and Secondary Distribution of Overheads (cont)

Solve both equations to obtain the fully loaded service department costs. These are then distributed to production departments using appropriate service-consumption bases.

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Primary and Secondary Distribution of Overheads (cont)

5. Important Distinctions

Primary and Secondary Distribution of Overheads (cont)

- Primary distribution: distributes overheads among production and service departments.

Primary and Secondary Distribution of Overheads (cont)

- Secondary distribution: redistributes service department costs.

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Primary and Secondary Distribution of Overheads (cont)

- Direct method: ignores inter-service department services.

Primary and Secondary Distribution of Overheads (cont)

- Step-down method: recognises partial inter-service department services.

Primary and Secondary Distribution of Overheads (cont)

- Reciprocal methods: recognise mutual services completely.

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Primary and Secondary Distribution of Overheads (cont)

- Production department overheads after secondary distribution form the basis for overhead absorption.

Primary and Secondary Distribution of Overheads (cont)

MCQ Traps

Primary and Secondary Distribution of Overheads (cont)

- Primary distribution comes before secondary distribution.

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Primary and Secondary Distribution of Overheads (cont)

- Secondary distribution is not simply another name for apportioning factory rent.

Primary and Secondary Distribution of Overheads (cont)

- Direct method ignores reciprocal services.

Primary and Secondary Distribution of Overheads (cont)

- Step-down method is sequential and does not reopen a department after its cost has been distributed.

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Primary and Secondary Distribution of Overheads (cont)

- Simultaneous equations and repeated distribution recognise reciprocal services.

Primary and Secondary Distribution of Overheads (cont)

- Under the simultaneous equation method, service department costs include the value of services received from other service departments.

Allocation and Apportionment of Overheads

1. Meaning of Allocation

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Allocation and Apportionment of Overheads (cont)

- Allocation = Charging the whole amount of an overhead cost directly to a specific cost centre or cost object.

Allocation and Apportionment of Overheads (cont)

- Used when the cost can be clearly identified with one department or cost centre.

Allocation and Apportionment of Overheads (cont)

- Examples:

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Allocation and Apportionment of Overheads (cont)

- Salary of a supervisor exclusively managing Department A.

Allocation and Apportionment of Overheads (cont)

- Depreciation of machinery exclusively used by Department B.

Allocation and Apportionment of Overheads (cont)

- Department-specific insurance.

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Allocation and Apportionment of Overheads (cont)

2. Meaning of Apportionment

Allocation and Apportionment of Overheads (cont)

- Apportionment = Distribution of a common overhead among two or more cost centres on a fair and reasonable basis.

Allocation and Apportionment of Overheads (cont)

- Used when an expense benefits multiple departments and cannot be directly allocated to one.

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Allocation and Apportionment of Overheads (cont)

- Examples:

Allocation and Apportionment of Overheads (cont)

- Factory rent shared by departments.

Allocation and Apportionment of Overheads (cont)

- Factory electricity shared by multiple departments.

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Allocation and Apportionment of Overheads (cont)

- Insurance covering the entire factory building.

Allocation and Apportionment of Overheads (cont)

3. Common Bases of Apportionment

Allocation and Apportionment of Overheads (cont)

- Floor Area: Factory rent, building insurance, lighting where area is relevant.

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Allocation and Apportionment of Overheads (cont)

- Capital Value of Assets: Insurance of machinery/buildings, depreciation where appropriate.

Allocation and Apportionment of Overheads (cont)

- Machine Hours: Machine-related expenses, power where machine usage is a suitable driver.

Allocation and Apportionment of Overheads (cont)

- Number of Workers: Welfare expenses, canteen expenses, personnel-related costs.

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Allocation and Apportionment of Overheads (cont)

- Labour Hours: Indirect labour or expenses linked to labour activity.

Allocation and Apportionment of Overheads (cont)

- Wages / Labour Cost: Employee-related overheads where wage cost reflects resource usage.

Allocation and Apportionment of Overheads (cont)

- Value of Materials: Material handling and purchasing-related expenses where appropriate.

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Allocation and Apportionment of Overheads (cont)

- Units Produced: Production-related overheads when output is a suitable allocation driver.

Allocation and Apportionment of Overheads (cont)

- Horsepower / Kilowatt Usage: Power expenses where electricity consumption is linked to equipment capacity or usage.

Allocation and Apportionment of Overheads (cont)

4. Principles for Selecting an Apportionment Basis

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Allocation and Apportionment of Overheads (cont)

- Cause-and-Effect Principle: Allocate overhead according to the factor causing the cost.

Allocation and Apportionment of Overheads (cont)

- Benefits-Received Principle: Allocate according to the benefit received by each department.

Allocation and Apportionment of Overheads (cont)

- Fairness / Equity Principle: Distribute costs fairly among cost centres.

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Allocation and Apportionment of Overheads (cont)

- Ability-to-Bear Principle: Costs may be distributed according to the capacity of departments/products to bear them, where appropriate.

Allocation and Apportionment of Overheads (cont)

5. Allocation vs Apportionment

Allocation and Apportionment of Overheads (cont)

- Allocation: Entire identifiable cost assigned to one cost centre.

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Allocation and Apportionment of Overheads (cont)

- Apportionment: Common cost distributed among several cost centres.

Allocation and Apportionment of Overheads (cont)

- Allocation generally involves direct identification.

Allocation and Apportionment of Overheads (cont)

- Apportionment requires a reasonable basis or allocation factor.

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Allocation and Apportionment of Overheads (cont)

- Both are steps in overhead distribution before absorption into products/jobs.

Allocation and Apportionment of Overheads (cont)

6. Primary Distribution

Allocation and Apportionment of Overheads (cont)

- Primary Distribution = Initial allocation and apportionment of overheads among all departments.

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Allocation and Apportionment of Overheads (cont)

- Departments are classified as:

Allocation and Apportionment of Overheads (cont)

- Production Departments: Directly involved in manufacturing.

Allocation and Apportionment of Overheads (cont)

- Service Departments: Provide support to production or other service departments.

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Allocation and Apportionment of Overheads (cont)

- Examples of service departments: maintenance, stores, canteen, power house and personnel.

Allocation and Apportionment of Overheads (cont)

- After primary distribution, each department has its share of overheads.

Allocation and Apportionment of Overheads (cont)

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Allocation and Apportionment of Overheads (cont)

- Allocation = whole cost to one cost centre.

Allocation and Apportionment of Overheads (cont)

- Apportionment = common cost distributed among cost centres.

Allocation and Apportionment of Overheads (cont)

- Rent is commonly apportioned by floor area.

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Allocation and Apportionment of Overheads (cont)

- Canteen expenses may be apportioned by number of employees.

Allocation and Apportionment of Overheads (cont)

- Machine-related costs may be apportioned by machine hours.

Allocation and Apportionment of Overheads (cont)

- Basis must reflect the nature of the expense; there is no universal basis for every overhead.

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Allocation and Apportionment of Overheads (cont)

- Primary distribution covers both production and service departments; it is not limited to production departments.

Types of Overheads

Factory, Administration, Selling and Distribution Overheads

Types of Overheads (cont)

1. Factory / Production Overheads

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Types of Overheads (cont)

- Indirect costs incurred within the manufacturing or production function.

Types of Overheads (cont)

- Also called works overheads or manufacturing overheads.

Types of Overheads (cont)

- Examples:

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Types of Overheads (cont)

- Factory rent, rates and insurance.

Types of Overheads (cont)

- Depreciation of factory buildings and machinery.

Types of Overheads (cont)

- Factory electricity, lighting and heating.

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Types of Overheads (cont)

- Repairs and maintenance of machinery.

Types of Overheads (cont)

- Salaries of factory supervisors and foremen.

Types of Overheads (cont)

- Indirect materials such as lubricants and cleaning supplies.

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Types of Overheads (cont)

- Indirect factory labour such as maintenance staff and storekeepers.

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Types of Overheads (cont)

- Factory overheads are added to Prime Cost to determine Factory/Works Cost.

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Types of Overheads (cont)

2. Administration Overheads

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Types of Overheads (cont)

- Costs incurred in formulating policies, directing and controlling the organisation and administering its general operations.

Types of Overheads (cont)

- Examples:

Types of Overheads (cont)

- Head-office rent and electricity.

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Types of Overheads (cont)

- Salaries of administrative staff and senior management.

Types of Overheads (cont)

- Audit, legal and professional fees.

Types of Overheads (cont)

- Office stationery and communication expenses.

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Types of Overheads (cont)

- Depreciation of office equipment.

Types of Overheads (cont)

- Production-related administration overheads may be included in production cost where appropriate.

Types of Overheads (cont)

- General administration overheads are generally treated as period costs.

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Types of Overheads (cont)

3. Selling Overheads

Types of Overheads (cont)

- Costs incurred to create demand, promote products and secure customer orders.

Types of Overheads (cont)

- Examples:

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Types of Overheads (cont)

- Advertising and publicity.

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Types of Overheads (cont)

- Sales promotion campaigns.

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Types of Overheads (cont)

- Sales commission.

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Types of Overheads (cont)

- Salaries of sales representatives.

Types of Overheads (cont)

- Market research and selling-related expenses.

Types of Overheads (cont)

- Sales department rent and expenses.

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Types of Overheads (cont)

- Selling overheads relate to obtaining sales, not physically delivering goods.

Types of Overheads (cont)

4. Distribution Overheads

Types of Overheads (cont)

- Costs incurred in storing, handling and delivering finished products to customers.

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Types of Overheads (cont)

- Examples:

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Types of Overheads (cont)

- Finished goods warehouse rent.

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Types of Overheads (cont)

- Carriage outward and delivery expenses.

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Types of Overheads (cont)

- Delivery vehicle depreciation, fuel and maintenance.

Types of Overheads (cont)

- Packing for transportation.

Types of Overheads (cont)

- Loading, unloading and handling of finished goods.

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Types of Overheads (cont)

- Distribution staff salaries.

Types of Overheads (cont)

- Distribution overheads relate to making goods available to customers after production.

Types of Overheads (cont)

5. Treatment in Cost Sheet

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Types of Overheads (cont)

- Prime Cost = Direct Material + Direct Labour + Direct Expenses.

Types of Overheads (cont)

- Factory Cost = Prime Cost + Factory Overheads + Opening Work-in-Progress − Closing Work-in-Progress.

Types of Overheads (cont)

- Cost of Production = Factory Cost + Production Administration Overheads.

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Types of Overheads (cont)

- Cost of Sales = Cost of Goods Sold + Selling and Distribution Overheads + relevant general administration overheads not included earlier.

Types of Overheads (cont)

- Avoid double-counting overheads already included in an earlier cost stage.

Types of Overheads (cont)

6. Important Classification Traps

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Types of Overheads (cont)

- Carriage inward = direct material cost/p-rocurement cost.

Types of Overheads (cont)

- Carriage outward = distribution overhead.

Types of Overheads (cont)

- Advertising = selling overhead.

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Types of Overheads (cont)

- Finished goods warehouse rent = distribution overhead.

Types of Overheads (cont)

- Raw material store expenses = generally factory overhead.

Types of Overheads (cont)

- Factory supervisor salary = factory overhead.

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Types of Overheads (cont)

- Office manager salary = administration overhead.

Types of Overheads (cont)

- Depreciation of factory machinery = factory overhead.

Types of Overheads (cont)

- Depreciation of sales vehicles = distribution overhead.

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Types of Overheads (cont)

- Packing for product protection may be production-related; packing for delivery is distribution-related.

Types of Overheads (cont)

- Classification depends on the purpose and function of the expenditure, not merely its name.

Meaning and Classification of Overheads

Meaning

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Meaning and Classification of Overheads (cont)

- Overheads = Aggregate of indirect material, indirect labour and indirect expenses incurred in connection with production, administration, selling or distribution.

Meaning and Classification of Overheads (cont)

- Overheads are costs that cannot be conveniently and economically traced to a specific cost unit.

Meaning and Classification of Overheads (cont)

- Also called indirect costs.

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Meaning and Classification of Overheads (cont)

- Examples: factory rent, supervisor salary, electricity, depreciation, office expenses and advertising.

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Meaning and Classification of Overheads (cont)

Elements of Overheads

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Meaning and Classification of Overheads (cont)

- Indirect Material: Materials not directly traceable to a product.

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Meaning and Classification of Overheads (cont)

- Lubricants, cleaning materials, cotton waste, small tools.

Meaning and Classification of Overheads (cont)

- Indirect Labour: Employee costs not directly traceable to a product.

Meaning and Classification of Overheads (cont)

- Factory supervisors, maintenance workers, storekeepers.

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Meaning and Classification of Overheads (cont)

- Indirect Expenses: Expenses other than indirect material and labour.

Meaning and Classification of Overheads (cont)

- Factory rent, insurance, depreciation, electricity.

Meaning and Classification of Overheads (cont)

1. Classification by Function

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Meaning and Classification of Overheads (cont)

- Factory/Production Overheads: Indirect costs incurred in manufacturing.

Meaning and Classification of Overheads (cont)

- Factory rent, machinery depreciation, factory power, repairs, indirect wages.

Meaning and Classification of Overheads (cont)

- Administration Overheads: Costs of general administration and management.

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Meaning and Classification of Overheads (cont)

- Office salaries, office rent, audit fees, office stationery.

Meaning and Classification of Overheads (cont)

- Selling Overheads: Costs incurred to create demand and secure sales.

Meaning and Classification of Overheads (cont)

- Advertising, sales commission, sales promotion, sales staff salaries.

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Meaning and Classification of Overheads (cont)

- Distribution Overheads: Costs incurred in storing and delivering finished goods.

Meaning and Classification of Overheads (cont)

- Warehouse expenses, carriage outward, delivery vehicle expenses, packing for delivery.

Meaning and Classification of Overheads (cont)

2. Classification by Behaviour

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Meaning and Classification of Overheads (cont)

- Fixed Overheads: Remain constant in total within a relevant range over a specified period.

Meaning and Classification of Overheads (cont)

- Factory rent, fixed salaries, insurance.

Meaning and Classification of Overheads (cont)

- Fixed cost per unit decreases as output increases.

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Meaning and Classification of Overheads (cont)

- Variable Overheads: Change in total in proportion to activity/output.

Meaning and Classification of Overheads (cont)

- Indirect materials, certain power and consumable costs.

Meaning and Classification of Overheads (cont)

- Variable cost per unit remains broadly constant.

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Meaning and Classification of Overheads (cont)

- Semi-variable/Semi-fixed Overheads: Contain both fixed and variable components.

Meaning and Classification of Overheads (cont)

- Electricity bills with fixed charges plus usage charges.

Meaning and Classification of Overheads (cont)

- Maintenance costs with a fixed base and activity-related component.

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Meaning and Classification of Overheads (cont)

3. Classification by Element

Meaning and Classification of Overheads (cont)

- Indirect Material Overheads.

Meaning and Classification of Overheads (cont)

- Indirect Labour Overheads.

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Meaning and Classification of Overheads (cont)

- Indirect Expenses.

Meaning and Classification of Overheads (cont)

4. Other Classifications

Meaning and Classification of Overheads (cont)

- Controllable Overheads: Can be influenced by a particular manager within their authority and time horizon.

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Meaning and Classification of Overheads (cont)

- Uncontrollable Overheads: Cannot be significantly influenced by that manager.

Meaning and Classification of Overheads (cont)

- Normal Overheads: Expected under normal operating conditions.

Meaning and Classification of Overheads (cont)

- Abnormal Overheads: Arise from unusual or abnormal events; generally excluded from normal product cost and separately charged.

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Meaning and Classification of Overheads (cont)

- Directly Identifiable vs Common Overheads: Some overheads are traceable to a particular department; others are shared among departments.

Meaning and Classification of Overheads (cont)

5. Important Cost Concepts

Meaning and Classification of Overheads (cont)

- Cost Allocation: Assigning an entire cost directly to a specific cost centre or cost object.

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Meaning and Classification of Overheads (cont)

- Cost Apportionment: Distributing a common cost among multiple cost centres using a suitable basis.

Meaning and Classification of Overheads (cont)

- Overhead Absorption: Charging overheads to products, jobs or cost units using an absorption rate.

Meaning and Classification of Overheads (cont)

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Meaning and Classification of Overheads (cont)

- Overheads consist of indirect material + indirect labour + indirect expenses.

Meaning and Classification of Overheads (cont)

- Factory supervisor salary = factory overhead, not direct labour.

Meaning and Classification of Overheads (cont)

- Carriage inward = direct material procurement cost; carriage outward = distribution overhead.

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Meaning and Classification of Overheads (cont)

- Advertising = selling overhead.

Meaning and Classification of Overheads (cont)

- Warehouse expenses for finished goods = distribution overhead.

Meaning and Classification of Overheads (cont)

- Factory power = production overhead.

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Meaning and Classification of Overheads (cont)

- Fixed overhead is fixed in total, not per unit.

Meaning and Classification of Overheads (cont)

- Variable overhead is variable in total, not necessarily per unit.

Meaning and Classification of Overheads (cont)

- Allocation means assigning an entire identifiable cost; apportionment means sharing a common cost.

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Overheads

Wage Calculations and Labour-Cost Control

1. Basic Wage Calculations

Wage Calculations and Labour-Cost Control (cont)

- Time Wages = Hours Worked × Hourly Wage Rate.

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Wage Calculations and Labour-Cost Control (cont)

- Daily Wages = Days Worked × Daily Wage Rate.

Wage Calculations and Labour-Cost Control (cont)

- Piece Wages = Units Produced × Rate per Unit.

Wage Calculations and Labour-Cost Control (cont)

- Gross Wages = Basic Wages + Allowances + Incentives + Overtime Earnings.

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Wage Calculations and Labour-Cost Control (cont)

- Net Wages = Gross Wages − Employee Deductions.

Wage Calculations and Labour-Cost Control (cont)

- Employer's total labour cost may additionally include employer contributions to statutory benefits and other employment-related costs.

Wage Calculations and Labour-Cost Control (cont)

2. Important Wage Calculation Formulas

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Wage Calculations and Labour-Cost Control (cont)

- Hourly Wage Rate = Daily Wage ÷ Normal Working Hours.

Wage Calculations and Labour-Cost Control (cont)

- Labour Cost per Unit = Total Labour Cost ÷ Units Produced.

Wage Calculations and Labour-Cost Control (cont)

- Labour Productivity = Units Produced ÷ Labour Hours Worked.

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Wage Calculations and Labour-Cost Control (cont)

- Labour Cost per Hour = Total Labour Cost ÷ Productive Labour Hours.

Wage Calculations and Labour-Cost Control (cont)

- Labour Cost as % of Sales = (Total Labour Cost ÷ Sales) × 100.

Wage Calculations and Labour-Cost Control (cont)

- Labour Cost as % of Total Cost = (Total Labour Cost ÷ Total Cost) × 100.

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Wage Calculations and Labour-Cost Control (cont)

3. Labour Efficiency and Variance Analysis

Wage Calculations and Labour-Cost Control (cont)

- Standard Hours = Hours that should be taken for actual output.

Wage Calculations and Labour-Cost Control (cont)

- Actual Hours = Hours actually worked.

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Wage Calculations and Labour-Cost Control (cont)

- Standard Rate = Predetermined wage rate per hour.

Wage Calculations and Labour-Cost Control (cont)

- Actual Rate = Actual labour cost per hour.

Wage Calculations and Labour-Cost Control (cont)

Labour Cost Variances

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Wage Calculations and Labour-Cost Control (cont)

- Labour Cost Variance (LCV) = Standard Labour Cost − Actual Labour Cost.

Wage Calculations and Labour-Cost Control (cont)

- Labour Rate Variance (LRV) = Actual Hours × (Standard Rate − Actual Rate).

Wage Calculations and Labour-Cost Control (cont)

- Labour Efficiency Variance (LEV) = Standard Rate × (Standard Hours − Actual Hours).

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Wage Calculations and Labour-Cost Control (cont)

- Labour Cost Variance = Labour Rate Variance + Labour Efficiency Variance.

Wage Calculations and Labour-Cost Control (cont)

Interpretation:

Wage Calculations and Labour-Cost Control (cont)

- Favourable variance: actual cost is lower than standard cost.

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Wage Calculations and Labour-Cost Control (cont)

- Adverse variance: actual cost is higher than standard cost.

Wage Calculations and Labour-Cost Control (cont)

- A favourable rate variance may arise from hiring lower-paid workers, but could be accompanied by adverse efficiency or quality outcomes.

Wage Calculations and Labour-Cost Control (cont)

4. Labour Productivity

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Wage Calculations and Labour-Cost Control (cont)

- Labour Productivity = Output ÷ Labour Input.

Wage Calculations and Labour-Cost Control (cont)

- Labour input may be measured in labour hours, worker-days or number of employees.

Wage Calculations and Labour-Cost Control (cont)

- Higher productivity means more output per unit of labour input.

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Wage Calculations and Labour-Cost Control (cont)

- Productivity can improve through training, technology, better workflow, motivation and reduced idle time.

Wage Calculations and Labour-Cost Control (cont)

5. Methods of Labour Time Recording

Wage Calculations and Labour-Cost Control (cont)

- Attendance Time Recording: records when workers enter and leave the workplace.

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Wage Calculations and Labour-Cost Control (cont)

- Job Time Recording: records time spent on individual jobs or operations.

Wage Calculations and Labour-Cost Control (cont)

- Time Card/Clock Card: records attendance and working hours.

Wage Calculations and Labour-Cost Control (cont)

- Job Card/Time Sheet: records time spent on specific jobs.

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Wage Calculations and Labour-Cost Control (cont)

- Idle Time Report: identifies and records unproductive paid time.

Wage Calculations and Labour-Cost Control (cont)

- Overtime Authorisation: documents approved overtime work.

Wage Calculations and Labour-Cost Control (cont)

6. Labour-Cost Control Techniques

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Wage Calculations and Labour-Cost Control (cont)

- Time and Motion Study: determines efficient methods and standard time for performing tasks.

Wage Calculations and Labour-Cost Control (cont)

- Work Study: systematic examination of work methods and time requirements.

Wage Calculations and Labour-Cost Control (cont)

- Method Study: identifies the most efficient way to perform work.

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Wage Calculations and Labour-Cost Control (cont)

- Work Measurement: determines the time required by a qualified worker at a defined performance level.

Wage Calculations and Labour-Cost Control (cont)

- Standard Costing: compares actual labour costs with predetermined standards.

Wage Calculations and Labour-Cost Control (cont)

- Budgetary Control: compares actual labour expenditure with budgeted expenditure.

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Wage Calculations and Labour-Cost Control (cont)

- Incentive Schemes: reward productivity and efficiency.

Wage Calculations and Labour-Cost Control (cont)

- Labour Turnover Control: reduces recruitment and training costs.

Wage Calculations and Labour-Cost Control (cont)

- Idle Time and Overtime Control: improves workforce utilisation.

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Wage Calculations and Labour-Cost Control (cont)

- Training and Skill Development: improves efficiency and reduces defects.

Wage Calculations and Labour-Cost Control (cont)

7. Important Labour-Cost Concepts

Wage Calculations and Labour-Cost Control (cont)

- Labour Utilisation Ratio = (Actual Productive Hours ÷ Total Available Hours) × 100.

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Wage Calculations and Labour-Cost Control (cont)

- Labour Efficiency Ratio = (Standard Hours for Actual Output ÷ Actual Hours) × 100.

Wage Calculations and Labour-Cost Control (cont)

- Labour Activity Ratio = (Standard Hours for Actual Output ÷ Budgeted Hours) × 100.

Wage Calculations and Labour-Cost Control (cont)

- Idle Time Ratio = (Idle Hours ÷ Total Available Hours) × 100.

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Wage Calculations and Labour-Cost Control (cont)

MCQ Traps

Wage Calculations and Labour-Cost Control (cont)

- Attendance records show time present; job cards show time spent on specific work.

Wage Calculations and Labour-Cost Control (cont)

- Method study focuses on how work is performed; work measurement focuses on how long it should take.

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Wage Calculations and Labour-Cost Control (cont)

- Labour rate variance relates to wage-rate differences.

Wage Calculations and Labour-Cost Control (cont)

- Labour efficiency variance relates to time taken compared with standard time.

Wage Calculations and Labour-Cost Control (cont)

- Labour cost variance = rate variance + efficiency variance.

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Wage Calculations and Labour-Cost Control (cont)

- Labour efficiency ratio uses standard hours for actual output, not budgeted output.

Wage Calculations and Labour-Cost Control (cont)

- Productive hours exclude idle hours.

Wage Calculations and Labour-Cost Control (cont)

- A favourable labour rate variance does not automatically mean overall labour performance is favourable.

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Direct and Indirect Labour

1. Direct Labour

Direct and Indirect Labour (cont)

- Labour that can be conveniently and economically identified with a specific product, job, process or cost unit.

Direct and Indirect Labour (cont)

- Directly involved in converting raw materials into finished goods or delivering a service.

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Direct and Indirect Labour (cont)

- Forms part of Prime Cost.

Direct and Indirect Labour (cont)

- Examples:

Direct and Indirect Labour (cont)

- Wages of machine operators manufacturing a specific product.

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Direct and Indirect Labour (cont)

- Wages of assembly-line workers.

Direct and Indirect Labour (cont)

- Wages of workers directly constructing a building.

Direct and Indirect Labour (cont)

- Wages of carpenters making a specific furniture order.

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Direct and Indirect Labour (cont)

2. Indirect Labour

Direct and Indirect Labour (cont)

- Labour that cannot be conveniently and economically traced to a specific product or cost unit.

Direct and Indirect Labour (cont)

- Supports production or business operations rather than directly manufacturing a particular product.

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Direct and Indirect Labour (cont)

- Treated as Overhead Cost.

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Direct and Indirect Labour (cont)

- Examples:

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Direct and Indirect Labour (cont)

- Factory supervisors.

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Direct and Indirect Labour (cont)

- Maintenance workers.

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Direct and Indirect Labour (cont)

- Storekeepers.

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Direct and Indirect Labour (cont)

- Security personnel.

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Direct and Indirect Labour (cont)

- Factory cleaners.

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Direct and Indirect Labour (cont)

- Quality-control supervisors (where not directly traceable).

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Direct and Indirect Labour (cont)

3. Classification of Labour Cost

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Direct and Indirect Labour (cont)

- Direct Labour Cost = Wages + Incentives + Applicable employee-related costs attributable to direct workers.

Direct and Indirect Labour (cont)

- Indirect Labour Cost = Wages and employee-related costs of supporting personnel.

Direct and Indirect Labour (cont)

- Factory labour overhead includes indirect wages, supervision, maintenance and other indirect employee costs.

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Direct and Indirect Labour (cont)

4. Labour Cost in Cost Sheet

Direct and Indirect Labour (cont)

- Prime Cost = Direct Material + Direct Labour + Direct Expenses.

Direct and Indirect Labour (cont)

- Factory Cost = Prime Cost + Factory Overheads + Opening Work-in-Progress − Closing Work-in-Progress.

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Direct and Indirect Labour (cont)

- Indirect labour is included in factory overhead when it relates to factory operations.

Direct and Indirect Labour (cont)

- Administrative, selling and distribution employee costs are classified according to their function, not automatically as factory overhead.

Direct and Indirect Labour (cont)

5. Important Distinctions

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Direct and Indirect Labour (cont)

- Direct vs indirect labour depends on traceability to the cost object, not on the employee's designation.

Direct and Indirect Labour (cont)

- A supervisor may be indirect labour for a product but direct labour for a supervision department's cost object.

Direct and Indirect Labour (cont)

- Direct labour is not necessarily variable in every situation; salaried direct workers may represent fixed costs within a relevant range.

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Direct and Indirect Labour (cont)

- Indirect labour is not necessarily fixed; some indirect labour costs may vary with activity.

Direct and Indirect Labour (cont)

6. Labour Cost Control

Direct and Indirect Labour (cont)

- Proper recruitment and deployment of workers.

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Direct and Indirect Labour (cont)

- Time recording and attendance monitoring.

Direct and Indirect Labour (cont)

- Job cards and labour allocation records.

Direct and Indirect Labour (cont)

- Standard time and performance measurement.

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Direct and Indirect Labour (cont)

- Incentive schemes linked to productivity and quality.

Direct and Indirect Labour (cont)

- Training and skill development.

Direct and Indirect Labour (cont)

- Control of idle time, overtime and labour turnover.

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Direct and Indirect Labour (cont)

- Comparison of actual labour cost with standard or budgeted labour cost.

Direct and Indirect Labour (cont)

MCQ Traps

Direct and Indirect Labour (cont)

- Direct labour forms part of Prime Cost.

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Direct and Indirect Labour (cont)

- Indirect labour forms part of overhead.

Direct and Indirect Labour (cont)

- Factory supervisor's wages are generally indirect labour.

Direct and Indirect Labour (cont)

- Workers directly manufacturing a specific product are generally direct labour.

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Direct and Indirect Labour (cont)

- Classification depends on the cost object and traceability.

Direct and Indirect Labour (cont)

- Not all employee salaries are direct labour; administrative and selling personnel are generally period/functional overhead costs.

Idle Time and Overtime

1. Idle Time

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Idle Time and Overtime (cont)

- Idle Time = Time for which workers are paid but during which no production work is performed.

Idle Time and Overtime (cont)

- Workers remain on the payroll despite being unable to perform productive work.

Idle Time and Overtime (cont)

- Formula:

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Idle Time and Overtime (cont)

Idle Time Cost = Idle Hours × Wage Rate per Hour.

Idle Time and Overtime (cont)

Causes of Idle Time

Idle Time and Overtime (cont)

- Normal Idle Time: unavoidable under normal operating conditions.

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Idle Time and Overtime (cont)

- Tea and rest intervals.

Idle Time and Overtime (cont)

- Time required for machine setting and adjustments.

Idle Time and Overtime (cont)

- Normal waiting between operations.

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Idle Time and Overtime (cont)

- Routine personal needs.

Idle Time and Overtime (cont)

- Abnormal Idle Time: arises due to unusual or avoidable circumstances.

Idle Time and Overtime (cont)

- Machine breakdown.

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Idle Time and Overtime (cont)

- Power failure.

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Idle Time and Overtime (cont)

- Material shortages.

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Idle Time and Overtime (cont)

- Strikes and lockouts.

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Idle Time and Overtime (cont)

- Poor planning or scheduling.

Idle Time and Overtime (cont)

Accounting Treatment

Idle Time and Overtime (cont)

- Normal idle time cost is generally treated as part of production overhead and absorbed into production cost.

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Idle Time and Overtime (cont)

- Abnormal idle time cost is charged separately to the Costing Profit and Loss Account.

Idle Time and Overtime (cont)

- Idle time caused by a specific job or operation may be charged directly to that cost object where identifiable and appropriate.

Idle Time and Overtime (cont)

2. Overtime

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Idle Time and Overtime (cont)

- Overtime = Work performed beyond the normal prescribed working hours.

Idle Time and Overtime (cont)

- Overtime wages generally include normal wages plus an additional premium.

Idle Time and Overtime (cont)

- Overtime Premium = Overtime Wages − Normal Wages for the Same Hours.

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Idle Time and Overtime (cont)

Overtime Wage Calculation

Idle Time and Overtime (cont)

- Overtime Earnings = Overtime Hours × Overtime Wage Rate.

Idle Time and Overtime (cont)

- If overtime is paid at 1.5 times the normal rate:

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Idle Time and Overtime (cont)

Overtime Earnings = Overtime Hours × Normal Hourly Rate × 1.5.

Idle Time and Overtime (cont)

- Overtime Premium = Overtime Hours × Normal Hourly Rate × 0.5.

Idle Time and Overtime (cont)

Accounting Treatment of Overtime Premium

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Idle Time and Overtime (cont)

- Due to general production pressure or unavoidable scheduling requirements: generally factory overhead.

Idle Time and Overtime (cont)

- Due to a specific customer/job requirement: chargeable to that specific job where identifiable.

Idle Time and Overtime (cont)

- Due to abnormal circumstances or avoidable inefficiency: generally charged separately to Costing Profit and Loss Account, depending on the cause and costing policy.

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Idle Time and Overtime (cont)

3. Difference Between Idle Time and Overtime

Idle Time and Overtime (cont)

- Idle time: paid time without productive work.

Idle Time and Overtime (cont)

- Overtime: additional working time beyond normal hours.

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Idle Time and Overtime (cont)

- Idle time increases labour cost without corresponding output.

Idle Time and Overtime (cont)

- Overtime increases labour cost because of additional hours and often a premium rate.

Idle Time and Overtime (cont)

4. Labour Cost Implications

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Idle Time and Overtime (cont)

- Idle time reduces labour productivity and increases cost per productive hour.

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Idle Time and Overtime (cont)

- Overtime premiums increase labour cost per unit.

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Idle Time and Overtime (cont)

- Excessive overtime can cause fatigue, accidents, errors and quality problems.

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Idle Time and Overtime (cont)

- Better production planning, preventive maintenance, adequate material availability and workforce scheduling help control both.

Idle Time and Overtime (cont)

MCQ Traps

Idle Time and Overtime (cont)

- Normal idle time is generally absorbed into production overhead.

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Idle Time and Overtime (cont)

- Abnormal idle time is generally charged to Costing Profit and Loss Account.

Idle Time and Overtime (cont)

- Overtime premium is only the additional amount over normal wages, not the entire overtime wage.

Idle Time and Overtime (cont)

- Overtime due to a specific customer order may be charged to that job.

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Idle Time and Overtime (cont)

- Machine breakdown and power failure are common causes of abnormal idle time.

Idle Time and Overtime (cont)

- Overtime is not automatically abnormal; its treatment depends on the reason it was incurred.

Idle Time and Overtime (cont)

- Statutory overtime eligibility and rates depend on applicable labour legislation; do not confuse textbook costing assumptions with legal wage requirements.

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Labour Turnover

Meaning

Labour Turnover (cont)

- Labour Turnover = Rate at which employees leave an organisation and are replaced by new employees during a specified period.

Labour Turnover (cont)

- Also called employee turnover or labour attrition.

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Labour Turnover (cont)

- High labour turnover may increase recruitment, selection, training and induction costs and disrupt production.

Labour Turnover (cont)

Causes of Labour Turnover

Labour Turnover (cont)

- Avoidable causes: low wages, poor working conditions, lack of promotion, dissatisfaction, poor supervision, inadequate welfare facilities and employee--management conflict.

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Labour Turnover (cont)

- Unavoidable causes: retirement, death, permanent disability, marriage or relocation, depending on circumstances.

Labour Turnover (cont)

- Voluntary turnover: employee chooses to leave.

Labour Turnover (cont)

- Involuntary turnover: employer terminates employment or initiates separation.

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Labour Turnover (cont)

Methods of Measuring Labour Turnover

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Labour Turnover (cont)

1. Separation Method

Labour Turnover (cont)

- Measures employees leaving during the period.

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Labour Turnover (cont)

Labour Turnover Rate (%) = (Number of Separations during Period ÷ Average Number of Employees) × 100.

Labour Turnover (cont)

2. Replacement Method

Labour Turnover (cont)

- Measures employees recruited to replace those who left.

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Labour Turnover (cont)

Labour Turnover Rate (%) = (Number of Replacements during Period ÷ Average Number of Employees) × 100.

Labour Turnover (cont)

3. Flux Method

Labour Turnover (cont)

- Measures both separations and replacements.

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Labour Turnover (cont)

Labour Turnover Rate (%) = [(Separations + Replacements) ÷ Average Number of Employees] × 100.

Labour Turnover (cont)

4. New Recruitment Method

Labour Turnover (cont)

- Measures total new employees recruited, whether to replace leavers or to expand the workforce.

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Labour Turnover (cont)

Labour Turnover Rate (%) = (Total New Employees Recruited ÷ Average Number of Employees) × 100.

Labour Turnover (cont)

Important: Average Number of Employees

Labour Turnover (cont)

- Average Employees = (Opening Employees + Closing Employees) ÷ 2.

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Labour Turnover (cont)

- Use the denominator and measurement convention specified in the question.

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Labour Turnover (cont)

Example

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Labour Turnover (cont)

- Opening employees = 500.

Labour Turnover (cont)

- Closing employees = 600.

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Labour Turnover (cont)

- Separations = 40.

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Labour Turnover (cont)

- Replacements = 30.

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Labour Turnover (cont)

- Average employees = (500 + 600) ÷ 2 = 550.

Labour Turnover (cont)

- Separation rate = 40/550 × 100 = 7.27%.

Labour Turnover (cont)

- Replacement rate = 30/550 × 100 = 5.45%.

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Labour Turnover (cont)

- Flux rate = (40 + 30)/550 × 100 = 12.73%.

Labour Turnover (cont)

Effects of High Labour Turnover

Labour Turnover (cont)

- Increased recruitment and training costs.

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Labour Turnover (cont)

- Loss of experienced and skilled employees.

Labour Turnover (cont)

- Reduced productivity and production continuity.

Labour Turnover (cont)

- Higher supervision and administrative costs.

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Labour Turnover (cont)

- Increased wastage, defects and accidents due to inexperienced workers.

Labour Turnover (cont)

- Loss of organisational knowledge and employee morale.

Labour Turnover (cont)

Labour Turnover Cost

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Labour Turnover (cont)

- Recruitment and selection costs.

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Labour Turnover (cont)

- Training and induction costs.

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Labour Turnover (cont)

- Lost output during vacancies.

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Labour Turnover (cont)

- Reduced efficiency of new workers.

Labour Turnover (cont)

- Separation and replacement administration costs.

Labour Turnover (cont)

Measures to Reduce Labour Turnover

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Labour Turnover (cont)

- Fair wages and incentives.

Labour Turnover (cont)

- Good working conditions and safety.

Labour Turnover (cont)

- Training, career development and promotion opportunities.

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Labour Turnover (cont)

- Employee welfare and grievance redressal.

Labour Turnover (cont)

- Effective supervision and employee engagement.

Labour Turnover (cont)

- Exit interviews to identify reasons for leaving.

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Labour Turnover (cont)

MCQ Traps

Labour Turnover (cont)

- Separation method counts employees leaving.

Labour Turnover (cont)

- Replacement method counts employees recruited specifically to replace leavers.

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Labour Turnover (cont)

- Flux method combines separations and replacements; it does not simply count all new recruits.

Labour Turnover (cont)

- Expansion recruitment is included in new recruitment but not necessarily in replacement.

Labour Turnover (cont)

- Average employees generally means opening plus closing employees divided by two.

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Labour Turnover (cont)

- High labour turnover is not always bad: some unavoidable or strategically necessary turnover may occur.

Marginal Costing

Numerical Problems in Marginal Costing

1. Core Formula Set — Memorise

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Numerical Problems in Marginal Costing (cont)

- Contribution per Unit = Selling Price per Unit − Variable Cost per Unit.

Numerical Problems in Marginal Costing (cont)

- Total Contribution = Sales − Total Variable Cost.

Numerical Problems in Marginal Costing (cont)

- Profit = Contribution − Fixed Cost.

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Numerical Problems in Marginal Costing (cont)

- P/V Ratio = (Contribution ÷ Sales) × 100.

Numerical Problems in Marginal Costing (cont)

- BEP Units = Fixed Cost ÷ Contribution per Unit.

Numerical Problems in Marginal Costing (cont)

- BEP Sales = Fixed Cost ÷ P/V Ratio.

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Numerical Problems in Marginal Costing (cont)

- MOS = Actual Sales − BEP Sales.

Numerical Problems in Marginal Costing (cont)

- MOS % = (MOS ÷ Actual Sales) × 100.

Numerical Problems in Marginal Costing (cont)

- Profit = MOS × P/V Ratio.

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Numerical Problems in Marginal Costing (cont)

- Required Units for Target Profit = (Fixed Cost + Target Profit) ÷ Contribution per Unit.

Numerical Problems in Marginal Costing (cont)

- Required Sales for Target Profit = (Fixed Cost + Target Profit) ÷ P/V Ratio.

Numerical Problems in Marginal Costing (cont)

2. Problem Type: Calculate Profit

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Numerical Problems in Marginal Costing (cont)

Given:

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Numerical Problems in Marginal Costing (cont)

- Selling price = ₹200/unit.

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Numerical Problems in Marginal Costing (cont)

- Variable cost = ₹120/unit.

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Numerical Problems in Marginal Costing (cont)

- Fixed cost = ₹40,000.

Numerical Problems in Marginal Costing (cont)

- Sales volume = 1,000 units.

Numerical Problems in Marginal Costing (cont)

Solution:

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Numerical Problems in Marginal Costing (cont)

- Contribution per unit = ₹200 − ₹120 = ₹80.

Numerical Problems in Marginal Costing (cont)

- Total contribution = 1,000 × ₹80 = ₹80,000.

Numerical Problems in Marginal Costing (cont)

- Profit = ₹80,000 − ₹40,000 = ₹40,000.

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Numerical Problems in Marginal Costing (cont)

3. Problem Type: Calculate BEP and MOS

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Numerical Problems in Marginal Costing (cont)

Given:

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Numerical Problems in Marginal Costing (cont)

- Selling price = ₹100/unit.

Numerical Problems in Marginal Costing (cont)

- Variable cost = ₹60/unit.

Numerical Problems in Marginal Costing (cont)

- Fixed cost = ₹30,000.

Numerical Problems in Marginal Costing (cont)

- Actual sales = 1,000 units.

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Numerical Problems in Marginal Costing (cont)

Solution:

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Numerical Problems in Marginal Costing (cont)

- Contribution per unit = ₹40.

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Numerical Problems in Marginal Costing (cont)

- BEP Units = ₹30,000 ÷ ₹40 = 750 units.

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Numerical Problems in Marginal Costing (cont)

- BEP Sales = 750 × ₹100 = ₹75,000.

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Numerical Problems in Marginal Costing (cont)

- Actual Sales = ₹1,00,000.

Numerical Problems in Marginal Costing (cont)

- MOS = 1,000 − 750 = 250 units.

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Numerical Problems in Marginal Costing (cont)

- MOS Value = ₹1,00,000 − ₹75,000 = ₹25,000.

Numerical Problems in Marginal Costing (cont)

- P/V Ratio = 40%.

Numerical Problems in Marginal Costing (cont)

- Profit = ₹25,000 × 40% = ₹10,000.

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Numerical Problems in Marginal Costing (cont)

4. Problem Type: Calculate Required Sales for Target Profit

Numerical Problems in Marginal Costing (cont)

Given:

Numerical Problems in Marginal Costing (cont)

- Fixed cost = ₹50,000.

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Numerical Problems in Marginal Costing (cont)

- P/V ratio = 25%.

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Numerical Problems in Marginal Costing (cont)

- Target profit = ₹30,000.

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Numerical Problems in Marginal Costing (cont)

Solution:

Numerical Problems in Marginal Costing (cont)

- Required Sales = (₹50,000 + ₹30,000) ÷ 0.25.

Numerical Problems in Marginal Costing (cont)

- Required Sales = ₹3,20,000.

Numerical Problems in Marginal Costing (cont)

5. Problem Type: Calculate Selling Price

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Numerical Problems in Marginal Costing (cont)

Given:

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Numerical Problems in Marginal Costing (cont)

- Variable cost per unit = ₹60.

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Numerical Problems in Marginal Costing (cont)

- Fixed cost = ₹40,000.

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Numerical Problems in Marginal Costing (cont)

- Required BEP = 1,000 units.

Numerical Problems in Marginal Costing (cont)

Solution:

Numerical Problems in Marginal Costing (cont)

- Required contribution per unit = ₹40,000 ÷ 1,000 = ₹40.

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Numerical Problems in Marginal Costing (cont)

- Selling Price = Variable Cost + Contribution.

Numerical Problems in Marginal Costing (cont)

- Selling Price = ₹60 + ₹40 = ₹100/unit.

Numerical Problems in Marginal Costing (cont)

6. Problem Type: Calculate Variable Cost

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Numerical Problems in Marginal Costing (cont)

Given:

Numerical Problems in Marginal Costing (cont)

- Selling price = ₹150/unit.

Numerical Problems in Marginal Costing (cont)

- P/V ratio = 40%.

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Numerical Problems in Marginal Costing (cont)

Solution:

Numerical Problems in Marginal Costing (cont)

- Contribution per unit = ₹150 × 40% = ₹60.

Numerical Problems in Marginal Costing (cont)

- Variable Cost per Unit = ₹150 − ₹60 = ₹90.

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Numerical Problems in Marginal Costing (cont)

7. Problem Type: Calculate Effect of Change in Sales Volume

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Numerical Problems in Marginal Costing (cont)

Given:

Numerical Problems in Marginal Costing (cont)

- Contribution per unit = ₹50.

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Numerical Problems in Marginal Costing (cont)

- Fixed cost = ₹1,00,000.

Numerical Problems in Marginal Costing (cont)

- Existing sales = 3,000 units.

Numerical Problems in Marginal Costing (cont)

- Additional sales = 500 units.

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Numerical Problems in Marginal Costing (cont)

Solution:

Numerical Problems in Marginal Costing (cont)

- Existing contribution = 3,000 × ₹50 = ₹1,50,000.

Numerical Problems in Marginal Costing (cont)

- Existing profit = ₹1,50,000 − ₹1,00,000 = ₹50,000.

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Numerical Problems in Marginal Costing (cont)

- Additional contribution = 500 × ₹50 = ₹25,000.

Numerical Problems in Marginal Costing (cont)

- New profit = ₹50,000 + ₹25,000 = ₹75,000.

Numerical Problems in Marginal Costing (cont)

8. Problem Type: Calculate Indifference Point

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Numerical Problems in Marginal Costing (cont)

Given:

Numerical Problems in Marginal Costing (cont)

- Alternative A: Fixed cost ₹1,00,000; variable cost ₹40/unit.

Numerical Problems in Marginal Costing (cont)

- Alternative B: Fixed cost ₹1,60,000; variable cost ₹30/unit.

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Numerical Problems in Marginal Costing (cont)

Solution:

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Numerical Problems in Marginal Costing (cont)

- Difference in fixed cost = ₹60,000.

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Numerical Problems in Marginal Costing (cont)

- Difference in variable cost = ₹10/unit.

Numerical Problems in Marginal Costing (cont)

- Indifference Output = ₹60,000 ÷ ₹10 = 6,000 units.

Numerical Problems in Marginal Costing (cont)

- Below 6,000 units → Alternative A has lower total cost.

Numerical Problems in Marginal Costing (cont)

- Above 6,000 units → Alternative B has lower total cost.

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Numerical Problems in Marginal Costing (cont)

- At 6,000 units → Both alternatives have equal total cost.

Numerical Problems in Marginal Costing (cont)

9. Problem Type: Calculate Sales Required After Tax

Numerical Problems in Marginal Costing (cont)

Given:

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Numerical Problems in Marginal Costing (cont)

- Fixed cost = ₹60,000.

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Numerical Problems in Marginal Costing (cont)

- Contribution per unit = ₹50.

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Numerical Problems in Marginal Costing (cont)

- Target profit after tax = ₹40,000.

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Numerical Problems in Marginal Costing (cont)

- Tax rate = 20%.

Numerical Problems in Marginal Costing (cont)

Solution:

Numerical Problems in Marginal Costing (cont)

- Required Profit Before Tax = ₹40,000 ÷ (1 − 0.20) = ₹50,000.

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Numerical Problems in Marginal Costing (cont)

- Required Units = (₹60,000 + ₹50,000) ÷ ₹50.

Numerical Problems in Marginal Costing (cont)

- Required Units = 2,200 units.

Numerical Problems in Marginal Costing (cont)

10. Common Numerical Traps

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Numerical Problems in Marginal Costing (cont)

- Convert P/V ratio percentages into decimals before dividing.

Numerical Problems in Marginal Costing (cont)

- Use contribution per unit for BEP in units and P/V ratio for BEP in sales value.

Numerical Problems in Marginal Costing (cont)

- Do not deduct fixed cost twice.

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Numerical Problems in Marginal Costing (cont)

- MOS is actual sales minus BEP sales.

Numerical Problems in Marginal Costing (cont)

- Profit = MOS × P/V ratio.

Numerical Problems in Marginal Costing (cont)

- For target profit after tax, convert it into pre-tax profit first.

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Numerical Problems in Marginal Costing (cont)

- For multiple products, use the weighted/-composite P/V ratio based on sales mix.

Numerical Problems in Marginal Costing (cont)

- Round up required units when fractional units cannot be sold.

Numerical Problems in Marginal Costing (cont)

- Distinguish between total variable cost and variable cost per unit.

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Numerical Problems in Marginal Costing (cont)

- For indifference point, compare fixed-cost difference with variable-cost difference, not total costs directly.

Changes in Cost, Selling Price and Sales Volume

1. Effect of Changes in Fixed Cost

Changes in Cost, Selling Price and Sales Volume (cont)

- Increase in fixed cost, with selling price and variable cost unchanged:

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Changes in Cost, Selling Price and Sales Volume (cont)

- Contribution per unit remains unchanged.

Changes in Cost, Selling Price and Sales Volume (cont)

- P/V ratio remains unchanged.

Changes in Cost, Selling Price and Sales Volume (cont)

- BEP increases.

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Changes in Cost, Selling Price and Sales Volume (cont)

- Profit decreases at the same sales volume.

Changes in Cost, Selling Price and Sales Volume (cont)

- Margin of Safety decreases.

Changes in Cost, Selling Price and Sales Volume (cont)

- Decrease in fixed cost produces the opposite effects.

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Changes in Cost, Selling Price and Sales Volume (cont)

- Formula:

Changes in Cost, Selling Price and Sales Volume (cont)

New BEP Units = New Fixed Cost ÷ Contribution per Unit.

Changes in Cost, Selling Price and Sales Volume (cont)

2. Effect of Changes in Variable Cost

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Changes in Cost, Selling Price and Sales Volume (cont)

- Increase in variable cost per unit, with selling price unchanged:

Changes in Cost, Selling Price and Sales Volume (cont)

- Contribution per unit decreases.

Changes in Cost, Selling Price and Sales Volume (cont)

- P/V ratio decreases.

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Changes in Cost, Selling Price and Sales Volume (cont)

- BEP increases.

Changes in Cost, Selling Price and Sales Volume (cont)

- Profit decreases at the same sales volume.

Changes in Cost, Selling Price and Sales Volume (cont)

- Margin of Safety generally decreases.

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Changes in Cost, Selling Price and Sales Volume (cont)

- Decrease in variable cost produces the opposite effects.

Changes in Cost, Selling Price and Sales Volume (cont)

- Formula:

Changes in Cost, Selling Price and Sales Volume (cont)

New Contribution per Unit = Selling Price − New Variable Cost per Unit.

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Changes in Cost, Selling Price and Sales Volume (cont)

3. Effect of Changes in Selling Price

Changes in Cost, Selling Price and Sales Volume (cont)

- Increase in selling price, with variable cost unchanged:

Changes in Cost, Selling Price and Sales Volume (cont)

- Contribution per unit increases.

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Changes in Cost, Selling Price and Sales Volume (cont)

- P/V ratio increases.

Changes in Cost, Selling Price and Sales Volume (cont)

- BEP decreases.

Changes in Cost, Selling Price and Sales Volume (cont)

- Profit increases at the same sales volume.

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Changes in Cost, Selling Price and Sales Volume (cont)

- Margin of Safety generally increases.

Changes in Cost, Selling Price and Sales Volume (cont)

- Decrease in selling price produces the opposite effects.

Changes in Cost, Selling Price and Sales Volume (cont)

- Formula:

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Changes in Cost, Selling Price and Sales Volume (cont)

New Contribution per Unit = New Selling Price − Variable Cost per Unit.

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Changes in Cost, Selling Price and Sales Volume (cont)

4. Effect of Changes in Sales Volume

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Changes in Cost, Selling Price and Sales Volume (cont)

Assuming selling price, variable cost per unit and fixed cost remain constant:

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Changes in Cost, Selling Price and Sales Volume (cont)

- Increase in sales volume:

Changes in Cost, Selling Price and Sales Volume (cont)

- Total sales increase.

Changes in Cost, Selling Price and Sales Volume (cont)

- Total variable cost increases.

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Changes in Cost, Selling Price and Sales Volume (cont)

- Total contribution increases.

Changes in Cost, Selling Price and Sales Volume (cont)

- Profit increases after BEP is crossed.

Changes in Cost, Selling Price and Sales Volume (cont)

- P/V ratio remains unchanged.

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Changes in Cost, Selling Price and Sales Volume (cont)

- BEP remains unchanged.

Changes in Cost, Selling Price and Sales Volume (cont)

- Margin of Safety increases.

Changes in Cost, Selling Price and Sales Volume (cont)

- Decrease in sales volume produces the opposite effects.

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Changes in Cost, Selling Price and Sales Volume (cont)

- Additional Profit = Additional Units Sold × Contribution per Unit.

Changes in Cost, Selling Price and Sales Volume (cont)

5. Effect of Simultaneous Changes

Changes in Cost, Selling Price and Sales Volume (cont)

- When selling price and variable cost both change, calculate the revised contribution per unit first.

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Changes in Cost, Selling Price and Sales Volume (cont)

- When fixed cost also changes, recalculate BEP using revised fixed cost and revised contribution.

Changes in Cost, Selling Price and Sales Volume (cont)

- When sales volume changes, calculate revised total contribution and deduct revised fixed cost.

Changes in Cost, Selling Price and Sales Volume (cont)

- Never assume that an increase in sales automatically increases profit: the effect depends on contribution and fixed costs.

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Changes in Cost, Selling Price and Sales Volume (cont)

6. Target Profit and Required Sales

Changes in Cost, Selling Price and Sales Volume (cont)

- Required Units = (Fixed Cost + Target Profit) ÷ Contribution per Unit.

Changes in Cost, Selling Price and Sales Volume (cont)

- Required Sales Value = (Fixed Cost + Target Profit) ÷ P/V Ratio.

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Changes in Cost, Selling Price and Sales Volume (cont)

- Required Contribution = Fixed Cost + Target Profit.

Changes in Cost, Selling Price and Sales Volume (cont)

- For a target profit after tax:

Changes in Cost, Selling Price and Sales Volume (cont)

Required Profit Before Tax = Target Profit After Tax ÷ (1 − Tax Rate).

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Changes in Cost, Selling Price and Sales Volume (cont)

- Required Units for Target After-Tax Profit = (Fixed Cost + Required Profit Before Tax) ÷ Contribution per Unit.

Changes in Cost, Selling Price and Sales Volume (cont)

7. Indifference Point / Cost-Volume Choice

Changes in Cost, Selling Price and Sales Volume (cont)

- Indifference Point is the output level at which two alternative cost structures generate equal total cost or equal profit, assuming the same selling price.

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Changes in Cost, Selling Price and Sales Volume (cont)

- Useful when choosing between:

Changes in Cost, Selling Price and Sales Volume (cont)

- Labour-intensive and machine-intensive production.

Changes in Cost, Selling Price and Sales Volume (cont)

- Alternative technologies.

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Changes in Cost, Selling Price and Sales Volume (cont)

- Different fixed-cost and variable-cost structures.

Changes in Cost, Selling Price and Sales Volume (cont)

- Formula:

Changes in Cost, Selling Price and Sales Volume (cont)

Indifference Output = Difference in Fixed Costs ÷ Difference in Variable Cost per Unit.

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Changes in Cost, Selling Price and Sales Volume (cont)

- At the indifference point, total costs are equal.

Changes in Cost, Selling Price and Sales Volume (cont)

- Above or below this point, the alternative with lower total cost is preferable.

Changes in Cost, Selling Price and Sales Volume (cont)

8. MCQ Traps

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Changes in Cost, Selling Price and Sales Volume (cont)

- Fixed cost changes do not directly change contribution per unit or P/V ratio.

Changes in Cost, Selling Price and Sales Volume (cont)

- Sales-volume changes alone do not change BEP or P/V ratio under basic assumptions.

Changes in Cost, Selling Price and Sales Volume (cont)

- Selling price and variable cost changes affect contribution per unit.

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Changes in Cost, Selling Price and Sales Volume (cont)

- Higher fixed cost increases BEP but does not change the P/V ratio if unit contribution is unchanged.

Changes in Cost, Selling Price and Sales Volume (cont)

- Always distinguish between a change in total contribution and a change in contribution per unit.

Changes in Cost, Selling Price and Sales Volume (cont)

- For target-profit calculations, use profit before tax unless the question specifically gives an after-tax target.

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Break-Even Charts and Profit-Volume Relationships

1. Break-Even Chart: Meaning

Break-Even Charts and Profit-Volume Relationships (cont)

- A Break-Even Chart is a graphical representation of the relationship between cost, sales revenue and output.

Break-Even Charts and Profit-Volume Relationships (cont)

- It identifies the break-even point and shows profit or loss at different activity levels.

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Break-Even Charts and Profit-Volume Relationships (cont)

2. Construction of a Break-Even Chart

Break-Even Charts and Profit-Volume Relationships (cont)

- X-axis: Output or sales volume (units).

Break-Even Charts and Profit-Volume Relationships (cont)

- Y-axis: Cost and revenue (₹).

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Break-Even Charts and Profit-Volume Relationships (cont)

- Fixed Cost Line: Horizontal line because total fixed cost remains constant within the relevant range.

Break-Even Charts and Profit-Volume Relationships (cont)

- Variable Cost Line: Starts from the origin and rises with output.

Break-Even Charts and Profit-Volume Relationships (cont)

- Total Cost Line: Starts at the fixed-cost level on the Y-axis and rises with variable cost.

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Break-Even Charts and Profit-Volume Relationships (cont)

- Sales Revenue Line: Starts from the origin and rises according to selling price per unit.

Break-Even Charts and Profit-Volume Relationships (cont)

- Intersection of Total Cost Line and Sales Revenue Line = Break-Even Point.

Break-Even Charts and Profit-Volume Relationships (cont)

3. Interpretation of the Chart

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Break-Even Charts and Profit-Volume Relationships (cont)

- Left of BEP: Total Cost exceeds Sales Revenue → Loss.

Break-Even Charts and Profit-Volume Relationships (cont)

- At BEP: Total Cost equals Sales Revenue → No profit or loss.

Break-Even Charts and Profit-Volume Relationships (cont)

- Right of BEP: Sales Revenue exceeds Total Cost → Profit.

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Break-Even Charts and Profit-Volume Relationships (cont)

- Angle of incidence: Angle between the sales line and total cost line at BEP.

Break-Even Charts and Profit-Volume Relationships (cont)

- Larger angle of incidence generally indicates a faster rate of profit generation beyond BEP.

Break-Even Charts and Profit-Volume Relationships (cont)

- Margin of Safety is the horizontal distance between actual/budgeted sales and break-even sales.

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Break-Even Charts and Profit-Volume Relationships (cont)

4. Profit-Volume (P/V) Graph

Break-Even Charts and Profit-Volume Relationships (cont)

- Shows the relationship between profit and sales volume.

Break-Even Charts and Profit-Volume Relationships (cont)

- X-axis: Sales volume or sales value.

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Break-Even Charts and Profit-Volume Relationships (cont)

- Y-axis: Profit or loss.

Break-Even Charts and Profit-Volume Relationships (cont)

- Fixed cost is represented by the loss at zero sales.

Break-Even Charts and Profit-Volume Relationships (cont)

- The P/V line rises as sales increase when contribution is positive.

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Break-Even Charts and Profit-Volume Relationships (cont)

- The point where the P/V line crosses the X-axis represents BEP.

Break-Even Charts and Profit-Volume Relationships (cont)

- Beyond BEP → Positive profit.

Break-Even Charts and Profit-Volume Relationships (cont)

- Before BEP → Loss.

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Break-Even Charts and Profit-Volume Relationships (cont)

5. Important Relationships

Break-Even Charts and Profit-Volume Relationships (cont)

- Profit = (Sales × P/V Ratio) − Fixed Cost.

Break-Even Charts and Profit-Volume Relationships (cont)

- At zero sales, loss = Fixed Cost.

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Break-Even Charts and Profit-Volume Relationships (cont)

- Slope of the P/V line is determined by the P/V ratio when the horizontal axis represents sales value.

Break-Even Charts and Profit-Volume Relationships (cont)

- Higher P/V ratio → Steeper upward P/V line.

Break-Even Charts and Profit-Volume Relationships (cont)

- Higher fixed cost → Greater initial loss and higher BEP, but does not change the slope if P/V ratio remains unchanged.

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Break-Even Charts and Profit-Volume Relationships (cont)

- Lower fixed cost → Lower BEP, with unchanged P/V ratio.

Break-Even Charts and Profit-Volume Relationships (cont)

6. Types of Break-Even Charts

Break-Even Charts and Profit-Volume Relationships (cont)

- Conventional break-even chart: Shows fixed cost, total cost and sales revenue lines.

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Break-Even Charts and Profit-Volume Relationships (cont)

- Contribution break-even chart: Highlights contribution and fixed-cost recovery.

Break-Even Charts and Profit-Volume Relationships (cont)

- P/V graph: Directly plots profit or loss against sales volume/value.

Break-Even Charts and Profit-Volume Relationships (cont)

7. Limitations

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Break-Even Charts and Profit-Volume Relationships (cont)

- Assumes constant selling price and variable cost per unit.

Break-Even Charts and Profit-Volume Relationships (cont)

- Assumes fixed costs remain constant within the relevant range.

Break-Even Charts and Profit-Volume Relationships (cont)

- May be difficult to apply where products have different contribution margins and sales mix changes.

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Break-Even Charts and Profit-Volume Relationships (cont)

- Real businesses may experience changes in efficiency, prices and costs as output changes.

Break-Even Charts and Profit-Volume Relationships (cont)

- Linear charts may not accurately represent economies or diseconomies of scale.

Break-Even Charts and Profit-Volume Relationships (cont)

8. MCQ Traps

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Break-Even Charts and Profit-Volume Relationships (cont)

- Fixed cost line is horizontal, but total cost line is not.

Break-Even Charts and Profit-Volume Relationships (cont)

- Total cost line starts at the fixed-cost intercept, not at the origin.

Break-Even Charts and Profit-Volume Relationships (cont)

- Sales revenue line starts at the origin under the basic assumptions.

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Break-Even Charts and Profit-Volume Relationships (cont)

- BEP is the intersection of sales revenue and total cost lines.

Break-Even Charts and Profit-Volume Relationships (cont)

- Angle of incidence indicates the rate at which profit increases beyond BEP.

Break-Even Charts and Profit-Volume Relationships (cont)

- P/V ratio determines the slope of the P/V line when sales value is on the X-axis.

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Margin of Safety (MOS)

1. Meaning

Margin of Safety (MOS) (cont)

- Margin of Safety (MOS) is the excess of actual or budgeted sales over break-even sales.

Margin of Safety (MOS) (cont)

- It indicates the extent to which sales can decline before the business reaches the break-even point.

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Margin of Safety (MOS) (cont)

- Higher MOS indicates a greater safety cushion and generally lower operating risk.

Margin of Safety (MOS) (cont)

- At break-even point, MOS = Zero.

Margin of Safety (MOS) (cont)

2. Formulas

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Margin of Safety (MOS) (cont)

- Margin of Safety (Sales Value) = Actual Sales − Break-Even Sales.

Margin of Safety (MOS) (cont)

- Margin of Safety (Units) = Actual Units Sold − Break-Even Units.

Margin of Safety (MOS) (cont)

- MOS (%) = (Margin of Safety ÷ Actual Sales) × 100.

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Margin of Safety (MOS) (cont)

- Actual Profit = Margin of Safety × P/V Ratio.

Margin of Safety (MOS) (cont)

- Margin of Safety = Profit ÷ P/V Ratio.

Margin of Safety (MOS) (cont)

- Expected Sales = Break-Even Sales + Margin of Safety.

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Margin of Safety (MOS) (cont)

3. Worked Example

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Margin of Safety (MOS) (cont)

Given:

Margin of Safety (MOS) (cont)

- Actual Sales = ₹1,00,000.

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Margin of Safety (MOS) (cont)

- Break-Even Sales = ₹60,000.

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Margin of Safety (MOS) (cont)

- P/V Ratio = 40%.

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Margin of Safety (MOS) (cont)

Calculation:

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Margin of Safety (MOS) (cont)

- MOS = ₹1,00,000 − ₹60,000 = ₹40,000.

Margin of Safety (MOS) (cont)

- MOS % = (₹40,000 ÷ ₹1,00,000) × 100 = 40%.

Margin of Safety (MOS) (cont)

- Profit = ₹40,000 × 40% = ₹16,000.

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Margin of Safety (MOS) (cont)

4. Factors Affecting Margin of Safety

Margin of Safety (MOS) (cont)

- Increase in sales, with BEP unchanged → MOS increases.

Margin of Safety (MOS) (cont)

- Increase in fixed cost → BEP increases and MOS decreases, assuming sales remain unchanged.

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Margin of Safety (MOS) (cont)

- Increase in variable cost per unit → Contribution falls, BEP rises and MOS generally decreases.

Margin of Safety (MOS) (cont)

- Increase in selling price → Contribution rises, BEP falls and MOS generally increases.

Margin of Safety (MOS) (cont)

- Higher P/V ratio generally improves MOS for a given sales level and fixed cost.

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Margin of Safety (MOS) (cont)

5. Margin of Safety and Business Risk

Margin of Safety (MOS) (cont)

- High MOS: business can withstand a larger fall in sales before incurring losses.

Margin of Safety (MOS) (cont)

- Low MOS: even a small fall in sales may push the business into losses.

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Margin of Safety (MOS) (cont)

- Negative MOS: actual sales are below break-even sales; business is incurring a loss.

Margin of Safety (MOS) (cont)

- MOS is useful for evaluating sales stability, profitability and operating risk.

Margin of Safety (MOS) (cont)

6. MCQ Traps

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Margin of Safety (MOS) (cont)

- MOS is calculated using actual/budgeted sales minus BEP sales, not sales minus total cost.

Margin of Safety (MOS) (cont)

- MOS is not the same as contribution.

Margin of Safety (MOS) (cont)

- Profit = MOS × P/V ratio, provided the relevant cost and sales relationships remain unchanged.

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Margin of Safety (MOS) (cont)

- MOS percentage uses actual sales as the denominator.

Margin of Safety (MOS) (cont)

- At BEP, profit and MOS are both zero.

Margin of Safety (MOS) (cont)

- Higher MOS generally means lower risk of operating loss, but does not necessarily mean higher absolute profit.

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Break-Even Point (BEP)

1. Meaning

Break-Even Point (BEP) (cont)

- Break-Even Point (BEP) is the level of sales or output at which total revenue equals total cost.

Break-Even Point (BEP) (cont)

- At BEP:

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Break-Even Point (BEP) (cont)

- Profit = Zero.

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Break-Even Point (BEP) (cont)

- Total Contribution = Fixed Cost.

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Break-Even Point (BEP) (cont)

- There is neither profit nor loss.

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Break-Even Point (BEP) (cont)

- Below BEP → Loss.

Break-Even Point (BEP) (cont)

- Above BEP → Profit, assuming the same cost and selling-price relationships.

Break-Even Point (BEP) (cont)

2. Break-Even Point in Units

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Break-Even Point (BEP) (cont)

BEP (Units) = Fixed Cost / Contribution per Unit

Break-Even Point (BEP) (cont)

Where:

Break-Even Point (BEP) (cont)

Contribution per Unit = Selling Price per Unit − Variable Cost per Unit.

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Break-Even Point (BEP) (cont)

3. Break-Even Point in Sales Value

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Break-Even Point (BEP) (cont)

BEP (Sales) = Fixed Cost / (P/V Ratio)

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Break-Even Point (BEP) (cont)

- Use P/V ratio in decimal form.

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Break-Even Point (BEP) (cont)

- Alternatively:

Break-Even Point (BEP) (cont)

BEP Sales = BEP Units × Selling Price per Unit.

Break-Even Point (BEP) (cont)

4. Worked Example

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Break-Even Point (BEP) (cont)

Given:

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Break-Even Point (BEP) (cont)

- Selling price = ₹100 per unit.

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Break-Even Point (BEP) (cont)

- Variable cost = ₹60 per unit.

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Break-Even Point (BEP) (cont)

- Fixed cost = ₹20,000.

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Break-Even Point (BEP) (cont)

Calculation:

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Break-Even Point (BEP) (cont)

- Contribution per unit = ₹100 − ₹60 = ₹40.

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Break-Even Point (BEP) (cont)

- BEP Units = ₹20,000 ÷ ₹40 = 500 units.

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Break-Even Point (BEP) (cont)

- P/V Ratio = ₹40 ÷ ₹100 = 40%.

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Break-Even Point (BEP) (cont)

- BEP Sales = ₹20,000 ÷ 0.40 = ₹50,000.

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Break-Even Point (BEP) (cont)

At 500 units:

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Break-Even Point (BEP) (cont)

- Sales = ₹50,000.

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Break-Even Point (BEP) (cont)

- Variable Cost = ₹30,000.

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Break-Even Point (BEP) (cont)

- Contribution = ₹20,000.

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Break-Even Point (BEP) (cont)

- Fixed Cost = ₹20,000.

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Break-Even Point (BEP) (cont)

- Profit = Zero.

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Break-Even Point (BEP) (cont)

5. Cash Break-Even Point

Break-Even Point (BEP) (cont)

- Cash BEP considers only cash fixed costs, excluding non-cash fixed expenses such as depreciation.

Break-Even Point (BEP) (cont)

- Cash BEP Units = Cash Fixed Cost ÷ Contribution per Unit.

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Break-Even Point (BEP) (cont)

- Useful for assessing the sales level required to cover cash operating expenses.

Break-Even Point (BEP) (cont)

- Cash BEP is generally lower than accounting BEP when non-cash fixed costs are positive.

Break-Even Point (BEP) (cont)

6. Multi-Product Break-Even Point

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Break-Even Point (BEP) (cont)

- For multiple products, use the weighted average contribution or composite P/V ratio based on the assumed sales mix.

Break-Even Point (BEP) (cont)

- Composite BEP Sales = Total Fixed Cost ÷ Composite P/V Ratio.

Break-Even Point (BEP) (cont)

- The calculated BEP is valid only while the assumed sales mix remains unchanged.

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Break-Even Point (BEP) (cont)

7. Factors Affecting BEP

Break-Even Point (BEP) (cont)

- Increase in fixed cost → BEP increases.

Break-Even Point (BEP) (cont)

- Increase in variable cost per unit → Contribution falls; BEP increases.

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Break-Even Point (BEP) (cont)

- Increase in selling price → Contribution rises; BEP decreases.

Break-Even Point (BEP) (cont)

- Higher contribution per unit → Lower BEP.

Break-Even Point (BEP) (cont)

- Changes in product sales mix can increase or decrease overall BEP.

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Break-Even Point (BEP) (cont)

8. Important Assumptions

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Break-Even Point (BEP) (cont)

- Selling price per unit remains constant.

Break-Even Point (BEP) (cont)

- Variable cost per unit remains constant.

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Break-Even Point (BEP) (cont)

- Total fixed cost remains constant within the relevant range.

Break-Even Point (BEP) (cont)

- Costs can be separated into fixed and variable components.

Break-Even Point (BEP) (cont)

- For multi-product analysis, sales mix remains constant.

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Break-Even Point (BEP) (cont)

- Production and sales are assumed equal, or inventory changes are ignored.

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Break-Even Point (BEP) (cont)

9. MCQ Traps

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Break-Even Point (BEP) (cont)

- BEP is expressed in either units or sales value; do not confuse the two.

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Break-Even Point (BEP) (cont)

- At BEP, contribution equals fixed cost, not total cost.

Break-Even Point (BEP) (cont)

- Margin of safety is zero at BEP.

Break-Even Point (BEP) (cont)

- A higher P/V ratio reduces BEP sales, all else equal.

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Break-Even Point (BEP) (cont)

- Depreciation is excluded when calculating cash BEP, but included in accounting fixed cost if applicable.

Break-Even Point (BEP) (cont)

- Break-even analysis is based on assumptions that generally hold only within a relevant operating range.

Profit-Volume (P/V) Ratio

1. Meaning

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Profit-Volume (P/V) Ratio (cont)

- Profit-Volume Ratio (P/V Ratio), also called the Contribution-to-Sales Ratio, measures contribution earned as a proportion of sales.

Profit-Volume (P/V) Ratio (cont)

- Indicates the relationship between contribution and sales.

Profit-Volume (P/V) Ratio (cont)

- Higher P/V ratio generally indicates better profitability, assuming fixed costs remain unchanged.

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Profit-Volume (P/V) Ratio (cont)

2. Formula

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Profit-Volume (P/V) Ratio (cont)

P/V Ratio = (Contribution / Sales) * 100

Profit-Volume (P/V) Ratio (cont)

Other equivalent formulas:

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Profit-Volume (P/V) Ratio (cont)

- P/V Ratio = (Contribution per Unit ÷ Selling Price per Unit) × 100.

Profit-Volume (P/V) Ratio (cont)

- P/V Ratio = (Change in Profit ÷ Change in Sales) × 100, provided fixed costs remain unchanged.

Profit-Volume (P/V) Ratio (cont)

- Contribution = Sales × P/V Ratio.

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Profit-Volume (P/V) Ratio (cont)

- Profit = (Sales × P/V Ratio) − Fixed Cost.

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Profit-Volume (P/V) Ratio (cont)

3. Worked Example

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Profit-Volume (P/V) Ratio (cont)

Given:

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Profit-Volume (P/V) Ratio (cont)

- Selling price per unit = ₹100.

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Profit-Volume (P/V) Ratio (cont)

- Variable cost per unit = ₹60.

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Profit-Volume (P/V) Ratio (cont)

- Sales = ₹2,00,000.

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Profit-Volume (P/V) Ratio (cont)

- Fixed cost = ₹50,000.

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Profit-Volume (P/V) Ratio (cont)

Calculation:

Profit-Volume (P/V) Ratio (cont)

- Contribution per unit = ₹100 − ₹60 = ₹40.

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Profit-Volume (P/V) Ratio (cont)

- P/V Ratio = (40 ÷ 100) × 100 = 40%.

Profit-Volume (P/V) Ratio (cont)

- Total contribution = ₹2,00,000 × 40% = ₹80,000.

Profit-Volume (P/V) Ratio (cont)

- Profit = ₹80,000 − ₹50,000 = ₹30,000.

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Profit-Volume (P/V) Ratio (cont)

4. Factors Affecting P/V Ratio

Profit-Volume (P/V) Ratio (cont)

- Increase in selling price, with variable cost unchanged → P/V ratio increases.

Profit-Volume (P/V) Ratio (cont)

- Decrease in variable cost, with selling price unchanged → P/V ratio increases.

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Profit-Volume (P/V) Ratio (cont)

- Increase in variable cost → P/V ratio decreases.

Profit-Volume (P/V) Ratio (cont)

- Decrease in selling price → P/V ratio decreases.

Profit-Volume (P/V) Ratio (cont)

- Changes in fixed cost do not directly affect the P/V ratio.

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Profit-Volume (P/V) Ratio (cont)

5. Relationship with Break-Even and Profit

Profit-Volume (P/V) Ratio (cont)

- Break-Even Sales = Fixed Cost ÷ P/V Ratio (expressed as a decimal).

Profit-Volume (P/V) Ratio (cont)

- Required Sales for Target Profit = (Fixed Cost + Target Profit) ÷ P/V Ratio.

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Profit-Volume (P/V) Ratio (cont)

- Profit = (Sales × P/V Ratio) − Fixed Cost.

Profit-Volume (P/V) Ratio (cont)

- Contribution required = Fixed Cost + Desired Profit.

Profit-Volume (P/V) Ratio (cont)

6. Composite P/V Ratio

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Profit-Volume (P/V) Ratio (cont)

- Used when a business sells multiple products.

Profit-Volume (P/V) Ratio (cont)

- Composite P/V Ratio = Total Contribution ÷ Total Sales × 100.

Profit-Volume (P/V) Ratio (cont)

- Depends on the sales mix of different products.

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Profit-Volume (P/V) Ratio (cont)

- A change in sales mix can change the overall P/V ratio even when individual product P/V ratios remain unchanged.

Profit-Volume (P/V) Ratio (cont)

- Higher-contribution products forming a larger share of sales generally improve the composite P/V ratio.

Profit-Volume (P/V) Ratio (cont)

7. MCQ Traps

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Profit-Volume (P/V) Ratio (cont)

- P/V ratio is based on contribution, not profit.

Profit-Volume (P/V) Ratio (cont)

- Fixed cost does not directly affect P/V ratio.

Profit-Volume (P/V) Ratio (cont)

- P/V ratio is generally constant only when selling price, variable cost per unit and sales mix remain unchanged.

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Profit-Volume (P/V) Ratio (cont)

- Do not confuse P/V ratio with profit percentage on sales.

Profit-Volume (P/V) Ratio (cont)

- Always convert a percentage into a decimal when using it directly in break-even and target-profit formulas.

Marginal Cost and Contribution

1. Marginal Cost

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Marginal Cost and Contribution (cont)

- Marginal Cost = Additional cost incurred by producing one additional unit of output.

Marginal Cost and Contribution (cont)

- Under marginal costing, marginal cost is generally treated as the variable cost of production.

Marginal Cost and Contribution (cont)

- Fixed production costs are treated as period costs and charged to the Profit and Loss Account for the period.

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Marginal Cost and Contribution (cont)

- Formula:

Marginal Cost and Contribution (cont)

Marginal Cost per Unit = Variable Cost per Unit.

Marginal Cost and Contribution (cont)

- Total Marginal Cost = Total Variable Cost.

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Marginal Cost and Contribution (cont)

2. Elements of Variable Cost

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Marginal Cost and Contribution (cont)

- Direct material.

Marginal Cost and Contribution (cont)

- Direct labour (where variable).

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Marginal Cost and Contribution (cont)

- Direct expenses (where variable).

Marginal Cost and Contribution (cont)

- Variable production overheads.

Marginal Cost and Contribution (cont)

- Variable selling and distribution costs are considered separately when calculating contribution after selling costs.

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Marginal Cost and Contribution (cont)

3. Contribution

Marginal Cost and Contribution (cont)

- Contribution = Sales Revenue − Variable Cost.

Marginal Cost and Contribution (cont)

- Contribution is the amount available to:

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Marginal Cost and Contribution (cont)

1. Recover fixed costs.

Marginal Cost and Contribution (cont)

2. Generate profit after fixed costs are recovered.

Marginal Cost and Contribution (cont)

Important Formulas

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Marginal Cost and Contribution (cont)

- Total Contribution = Sales − Total Variable Cost.

Marginal Cost and Contribution (cont)

- Contribution per Unit = Selling Price per Unit − Variable Cost per Unit.

Marginal Cost and Contribution (cont)

- Profit = Total Contribution − Fixed Cost.

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Marginal Cost and Contribution (cont)

- Total Contribution = Fixed Cost + Profit.

Marginal Cost and Contribution (cont)

- If contribution is less than fixed cost → Loss.

Marginal Cost and Contribution (cont)

- If contribution equals fixed cost → Break--even.

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Marginal Cost and Contribution (cont)

- If contribution exceeds fixed cost → Profit.

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Marginal Cost and Contribution (cont)

4. Worked Example

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Marginal Cost and Contribution (cont)

Given:

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Marginal Cost and Contribution (cont)

- Selling price per unit = ₹100.

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Marginal Cost and Contribution (cont)

- Variable cost per unit = ₹60.

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Marginal Cost and Contribution (cont)

- Fixed cost = ₹20,000.

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Marginal Cost and Contribution (cont)

- Units sold = 1,000.

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Marginal Cost and Contribution (cont)

Calculations:

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Marginal Cost and Contribution (cont)

- Sales = 1,000 × ₹100 = ₹1,00,000.

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Marginal Cost and Contribution (cont)

- Variable cost = 1,000 × ₹60 = ₹60,000.

Marginal Cost and Contribution (cont)

- Contribution per unit = ₹100 − ₹60 = ₹40.

Marginal Cost and Contribution (cont)

- Total contribution = ₹40,000.

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Marginal Cost and Contribution (cont)

- Profit = ₹40,000 − ₹20,000 = ₹20,000.

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Marginal Cost and Contribution (cont)

5. Marginal Costing vs Absorption Costing

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Marginal Cost and Contribution (cont)

- Marginal Costing:

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Marginal Cost and Contribution (cont)

- Only variable production costs are included in product cost.

Marginal Cost and Contribution (cont)

- Fixed production overheads are treated as period costs.

Marginal Cost and Contribution (cont)

- Inventory is valued at variable production cost.

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Marginal Cost and Contribution (cont)

- Absorption Costing:

Marginal Cost and Contribution (cont)

- Both variable and fixed production costs are included in product cost.

Marginal Cost and Contribution (cont)

- Fixed production overheads are absorbed into units produced.

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Marginal Cost and Contribution (cont)

- Inventory includes an allocated share of fixed production overhead.

Marginal Cost and Contribution (cont)

6. Important Assumptions of Marginal Costing

Marginal Cost and Contribution (cont)

- Costs can be classified into fixed and variable components.

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Marginal Cost and Contribution (cont)

- Variable cost per unit remains constant within the relevant range.

Marginal Cost and Contribution (cont)

- Total fixed cost remains constant within the relevant range.

Marginal Cost and Contribution (cont)

- Selling price per unit is assumed constant for basic CVP analysis.

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Marginal Cost and Contribution (cont)

- Production and sales relationships are sufficiently stable for the analysis.

Marginal Cost and Contribution (cont)

- For simple break-even calculations, production equals sales or inventory changes are ignored.

Marginal Cost and Contribution (cont)

MCQ Traps

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Marginal Cost and Contribution (cont)

- Marginal cost is not the same as selling price minus fixed cost.

Marginal Cost and Contribution (cont)

- Contribution is not profit; fixed costs must still be deducted.

Marginal Cost and Contribution (cont)

- Contribution first covers fixed costs and then generates profit.

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Marginal Cost and Contribution (cont)

- Fixed production overhead is excluded from product cost under marginal costing.

Marginal Cost and Contribution (cont)

- Variable cost per unit is generally constant; total variable cost changes with output.

Marginal Cost and Contribution (cont)

- Higher contribution per unit generally means a lower break-even volume, assuming fixed costs remain unchanged.

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Marginal-Costing Decisions

Make-or-Buy Decisions

1. Meaning

Make-or-Buy Decisions (cont)

- A make-or-buy decision determines whether a business should manufacture a component/product internally or purchase it from an external supplier.

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Make-or-Buy Decisions (cont)

- It is a short-term decision based on relevant costs, available capacity, quality and strategic considerations.

Make-or-Buy Decisions (cont)

- The objective is to choose the alternative with the lower relevant cost, subject to operational constraints.

Make-or-Buy Decisions (cont)

2. Relevant Costs in Make-or-Buy Decisions

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Make-or-Buy Decisions (cont)

- Relevant costs of making:

Make-or-Buy Decisions (cont)

- Direct material.

Make-or-Buy Decisions (cont)

- Direct labour, if avoidable.

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Make-or-Buy Decisions (cont)

- Variable production overheads.

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Make-or-Buy Decisions (cont)

- Avoidable fixed overheads.

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Make-or-Buy Decisions (cont)

- Opportunity cost of capacity used.

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Make-or-Buy Decisions (cont)

- Relevant costs of buying:

Make-or-Buy Decisions (cont)

- Purchase price.

Make-or-Buy Decisions (cont)

- Freight, inspection and procurement costs.

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Make-or-Buy Decisions (cont)

- Any additional costs associated with outsourcing.

Make-or-Buy Decisions (cont)

- Unavoidable fixed overheads are generally irrelevant because they continue under either alternative.

Make-or-Buy Decisions (cont)

- Sunk costs and past expenditure are irrelevant.

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Make-or-Buy Decisions (cont)

3. Decision Rule

Make-or-Buy Decisions (cont)

- Relevant Cost of Making = Avoidable Manufacturing Costs + Opportunity Cost.

Make-or-Buy Decisions (cont)

- Relevant Cost of Buying = Purchase Price + Additional Procurement Costs.

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Make-or-Buy Decisions (cont)

- If relevant cost of making is lower → Make internally.

Make-or-Buy Decisions (cont)

- If relevant cost of buying is lower → Buy externally.

Make-or-Buy Decisions (cont)

- Consider quality, supplier reliability, delivery time, confidentiality and strategic control before deciding.

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Make-or-Buy Decisions (cont)

4. Worked Example

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Make-or-Buy Decisions (cont)

A company requires 10,000 components.

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Make-or-Buy Decisions (cont)

Cost of making per unit:

Make-or-Buy Decisions (cont)

- Direct material = ₹20.

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Make-or-Buy Decisions (cont)

- Direct labour = ₹15.

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Make-or-Buy Decisions (cont)

- Variable overhead = ₹5.

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Make-or-Buy Decisions (cont)

- Fixed overhead = ₹10, of which only ₹4 is avoidable.

Make-or-Buy Decisions (cont)

Supplier's offer = ₹43 per unit.

Make-or-Buy Decisions (cont)

Calculation:

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Make-or-Buy Decisions (cont)

- Relevant making cost/unit = ₹20 + ₹15 + ₹5 + ₹4 = ₹44.

Make-or-Buy Decisions (cont)

- Total making cost = 10,000 × ₹44 = ₹4,40,000.

Make-or-Buy Decisions (cont)

- Total buying cost = 10,000 × ₹43 = ₹4,30,000.

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Make-or-Buy Decisions (cont)

- Buying saves ₹10,000.

Make-or-Buy Decisions (cont)

Decision: Buy, assuming quality and supply reliability are acceptable.

Make-or-Buy Decisions (cont)

5. Opportunity Cost of Capacity

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Make-or-Buy Decisions (cont)

- If internal capacity released by outsourcing can be used for another profitable activity, the contribution sacrificed by continuing to make internally is an opportunity cost.

Make-or-Buy Decisions (cont)

- Include this lost contribution in the relevant cost of making.

Make-or-Buy Decisions (cont)

- If idle capacity has no alternative use, there may be no opportunity cost.

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Make-or-Buy Decisions (cont)

6. Strategic Considerations

Make-or-Buy Decisions (cont)

- Quality and technical specifications.

Make-or-Buy Decisions (cont)

- Supplier dependability and delivery schedules.

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Make-or-Buy Decisions (cont)

- Risk of supply disruption and price fluctuations.

Make-or-Buy Decisions (cont)

- Confidentiality and protection of intellectual property.

Make-or-Buy Decisions (cont)

- Long-term dependence on suppliers.

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Make-or-Buy Decisions (cont)

- Control over production and core competencies.

Make-or-Buy Decisions (cont)

- Employment and regulatory considerations.

Make-or-Buy Decisions (cont)

7. MCQ Traps

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Make-or-Buy Decisions (cont)

- Allocated fixed overhead is not automatically relevant.

Make-or-Buy Decisions (cont)

- Only avoidable fixed costs are relevant to the decision.

Make-or-Buy Decisions (cont)

- Sunk costs are irrelevant.

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Make-or-Buy Decisions (cont)

- Opportunity cost must be considered when capacity has an alternative profitable use.

Make-or-Buy Decisions (cont)

- A lower purchase price alone does not guarantee that buying is preferable.

Make-or-Buy Decisions (cont)

- Make-or-buy decisions generally use relevant costs, not full absorption cost per unit.

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Product-Mix Decisions

1. Meaning

Product-Mix Decisions (cont)

- Product-mix decision determines the combination and quantity of products a business should produce and sell to maximise profit.

Product-Mix Decisions (cont)

- It is particularly important when resources such as labour, machine hours, materials or production capacity are limited.

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Product-Mix Decisions (cont)

- The objective is to maximise total contribution, subject to demand and resource constraints.

Product-Mix Decisions (cont)

2. Basic Decision Rule

Product-Mix Decisions (cont)

- When there is no limiting factor and demand is unrestricted, prioritise products with the highest contribution per unit.

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Product-Mix Decisions (cont)

- When a limiting factor exists, prioritise products based on contribution per unit of limiting factor, not contribution per unit of product.

Product-Mix Decisions (cont)

3. Relevant Formulas

Product-Mix Decisions (cont)

- Contribution per Unit = Selling Price per Unit − Variable Cost per Unit.

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Product-Mix Decisions (cont)

- Total Contribution = Contribution per Unit × Units Sold.

Product-Mix Decisions (cont)

- Profit = Total Contribution − Fixed Cost.

Product-Mix Decisions (cont)

- Contribution per Limiting Factor = Contribution per Unit ÷ Limiting Factor Required per Unit.

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Product-Mix Decisions (cont)

4. Worked Example — Single Limiting Factor

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Product-Mix Decisions (cont)

A company manufactures two products:

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Product-Mix Decisions (cont)

Product A:

Product-Mix Decisions (cont)

- Contribution per unit = ₹60.

Product-Mix Decisions (cont)

- Machine hours required = 3 hours.

Product-Mix Decisions (cont)

- Contribution per machine hour = ₹60 ÷ 3 = ₹20.

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Product-Mix Decisions (cont)

Product B:

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Product-Mix Decisions (cont)

- Contribution per unit = ₹50.

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Product-Mix Decisions (cont)

- Machine hours required = 2 hours.

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Product-Mix Decisions (cont)

- Contribution per machine hour = ₹50 ÷ 2 = ₹25.

Product-Mix Decisions (cont)

- Machine hours are the limiting factor.

Product-Mix Decisions (cont)

- Product B generates higher contribution per machine hour.

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Product-Mix Decisions (cont)

Decision: Prioritise Product B, subject to demand and other constraints.

Product-Mix Decisions (cont)

5. Product Mix with Demand Constraints

Product-Mix Decisions (cont)

- If demand for the highest-ranked product is limited, satisfy its demand first and allocate remaining capacity to the next-r-anked product.

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Product-Mix Decisions (cont)

- Continue until available capacity is exhausted.

Product-Mix Decisions (cont)

- The optimal mix may include multiple products.

Product-Mix Decisions (cont)

- Consider minimum production requirements and contractual commitments where applicable.

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Product-Mix Decisions (cont)

6. Multiple Limiting Factors

Product-Mix Decisions (cont)

- If more than one resource is scarce (e.g. labour hours and machine hours), simply ranking products by contribution per limiting factor may not give the optimal solution.

Product-Mix Decisions (cont)

- Linear Programming (LP) can be used to determine the optimal product mix.

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Product-Mix Decisions (cont)

- Objective: Maximise total contribution.

Product-Mix Decisions (cont)

- Constraints: Resource availability, demand limits, production capacity and non-negativity of production quantities.

Product-Mix Decisions (cont)

- Graphical method is suitable for simple problems involving two decision variables; simplex method handles more complex problems.

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Product-Mix Decisions (cont)

7. Factors Affecting Product Mix

Product-Mix Decisions (cont)

- Contribution per unit and per limiting factor.

Product-Mix Decisions (cont)

- Availability of materials, labour and machine capacity.

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Product-Mix Decisions (cont)

- Market demand and selling-price constr-aints.

Product-Mix Decisions (cont)

- Production time and technical capacity.

Product-Mix Decisions (cont)

- Product quality and customer commit-ments.

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Product-Mix Decisions (cont)

- Interdependence between products and joint production requirements.

Product-Mix Decisions (cont)

8. MCQ Traps

Product-Mix Decisions (cont)

- Highest contribution per unit does not necessarily mean highest profitability when a resource is scarce.

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Product-Mix Decisions (cont)

- Use contribution per unit of the limiting factor.

Product-Mix Decisions (cont)

- Fixed costs that remain unchanged are generally irrelevant to short-term product-mix ranking.

Product-Mix Decisions (cont)

- Product demand constraints must be respected.

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Product-Mix Decisions (cont)

- If no resource is limiting, contribution per unit is the usual ranking basis.

Product-Mix Decisions (cont)

- With multiple limiting factors, linear programming may be required.

Limiting-Factor Analysis

1. Meaning

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Limiting-Factor Analysis (cont)

- A limiting factor (key factor) is a resource or constraint that restricts the level of production or sales.

Limiting-Factor Analysis (cont)

- It prevents a business from achieving its desired output or profit.

Limiting-Factor Analysis (cont)

- Common limiting factors:

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Limiting-Factor Analysis (cont)

- Raw material availability.

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Limiting-Factor Analysis (cont)

- Skilled labour hours.

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Limiting-Factor Analysis (cont)

- Machine hours.

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Limiting-Factor Analysis (cont)

- Production capacity.

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Limiting-Factor Analysis (cont)

- Working capital.

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Limiting-Factor Analysis (cont)

- Market demand.

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Limiting-Factor Analysis (cont)

- The objective is to maximise contribution from the scarce resource.

Limiting-Factor Analysis (cont)

2. Key Decision Rule

Limiting-Factor Analysis (cont)

- Rank products according to Contribution per Unit of Limiting Factor.

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Limiting-Factor Analysis (cont)

- Give priority to the product generating the highest contribution per unit of scarce resource.

Limiting-Factor Analysis (cont)

- Allocate the resource in descending order of contribution per limiting factor, subject to demand constraints.

Limiting-Factor Analysis (cont)

3. Important Formulas

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Limiting-Factor Analysis (cont)

- Contribution per Unit = Selling Price − Variable Cost.

Limiting-Factor Analysis (cont)

- Contribution per Limiting Factor = Contribution per Unit ÷ Quantity of Limiting Factor Required per Unit.

Limiting-Factor Analysis (cont)

- Total Contribution = Contribution per Unit × Units Produced.

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Limiting-Factor Analysis (cont)

- Profit = Total Contribution − Fixed Cost.

Limiting-Factor Analysis (cont)

- Contribution per Labour Hour = Contribution per Unit ÷ Labour Hours per Unit.

Limiting-Factor Analysis (cont)

- Contribution per Machine Hour = Contribution per Unit ÷ Machine Hours per Unit.

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Limiting-Factor Analysis (cont)

- Contribution per kg of Material = Contribution per Unit ÷ Material Required per Unit.

Limiting-Factor Analysis (cont)

4. Worked Example

Limiting-Factor Analysis (cont)

A company has 1,000 machine hours available.

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Limiting-Factor Analysis (cont)

- Product A:

Limiting-Factor Analysis (cont)

- Contribution per unit = ₹100.

Limiting-Factor Analysis (cont)

- Machine hours per unit = 5.

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Limiting-Factor Analysis (cont)

- Contribution per machine hour = ₹20.

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Limiting-Factor Analysis (cont)

- Product B:

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Limiting-Factor Analysis (cont)

- Contribution per unit = ₹80.

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Limiting-Factor Analysis (cont)

- Machine hours per unit = 2.

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Limiting-Factor Analysis (cont)

- Contribution per machine hour = ₹40.

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Limiting-Factor Analysis (cont)

Ranking:

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Limiting-Factor Analysis (cont)

- Product B = ₹40 per machine hour → Rank 1.

Limiting-Factor Analysis (cont)

- Product A = ₹20 per machine hour → Rank 2.

Limiting-Factor Analysis (cont)

- Produce Product B first, subject to demand.

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Limiting-Factor Analysis (cont)

- Allocate remaining machine hours to Product A.

Limiting-Factor Analysis (cont)

- The objective is to maximise total contribution from the available 1,000 hours.

Limiting-Factor Analysis (cont)

5. Limiting Factor vs Non-Limiting Factor

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Limiting-Factor Analysis (cont)

- Limiting factor: Resource in short supply; determines the production ceiling.

Limiting-Factor Analysis (cont)

- Non-limiting factor: Resource available in sufficient quantity; does not currently restrict output.

Limiting-Factor Analysis (cont)

- The limiting factor may change when resource availability or market conditions change.

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Limiting-Factor Analysis (cont)

6. Shadow Price / Value of an Additional Resource

Limiting-Factor Analysis (cont)

- Shadow Price represents the additional contribution or objective value obtainable from one extra unit of a scarce resource, within the relevant range.

Limiting-Factor Analysis (cont)

- It indicates the maximum amount a business should theoretically be willing to pay for one additional unit of the limiting resource.

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Limiting-Factor Analysis (cont)

- If the cost of obtaining an additional resource is lower than its shadow price, acquiring it may be beneficial.

Limiting-Factor Analysis (cont)

- In linear programming, the shadow price is the change in optimal objective value resulting from a one-unit increase in a resource constraint, assuming the current solution remains within its allowable range.

Limiting-Factor Analysis (cont)

7. Multiple Limiting Factors

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Limiting-Factor Analysis (cont)

- When two or more resources are scarce, ranking based on one resource alone may not maximise profit.

Limiting-Factor Analysis (cont)

- Linear Programming (LP) is used to optimise the product mix subject to multiple constraints.

Limiting-Factor Analysis (cont)

- Objective function: Maximise total contribution.

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Limiting-Factor Analysis (cont)

- Constraints: Resource availability, demand limits and production capacity.

Limiting-Factor Analysis (cont)

- Non-negativity condition: Production quantities cannot be negative.

Limiting-Factor Analysis (cont)

8. MCQ Traps

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Limiting-Factor Analysis (cont)

- A limiting factor restricts output; it is not necessarily the most expensive resource.

Limiting-Factor Analysis (cont)

- Rank products using contribution per unit of the limiting factor, not contribution per unit.

Limiting-Factor Analysis (cont)

- Fixed costs are generally irrelevant when unchanged.

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Limiting-Factor Analysis (cont)

- Demand limits must be considered before allocating scarce resources.

Limiting-Factor Analysis (cont)

- Shadow price measures the marginal value of an additional unit of a constrained resource, not its purchase price.

Limiting-Factor Analysis (cont)

- Shadow price can be zero when a resource constraint is non-binding.

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Shut-Down or Continue Decisions

1. Meaning

Shut-Down or Continue Decisions (cont)

- A shut-down decision determines whether a business, department, product line or factory should temporarily stop operations or continue operating.

Shut-Down or Continue Decisions (cont)

- The decision is based on whether continuing operations generates sufficient contribution to cover avoidable costs.

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Shut-Down or Continue Decisions (cont)

- A temporary shut-down does not necessarily mean permanent closure.

Shut-Down or Continue Decisions (cont)

2. Basic Decision Rule

Shut-Down or Continue Decisions (cont)

- Continue operating if contribution earned exceeds avoidable fixed costs of continuing operations.

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Shut-Down or Continue Decisions (cont)

- Shut down if the contribution lost by continuing is less than the costs saved through closure, after considering shutdown and reopening costs.

Shut-Down or Continue Decisions (cont)

- Unavoidable fixed costs must be considered even during temporary closure.

Shut-Down or Continue Decisions (cont)

3. Relevant Cost Comparison

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Shut-Down or Continue Decisions (cont)

Continue:

Shut-Down or Continue Decisions (cont)

- Contribution from operations.

Shut-Down or Continue Decisions (cont)

- Fixed costs that continue regardless of the decision.

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Shut-Down or Continue Decisions (cont)

- Avoidable operating costs.

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Shut-Down or Continue Decisions (cont)

Shut Down:

Shut-Down or Continue Decisions (cont)

- Contribution lost.

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Shut-Down or Continue Decisions (cont)

- Fixed costs avoided through closure.

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Shut-Down or Continue Decisions (cont)

- Shutdown costs.

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Shut-Down or Continue Decisions (cont)

- Reopening costs, if applicable.

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Shut-Down or Continue Decisions (cont)

- Salvage value or alternative use of assets, where relevant.

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Shut-Down or Continue Decisions (cont)

4. Worked Example

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Shut-Down or Continue Decisions (cont)

A department reports:

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Shut-Down or Continue Decisions (cont)

- Sales = ₹5,00,000.

Shut-Down or Continue Decisions (cont)

- Variable costs = ₹3,00,000.

Shut-Down or Continue Decisions (cont)

- Fixed costs = ₹2,50,000.

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Shut-Down or Continue Decisions (cont)

- Of fixed costs, ₹1,80,000 are avoidable and ₹70,000 are unavoidable.

Shut-Down or Continue Decisions (cont)

If it continues:

Shut-Down or Continue Decisions (cont)

- Contribution = ₹5,00,000 − ₹3,00,000 = ₹2,00,000.

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Shut-Down or Continue Decisions (cont)

- Net result = ₹2,00,000 − ₹2,50,000 = ₹50,000 loss.

Shut-Down or Continue Decisions (cont)

If it shuts down:

Shut-Down or Continue Decisions (cont)

- Avoidable fixed costs saved = ₹1,80,000.

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Shut-Down or Continue Decisions (cont)

- Unavoidable fixed costs continue = ₹70,000.

Shut-Down or Continue Decisions (cont)

- Loss = ₹70,000.

Shut-Down or Continue Decisions (cont)

Decision: Continue.

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Shut-Down or Continue Decisions (cont)

- Continuing results in a ₹50,000 loss, whereas shutting down results in a ₹70,000 loss.

Shut-Down or Continue Decisions (cont)

- Continuing is better by ₹20,000.

Shut-Down or Continue Decisions (cont)

5. Shutdown Point

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Shut-Down or Continue Decisions (cont)

- Shutdown Point is the level of sales/output below which temporary closure may be economically preferable.

Shut-Down or Continue Decisions (cont)

- In a simplified short-run model:

Shut-Down or Continue Decisions (cont)

Shutdown Sales/Output occurs when Contribution = Avoidable Fixed Costs.

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Shut-Down or Continue Decisions (cont)

- If contribution is below avoidable fixed costs, shutting down may reduce the loss.

Shut-Down or Continue Decisions (cont)

- This is a short-run decision rule; actual shutdown decisions must also consider shutdown costs, reopening costs and other relevant factors.

Shut-Down or Continue Decisions (cont)

6. Qualitative Factors

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Shut-Down or Continue Decisions (cont)

- Possibility of recovering market share after reopening.

Shut-Down or Continue Decisions (cont)

- Employee retention and retraining costs.

Shut-Down or Continue Decisions (cont)

- Customer relationships and contractual obligations.

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Shut-Down or Continue Decisions (cont)

- Supplier relationships.

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Shut-Down or Continue Decisions (cont)

- Future demand expectations.

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Shut-Down or Continue Decisions (cont)

- Legal and regulatory obligations.

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Shut-Down or Continue Decisions (cont)

- Impact on brand reputation and long-term strategy.

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Shut-Down or Continue Decisions (cont)

7. MCQ Traps

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Shut-Down or Continue Decisions (cont)

- Accounting loss does not automatically mean the department should shut down.

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Shut-Down or Continue Decisions (cont)

- Unavoidable fixed costs are incurred even after shutdown.

Shut-Down or Continue Decisions (cont)

- Contribution lost through shutdown must be compared with avoidable costs saved.

Shut-Down or Continue Decisions (cont)

- A department may rationally continue operating despite reporting an accounting loss.

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Shut-Down or Continue Decisions (cont)

- Temporary shutdown and permanent closure are different decisions.

Shut-Down or Continue Decisions (cont)

- Shutdown costs and reopening costs can change the decision.

Special-Order Decisions

1. Meaning

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Special-Order Decisions (cont)

- A special order is a one-time or non-routine customer order, often at a price different from the normal selling price.

Special-Order Decisions (cont)

- The business must decide whether to accept the order based on its incremental profitability.

Special-Order Decisions (cont)

- Common examples: bulk orders at discounted prices, export orders, institutional orders and customised orders.

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Special-Order Decisions (cont)

2. Relevant Costs

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Special-Order Decisions (cont)

Include:

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Special-Order Decisions (cont)

- Additional direct material.

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Special-Order Decisions (cont)

- Additional direct labour.

Special-Order Decisions (cont)

- Incremental variable production overheads.

Special-Order Decisions (cont)

- Special packaging, transportation or distribution costs.

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Special-Order Decisions (cont)

- Additional fixed costs incurred specifically for the order.

Special-Order Decisions (cont)

- Opportunity cost of using capacity that could otherwise generate contribution.

Special-Order Decisions (cont)

Exclude:

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Special-Order Decisions (cont)

- Sunk costs.

Special-Order Decisions (cont)

- Existing unavoidable fixed costs.

Special-Order Decisions (cont)

- Allocated overheads that do not change because of the order.

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Special-Order Decisions (cont)

3. Basic Decision Rule

Special-Order Decisions (cont)

- Incremental Revenue = Special Order Quantity × Special Order Price.

Special-Order Decisions (cont)

- Incremental Cost = Additional costs attributable to the order.

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Special-Order Decisions (cont)

- Incremental Profit = Incremental Revenue − Incremental Cost.

Special-Order Decisions (cont)

- Accept if incremental profit is positive and there are no overriding strategic or contra-ctual concerns.

Special-Order Decisions (cont)

- If capacity is fully utilised, include the opportunity cost of regular sales displaced by the special order.

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Special-Order Decisions (cont)

4. Worked Example — Idle Capacity

Special-Order Decisions (cont)

A company has idle production capacity and receives a special order for 2,000 units at ₹70 per unit.

Special-Order Decisions (cont)

- Normal selling price = ₹100.

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Special-Order Decisions (cont)

- Variable manufacturing cost = ₹50/unit.

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Special-Order Decisions (cont)

- Special packaging cost = ₹5/unit.

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Special-Order Decisions (cont)

- No additional fixed cost.

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Special-Order Decisions (cont)

Calculation:

Special-Order Decisions (cont)

- Incremental Revenue = 2,000 × ₹70 = ₹1,40,000.

Special-Order Decisions (cont)

- Incremental Cost per unit = ₹50 + ₹5 = ₹55.

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Special-Order Decisions (cont)

- Total Incremental Cost = 2,000 × ₹55 = ₹1,10,000.

Special-Order Decisions (cont)

- Incremental Profit = ₹1,40,000 − ₹1,10,000 = ₹30,000.

Special-Order Decisions (cont)

Decision: Accept, assuming idle capacity is genuinely available and normal sales are unaffected.

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Special-Order Decisions (cont)

5. Special Order with Full Capacity

Special-Order Decisions (cont)

- If accepting the order displaces regular sales, the contribution sacrificed on those sales is an opportunity cost.

Special-Order Decisions (cont)

- Compare special-order contribution with the contribution lost from displaced regular sales.

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Special-Order Decisions (cont)

- Accept only if the net incremental benefit is positive.

Special-Order Decisions (cont)

6. Qualitative Considerations

Special-Order Decisions (cont)

- Whether the special price will affect normal market prices.

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Special-Order Decisions (cont)

- Risk of existing customers demanding similar discounts.

Special-Order Decisions (cont)

- Quality and delivery commitments.

Special-Order Decisions (cont)

- Whether the order may lead to repeat business.

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Special-Order Decisions (cont)

- Impact on brand positioning.

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Special-Order Decisions (cont)

- Risk of disrupting regular production.

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Special-Order Decisions (cont)

7. MCQ Traps

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Special-Order Decisions (cont)

- Special orders should be evaluated using incremental costs, not full absorption cost.

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Special-Order Decisions (cont)

- Existing fixed overheads are irrelevant if they remain unchanged.

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Special-Order Decisions (cont)

- Idle capacity makes accepting a lower--priced order potentially profitable.

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Special-Order Decisions (cont)

- A special order below normal selling price is not automatically loss-making.

Special-Order Decisions (cont)

- Include opportunity cost if regular sales are displaced.

Special-Order Decisions (cont)

- Special-order acceptance should not compromise normal customer commitments.

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Accept or Reject Decisions

1. Meaning

Accept or Reject Decisions (cont)

- Accept or reject decisions involve evaluating whether a business should undertake a particular activity, order, contract or proposal.

Accept or Reject Decisions (cont)

- The decision is based on incremental revenue, relevant costs and opportunity costs.

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Accept or Reject Decisions (cont)

- The objective is to determine whether accepting the proposal improves overall profitability.

Accept or Reject Decisions (cont)

2. Basic Decision Rule

Accept or Reject Decisions (cont)

- Incremental Profit = Incremental Revenue − Incremental Relevant Cost.

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Accept or Reject Decisions (cont)

- Accept if incremental profit is positive.

Accept or Reject Decisions (cont)

- Reject if incremental profit is negative.

Accept or Reject Decisions (cont)

- If incremental profit is zero, the decision is financially indifferent; consider qualitative factors.

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Accept or Reject Decisions (cont)

3. Relevant Factors

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Accept or Reject Decisions (cont)

- Additional revenue generated.

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Accept or Reject Decisions (cont)

- Additional variable costs.

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Accept or Reject Decisions (cont)

- Avoidable fixed costs.

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Accept or Reject Decisions (cont)

- Additional fixed costs specifically incurred.

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Accept or Reject Decisions (cont)

- Opportunity cost of scarce resources.

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Accept or Reject Decisions (cont)

- Alternative uses of available capacity.

Accept or Reject Decisions (cont)

- Quality, customer relationships and strategic considerations.

Accept or Reject Decisions (cont)

4. Worked Example — Accept or Reject an Order

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Accept or Reject Decisions (cont)

A company receives an order for 1,000 units at ₹90 per unit.

Accept or Reject Decisions (cont)

- Variable cost per unit = ₹70.

Accept or Reject Decisions (cont)

- Additional fixed cost for the order = ₹5,000.

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Accept or Reject Decisions (cont)

- Existing fixed costs remain unchanged.

Accept or Reject Decisions (cont)

Calculation:

Accept or Reject Decisions (cont)

- Incremental Revenue = 1,000 × ₹90 = ₹90,000.

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Accept or Reject Decisions (cont)

- Variable Cost = 1,000 × ₹70 = ₹70,000.

Accept or Reject Decisions (cont)

- Additional Fixed Cost = ₹5,000.

Accept or Reject Decisions (cont)

- Incremental Profit = ₹90,000 − ₹70,000 − ₹5,000 = ₹15,000.

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Accept or Reject Decisions (cont)

Decision: Accept, subject to capacity and other relevant considerations.

Accept or Reject Decisions (cont)

5. Accept or Reject under a Limiting Factor

Accept or Reject Decisions (cont)

- When a scarce resource is involved, compare contribution per unit of the limiting factor.

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Accept or Reject Decisions (cont)

- Accept the proposal if it generates greater contribution than the alternative use of that scarce resource.

Accept or Reject Decisions (cont)

- Include the opportunity cost of displaced production.

Accept or Reject Decisions (cont)

- A proposal with positive standalone contribution may still be rejected if it displaces a more profitable alternative.

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Accept or Reject Decisions (cont)

6. Accept or Reject a Product / Segment

Accept or Reject Decisions (cont)

- A product or business segment should not be discontinued merely because it reports an accounting loss.

Accept or Reject Decisions (cont)

- Compare the contribution lost from discontinuation with the fixed costs actually avoided.

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Accept or Reject Decisions (cont)

- Continue if contribution exceeds avoidable fixed costs, subject to other considerations.

Accept or Reject Decisions (cont)

- Discontinue if avoidable costs saved exceed contribution sacrificed, after considering closure and other relevant costs.

Accept or Reject Decisions (cont)

7. MCQ Traps

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Accept or Reject Decisions (cont)

- Accept/reject decisions focus on incremental costs and benefits.

Accept or Reject Decisions (cont)

- Allocated fixed costs are not automatically relevant.

Accept or Reject Decisions (cont)

- Sunk costs are irrelevant.

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Accept or Reject Decisions (cont)

- Opportunity costs must be included.

Accept or Reject Decisions (cont)

- Positive contribution does not always mean accepting an order is optimal when capacity is constrained.

Accept or Reject Decisions (cont)

- Accounting profit and incremental profit are different concepts.

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Pricing Under Different Market Conditions

1. Meaning

Pricing Under Different Market Conditions (cont)

- Pricing decisions determine the selling price of a product or service under different competitive, demand and cost conditions.

Pricing Under Different Market Conditions (cont)

- Marginal costing helps determine the minimum acceptable price in the short run by identifying variable costs and contribution.

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Pricing Under Different Market Conditions (cont)

- Pricing must also consider demand, competition, capacity, customer perception and long-term profitability.

Pricing Under Different Market Conditions (cont)

2. Cost-Plus Pricing

Pricing Under Different Market Conditions (cont)

- Selling Price = Total Cost + Profit Margin.

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Pricing Under Different Market Conditions (cont)

- Under marginal-cost-plus pricing:

Pricing Under Different Market Conditions (cont)

Selling Price = Variable Cost + Desired Contribution.

Pricing Under Different Market Conditions (cont)

- Mark-up is added to the selected cost base to determine the selling price.

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Pricing Under Different Market Conditions (cont)

- A mark-up on cost and a margin on selling price are different:

Pricing Under Different Market Conditions (cont)

- Mark-up % = Profit ÷ Cost × 100.

Pricing Under Different Market Conditions (cont)

- Profit Margin % = Profit ÷ Selling Price × 100.

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Pricing Under Different Market Conditions (cont)

3. Pricing under Perfect Competition

Pricing Under Different Market Conditions (cont)

- Many buyers and sellers.

Pricing Under Different Market Conditions (cont)

- Homogeneous products.

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Pricing Under Different Market Conditions (cont)

- Individual firms have little or no control over market price.

Pricing Under Different Market Conditions (cont)

- Firms are generally price takers.

Pricing Under Different Market Conditions (cont)

- In the long run, economic profit tends towards normal profit under standard competitive assumptions.

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Pricing Under Different Market Conditions (cont)

- A firm may accept a price above incremental cost in the short run if it covers relevant costs and contributes towards fixed costs.

Pricing Under Different Market Conditions (cont)

4. Pricing under Monopoly

Pricing Under Different Market Conditions (cont)

- A single dominant seller with no close substitutes and significant barriers to entry.

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Pricing Under Different Market Conditions (cont)

- The seller has greater price-setting power.

Pricing Under Different Market Conditions (cont)

- Price and output decisions depend on demand and marginal revenue/marginal cost.

Pricing Under Different Market Conditions (cont)

- Profit-maximising output under standard economic theory occurs where:

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Pricing Under Different Market Conditions (cont)

Marginal Revenue (MR) = Marginal Cost (MC).

Pricing Under Different Market Conditions (cont)

- The selling price is then determined from the demand curve.

Pricing Under Different Market Conditions (cont)

- Monopoly does not mean unlimited pricing power; demand and regulation constrain prices.

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Pricing Under Different Market Conditions (cont)

5. Pricing under Monopolistic Competition

Pricing Under Different Market Conditions (cont)

- Many sellers offer differentiated products.

Pricing Under Different Market Conditions (cont)

- Product differentiation may arise from branding, quality, design, service and location.

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Pricing Under Different Market Conditions (cont)

- Firms have some control over prices.

Pricing Under Different Market Conditions (cont)

- Advertising and selling expenses can be significant.

Pricing Under Different Market Conditions (cont)

- In the long run, entry of competing firms tends to eliminate abnormal economic profits under standard assumptions.

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Pricing Under Different Market Conditions (cont)

6. Pricing under Oligopoly

Pricing Under Different Market Conditions (cont)

- A small number of large firms dominate the market.

Pricing Under Different Market Conditions (cont)

- Firms are interdependent: one firm's pricing decision affects competitors.

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Pricing Under Different Market Conditions (cont)

- Prices may be relatively rigid because firms anticipate competitor reactions.

Pricing Under Different Market Conditions (cont)

- Common pricing approaches:

Pricing Under Different Market Conditions (cont)

- Price leadership: One major firm sets a price followed by others.

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Pricing Under Different Market Conditions (cont)

- Competitive pricing: Firms respond to competitors' prices.

Pricing Under Different Market Conditions (cont)

- Collusive pricing: Firms coordinate prices/output; unlawful where prohibited by competition law.

Pricing Under Different Market Conditions (cont)

- Non-price competition through advertising, quality and service is common.

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Pricing Under Different Market Conditions (cont)

7. Short-Run Special Pricing

Pricing Under Different Market Conditions (cont)

- When idle capacity exists, a business may accept an order below normal full cost if the price covers incremental costs and generates positive contribution.

Pricing Under Different Market Conditions (cont)

- Minimum acceptable price generally covers:

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Pricing Under Different Market Conditions (cont)

- Variable costs.

Pricing Under Different Market Conditions (cont)

- Additional order-specific costs.

Pricing Under Different Market Conditions (cont)

- Opportunity cost, if capacity is constrained.

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Pricing Under Different Market Conditions (cont)

- Existing unavoidable fixed costs need not be recovered by every individual order in the short run.

Pricing Under Different Market Conditions (cont)

8. Penetration and Skimming Pricing

Pricing Under Different Market Conditions (cont)

- Penetration Pricing:

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Pricing Under Different Market Conditions (cont)

- Initially sets a relatively low price to attract customers and gain market share.

Pricing Under Different Market Conditions (cont)

- Suitable when price sensitivity is high and large-scale sales can reduce unit costs.

Pricing Under Different Market Conditions (cont)

- May discourage new competitors through early market presence.

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Pricing Under Different Market Conditions (cont)

- Price Skimming:

Pricing Under Different Market Conditions (cont)

- Initially sets a high price for a new or differentiated product.

Pricing Under Different Market Conditions (cont)

- Targets customers willing to pay more initially.

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Pricing Under Different Market Conditions (cont)

- Price may be reduced over time to reach broader market segments.

Pricing Under Different Market Conditions (cont)

- Common where innovation, uniqueness or limited competition exists.

Pricing Under Different Market Conditions (cont)

9. Other Pricing Methods

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Pricing Under Different Market Conditions (cont)

- Going-rate pricing: Price based on prevailing market or competitor prices.

Pricing Under Different Market Conditions (cont)

- Target costing: Determine allowable cost by subtracting desired profit from market-based target selling price.

Pricing Under Different Market Conditions (cont)

- Differential pricing: Charge different prices to different customers or market segments, subject to applicable laws.

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Pricing Under Different Market Conditions (cont)

- Peak-load pricing: Charge higher prices during periods of high demand or capacity pressure.

Pricing Under Different Market Conditions (cont)

- Predatory pricing: Pricing below cost with the intention of eliminating competition; may attract competition-law scrutiny depending on the applicable legal test.

Pricing Under Different Market Conditions (cont)

10. MCQ Traps

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Pricing Under Different Market Conditions (cont)

- Marginal cost is particularly useful for short-run pricing decisions.

Pricing Under Different Market Conditions (cont)

- A price below full cost is not automatically unacceptable if idle capacity exists and incremental contribution is positive.

Pricing Under Different Market Conditions (cont)

- Long-run pricing must generally provide for recovery of total costs and a sustainable return.

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Pricing Under Different Market Conditions (cont)

- Perfect competition → Price taker.

Pricing Under Different Market Conditions (cont)

- Monopoly → Price-setting power, constrained by demand.

Pricing Under Different Market Conditions (cont)

- Oligopoly → Strategic interdependence.

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Pricing Under Different Market Conditions (cont)

- Monopolistic competition → Product differentiation.

Pricing Under Different Market Conditions (cont)

- Penetration pricing starts low; skimming pricing starts high.

Pricing Under Different Market Conditions (cont)

- MR = MC determines the profit-maximising output under standard economic assumptions, not necessarily the selling price directly.

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Relevant-Cost Analysis

1. Meaning

Relevant-Cost Analysis (cont)

- Relevant-cost analysis is the process of identifying costs and revenues that differ between alternative decisions.

Relevant-Cost Analysis (cont)

- A cost is relevant if it is:

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Relevant-Cost Analysis (cont)

- A future cost; and

Relevant-Cost Analysis (cont)

- Different under the alternatives being considered.

Relevant-Cost Analysis (cont)

- It is used in make-or-buy, product-mix, special-order, shutdown, replacement and accept/reject decisions.

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Relevant-Cost Analysis (cont)

- Also called differential cost analysis in many decision-making contexts.

Relevant-Cost Analysis (cont)

2. Types of Relevant Costs

Relevant-Cost Analysis (cont)

- Incremental Cost: Additional cost incurred due to a decision.

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Relevant-Cost Analysis (cont)

- Differential Cost: Difference in total cost between two alternatives.

Relevant-Cost Analysis (cont)

- Avoidable Cost: Cost that can be eliminated by choosing a particular alternative.

Relevant-Cost Analysis (cont)

- Opportunity Cost: Benefit sacrificed by choosing one alternative instead of the next-best alternative.

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Relevant-Cost Analysis (cont)

- Replacement Cost: Current cost of replacing an existing asset or material.

Relevant-Cost Analysis (cont)

- Marginal Cost: Additional cost of producing one additional unit.

Relevant-Cost Analysis (cont)

3. Irrelevant Costs

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Relevant-Cost Analysis (cont)

- Sunk Cost: Cost already incurred and unrecoverable; irrelevant to future decisions.

Relevant-Cost Analysis (cont)

- Committed Cost: Cost arising from an existing commitment that cannot be avoided in the decision period.

Relevant-Cost Analysis (cont)

- Unavoidable Fixed Cost: Cost that continues regardless of the alternative selected.

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Relevant-Cost Analysis (cont)

- Book Value: Historical carrying amount of an asset; generally irrelevant to replacement decisions.

Relevant-Cost Analysis (cont)

- Allocated Overhead: Irrelevant if the allocation does not change between alternatives.

Relevant-Cost Analysis (cont)

- Depreciation: Generally irrelevant as a non-cash allocation of historical cost; however, tax effects or changes in future cash flows associated with an asset may be relevant.

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Relevant-Cost Analysis (cont)

4. Relevant vs Irrelevant Cost — Important Distinctions

Relevant-Cost Analysis (cont)

- Past expenditure → Sunk cost → Irrelevant.

Relevant-Cost Analysis (cont)

- Future expenditure that is identical under all alternatives → Irrelevant.

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Relevant-Cost Analysis (cont)

- Future expenditure that differs between alternatives → Relevant.

Relevant-Cost Analysis (cont)

- Fixed cost → Not automatically irrelevant; avoidable fixed costs may be relevant.

Relevant-Cost Analysis (cont)

- Variable cost → Usually relevant when output changes, but only if it differs between alternatives.

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Relevant-Cost Analysis (cont)

- Opportunity cost → Relevant even though it may not appear in accounting records.

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Relevant-Cost Analysis (cont)

5. Worked Example — Relevant Cost of Material

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Relevant-Cost Analysis (cont)

A company has 100 units of material in inventory.

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Relevant-Cost Analysis (cont)

- Original purchase price = ₹50/unit.

Relevant-Cost Analysis (cont)

- Current replacement price = ₹80/unit.

Relevant-Cost Analysis (cont)

- The material is regularly used in production and must be replaced if used for the proposed job.

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Relevant-Cost Analysis (cont)

Relevant material cost = 100 × ₹80 = ₹8,000.

Relevant-Cost Analysis (cont)

- Historical purchase cost = ₹5,000.

Relevant-Cost Analysis (cont)

- It is a sunk cost and is not relevant to the current decision.

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Relevant-Cost Analysis (cont)

- Replacement cost is relevant because using the material creates a future replacement requirement.

Relevant-Cost Analysis (cont)

6. Worked Example — Alternative Use of Material

Relevant-Cost Analysis (cont)

- If the material has no other use and cannot be sold, its relevant cost may be zero, provided there is no disposal or other cost of using it.

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Relevant-Cost Analysis (cont)

- If it can be sold for ₹30/unit, using it internally sacrifices sale proceeds.

Relevant-Cost Analysis (cont)

- Relevant opportunity cost = 100 × ₹30 = ₹3,000.

Relevant-Cost Analysis (cont)

7. Relevant-Cost Analysis: Decision Procedure

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Relevant-Cost Analysis (cont)

- Identify the alternatives.

Relevant-Cost Analysis (cont)

- Identify future revenues and costs under each alternative.

Relevant-Cost Analysis (cont)

- Exclude sunk costs and costs that remain unchanged.

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Relevant-Cost Analysis (cont)

- Include avoidable costs, incremental costs and opportunity costs.

Relevant-Cost Analysis (cont)

- Compare the net financial benefit of each alternative.

Relevant-Cost Analysis (cont)

- Consider qualitative factors before making the final decision.

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Relevant-Cost Analysis (cont)

8. Applications

Relevant-Cost Analysis (cont)

- Make-or-buy: Compare avoidable manufacturing costs with purchase costs.

Relevant-Cost Analysis (cont)

- Product mix: Compare contribution per unit of scarce resource.

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Relevant-Cost Analysis (cont)

- Special orders: Compare incremental revenue with incremental costs.

Relevant-Cost Analysis (cont)

- Shutdown: Compare contribution lost with avoidable costs saved.

Relevant-Cost Analysis (cont)

- Replacement: Compare future operating costs, purchase cost and disposal proceeds; ignore historical book value.

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Relevant-Cost Analysis (cont)

- Accept/reject: Evaluate incremental benefit and opportunity cost.

Relevant-Cost Analysis (cont)

9. MCQ Traps

Relevant-Cost Analysis (cont)

- Relevant costs must be future-oriented and differ between alternatives.

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Relevant-Cost Analysis (cont)

- All fixed costs are not irrelevant.

Relevant-Cost Analysis (cont)

- All variable costs are not automatically relevant.

Relevant-Cost Analysis (cont)

- Sunk costs are always excluded from forward-looking decisions.

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Relevant-Cost Analysis (cont)

- Opportunity cost is relevant even if it is not recorded in financial accounts.

Relevant-Cost Analysis (cont)

- Book value is generally irrelevant; disposal proceeds and future operating savings may be relevant.

Relevant-Cost Analysis (cont)

- A cost can be relevant for one decision but irrelevant for another.

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Costing Cheat Sheet

by keersri05 via cheatography.com/217923/cs/48568/

Standard Costing and Variance Analysis

Meaning, Objectives and Advantages

1. Meaning

Meaning, Objectives and Advantages (cont)

- Standard Costing is a costing technique in which predetermined costs are established for products, services or operations under specified conditions.

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Meaning, Objectives and Advantages (cont)

- Actual costs are compared with standard costs to identify variances.

Meaning, Objectives and Advantages (cont)

- Variances are analysed to identify causes and take corrective action.

Meaning, Objectives and Advantages (cont)

- Standard Costing is an important tool of cost control and management by exception.

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Meaning, Objectives and Advantages (cont)

2. Key Terms

Meaning, Objectives and Advantages (cont)

- Standard Cost: Predetermined cost of producing a unit or performing an activity under specified conditions.

Meaning, Objectives and Advantages (cont)

- Actual Cost: Cost actually incurred.

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Meaning, Objectives and Advantages (cont)

- Variance: Difference between standard cost and actual cost.

Meaning, Objectives and Advantages (cont)

- Favourable Variance (F): Actual performance is better than standard, generally increasing profit or reducing cost.

Meaning, Objectives and Advantages (cont)

- Adverse/Unfavourable Variance (A): Actual performance is worse than standard, generally reducing profit or increasing cost.

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Meaning, Objectives and Advantages (cont)

- Management by Exception: Management focuses attention on significant deviations from standards rather than investigating every transaction.

Meaning, Objectives and Advantages (cont)

3. Objectives of Standard Costing

Meaning, Objectives and Advantages (cont)

- Cost control through comparison of actual and standard costs.

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Meaning, Objectives and Advantages (cont)

- Identification of inefficiencies and wastage.

Meaning, Objectives and Advantages (cont)

- Measurement of operational performance.

Meaning, Objectives and Advantages (cont)

- Fixing responsibility for cost deviations.

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Meaning, Objectives and Advantages (cont)

- Supporting budgeting and production planning.

Meaning, Objectives and Advantages (cont)

- Facilitating managerial decision-making.

Meaning, Objectives and Advantages (cont)

- Improving resource utilisation and productivity.

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Meaning, Objectives and Advantages (cont)

- Establishing cost benchmarks for performance evaluation.

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Meaning, Objectives and Advantages (cont)

4. Advantages

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Meaning, Objectives and Advantages (cont)

- Cost Control: Identifies deviations and areas requiring corrective action.

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Meaning, Objectives and Advantages (cont)

- Performance Measurement: Helps evaluate departmental and employee efficiency.

Meaning, Objectives and Advantages (cont)

- Management by Exception: Focuses attention on material variances.

Meaning, Objectives and Advantages (cont)

- Budgeting: Provides a basis for preparing budgets and estimating costs.

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Meaning, Objectives and Advantages (cont)

- Decision-Making: Supports pricing, production and cost-reduction decisions.

Meaning, Objectives and Advantages (cont)

- Responsibility Accounting: Helps identify departments or activities responsible for deviations.

Meaning, Objectives and Advantages (cont)

- Inventory Valuation: Standard costs may be used for inventory valuation where permitted by applicable accounting standards, provided they reasonably approximate actual cost.

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Meaning, Objectives and Advantages (cont)

5. Limitations

Meaning, Objectives and Advantages (cont)

- Establishing accurate standards requires time, expertise and cost.

Meaning, Objectives and Advantages (cont)

- Standards may become outdated due to inflation, technology or market changes.

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Meaning, Objectives and Advantages (cont)

- Unrealistic standards may demotivate employees.

Meaning, Objectives and Advantages (cont)

- Variances may arise due to factors beyond management's control.

Meaning, Objectives and Advantages (cont)

- Excessive focus on cost reduction may compromise quality.

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Meaning, Objectives and Advantages (cont)

- Standard costing is less suitable where production is highly customised or conditions change frequently.

Meaning, Objectives and Advantages (cont)

- Favourable variances do not always indicate good performance; for example, cheaper materials may reduce quality.

Meaning, Objectives and Advantages (cont)

6. Types of Standards

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Meaning, Objectives and Advantages (cont)

- Ideal Standard: Assumes perfect operating conditions with no wastage or inefficiency; difficult to achieve.

Meaning, Objectives and Advantages (cont)

- Practical/Attainable Standard: Achievable under efficient operating conditions, allowing for normal unavoidable losses.

Meaning, Objectives and Advantages (cont)

- Basic Standard: Long-term standard kept unchanged for comparison over several years.

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Meaning, Objectives and Advantages (cont)

- Current Standard: Based on current operating conditions.

Meaning, Objectives and Advantages (cont)

- Normal Standard: Based on average expected conditions over a representative period.

Meaning, Objectives and Advantages (cont)

7. Important MCQ Traps

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Meaning, Objectives and Advantages (cont)

- Standard costing is a cost-control technique, whereas budgetary control focuses on planning and controlling overall activities.

Meaning, Objectives and Advantages (cont)

- Variance analysis compares actual performance with predetermined standards.

Meaning, Objectives and Advantages (cont)

- Favourable variance does not necessarily mean overall efficiency.

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Meaning, Objectives and Advantages (cont)

- Ideal standards may be demotivating because they assume perfect conditions.

Meaning, Objectives and Advantages (cont)

- Practical standards include normal unavoidable inefficiencies.

Meaning, Objectives and Advantages (cont)

- Standards must be reviewed periodically to remain relevant.

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Meaning, Objectives and Advantages (cont)

- Standard costing is particularly useful in repetitive and standardised production.

Setting Standards

Meaning

Setting Standards (cont)

- Standard setting = establishing predetermined cost, quantity, time and performance benchmarks for a product, service or operation under specified operating conditions.

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Setting Standards (cont)

- Standards should be realistic, measurable, clearly communicated and periodically reviewed.

Setting Standards (cont)

- A standard cost card records the standard cost per unit, usually by material, labour and overhead components.

Setting Standards (cont)

How Standards Are Set

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Setting Standards (cont)

- Direct Materials

Setting Standards (cont)

- Standard Quantity (SQ): quantity of material required per unit of output, based on technical specifications, product design and Bill of Materials (BOM).

Setting Standards (cont)

- Allowances may be included for normal wastage, scrap and process loss.

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Setting Standards (cont)

- Standard Price (SP): expected purchase price, including relevant freight, duties and procurement costs, less applicable discounts.

Setting Standards (cont)

- Based on supplier quotations, market prices, purchase contracts and expected price trends.

Setting Standards (cont)

- Direct Labour

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Setting Standards (cont)

- Standard Time (SH): labour hours required per unit under specified working conditions.

Setting Standards (cont)

- Determined through time study, motion study, work study and past production records.

Setting Standards (cont)

- Standard Rate (SR): expected wage rate per labour hour, including relevant allowances and wage components.

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Setting Standards (cont)

- Based on wage agreements, skill requirements, labour laws and expected wage revisions.

Setting Standards (cont)

- Variable Overheads

Setting Standards (cont)

- Standard variable overhead rate is determined per unit of activity, such as machine hour or labour hour.

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Setting Standards (cont)

- Based on budgeted variable overhead and the selected activity level.

Setting Standards (cont)

- Example: power and consumables linked to machine hours.

Setting Standards (cont)

- Fixed Overheads

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Setting Standards (cont)

- Fixed overhead budget is estimated for a defined period and relevant capacity.

Setting Standards (cont)

- Standard absorption rate is calculated using budgeted fixed overhead and budgeted normal activity.

Setting Standards (cont)

- Fixed overhead per unit depends on the activity level used for absorption.

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Setting Standards (cont)

- Sales Standards

Setting Standards (cont)

- Standard selling price is based on market conditions, competition, demand and pricing policy.

Setting Standards (cont)

- Standard sales volume is based on sales forecasts, market demand, production capacity and past trends.

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Setting Standards (cont)

Standard-Setting Process

Setting Standards (cont)

1. Study the product, production process and operating conditions.

Setting Standards (cont)

2. Collect historical cost, usage, time and performance data.

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Setting Standards (cont)

3. Conduct technical studies, work measurement and supplier/market analysis.

Setting Standards (cont)

4. Consult relevant departments and establish achievable standards.

Setting Standards (cont)

5. Calculate standard quantities, prices, hours, rates and overhead absorption rates.

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Setting Standards (cont)

6. Prepare standard cost cards and communicate standards to responsible managers.

Setting Standards (cont)

7. Compare actual performance with standards and investigate significant variances.

Setting Standards (cont)

8. Revise standards when underlying conditions change materially.

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Setting Standards (cont)

Departments Involved

Setting Standards (cont)

- Engineering/design: product specifications, material requirements and production methods.

Setting Standards (cont)

- Purchase: material prices, suppliers and procurement terms.

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Setting Standards (cont)

- Production: material usage, output levels and process efficiency.

Setting Standards (cont)

- Human Resources: wage rates, staffing and labour agreements.

Setting Standards (cont)

- Cost Accounting: standard cost calculations, cost cards and variance analysis.

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Setting Standards (cont)

- Sales/Marketing: selling prices, demand forecasts and sales volume standards.

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Setting Standards (cont)

Revision of Standards

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Setting Standards (cont)

- Changes in material prices, wage rates or supplier contracts.

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Setting Standards (cont)

- Changes in technology, machinery, production methods or product design.

Setting Standards (cont)

- Changes in capacity, efficiency, normal wastage or operating conditions.

Setting Standards (cont)

- Changes in labour agreements, taxation or other relevant regulations.

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Setting Standards (cont)

- Standards should not be changed merely to conceal poor performance; revisions should reflect genuine changes in operating conditions.

Setting Standards (cont)

MCQ Traps

Setting Standards (cont)

- Standard Quantity and Standard Price are separate benchmarks; actual purchase price affects price variance, while actual usage affects usage variance.

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Setting Standards (cont)

- Standard Time and Standard Rate are separate labour benchmarks.

Setting Standards (cont)

- A Bill of Materials helps establish material quantity standards.

Setting Standards (cont)

- Time and motion studies help establish labour time standards.

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Setting Standards (cont)

- Standard variable overhead is generally linked to activity; fixed overhead standards are linked to budgeted capacity/activity.

Setting Standards (cont)

- Unrealistically high standards can demotivate employees; excessively loose standards weaken cost control.

Setting Standards (cont)

- Standards are benchmarks for comparison, not necessarily actual costs or guaranteed outcomes.

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Standard Cost vs Budgeted Cost

Standard Cost

Standard Cost vs Budgeted Cost (cont)

- Predetermined cost of producing one unit of product, performing one operation or providing one service under specified conditions.

Standard Cost vs Budgeted Cost (cont)

- Established using standard quantities, prices, rates and overhead absorption rates.

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Standard Cost vs Budgeted Cost (cont)

- Primarily used for cost control, performance measurement and variance analysis.

Standard Cost vs Budgeted Cost (cont)

- Example: Standard material cost per unit = 5 kg × ₹20 = ₹100.

Standard Cost vs Budgeted Cost (cont)

Budgeted Cost

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Standard Cost vs Budgeted Cost (cont)

- Estimated total cost for a specified future period and planned level of activity.

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Standard Cost vs Budgeted Cost (cont)

- Prepared as part of the budgeting process.

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Standard Cost vs Budgeted Cost (cont)

- May cover an entire organisation, department, product line or activity.

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Standard Cost vs Budgeted Cost (cont)

- Example: Budgeted material cost for 10,000 units = ₹10,00,000, assuming ₹100 per unit.

Standard Cost vs Budgeted Cost (cont)

Key Differences

Standard Cost vs Budgeted Cost (cont)

- Standard cost is generally expressed per unit or unit of activity; budgeted cost is generally expressed as a total for a period or planned activity.

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Standard Cost vs Budgeted Cost (cont)

- Standard cost is a benchmark for measuring actual performance; budgeted cost is a financial plan for future operations.

Standard Cost vs Budgeted Cost (cont)

- Standard costing focuses on cost standards and variance analysis; budgetary control compares actual results with budgets.

Standard Cost vs Budgeted Cost (cont)

- Standards are usually established for individual cost elements; budgets combine expected costs and revenues for broader activities.

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Standard Cost vs Budgeted Cost (cont)

- Standard costs are used in preparing budgets, while budgets may incorporate standard costs multiplied by planned output.

Standard Cost vs Budgeted Cost (cont)

- A flexible budget adjusts budgeted costs to actual activity levels; standard costs provide unit-level benchmarks for that activity.

Standard Cost vs Budgeted Cost (cont)

Relationship

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Standard Cost vs Budgeted Cost (cont)

- Budgeted Cost = Standard Cost per Unit × Budgeted Output, where the budget is based on standard costs and the same assumptions.

Standard Cost vs Budgeted Cost (cont)

- Example: Standard cost ₹100 per unit × Budgeted production 10,000 units = Budgeted cost ₹10,00,000.

Standard Cost vs Budgeted Cost (cont)

- Actual cost can be compared with both the standard cost allowed for actual output and the budgeted cost for planned output.

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Standard Cost vs Budgeted Cost (cont)

MCQ Traps

Standard Cost vs Budgeted Cost (cont)

- Standard cost is not necessarily the same as budgeted cost.

Standard Cost vs Budgeted Cost (cont)

- A standard is a unit/activity benchmark; a budget is a plan for a defined period and activity level.

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Standard Cost vs Budgeted Cost (cont)

- Standard costing and budgetary control are complementary techniques, not mutually exclusive.

Standard Cost vs Budgeted Cost (cont)

- A flexible budget is adjusted for actual activity; a fixed budget remains based on the originally planned activity level.

Standard Cost vs Budgeted Cost (cont)

- Standard cost per unit multiplied by budgeted output can form the basis of a budgeted total cost.

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Target Costing

Meaning

Target Costing (cont)

- Target Costing is a market-driven cost management technique in which the allowable cost of a product is determined by subtracting the desired profit from its expected selling price.

Target Costing (cont)

- The product is designed and production processes are planned to ensure that the target cost is achieved.

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Target Costing (cont)

- It is primarily a cost-reduction technique used during product design and development, rather than after production begins.

Target Costing (cont)

Core Formula

Target Costing (cont)

Target Cost = Target Selling Price - Desired Profit

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Target Costing (cont)

- Target Selling Price: price customers are willing to pay, based on market research and competition.

Target Costing (cont)

- Desired Profit: profit margin or return required by the organisation.

Target Costing (cont)

- Target Cost: maximum allowable cost to achieve the desired profit.

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Target Costing (cont)

Numerical Example

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Target Costing (cont)

- Expected market selling price = ₹1,000.

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Target Costing (cont)

- Desired profit = ₹250.

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Target Costing (cont)

- Target Cost = ₹1,000 − ₹250 = ₹750.

Target Costing (cont)

- If estimated product cost is ₹850, the organisation must reduce cost by ₹100 to achieve the target.

Target Costing (cont)

Target Costing Process

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Target Costing (cont)

1. Identify customer needs and market requirements.

Target Costing (cont)

2. Estimate the competitive selling price.

Target Costing (cont)

3. Determine the desired profit margin.

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Target Costing (cont)

4. Calculate the allowable target cost.

Target Costing (cont)

5. Estimate the current/design-stage product cost.

Target Costing (cont)

6. Identify the cost gap.

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Target Costing (cont)

7. Apply value engineering, design optimisation and supplier negotiations to reduce cost.

Target Costing (cont)

8. Finalise the product design and monitor actual costs against the target.

Target Costing (cont)

Important Concepts

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Target Costing (cont)

- Cost Gap: Difference between estimated current cost and target cost.

Target Costing (cont)

Cost Gap= Estimated Cost - Target Cost

Target Costing (cont)

- Value Engineering: Redesigning products and processes to achieve required functionality at lower cost.

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Target Costing (cont)

- Cross-functional Teams: Design, engineering, production, purchase, marketing and finance work together to achieve target cost.

Target Costing (cont)

- Life-cycle Perspective: Consider costs across design, production, distribution, use and disposal where relevant.

Target Costing (cont)

Target Costing vs Traditional Cost-Plus Pricing

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Target Costing (cont)

- Target costing: Market price − desired profit = allowable cost.

Target Costing (cont)

- Cost-plus pricing: Cost + desired profit = selling price.

Target Costing (cont)

- Target costing is market-driven; cost-plus pricing is cost-driven.

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Target Costing (cont)

- Target costing focuses on reducing cost before production; traditional cost-plus pricing may simply add a margin to existing cost.

Target Costing (cont)

Advantages

Target Costing (cont)

- Focuses on customer expectations and market competitiveness.

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Target Costing (cont)

- Encourages cost reduction at the design stage, when changes are less expensive.

Target Costing (cont)

- Promotes cross-functional coordination and supplier involvement.

Target Costing (cont)

- Helps protect desired profit margins.

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Target Costing (cont)

- Encourages innovation and efficient product design.

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Target Costing (cont)

Limitations

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Target Costing (cont)

- Requires reliable market research and accurate price estimates.

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Target Costing (cont)

- Excessive cost pressure may compromise quality or functionality.

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Target Costing (cont)

- Can create conflicts among departments and suppliers.

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Target Costing (cont)

- Difficult where products are highly customised or market prices are volatile.

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Target Costing (cont)

- Requires significant planning and coordination.

Target Costing (cont)

MCQ Traps

Target Costing (cont)

- Target cost is calculated by subtracting desired profit from market-based selling price.

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Target Costing (cont)

- Target costing begins before production, particularly during product design.

Target Costing (cont)

- It is proactive, not merely a method of analysing historical costs.

Target Costing (cont)

- Value engineering is an important tool for achieving target cost.

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Target Costing (cont)

- Target costing does not mean reducing cost at the expense of essential quality or customer requirements.

Target Costing (cont)

- Target costing is particularly associated with competitive markets and product development.

Value Analysis and Value Engineering

Meaning

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Value Analysis and Value Engineering (cont)

- Value Analysis (VA): A systematic examination of an existing product, service or process to improve its value by reducing unnecessary costs without compromising required functions, quality or performance.

Value Analysis and Value Engineering (cont)

- Value Engineering (VE): A systematic approach applied mainly during the design and development stage to achieve the required functions at the lowest overall life-cycle cost.

Value Analysis and Value Engineering (cont)

- Both techniques aim to eliminate unnecessary costs while preserving customer-required functionality.

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Value Analysis and Value Engineering (cont)

Meaning of Value

Value Analysis and Value Engineering (cont)

Value= Function or Utility / Cost

Value Analysis and Value Engineering (cont)

- Value increases when the required function is achieved at a lower cost without sacrificing essential quality.

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Value Analysis and Value Engineering (cont)

- Value can also increase through improved functionality at the same cost.

Value Analysis and Value Engineering (cont)

- Lowest cost does not automatically mean highest value.

Value Analysis and Value Engineering (cont)

Key Concepts

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Value Analysis and Value Engineering (cont)

- Function: Purpose or utility provided by a product or component.

Value Analysis and Value Engineering (cont)

- Basic Function: Primary purpose for which a product exists.

Value Analysis and Value Engineering (cont)

- Secondary Function: Additional function that supports the basic function or improves usability.

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Value Analysis and Value Engineering (cont)

- Unnecessary Function: Function that does not provide sufficient customer value relative to its cost.

Value Analysis and Value Engineering (cont)

- Cost-Worth Analysis: Comparison of the cost of providing a function with the value or worth of that function.

Value Analysis and Value Engineering (cont)

- Life-Cycle Cost: Total cost over the product's life, including design, production, operation, maintenance and disposal.

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Value Analysis and Value Engineering (cont)

Value Engineering / Analysis Process

Value Analysis and Value Engineering (cont)

1. Information Phase: Collect information about the product, functions, costs and customer requirements.

Value Analysis and Value Engineering (cont)

2. Function Analysis Phase: Identify basic and secondary functions; define them using a verb–noun approach.

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Value Analysis and Value Engineering (cont)

3. Creative Phase: Generate alternative ways to perform the required functions.

Value Analysis and Value Engineering (cont)

4. Evaluation Phase: Assess alternatives for feasibility, cost, quality and performance.

Value Analysis and Value Engineering (cont)

5. Development Phase: Develop the most promising alternatives into practical proposals.

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Value Analysis and Value Engineering (cont)

6. Presentation / Implementation Phase: Present proposals, obtain approval and implement changes.

Value Analysis and Value Engineering (cont)

7. Follow-up Phase: Monitor whether expected savings and functional requirements are achieved.

Value Analysis and Value Engineering (cont)

Important Techniques

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Value Analysis and Value Engineering (cont)

- Function Analysis System Technique (FAST): Maps the logical relationships between functions by asking "How?" and "-Why?"

Value Analysis and Value Engineering (cont)

- Brainstorming: Generates alternative ways to perform functions.

Value Analysis and Value Engineering (cont)

- Cost-Worth Analysis: Identifies functions whose costs are disproportionately high relative to their worth.

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Value Analysis and Value Engineering (cont)

- Component Analysis: Examines whether components can be simplified, standardised or replaced.

Value Analysis and Value Engineering (cont)

- Supplier Collaboration: Identifies alternative materials, components and production methods.

Value Analysis and Value Engineering (cont)

Value Analysis vs Value Engineering

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Value Analysis and Value Engineering (cont)

- Value Analysis is generally applied to existing products or processes.

Value Analysis and Value Engineering (cont)

- Value Engineering is generally applied during the design and development of new products or processes.

Value Analysis and Value Engineering (cont)

- VA focuses on improving existing value; VE builds cost-effective value into the design from the beginning.

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Value Analysis and Value Engineering (cont)

- Both use systematic function analysis and cost reduction.

Value Analysis and Value Engineering (cont)

Numerical Example

Value Analysis and Value Engineering (cont)

- Existing component cost = ₹100.

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Value Analysis and Value Engineering (cont)

- Required function can be achieved using an alternative component costing ₹75.

Value Analysis and Value Engineering (cont)

- Quality and performance remain unchanged.

Value Analysis and Value Engineering (cont)

Cost Saving=100-75=₹25

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Value Analysis and Value Engineering (cont)

Cost Reduction %= (25 /100) x 100 = 25%

Value Analysis and Value Engineering (cont)

Advantages

Value Analysis and Value Engineering (cont)

- Eliminates unnecessary costs without compromising essential functions.

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Value Analysis and Value Engineering (cont)

- Encourages innovation and alternative designs.

Value Analysis and Value Engineering (cont)

- Improves product competitiveness and profitability.

Value Analysis and Value Engineering (cont)

- Promotes cross-functional teamwork.

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Value Analysis and Value Engineering (cont)

- Can reduce material, labour, manufacturing and maintenance costs.

Value Analysis and Value Engineering (cont)

- Supports target costing and life-cycle cost management.

Value Analysis and Value Engineering (cont)

Limitations

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Value Analysis and Value Engineering (cont)

- Requires technical expertise and cross--functional coordination.

Value Analysis and Value Engineering (cont)

- Alternative designs may require testing and investment.

Value Analysis and Value Engineering (cont)

- Excessive cost reduction can compromise reliability or safety.

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Value Analysis and Value Engineering (cont)

- Employee or supplier resistance may delay implementation.

Value Analysis and Value Engineering (cont)

- Savings can be difficult to estimate accurately before implementation.

Value Analysis and Value Engineering (cont)

MCQ Traps

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Value Analysis and Value Engineering (cont)

- Value = Function ÷ Cost.

Value Analysis and Value Engineering (cont)

- Value Engineering is primarily associated with the design stage.

Value Analysis and Value Engineering (cont)

- Value Analysis is primarily associated with existing products.

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Value Analysis and Value Engineering (cont)

- Both focus on required functions, not indiscriminate cost cutting.

Value Analysis and Value Engineering (cont)

- Basic functions represent the primary purpose of a product.

Value Analysis and Value Engineering (cont)

- FAST stands for Function Analysis System Technique.

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Value Analysis and Value Engineering (cont)

- Value engineering considers life-cycle costs, not merely initial purchase or manufacturing cost.

Environmental Costing

Meaning

Environmental Costing (cont)

- Environmental Costing is the identification, measurement, allocation and management of costs arising from an organisation's environmental impact.

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Environmental Costing (cont)

- It includes costs of preventing pollution, managing waste, complying with environmental regulations and restoring the environment.

Environmental Costing (cont)

- It helps organisations incorporate environmental considerations into production, pricing, investment and operational decisions.

Environmental Costing (cont)

Types of Environmental Costs

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Environmental Costing (cont)

1. Prevention Costs

Environmental Costing (cont)

- Costs incurred to prevent environmental damage.

Environmental Costing (cont)

- Examples:

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Environmental Costing (cont)

- Cleaner production technologies.

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Environmental Costing (cont)

- Energy-efficient machinery.

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Environmental Costing (cont)

- Pollution prevention systems.

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Environmental Costing (cont)

- Environment-friendly product design.

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Environmental Costing (cont)

- Employee environmental training.

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Environmental Costing (cont)

2. Detection / Appraisal Costs

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Environmental Costing (cont)

- Costs incurred to monitor and assess environmental performance.

Environmental Costing (cont)

- Examples:

Environmental Costing (cont)

- Environmental audits.

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Environmental Costing (cont)

- Pollution testing and monitoring.

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Environmental Costing (cont)

- Emission measurement.

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Environmental Costing (cont)

- Environmental impact assessments.

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Environmental Costing (cont)

- Compliance inspections.

Environmental Costing (cont)

3. Internal Failure Costs

Environmental Costing (cont)

- Costs of managing environmental damage or waste before it affects the external environment.

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Environmental Costing (cont)

- Examples:

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Environmental Costing (cont)

- Waste treatment and disposal.

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Environmental Costing (cont)

- Recycling and reuse of production waste.

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Environmental Costing (cont)

- Treatment of wastewater.

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Environmental Costing (cont)

- Handling hazardous materials.

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Environmental Costing (cont)

- Operating pollution-control equipment.

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Environmental Costing (cont)

4. External Failure Costs

Environmental Costing (cont)

- Costs arising from environmental damage affecting the external environment or society.

Environmental Costing (cont)

- Examples:

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Environmental Costing (cont)

- Environmental remediation and restoration.

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Environmental Costing (cont)

- Compensation for pollution damage.

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Environmental Costing (cont)

- Fines and penalties for violations.

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Environmental Costing (cont)

- Cleanup of contaminated land or water.

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Environmental Costing (cont)

- Legal liabilities and reputational damage.

Environmental Costing (cont)

Environmental Cost Classification

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Environmental Costing (cont)

- Conventional costs: Materials, energy, water and other resources used in production.

Environmental Costing (cont)

- Potentially hidden costs: Environmental costs embedded in overheads, such as monitoring, permits and compliance.

Environmental Costing (cont)

- Contingent costs: Possible future liabilities, such as environmental claims, penalties or remediation obligations.

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Environmental Costing (cont)

- Image and relationship costs: Costs associated with environmental reputation, stakeholder relations and sustainability reporting.

Environmental Costing (cont)

Important Environmental Cost Concepts

Environmental Costing (cont)

- Environmental Management Accounting (EMA): Identification and analysis of physical environmental information (materials, energy, water, emissions and waste) and related monetary costs.

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Environmental Costing (cont)

- Material Flow Cost Accounting (MFCA): Tracks physical material flows and assigns costs to both products and material losses/waste.

Environmental Costing (cont)

- Life-Cycle Assessment (LCA): Evaluates environmental impacts of a product across its life cycle, from raw material extraction to disposal.

Environmental Costing (cont)

- Extended Producer Responsibility (EPR): Makes producers responsible for specified post-consumer management of their products and packaging under applicable regulations.

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Environmental Costing (cont)

- Carbon Footprint: Total greenhouse gas emissions associated with an entity, product or activity, generally expressed in carbon dioxide equivalent (CO_2e).

Environmental Costing (cont)

- Polluter Pays Principle: Those responsible for pollution should bear the costs of preventing and managing the resulting environmental damage.

Environmental Costing (cont)

Material Flow Cost Accounting (MFCA)

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Environmental Costing (cont)

- Separates material input into:

Environmental Costing (cont)

- Positive products: material incorporated into saleable output.

Environmental Costing (cont)

- Material losses: waste, scrap, emissions and other losses.

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Environmental Costing (cont)

- Assigns costs to both output and material losses.

Environmental Costing (cont)

- Helps identify hidden costs of waste and inefficiency.

Environmental Costing (cont)

- Encourages material conservation and process improvements.

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Environmental Costing (cont)

Environmental Cost Management Process

Environmental Costing (cont)

1. Identify environmental aspects of operations.

Environmental Costing (cont)

2. Measure resource consumption, emissions and waste.

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Environmental Costing (cont)

3. Identify associated monetary costs.

Environmental Costing (cont)

4. Allocate costs to activities, products or processes.

Environmental Costing (cont)

5. Identify opportunities for prevention, recycling and resource efficiency.

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Environmental Costing (cont)

6. Monitor environmental performance and compliance.

Environmental Costing (cont)

Advantages

Environmental Costing (cont)

- Makes environmental costs visible rather than hiding them in general overheads.

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Environmental Costing (cont)

- Helps reduce material, energy and water wastage.

Environmental Costing (cont)

- Supports regulatory compliance and risk management.

Environmental Costing (cont)

- Improves resource efficiency and operational performance.

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Environmental Costing (cont)

- Supports sustainability reporting and responsible investment decisions.

Environmental Costing (cont)

- Can improve brand reputation and stakeholder confidence.

Environmental Costing (cont)

Limitations

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Environmental Costing (cont)

- Difficult to identify and allocate indirect environmental costs.

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Environmental Costing (cont)

- Long-term environmental damage can be difficult to quantify financially.

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Environmental Costing (cont)

- Requires specialised measurement and monitoring systems.

Environmental Costing (cont)

- Environmental benefits may take time to materialise.

Environmental Costing (cont)

- Regulatory requirements and measurement methodologies may differ across jurisdictions.

Environmental Costing (cont)

MCQ Traps

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Environmental Costing (cont)

- Environmental costing includes prevention, monitoring, waste management and remediation costs.

Environmental Costing (cont)

- MFCA tracks both physical material flows and associated costs.

Environmental Costing (cont)

- LCA examines environmental impacts across the product's life cycle.

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Environmental Costing (cont)

- Polluter Pays Principle places environmental costs on the polluter.

Environmental Costing (cont)

- EPR concerns producer responsibility for specified post-consumer management.

Environmental Costing (cont)

- Environmental costs may be hidden in conventional overhead accounts.

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Environmental Costing (cont)

- Environmental costing is not limited to pollution-control expenditure; it also includes resource consumption, waste and potential liabilities.

Quality Costing

Meaning

Quality Costing (cont)

- Quality Costing is the identification, measurement, classification and analysis of costs incurred to achieve quality and costs arising from poor quality.

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Quality Costing (cont)

- It helps organisations balance the cost of preventing defects against the cost of correcting failures.

Quality Costing (cont)

- Also called Cost of Quality (COQ).

Quality Costing (cont)

Four Categories of Quality Costs

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Quality Costing (cont)

1. Prevention Costs

Quality Costing (cont)

- Costs incurred to prevent defects from occurring.

Quality Costing (cont)

- Examples:

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Quality Costing (cont)

- Employee training and quality awareness.

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Quality Costing (cont)

- Quality planning and process design.

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Quality Costing (cont)

- Supplier evaluation and quality audits.

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Quality Costing (cont)

- Preventive maintenance.

Quality Costing (cont)

- Process improvement and quality engineering.

Quality Costing (cont)

- Objective: Avoid defects before production or service delivery.

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Quality Costing (cont)

2. Appraisal Costs

Quality Costing (cont)

- Costs incurred to inspect, measure and evaluate products or processes to ensure quality standards are met.

Quality Costing (cont)

- Examples:

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Quality Costing (cont)

- Raw material inspection.

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Quality Costing (cont)

- Product testing and quality checks.

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Quality Costing (cont)

- Calibration of testing equipment.

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Quality Costing (cont)

- Quality audits and inspection salaries.

Quality Costing (cont)

- Laboratory testing.

Quality Costing (cont)

- Objective: Detect defects before products reach customers.

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Quality Costing (cont)

3. Internal Failure Costs

Quality Costing (cont)

- Costs arising from defects identified before delivery to customers.

Quality Costing (cont)

- Examples:

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Quality Costing (cont)

- Scrap and material wastage.

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Quality Costing (cont)

- Rework and repair.

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Quality Costing (cont)

- Re-inspection and retesting.

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Quality Costing (cont)

- Production downtime due to defects.

Quality Costing (cont)

- Rejection and disposal of defective products.

Quality Costing (cont)

- Objective: Correct defects within the organisation.

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Quality Costing (cont)

4. External Failure Costs

Quality Costing (cont)

- Costs arising from defects identified after delivery to customers.

Quality Costing (cont)

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Quality Costing (cont)

- Warranty claims and repairs.

Quality Costing (cont)

- Product returns and replacements.

Quality Costing (cont)

- Customer complaints and service costs.

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Quality Costing (cont)

- Product recalls.

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Quality Costing (cont)

- Compensation and legal costs.

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Quality Costing (cont)

- Loss of reputation and future sales.

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Quality Costing (cont)

- Generally considered particularly damaging because they affect customer satisfaction and brand reputation.

Quality Costing (cont)

Important Classification

Quality Costing (cont)

- Prevention + Appraisal = Cost of Conformance.

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Quality Costing (cont)

- Internal Failure + External Failure = Cost of Non-Conformance.

Quality Costing (cont)

Total Cost of Quality=P+A+IF+EF

Quality Costing (cont)

Where:

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Quality Costing (cont)

- P = Prevention Cost.

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Quality Costing (cont)

- A = Appraisal Cost.

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Quality Costing (cont)

- IF = Internal Failure Cost.

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Quality Costing (cont)

- EF = External Failure Cost.

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Quality Costing (cont)

Numerical Example

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Quality Costing (cont)

- Prevention costs = ₹2 lakh.

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Quality Costing (cont)

- Appraisal costs = ₹1 lakh.

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Quality Costing (cont)

- Internal failure costs = ₹3 lakh.

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Quality Costing (cont)

- External failure costs = ₹4 lakh.

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Quality Costing (cont)

Total COQ =2+1+3+4=₹10 lakh

Quality Costing (cont)

Cost of Conformance =2+1=₹3 lakh

Quality Costing (cont)

Cost of Non-Conformance=3+4=₹7 lakh

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Quality Costing (cont)

Quality Cost Management

Quality Costing (cont)

- Invest in prevention to reduce the occurrence of defects.

Quality Costing (cont)

- Use appraisal to detect defects before delivery.

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Quality Costing (cont)

- Analyse failure costs to identify root causes.

Quality Costing (cont)

- Apply continuous improvement and corrective actions.

Quality Costing (cont)

- Monitor quality costs as a percentage of sales or production cost.

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Quality Costing (cont)

- Aim to reduce total quality cost while maintaining required quality standards.

Quality Costing (cont)

Important Concepts

Quality Costing (cont)

- Zero Defects: Quality philosophy aiming to eliminate defects rather than accept a predetermined defect level.

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Quality Costing (cont)

- Total Quality Management (TQM): Organisation-wide approach to continuous quality improvement and customer satisfaction.

Quality Costing (cont)

- Cost of Poor Quality (COPQ): Costs arising from failures, defects, rework, waste and related consequences.

Quality Costing (cont)

- Quality Assurance: Process-oriented activities designed to provide confidence that quality requirements will be met.

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Quality Costing (cont)

- Quality Control: Operational techniques used to inspect and verify whether quality requirements are met.

Quality Costing (cont)

Advantages

Quality Costing (cont)

- Identifies the financial impact of poor quality.

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Quality Costing (cont)

- Helps reduce scrap, rework and warranty expenses.

Quality Costing (cont)

- Improves customer satisfaction and reliability.

Quality Costing (cont)

- Supports continuous improvement and better resource utilisation.

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Quality Costing (cont)

- Helps management justify investments in prevention and quality systems.

Quality Costing (cont)

MCQ Traps

Quality Costing (cont)

- Prevention costs aim to prevent defects; appraisal costs detect defects.

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Quality Costing (cont)

- Rework before delivery = internal failure cost.

Quality Costing (cont)

- Warranty claims and product recalls = external failure costs.

Quality Costing (cont)

- Prevention + appraisal = conformance costs.

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Quality Costing (cont)

- Internal + external failure = non-confo-rmance costs.

Quality Costing (cont)

- Training for quality improvement is generally a prevention cost.

Quality Costing (cont)

- Inspection and testing are appraisal costs.

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Quality Costing (cont)

- Quality costing does not mean that higher quality always requires higher total cost; effective prevention can reduce overall quality costs.

Throughput Costing

Meaning

Throughput Costing (cont)

- Throughput Costing is a costing approach associated with the Theory of Constraints (TOC), developed by Eliyahu M. Goldratt.

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Throughput Costing (cont)

- It focuses on maximising the rate at which an organisation generates money through sales while managing bottlenecks or constr-aints.

Throughput Costing (cont)

- Under the traditional Theory of Constraints approach, direct material is treated as the only fully variable cost in the short run; labour and manufacturing overheads are generally treated as operating expenses.

Throughput Costing (cont)

- The emphasis is on throughput rather than conventional product-cost absorption.

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Throughput Costing (cont)

Key Terminology

Throughput Costing (cont)

- Throughput: Rate at which the organisation generates money through sales.

Throughput Costing (cont)

- Bottleneck: Resource or process that limits the overall production capacity.

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Throughput Costing (cont)

- Constraint: Any factor restricting achievement of organisational goals.

Throughput Costing (cont)

- Operating Expense: Cost incurred to convert inventory into throughput, including labour, rent, depreciation and other operating costs.

Throughput Costing (cont)

- Inventory: Money invested in things intended to be sold, including raw materials, work-in-progress and finished goods.

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Throughput Costing (cont)

Important Formulas

Throughput Costing (cont)

Throughput per Unit = Selling Price per Unit - Direct Material Cost per Unit

Throughput Costing (cont)

Total Throughput = Sales Revenue - Total Direct Material Cost of Units Sold

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Throughput Costing (cont)

Net Profit = Total Throughput - Operating Expenses

Throughput Costing (cont)

Return on Investment (TOC) = (Net Profit / Investment) x 100

Throughput Costing (cont)

Example

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Throughput Costing (cont)

- Selling price per unit = ₹500.

Throughput Costing (cont)

- Direct material cost per unit = ₹200.

Throughput Costing (cont)

- Throughput per unit = ₹500 − ₹200 = ₹300.

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Throughput Costing (cont)

- If 100 units are sold, total throughput = ₹30,000.

Throughput Costing (cont)

- If operating expenses are ₹20,000, net profit = ₹10,000.

Throughput Costing (cont)

Theory of Constraints: Five Focusing Steps

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Throughput Costing (cont)

1. Identify the system's constraint or bottleneck.

Throughput Costing (cont)

2. Exploit the constraint by maximising its productive use without major additional investment.

Throughput Costing (cont)

3. Subordinate other activities to the constraint's requirements.

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Throughput Costing (cont)

4. Elevate the constraint by increasing its capacity, if necessary.

Throughput Costing (cont)

5. Repeat: Once the constraint is removed, identify the next constraint.

Throughput Costing (cont)

Bottleneck Management

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Throughput Costing (cont)

- Improve throughput at the bottleneck rather than optimising every department independently.

Throughput Costing (cont)

- Avoid idle time at the bottleneck.

Throughput Costing (cont)

- Ensure that the bottleneck receives quality materials and appropriate support.

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Throughput Costing (cont)

- Avoid producing unnecessary inventory ahead of the bottleneck.

Throughput Costing (cont)

- Evaluate products based on throughput generated per unit of bottleneck resource.

Throughput Costing (cont)

Throughput per Bottleneck Hour

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Throughput Costing (cont)

Throughput per Bottleneck Hour = Throughput per Unit / Bottleneck Hours per Unit

Throughput Costing (cont)

- Products with higher throughput per bottleneck hour generally receive priority when the bottleneck is the limiting resource and other relevant constraints are satisfied.

Throughput Costing (cont)

Throughput Costing vs Marginal Costing

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Throughput Costing (cont)

- Throughput costing generally treats direct material as variable in the short run.

Throughput Costing (cont)

- Marginal costing generally treats all variable production costs, including variable labour and variable overhead, as product costs.

Throughput Costing (cont)

- Throughput costing focuses on bottle-necks and overall throughput.

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Throughput Costing (cont)

- Marginal costing focuses on contribution, cost behaviour and cost-volume-profit analysis.

Throughput Costing (cont)

- Under throughput costing, labour and factory overhead are generally treated as operating expenses in the short-run model.

Throughput Costing (cont)

Advantages

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Throughput Costing (cont)

- Directs management attention towards bottlenecks.

Throughput Costing (cont)

- Improves overall production flow and throughput.

Throughput Costing (cont)

- Discourages unnecessary inventory accumulation.

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Throughput Costing (cont)

- Supports product-mix decisions under capacity constraints.

Throughput Costing (cont)

- Encourages system-wide optimisation rather than isolated departmental efficiency.

Throughput Costing (cont)

Limitations

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Throughput Costing (cont)

- Treating labour and overhead as fixed in the short run may not suit every operating environment.

Throughput Costing (cont)

- Identifying and managing constraints requires reliable operational data.

Throughput Costing (cont)

- Bottlenecks may shift as production conditions change.

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Throughput Costing (cont)

- Less suitable as a standalone method for external financial reporting and inventory valuation.

Throughput Costing (cont)

- Excessive focus on throughput may overlook other long-term strategic and quality considerations.

Throughput Costing (cont)

MCQ Traps

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Throughput Costing (cont)

- Throughput costing is closely associated with Theory of Constraints and Eliyahu Goldratt.

Throughput Costing (cont)

- Direct material is generally the only fully variable product cost under the traditional short-run throughput model.

Throughput Costing (cont)

- Throughput = Sales − Direct Material Cost of goods sold.

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Throughput Costing (cont)

- Labour and overhead are generally treated as operating expenses, not deducted in calculating throughput.

Throughput Costing (cont)

- The bottleneck determines the system's effective capacity.

Throughput Costing (cont)

- The five focusing steps begin with identifying the constraint and end with repeating the process.

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Throughput Costing (cont)

- Throughput per bottleneck hour is more useful than throughput per unit when a bottleneck resource is limiting production.

Modern Costing Techniques

Backflush Costing

Meaning

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Backflush Costing (cont)

- Backflush Costing is a simplified costing method in which costs are assigned to products at the end of a production process or at specified completion points, rather than recording every cost movement as it occurs.

Backflush Costing (cont)

- Costs are recorded or "flushed back" through the production system using predetermined costs and output information.

Backflush Costing (cont)

- It is commonly associated with Just-in-Time (JIT) production and low-inventory environments.

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Backflush Costing (cont)

Core Principle

Backflush Costing (cont)

- Traditional costing records material, labour and overhead costs as they move through each production stage.

Backflush Costing (cont)

- Backflush costing delays detailed cost recording until a trigger point, such as completion of production or sale.

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Backflush Costing (cont)

- Costs are then assigned retrospectively to products using standard costs or predetermined rates.

Backflush Costing (cont)

How Backflush Costing Works

Backflush Costing (cont)

1. Materials are purchased and production takes place with minimal inventory accumulation.

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Backflush Costing (cont)

2. Detailed transaction-by-transaction cost tracking through work-in-progress may be reduced or avoided.

Backflush Costing (cont)

3. At a designated trigger point, costs are recorded against completed production or sales.

Backflush Costing (cont)

4. Standard costs are used to assign material, labour and overhead costs.

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Backflush Costing (cont)

5. Differences between actual and standard costs are identified and adjusted as necessary.

Backflush Costing (cont)

Trigger Points

Backflush Costing (cont)

- Purchase of materials.

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Backflush Costing (cont)

- Completion of production.

Backflush Costing (cont)

- Sale of finished goods.

Backflush Costing (cont)

- Some systems use a single trigger point; others use multiple trigger points.

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Backflush Costing (cont)

- The choice depends on the production and inventory system.

Backflush Costing (cont)

Important Terminology

Backflush Costing (cont)

- Trigger Point: Event at which costs are recorded or assigned.

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Backflush Costing (cont)

- Backflushing: Retrospective assignment of costs to products.

Backflush Costing (cont)

- Standard Cost: Predetermined cost used to calculate product costs.

Backflush Costing (cont)

- JIT: Just-in-Time production, which aims to receive materials and produce goods as needed, minimising inventory.

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Backflush Costing (cont)

Advantages

Backflush Costing (cont)

- Reduces detailed inventory and work-in-p-rogress accounting.

Backflush Costing (cont)

- Simplifies cost-recording procedures.

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Backflush Costing (cont)

- Reduces administrative effort and transaction-processing costs.

Backflush Costing (cont)

- Supports lean production and JIT systems.

Backflush Costing (cont)

- Useful where production cycles are short and inventory levels are low.

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Backflush Costing (cont)

Limitations

Backflush Costing (cont)

- Less suitable for long or complex production processes with significant work-in-progress.

Backflush Costing (cont)

- Provides less detailed tracking of costs at individual production stages.

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Backflush Costing (cont)

- Errors or unusual wastage may be identified later.

Backflush Costing (cont)

- Requires reliable production records and standard cost estimates.

Backflush Costing (cont)

- Less appropriate where strict stage-wise inventory valuation and cost traceability are essential.

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Backflush Costing (cont)

Backflush Costing vs Traditional Costing

Backflush Costing (cont)

- Traditional costing records costs as materials are purchased, issued and converted through production.

Backflush Costing (cont)

- Backflush costing records costs retrospectively at predetermined trigger points.

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Backflush Costing (cont)

- Traditional costing provides detailed stage-wise cost information.

Backflush Costing (cont)

- Backflush costing simplifies accounting by reducing intermediate cost entries.

Backflush Costing (cont)

- Traditional costing is more suitable for complex, inventory-intensive processes; backflush costing is more suitable for streamlined JIT environments.

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Backflush Costing (cont)

MCQ Traps

Backflush Costing (cont)

- Backflush costing is associated with JIT and low inventory.

Backflush Costing (cont)

- Costs are assigned retrospectively, not necessarily recorded at every production stage.

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Backflush Costing (cont)

- It commonly uses standard costs.

Backflush Costing (cont)

- Trigger points determine when costs are recorded.

Backflush Costing (cont)

- It is a cost-accounting technique, not a physical production method.

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Backflush Costing (cont)

- Backflush costing does not mean costs are ignored; they are recorded at selected points rather than continuously.

Kaizen Costing

Meaning

Kaizen Costing (cont)

- Kaizen Costing is a continuous cost-reduction technique based on making small, incremental improvements in production processes and operations.

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Kaizen Costing (cont)

- The term Kaizen is Japanese and means continuous improvement.

Kaizen Costing (cont)

- It focuses on reducing costs during the manufacturing stage, after product design and specifications have generally been finalised.

Kaizen Costing (cont)

- It involves participation from employees at all levels, not just management.

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Kaizen Costing (cont)

Key Principles

Kaizen Costing (cont)

- Continuous, incremental improvements rather than occasional major changes.

Kaizen Costing (cont)

- Employee participation and teamwork.

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Kaizen Costing (cont)

- Elimination of waste and non-value-added activities.

Kaizen Costing (cont)

- Improvement in productivity, quality and operational efficiency.

Kaizen Costing (cont)

- Standardisation of improved processes to sustain cost savings.

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Kaizen Costing (cont)

- Focus on long-term cost reduction rather than one-time savings.

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Kaizen Costing (cont)

Types of Waste Targeted

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Kaizen Costing (cont)

The Japanese concept of Muda refers to waste. Common forms include:

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Kaizen Costing (cont)

- Overproduction: producing more than required.

Kaizen Costing (cont)

- Waiting: idle time of workers or machines.

Kaizen Costing (cont)

- Transportation: unnecessary movement of materials.

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Kaizen Costing (cont)

- Over-processing: performing unnecessary operations.

Kaizen Costing (cont)

- Inventory: excessive raw materials, work-in-progress or finished goods.

Kaizen Costing (cont)

- Motion: unnecessary movement by workers.

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Kaizen Costing (cont)

- Defects: rework, scrap and rejected products.

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Kaizen Costing (cont)

Kaizen Costing Process

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Kaizen Costing (cont)

1. Establish current production cost and performance levels.

Kaizen Costing (cont)

2. Set achievable cost-reduction targets.

Kaizen Costing (cont)

3. Identify sources of waste and inefficiency.

Kaizen Costing (cont)

4. Encourage employees to suggest improvements.

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Kaizen Costing (cont)

5. Implement small process changes.

Kaizen Costing (cont)

6. Measure actual cost savings and operational improvements.

Kaizen Costing (cont)

7. Standardise successful changes and continue improvement.

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Kaizen Costing (cont)

Kaizen Costing vs Target Costing

Kaizen Costing (cont)

- Target costing operates mainly during product design and development.

Kaizen Costing (cont)

- Kaizen costing operates mainly during the manufacturing stage.

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Kaizen Costing (cont)

- Target costing determines the allowable cost before production.

Kaizen Costing (cont)

- Kaizen costing continuously reduces actual production costs.

Kaizen Costing (cont)

- Both aim to achieve and maintain competitive costs and desired profitability.

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Kaizen Costing (cont)

Kaizen Costing vs Traditional Cost Reduction

Kaizen Costing (cont)

- Kaizen focuses on continuous small improvements; traditional cost reduction may involve one-time or large-scale cost-cutting programmes.

Kaizen Costing (cont)

- Kaizen involves employees at all levels; traditional initiatives may be primarily management-driven.

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Kaizen Costing (cont)

- Kaizen emphasises eliminating waste without compromising quality.

Kaizen Costing (cont)

- Kaizen is an ongoing process, not a one-time exercise.

Kaizen Costing (cont)

Advantages

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Kaizen Costing (cont)

- Continuous reduction in production costs.

Kaizen Costing (cont)

- Better productivity and resource utilisation.

Kaizen Costing (cont)

- Reduced defects, wastage and rework.

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Kaizen Costing (cont)

- Greater employee involvement and ownership.

Kaizen Costing (cont)

- Improved quality and operational efficiency.

Kaizen Costing (cont)

- Encourages a culture of continuous improvement.

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Kaizen Costing (cont)

Limitations

Kaizen Costing (cont)

- Benefits may be small initially and take time to accumulate.

Kaizen Costing (cont)

- Requires sustained employee participation and management commitment.

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Kaizen Costing (cont)

- Resistance to change may affect implementation.

Kaizen Costing (cont)

- Excessive pressure to reduce costs can harm quality or morale.

Kaizen Costing (cont)

- Difficult to maintain momentum without proper monitoring.

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Kaizen Costing (cont)

MCQ Traps

Kaizen Costing (cont)

- Kaizen is Japanese for continuous improvement.

Kaizen Costing (cont)

- Kaizen costing is primarily associated with the production/manufacturing stage.

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Kaizen Costing (cont)

- Target costing is mainly pre-production; Kaizen costing is mainly during production.

Kaizen Costing (cont)

- Kaizen relies on small, continuous improvements rather than only radical changes.

Kaizen Costing (cont)

- Employee involvement is a central feature.

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Kaizen Costing (cont)

- Cost reduction should not compromise product quality or customer value.

Life-Cycle Costing

Meaning

Life-Cycle Costing (cont)

- Life-Cycle Costing (LCC) is a costing technique that considers the total cost of a product over its entire life cycle, from research and development to withdrawal and disposal.

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Life-Cycle Costing (cont)

- Unlike traditional costing, which often focuses mainly on manufacturing costs, LCC considers costs incurred before, during and after production.

Life-Cycle Costing (cont)

- Main principle: A product's profitability should be evaluated over its entire life, not merely during its manufacturing period.

Life-Cycle Costing (cont)

Stages of Product Life Cycle

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Life-Cycle Costing (cont)

1. Research and Development: Product research, design, prototyping, testing and development costs.

Life-Cycle Costing (cont)

2. Introduction: Initial production, launch, advertising, distribution and promotion costs.

Life-Cycle Costing (cont)

3. Growth: Increasing production, capacity expansion, marketing and distribution costs.

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Life-Cycle Costing (cont)

4. Maturity: Stable or high sales, competition, maintenance, efficiency improvements and product differentiation costs.

Life-Cycle Costing (cont)

5. Decline: Falling demand, reduced production, inventory clearance, product withdrawal and disposal costs.

Life-Cycle Costing (cont)

Types of Life-Cycle Costs

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Life-Cycle Costing (cont)

- Pre-production costs: Research, design, development, testing and engineering.

Life-Cycle Costing (cont)

- Production costs: Materials, labour, manufacturing overheads and quality control.

Life-Cycle Costing (cont)

- Marketing and distribution costs: Advertising, promotion, transportation, warehousing and selling.

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Life-Cycle Costing (cont)

- Post-sale costs: Warranty, repairs, servicing, customer support and product recalls.

Life-Cycle Costing (cont)

- End-of-life costs: Decommissioning, disposal, recycling and environmental restoration.

Life-Cycle Costing (cont)

Important Formula

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Life-Cycle Costing (cont)

Life-Cycle Cost = Costs Incurred Across All Life - Cycle Stages

Life-Cycle Costing (cont)

Life-Cycle Profit = Total Life-Cycle Revenue - Total Life-Cycle Cost

Life-Cycle Costing (cont)

- For investment appraisal involving cash flows across multiple years, discounted cash flow (DCF) techniques may be used to calculate present value.

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Life-Cycle Costing (cont)

Key Characteristics

Life-Cycle Costing (cont)

- Takes a long-term perspective rather than focusing only on one accounting period.

Life-Cycle Costing (cont)

- Recognises that design decisions influence costs throughout a product's life.

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Life-Cycle Costing (cont)

- Helps identify products that may have high development costs but lower operating costs, or vice versa.

Life-Cycle Costing (cont)

- Considers after-sales and disposal costs, which may be significant.

Life-Cycle Costing (cont)

- Useful for pricing, product planning, profitability analysis and investment decisions.

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Life-Cycle Costing (cont)

Life-Cycle Costing vs Traditional Costing

Life-Cycle Costing (cont)

- Life-cycle costing considers pre-production, production and post-production costs.

Life-Cycle Costing (cont)

- Traditional product costing often concentrates on manufacturing costs.

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Life-Cycle Costing (cont)

- Life-cycle costing evaluates profitability across the entire product life.

Life-Cycle Costing (cont)

- Traditional periodic costing evaluates costs and profits for individual accounting periods.

Life-Cycle Costing (cont)

Advantages

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Life-Cycle Costing (cont)

- Provides a comprehensive picture of total product profitability.

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Life-Cycle Costing (cont)

- Encourages cost reduction at the design and development stage.

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Life-Cycle Costing (cont)

- Helps pricing and product discontinuation decisions.

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Life-Cycle Costing (cont)

- Identifies expensive after-sales and disposal obligations.

Life-Cycle Costing (cont)

- Supports environmental and sustainability considerations.

Life-Cycle Costing (cont)

- Helps compare alternative product designs and technologies.

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Life-Cycle Costing (cont)

Limitations

Life-Cycle Costing (cont)

- Estimating future costs and revenues involves uncertainty.

Life-Cycle Costing (cont)

- Long product life cycles make forecasting difficult.

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Life-Cycle Costing (cont)

- Requires extensive data and coordination across departments.

Life-Cycle Costing (cont)

- Allocation of common costs across products and stages can be difficult.

Life-Cycle Costing (cont)

- Technological changes and market disruptions can make estimates outdated.

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Life-Cycle Costing (cont)

MCQ Traps

Life-Cycle Costing (cont)

- Life-cycle costing covers the entire product life, not just production.

Life-Cycle Costing (cont)

- Research and development costs are included.

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Life-Cycle Costing (cont)

- Warranty, servicing and disposal costs are also relevant.

Life-Cycle Costing (cont)

- It is different from product life-cycle marketing analysis, although both use the same broad stages.

Life-Cycle Costing (cont)

- A product with high initial cost may have lower lifetime operating costs.

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Life-Cycle Costing (cont)

- Life-cycle costing supports target costing and environmental costing by highlighting costs beyond manufacturing.

Material Cost, Price and Usage Variances

Meaning

Material Cost, Price and Usage Variances (cont)

- Material variance = difference between the standard material cost allowed for actual output and the actual material cost incurred.

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Material Cost, Price and Usage Variances (cont)

- Used to identify whether material costs differ because of purchase-price changes, excess consumption, wastage or inefficient usage.

Material Cost, Price and Usage Variances (cont)

- Standard Quantity (SQ) means material quantity allowed for actual output, not budgeted output.

Material Cost, Price and Usage Variances (cont)

- Actual Quantity (AQ) means material quantity actually consumed, unless the question specifically refers to quantity purchased.

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Material Cost, Price and Usage Variances (cont)

- Standard Price (SP) = predetermined price per unit of material.

Material Cost, Price and Usage Variances (cont)

- Actual Price (AP) = actual price per unit of material.

Material Cost, Price and Usage Variances (cont)

1. Material Cost Variance (MCV)

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Material Cost, Price and Usage Variances (cont)

- Measures the total difference between standard material cost and actual material cost.

Material Cost, Price and Usage Variances (cont)

MCV=(SQ x SP) - (AQ x AP)

Material Cost, Price and Usage Variances (cont)

- Favourable (F): Standard cost exceeds actual cost.

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Material Cost, Price and Usage Variances (cont)

- Adverse (A): Actual cost exceeds standard cost.

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Material Cost, Price and Usage Variances (cont)

2. Material Price Variance (MPV)

Material Cost, Price and Usage Variances (cont)

- Measures the effect of paying a price different from the standard price.

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Material Cost, Price and Usage Variances (cont)

MPV=AQ x (SP-AP)

Material Cost, Price and Usage Variances (cont)

- Favourable: Actual price is lower than standard price.

Material Cost, Price and Usage Variances (cont)

- Adverse: Actual price is higher than standard price.

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Material Cost, Price and Usage Variances (cont)

- Normally calculated on actual quantity purchased or used, depending on the question's stated convention.

Material Cost, Price and Usage Variances (cont)

- If price variance is calculated at the time of purchase, use actual quantity purchased; usage variance generally uses quantity consumed.

Material Cost, Price and Usage Variances (cont)

3. Material Usage Variance (MUV)

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Material Cost, Price and Usage Variances (cont)

- Measures the effect of using more or less material than the standard quantity allowed for actual output.

Material Cost, Price and Usage Variances (cont)

MUV=SP x (SQ-AQ)

Material Cost, Price and Usage Variances (cont)

- Favourable: Actual consumption is lower than standard consumption.

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Material Cost, Price and Usage Variances (cont)

- Adverse: Actual consumption exceeds standard consumption.

Material Cost, Price and Usage Variances (cont)

- May arise from wastage, defective materials, poor handling, inefficient production methods or material quality.

Material Cost, Price and Usage Variances (cont)

Relationship

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Material Cost, Price and Usage Variances (cont)

MCV=MPV+MUV

Material Cost, Price and Usage Variances (cont)

- This reconciliation holds when price and usage variances use a consistent quantity basis, normally actual quantity consumed.

Material Cost, Price and Usage Variances (cont)

- If price variance is calculated on purchases while usage variance is calculated on consumption, the difference may include the price variance on materials held in inventory.

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Material Cost, Price and Usage Variances (cont)

Numerical Example

Material Cost, Price and Usage Variances (cont)

- Standard material for actual output: 100 kg at ₹10/kg.

Material Cost, Price and Usage Variances (cont)

- Actual material consumed: 110 kg at ₹12/kg.

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Material Cost, Price and Usage Variances (cont)

- Standard Cost = 100 × ₹10 = ₹1,000.

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Material Cost, Price and Usage Variances (cont)

- Actual Cost = 110 × ₹12 = ₹1,320.

Material Cost, Price and Usage Variances (cont)

MCV=1,000-1,320=₹320\ A

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Material Cost, Price and Usage Variances (cont)

MPV=110(10-12)=₹220\ A

Material Cost, Price and Usage Variances (cont)

MUV=10(100-110)=₹100\ A

Material Cost, Price and Usage Variances (cont)

- Reconciliation: ₹220 A + ₹100 A = ₹320 A.

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Material Cost, Price and Usage Variances (cont)

Factors Affecting Material Variances

Material Cost, Price and Usage Variances (cont)

- Price variance: supplier price changes, discounts, freight, emergency purchases, purchase timing, market shortages and procurement decisions.

Material Cost, Price and Usage Variances (cont)

- Usage variance: material quality, wastage, theft, defective production, machine efficiency, worker skill and production methods.

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Material Cost, Price and Usage Variances (cont)

- Responsibility should be assigned carefully: purchasing may influence price variance, while production may influence usage variance, but responsibility can overlap.

Material Cost, Price and Usage Variances (cont)

MCQ Traps

Material Cost, Price and Usage Variances (cont)

- Material price variance uses actual quantity × price difference; material usage variance uses standard price × quantity difference.

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Material Cost, Price and Usage Variances (cont)

- Standard quantity must relate to actual output.

Material Cost, Price and Usage Variances (cont)

- Lower actual price does not automatically mean favourable overall performance; cheaper material may cause higher wastage or poor quality.

Material Cost, Price and Usage Variances (cont)

- Lower actual consumption is not always favourable if it results in inferior product quality.

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Material Cost, Price and Usage Variances (cont)

- Always distinguish quantity purchased from quantity consumed.

Material Cost, Price and Usage Variances (cont)

- Favourable variance is not necessarily evidence of good management; investigate its underlying cause.

Activity-Based Costing (ABC)

Meaning

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Activity-Based Costing (ABC) (cont)

- Activity-Based Costing (ABC) is a costing method that identifies activities performed in an organisation and assigns overhead costs to products/services based on their consumption of those activities.

Activity-Based Costing (ABC) (cont)

- Traditional costing often allocates overhead using a single volume-based measure such as labour hours or machine hours.

Activity-Based Costing (ABC) (cont)

- ABC recognises that overheads are driven by multiple activities, not merely production volume.

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Activity-Based Costing (ABC) (cont)

- Main principle: Products consume activities; activities consume resources.

Activity-Based Costing (ABC) (cont)

Key Terminology

Activity-Based Costing (ABC) (cont)

- Activity: A task or process that consumes resources, e.g. machine setup, inspection, material handling.

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Activity-Based Costing (ABC) (cont)

- Cost Pool: Group of overhead costs relating to a particular activity.

Activity-Based Costing (ABC) (cont)

- Cost Driver: Factor that causes or influences the cost of an activity.

Activity-Based Costing (ABC) (cont)

- Cost Object: Product, service, customer or job for which cost is calculated.

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Activity-Based Costing (ABC) (cont)

- Activity Cost Driver Rate: Cost allocated per unit of activity driver.

Activity-Based Costing (ABC) (cont)

Types of Activities

Activity-Based Costing (ABC) (cont)

- Unit-level activities: performed for every unit produced; e.g. machine operation, direct labour.

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Activity-Based Costing (ABC) (cont)

- Batch-level activities: performed for each batch, regardless of batch size; e.g. machine setup, purchase orders.

Activity-Based Costing (ABC) (cont)

- Product-sustaining activities: support a particular product irrespective of units/batches; e.g. product design, product testing.

Activity-Based Costing (ABC) (cont)

- Facility-sustaining activities: support the organisation as a whole; e.g. factory security, general administration.

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Activity-Based Costing (ABC) (cont)

- Customer-level activities: support individual customers; e.g. customer visits, account management.

Activity-Based Costing (ABC) (cont)

ABC Procedure

Activity-Based Costing (ABC) (cont)

1. Identify major activities performed.

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Activity-Based Costing (ABC) (cont)

2. Create separate cost pools for each activity.

Activity-Based Costing (ABC) (cont)

3. Assign overhead costs to activity cost pools.

Activity-Based Costing (ABC) (cont)

4. Identify an appropriate cost driver for each activity.

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Activity-Based Costing (ABC) (cont)

5. Calculate the cost driver rate.

Activity-Based Costing (ABC) (cont)

6. Determine each product's consumption of activity drivers.

Activity-Based Costing (ABC) (cont)

7. Allocate activity costs to products based on driver consumption.

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Activity-Based Costing (ABC) (cont)

Important Formulas

Activity-Based Costing (ABC) (cont)

Activity Cost Driver Rate = Total Activity Cost / Total Cost Driver Units

Activity-Based Costing (ABC) (cont)

Overhead Allocated to Product = Driver Rate x Product's Driver Usage

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Activity-Based Costing (ABC) (cont)

Total Product Cost = Direct Costs + ABC Overheads

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Activity-Based Costing (ABC) (cont)

Examples of Cost Drivers

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Activity-Based Costing (ABC) (cont)

- Machine setup → Number of setups.

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Activity-Based Costing (ABC) (cont)

- Quality inspection → Number of inspections.

Activity-Based Costing (ABC) (cont)

- Material handling → Number of material movements.

Activity-Based Costing (ABC) (cont)

- Purchase department → Number of purchase orders.

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Activity-Based Costing (ABC) (cont)

- Production scheduling → Number of production runs.

Activity-Based Costing (ABC) (cont)

- Customer service → Number of customer service requests.

Activity-Based Costing (ABC) (cont)

Numerical Example

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Activity-Based Costing (ABC) (cont)

- Setup cost pool = ₹1,00,000.

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Activity-Based Costing (ABC) (cont)

- Total setups = 50.

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Activity-Based Costing (ABC) (cont)

- Product A uses 10 setups.

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Activity-Based Costing (ABC) (cont)

Setup Rate =1,00,000/50=₹2,000

Activity-Based Costing (ABC) (cont)

Setup Cost for A=10\times2,000=₹20,000

Activity-Based Costing (ABC) (cont)

Advantages

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Activity-Based Costing (ABC) (cont)

- More accurate overhead allocation, especially where overheads are high and products are diverse.

Activity-Based Costing (ABC) (cont)

- Identifies costly activities and operational inefficiencies.

Activity-Based Costing (ABC) (cont)

- Helps product pricing, profitability analysis and product-mix decisions.

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Activity-Based Costing (ABC) (cont)

- Supports cost reduction and process improvement.

Activity-Based Costing (ABC) (cont)

- Highlights non-value-added activities.

Activity-Based Costing (ABC) (cont)

Limitations

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Activity-Based Costing (ABC) (cont)

- Expensive and time-consuming to implement and maintain.

Activity-Based Costing (ABC) (cont)

- Requires extensive data collection and employee cooperation.

Activity-Based Costing (ABC) (cont)

- Selecting appropriate cost drivers can be subjective.

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Activity-Based Costing (ABC) (cont)

- Less beneficial where overheads are low or production is homogeneous.

Activity-Based Costing (ABC) (cont)

- Some facility-sustaining costs cannot be meaningfully traced to individual products.

Activity-Based Costing (ABC) (cont)

Traditional Costing vs ABC

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Activity-Based Costing (ABC) (cont)

- Traditional costing generally uses a limited number of volume-based allocation bases.

Activity-Based Costing (ABC) (cont)

- ABC uses multiple activity-based cost drivers.

Activity-Based Costing (ABC) (cont)

- Traditional costing can overcost high-volume simple products and undercost low-volume complex products.

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Activity-Based Costing (ABC) (cont)

- ABC is particularly useful where products differ in batch sizes, complexity, setups and support requirements.

Activity-Based Costing (ABC) (cont)

MCQ Traps

Activity-Based Costing (ABC) (cont)

- ABC means Activity-Based Costing, not Activity-Based Budgeting.

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Activity-Based Costing (ABC) (cont)

- A cost driver causes or influences activity cost; it is not necessarily the same as the activity itself.

Activity-Based Costing (ABC) (cont)

- Number of setups is a batch-level cost driver.

Activity-Based Costing (ABC) (cont)

- Product design is generally product-sust-aining.

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Activity-Based Costing (ABC) (cont)

- Factory security is generally facility-sustaining.

Activity-Based Costing (ABC) (cont)

- ABC does not mean all overhead costs can be directly traced to products.

Activity-Based Costing (ABC) (cont)

- ABC is especially useful in automated, overhead-intensive and diversified production environments.

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Interpretation and Numerical Problems

1. General Approach to Variance Problems

Interpretation and Numerical Problems (cont)

- Step 1: Identify the standard and actual figures given in the question.

Interpretation and Numerical Problems (cont)

- Step 2: Calculate standard quantity/hours allowed for actual output.

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Interpretation and Numerical Problems (cont)

- Step 3: Calculate standard cost and actual cost.

Interpretation and Numerical Problems (cont)

- Step 4: Apply the relevant variance formula.

Interpretation and Numerical Problems (cont)

- Step 5: Mark the result as Favourable (F) or Adverse (A).

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Interpretation and Numerical Problems (cont)

- Step 6: Reconcile component variances with the total variance.

Interpretation and Numerical Problems (cont)

2. Master Formula Sheet

Interpretation and Numerical Problems (cont)

Material Variances

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Interpretation and Numerical Problems (cont)

MCV=(SQ x SP) - (AQ x AP)

Interpretation and Numerical Problems (cont)

MPV=AQ(SP-AP)

Interpretation and Numerical Problems (cont)

MUV=SP(SQ-AQ)

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Interpretation and Numerical Problems (cont)

MCV=MPV+MUV

Interpretation and Numerical Problems (cont)

Labour Variances

Interpretation and Numerical Problems (cont)

LCV=(SH x SR)-(AH x AR)

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Interpretation and Numerical Problems (cont)

LRV=AH(SR-AR)

Interpretation and Numerical Problems (cont)

LEV=SR(SH-AH)

Interpretation and Numerical Problems (cont)

LCV=LRV+LEV

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Interpretation and Numerical Problems (cont)

Idle Time Variance = Idle Hours x SR

Interpretation and Numerical Problems (cont)

Variable Overhead Variances

Interpretation and Numerical Problems (cont)

VOCV=(SH x SVOR) - AOH

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Interpretation and Numerical Problems (cont)

Expenditure Variance = (AH x SVOR) - AOH

Interpretation and Numerical Problems (cont)

Efficiency Variance =(SH-AH) x SVOR

Interpretation and Numerical Problems (cont)

VOCV= Expenditure Variance + Efficiency Variance

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Interpretation and Numerical Problems (cont)

Fixed Overhead Variances

Interpretation and Numerical Problems (cont)

FOCV=(SH x FOAR)-AFO

Interpretation and Numerical Problems (cont)

Expenditure Variance=BFO-AFO

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Interpretation and Numerical Problems (cont)

Volume Variance=(SH-BH) x FOAR

Interpretation and Numerical Problems (cont)

Capacity Variance=(AH-BH) x FOAR

Interpretation and Numerical Problems (cont)

Efficiency Variance=(SH-AH) x FOAR

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Interpretation and Numerical Problems (cont)

FOCV= Expenditure Variance + Volume Variance

Interpretation and Numerical Problems (cont)

Volume Variance= Capacity Variance+ Efficiency Variance

Interpretation and Numerical Problems (cont)

Sales Variances

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Interpretation and Numerical Problems (cont)

Sales Value Variance =(AQ x AP) - (SQx SP)

Interpretation and Numerical Problems (cont)

Sales Price Variance = AQ(AP-SP)

Interpretation and Numerical Problems (cont)

Sales Volume Variance=SP(AQ-SQ)

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Interpretation and Numerical Problems (cont)

Sales Value Variance= Price Variance + Volume Variance

Interpretation and Numerical Problems (cont)

3. Favourable vs Adverse: Quick Interpretation

Interpretation and Numerical Problems (cont)

- Cost variances: Actual cost below standard cost = Favourable; actual cost above standard cost = Adverse.

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Interpretation and Numerical Problems (cont)

- Revenue variances: Actual revenue above budgeted revenue = Favourable; actual revenue below budgeted revenue = Adverse.

Interpretation and Numerical Problems (cont)

- Efficiency variances: Actual usage/time below standard allowance = Favourable, provided quality and output requirements are maintained.

Interpretation and Numerical Problems (cont)

- Volume variances: Higher output generally increases fixed overhead absorption and creates a favourable volume variance.

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Interpretation and Numerical Problems (cont)

4. Key Numerical Problem Traps

Interpretation and Numerical Problems (cont)

- Always calculate standard quantity or hours for actual output first.

Interpretation and Numerical Problems (cont)

- Never compare actual consumption with budgeted consumption if output differs.

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Interpretation and Numerical Problems (cont)

- Use actual quantity for material price variance under the usual consumption--based convention; purchase-based questions may specify quantity purchased.

Interpretation and Numerical Problems (cont)

- Use actual hours for labour rate variance.

Interpretation and Numerical Problems (cont)

- Use standard rate for labour efficiency variance.

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Interpretation and Numerical Problems (cont)

- Separate idle time variance when the question requires it; avoid double-counting idle hours.

Interpretation and Numerical Problems (cont)

- Variable overhead efficiency variance depends on the activity base used for absorption.

Interpretation and Numerical Problems (cont)

- Fixed overhead volume variance is an absorption/activity variance, not a spending variance.

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Interpretation and Numerical Problems (cont)

- Sales price variance uses actual quantity; sales volume variance uses standard price.

Interpretation and Numerical Problems (cont)

- Clearly distinguish sales value variances from sales margin/profit variances.

Interpretation and Numerical Problems (cont)

- Always verify the reconciliation between total and component variances.

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Interpretation and Numerical Problems (cont)

5. Interpretation of Combined Variances

Interpretation and Numerical Problems (cont)

- Favourable material price + adverse material usage: cheaper materials may have caused higher wastage or lower quality.

Interpretation and Numerical Problems (cont)

- Adverse labour rate + favourable labour efficiency: more skilled or expensive workers may have produced output faster.

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Interpretation and Numerical Problems (cont)

- Favourable labour rate + adverse labour efficiency: cheaper or less-skilled workers may have taken longer.

Interpretation and Numerical Problems (cont)

- Adverse variable overhead expenditure: higher input prices or overspending per activity hour.

Interpretation and Numerical Problems (cont)

- Adverse fixed overhead expenditure: actual fixed spending exceeded budget.

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Interpretation and Numerical Problems (cont)

- Adverse fixed overhead volume: production activity was below budgeted activity.

Interpretation and Numerical Problems (cont)

- Favourable sales volume + adverse sales price: discounts may have increased quantity sold.

Interpretation and Numerical Problems (cont)

- Favourable sales revenue does not necessarily mean favourable profitability; check contribution and margins.

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Interpretation and Numerical Problems (cont)

6. Responsibility and Corrective Action

Interpretation and Numerical Problems (cont)

- Purchase department: investigate material price variance and supplier terms.

Interpretation and Numerical Problems (cont)

- Production department: investigate material usage, labour efficiency and production-related overhead variances.

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Interpretation and Numerical Problems (cont)

- Human Resources/management: examine wage-rate differences and staffing decisions.

Interpretation and Numerical Problems (cont)

- Maintenance: investigate machine breakdowns, idle time and operating inefficiency.

Interpretation and Numerical Problems (cont)

- Sales department: investigate selling price, volume and product mix.

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Interpretation and Numerical Problems (cont)

- Management: identify significant variances, determine root causes and take corrective action.

Interpretation and Numerical Problems (cont)

7. Important Concepts

Interpretation and Numerical Problems (cont)

- Management by Exception: investigate significant deviations rather than every minor variance.

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Interpretation and Numerical Problems (cont)

- Controllable variance: arises from factors that a responsible manager can influence.

Interpretation and Numerical Problems (cont)

- Uncontrollable variance: arises from external or unavoidable factors beyond the manager's control.

Interpretation and Numerical Problems (cont)

- Interdependence: one favourable variance may cause another adverse variance.

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Interpretation and Numerical Problems (cont)

- Variance analysis is useful only when followed by investigation and corrective action.

Interpretation and Numerical Problems (cont)

- Standards should be reviewed when operating conditions change materially.

Sales Variances

Meaning

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Sales Variances (cont)

- Sales variance = difference between actual sales performance and the sales performance expected under standard or budgeted conditions.

Sales Variances (cont)

- Used to analyse the impact of changes in selling price and sales volume.

Sales Variances (cont)

- Standard Selling Price (SP) = predetermined selling price per unit.

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Sales Variances (cont)

- Actual Selling Price (AP) = actual selling price per unit.

Sales Variances (cont)

- Standard Quantity (SQ) = budgeted sales quantity.

Sales Variances (cont)

- Actual Quantity (AQ) = actual quantity sold.

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Sales Variances (cont)

A. Sales Value Variances

Sales Variances (cont)

1. Sales Value Variance

Sales Variances (cont)

- Measures the difference between actual sales revenue and budgeted sales revenue.

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Sales Variances (cont)

Sales Value Variance}=(AQ x AP) - (SQ x SP)

Sales Variances (cont)

- Favourable (F): Actual sales revenue exceeds budgeted sales revenue.

Sales Variances (cont)

- Adverse (A): Actual sales revenue is below budgeted sales revenue.

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Sales Variances (cont)

2. Sales Price Variance

Sales Variances (cont)

- Measures the effect of selling at a price different from the standard price.

Sales Variances (cont)

Sales Price Variance = AQ x (AP - SP)

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Sales Variances (cont)

- Favourable: Actual selling price exceeds standard selling price.

Sales Variances (cont)

- Adverse: Actual selling price is below standard selling price.

Sales Variances (cont)

- Causes: discounts, competition, market demand, pricing policy and changes in product mix.

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Sales Variances (cont)

3. Sales Volume Variance

Sales Variances (cont)

- Measures the effect of selling a quantity different from the budgeted quantity, valued at standard selling price.

Sales Variances (cont)

Sales Volume Variance = SP x (AQ - SQ)

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Sales Variances (cont)

- Favourable: Actual quantity sold exceeds budgeted quantity.

Sales Variances (cont)

- Adverse: Actual quantity sold is below budgeted quantity.

Sales Variances (cont)

Relationship

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Sales Variances (cont)

Sales Value Variance = Sales Price Variance+ Sales Volume Variance

Sales Variances (cont)

Numerical Example

Sales Variances (cont)

- Budgeted sales: 1,000 units at ₹50 = ₹50,000.

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Sales Variances (cont)

- Actual sales: 1,100 units at ₹48 = ₹52,800.

Sales Variances (cont)

Sales Value Variance= 52,800 - 50,000-=₹2,800 F

Sales Variances (cont)

Price Variance= 1,100(48-50)=₹2,200 A

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Sales Variances (cont)

Volume Variance= 50(1,100-1,000)=₹5,000 F

Sales Variances (cont)

- Reconciliation: ₹5,000 F − ₹2,200 A = ₹2,800 F.

Sales Variances (cont)

B. Sales Margin / Profit Variances

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Sales Variances (cont)

- Sales value variance analyses revenue; sales margin or profit variance analyses the effect on contribution or profit.

Sales Variances (cont)

- When the syllabus or question refers to sales margin variances, use standard profit/contribution per unit rather than standard selling price.

Sales Variances (cont)

1. Sales Margin Price Variance

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Sales Variances (cont)

Margin Price Variance=AQ (Actual Margin per Unit -Standard Margin per Unit)

Sales Variances (cont)

- Measures the effect of changes in selling price on profit/contribution per unit, assuming standard cost remains unchanged.

Sales Variances (cont)

2. Sales Margin Volume Variance

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Sales Variances (cont)

Margin Volume Variance =(AQ-SQ) x Standard Margin per Unit

Sales Variances (cont)

- Measures the effect of selling more or fewer units on contribution/profit.

Sales Variances (cont)

- Favourable when actual sales quantity exceeds budgeted quantity, assuming positive standard margin.

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Sales Variances (cont)

3. Sales Mix Variance

Sales Variances (cont)

- Arises when the proportion of different products sold differs from the budgeted sales mix.

Sales Variances (cont)

- Calculated using actual total quantity, revised standard quantities at the budgeted mix, and standard margin per unit.

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Sales Variances (cont)

4. Sales Quantity Variance

Sales Variances (cont)

- Measures the effect of total sales quantity differing from budgeted quantity, holding the budgeted mix constant.

Sales Variances (cont)

- Sales Mix Variance + Sales Quantity Variance = Sales Volume Variance, when expressed on a standard margin basis.

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Sales Variances (cont)

Interpretation

Sales Variances (cont)

- Higher sales volume may increase revenue but not necessarily profit if discounts or low-margin products dominate.

Sales Variances (cont)

- A favourable price variance may arise from premium pricing or reduced discounts.

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Sales Variances (cont)

- An adverse price variance may be a deliberate strategy to increase market share.

Sales Variances (cont)

- Sales mix matters because products have different contribution margins.

Sales Variances (cont)

- Evaluate sales variances alongside cost and contribution variances rather than interpreting revenue alone.

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Sales Variances (cont)

MCQ Traps

Sales Variances (cont)

- Sales price variance uses actual quantity × difference in selling prices.

Sales Variances (cont)

- Sales volume variance uses standard selling price × difference in quantities for sales value analysis.

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Sales Variances (cont)

- Do not confuse sales value variance with sales margin/profit variance.

Sales Variances (cont)

- For margin variances, use standard margin/contribution per unit, not selling price.

Sales Variances (cont)

- Higher sales revenue does not automatically mean higher profit.

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Sales Variances (cont)

- Always identify whether the question asks for sales value, sales margin or sales profit variances.

Fixed Overhead Variances

Meaning

Fixed Overhead Variances (cont)

- Fixed overhead variance = difference between fixed overhead absorbed into actual production and actual fixed overhead incurred.

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Fixed Overhead Variances (cont)

- Fixed overheads remain constant in total within the relevant range, irrespective of short-term changes in output.

Fixed Overhead Variances (cont)

- Examples: factory rent, insurance, fixed salaries, depreciation and factory supervision.

Fixed Overhead Variances (cont)

- Budgeted Fixed Overhead (BFO) = fixed overhead estimated for the budget period.

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Fixed Overhead Variances (cont)

- Actual Fixed Overhead (AFO) = fixed overhead actually incurred.

Fixed Overhead Variances (cont)

- Standard Hours (SH) = hours allowed for actual output.

Fixed Overhead Variances (cont)

- Actual Hours (AH) = actual hours worked.

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Fixed Overhead Variances (cont)

- Budgeted Hours (BH) = hours planned for the budget period.

Fixed Overhead Variances (cont)

- Fixed Overhead Absorption Rate (FOAR) = Budgeted Fixed Overhead ÷ Budgeted Activity.

Fixed Overhead Variances (cont)

1. Fixed Overhead Cost Variance (FOCV)

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Fixed Overhead Variances (cont)

- Measures the difference between fixed overhead absorbed and actual fixed overhead.

Fixed Overhead Variances (cont)

FOCV= Fixed OH Absorbed - AFO

Fixed Overhead Variances (cont)

FOCV=(SH x FOAR)-AFO

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Fixed Overhead Variances (cont)

- Favourable (F): Overhead absorbed exceeds actual overhead.

Fixed Overhead Variances (cont)

- Adverse (A): Actual overhead exceeds overhead absorbed.

Fixed Overhead Variances (cont)

2. Fixed Overhead Expenditure Variance

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Fixed Overhead Variances (cont)

- Measures the difference between budgeted fixed overhead and actual fixed overhead.

Fixed Overhead Variances (cont)

Expenditure Variance= BFO - AFO

Fixed Overhead Variances (cont)

- Favourable: Actual fixed overhead is lower than budgeted.

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Fixed Overhead Variances (cont)

- Adverse: Actual fixed overhead exceeds budgeted.

Fixed Overhead Variances (cont)

- Causes: rent revisions, unexpected repairs, insurance changes and spending control.

Fixed Overhead Variances (cont)

3. Fixed Overhead Volume Variance

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Fixed Overhead Variances (cont)

- Measures the effect of actual production activity differing from budgeted activity on fixed overhead absorption.

Fixed Overhead Variances (cont)

Volume Variance = Fixed OH Absorbed - BFO

Fixed Overhead Variances (cont)

=(SH-BH) x FOAR

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Fixed Overhead Variances (cont)

- Favourable: Actual output/activity exceeds budgeted activity, increasing fixed overhead absorption.

Fixed Overhead Variances (cont)

- Adverse: Actual output/activity is below budgeted activity, reducing fixed overhead absorption.

Fixed Overhead Variances (cont)

4. Fixed Overhead Capacity Variance

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Fixed Overhead Variances (cont)

- Measures the effect of actual hours worked differing from budgeted hours.

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Fixed Overhead Variances (cont)

Capacity Variance =(AH-BH) x FOAR

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Fixed Overhead Variances (cont)

- Favourable: Actual hours exceed budgeted hours.

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Fixed Overhead Variances (cont)

- Adverse: Actual hours are below budgeted hours.

Fixed Overhead Variances (cont)

- Reflects under-utilisation or over-utilisation of available capacity, based on the budgeted-hour convention.

Fixed Overhead Variances (cont)

5. Fixed Overhead Efficiency Variance

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Fixed Overhead Variances (cont)

- Measures the effect of using more or fewer hours than the standard hours allowed for actual output.

Fixed Overhead Variances (cont)

Efficiency Variance =(SH-AH) x FOAR

Fixed Overhead Variances (cont)

- Favourable: Standard hours for actual output exceed actual hours.

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Fixed Overhead Variances (cont)

- Adverse: Actual hours exceed standard hours.

Fixed Overhead Variances (cont)

- Reflects production efficiency rather than spending.

Fixed Overhead Variances (cont)

Relationships

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Fixed Overhead Variances (cont)

FOCV= Expenditure Variance + Volume Variance

Fixed Overhead Variances (cont)

Volume Variance = Capacity Variance + Efficiency Variance

Fixed Overhead Variances (cont)

Numerical Example

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Fixed Overhead Variances (cont)

- Budgeted fixed overhead = ₹10,000.

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Fixed Overhead Variances (cont)

- Budgeted hours = 1,000.

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Fixed Overhead Variances (cont)

- Standard hours for actual output = 900.

Fixed Overhead Variances (cont)

- Actual hours = 950.

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Fixed Overhead Variances (cont)

- Actual fixed overhead = ₹10,500.

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Fixed Overhead Variances (cont)

FOAR=10,000/1,000=₹10/hour

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Fixed Overhead Variances (cont)

Fixed OH Absorbed =900 x 10=₹9,000

Fixed Overhead Variances (cont)

- Fixed Overhead Cost Variance = ₹9,000 − ₹10,500 = ₹1,500 A.

Fixed Overhead Variances (cont)

- Expenditure Variance = ₹10,000 − ₹10,500 = ₹500 A.

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Fixed Overhead Variances (cont)

- Volume Variance = ₹9,000 − ₹10,000 = ₹1,000 A.

Fixed Overhead Variances (cont)

- Capacity Variance = (950 − 1,000) × ₹10 = ₹500 A.

Fixed Overhead Variances (cont)

- Efficiency Variance = (900 − 950) × ₹10 = ₹500 A.

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Fixed Overhead Variances (cont)

- Reconciliation: ₹500 A + ₹500 A + ₹500 A = ₹1,500 A.

Fixed Overhead Variances (cont)

Important Distinction

Fixed Overhead Variances (cont)

- Expenditure variance: Did the organisation spend more or less than budgeted?

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Fixed Overhead Variances (cont)

- Volume variance: Did production activity differ from the budgeted level?

Fixed Overhead Variances (cont)

- Capacity variance: Were actual hours different from budgeted hours?

Fixed Overhead Variances (cont)

- Efficiency variance: Were actual hours different from standard hours allowed for actual output?

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Fixed Overhead Variances (cont)

MCQ Traps

Fixed Overhead Variances (cont)

- Fixed overhead expenditure variance compares budgeted and actual fixed overhead.

Fixed Overhead Variances (cont)

- Fixed overhead volume variance compares absorbed fixed overhead with budgeted fixed overhead.

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Fixed Overhead Variances (cont)

- Capacity variance uses actual hours and budgeted hours.

Fixed Overhead Variances (cont)

- Efficiency variance uses standard hours for actual output and actual hours.

Fixed Overhead Variances (cont)

- Fixed overhead volume variance is generally zero under a fixed budget when actual output equals budgeted output.

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Fixed Overhead Variances (cont)

- Under-absorption of fixed overhead may arise from lower production volume, even when actual fixed spending is exactly on budget.

Variable Overhead Variances

Meaning

Variable Overhead Variances (cont)

- Variable overhead variance = difference between standard variable overhead allowed for actual output and actual variable overhead incurred.

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Variable Overhead Variances (cont)

- Variable overheads change broadly in proportion to the level of activity.

Variable Overhead Variances (cont)

- Examples: indirect materials, machine power, consumables and production supplies.

Variable Overhead Variances (cont)

- Standard Hours (SH) = hours allowed for actual output.

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Variable Overhead Variances (cont)

- Actual Hours (AH) = actual hours worked or activity hours incurred.

Variable Overhead Variances (cont)

- Standard Variable Overhead Rate (SVOR) = predetermined variable overhead cost per standard activity hour.

Variable Overhead Variances (cont)

- Actual Variable Overhead Rate (AVOR) = actual variable overhead per actual activity hour.

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Variable Overhead Variances (cont)

1. Variable Overhead Cost Variance (VOCV)

Variable Overhead Variances (cont)

- Measures total difference between standard variable overhead and actual variable overhead.

Variable Overhead Variances (cont)

VOCV=(SH x SVOR) - Actual Variable OH

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Variable Overhead Variances (cont)

- Favourable (F): Standard variable overhead exceeds actual overhead.

Variable Overhead Variances (cont)

- Adverse (A): Actual variable overhead exceeds standard overhead.

Variable Overhead Variances (cont)

2. Variable Overhead Expenditure Variance

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Variable Overhead Variances (cont)

- Measures the effect of spending more or less per actual activity hour than the standard rate.

Variable Overhead Variances (cont)

Expenditure Variance =(AH x SVOR)- Actual Variable OH

Variable Overhead Variances (cont)

- Favourable: Actual variable overhead rate is lower than standard rate.

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Variable Overhead Variances (cont)

- Adverse: Actual variable overhead rate is higher than standard rate.

Variable Overhead Variances (cont)

- Causes: changes in power tariffs, consumable prices, indirect material costs and inefficient spending.

Variable Overhead Variances (cont)

3. Variable Overhead Efficiency Variance

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Variable Overhead Variances (cont)

- Measures the overhead impact of using more or fewer activity hours than the standard hours allowed for actual output.

Variable Overhead Variances (cont)

Efficiency Variance =(SH-AH) x SVOR

Variable Overhead Variances (cont)

- Favourable: Actual hours are lower than standard hours.

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Variable Overhead Variances (cont)

- Adverse: Actual hours exceed standard hours.

Variable Overhead Variances (cont)

- Causes: machine inefficiency, production delays, poor supervision, worker productivity and material quality.

Variable Overhead Variances (cont)

Relationship

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Variable Overhead Variances (cont)

VOCV= Expenditure Variance+ Efficiency Variance

Variable Overhead Variances (cont)

Numerical Example

Variable Overhead Variances (cont)

- Standard hours for actual output = 100 hours.

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Variable Overhead Variances (cont)

- Actual hours = 110 hours.

Variable Overhead Variances (cont)

- Standard variable overhead rate = ₹20/hour.

Variable Overhead Variances (cont)

- Actual variable overhead = ₹2,420.

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Variable Overhead Variances (cont)

VOCV=(100 x 20)-2,420=₹420 A

Variable Overhead Variances (cont)

Expenditure Variance=(110 x 20)-2,420-=₹220 A

Variable Overhead Variances (cont)

Efficiency Variance=(100-110) x 20=₹200 A

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Variable Overhead Variances (cont)

- Reconciliation: ₹220 A + ₹200 A = ₹420 A.

Variable Overhead Variances (cont)

Interpretation

Variable Overhead Variances (cont)

- Expenditure variance relates to the cost incurred per activity hour.

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Variable Overhead Variances (cont)

- Efficiency variance relates to the number of activity hours used for actual production.

Variable Overhead Variances (cont)

- Variable overhead efficiency variance often moves in the same direction as labour or machine-hour efficiency variance when the same activity base is used.

Variable Overhead Variances (cont)

- The activity base must match the overhead being analysed: labour hours, machine hours or another relevant measure.

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Variable Overhead Variances (cont)

MCQ Traps

Variable Overhead Variances (cont)

- Variable overhead expenditure variance uses actual hours and the standard rate.

Variable Overhead Variances (cont)

- Variable overhead efficiency variance uses the difference between standard and actual hours multiplied by the standard rate.

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Variable Overhead Variances (cont)

- Standard hours are based on actual output.

Variable Overhead Variances (cont)

- Do not use fixed overhead absorption formulas for variable overhead variance calculations.

Variable Overhead Variances (cont)

- If overhead is absorbed on machine hours, use machine hours rather than labour hours.

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Labour Cost, Rate and Efficiency Variances

Meaning

Labour Cost, Rate and Efficiency Variances (cont)

- Labour variance = difference between standard labour cost allowed for actual output and actual labour cost incurred.

Labour Cost, Rate and Efficiency Variances (cont)

- Used to identify the impact of wage-rate differences, labour productivity and time taken.

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Labour Cost, Rate and Efficiency Variances (cont)

- Standard Hours (SH) = hours allowed for actual output.

Labour Cost, Rate and Efficiency Variances (cont)

- Actual Hours (AH) = hours actually worked.

Labour Cost, Rate and Efficiency Variances (cont)

- Standard Rate (SR) = predetermined wage rate per hour.

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Labour Cost, Rate and Efficiency Variances (cont)

- Actual Rate (AR) = actual wage cost per hour.

Labour Cost, Rate and Efficiency Variances (cont)

1. Labour Cost Variance (LCV)

Labour Cost, Rate and Efficiency Variances (cont)

- Measures the total difference between standard labour cost and actual labour cost.

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Labour Cost, Rate and Efficiency Variances (cont)

LCV=(SH x SR)-(AH x AR)

Labour Cost, Rate and Efficiency Variances (cont)

- Favourable (F): Standard labour cost exceeds actual labour cost.

Labour Cost, Rate and Efficiency Variances (cont)

- Adverse (A): Actual labour cost exceeds standard labour cost.

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Labour Cost, Rate and Efficiency Variances (cont)

2. Labour Rate Variance (LRV)

Labour Cost, Rate and Efficiency Variances (cont)

- Measures the effect of paying a wage rate different from the standard rate.

Labour Cost, Rate and Efficiency Variances (cont)

LRV=AH x (SR-AR)

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Labour Cost, Rate and Efficiency Variances (cont)

- Favourable: Actual wage rate is lower than standard rate.

Labour Cost, Rate and Efficiency Variances (cont)

- Adverse: Actual wage rate is higher than standard rate.

Labour Cost, Rate and Efficiency Variances (cont)

- Causes: wage revisions, overtime premiums, employment of workers with different skill levels, labour-market conditions and changes in worker composition.

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Labour Cost, Rate and Efficiency Variances (cont)

3. Labour Efficiency Variance (LEV)

Labour Cost, Rate and Efficiency Variances (cont)

- Measures the effect of taking more or less time than the standard hours allowed for actual output.

Labour Cost, Rate and Efficiency Variances (cont)

LEV=SR x (SH-AH)

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Labour Cost, Rate and Efficiency Variances (cont)

- Favourable: Actual hours are lower than standard hours.

Labour Cost, Rate and Efficiency Variances (cont)

- Adverse: Actual hours exceed standard hours.

Labour Cost, Rate and Efficiency Variances (cont)

- Causes: worker skill, supervision, training, machine efficiency, working conditions, material quality and production planning.

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Labour Cost, Rate and Efficiency Variances (cont)

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Labour Cost, Rate and Efficiency Variances (cont)

LCV=LRV+LEV

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Labour Cost, Rate and Efficiency Variances (cont)

4. Idle Time Variance

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Labour Cost, Rate and Efficiency Variances (cont)

- Separately identifies the cost of paid hours during which workers could not perform productive work.

Labour Cost, Rate and Efficiency Variances (cont)

- Usually treated as an adverse variance.

Labour Cost, Rate and Efficiency Variances (cont)

Idle Time Variance=Idle Hours x SR

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Labour Cost, Rate and Efficiency Variances (cont)

- Causes: power failure, machine breakdown, material shortage, strikes and poor production scheduling.

Labour Cost, Rate and Efficiency Variances (cont)

- If idle time is separately identified, efficiency variance is generally calculated using productive hours; idle time variance is then added to reconcile total labour cost variance.

Labour Cost, Rate and Efficiency Variances (cont)

- Avoid double-counting idle hours in both efficiency and idle-time variances.

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Labour Cost, Rate and Efficiency Variances (cont)

Numerical Example

Labour Cost, Rate and Efficiency Variances (cont)

- Standard labour: 10 hours at ₹100/hour for actual output.

Labour Cost, Rate and Efficiency Variances (cont)

- Actual labour: 12 hours at ₹110/hour.

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Labour Cost, Rate and Efficiency Variances (cont)

LCV=(10 x 100)-(12 x 110) =₹1,320 A

Labour Cost, Rate and Efficiency Variances (cont)

LRV=12(100-110)=₹120 A

Labour Cost, Rate and Efficiency Variances (cont)

LEV=100(10-12)=₹200 A

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Labour Cost, Rate and Efficiency Variances (cont)

- Reconciliation: ₹120 A + ₹200 A = ₹320 A.

Labour Cost, Rate and Efficiency Variances (cont)

Interpretation and Responsibility

Labour Cost, Rate and Efficiency Variances (cont)

- Rate variance may be influenced by Human Resources, wage agreements and production management.

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Labour Cost, Rate and Efficiency Variances (cont)

- Efficiency variance may be influenced by production supervisors, worker training, machinery, material quality and working conditions.

Labour Cost, Rate and Efficiency Variances (cont)

- Paying a higher rate for skilled workers may produce a favourable efficiency variance; evaluate the combined effect.

Labour Cost, Rate and Efficiency Variances (cont)

- Overtime can create an adverse rate variance because of premium wages, even if it helps meet production targets.

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Labour Cost, Rate and Efficiency Variances (cont)

MCQ Traps

Labour Cost, Rate and Efficiency Variances (cont)

- Rate variance uses actual hours × rate difference.

Labour Cost, Rate and Efficiency Variances (cont)

- Efficiency variance uses standard rate × hour difference.

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Labour Cost, Rate and Efficiency Variances (cont)

- Standard hours must relate to actual output, not budgeted output.

Labour Cost, Rate and Efficiency Variances (cont)

- Lower wage rates do not automatically indicate better performance.

Labour Cost, Rate and Efficiency Variances (cont)

- Higher-skilled or more expensive labour may improve productivity.

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Labour Cost, Rate and Efficiency Variances (cont)

- Idle time is paid but unproductive time; separately identify it to avoid double-co-unting.

Lean Systems and Cost Management

Responsibility Accounting and Cost Centres

Meaning of Responsibility Accounting

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Responsibility Accounting and Cost Centres (cont)

- Responsibility accounting is a system of management accounting in which organi-sational activities and costs are assigned to specific managers or responsibility centres.

Responsibility Accounting and Cost Centres (cont)

- Each manager is held accountable for the financial and operational performance of the area under their control.

Responsibility Accounting and Cost Centres (cont)

- It supports decentralisation, performance evaluation, cost control and managerial accountability.

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Responsibility Accounting and Cost Centres (cont)

- The principle is controllability: managers should primarily be evaluated on factors they can influence.

Responsibility Accounting and Cost Centres (cont)

Types of Responsibility Centres

Responsibility Accounting and Cost Centres (cont)

- 1. Cost Centre

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Responsibility Accounting and Cost Centres (cont)

- Manager is responsible for controlling costs but not directly responsible for revenue.

Responsibility Accounting and Cost Centres (cont)

- Examples: production department, maintenance department, HR department.

Responsibility Accounting and Cost Centres (cont)

- Performance measured through actual costs versus budgeted or standard costs.

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Responsibility Accounting and Cost Centres (cont)

- 2. Revenue Centre

Responsibility Accounting and Cost Centres (cont)

- Manager is responsible primarily for generating revenue.

Responsibility Accounting and Cost Centres (cont)

- Costs may be monitored, but the manager is not primarily accountable for profit.

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Responsibility Accounting and Cost Centres (cont)

- Example: sales department.

Responsibility Accounting and Cost Centres (cont)

- Performance measured through sales targets, revenue growth and market share.

Responsibility Accounting and Cost Centres (cont)

- 3. Profit Centre

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Responsibility Accounting and Cost Centres (cont)

- Manager is responsible for both revenue and costs and therefore the profit generated.

Responsibility Accounting and Cost Centres (cont)

- Example: a regional business division or individual store.

Responsibility Accounting and Cost Centres (cont)

- Performance measured through operating profit, contribution and profit margins.

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Responsibility Accounting and Cost Centres (cont)

- 4. Investment Centre

Responsibility Accounting and Cost Centres (cont)

- Manager is responsible for revenue, costs, profits and investment in assets.

Responsibility Accounting and Cost Centres (cont)

- Example: an independent subsidiary or major business division.

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Responsibility Accounting and Cost Centres (cont)

- Performance measured through Return on Investment (ROI), Residual Income (RI) and asset utilisation.

Responsibility Accounting and Cost Centres (cont)

Cost Centre – Meaning and Classification

Responsibility Accounting and Cost Centres (cont)

- A cost centre is a location, person, department, machine, activity or function for which costs are accumulated and measured.

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Responsibility Accounting and Cost Centres (cont)

- It is the basic unit for cost collection, allocation and control.

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Responsibility Accounting and Cost Centres (cont)

Types of Cost Centres

Responsibility Accounting and Cost Centres (cont)

- Production Cost Centre: directly involved in manufacturing or production.

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Responsibility Accounting and Cost Centres (cont)

- Examples: machining, assembly, processing.

Responsibility Accounting and Cost Centres (cont)

- Service Cost Centre: provides services to production or other departments.

Responsibility Accounting and Cost Centres (cont)

- Examples: maintenance, stores, canteen, power house.

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Responsibility Accounting and Cost Centres (cont)

- Personal Cost Centre: associated with an individual or group of persons.

Responsibility Accounting and Cost Centres (cont)

- Impersonal Cost Centre: associated with a location, machine, equipment or department.

Responsibility Accounting and Cost Centres (cont)

- Operation Cost Centre: represents a specific operation or activity.

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Responsibility Accounting and Cost Centres (cont)

- Process Cost Centre: represents a distinct stage or process of production.

Responsibility Accounting and Cost Centres (cont)

Performance Evaluation Measures

Responsibility Accounting and Cost Centres (cont)

- Cost Centre: cost variance, efficiency, cost per unit and budget adherence.

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Responsibility Accounting and Cost Centres (cont)

- Revenue Centre: revenue growth, sales volume and achievement of targets.

Responsibility Accounting and Cost Centres (cont)

- Profit Centre: operating profit, contribution and profit margin.

Responsibility Accounting and Cost Centres (cont)

- Investment Centre: ROI and Residual Income.

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Responsibility Accounting and Cost Centres (cont)

Important Formulas

Responsibility Accounting and Cost Centres (cont)

- ROI = (Operating Profit ÷ Average Operating Investment) × 100.

Responsibility Accounting and Cost Centres (cont)

- Residual Income (RI) = Operating Profit − (Required Rate of Return × Average Operating Investment).

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Responsibility Accounting and Cost Centres (cont)

- Profit Margin = (Operating Profit ÷ Sales) × 100.

Responsibility Accounting and Cost Centres (cont)

- Asset Turnover = Sales ÷ Average Operating Investment.

Responsibility Accounting and Cost Centres (cont)

- ROI = Profit Margin × Asset Turnover.

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Responsibility Accounting and Cost Centres (cont)

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Responsibility Accounting and Cost Centres (cont)

- Operating profit = ₹20 lakh.

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Responsibility Accounting and Cost Centres (cont)

- Average investment = ₹100 lakh.

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Responsibility Accounting and Cost Centres (cont)

- ROI = 20 ÷ 100 × 100 = 20%.

Responsibility Accounting and Cost Centres (cont)

- Required return = 15%.

Responsibility Accounting and Cost Centres (cont)

- Residual Income = ₹20 lakh − (15% × ₹100 lakh) = ₹5 lakh.

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Responsibility Accounting and Cost Centres (cont)

Advantages

Responsibility Accounting and Cost Centres (cont)

- Fixes accountability for costs and operational results.

Responsibility Accounting and Cost Centres (cont)

- Supports decentralised decision-making.

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Responsibility Accounting and Cost Centres (cont)

- Helps identify inefficient departments and activities.

Responsibility Accounting and Cost Centres (cont)

- Improves budgeting and performance evaluation.

Responsibility Accounting and Cost Centres (cont)

- Encourages cost consciousness among managers.

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Responsibility Accounting and Cost Centres (cont)

- Facilitates comparison between budgeted and actual performance.

Responsibility Accounting and Cost Centres (cont)

Limitations

Responsibility Accounting and Cost Centres (cont)

- Managers may focus on departmental targets at the expense of organisational objectives.

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Responsibility Accounting and Cost Centres (cont)

- Shared costs may be difficult to allocate fairly.

Responsibility Accounting and Cost Centres (cont)

- External factors can affect performance beyond managerial control.

Responsibility Accounting and Cost Centres (cont)

- Transfer pricing between responsibility centres can distort performance evaluation.

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Responsibility Accounting and Cost Centres (cont)

- Excessive emphasis on short-term financial targets may discourage long-term investment.

Responsibility Accounting and Cost Centres (cont)

MCQ Traps

Responsibility Accounting and Cost Centres (cont)

- Cost centre = responsibility for costs.

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Responsibility Accounting and Cost Centres (cont)

- Revenue centre = responsibility for revenue.

Responsibility Accounting and Cost Centres (cont)

- Profit centre = responsibility for revenue and costs.

Responsibility Accounting and Cost Centres (cont)

- Investment centre = responsibility for profit and invested assets.

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Responsibility Accounting and Cost Centres (cont)

- ROI and Residual Income are particularly relevant to investment centres.

Responsibility Accounting and Cost Centres (cont)

- A service department can itself be a cost centre.

Responsibility Accounting and Cost Centres (cont)

- A cost centre is a unit for cost accumulation; a responsibility centre is a unit of managerial accountability.

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Responsibility Accounting and Cost Centres (cont)

- Responsibility accounting follows the controllability principle.

Reconciliation Between Cost and Financial Accounts

Meaning

Reconciliation Between Cost and Financial Accounts (cont)

- Reconciliation is the process of identifying and explaining differences between profit or loss shown by cost accounts and financial accounts.

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Reconciliation Between Cost and Financial Accounts (cont)

- It ensures that both accounting systems ultimately reflect the same underlying business transactions.

Reconciliation Between Cost and Financial Accounts (cont)

- Reconciliation is necessary when cost accounts and financial accounts are maintained separately, particularly under a non-integrated accounting system.

Reconciliation Between Cost and Financial Accounts (cont)

Why Differences Arise

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Reconciliation Between Cost and Financial Accounts (cont)

1. Items Included Only in Financial Accounts

Reconciliation Between Cost and Financial Accounts (cont)

- Interest paid on loans and debentures.

Reconciliation Between Cost and Financial Accounts (cont)

- Income tax.

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Reconciliation Between Cost and Financial Accounts (cont)

- Donations and charitable contributions.

Reconciliation Between Cost and Financial Accounts (cont)

- Loss on sale of fixed assets.

Reconciliation Between Cost and Financial Accounts (cont)

- Goodwill written off.

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Reconciliation Between Cost and Financial Accounts (cont)

- Dividends paid.

Reconciliation Between Cost and Financial Accounts (cont)

- Fines and penalties.

Reconciliation Between Cost and Financial Accounts (cont)

- These are generally excluded from normal cost accounts because they are financial or non-cost items.

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Reconciliation Between Cost and Financial Accounts (cont)

2. Items Included Only in Cost Accounts

Reconciliation Between Cost and Financial Accounts (cont)

- Notional rent on owned premises.

Reconciliation Between Cost and Financial Accounts (cont)

- Notional interest on capital employed.

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Reconciliation Between Cost and Financial Accounts (cont)

- Imputed salary of the proprietor.

Reconciliation Between Cost and Financial Accounts (cont)

- These are included for managerial cost analysis despite not being actual expenses in financial accounts.

Reconciliation Between Cost and Financial Accounts (cont)

3. Differences in Valuation

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Reconciliation Between Cost and Financial Accounts (cont)

- Different methods of stock valuation (FIFO, weighted average, etc.).

Reconciliation Between Cost and Financial Accounts (cont)

- Different valuation of WIP and finished goods.

Reconciliation Between Cost and Financial Accounts (cont)

- Different treatment of depreciation.

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Reconciliation Between Cost and Financial Accounts (cont)

- Different rates of overhead absorption.

Reconciliation Between Cost and Financial Accounts (cont)

- Different treatment of abnormal losses and wastage.

Reconciliation Between Cost and Financial Accounts (cont)

4. Overhead Under- or Over-Absorption

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Reconciliation Between Cost and Financial Accounts (cont)

- Under-absorption: overhead absorbed in cost accounts is less than actual overhead incurred.

Reconciliation Between Cost and Financial Accounts (cont)

- Over-absorption: overhead absorbed in cost accounts is greater than actual overhead incurred.

Reconciliation Between Cost and Financial Accounts (cont)

- This creates a difference between the profits reported by the two systems.

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Reconciliation Between Cost and Financial Accounts (cont)

5. Differences in Accounting Treatment

Reconciliation Between Cost and Financial Accounts (cont)

- Different treatment of research and development expenditure.

Reconciliation Between Cost and Financial Accounts (cont)

- Different treatment of provisions and write-offs.

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Reconciliation Between Cost and Financial Accounts (cont)

- Different treatment of discounts, interest and other income.

Reconciliation Between Cost and Financial Accounts (cont)

Reconciliation Procedure

Reconciliation Between Cost and Financial Accounts (cont)

- Start with profit as per cost accounts or financial accounts.

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Reconciliation Between Cost and Financial Accounts (cont)

- Identify items recorded only in one accounting system.

Reconciliation Between Cost and Financial Accounts (cont)

- Identify differences in stock valuation, depreciation and overhead absorption.

Reconciliation Between Cost and Financial Accounts (cont)

- Adjust for each item according to its effect on profit.

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Reconciliation Between Cost and Financial Accounts (cont)

- Arrive at the profit shown by the other accounting system.

Reconciliation Between Cost and Financial Accounts (cont)

Profit Reconciliation – Adjustment Rules

Reconciliation Between Cost and Financial Accounts (cont)

When starting with profit as per Cost Accounts to arrive at financial profit:

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Reconciliation Between Cost and Financial Accounts (cont)

- Add incomes recorded only in financial accounts.

Reconciliation Between Cost and Financial Accounts (cont)

- Add expenses charged only in cost accounts.

Reconciliation Between Cost and Financial Accounts (cont)

- Add over-absorption of overheads.

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Reconciliation Between Cost and Financial Accounts (cont)

- Add closing stock overvaluation in cost accounts compared with financial accounts.

Reconciliation Between Cost and Financial Accounts (cont)

- Deduct expenses recorded only in financial accounts.

Reconciliation Between Cost and Financial Accounts (cont)

- Deduct incomes recorded only in cost accounts.

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Reconciliation Between Cost and Financial Accounts (cont)

- Deduct under-absorption of overheads.

Reconciliation Between Cost and Financial Accounts (cont)

- Deduct closing stock undervaluation in cost accounts compared with financial accounts.

Reconciliation Between Cost and Financial Accounts (cont)

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Reconciliation Between Cost and Financial Accounts (cont)

- Profit as per Cost Accounts = ₹5,00,000.

Reconciliation Between Cost and Financial Accounts (cont)

- Interest income appearing only in financial accounts = ₹20,000.

Reconciliation Between Cost and Financial Accounts (cont)

- Goodwill written off only in financial accounts = ₹30,000.

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Reconciliation Between Cost and Financial Accounts (cont)

- Over-absorption of overheads in cost accounts = ₹10,000.

Reconciliation Between Cost and Financial Accounts (cont)

Profit as per Financial Accounts:

Reconciliation Between Cost and Financial Accounts (cont)

= ₹5,00,000 + ₹20,000 − ₹30,000 + ₹10,000

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Reconciliation Between Cost and Financial Accounts (cont)

= ₹5,00,000

Reconciliation Between Cost and Financial Accounts (cont)

Integrated vs Non-Integrated Accounting System

Reconciliation Between Cost and Financial Accounts (cont)

- Integrated System: cost and financial accounts are maintained within a single accounting system; separate reconciliation is generally unnecessary.

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Reconciliation Between Cost and Financial Accounts (cont)

- Non-Integrated System: separate cost and financial books are maintained; reconciliation is required to explain differences.

Reconciliation Between Cost and Financial Accounts (cont)

Objectives and Benefits

Reconciliation Between Cost and Financial Accounts (cont)

- Ensures accuracy and reliability of cost and financial information.

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Reconciliation Between Cost and Financial Accounts (cont)

- Detects errors and omissions.

Reconciliation Between Cost and Financial Accounts (cont)

- Improves internal control.

Reconciliation Between Cost and Financial Accounts (cont)

- Establishes consistency between cost profit and financial profit.

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Reconciliation Between Cost and Financial Accounts (cont)

- Supports management decisions and statutory audit requirements.

Reconciliation Between Cost and Financial Accounts (cont)

MCQ Traps

Reconciliation Between Cost and Financial Accounts (cont)

- Under-absorption of overheads reduces profit as per cost accounts relative to financial accounts, all else equal.

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Reconciliation Between Cost and Financial Accounts (cont)

- Over-absorption increases profit as per cost accounts relative to financial accounts.

Reconciliation Between Cost and Financial Accounts (cont)

- Interest on loans, income tax and dividends are generally excluded from cost accounts.

Reconciliation Between Cost and Financial Accounts (cont)

- Notional rent and notional interest may be included in cost accounts.

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Reconciliation Between Cost and Financial Accounts (cont)

- Reconciliation is generally necessary under non-integrated accounting.

Reconciliation Between Cost and Financial Accounts (cont)

- Always check the starting point: adjustment signs reverse when reconciling from financial profit to cost profit.

Cost Auditor Appointment and Reporting Basics

Legal Framework

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Cost Auditor Appointment and Reporting Basics (cont)

- Governed by Section 148 of the Companies Act, 2013 and the Companies (Cost Records and Audit) Rules, 2014.

Cost Auditor Appointment and Reporting Basics (cont)

- Cost auditor must be a Cost Accountant in Practice.

Cost Auditor Appointment and Reporting Basics (cont)

- A person who is disqualified under Section 141(3) for appointment as a statutory auditor is also disqualified from appointment as a cost auditor.

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Cost Auditor Appointment and Reporting Basics (cont)

- Cost audit is additional to the statutory financial audit.

Cost Auditor Appointment and Reporting Basics (cont)

Appointment of Cost Auditor

Cost Auditor Appointment and Reporting Basics (cont)

- The Board of Directors appoints the cost auditor within 180 days from the commencement of every financial year.

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Cost Auditor Appointment and Reporting Basics (cont)

- The company must inform the Central Government of the appointment within 30 days of the Board meeting or 180 days from commencement of the financial year, whichever is earlier.

Cost Auditor Appointment and Reporting Basics (cont)

- Appointment intimation is filed in Form CRA-2.

Cost Auditor Appointment and Reporting Basics (cont)

- The cost auditor's remuneration is determined by the Board and ratified by shareholders subsequently, as prescribed.

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Cost Auditor Appointment and Reporting Basics (cont)

- A statutory financial auditor appointed under Section 139 cannot be appointed as the cost auditor of the same company.

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Cost Auditor Appointment and Reporting Basics (cont)

Cost Auditor's Duties

Cost Auditor Appointment and Reporting Basics (cont)

- Examine cost records maintained by the company.

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Cost Auditor Appointment and Reporting Basics (cont)

- Verify whether cost statements comply with applicable Cost Accounting Standards.

Cost Auditor Appointment and Reporting Basics (cont)

- Check correctness of cost allocation, classification and ascertainment.

Cost Auditor Appointment and Reporting Basics (cont)

- Examine material consumption, labour utilisation and overhead treatment.

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Cost Auditor Appointment and Reporting Basics (cont)

- Identify inefficiencies, abnormal losses and irregularities.

Cost Auditor Appointment and Reporting Basics (cont)

- Report observations, qualifications and discrepancies.

Cost Auditor Appointment and Reporting Basics (cont)

- Comply with applicable auditing standards and statutory reporting requirements.

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Cost Auditor Appointment and Reporting Basics (cont)

Cost Audit Report

Cost Auditor Appointment and Reporting Basics (cont)

- Cost auditor submits the report to the Board of Directors.

Cost Auditor Appointment and Reporting Basics (cont)

- Report is prepared in Form CRA-3.

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Cost Auditor Appointment and Reporting Basics (cont)

- It contains prescribed particulars regarding cost records, cost statements, observations and qualifications.

Cost Auditor Appointment and Reporting Basics (cont)

- The company must file the report with the Central Government in Form CRA-4 within 30 days of receiving the cost audit report.

Cost Auditor Appointment and Reporting Basics (cont)

- If the company receives an extension from the Central Government, the extended period applies.

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Cost Auditor Appointment and Reporting Basics (cont)

Company's Responsibilities

Cost Auditor Appointment and Reporting Basics (cont)

- Maintain prescribed cost records.

Cost Auditor Appointment and Reporting Basics (cont)

- Provide the cost auditor access to books, documents and relevant information.

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Cost Auditor Appointment and Reporting Basics (cont)

- Provide explanations and assistance required for the audit.

Cost Auditor Appointment and Reporting Basics (cont)

- Furnish the report to the Central Government within the prescribed period.

Cost Auditor Appointment and Reporting Basics (cont)

- Provide a copy of the cost audit report to members along with the Board's report, where required under Section 148(6).

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Cost Auditor Appointment and Reporting Basics (cont)

Important Forms – Quick Recall

Cost Auditor Appointment and Reporting Basics (cont)

- CRA-1: particulars of cost records.

Cost Auditor Appointment and Reporting Basics (cont)

- CRA-2: intimation of appointment of cost auditor.

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Cost Auditor Appointment and Reporting Basics (cont)

- CRA-3: cost audit report.

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Cost Auditor Appointment and Reporting Basics (cont)

- CRA-4: filing of cost audit report.

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Cost Auditor Appointment and Reporting Basics (cont)

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Cost Auditor Appointment and Reporting Basics (cont)

- Cost auditor is appointed by the Board of Directors, not directly by the Central Government.

Cost Auditor Appointment and Reporting Basics (cont)

- CRA-2 is for appointment intimation; CRA-3 is the actual audit report; CRA-4 is the company's filing.

Cost Auditor Appointment and Reporting Basics (cont)

- Cost auditor must be a Cost Accountant in Practice.

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Cost Auditor Appointment and Reporting Basics (cont)

- Cost auditor and statutory financial auditor of the same company cannot be the same person.

Cost Auditor Appointment and Reporting Basics (cont)

- Appointment timeline: 180 days from commencement of financial year.

Cost Auditor Appointment and Reporting Basics (cont)

- Filing CRA-4: 30 days from receipt of the report.

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Cost Records and Cost Statements

Meaning of Cost Records

Cost Records and Cost Statements (cont)

- Cost records are books, accounts, documents and other records maintained by a company to capture and analyse the cost of materials, labour, overheads, production, operations and services.

Cost Records and Cost Statements (cont)

- They provide detailed information for determining the cost of individual products, services, processes and activities.

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Cost Records and Cost Statements (cont)

- Under Section 148(1) of the Companies Act, 2013, specified classes of companies must maintain prescribed cost records.

Cost Records and Cost Statements (cont)

- Cost records are maintained in accordance with the principles and procedures specified in CRA-1.

Cost Records and Cost Statements (cont)

Important Cost Records

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Cost Records and Cost Statements (cont)

- Material Records: purchase, receipt, storage, issue, consumption, wastage and closing inventory.

Cost Records and Cost Statements (cont)

- Labour Records: attendance, time booking, wages, incentives, idle time and labour utilisation.

Cost Records and Cost Statements (cont)

- Overhead Records: collection, classification, allocation, apportionment and absorption of overheads.

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Cost Records and Cost Statements (cont)

- Production Records: units produced, process details, WIP, normal loss, abnormal loss and finished goods.

Cost Records and Cost Statements (cont)

- Utilities Records: consumption and cost of electricity, fuel, water and other utilities.

Cost Records and Cost Statements (cont)

- Fixed Asset Records: acquisition, utilisation, depreciation and maintenance of assets.

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Cost Records and Cost Statements (cont)

- Inventory Records: opening stock, purchases, consumption, transfers and closing stock.

Cost Records and Cost Statements (cont)

- Sales Records: quantities sold, sales realisation, product-wise revenue and distribution costs.

Cost Records and Cost Statements (cont)

- Cost Centre Records: costs incurred by individual departments, locations, processes or responsibility centres.

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Cost Records and Cost Statements (cont)

Cost Statements

Cost Records and Cost Statements (cont)

- Cost statements are structured summaries of cost information prepared to ascertain and analyse the cost of products, services or operations.

Cost Records and Cost Statements (cont)

- They present cost under appropriate heads and may be prepared for individual products, processes, departments or the organisation as a whole.

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Cost Records and Cost Statements (cont)

Important Cost Statements

Cost Records and Cost Statements (cont)

- Cost Sheet: summarises prime cost, factory cost, cost of production, cost of goods sold and cost of sales.

Cost Records and Cost Statements (cont)

- Statement of Cost of Production: determines the cost incurred in manufacturing output during a period.

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Cost Records and Cost Statements (cont)

- Statement of Cost of Sales: includes production cost and relevant selling/distribution expenses.

Cost Records and Cost Statements (cont)

- Product-wise Cost Statement: identifies cost and profitability of individual products.

Cost Records and Cost Statements (cont)

- Service Cost Statement: determines the cost per unit of services such as transport, electricity or healthcare.

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Cost Records and Cost Statements (cont)

- Reconciliation Statement: explains differences between profit as per cost accounts and financial accounts.

Cost Records and Cost Statements (cont)

Companies Act – Important Forms

Cost Records and Cost Statements (cont)

- CRA-1: particulars relating to items of cost to be included in the books of account.

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Cost Records and Cost Statements (cont)

- CRA-2: form for filing intimation of appointment of cost auditor with the Central Government.

Cost Records and Cost Statements (cont)

- CRA-3: format of the cost audit report.

Cost Records and Cost Statements (cont)

- CRA-4: form for filing the cost audit report with the Central Government.

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Cost Records and Cost Statements (cont)

Cost Accounting Standards (CAS)

Cost Records and Cost Statements (cont)

- Cost Accounting Standards prescribe uniform principles for measurement, assignment, presentation and disclosure of cost.

Cost Records and Cost Statements (cont)

- Issued by the Institute of Cost Accountants of India (ICMAI) through its Cost Accounting Standards Board.

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Cost Records and Cost Statements (cont)

- They improve consistency, comparability and reliability of cost information.

Cost Records and Cost Statements (cont)

- Examples of important standards:

Cost Records and Cost Statements (cont)

- CAS-1: Classification of Cost.

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Cost Records and Cost Statements (cont)

- CAS-2: Capacity Determination.

Cost Records and Cost Statements (cont)

- CAS-3: Production and Operation Overheads.

Cost Records and Cost Statements (cont)

- CAS-4: Cost of Production for Captive Consumption.

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Cost Records and Cost Statements (cont)

- CAS-6: Material Cost.

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Cost Records and Cost Statements (cont)

- CAS-7: Employee Cost.

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Cost Records and Cost Statements (cont)

- CAS-8: Cost of Utilities.

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Cost Records and Cost Statements (cont)

- CAS-10: Direct Expenses.

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Cost Records and Cost Statements (cont)

- CAS-11: Administrative Overheads.

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Cost Records and Cost Statements (cont)

- CAS-12: Repairs and Maintenance Cost.

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Cost Records and Cost Statements (cont)

- CAS-13: Cost of Service Cost Centre.

Cost Records and Cost Statements (cont)

- CAS-14: Pollution Control Cost.

Cost Records and Cost Statements (cont)

- CAS-16: Depreciation and Amortisation.

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Cost Records and Cost Statements (cont)

- CAS-17: Interest and Financing Charges.

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Cost Records and Cost Statements (cont)

- CAS-21: Quality Control.

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Cost Records and Cost Statements (cont)

- CAS-22: Manufacturing Cost.

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Cost Records and Cost Statements (cont)

- CAS-24: Treatment of Revenue in Cost Statements.

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Cost Records and Cost Statements (cont)

Benefits of Cost Records

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Cost Records and Cost Statements (cont)

- Enable accurate cost ascertainment.

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Cost Records and Cost Statements (cont)

- Support budgeting and variance analysis.

Cost Records and Cost Statements (cont)

- Help identify inefficiencies and wastage.

Cost Records and Cost Statements (cont)

- Improve pricing and product-mix decisions.

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Cost Records and Cost Statements (cont)

- Support cost audit and statutory compliance.

Cost Records and Cost Statements (cont)

- Facilitate comparison across products, periods and cost centres.

Cost Records and Cost Statements (cont)

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Cost Records and Cost Statements (cont)

- CRA-1 = cost record particulars; CRA-2 = appointment intimation; CRA-3 = cost audit report; CRA-4 = filing of cost audit report.

Cost Records and Cost Statements (cont)

- Cost records are detailed underlying records; cost statements are structured summaries derived from those records.

Cost Records and Cost Statements (cont)

- Cost Accounting Standards are issued by ICMAI, not SEBI or RBI.

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Cost Records and Cost Statements (cont)

- Cost records are required only for prescribed classes of companies under applicable rules, not universally.

Cost Records and Cost Statements (cont)

-Cost records and financial accounts are related but serve different analytical purposes.

Cost Audit vs Financial Audit

Meaning of Financial Audit

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Cost Audit vs Financial Audit (cont)

- Financial audit is the independent examination of a company's financial statements to express an opinion on whether they present a true and fair view of its financial position and performance.

Cost Audit vs Financial Audit (cont)

- Governed primarily by the Companies Act, 2013, and applicable auditing standards.

Cost Audit vs Financial Audit (cont)

- Statutory financial audit is covered under Section 139 and auditor duties under Section 143.

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Cost Audit vs Financial Audit (cont)

Key Differences

Cost Audit vs Financial Audit (cont)

- Primary objective

Cost Audit vs Financial Audit (cont)

- Cost audit: verify correctness and compliance of cost records and cost statements.

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Cost Audit vs Financial Audit (cont)

- Financial audit: express an opinion on whether financial statements present a true and fair view.

Cost Audit vs Financial Audit (cont)

- Main focus

Cost Audit vs Financial Audit (cont)

- Cost audit: cost of production, operations, services, materials, labour and overheads.

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Cost Audit vs Financial Audit (cont)

- Financial audit: assets, liabilities, income, expenses, profits and cash flows.

Cost Audit vs Financial Audit (cont)

- Legal provisions

Cost Audit vs Financial Audit (cont)

- Cost audit: Section 148, Companies Act, 2013.

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Cost Audit vs Financial Audit (cont)

- Financial audit: Sections 139–147, Companies Act, 2013.

Cost Audit vs Financial Audit (cont)

- Applicability

Cost Audit vs Financial Audit (cont)

- Cost audit: prescribed classes of companies satisfying applicable conditions and thresholds.

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Cost Audit vs Financial Audit (cont)

- Financial audit: every company is required to appoint a statutory auditor, subject to applicable provisions.

Cost Audit vs Financial Audit (cont)

- Auditor qualification

Cost Audit vs Financial Audit (cont)

- Cost auditor: Cost Accountant in Practice.

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Cost Audit vs Financial Audit (cont)

- Financial auditor: Chartered Accountant in Practice or eligible audit firm.

Cost Audit vs Financial Audit (cont)

- Appointment

Cost Audit vs Financial Audit (cont)

- Cost auditor: appointed by the Board of Directors, subject to prescribed requirements and remuneration approval.

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Cost Audit vs Financial Audit (cont)

- Financial auditor: appointed according to Section 139, generally by shareholders, with specified exceptions for first auditors and casual vacancies.

Cost Audit vs Financial Audit (cont)

- Reporting

Cost Audit vs Financial Audit (cont)

- Cost auditor: reports on cost records and cost statements, including observations and prescribed particulars.

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Cost Audit vs Financial Audit (cont)

- Financial auditor: gives an audit opinion on financial statements and reports under applicable statutory requirements.

Cost Audit vs Financial Audit (cont)

- Users

Cost Audit vs Financial Audit (cont)

- Cost audit: management, Central Government and other stakeholders requiring reliable cost information.

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Cost Audit vs Financial Audit (cont)

- Financial audit: shareholders, investors, lenders, regulators and other users of financial statements.

Cost Audit vs Financial Audit (cont)

- Frequency

Cost Audit vs Financial Audit (cont)

- Both are generally annual statutory audits where applicable.

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Cost Audit vs Financial Audit (cont)

Relationship Between the Two

Cost Audit vs Financial Audit (cont)

- Cost audit and financial audit complement each other.

Cost Audit vs Financial Audit (cont)

- Cost audit examines cost-related information and operational cost efficiency.

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Cost Audit vs Financial Audit (cont)

- Financial audit examines the reliability and fair presentation of financial statements.

Cost Audit vs Financial Audit (cont)

- Cost audit may identify cost inefficiencies that are not directly evident from financial statements.

Cost Audit vs Financial Audit (cont)

- Both support transparency, accountability and better corporate governance.

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Cost Audit vs Financial Audit (cont)

MCQ Traps

Cost Audit vs Financial Audit (cont)

- Section 148 = cost audit; Section 143 = powers and duties of financial auditor.

Cost Audit vs Financial Audit (cont)

- Cost auditor = Cost Accountant in Practice; statutory financial auditor = Chartered Accountant in Practice.

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Cost Audit vs Financial Audit (cont)

- Cost audit does not certify that financial statements give a true and fair view.

Cost Audit vs Financial Audit (cont)

- Financial audit does not necessarily examine product-wise cost efficiency in the detail required under cost audit.

Cost Audit vs Financial Audit (cont)

- Cost audit is additional to statutory financial audit.

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Cost Audit vs Financial Audit (cont)

- Both are independent statutory audit functions, but their objectives and reporting requirements differ.

Meaning and Objectives of Cost Audit

Meaning

Meaning and Objectives of Cost Audit (cont)

- Cost audit is the examination and verification of cost records and cost accounts to ensure their accuracy, compliance with applicable cost accounting standards and relevant legal requirements.

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Meaning and Objectives of Cost Audit (cont)

- It involves checking whether the cost of production, services, operations and other cost elements have been correctly determined and recorded.

Meaning and Objectives of Cost Audit (cont)

- Under the Companies Act, 2013, cost audit is governed primarily by Section 148 and the Companies (Cost Records and Audit) Rules, 2014.

Meaning and Objectives of Cost Audit (cont)

- Cost audit is conducted by a Cost Accountant in Practice appointed as the cost auditor.

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Meaning and Objectives of Cost Audit (cont)

Objectives of Cost Audit

Meaning and Objectives of Cost Audit (cont)

- Accuracy of Cost Records: verify correctness of material, labour, overhead and other cost data.

Meaning and Objectives of Cost Audit (cont)

- Cost Ascertainment: ensure that product/service costs are correctly determined.

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Meaning and Objectives of Cost Audit (cont)

- Cost Control: identify inefficiencies, wastage, excessive expenditure and avoidable costs.

Meaning and Objectives of Cost Audit (cont)

- Cost Reduction: identify opportunities for improving operational efficiency and reducing costs.

Meaning and Objectives of Cost Audit (cont)

- Legal Compliance: verify compliance with applicable cost accounting standards and statutory requirements.

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Meaning and Objectives of Cost Audit (cont)

- Resource Utilisation: assess efficient utilisation of materials, labour, machinery and other resources.

Meaning and Objectives of Cost Audit (cont)

- Management Information: provide reliable cost information for pricing, budgeting, profitability and managerial decisions.

Meaning and Objectives of Cost Audit (cont)

- Transparency and Accountability: improve reliability of cost information and accountability within the organisation.

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Meaning and Objectives of Cost Audit (cont)

- Detection of Errors and Irregularities: identify incorrect cost allocation, classification, recording or reporting.

Meaning and Objectives of Cost Audit (cont)

Companies Act, 2013 – Section 148

Meaning and Objectives of Cost Audit (cont)

- Central Government may direct specified classes of companies engaged in production of goods or providing services to maintain prescribed cost records.

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Meaning and Objectives of Cost Audit (cont)

- The Central Government may also require a cost audit of such companies.

Meaning and Objectives of Cost Audit (cont)

- Cost audit is conducted in addition to the statutory financial audit.

Meaning and Objectives of Cost Audit (cont)

- Cost records and cost audit requirements are prescribed under the Companies (Cost Records and Audit) Rules, 2014, as amended.

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Meaning and Objectives of Cost Audit (cont)

- Cost records are maintained in Form CRA-1.

Meaning and Objectives of Cost Audit (cont)

- Cost audit report is submitted in Form CRA-3.

Meaning and Objectives of Cost Audit (cont)

- Company files the cost audit report with the Central Government in Form CRA-4.

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Meaning and Objectives of Cost Audit (cont)

Types / Scope of Cost Audit

Meaning and Objectives of Cost Audit (cont)

- Statutory Cost Audit: conducted when required under Section 148 and applicable rules.

Meaning and Objectives of Cost Audit (cont)

- Internal Cost Audit: examination of cost records and systems by an internal function or appointed professional for management purposes.

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Meaning and Objectives of Cost Audit (cont)

- Efficiency Audit: examines whether resources are being used economically and efficiently.

Meaning and Objectives of Cost Audit (cont)

- Propriety Audit: examines whether expenditure and decisions are justified and prudent.

Meaning and Objectives of Cost Audit (cont)

- Performance Audit: evaluates economy, efficiency and effectiveness of operations.

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Meaning and Objectives of Cost Audit (cont)

Benefits

Meaning and Objectives of Cost Audit (cont)

- Improves reliability of cost information.

Meaning and Objectives of Cost Audit (cont)

- Helps management identify operational inefficiencies.

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Meaning and Objectives of Cost Audit (cont)

- Supports cost control, pricing and profit-ability analysis.

Meaning and Objectives of Cost Audit (cont)

- Promotes compliance and accountability.

Meaning and Objectives of Cost Audit (cont)

- Helps identify opportunities for productivity improvement.

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Meaning and Objectives of Cost Audit (cont)

MCQ Traps

Meaning and Objectives of Cost Audit (cont)

- Cost audit is concerned with cost records and cost accounts, not merely financial statements.

Meaning and Objectives of Cost Audit (cont)

- Section 148 of the Companies Act, 2013 deals with maintenance of cost records and cost audit.

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Meaning and Objectives of Cost Audit (cont)

- Cost audit is additional to financial audit, not a replacement.

Meaning and Objectives of Cost Audit (cont)

- Cost auditor must be a Cost Accountant in Practice.

Meaning and Objectives of Cost Audit (cont)

- CRA-1 = cost records; CRA-3 = cost audit report; CRA-4 = filing of cost audit report.

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Meaning and Objectives of Cost Audit (cont)

- Cost audit does not automatically apply to every company; applicability depends on prescribed classes and thresholds.

Cost Audit and Cost Records

Cost Reduction vs Cost Control

Meaning of Cost Control

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Cost Reduction vs Cost Control (cont)

- Cost control is the process of regulating costs by comparing actual expenditure with predetermined standards, budgets or targets and taking corrective action.

Cost Reduction vs Cost Control (cont)

- Objective: ensure costs remain within established limits without compromising required quality or efficiency.

Cost Reduction vs Cost Control (cont)

- It is primarily concerned with maintaining costs at planned levels.

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Cost Reduction vs Cost Control (cont)

Process of Cost Control

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Cost Reduction vs Cost Control (cont)

- Establish cost standards and budgets.

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Cost Reduction vs Cost Control (cont)

- Measure and record actual costs.

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Cost Reduction vs Cost Control (cont)

- Compare actual costs with standards/budgets.

Cost Reduction vs Cost Control (cont)

- Identify and analyse variances.

Cost Reduction vs Cost Control (cont)

- Investigate reasons for deviations.

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Cost Reduction vs Cost Control (cont)

- Take corrective action to prevent recurr-ence.

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Cost Reduction vs Cost Control (cont)

Techniques of Cost Control

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Cost Reduction vs Cost Control (cont)

- Budgetary control.

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Cost Reduction vs Cost Control (cont)

- Standard costing and variance analysis.

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Cost Reduction vs Cost Control (cont)

- Inventory control and EOQ.

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Cost Reduction vs Cost Control (cont)

- Responsibility accounting.

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Cost Reduction vs Cost Control (cont)

- Internal controls and performance reporting.

Cost Reduction vs Cost Control (cont)

- Management by exception: investigate significant deviations rather than every minor variation.

Cost Reduction vs Cost Control (cont)

Meaning of Cost Reduction

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Cost Reduction vs Cost Control (cont)

- Cost reduction is the real and permanent reduction in the unit cost of a product or service without impairing its quality, utility, performance or suitability.

Cost Reduction vs Cost Control (cont)

- Objective: achieve lower costs through improvements in methods, processes, design, technology and resource utilisation.

Cost Reduction vs Cost Control (cont)

- It seeks to bring costs below previously established levels.

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Cost Reduction vs Cost Control (cont)

Techniques of Cost Reduction

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Cost Reduction vs Cost Control (cont)

- Value analysis and Value Engineering.

Cost Reduction vs Cost Control (cont)

- Kaizen and continuous improvement.

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Cost Reduction vs Cost Control (cont)

- Lean production and waste elimination.

Cost Reduction vs Cost Control (cont)

- Business Process Re-engineering (BPR).

Cost Reduction vs Cost Control (cont)

- Activity-Based Costing (ABC) to identify costly activities.

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Cost Reduction vs Cost Control (cont)

- Improved procurement and supplier management.

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Cost Reduction vs Cost Control (cont)

- Automation and improved technology.

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Cost Reduction vs Cost Control (cont)

- Better capacity utilisation and productivity.

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Cost Reduction vs Cost Control (cont)

- Product and process redesign.

Cost Reduction vs Cost Control (cont)

Key Differences

Cost Reduction vs Cost Control (cont)

- Objective: Cost control keeps costs within planned limits; cost reduction lowers existing cost levels.

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Cost Reduction vs Cost Control (cont)

- Approach: Cost control is preventive and corrective; cost reduction is improvement--oriented and proactive.

Cost Reduction vs Cost Control (cont)

- Benchmark: Cost control uses predet-ermined standards/budgets; cost reduction challenges existing cost levels and seeks better alternatives.

Cost Reduction vs Cost Control (cont)

- Nature: Cost control is an ongoing process of monitoring; cost reduction seeks sustained, permanent savings.

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Cost Reduction vs Cost Control (cont)

- Scope: Cost control generally operates within existing methods and standards; cost reduction may require changes in methods, design, technology or processes.

Cost Reduction vs Cost Control (cont)

- Relationship: Cost control helps prevent unnecessary increases; cost reduction creates opportunities for further efficiency.

Cost Reduction vs Cost Control (cont)

Important Principles of Cost Reduction

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Cost Reduction vs Cost Control (cont)

- Reduction must be genuine and measurable, not merely a transfer of cost from one department to another.

Cost Reduction vs Cost Control (cont)

- Savings must be sustainable rather than temporary.

Cost Reduction vs Cost Control (cont)

- Product quality, safety, utility and customer satisfaction must not deteriorate.

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Cost Reduction vs Cost Control (cont)

- Cost reduction should involve all departments and employees.

Cost Reduction vs Cost Control (cont)

- It should consider total life-cycle cost, not merely immediate expenditure.

Cost Reduction vs Cost Control (cont)

- Avoid reducing preventive maintenance, training or quality assurance in ways that create higher future costs.

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Cost Reduction vs Cost Control (cont)

Example

Cost Reduction vs Cost Control (cont)

- Cost control: a department has a travel budget of ₹10 lakh and ensures actual expenditure stays within that limit.

Cost Reduction vs Cost Control (cont)

- Cost reduction: redesigning the travel approval and procurement process reduces the cost of comparable travel services from ₹10 lakh to ₹8 lakh without reducing service quality.

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Cost Reduction vs Cost Control (cont)

MCQ Traps

Cost Reduction vs Cost Control (cont)

- Cost control = adherence to predetermined cost standards.

Cost Reduction vs Cost Control (cont)

- Cost reduction = genuine and permanent reduction in unit cost.

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Cost Reduction vs Cost Control (cont)

- Cost reduction must not compromise quality or utility.

Cost Reduction vs Cost Control (cont)

- Cost control does not necessarily mean costs must decrease; it means costs are kept within authorised limits.

Cost Reduction vs Cost Control (cont)

- Cost reduction can operate even when costs are already within budget.

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Cost Reduction vs Cost Control (cont)

- Cost control and cost reduction are complementary, not mutually exclusive.

Lean Production and Waste Elimination

Meaning

Lean Production and Waste Elimination (cont)

- Lean production is a systematic approach to maximising customer value while minimising waste and non-value-adding activities.

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Lean Production and Waste Elimination (cont)

- Originated from the Toyota Production System (TPS) in Japan.

Lean Production and Waste Elimination (cont)

- Focuses on producing more value with fewer resources, less time, lower inventory and fewer defects.

Lean Production and Waste Elimination (cont)

- A value-adding activity transforms a product/service in a way the customer is willing to pay for; non-value-adding activities consume resources without adding customer value.

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Lean Production and Waste Elimination (cont)

Five Core Principles of Lean

Lean Production and Waste Elimination (cont)

- 1. Identify Value: determine what the customer considers valuable.

Lean Production and Waste Elimination (cont)

- 2. Map the Value Stream: identify all activities involved in delivering the product/service and distinguish value-adding from wasteful activities.

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Lean Production and Waste Elimination (cont)

- 3. Create Flow: ensure smooth movement of materials and information without interr-uptions or bottlenecks.

Lean Production and Waste Elimination (cont)

- 4. Establish Pull: produce according to actual customer demand rather than pushing output based only on forecasts.

Lean Production and Waste Elimination (cont)

- 5. Pursue Perfection: continuously eliminate waste through Kaizen.

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Lean Production and Waste Elimination (cont)

Eight Types of Waste – DOWNTIME

Lean Production and Waste Elimination (cont)

- D – Defects: errors, rework, scrap and rejected products.

Lean Production and Waste Elimination (cont)

- O – Overproduction: producing more or earlier than required.

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Lean Production and Waste Elimination (cont)

- W – Waiting: idle time due to delays, approvals, breakdowns or material shortages.

Lean Production and Waste Elimination (cont)

- N – Non-utilised Talent: failure to use employees' skills, knowledge and ideas.

Lean Production and Waste Elimination (cont)

- T – Transportation: unnecessary movement of materials or products.

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Lean Production and Waste Elimination (cont)

- I – Inventory: excess raw materials, WIP or finished goods.

Lean Production and Waste Elimination (cont)

- M – Motion: unnecessary movement of workers or equipment.

Lean Production and Waste Elimination (cont)

- E – Extra Processing: unnecessary steps, excessive inspection or work beyond customer requirements.

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Lean Production and Waste Elimination (cont)

Important Lean Tools and Techniques

Lean Production and Waste Elimination (cont)

- Value Stream Mapping (VSM): visualises material and information flows to identify waste and delays.

Lean Production and Waste Elimination (cont)

- 5S: workplace organisation through Sort, Set in Order, Shine, Standardise and Sustain.

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Lean Production and Waste Elimination (cont)

- Kaizen: continuous incremental improvement involving employees.

Lean Production and Waste Elimination (cont)

- Kanban: visual signalling system controlling production and material movement.

Lean Production and Waste Elimination (cont)

- Just-in-Time (JIT): producing and supplying materials when required.

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Lean Production and Waste Elimination (cont)

- Poka-Yoke: mistake-proofing techniques that prevent errors or make them immediately detectable.

Lean Production and Waste Elimination (cont)

- Jidoka: automation with a human touch; machines/processes detect abnormalities and stop to prevent defective output.

Lean Production and Waste Elimination (cont)

- Heijunka: production levelling to reduce fluctuations in production volume and product mix.

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Lean Production and Waste Elimination (cont)

- Andon: visual or audible signal indicating an abnormality or need for assistance.

Lean Production and Waste Elimination (cont)

- Single-Minute Exchange of Die (SMED): technique to reduce equipment setup/changeover time, traditionally targeting single-digit minutes.

Lean Production and Waste Elimination (cont)

Lean Production and Cost Management

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Lean Production and Waste Elimination (cont)

- Reduces inventory carrying and storage costs.

Lean Production and Waste Elimination (cont)

- Reduces scrap, rework and quality-related costs.

Lean Production and Waste Elimination (cont)

- Improves labour and machine utilisation.

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Lean Production and Waste Elimination (cont)

- Reduces lead time and working capital tied up in inventory.

Lean Production and Waste Elimination (cont)

- Improves throughput and customer responsiveness.

Lean Production and Waste Elimination (cont)

- Encourages prevention and elimination of waste rather than merely controlling expenditure.

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Lean Production and Waste Elimination (cont)

Lean vs Traditional Production

Lean Production and Waste Elimination (cont)

- Lean: demand-driven, smaller batches, lower inventory, continuous flow and ongoing improvement.

Lean Production and Waste Elimination (cont)

- Traditional mass production: often forecast-driven, larger batches and higher buffer inventories.

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Lean Production and Waste Elimination (cont)

- Lean does not necessarily mean producing in the smallest possible batches; batch size should support efficient flow and customer demand.

Lean Production and Waste Elimination (cont)

MCQ Traps

Lean Production and Waste Elimination (cont)

- DOWNTIME represents the eight wastes; older Lean frameworks commonly use seven wastes, excluding non-utilised talent.

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Lean Production and Waste Elimination (cont)

- Overproduction is often considered the most serious waste because it creates or conceals other wastes.

Lean Production and Waste Elimination (cont)

- Poka-Yoke = mistake-proofing; Jidoka = stop/detect abnormalities; Andon = signal system.

Lean Production and Waste Elimination (cont)

- Heijunka = production levelling; Kanban = visual pull signal.

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Lean Production and Waste Elimination (cont)

- Lean is not simply cost cutting, downsizing or reducing inventory indiscriminately. It seeks to eliminate waste while preserving customer value and quality.

Business Process Re-engineering (BPR)

Meaning

Business Process Re-engineering (BPR) (cont)

- Business Process Re-engineering (BPR) is the fundamental rethinking and radical redesign of business processes to achieve dramatic improvements in critical performance measures.

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Business Process Re-engineering (BPR) (cont)

- Performance measures include cost, quality, service and speed.

Business Process Re-engineering (BPR) (cont)

- Popularised by Michael Hammer and James Champy in the 1990s.

Business Process Re-engineering (BPR) (cont)

- Focuses on redesigning entire processes rather than making small incremental improvements.

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Business Process Re-engineering (BPR) (cont)

Core Principles

Business Process Re-engineering (BPR) (cont)

- Fundamental rethinking: question existing assumptions and procedures.

Business Process Re-engineering (BPR) (cont)

- Radical redesign: make major structural changes rather than minor adjustments.

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Business Process Re-engineering (BPR) (cont)

- Process orientation: focus on end-to-end business processes instead of isolated departments.

Business Process Re-engineering (BPR) (cont)

- Dramatic improvement: aim for substantial gains in cost, quality, speed and service.

Business Process Re-engineering (BPR) (cont)

- Technology enablement: use information technology and automation to transform processes.

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Business Process Re-engineering (BPR) (cont)

- Customer focus: redesign processes around customer requirements.

Business Process Re-engineering (BPR) (cont)

Steps in BPR

Business Process Re-engineering (BPR) (cont)

- Identify processes requiring major improvement.

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Business Process Re-engineering (BPR) (cont)

- Define objectives and performance targets.

Business Process Re-engineering (BPR) (cont)

- Map and analyse existing processes (As-Is process).

Business Process Re-engineering (BPR) (cont)

- Identify duplication, bottlenecks, delays and unnecessary activities.

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Business Process Re-engineering (BPR) (cont)

- Design the improved process (To-Be process).

Business Process Re-engineering (BPR) (cont)

- Implement redesigned processes, supported by technology and organisational changes.

Business Process Re-engineering (BPR) (cont)

- Monitor performance and refine the new process.

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Business Process Re-engineering (BPR) (cont)

Examples

Business Process Re-engineering (BPR) (cont)

- Replacing multiple manual approval stages with an integrated digital approval workflow.

Business Process Re-engineering (BPR) (cont)

- Redesigning order fulfilment so that sales, inventory, logistics and billing operate through one integrated system.

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Business Process Re-engineering (BPR) (cont)

- Replacing fragmented customer-service departments with a single end-to-end customer support process.

Business Process Re-engineering (BPR) (cont)

Benefits

Business Process Re-engineering (BPR) (cont)

- Significant reduction in operating costs and processing time.

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Business Process Re-engineering (BPR) (cont)

- Improved customer service and quality.

Business Process Re-engineering (BPR) (cont)

- Elimination of redundant activities and organisational bottlenecks.

Business Process Re-engineering (BPR) (cont)

- Better coordination across departments.

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Business Process Re-engineering (BPR) (cont)

- Improved productivity through process automation and integration.

Business Process Re-engineering (BPR) (cont)

Limitations / Risks

Business Process Re-engineering (BPR) (cont)

- High implementation costs and disruption.

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Business Process Re-engineering (BPR) (cont)

- Employee resistance due to changes in roles and responsibilities.

Business Process Re-engineering (BPR) (cont)

- Risk of failure due to poor planning or inadequate leadership.

Business Process Re-engineering (BPR) (cont)

- Excessive focus on automation without fixing underlying process problems.

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Business Process Re-engineering (BPR) (cont)

- May involve workforce restructuring and retraining.

Business Process Re-engineering (BPR) (cont)

BPR vs Continuous Improvement

Business Process Re-engineering (BPR) (cont)

- BPR involves radical, fundamental redesign and dramatic improvement.

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Business Process Re-engineering (BPR) (cont)

- Kaizen/continuous improvement involves small, incremental and ongoing improvements.

Business Process Re-engineering (BPR) (cont)

- BPR may transform the entire process; Kaizen generally improves existing processes progressively.

Business Process Re-engineering (BPR) (cont)

MCQ Traps

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Business Process Re-engineering (BPR) (cont)

- BPR is associated with Michael Hammer and James Champy.

Business Process Re-engineering (BPR) (cont)

- Key phrase: fundamental rethinking and radical redesign.

Business Process Re-engineering (BPR) (cont)

- BPR is not merely automation or comput-erisation of existing procedures.

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Business Process Re-engineering (BPR) (cont)

- Focus is on end-to-end processes, not individual departmental functions.

Business Process Re-engineering (BPR) (cont)

- Unlike Kaizen, BPR is not primarily incremental improvement.

Six Sigma

Meaning

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Six Sigma (cont)

- Six Sigma is a data-driven quality and process-improvement methodology aimed at reducing defects, process variation and errors.

Six Sigma (cont)

- Objective: improve process capability, customer satisfaction and operational efficiency.

Six Sigma (cont)

- Originally developed at Motorola in 1986; popularised by General Electric (GE) under Jack Welch.

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Six Sigma (cont)

- The term Sigma (σ) represents standard deviation, a measure of process variation.

Six Sigma (cont)

Six Sigma Quality Level

Six Sigma (cont)

- A process operating at Six Sigma quality is conventionally associated with 3.4 defects per million opportunities (DPMO), using the standard 1.5-sigma shift convention.

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Six Sigma (cont)

- DPMO = (Number of Defects ÷ (Number of Units × Defect Opportunities per Unit)) × 10^6.

Six Sigma (cont)

- A defect is a failure to meet a requirement; one unit can contain multiple defects.

Six Sigma (cont)

- Higher sigma levels indicate lower process variation and fewer defects.

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Six Sigma (cont)

DMAIC Methodology

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Six Sigma (cont)

Used to improve an existing process.

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Six Sigma (cont)

- D – Define

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Six Sigma (cont)

- Define the problem, customer requirements, project scope and objectives.

Six Sigma (cont)

- Identify Critical-to-Quality (CTQ) characteristics.

Six Sigma (cont)

- M – Measure

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Six Sigma (cont)

- Collect process data and establish baseline performance.

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Six Sigma (cont)

- Identify relevant metrics and defect rates.

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Six Sigma (cont)

- A – Analyse

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Six Sigma (cont)

- Identify root causes of defects and process variation.

Six Sigma (cont)

- Use tools such as Pareto charts, fishbone diagrams and statistical analysis.

Six Sigma (cont)

- I – Improve

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Six Sigma (cont)

- Develop, test and implement solutions to eliminate root causes.

Six Sigma (cont)

- Use process redesign and experimentation.

Six Sigma (cont)

- C – Control

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Six Sigma (cont)

- Monitor improvements and sustain results.

Six Sigma (cont)

- Use control charts, standard procedures and ongoing performance monitoring.

Six Sigma (cont)

DMADV Methodology

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Six Sigma (cont)

- Used to design a new process/product or fundamentally redesign an existing one.

Six Sigma (cont)

- D – Define: identify customer needs and project goals.

Six Sigma (cont)

- M – Measure: identify and quantify customer requirements.

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Six Sigma (cont)

- A – Analyse: evaluate design alternatives.

Six Sigma (cont)

- D – Design: develop the selected design.

Six Sigma (cont)

- V – Verify: test and validate that the design meets requirements.

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Six Sigma (cont)

Important Tools

Six Sigma (cont)

- Pareto Chart: identifies the most significant causes of defects; based on the 80/20 principle.

Six Sigma (cont)

- Fishbone Diagram (Ishikawa/Cause-and-Effect Diagram): identifies possible root causes.

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Six Sigma (cont)

- Control Charts: monitor process variation over time and distinguish common-cause from special-cause variation.

Six Sigma (cont)

- Histogram: shows frequency distribution of data.

Six Sigma (cont)

- Scatter Diagram: examines relationships between two variables.

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Six Sigma (cont)

- Process Mapping: visual representation of process steps and bottlenecks.

Six Sigma (cont)

- Failure Mode and Effects Analysis (FMEA): identifies potential failures, their effects and priorities for corrective action.

Six Sigma (cont)

Six Sigma Roles

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Six Sigma (cont)

- Champion: provides leadership support and removes organisational barriers.

Six Sigma (cont)

- Master Black Belt: senior expert who guides methodology and trains others.

Six Sigma (cont)

- Black Belt: leads major Six Sigma improvement projects.

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Six Sigma (cont)

- Green Belt: supports or leads smaller projects, often alongside regular duties.

Six Sigma (cont)

- Yellow Belt: understands basic Six Sigma concepts and supports projects.

Six Sigma (cont)

Lean Six Sigma

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Six Sigma (cont)

- Combines Lean's focus on eliminating waste and improving flow with Six Sigma's focus on reducing defects and variation.

Six Sigma (cont)

- Lean improves speed and efficiency; Six Sigma improves consistency and quality.

Six Sigma (cont)

Benefits

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Six Sigma (cont)

- Reduces defects, rework and operational costs.

Six Sigma (cont)

- Improves process consistency and customer satisfaction.

Six Sigma (cont)

- Supports data-driven decision-making.

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Six Sigma (cont)

- Improves productivity and process capability.

Six Sigma (cont)

MCQ Traps

Six Sigma (cont)

- DMAIC → existing processes; DMADV → new or fundamentally redesigned processes.

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Six Sigma (cont)

- Six Sigma is both a statistical concept and a structured improvement methodology.

Six Sigma (cont)

- 3.4 DPMO is associated with the conventional 1.5-sigma shift assumption.

Six Sigma (cont)

- Pareto identifies major contributors; fishbone explores possible causes; control charts monitor process stability.

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Six Sigma (cont)

- Six Sigma focuses on variation and defects; Lean focuses on waste and flow.

Total Productive Maintenance (TPM)

Meaning

Total Productive Maintenance (TPM) (cont)

- Total Productive Maintenance (TPM) is a comprehensive approach to maintaining equipment and machinery through the participation of employees across the organisation.

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Total Productive Maintenance (TPM) (cont)

- Objective: maximise equipment effectiveness by preventing breakdowns, defects and accidents.

Total Productive Maintenance (TPM) (cont)

- Originated in Japan and strongly associated with the Japan Institute of Plant Maintenance (JIPM).

Total Productive Maintenance (TPM) (cont)

Key Objectives

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Total Productive Maintenance (TPM) (cont)

- Zero breakdowns.

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Total Productive Maintenance (TPM) (cont)

- Zero equipment-related defects.

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Total Productive Maintenance (TPM) (cont)

- Zero accidents.

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Total Productive Maintenance (TPM) (cont)

- Maximise Overall Equipment Effectiveness (OEE).

Total Productive Maintenance (TPM) (cont)

- Shift maintenance from reactive repairs to proactive and preventive practices.

Total Productive Maintenance (TPM) (cont)

Eight Pillars of TPM

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Total Productive Maintenance (TPM) (cont)

- 1. Autonomous Maintenance

Total Productive Maintenance (TPM) (cont)

- Operators undertake routine cleaning, inspection, lubrication and basic maintenance.

Total Productive Maintenance (TPM) (cont)

- Encourages ownership of equipment.

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Total Productive Maintenance (TPM) (cont)

- 2. Focused Improvement (Kaizen)

Total Productive Maintenance (TPM) (cont)

- Cross-functional teams eliminate recurring losses and improve equipment performance.

Total Productive Maintenance (TPM) (cont)

- 3. Planned Maintenance

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Total Productive Maintenance (TPM) (cont)

- Scheduled preventive and predictive maintenance to reduce unexpected breakd-owns.

Total Productive Maintenance (TPM) (cont)

- 4. Quality Maintenance

Total Productive Maintenance (TPM) (cont)

- Maintain equipment conditions that prevent defects and ensure consistent product quality.

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Total Productive Maintenance (TPM) (cont)

- 5. Education and Training

Total Productive Maintenance (TPM) (cont)

- Develop operator and maintenance-worker skills to operate and maintain equipment effectively.

Total Productive Maintenance (TPM) (cont)

- 6. Early Equipment Management

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Total Productive Maintenance (TPM) (cont)

- Incorporate maintainability, reliability and ease of operation into the design and acquisition of new equipment.

Total Productive Maintenance (TPM) (cont)

- 7. Safety, Health and Environment

Total Productive Maintenance (TPM) (cont)

- Create a safe workplace and prevent accidents and environmental harm.

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Total Productive Maintenance (TPM) (cont)

- 8. Office TPM

Total Productive Maintenance (TPM) (cont)

- Apply TPM principles to administrative functions to improve efficiency and eliminate office-related losses.

Total Productive Maintenance (TPM) (cont)

Overall Equipment Effectiveness (OEE)

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Total Productive Maintenance (TPM) (cont)

- OEE measures how effectively equipment is utilised.

Total Productive Maintenance (TPM) (cont)

- OEE = Availability × Performance Efficiency × Quality Rate

Total Productive Maintenance (TPM) (cont)

- Availability = Operating Time ÷ Planned Production Time.

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Total Productive Maintenance (TPM) (cont)

- Performance Efficiency = (Ideal Cycle Time × Total Output) ÷ Operating Time.

Total Productive Maintenance (TPM) (cont)

- Quality Rate = Good Output ÷ Total Output.

Total Productive Maintenance (TPM) (cont)

- Express all three components as decimals when calculating OEE; multiply by 100 to express the final result as a percentage.

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Total Productive Maintenance (TPM) (cont)

- OEE losses are commonly grouped into:

Total Productive Maintenance (TPM) (cont)

- Availability losses: equipment breakdowns and setup/adjustment.

Total Productive Maintenance (TPM) (cont)

- Performance losses: minor stoppages and reduced operating speed.

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Total Productive Maintenance (TPM) (cont)

- Quality losses: production defects and startup/rework losses.

Total Productive Maintenance (TPM) (cont)

Types of Maintenance

Total Productive Maintenance (TPM) (cont)

- Breakdown maintenance: repair after equipment failure.

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Total Productive Maintenance (TPM) (cont)

- Preventive maintenance: scheduled maintenance to prevent failure.

Total Productive Maintenance (TPM) (cont)

- Predictive maintenance: uses condition-monitoring data to predict potential failures.

Total Productive Maintenance (TPM) (cont)

- Corrective maintenance: modifies equipment or processes to eliminate recurring problems and improve reliability.

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Total Productive Maintenance (TPM) (cont)

Benefits

Total Productive Maintenance (TPM) (cont)

- Reduces machine downtime and repair costs.

Total Productive Maintenance (TPM) (cont)

- Improves equipment life, productivity and quality.

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Total Productive Maintenance (TPM) (cont)

- Reduces production interruptions and wastage.

Total Productive Maintenance (TPM) (cont)

- Increases employee involvement and workplace safety.

Total Productive Maintenance (TPM) (cont)

MCQ Traps

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Total Productive Maintenance (TPM) (cont)

- TPM involves the entire workforce, not only the maintenance department.

Total Productive Maintenance (TPM) (cont)

- Autonomous maintenance is primarily performed by equipment operators.

Total Productive Maintenance (TPM) (cont)

- OEE has three components: Availability, Performance and Quality.

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Total Productive Maintenance (TPM) (cont)

- Predictive maintenance is condition-based; preventive maintenance is generally schedule-based.

Total Productive Maintenance (TPM) (cont)

- TPM aims at maximising equipment effectiveness, not simply minimising maintenance expenditure.

5S

Meaning

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5S (cont)

- 5S is a Japanese workplace organisation and housekeeping methodology aimed at creating a clean, orderly, safe and efficient work environment.

5S (cont)

- It improves productivity, reduces waste, prevents errors and supports continuous improvement.

5S (cont)

- Commonly associated with Lean Manufacturing and the Toyota Production System.

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5S (cont)

The Five S's

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5S (cont)

- 1. Seiri – Sort

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5S (cont)

- Separate necessary items from unnecessary items.

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5S (cont)

- Remove obsolete tools, materials, documents and equipment.

5S (cont)

- Objective: eliminate clutter and free up workspace.

5S (cont)

- 2. Seiton – Set in Order

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5S (cont)

- Arrange necessary items so they are easy to locate, access and return.

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5S (cont)

- Use labels, markings, designated storage locations and visual controls.

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5S (cont)

- Principle: A place for everything and everything in its place.

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5S (cont)

- 3. Seiso – Shine

5S (cont)

- Clean the workplace, machines and equipment regularly.

5S (cont)

- Cleaning also helps identify leaks, defects, wear and abnormal conditions.

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5S (cont)

- Objective: cleanliness and early detection of problems.

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5S (cont)

- 4. Seiketsu – Standardise

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5S (cont)

- Establish standard procedures to maintain the first three S's.

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5S (cont)

- Use checklists, schedules, labels, visual standards and standard operating procedures (SOPs).

5S (cont)

- 5. Shitsuke – Sustain

5S (cont)

- Develop discipline and habits to maintain 5S continuously.

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5S (cont)

- Conduct regular audits, training and monitoring.

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5S (cont)

- Make 5S part of organisational culture.

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5S (cont)

Benefits

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5S (cont)

- Reduces time spent searching for tools and materials.

5S (cont)

- Improves workplace safety and housek-eeping.

5S (cont)

- Reduces unnecessary movement, delays and defects.

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5S (cont)

- Improves space utilisation and productivity.

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5S (cont)

- Supports standardisation and continuous improvement.

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5S (cont)

MCQ Traps

5S (cont)

- 5S originated in Japan.

5S (cont)

- Seiri = Sort; Seiton = Set in Order; Seiso = Shine; Seiketsu = Standardise; Shitsuke = Sustain.

5S (cont)

- Standardisation is the fourth S; Sustain is the fifth.

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5S (cont)

- 5S is not merely cleaning; it is a systematic workplace-management methodology.

Just-in-Time (JIT)

Meaning

Just-in-Time (JIT) (cont)

- Just-in-Time (JIT) is an inventory and production system in which materials are purchased and products are manufactured only when required, in the required quantity and at the required time.

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Just-in-Time (JIT) (cont)

- Objective: minimise inventory, eliminate waste, reduce lead time and improve operational efficiency.

Just-in-Time (JIT) (cont)

- Associated with the Toyota Production System (TPS).

Just-in-Time (JIT) (cont)

Key Principles

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Just-in-Time (JIT) (cont)

- Pull system: production is driven by actual customer demand rather than forecasts alone.

Just-in-Time (JIT) (cont)

- Produce only what is needed, when needed, in the quantity needed.

Just-in-Time (JIT) (cont)

- Maintain continuous workflow and small batch sizes.

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Just-in-Time (JIT) (cont)

- Build quality into the process; detect defects early.

Just-in-Time (JIT) (cont)

- Develop reliable supplier relationships and frequent deliveries.

Just-in-Time (JIT) (cont)

- Continuous improvement (Kaizen).

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Just-in-Time (JIT) (cont)

Push vs Pull System

Just-in-Time (JIT) (cont)

- Push system: production based on forecasts; goods are pushed through the production process.

Just-in-Time (JIT) (cont)

- Pull system: production triggered by actual demand or downstream consumption.

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Just-in-Time (JIT) (cont)

- JIT is primarily a pull-based system.

Just-in-Time (JIT) (cont)

- Kanban is a visual signalling mechanism used to authorise production or movement of materials.

Just-in-Time (JIT) (cont)

JIT and Inventory

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Just-in-Time (JIT) (cont)

- Reduces raw material, work-in-progress (WIP) and finished goods inventory.

Just-in-Time (JIT) (cont)

- Reduces storage, insurance, handling, obsolescence and carrying costs.

Just-in-Time (JIT) (cont)

- Shortens production cycle and inventory holding period.

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Just-in-Time (JIT) (cont)

- Can improve inventory turnover and release working capital.

Just-in-Time (JIT) (cont)

- Requires accurate demand information, reliable suppliers and consistent quality.

Just-in-Time (JIT) (cont)

Advantages

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Just-in-Time (JIT) (cont)

- Lower inventory and carrying costs.

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Just-in-Time (JIT) (cont)

- Reduced waste and storage requirements.

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Just-in-Time (JIT) (cont)

- Faster production and shorter lead times.

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Just-in-Time (JIT) (cont)

- Early identification of defects and process problems.

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Just-in-Time (JIT) (cont)

- Better utilisation of working capital.

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Just-in-Time (JIT) (cont)

Limitations / Risks

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Just-in-Time (JIT) (cont)

- Supply disruptions can stop production because buffer inventory is low.

Just-in-Time (JIT) (cont)

- Highly dependent on supplier reliability, transport and coordination.

Just-in-Time (JIT) (cont)

- Sudden demand fluctuations can disrupt production.

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Just-in-Time (JIT) (cont)

- Requires disciplined scheduling, quality control and workforce involvement.

Just-in-Time (JIT) (cont)

- Not equally suitable for every industry or uncertain supply environment.

Just-in-Time (JIT) (cont)

JIT and Cost Accounting

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Just-in-Time (JIT) (cont)

- Lower inventory reduces carrying costs and inventory-related waste.

Just-in-Time (JIT) (cont)

- Small lot sizes may increase ordering frequency and procurement costs.

Just-in-Time (JIT) (cont)

- Reduced WIP simplifies production tracking and may support backflush costing.

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Just-in-Time (JIT) (cont)

- JIT can reduce total cost even if individual purchase prices are not lower.

Just-in-Time (JIT) (cont)

MCQ Traps

Just-in-Time (JIT) (cont)

- JIT does not mean zero inventory under all circumstances; strategic safety stock may still be necessary.

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Just-in-Time (JIT) (cont)

- JIT is a production and inventory philosophy, not merely a purchasing technique.

Just-in-Time (JIT) (cont)

- Kanban is a signalling/control tool, not the same thing as JIT.

Just-in-Time (JIT) (cont)

- JIT focuses on eliminating waste and improving flow, not simply reducing workforce or inventory indiscriminately.

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Costing Cheat Sheet

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Numerical and Applied Coverage

Cost-Sheet Preparation

Objective

Cost-Sheet Preparation (cont)

- Prepare a cost sheet to calculate total cost, cost per unit and selling price.

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Cost-Sheet Preparation (cont)

- Follow the correct sequence of cost elements and adjustments for opening/closing inventory and work-in-progress.

Cost-Sheet Preparation (cont)

Standard Format

Cost-Sheet Preparation (cont)

1. Prime Cost

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Cost-Sheet Preparation (cont)

- Direct Material Consumed

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Cost-Sheet Preparation (cont)

- - Direct Labour

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Cost-Sheet Preparation (cont)

- - Direct Expenses

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Cost-Sheet Preparation (cont)

- = Prime Cost

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Cost-Sheet Preparation (cont)

2. Factory / Works Cost

Cost-Sheet Preparation (cont)

- Prime Cost

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Cost-Sheet Preparation (cont)

- - Factory / Production Overheads

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Cost-Sheet Preparation (cont)

- - Opening Work-in-Progress (WIP)

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Cost-Sheet Preparation (cont)

- − Closing WIP

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Cost-Sheet Preparation (cont)

- = Factory Cost

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Cost-Sheet Preparation (cont)

3. Cost of Production

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Cost-Sheet Preparation (cont)

- Factory Cost

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Cost-Sheet Preparation (cont)

- - Production Administration Overheads

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Cost-Sheet Preparation (cont)

- = Cost of Production

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Cost-Sheet Preparation (cont)

4. Cost of Goods Sold (COGS)

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Cost-Sheet Preparation (cont)

- Cost of Production

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Cost-Sheet Preparation (cont)

- - Opening Finished Goods

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Cost-Sheet Preparation (cont)

- − Closing Finished Goods

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Cost-Sheet Preparation (cont)

- = Cost of Goods Sold

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Cost-Sheet Preparation (cont)

5. Cost of Sales

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Cost-Sheet Preparation (cont)

- Cost of Goods Sold

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Cost-Sheet Preparation (cont)

- - Selling and Distribution Overheads

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Cost-Sheet Preparation (cont)

- - Other relevant non-production overheads

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Cost-Sheet Preparation (cont)

- = Cost of Sales

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Cost-Sheet Preparation (cont)

6. Profit and Sales

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Cost-Sheet Preparation (cont)

- Sales − Cost of Sales = Profit.

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Cost-Sheet Preparation (cont)

- Sales = Cost of Sales + Profit.

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Cost-Sheet Preparation (cont)

- Profit % on Cost = Profit ÷ Cost × 100.

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Cost-Sheet Preparation (cont)

- Profit % on Sales = Profit ÷ Sales × 100.

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Cost-Sheet Preparation (cont)

Important Supporting Formulas

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Cost-Sheet Preparation (cont)

- Direct Material Consumed = Opening Raw Material + Purchases + Carriage Inward − Purchase Returns − Closing Raw Material.

Cost-Sheet Preparation (cont)

- Prime Cost = Direct Material Consumed + Direct Labour + Direct Expenses.

Cost-Sheet Preparation (cont)

- Factory Cost = Prime Cost + Factory OH + Opening WIP − Closing WIP.

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Cost-Sheet Preparation (cont)

- Cost of Production = Factory Cost + Production Administration OH.

Cost-Sheet Preparation (cont)

- COGS = Cost of Production + Opening Finished Goods − Closing Finished Goods.

Cost-Sheet Preparation (cont)

- Cost of Sales = COGS + Selling and Distribution OH.

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Cost-Sheet Preparation (cont)

Illustration

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Cost-Sheet Preparation (cont)

Given:

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Cost-Sheet Preparation (cont)

- Direct material consumed = ₹2,00,000.

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Cost-Sheet Preparation (cont)

- Direct labour = ₹80,000.

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Cost-Sheet Preparation (cont)

- Direct expenses = ₹20,000.

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Cost-Sheet Preparation (cont)

- Factory OH = ₹50,000.

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Cost-Sheet Preparation (cont)

- Opening WIP = ₹10,000; closing WIP = ₹5,000.

Cost-Sheet Preparation (cont)

- Production administration OH = ₹15,000.

Cost-Sheet Preparation (cont)

- Opening finished goods = ₹20,000; closing finished goods = ₹10,000.

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Cost-Sheet Preparation (cont)

- Selling and distribution OH = ₹25,000.

Cost-Sheet Preparation (cont)

Calculation:

Cost-Sheet Preparation (cont)

- Prime Cost = 2,00,000 + 80,000 + 20,000 = ₹3,00,000.

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Cost-Sheet Preparation (cont)

- Factory Cost = 3,00,000 + 50,000 + 10,000 − 5,000 = ₹3,55,000.

Cost-Sheet Preparation (cont)

- Cost of Production = 3,55,000 + 15,000 = ₹3,70,000.

Cost-Sheet Preparation (cont)

- COGS = 3,70,000 + 20,000 − 10,000 = ₹3,80,000.

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Cost-Sheet Preparation (cont)

- Cost of Sales = 3,80,000 + 25,000 = ₹4,05,000.

Cost-Sheet Preparation (cont)

If sales = ₹4,50,000:

Cost-Sheet Preparation (cont)

- Profit = 4,50,000 − 4,05,000 = ₹45,000.

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Cost-Sheet Preparation (cont)

- Profit on Cost = 45,000 ÷ 4,05,000 × 100 = 11.11%.

Cost-Sheet Preparation (cont)

- Profit on Sales = 45,000 ÷ 4,50,000 × 100 = 10%.

Cost-Sheet Preparation (cont)

Important Adjustments and Traps

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Cost-Sheet Preparation (cont)

- Carriage inward = direct material procurement cost; carriage outward = distribution overhead.

Cost-Sheet Preparation (cont)

- Opening stock is added; closing stock is deducted.

Cost-Sheet Preparation (cont)

- Opening WIP is added and closing WIP deducted while calculating factory cost.

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Cost-Sheet Preparation (cont)

- Opening finished goods are added and closing finished goods deducted while calculating COGS.

Cost-Sheet Preparation (cont)

- Factory rent, power and factory supervision = factory overhead.

Cost-Sheet Preparation (cont)

- Office salaries = administration overhead.

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Cost-Sheet Preparation (cont)

- Advertising and sales commission = selling overhead.

Cost-Sheet Preparation (cont)

- Finished goods delivery expenses = distribution overhead.

Cost-Sheet Preparation (cont)

- Abnormal losses should be treated separately, not automatically loaded into normal production cost.

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Cost-Sheet Preparation (cont)

- If production administration overhead is already included in factory overhead, do not add it again.

Cost-Sheet Preparation (cont)

- Cost per unit = Total Cost ÷ Relevant Units.

Cost-Sheet Preparation (cont)

- Use units produced for cost of production per unit; use units sold for cost of sales per unit, subject to the question's inventory and costing basis.

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EOQ and Inventory Levels

A. Economic Order Quantity (EOQ)

EOQ and Inventory Levels (cont)

Meaning

EOQ and Inventory Levels (cont)

- EOQ is the optimal order quantity that minimises the total of annual ordering costs and annual inventory carrying costs.

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EOQ and Inventory Levels (cont)

- At EOQ, annual ordering cost = annual carrying cost, assuming the basic EOQ model.

EOQ and Inventory Levels (cont)

Formula

EOQ and Inventory Levels (cont)

EOQ=sqrt{2DS / H}

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EOQ and Inventory Levels (cont)

- D = Annual demand in units.

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EOQ and Inventory Levels (cont)

- S = Ordering cost per order.

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EOQ and Inventory Levels (cont)

- H = Annual holding/carrying cost per unit.

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EOQ and Inventory Levels (cont)

Supporting Formulas

EOQ and Inventory Levels (cont)

- Number of orders = Annual Demand ÷ EOQ.

EOQ and Inventory Levels (cont)

- Average inventory = EOQ ÷ 2 (without safety stock).

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EOQ and Inventory Levels (cont)

- Annual ordering cost = (D ÷ Q) × S.

EOQ and Inventory Levels (cont)

- Annual carrying cost = (Q ÷ 2) × H.

EOQ and Inventory Levels (cont)

- Total relevant inventory cost = Ordering Cost + Carrying Cost.

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EOQ and Inventory Levels (cont)

- Time between orders = Working days/year ÷ Number of orders.

EOQ and Inventory Levels (cont)

Illustration

EOQ and Inventory Levels (cont)

- Annual demand = 10,000 units.

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EOQ and Inventory Levels (cont)

- Ordering cost = ₹200/order.

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EOQ and Inventory Levels (cont)

- Holding cost = ₹10/unit/year.

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EOQ and Inventory Levels (cont)

EOQ=sqrt{2(10,000)(200) / 10}=632.46

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EOQ and Inventory Levels (cont)

- Approximate order quantity = 632 units.

EOQ and Inventory Levels (cont)

- Number of orders ≈ 10,000 ÷ 632.46 = 15.81 orders.

EOQ and Inventory Levels (cont)

- At EOQ, annual ordering and holding costs are approximately equal.

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EOQ and Inventory Levels (cont)

EOQ Assumptions

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EOQ and Inventory Levels (cont)

- Demand is known and constant.

EOQ and Inventory Levels (cont)

- Ordering cost per order is constant.

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EOQ and Inventory Levels (cont)

- Holding cost per unit is constant.

EOQ and Inventory Levels (cont)

- Lead time is known and constant.

EOQ and Inventory Levels (cont)

- Replenishment is instantaneous in the basic model.

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EOQ and Inventory Levels (cont)

- No stockouts are permitted.

EOQ and Inventory Levels (cont)

- Quantity discounts are excluded in the basic model.

EOQ and Inventory Levels (cont)

B. Inventory Levels

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EOQ and Inventory Levels (cont)

1. Reorder Level

EOQ and Inventory Levels (cont)

- Stock level at which a fresh purchase order should be placed.

EOQ and Inventory Levels (cont)

- Traditional formula:

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EOQ and Inventory Levels (cont)

Reorder Level = Maximum Consumption × Maximum Reorder Period.

EOQ and Inventory Levels (cont)

- Alternative formulation:

EOQ and Inventory Levels (cont)

Reorder Point = Expected Demand During Lead Time + Safety Stock.

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EOQ and Inventory Levels (cont)

2. Minimum Stock Level

EOQ and Inventory Levels (cont)

- Lowest desirable stock level under normal operating conditions.

EOQ and Inventory Levels (cont)

Minimum Level = Reorder Level − (Normal Consumption × Normal Reorder Period).

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EOQ and Inventory Levels (cont)

3. Maximum Stock Level

EOQ and Inventory Levels (cont)

- Highest desirable stock level to avoid excessive inventory.

EOQ and Inventory Levels (cont)

Maximum Level = Reorder Level + Reorder Quantity − (Minimum Consumption × Minimum Reorder Period).

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EOQ and Inventory Levels (cont)

4. Danger Level

EOQ and Inventory Levels (cont)

- Stock level below the minimum level that indicates an emergency.

EOQ and Inventory Levels (cont)

- Danger Level = Average Consumption × Emergency Lead Time.

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EOQ and Inventory Levels (cont)

- Emergency purchases may be required.

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EOQ and Inventory Levels (cont)

5. Average Stock Level

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EOQ and Inventory Levels (cont)

- Traditional formula:

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EOQ and Inventory Levels (cont)

Average Stock Level = Minimum Level + (Reorder Quantity ÷ 2).

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EOQ and Inventory Levels (cont)

- Alternative formula:

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EOQ and Inventory Levels (cont)

Average Stock Level = (Minimum Level + Maximum Level) ÷ 2.

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EOQ and Inventory Levels (cont)

- Use the formula specified by the question or textbook convention.

EOQ and Inventory Levels (cont)

C. Safety Stock

EOQ and Inventory Levels (cont)

- Extra inventory maintained to protect against uncertainty in demand, lead time or supply.

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EOQ and Inventory Levels (cont)

- Safety Stock = Reorder Point − Expected Demand During Lead Time.

EOQ and Inventory Levels (cont)

- Traditional simplified formula:

EOQ and Inventory Levels (cont)

Safety Stock = (Maximum Usage × Maximum Lead Time) − (Average Usage × Average Lead Time).

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EOQ and Inventory Levels (cont)

D. Numerical Illustration – Inventory Levels

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EOQ and Inventory Levels (cont)

Given:

EOQ and Inventory Levels (cont)

- Maximum consumption = 100 units/week.

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EOQ and Inventory Levels (cont)

- Normal consumption = 80 units/week.

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EOQ and Inventory Levels (cont)

- Minimum consumption = 60 units/week.

EOQ and Inventory Levels (cont)

- Maximum lead time = 6 weeks.

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EOQ and Inventory Levels (cont)

- Normal lead time = 4 weeks.

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EOQ and Inventory Levels (cont)

- Minimum lead time = 2 weeks.

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EOQ and Inventory Levels (cont)

- Reorder quantity = 1,000 units.

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EOQ and Inventory Levels (cont)

- Emergency lead time = 1 week.

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EOQ and Inventory Levels (cont)

Calculations:

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EOQ and Inventory Levels (cont)

- Reorder Level = 100 × 6 = 600 units.

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EOQ and Inventory Levels (cont)

- Minimum Level = 600 − (80 × 4) = 280 units.

EOQ and Inventory Levels (cont)

- Maximum Level = 600 + 1,000 − (60 × 2) = 1,480 units.

EOQ and Inventory Levels (cont)

- Danger Level = 80 × 1 = 80 units.

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EOQ and Inventory Levels (cont)

- Average Stock Level = 280 + (1,000 ÷ 2) = 780 units.

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EOQ and Inventory Levels (cont)

E. Inventory Control – Important Concepts

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EOQ and Inventory Levels (cont)

- Perpetual Inventory System: continuous recording of receipts, issues and balances.

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EOQ and Inventory Levels (cont)

- Continuous Stock Verification: physical verification throughout the year.

EOQ and Inventory Levels (cont)

- Two-Bin System: first bin supplies normal consumption; second bin provides reserve during replenishment.

EOQ and Inventory Levels (cont)

- ABC Analysis: classification based on annual consumption value.

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EOQ and Inventory Levels (cont)

- VED Analysis: classification based on criticality.

EOQ and Inventory Levels (cont)

- FSN Analysis: classification based on movement.

EOQ and Inventory Levels (cont)

- HML Analysis: classification based on unit price.

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EOQ and Inventory Levels (cont)

- XYZ Analysis: classification based on inventory value at a particular point in time.

EOQ and Inventory Levels (cont)

MCQ Traps

EOQ and Inventory Levels (cont)

- EOQ minimises ordering + carrying costs, not necessarily total purchase cost.

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EOQ and Inventory Levels (cont)

- At EOQ, annual ordering cost equals annual holding cost under basic assumptions.

EOQ and Inventory Levels (cont)

- Safety stock is additional buffer inventory, not the same as EOQ.

EOQ and Inventory Levels (cont)

- Reorder level determines when to order; reorder quantity determines how much to order.

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EOQ and Inventory Levels (cont)

- ABC = annual consumption value; VED = criticality; HML = unit price; FSN = movement; XYZ = closing stock value.

EOQ and Inventory Levels (cont)

- Higher ordering cost generally increases EOQ; higher holding cost generally decreases EOQ.

EOQ and Inventory Levels (cont)

- If safety stock is maintained, average inventory is generally EOQ/2 + safety stock under the basic constant-demand model.

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Labour Remuneration

A. Time Rate System

Labour Remuneration (cont)

- Wages are paid according to time worked, irrespective of output.

Labour Remuneration (cont)

- Suitable where quality is more important than quantity or output cannot be measured accurately.

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Labour Remuneration (cont)

Formula

Labour Remuneration (cont)

Wages = Actual Hours Worked × Hourly Wage Rate.

Labour Remuneration (cont)

Example:

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Labour Remuneration (cont)

- Hours worked = 8.

Labour Remuneration (cont)

- Hourly rate = ₹150.

Labour Remuneration (cont)

- Wages = 8 × 150 = ₹1,200.

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Labour Remuneration (cont)

B. Piece Rate System

Labour Remuneration (cont)

- Wages are paid according to units produced.

Labour Remuneration (cont)

- Suitable for measurable, standardised work where output is directly attributable to employees.

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Labour Remuneration (cont)

Formula

Labour Remuneration (cont)

Wages = Units Produced × Rate per Unit.

Labour Remuneration (cont)

Example:

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Labour Remuneration (cont)

- Units produced = 100.

Labour Remuneration (cont)

- Rate per unit = ₹12.

Labour Remuneration (cont)

- Wages = 100 × 12 = ₹1,200.

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Labour Remuneration (cont)

C. Differential Piece Rate Systems

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Labour Remuneration (cont)

1. Taylor Differential Piece Rate

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Labour Remuneration (cont)

- Two different piece rates are fixed:

Labour Remuneration (cont)

- Lower rate for output below standard.

Labour Remuneration (cont)

- Higher rate for output at or above standard.

Labour Remuneration (cont)

- Designed to reward efficient workers and penalise below-standard performance.

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Labour Remuneration (cont)

2. Merrick Differential Piece Rate

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Labour Remuneration (cont)

- Uses graduated efficiency slabs.

Labour Remuneration (cont)

- Traditional textbook structure:

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Labour Remuneration (cont)

- Below 83% efficiency: ordinary piece rate.

Labour Remuneration (cont)

- 83% to below 100%: 110% of ordinary piece rate.

Labour Remuneration (cont)

- 100% and above: 120% of ordinary piece rate.

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Labour Remuneration (cont)

- Follow the exact slab percentages given in the question if specified.

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Labour Remuneration (cont)

D. Premium Bonus Plans

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Labour Remuneration (cont)

1. Halsey Plan

Labour Remuneration (cont)

- Worker receives time wages plus a fixed percentage of wages for time saved.

Labour Remuneration (cont)

- Common bonus-sharing proportion: 50%.

Labour Remuneration (cont)

Time Saved = Time Allowed − Actual Time.

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Labour Remuneration (cont)

Time Wages = Actual Time × Hourly Rate.

Labour Remuneration (cont)

Bonus = Time Saved × Hourly Rate × Bonus Percentage.

Labour Remuneration (cont)

Total Earnings = Time Wages + Bonus.

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Labour Remuneration (cont)

2. Rowan Plan

Labour Remuneration (cont)

- Worker receives time wages plus a bonus based on the proportion of time saved to time allowed.

Labour Remuneration (cont)

Bonus = (Time Saved ÷ Time Allowed) × Actual Time × Hourly Rate.

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Labour Remuneration (cont)

Total Earnings = Time Wages + Bonus.

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Labour Remuneration (cont)

3. Gantt Task and Bonus Plan

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Labour Remuneration (cont)

- Below standard: guaranteed time wages.

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Labour Remuneration (cont)

- At standard: time wages plus a bonus.

Labour Remuneration (cont)

- Above standard: higher piece-rate earnings.

Labour Remuneration (cont)

4. Emerson Efficiency Plan

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Labour Remuneration (cont)

- Guaranteed time wages.

Labour Remuneration (cont)

- Bonus increases progressively with efficiency after reaching specified efficiency thresholds.

Labour Remuneration (cont)

- Traditional textbook schedules often start bonus eligibility around 66⅔% efficiency; exact rates depend on the schedule provided.

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Labour Remuneration (cont)

Worked Example – Halsey and Rowan

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Labour Remuneration (cont)

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Labour Remuneration (cont)

- Time allowed = 10 hours.

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Labour Remuneration (cont)

- Actual time = 8 hours.

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Labour Remuneration (cont)

- Hourly rate = ₹100.

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Labour Remuneration (cont)

- Halsey bonus percentage = 50%.

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Labour Remuneration (cont)

Time Saved = 10 − 8 = 2 hours.

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Labour Remuneration (cont)

Time Wages = 8 × 100 = ₹800.

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Labour Remuneration (cont)

Halsey Bonus = 2 × 100 × 50% = ₹100.

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Labour Remuneration (cont)

Halsey Earnings = ₹900.

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Labour Remuneration (cont)

Rowan Bonus = (2 ÷ 10) × 8 × 100 = ₹160.

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Labour Remuneration (cont)

Rowan Earnings = ₹960.

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Labour Remuneration (cont)

E. Labour Cost and Productivity Formulas

Labour Remuneration (cont)

- Labour Cost per Unit = Total Labour Cost ÷ Units Produced.

Labour Remuneration (cont)

- Labour Productivity = Output ÷ Labour Hours.

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Labour Remuneration (cont)

- Labour Cost per Hour = Total Labour Cost ÷ Labour Hours.

Labour Remuneration (cont)

- Labour Utilisation Ratio = Productive Hours ÷ Total Available Hours × 100.

Labour Remuneration (cont)

- Labour Efficiency Ratio = Standard Hours for Actual Output ÷ Actual Hours × 100.

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Labour Remuneration (cont)

F. Labour Turnover

Labour Remuneration (cont)

- Separation Rate = Separations ÷ Average Number of Employees × 100.

Labour Remuneration (cont)

- Replacement Rate = Replacements ÷ Average Number of Employees × 100.

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Labour Remuneration (cont)

- Flux Rate = (Separations + Replacements) ÷ Average Number of Employees × 100.

Labour Remuneration (cont)

- Average Employees = (Opening Employees + Closing Employees) ÷ 2.

Labour Remuneration (cont)

MCQ Traps

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Labour Remuneration (cont)

- Time rate rewards time worked; piece rate rewards output.

Labour Remuneration (cont)

- Taylor uses two differential rates; Merrick uses graduated slabs.

Labour Remuneration (cont)

- Halsey bonus depends on a fixed share of time saved.

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Labour Remuneration (cont)

- Rowan bonus depends on the ratio of time saved to time allowed.

Labour Remuneration (cont)

- For the same inputs, Rowan may give a higher bonus than Halsey at lower time-s-aving percentages, but the result depends on the Halsey sharing percentage.

Labour Remuneration (cont)

- Gantt guarantees time wages below standard and provides higher rewards for achieving/exceeding standard.

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Labour Remuneration (cont)

- Always distinguish time saved from actual time taken in bonus calculations.

Overhead Absorption

A. Meaning

Overhead Absorption (cont)

- Overhead absorption is the process of charging production overheads to cost units, jobs, products or services.

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Overhead Absorption (cont)

- It is performed after overhead allocation, apportionment and departmental distribution.

Overhead Absorption (cont)

- Objective: include an appropriate share of indirect production costs in product or service cost.

Overhead Absorption (cont)

B. Predetermined Overhead Absorption Rate (OAR)

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Overhead Absorption (cont)

OAR= {Budgeted Overheads / Budgeted Activity}

Overhead Absorption (cont)

- Budgeted activity may be measured in units, labour hours, machine hours or another suitable base.

Overhead Absorption (cont)

- Overhead Absorbed = Actual Activity × Predetermined OAR.

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Overhead Absorption (cont)

C. Methods of Overhead Absorption

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Overhead Absorption (cont)

1. Direct Material Cost Percentage

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Overhead Absorption (cont)

Rate = (Production OH ÷ Direct Material Cost) × 100.

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Overhead Absorption (cont)

Absorbed OH = Direct Material Cost × Rate%.

Overhead Absorption (cont)

2. Direct Labour Cost Percentage

Overhead Absorption (cont)

Rate = (Production OH ÷ Direct Labour Cost) × 100.

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Overhead Absorption (cont)

Absorbed OH = Direct Labour Cost × Rate%.

Overhead Absorption (cont)

3. Prime Cost Percentage

Overhead Absorption (cont)

Rate = (Production OH ÷ Prime Cost) × 100.

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Overhead Absorption (cont)

Absorbed OH = Prime Cost × Rate%.

Overhead Absorption (cont)

4. Labour Hour Rate

Overhead Absorption (cont)

Labour Hour Rate = Production OH ÷ Budgeted Direct Labour Hours.

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Overhead Absorption (cont)

Absorbed OH = Actual Labour Hours × Labour Hour Rate.

Overhead Absorption (cont)

5. Machine Hour Rate

Overhead Absorption (cont)

Machine Hour Rate = Machine-related OH ÷ Budgeted Machine Hours.

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Overhead Absorption (cont)

Absorbed OH = Actual Machine Hours × Machine Hour Rate.

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Overhead Absorption (cont)

6. Unit Production Rate

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Overhead Absorption (cont)

Rate per Unit = Production OH ÷ Budgeted Production Units.

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Overhead Absorption (cont)

Absorbed OH = Actual Units Produced × Rate per Unit.

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Overhead Absorption (cont)

D. Numerical Illustration

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Overhead Absorption (cont)

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Overhead Absorption (cont)

- Budgeted factory overhead = ₹6,00,000.

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Overhead Absorption (cont)

- Budgeted machine hours = 20,000.

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Overhead Absorption (cont)

- Actual machine hours = 18,000.

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Overhead Absorption (cont)

Machine Hour Rate = 6,00,000 ÷ 20,000 = ₹30/hour.

Overhead Absorption (cont)

Overhead Absorbed = 18,000 × 30 = ₹5,40,000.

Overhead Absorption (cont)

If actual factory overhead = ₹5,80,000:

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Overhead Absorption (cont)

Under-absorption = 5,80,000 − 5,40,000 = ₹40,000.

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Overhead Absorption (cont)

E. Under-Absorption and Over-Absorption

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Overhead Absorption (cont)

- Under-absorption: Actual Overheads > Absorbed Overheads.

Overhead Absorption (cont)

- Under-absorption = Actual OH − Absorbed OH.

Overhead Absorption (cont)

- Over-absorption: Absorbed Overheads > Actual Overheads.

Overhead Absorption (cont)

- Over-absorption = Absorbed OH − Actual OH.

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Overhead Absorption (cont)

Causes

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Overhead Absorption (cont)

- Incorrect budget estimates.

Overhead Absorption (cont)

- Unexpected changes in overhead expenditure.

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Overhead Absorption (cont)

- Higher or lower production activity than expected.

Overhead Absorption (cont)

- Idle capacity and abnormal downtime.

Overhead Absorption (cont)

- Changes in wage rates, electricity tariffs or other input costs.

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Overhead Absorption (cont)

Treatment

Overhead Absorption (cont)

- Supplementary rate: adjust WIP, finished goods and cost of sales.

Overhead Absorption (cont)

- Write off to Costing Profit and Loss Account if the difference is small and immaterial.

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Overhead Absorption (cont)

- Abnormal and avoidable overheads are generally charged to Costing Profit and Loss Account.

Overhead Absorption (cont)

- Carry forward only where permitted and appropriate for temporary differences.

Overhead Absorption (cont)

F. Blanket Rate vs Departmental Rate

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Overhead Absorption (cont)

- Blanket rate: one common absorption rate for the entire factory.

Overhead Absorption (cont)

- Departmental rate: separate rates for individual departments based on their cost structures and activity.

Overhead Absorption (cont)

- Departmental rates are generally more accurate where departments have different production processes and overhead patterns.

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Overhead Absorption (cont)

G. Selection of Absorption Base

Overhead Absorption (cont)

- Machine-intensive production → Machine hours.

Overhead Absorption (cont)

- Labour-intensive production → Labour hours.

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Overhead Absorption (cont)

- Material-intensive production → Direct material cost.

Overhead Absorption (cont)

- Labour-cost-intensive production → Direct labour cost.

Overhead Absorption (cont)

- Homogeneous production with similar units → Units produced.

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Overhead Absorption (cont)

- The chosen base should reasonably reflect the relationship between overhead consumption and production activity.

Overhead Absorption (cont)

MCQ Traps

Overhead Absorption (cont)

- Allocation = charging an identifiable cost to a cost centre.

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Overhead Absorption (cont)

- Apportionment = distributing common overhead among cost centres.

Overhead Absorption (cont)

- Absorption = charging overhead to cost units.

Overhead Absorption (cont)

- Predetermined OAR uses budgeted overhead and budgeted activity.

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Overhead Absorption (cont)

- Under-absorption means actual OH exceeds absorbed OH.

Overhead Absorption (cont)

- Over-absorption means absorbed OH exceeds actual OH.

Overhead Absorption (cont)

- Machine hour rate is especially appropriate for mechanised production.

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Overhead Absorption (cont)

- A blanket rate can distort product costs when departments have significantly different overhead structures.

Break-Even and Contribution

1. Contribution

Break-Even and Contribution (cont)

- Contribution = Sales − Variable Cost.

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Break-Even and Contribution (cont)

- Contribution per unit = Selling Price per unit − Variable Cost per unit.

Break-Even and Contribution (cont)

- Contribution first covers fixed costs; any surplus becomes profit.

Break-Even and Contribution (cont)

- Profit = Total Contribution − Fixed Cost.

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Break-Even and Contribution (cont)

- Total Contribution = Fixed Cost + Profit.

Break-Even and Contribution (cont)

- At break-even, contribution exactly equals fixed cost; profit is zero.

Break-Even and Contribution (cont)

- Contribution is also called marginal contribution.

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Break-Even and Contribution (cont)

2. Profit–Volume (P/V) Ratio

Break-Even and Contribution (cont)

- P/V Ratio = (Contribution / Sales) × 100.

Break-Even and Contribution (cont)

- P/V Ratio = (Contribution per unit / Selling Price per unit) × 100.

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Break-Even and Contribution (cont)

- Measures contribution earned per rupee of sales.

Break-Even and Contribution (cont)

- Higher P/V ratio generally means higher profitability, assuming fixed costs remain unchanged.

Break-Even and Contribution (cont)

- Change in P/V ratio can arise from changes in selling price, variable cost or sales mix.

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Break-Even and Contribution (cont)

3. Break-Even Point (BEP)

Break-Even and Contribution (cont)

- Break-even point is the level of sales at which total revenue equals total cost.

Break-Even and Contribution (cont)

- At BEP: Total Contribution = Fixed Cost; Profit = Nil; Total Cost = Total Sales.

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Break-Even and Contribution (cont)

- BEP (Units) = Fixed Cost / Contribution per unit.

Break-Even and Contribution (cont)

- BEP (Sales Value) = Fixed Cost / P/V Ratio (use P/V ratio in decimal form).

Break-Even and Contribution (cont)

- Below BEP → Loss; above BEP → Profit, assuming the same cost and selling-price structure.

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Break-Even and Contribution (cont)

4. Margin of Safety (MOS)

Break-Even and Contribution (cont)

- Margin of Safety = Actual Sales − Break-Even Sales.

Break-Even and Contribution (cont)

- Budgeted MOS = Budgeted Sales − Break-Even Sales.

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Break-Even and Contribution (cont)

- MOS Ratio = (MOS / Actual or Budgeted Sales, as applicable) × 100.

Break-Even and Contribution (cont)

- Indicates how far sales can fall before the business reaches break-even.

Break-Even and Contribution (cont)

- Higher MOS indicates a greater safety cushion and generally lower operating risk.

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Break-Even and Contribution (cont)

- Profit = Margin of Safety × P/V Ratio (P/V ratio in decimal form).

Break-Even and Contribution (cont)

- A low or negative MOS indicates vulnerability or an existing loss.

Break-Even and Contribution (cont)

5. Target Profit

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Break-Even and Contribution (cont)

- Required Contribution = Fixed Cost + Target Profit.

Break-Even and Contribution (cont)

- Required Units = (Fixed Cost + Target Profit) / Contribution per unit.

Break-Even and Contribution (cont)

- Required Sales Value = (Fixed Cost + Target Profit) / P/V Ratio.

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Break-Even and Contribution (cont)

- For target profit after tax:

Break-Even and Contribution (cont)

- Required pre-tax profit = Target post-tax profit / (1 − Tax Rate).

Break-Even and Contribution (cont)

- Then add fixed cost to obtain required contribution.

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Break-Even and Contribution (cont)

- If units are required, round up to the next whole unit where partial units cannot be sold.

Break-Even and Contribution (cont)

6. Cash Break-Even Point

Break-Even and Contribution (cont)

- Cash BEP excludes non-cash fixed expenses, particularly depreciation.

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Break-Even and Contribution (cont)

- Cash Fixed Cost = Total Fixed Cost − Non-cash Fixed Expenses.

Break-Even and Contribution (cont)

- Cash BEP (Units) = Cash Fixed Cost / Contribution per unit.

Break-Even and Contribution (cont)

- Cash BEP is generally lower than accounting BEP when non-cash fixed expenses are positive.

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Break-Even and Contribution (cont)

- Useful for assessing the minimum sales required to meet cash operating commitments.

Break-Even and Contribution (cont)

- Cash BEP is not the same as cash-flow break-even in a full cash-flow analysis, which may also consider capital expenditure, working capital and financing cash flows.

Break-Even and Contribution (cont)

7. Multi-Product Break-Even Analysis

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Break-Even and Contribution (cont)

- When multiple products are sold, each product may have a different contribution and P/V ratio.

Break-Even and Contribution (cont)

- Composite P/V Ratio = Total Contribution / Total Sales × 100.

Break-Even and Contribution (cont)

- Composite BEP Sales = Total Fixed Cost / Composite P/V Ratio.

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Break-Even and Contribution (cont)

- A weighted-average contribution per unit can be used when the sales mix is expressed in fixed unit proportions.

Break-Even and Contribution (cont)

- Assumes a stable sales mix; a shift towards higher-contribution products generally improves profitability.

Break-Even and Contribution (cont)

- If sales mix changes, the composite P/V ratio and BEP may also change.

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Break-Even and Contribution (cont)

8. Break-Even Chart

Break-Even and Contribution (cont)

- X-axis: Output or sales volume.

Break-Even and Contribution (cont)

- Y-axis: Cost and revenue.

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Break-Even and Contribution (cont)

- Fixed Cost Line: Horizontal line because total fixed cost remains constant within the relevant range.

Break-Even and Contribution (cont)

- Variable Cost Line: Starts from the origin under the conventional assumption; rises with output.

Break-Even and Contribution (cont)

- Total Cost Line: Starts at the fixed-cost level and rises with variable cost.

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Break-Even and Contribution (cont)

- Sales Revenue Line: Starts from the origin and rises with sales volume.

Break-Even and Contribution (cont)

- Intersection of Total Revenue and Total Cost = BEP.

Break-Even and Contribution (cont)

- Angle of Incidence: Angle between sales revenue and total cost lines at BEP; a wider angle generally indicates a faster movement into profit after break-even.

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Break-Even and Contribution (cont)

- Profit Area: Sales revenue exceeds total cost.

Break-Even and Contribution (cont)

- Loss Area: Total cost exceeds sales revenue.

Break-Even and Contribution (cont)

9. Effect of Changes on BEP and Profit

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Break-Even and Contribution (cont)

- Selling price increases → contribution/unit and P/V ratio increase → BEP generally decreases.

Break-Even and Contribution (cont)

- Variable cost/unit increases → contribution/unit and P/V ratio decrease → BEP generally increases.

Break-Even and Contribution (cont)

- Fixed cost increases → BEP increases; profit falls at the same sales volume.

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Break-Even and Contribution (cont)

- Sales volume increases → total contribution and profit increase after covering fixed costs.

Break-Even and Contribution (cont)

- Fixed cost reduction lowers BEP.

Break-Even and Contribution (cont)

- Variable cost reduction improves contribution and generally lowers BEP.

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Break-Even and Contribution (cont)

- A higher P/V ratio improves profit for a given sales value, provided fixed costs are unchanged.

Break-Even and Contribution (cont)

10. Numerical Example

Break-Even and Contribution (cont)

Given:

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Break-Even and Contribution (cont)

- Selling price = ₹100 per unit.

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Break-Even and Contribution (cont)

- Variable cost = ₹60 per unit.

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Break-Even and Contribution (cont)

- Fixed cost = ₹80,000.

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Break-Even and Contribution (cont)

- Actual sales = 3,000 units.

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Break-Even and Contribution (cont)

Calculation:

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Break-Even and Contribution (cont)

- Contribution/unit = ₹100 − ₹60 = ₹40.

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Break-Even and Contribution (cont)

- Total contribution = 3,000 × ₹40 = ₹1,20,000.

Break-Even and Contribution (cont)

- P/V Ratio = ₹40 / ₹100 × 100 = 40%.

Break-Even and Contribution (cont)

- BEP units = ₹80,000 / ₹40 = 2,000 units.

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Break-Even and Contribution (cont)

- BEP sales = ₹80,000 / 0.40 = ₹2,00,000.

Break-Even and Contribution (cont)

- Actual sales value = 3,000 × ₹100 = ₹3,00,000.

Break-Even and Contribution (cont)

- MOS = ₹3,00,000 − ₹2,00,000 = ₹1,00,000.

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Break-Even and Contribution (cont)

- MOS Ratio = ₹1,00,000 / ₹3,00,000 × 100 = 33.33%.

Break-Even and Contribution (cont)

- Profit = ₹1,20,000 − ₹80,000 = ₹40,000.

Break-Even and Contribution (cont)

- Verification: MOS × P/V Ratio = ₹1,00,000 × 40% = ₹40,000.

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Break-Even and Contribution (cont)

MCQ Traps

Break-Even and Contribution (cont)

- BEP is where profit is zero, not where contribution is zero.

Break-Even and Contribution (cont)

- Contribution is not profit; fixed costs must still be deducted.

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Break-Even and Contribution (cont)

- P/V ratio is based on contribution, not profit.

Break-Even and Contribution (cont)

- BEP sales formula requires P/V ratio in decimal form.

Break-Even and Contribution (cont)

- Higher fixed costs increase BEP but do not change contribution per unit.

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Break-Even and Contribution (cont)

- Higher variable cost reduces contribution per unit.

Break-Even and Contribution (cont)

- MOS is measured from actual or budgeted sales to BEP, not from total cost.

Break-Even and Contribution (cont)

- Cash BEP excludes non-cash fixed expenses; accounting BEP includes them.

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Break-Even and Contribution (cont)

- Break-even analysis assumes selling price, variable cost per unit and fixed costs remain constant within the relevant range.

Marginal-Costing Decisions

1. Relevant Cost Concepts

Marginal-Costing Decisions (cont)

- Relevant Cost: Future cost that differs between alternatives; considered in decisi-on-making.

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Marginal-Costing Decisions (cont)

- Irrelevant Cost: Cost that remains unchanged across alternatives or does not affect the decision.

Marginal-Costing Decisions (cont)

- Incremental Cost: Additional cost arising from choosing one alternative over another.

Marginal-Costing Decisions (cont)

- Differential Cost: Difference in total cost between two alternatives.

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Marginal-Costing Decisions (cont)

- Avoidable Cost: Cost that can be eliminated by choosing a particular alternative.

Marginal-Costing Decisions (cont)

- Unavoidable Cost: Cost that continues regardless of the decision.

Marginal-Costing Decisions (cont)

- Sunk Cost: Past cost already incurred; irrelevant to future decisions.

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Marginal-Costing Decisions (cont)

- Opportunity Cost: Benefit sacrificed by selecting one alternative instead of the next-best alternative.

Marginal-Costing Decisions (cont)

- Imputed Cost: Notional cost included for decision-making, although no actual payment may occur.

Marginal-Costing Decisions (cont)

- Committed Cost: Cost arising from prior commitments that cannot easily be avoided in the short term.

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Marginal-Costing Decisions (cont)

2. Make-or-Buy Decision

Marginal-Costing Decisions (cont)

- Decide whether to manufacture a component internally or purchase it externally.

Marginal-Costing Decisions (cont)

- Compare relevant in-house manufacturing cost with the supplier's purchase price.

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Marginal-Costing Decisions (cont)

- Make Cost = Relevant Direct Material + Relevant Direct Labour + Variable Production OH + Avoidable Fixed Cost + Opportunity Cost.

Marginal-Costing Decisions (cont)

- Buy Cost = Purchase Price + Freight/Inspection/Other Relevant Procurement Costs.

Marginal-Costing Decisions (cont)

- Choose the lower relevant-cost alternative, subject to quality, capacity, reliability and strategic considerations.

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Marginal-Costing Decisions (cont)

- Allocated fixed overhead that continues even if production is stopped is generally irrelevant.

Marginal-Costing Decisions (cont)

- If spare capacity exists, opportunity cost may be nil.

Marginal-Costing Decisions (cont)

- If internal production uses capacity that could earn contribution elsewhere, include that lost contribution as opportunity cost.

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Marginal-Costing Decisions (cont)

3. Shut-Down or Continue Decision

Marginal-Costing Decisions (cont)

- Compare contribution earned from continuing operations with avoidable fixed costs of continuing.

Marginal-Costing Decisions (cont)

- Continue if contribution exceeds avoidable fixed costs, assuming no other strategic considerations.

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Marginal-Costing Decisions (cont)

- Shut down if avoidable costs saved exceed contribution lost, subject to restart costs and other consequences.

Marginal-Costing Decisions (cont)

- Unavoidable fixed costs continue even after shutdown and should not be treated as savings.

Marginal-Costing Decisions (cont)

- Consider customer relationships, employee costs, legal obligations, market position and future demand.

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Marginal-Costing Decisions (cont)

4. Product-Mix Decision Under a Limiting Factor

Marginal-Costing Decisions (cont)

- Limiting Factor: Resource in short supply that restricts production or sales, e.g. machine hours, labour hours, raw material or capacity.

Marginal-Costing Decisions (cont)

- Contribution per unit = Selling Price per unit − Variable Cost per unit.

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Marginal-Costing Decisions (cont)

- Contribution per unit of limiting factor = Contribution per unit / Limiting factor required per unit.

Marginal-Costing Decisions (cont)

- Rank products in descending order of contribution per unit of scarce resource.

Marginal-Costing Decisions (cont)

- Allocate the scarce resource to products with the highest contribution per limiting factor, subject to demand and other constr-aints.

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Marginal-Costing Decisions (cont)

- Do not rank solely by contribution per unit when resource consumption differs.

Marginal-Costing Decisions (cont)

- If multiple constraints exist, simple ranking may not work; linear programming may be required.

Marginal-Costing Decisions (cont)

5. Special Order / Export Order Pricing

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Marginal-Costing Decisions (cont)

- Special order: One-time or additional order, often at a price different from normal selling price.

Marginal-Costing Decisions (cont)

- Accept if incremental revenue exceeds incremental relevant cost and the order does not adversely affect regular business.

Marginal-Costing Decisions (cont)

- Minimum acceptable price = Incremental Variable Cost + Incremental Fixed Cost + Opportunity Cost per unit.

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Marginal-Costing Decisions (cont)

- With idle capacity and no additional fixed costs or opportunity cost, minimum price may be the incremental variable cost per unit.

Marginal-Costing Decisions (cont)

- If capacity is fully utilised, include contribution lost from displaced regular sales.

Marginal-Costing Decisions (cont)

- Consider export duties, freight, insurance, foreign exchange risk, quality requirements and possible impact on normal market prices.

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Marginal-Costing Decisions (cont)

- A price below full cost can still be acceptable in the short run if it covers relevant incremental costs and adds positive contribution.

Marginal-Costing Decisions (cont)

6. Sell or Process Further

Marginal-Costing Decisions (cont)

- Compare additional revenue from further processing with additional processing cost.

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Marginal-Costing Decisions (cont)

- Incremental Revenue = Sales Value after Further Processing − Sales Value at Split-off Point.

Marginal-Costing Decisions (cont)

- Incremental Profit = Incremental Revenue − Additional Processing Cost.

Marginal-Costing Decisions (cont)

- Process further if incremental revenue exceeds additional relevant cost.

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Marginal-Costing Decisions (cont)

- Joint costs incurred before the split-off point are generally sunk for this decision and should not be allocated to determine the choice.

Marginal-Costing Decisions (cont)

- Consider capacity constraints and opportunity cost of additional processing resources.

Marginal-Costing Decisions (cont)

7. Replacement of Equipment

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Marginal-Costing Decisions (cont)

- Compare future operating and maintenance costs of existing equipment with those of replacement equipment.

Marginal-Costing Decisions (cont)

- Relevant items include purchase cost of new equipment, installation, disposal proceeds of old equipment, operating savings, maintenance costs and additional working capital.

Marginal-Costing Decisions (cont)

- Original purchase cost and accumulated depreciation of existing equipment are sunk costs.

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Marginal-Costing Decisions (cont)

- Book value is generally irrelevant, except for tax consequences or accounting implications.

Marginal-Costing Decisions (cont)

- Include opportunity cost of retaining or disposing of the existing asset.

Marginal-Costing Decisions (cont)

- Use discounted cash flow / Net Present Value (NPV) when cash flows occur over multiple years and time value of money is material.

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Marginal-Costing Decisions (cont)

8. Key Decision Rules and Numerical Illustration

Marginal-Costing Decisions (cont)

- General rule: Choose the alternative with the highest relevant benefit or the lowest relevant cost.

Marginal-Costing Decisions (cont)

- Incremental Profit = Incremental Revenue − Incremental Relevant Cost.

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Marginal-Costing Decisions (cont)

- Positive incremental profit → financially favourable, subject to qualitative constr-aints.

Marginal-Costing Decisions (cont)

Example — Make or Buy:

Marginal-Costing Decisions (cont)

- In-house variable cost per unit = ₹50.

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Marginal-Costing Decisions (cont)

- Avoidable fixed cost per unit = ₹10.

Marginal-Costing Decisions (cont)

- Supplier price per unit = ₹65.

Marginal-Costing Decisions (cont)

- Unavoidable allocated fixed cost per unit = ₹15.

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Marginal-Costing Decisions (cont)

- Relevant make cost = ₹50 + ₹10 = ₹60.

Marginal-Costing Decisions (cont)

- Relevant buy cost = ₹65.

Marginal-Costing Decisions (cont)

- Making saves ₹5 per unit; therefore, make internally, assuming no opportunity cost or qualitative disadvantage.

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Marginal-Costing Decisions (cont)

- The unavoidable allocated fixed cost of ₹15 is excluded.

Marginal-Costing Decisions (cont)

MCQ Traps

Marginal-Costing Decisions (cont)

- Sunk costs are never relevant to a future choice merely because they are large.

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Marginal-Costing Decisions (cont)

- Opportunity cost is relevant even though it may not appear in accounting records.

Marginal-Costing Decisions (cont)

- Allocated fixed overhead is not automatically avoidable.

Marginal-Costing Decisions (cont)

- Make-or-buy decisions compare relevant costs, not full absorption cost.

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Marginal-Costing Decisions (cont)

- Product ranking under a limiting factor uses contribution per unit of scarce resource.

Marginal-Costing Decisions (cont)

- Joint costs before split-off are irrelevant to sell-or-process-further decisions.

Marginal-Costing Decisions (cont)

- A special order below normal selling price may still be profitable.

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Marginal-Costing Decisions (cont)

- Replacement decisions ignore historical book cost but consider future cash flows and disposal value.

Variance Calculations

1. Basic Concepts

Variance Calculations (cont)

- Variance = Standard Cost − Actual Cost (for cost variances).

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Variance Calculations (cont)

- Favourable (F) Variance: Actual cost is lower than standard cost, or actual revenue/profit is higher than standard.

Variance Calculations (cont)

- Adverse (A) Variance: Actual cost is higher than standard cost, or actual revenue/profit is lower than standard.

Variance Calculations (cont)

- Standard Quantity (SQ): Quantity allowed for actual output.

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Variance Calculations (cont)

- Actual Quantity (AQ): Quantity actually used or purchased, depending on the variance.

Variance Calculations (cont)

- Standard Price (SP): Predetermined price per unit.

Variance Calculations (cont)

- Actual Price (AP): Actual price per unit.

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Variance Calculations (cont)

- Standard Hours (SH): Hours allowed for actual output.

Variance Calculations (cont)

- Actual Hours (AH): Hours actually worked.

Variance Calculations (cont)

- Standard Rate (SR): Standard wage rate per hour.

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Variance Calculations (cont)

- Actual Rate (AR): Actual wage rate per hour.

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Variance Calculations (cont)

- Always calculate standard input for actual output, not budgeted output.

Variance Calculations (cont)

2. Material Cost Variances

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Variance Calculations (cont)

- Material Cost Variance (MCV) = (SQ × SP) − (AQ × AP).

Variance Calculations (cont)

- Material Price Variance (MPV) = AQ × (SP − AP).

Variance Calculations (cont)

- Material Usage Variance (MUV) = SP × (SQ − AQ).

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Variance Calculations (cont)

- Material Mix Variance (MMV) = Σ[SP × (Revised Standard Quantity − Actual Quantity)].

Variance Calculations (cont)

- Material Yield Variance (MYV) = Standard Cost per unit of output × (Actual Yield − Standard Yield from actual input), expressed consistently.

Variance Calculations (cont)

- MCV = MPV + MUV, where the same quantity basis is used.

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Variance Calculations (cont)

- MUV = MMV + MYV, where the mix and yield analysis uses a consistent standard-cost basis.

Variance Calculations (cont)

- Price variance may be calculated on quantity purchased or quantity consumed, depending on the question's stated convention.

Variance Calculations (cont)

- If price variance is calculated on purchases while usage variance is calculated on consumption, reconciliation may require a separate stock-price adjustment.

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Variance Calculations (cont)

3. Labour Cost Variances

Variance Calculations (cont)

- Labour Cost Variance (LCV) = (SH × SR) − (AH × AR).

Variance Calculations (cont)

- Labour Rate Variance (LRV) = AH × (SR − AR).

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Variance Calculations (cont)

- Labour Efficiency Variance (LEV) = SR × (SH − AH).

Variance Calculations (cont)

- Labour Mix Variance = Σ[SR × (Revised Standard Hours − Actual Hours)].

Variance Calculations (cont)

- Labour Yield Variance = Standard Labour Cost per unit of output × (Actual Output − Standard Output from actual labour input), using a consistent basis.

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Variance Calculations (cont)

- LCV = LRV + LEV.

Variance Calculations (cont)

- Idle Time Variance = Idle Hours × SR, normally adverse.

Variance Calculations (cont)

- When idle time is separately identified, efficiency calculations must follow the question's convention to avoid double counting.

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Variance Calculations (cont)

4. Variable Overhead Variances

Variance Calculations (cont)

- Variable Overhead Cost Variance (VOCV) = (SH × Standard Variable Overhead Rate) − Actual Variable Overhead.

Variance Calculations (cont)

- Variable Overhead Expenditure Variance = (AH × Standard Variable Overhead Rate) − Actual Variable Overhead.

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Variance Calculations (cont)

- Variable Overhead Efficiency Variance = (SH − AH) × Standard Variable Overhead Rate.

Variance Calculations (cont)

- VOCV = Expenditure Variance + Efficiency Variance.

Variance Calculations (cont)

- Use the same activity base for standard and actual hours (labour hours or machine hours).

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Variance Calculations (cont)

5. Fixed Overhead Variances

Variance Calculations (cont)

- Fixed Overhead Absorption Rate (FOAR) = Budgeted Fixed Overhead / Budgeted Hours.

Variance Calculations (cont)

- Fixed Overhead Cost Variance (FOCV) = (SH × FOAR) − Actual Fixed Overhead.

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Variance Calculations (cont)

- Fixed Overhead Expenditure Variance = Budgeted Fixed Overhead − Actual Fixed Overhead.

Variance Calculations (cont)

- Fixed Overhead Volume Variance = (SH − Budgeted Hours) × FOAR.

Variance Calculations (cont)

- Capacity Variance = (Actual Hours − Budgeted Hours) × FOAR.

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Variance Calculations (cont)

- Efficiency Variance = (SH − Actual Hours) × FOAR.

Variance Calculations (cont)

- FOCV = Expenditure Variance + Volume Variance.

Variance Calculations (cont)

- Volume Variance = Capacity Variance + Efficiency Variance.

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Variance Calculations (cont)

- Fixed overhead expenditure variance relates to spending; volume variance relates to production/activity differing from budget.

Variance Calculations (cont)

6. Sales Variances

Variance Calculations (cont)

- Sales Value Variance = (Actual Quantity × Actual Selling Price) − (Standard Quantity × Standard Selling Price).

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Variance Calculations (cont)

- Sales Price Variance = Actual Quantity × (Actual Selling Price − Standard Selling Price).

Variance Calculations (cont)

- Sales Volume Variance = Standard Selling Price × (Actual Quantity − Standard Quantity).

Variance Calculations (cont)

- Sales Value Variance = Sales Price Variance + Sales Volume Variance.

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Variance Calculations (cont)

- For sales margin/profit variances, use standard profit or contribution per unit rather than selling price.

Variance Calculations (cont)

- Sales Mix Variance measures the effect of selling a different product mix.

Variance Calculations (cont)

- Sales Quantity Variance measures the effect of total quantity sold differing from budget.

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Variance Calculations (cont)

- Do not confuse sales value variance with sales margin variance.

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Variance Calculations (cont)

7. Worked Numerical Example — Material Variances

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Variance Calculations (cont)

Given:

Variance Calculations (cont)

- Standard quantity for actual output = 100 kg.

Variance Calculations (cont)

- Standard price = ₹10/kg.

Variance Calculations (cont)

- Actual quantity consumed = 110 kg.

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Variance Calculations (cont)

- Actual price = ₹12/kg.

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Variance Calculations (cont)

Calculation:

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Variance Calculations (cont)

- Standard Cost = 100 × ₹10 = ₹1,000.

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Variance Calculations (cont)

- Actual Cost = 110 × ₹12 = ₹1,320.

Variance Calculations (cont)

- MCV = ₹1,000 − ₹1,320 = ₹320 Adverse.

Variance Calculations (cont)

- MPV = 110 × (₹10 − ₹12) = ₹220 Adverse.

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Variance Calculations (cont)

- MUV = ₹10 × (100 − 110) = ₹100 Adverse.

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Variance Calculations (cont)

- Reconciliation: ₹220 A + ₹100 A = ₹320 A.

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Variance Calculations (cont)

8. Interpretation and Common Causes

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Variance Calculations (cont)

- Adverse material price variance: supplier price increase, emergency purchasing, lower discounts, poor procurement.

Variance Calculations (cont)

- Favourable material price variance: bulk discounts, better sourcing, lower-quality material (may cause adverse usage).

Variance Calculations (cont)

- Adverse material usage variance: wastage, defective inputs, poor handling, inefficient production.

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Variance Calculations (cont)

- Adverse labour rate variance: wage increases, overtime premium, use of highly skilled labour.

Variance Calculations (cont)

- Adverse labour efficiency variance: poor training, machine breakdowns, low-quality material, weak supervision.

Variance Calculations (cont)

- Adverse variable overhead expenditure: increased indirect input prices or inefficient spending.

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Variance Calculations (cont)

- Fixed overhead expenditure variance: actual fixed overhead differs from budget.

Variance Calculations (cont)

- Fixed overhead capacity variance: actual hours differ from budgeted hours.

Variance Calculations (cont)

- Fixed overhead efficiency variance: standard hours for actual output differ from actual hours.

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Variance Calculations (cont)

- Variances are investigation signals, not automatic proof of poor performance; interdependent causes and external factors must be examined.

Variance Calculations (cont)

MCQ Traps

Variance Calculations (cont)

- Use standard quantity/hours for actual output.

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Variance Calculations (cont)

- Cost variance formula is generally standard cost minus actual cost; sales variance signs are usually actual minus standard.

Variance Calculations (cont)

- Material price variance may use purchased quantity or consumed quantity depending on the question.

Variance Calculations (cont)

- Labour rate variance uses actual hours.

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Variance Calculations (cont)

- Labour efficiency variance uses standard rate.

Variance Calculations (cont)

- Idle time variance is normally adverse.

Variance Calculations (cont)

- Fixed overhead expenditure and volume variances are distinct.

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Variance Calculations (cont)

- Capacity variance and efficiency variance together explain fixed overhead volume variance.

Variance Calculations (cont)

- Favourable price variance can coexist with adverse usage variance; assess total cost variance.

Budget Preparation and Flexible-Budget Problems

1. Meaning and Objectives of Budgeting

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Budget Preparation and Flexible-Budget Problems (cont)

- Budget: Quantitative or financial plan prepared for a future period.

Budget Preparation and Flexible-Budget Problems (cont)

- Budgeting: Process of preparing budgets.

Budget Preparation and Flexible-Budget Problems (cont)

- Budgetary Control: Comparing actual performance with budgets, identifying variances and taking corrective action.

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Budget Preparation and Flexible-Budget Problems (cont)

- Objectives: Planning, coordination, communication, resource allocation, cost control, performance evaluation and responsibility assignment.

Budget Preparation and Flexible-Budget Problems (cont)

- A budget is a planning and control tool, not merely a cost-cutting exercise.

Budget Preparation and Flexible-Budget Problems (cont)

2. Classification of Budgets

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Budget Preparation and Flexible-Budget Problems (cont)

- Functional Budgets: Prepared for individual functions.

Budget Preparation and Flexible-Budget Problems (cont)

- Sales Budget: Expected sales quantity and value.

Budget Preparation and Flexible-Budget Problems (cont)

- Production Budget: Units to be produced.

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Budget Preparation and Flexible-Budget Problems (cont)

- Material Consumption Budget: Material required for planned production.

Budget Preparation and Flexible-Budget Problems (cont)

- Material Purchase Budget: Material to be purchased.

Budget Preparation and Flexible-Budget Problems (cont)

- Labour Budget: Labour hours and labour cost.

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Budget Preparation and Flexible-Budget Problems (cont)

- Production Overhead Budget: Factory overheads.

Budget Preparation and Flexible-Budget Problems (cont)

- Administration Overhead Budget: Administrative expenses.

Budget Preparation and Flexible-Budget Problems (cont)

- Selling and Distribution Budget: Selling and distribution expenses.

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Budget Preparation and Flexible-Budget Problems (cont)

- Cash Budget: Expected cash receipts and payments.

Budget Preparation and Flexible-Budget Problems (cont)

- Capital Expenditure Budget: Planned investment in fixed assets.

Budget Preparation and Flexible-Budget Problems (cont)

- Master Budget: Consolidated summary of functional budgets, generally including budgeted income statement, balance sheet and cash budget.

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Budget Preparation and Flexible-Budget Problems (cont)

- Fixed Budget: Prepared for one activity level; does not change with actual output.

Budget Preparation and Flexible-Budget Problems (cont)

- Flexible Budget: Adjusted for different activity levels; separates fixed, variable and semi-variable costs.

Budget Preparation and Flexible-Budget Problems (cont)

- Rolling Budget: Continuously updated by adding a new period as the current period ends.

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Budget Preparation and Flexible-Budget Problems (cont)

- Zero-Based Budgeting (ZBB): Every expenditure must be justified from a zero base; no automatic carry-forward of previous allocations.

Budget Preparation and Flexible-Budget Problems (cont)

- Performance Budgeting: Links expenditure to activities, outputs and performance.

Budget Preparation and Flexible-Budget Problems (cont)

- Programme Budgeting: Organises expenditure around programmes and objectives.

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Budget Preparation and Flexible-Budget Problems (cont)

- Incremental Budgeting: Uses the previous budget as a base and adjusts for expected changes.

Budget Preparation and Flexible-Budget Problems (cont)

3. Preparation of Key Functional Budgets

Budget Preparation and Flexible-Budget Problems (cont)

- Sales Budget

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Budget Preparation and Flexible-Budget Problems (cont)

- Budgeted Sales Value = Expected Units Sold × Expected Selling Price.

Budget Preparation and Flexible-Budget Problems (cont)

- Usually prepared first because sales forecasts influence production and other budgets.

Budget Preparation and Flexible-Budget Problems (cont)

- Production Budget

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Budget Preparation and Flexible-Budget Problems (cont)

- Production Units = Budgeted Sales + Desired Closing Finished Goods − Opening Finished Goods.

Budget Preparation and Flexible-Budget Problems (cont)

- Production is not necessarily equal to sales because inventory changes.

Budget Preparation and Flexible-Budget Problems (cont)

- Material Consumption Budget

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Budget Preparation and Flexible-Budget Problems (cont)

- Material Required = Production Units × Material Required per Unit.

Budget Preparation and Flexible-Budget Problems (cont)

- Material Purchase Budget

Budget Preparation and Flexible-Budget Problems (cont)

- Purchases = Material Required for Production + Desired Closing Raw Material − Opening Raw Material.

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Budget Preparation and Flexible-Budget Problems (cont)

- Purchase Value = Purchase Quantity × Purchase Price.

Budget Preparation and Flexible-Budget Problems (cont)

- Labour Budget

Budget Preparation and Flexible-Budget Problems (cont)

- Labour Hours = Production Units × Standard Labour Hours per Unit.

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Budget Preparation and Flexible-Budget Problems (cont)

- Labour Cost = Labour Hours × Wage Rate per Hour.

Budget Preparation and Flexible-Budget Problems (cont)

- Overhead Budget

Budget Preparation and Flexible-Budget Problems (cont)

- Separately estimates variable, fixed and semi-variable overheads.

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Budget Preparation and Flexible-Budget Problems (cont)

- Cash Budget

Budget Preparation and Flexible-Budget Problems (cont)

- Closing Cash = Opening Cash + Cash Receipts − Cash Payments.

Budget Preparation and Flexible-Budget Problems (cont)

- Includes actual expected cash movements, not merely accounting income and expenses.

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Budget Preparation and Flexible-Budget Problems (cont)

4. Fixed Budget vs Flexible Budget

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Budget Preparation and Flexible-Budget Problems (cont)

- Fixed Budget:

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Budget Preparation and Flexible-Budget Problems (cont)

- Prepared for a single activity level.

Budget Preparation and Flexible-Budget Problems (cont)

- Remains unchanged despite actual output variation.

Budget Preparation and Flexible-Budget Problems (cont)

- Useful when activity is stable and predictable.

Budget Preparation and Flexible-Budget Problems (cont)

- Can produce misleading comparisons when actual output differs significantly from budget.

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Budget Preparation and Flexible-Budget Problems (cont)

- Flexible Budget:

Budget Preparation and Flexible-Budget Problems (cont)

- Prepared for multiple activity levels or adjusted to actual activity.

Budget Preparation and Flexible-Budget Problems (cont)

- Separates fixed, variable and semi-v-ariable costs.

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Budget Preparation and Flexible-Budget Problems (cont)

- Enables meaningful comparison of actual costs with costs expected at actual output.

Budget Preparation and Flexible-Budget Problems (cont)

- Particularly useful where output, capacity utilisation or demand fluctuates.

Budget Preparation and Flexible-Budget Problems (cont)

- Key distinction: Fixed budget remains unchanged; flexible budget adjusts expected costs to the actual level of activity.

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Budget Preparation and Flexible-Budget Problems (cont)

5. Flexible Budget Preparation

Budget Preparation and Flexible-Budget Problems (cont)

- Step 1: Identify the relevant activity measure, e.g. units, machine hours or labour hours.

Budget Preparation and Flexible-Budget Problems (cont)

- Step 2: Classify costs as fixed, variable or semi-variable.

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Budget Preparation and Flexible-Budget Problems (cont)

- Step 3: Determine the variable cost per unit or activity measure.

Budget Preparation and Flexible-Budget Problems (cont)

- Step 4: Estimate fixed costs within the relevant range.

Budget Preparation and Flexible-Budget Problems (cont)

- Step 5: Calculate expected costs at the required activity level.

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Budget Preparation and Flexible-Budget Problems (cont)

- Variable Cost = Variable Cost per Unit × Activity.

Budget Preparation and Flexible-Budget Problems (cont)

- Total Cost = Fixed Cost + Variable Cost.

Budget Preparation and Flexible-Budget Problems (cont)

- Semi-variable costs may be split into fixed and variable components using the high-low method or another suitable cost-estimation technique.

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Budget Preparation and Flexible-Budget Problems (cont)

- Flexible budgeting assumes cost behaviour remains reasonably stable within the relevant range.

Budget Preparation and Flexible-Budget Problems (cont)

6. High-Low Method for Semi-Variable Costs

Budget Preparation and Flexible-Budget Problems (cont)

- Used to estimate fixed and variable components of a mixed cost.

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Budget Preparation and Flexible-Budget Problems (cont)

- Variable Cost per Unit = (Cost at Highest Activity − Cost at Lowest Activity) / (Highest Activity − Lowest Activity).

Budget Preparation and Flexible-Budget Problems (cont)

- Fixed Cost = Total Cost − (Variable Cost per Unit × Activity).

Budget Preparation and Flexible-Budget Problems (cont)

- Use the highest and lowest activity levels, not necessarily the highest and lowest costs.

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Budget Preparation and Flexible-Budget Problems (cont)

- The method assumes a linear cost relationship and can be distorted by abnormal costs or unusual activity periods.

Budget Preparation and Flexible-Budget Problems (cont)

7. Numerical Example — Flexible Budget

Budget Preparation and Flexible-Budget Problems (cont)

Given:

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Budget Preparation and Flexible-Budget Problems (cont)

- Fixed cost = ₹50,000.

Budget Preparation and Flexible-Budget Problems (cont)

- Variable cost = ₹20 per unit.

Budget Preparation and Flexible-Budget Problems (cont)

- Actual output = 4,000 units.

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Budget Preparation and Flexible-Budget Problems (cont)

Calculation:

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- Variable Cost = 4,000 × ₹20 = ₹80,000.

Budget Preparation and Flexible-Budget Problems (cont)

- Flexible Budget Cost = ₹50,000 + ₹80,000 = ₹1,30,000.

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Budget Preparation and Flexible-Budget Problems (cont)

At 5,000 units:

Budget Preparation and Flexible-Budget Problems (cont)

- Variable Cost = 5,000 × ₹20 = ₹1,00,000.

Budget Preparation and Flexible-Budget Problems (cont)

- Flexible Budget Cost = ₹50,000 + ₹1,00,000 = ₹1,50,000.

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Budget Preparation and Flexible-Budget Problems (cont)

At 6,000 units:

Budget Preparation and Flexible-Budget Problems (cont)

- Variable Cost = 6,000 × ₹20 = ₹1,20,000.

Budget Preparation and Flexible-Budget Problems (cont)

- Flexible Budget Cost = ₹50,000 + ₹1,20,000 = ₹1,70,000.

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Budget Preparation and Flexible-Budget Problems (cont)

Observation:

Budget Preparation and Flexible-Budget Problems (cont)

- Fixed cost remains ₹50,000 across all three activity levels.

Budget Preparation and Flexible-Budget Problems (cont)

- Variable cost changes proportionately with output.

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Budget Preparation and Flexible-Budget Problems (cont)

- Total cost increases as output increases.

Budget Preparation and Flexible-Budget Problems (cont)

8. Budgetary Control and Performance Evaluation

Budget Preparation and Flexible-Budget Problems (cont)

- Compare actual performance with the appropriate budget.

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Budget Preparation and Flexible-Budget Problems (cont)

- Use flexible budget figures when actual activity differs from the original planned activity.

Budget Preparation and Flexible-Budget Problems (cont)

- Identify favourable and adverse variances.

Budget Preparation and Flexible-Budget Problems (cont)

- Investigate causes and assign responsibility to relevant managers.

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Budget Preparation and Flexible-Budget Problems (cont)

- Take corrective action and revise forecasts where necessary.

Budget Preparation and Flexible-Budget Problems (cont)

- Controllable costs should be evaluated against the manager's authority and responsibility.

Budget Preparation and Flexible-Budget Problems (cont)

- Budgetary slack: Deliberate understatement of expected revenue or overstatement of expected costs to make targets easier to achieve.

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Budget Preparation and Flexible-Budget Problems (cont)

9. Important Budgeting Concepts

Budget Preparation and Flexible-Budget Problems (cont)

- Key Budget Factor / Principal Budget Factor: Resource or constraint that limits overall activity, e.g. sales demand, raw materials, labour or machine capacity.

Budget Preparation and Flexible-Budget Problems (cont)

- Budget Committee: Coordinates budget preparation and review.

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Budget Preparation and Flexible-Budget Problems (cont)

- Budget Manual: Document describing budget procedures, responsibilities and formats.

Budget Preparation and Flexible-Budget Problems (cont)

- Budget Period: Period covered by the budget.

Budget Preparation and Flexible-Budget Problems (cont)

- Budget Centre: Section or unit for which a budget is prepared.

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Budget Preparation and Flexible-Budget Problems (cont)

- Participative Budgeting: Involves managers and employees in budget preparation; can improve ownership but may encourage budgetary slack.

Budget Preparation and Flexible-Budget Problems (cont)

- Kaizen Budgeting: Incorporates continuous, incremental improvement into budget targets.

Budget Preparation and Flexible-Budget Problems (cont)

MCQ Traps

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Budget Preparation and Flexible-Budget Problems (cont)

- Sales budget usually precedes production budget.

Budget Preparation and Flexible-Budget Problems (cont)

- Production Budget = Sales + Closing FG − Opening FG.

Budget Preparation and Flexible-Budget Problems (cont)

- Material Purchase Budget = Material Required + Closing RM − Opening RM.

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Budget Preparation and Flexible-Budget Problems (cont)

- Production and sales quantities are not necessarily equal.

Budget Preparation and Flexible-Budget Problems (cont)

- Master Budget consolidates functional budgets.

Budget Preparation and Flexible-Budget Problems (cont)

- Flexible budgets adjust costs to activity; fixed budgets do not.

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Budget Preparation and Flexible-Budget Problems (cont)

- Fixed cost remains constant in total within the relevant range, but fixed cost per unit decreases as output increases.

Budget Preparation and Flexible-Budget Problems (cont)

- Variable cost remains constant per unit within the relevant range, but total variable cost changes with output.

Budget Preparation and Flexible-Budget Problems (cont)

- Semi-variable cost contains both fixed and variable components.

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Budget Preparation and Flexible-Budget Problems (cont)

- High-low method uses highest and lowest activity levels.

Budget Preparation and Flexible-Budget Problems (cont)

- Cash budget records cash receipts and payments, not depreciation or other non-cash expenses.

Budget Preparation and Flexible-Budget Problems (cont)

- Zero-based budgeting requires justification from a zero base; incremental budgeting starts with the previous budget.

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