

CHAPTER 2

COST ESTIMATION AND FORECASTING

A DEFINITION OF COST

Cost may be defined as the amount of resources, usually measured in monetary terms, sacrificed to achieve a particular objective. The objective might be to retain a car, to buy a particular house, to make a particular product, or to render a particular service.

DIRECT COSTS AND INDIRECT COST

DIRECT COSTS

These are those that can be directly identified with a job, a product, or service. E.g. direct material, direct labor, direct expense

INDIRECT COST

These include material, labor, expense that cannot be directly identified with a product. The total of indirect costs forms the overheads. Different organizations classify overheads differently. E.g. in a typical manufacturing firm, classifications into production overheads, administration overheads etc will be common.

ESTABLISHING OVERHEADS

Overheads are more complex to come up with than direct costs. Before embarking on the different methods, some terminologies have to be explained.

- **Cost center**

Production or service location, activity or item of equipment for which costs are accumulated.

- **Cost allocation**

Assigning a whole item of cost, or revenue, to a single cost unit, cost center, account or time period.

- **Cost apportionment**

Spreading revenues or costs over two or more cost units, cost centers, accounts or time periods. This is done on a basis that is deemed to reflect the benefits received.

ABSORPTION COSTING

Its objective is to include the total cost of a product and the appropriate share of the organization's total overheads. Appropriate share means an amount which reflects the amount of time and effort that has gone into producing a unit or completing a job. Since total cost is made up of a variable and a fixed component total absorption will have implications on stock valuations and performance management and is seriously criticized by some accountants.

MARGINAL COSTING

Marginal costing distinguishes between fixed costs and variable costs. It excludes fixed costs from the absorption process and charges them in total against the period's result.

COSTING METHODS

- Job costing
- Batch costing
- Process costing

COST CLASSIFICATION

- **Fixed costs:** Those costs that do not change (within a relevant range) in proportion to the level of activity.
- **Variable costs:** These costs do change in proportion to the level of activity.

COSTS FORECASTING

- Engineering method
- Account analysis

QUESTIONS

1. Define the word 'cost' in the context of management accounting.
2. Define the following:
 - Direct cost
 - Indirect cost
 - Cost center
3. Distinguish between marginal costing and absorption costing.

REFERENCE

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