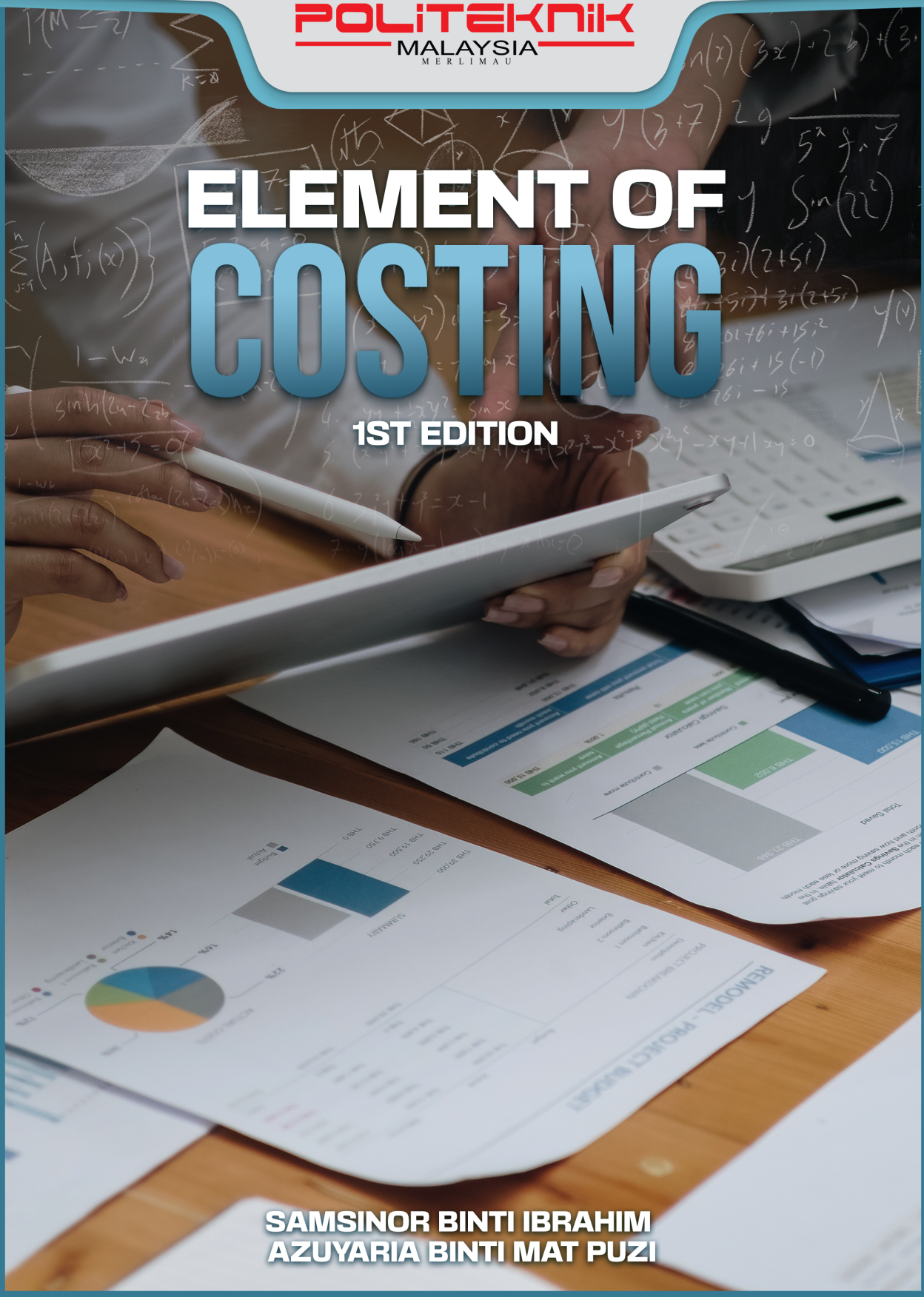
POLITEKNIK MALAYSIA
MERLIMAU

ELEMENT OF COSTING

1ST EDITION



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EDITORIAL BOARD

ACKNOWLEDGEMENT

We would like to record our warmest appreciation and thanks to the many people who have provided encouragement and helpful comments towards the arrangement of this Element of Costing e-book. It is our hope that this e-book would help students and readers to gain better understanding of this course.

PREFACE

This e-book is designed primarily for students who need clear understanding of Element of costing. It is one of the additional reference sources for all students who take Cost and Management Accounting or who are interested in this topic.

This topic covers a very significant part of the syllabus in cost and management accounting. Special care has been taken to keep the contents and explanations clear and concise without sacrificing depth. Concepts requiring calculations are explained with simple worked examples to increase clarity. Comprehensive examples enable students to apply their understanding to deal with issues of cost accounting. Hopefully this e-book will help students and readers in enhancing their knowledge and understanding of the element of costing.

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INTRODUCTION

Cost accounting is a branch of accounting and has been developed due to limitations of financial accounting.

The management of every business enterprise is interested to know much more than the usual information supplied to outsiders. In order to carry out its functions of planning, decision-making and control.

Financial accounting is primarily concerned with record keeping directed towards the preparation of gross profit acocunt, profit and loss account and balance sheet. The information concerning the business or enterprise is helpful to the management to control on business.

DEFINITION

Cost accounting is concerned with classification, accumulation, control and assignment of costs.

Classification costs according to patterns of behaviours, activities or processes to which they relate products dependent on the types of measurement desired costs may be accumulated by accounts, jobs processes products or other business segments.

Important : the cost accounting system is not independent of the financial accounts.

DEFINITION

The following are the important definition of cost accounting:

The application of accounting and costing principles, methods and techniques in the ascertainment of costs and the analysis of savings and/or excesses as compared with the previous experience or standards.

CHARTERED INSTITUTE OF MANAGEMENT ACCOUNTANTS (CIMA)

Concerned with cost accumulation for stock valuation to meet the requirements of external reporting Related to the provision of appropriate information for people within the organization to help them make better decisions

COLIN DRURY

Establishing of budgets, standard costs and actual costs of operations, processes, activities or products and the analysis of variances, profitability or the social use of funds.

T. LUCEY

Costing is the classifying, recording and appropriate allocation of expenditure for the determination of the cost of products or services, and for the presentation of suitably arranged data for purposes of control and guidance of the management. it includes the ascertainment of cost of every order, job, contract, process, service or unit at as may be appropriate. it deals with the costs of production, selling and distribution.

HAROLD J.WHELDON

OBJECTIVE

Objective of cost accounting are:

1. Ascertainment of cost

2. To control cost

3. To provide information for decision making

4. To determine selling price

5. To ascertain costing profit

IMPORTANCE OF COST ACCOUNTING TO THE MANAGEMENT

1

To determine product cost

The total product cost and cost per unit of product are important in making stock valuation, deciding price of the product and managerial decision making

2

To facilitate planning and control

The accumulation, classification and analysis of cost is done in such a way as to help management decision regarding business activities.

3

To supply information for short and long run decision

Provide data for short and long run decisions of a non-recurring nature and these decision naturally involve high cost commitment

WHAT IS COST?

A cost can be defined as the amount of resources given up in exchange for any goods or service.

Anything incurred during the production of the good or service to get the output into the hands of the customer.

e.g
Material cost, Labour cost, electricity cost, fuel cost etc.

Factory

Production

Consumer

COST ACCOUNTING vs FINANCIAL ACCOUNTING

Differences between of Cost Accounting and Financial Accounting

	COST ACCOUNTING	FINANCIAL ACCOUNTING
Nature	Classifies, records, present and interprets in significant manner the material, labour and overhead costs involved in manufacturing and selling each product, job or service	Classifies, records, presents and interprets in terms of financial character and provides the figures for the preparation of financial statement
Primary Users	Internal User Eg: members of Management	External Users Eg: Shareholder, creditors, financial analyst, government authorities
Accounting Method	Doesn't based on the double entry system	Based on double entry system
Accounting principle	Not required to follow MFRS. Can use any accounting technique that generates useful information	Follow MFRS (Malaysia Financial Reporting Standard)
Unit of measurement	Applies any measurement unit Eg : labour hours, machine hours	Monetary terms
Report frequency	Prepared whenever needed Eg: monthly, weekly, daily basis	Data and statement are developed for a definite period Eg: annually, semi annually
Time dimension	Concerned with future information as well as past information	Reports what has happened in the past in an organization

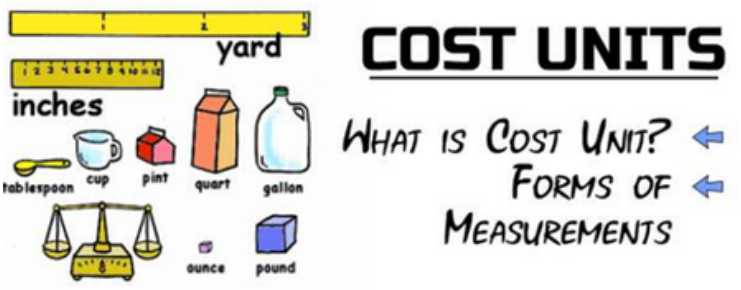
COST UNIT

Unit of product or service in relation to which costs are ascertained.

The following are some the example of cost units selected from different industries or organization:

Cost units selected from different industries

Name of the industry or Organization	Product	COST UNIT
Cement Industry	Cement	Per tonne
Power Industry	Electricity	Per kilo-watt hour
Sugar Industry	Sugar	Per tonne
Cotton Textile Company	Yarn	Per kg
Transport companies	Service	Per passenger-mile
Hospital	Service	Per bed-day
Canteen	Service	Per meal



COST CENTRE

Production or service location, function, activity or item of equipment whose costs may be attributed to cost units.

Example : Operation and process cost centre, Production and Service cost centre, Personal and impersonal cost centre.

PRODUCTION COST CENTRE

Actual production process is carried out. The manufacturing and non-manufacturing costs are charged to production cost centre

Example : Machining department and assembling department

SERVICE COST CENTRE

One which provides services to other cost centre. Only non-manufacturing costs are charged to service cost centre.

For example : Stores, maintenance, production, planning and personnel.

PROCESS COST CENTRE

specific process or a continuous process of operations is carried out

For example : in a food processing process such as mixing, cooking, sterilizing & packing department.

COST OBJECT

Any item, product or activity for which a company wants to assign and ascertain the cost. A cost object can also be a customer, a machine, a group of machine, a group of employees.

Cake

Bridal dress

House

CONVERSION COST

Labour costs and manufacturing overheads are needed to convert raw materials into finished goods, excluding direct material.

Example : Machinery depreciation, plant and machinery maintenance, salary to production staff, direct labour benefits, rent of factory, utility bills, factory insurance, production supervision salary of staff related to production.

CONVERSION COSTS

CONVERSION COST is a combination of all the direct and indirect production costs that a company incurs to convert raw material into finished goods.

- It includes Direct Labour and Overheads.
- But, it does not include Direct Material.

IMPORTANCE

- Useful for calculation of cost of equivalent units.
- It is also time saving method
- Assist in calculation of value of finished stock
- Helps in identification of wastage

FORMULA

Direct Labor + Manufacturing Overheads cost **OR** Manufacturing Costs - Direct Material.

PRIME COST	CONVERSION COST
➢ These are the expenses that directly relate to creating finished products. ➢ Includes Direct Material and Direct Labour	➢ These are expenses that a company incurs in converting raw materials into a finished product. ➢ Conversion Costs includes direct as well as indirect labour.

LABOUR

CONVERSION COST

Example :

Samsung has a cell phone production unit with a production capacity of 10,000 daily. It incurs day to day expenses to carry on its business running. The company wants to know its conversion cost from the information given below:

Particular	Amount ($)
Equipement Depreciation	10,000
Factory Insurance	5,000
Indirect Material	1,00,000
Direct Material	15,00,000
Direct Wages	3,00,000
Office Expenses	1,00,000
Factory Rent	20,000
Electricity Expense	90,000
Maintenanse Expense	1,00,000
Inspection Expense	5,000

Solution:

Conversion Cost = Manufacturing Overheads + Direct Labour

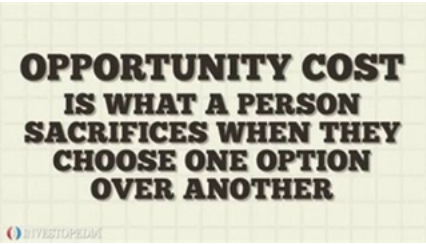
Direct Labour = $3,00,000

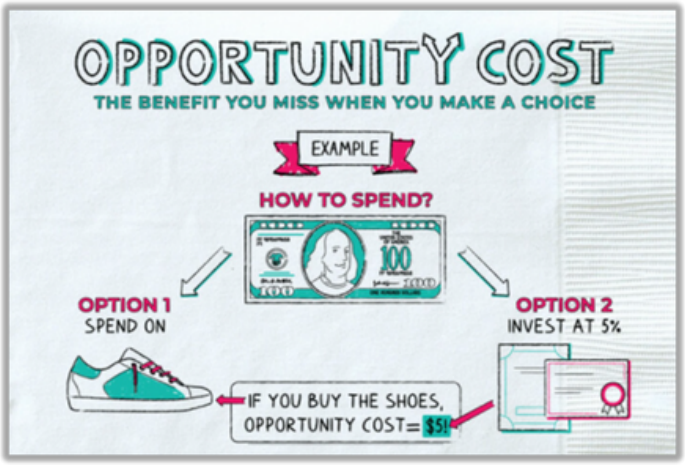
Manufacturing Overheads = 10,000 (Equipment Depreciation) + 5,000 (Factory Insurance) + 80,000(Indirect Material) + 20,000(Factory Rent) + 90,000(Electricity expense) + 1,00,000(Maintenance expense) + 5,000(Inspection expense)

- Manufacturing Overheads = $3,10,000
- = $3,00,000 + $3,10,000
- **Conversion Cost = $6,10,000**
- = $6,10,000 / 10,000
- **Conversion Cost per Unit = $610**

OPPORTUNITY COST

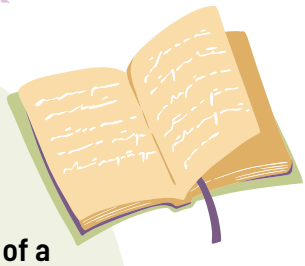
The cost of the next best alternative foregone. It is used in decision making where managers are faced with a choice between alternatives courses of action. He then has to decide which is the best alternative to adopt.





INCREMENTAL COST

Also known as differential costs [difference in the total cost between 2 alternatives]. Additional cost which will incur if one alternative is chosen in place of other.



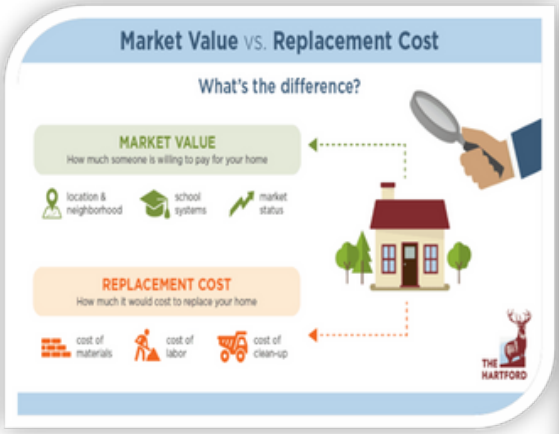
Example :

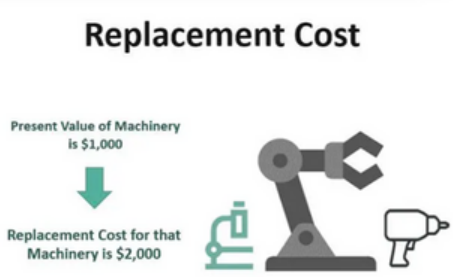
Decision regarding the purchase of a machinery out of two. The differential cost is the difference in the prices paid plus the costs of operating the machines.

REPLACEMENT COST

Cost that is required to replace any existing asset having similar characteristics.

An organization often chooses to replace its assets when the repair and maintenance costs increase beyond the acceptable level over a period of time.

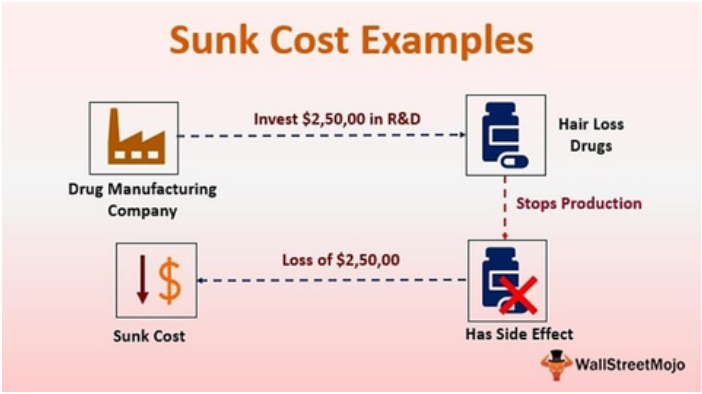


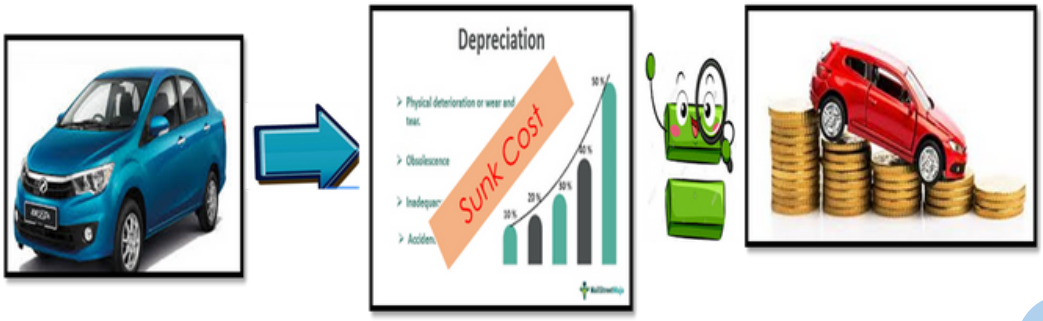


SUNK COST

A past expenditure that cannot be recovered. Sunk cost is not relevant to a firm when deciding how much to produce now.

Example : Book value of existing assets such as plant and equipment, inventory, investment in securities, cost incurred on R&D of a product will be irrelevant while making decision and etc.





DISCUSSION QUESTION

1. Who are the users of accounting information?

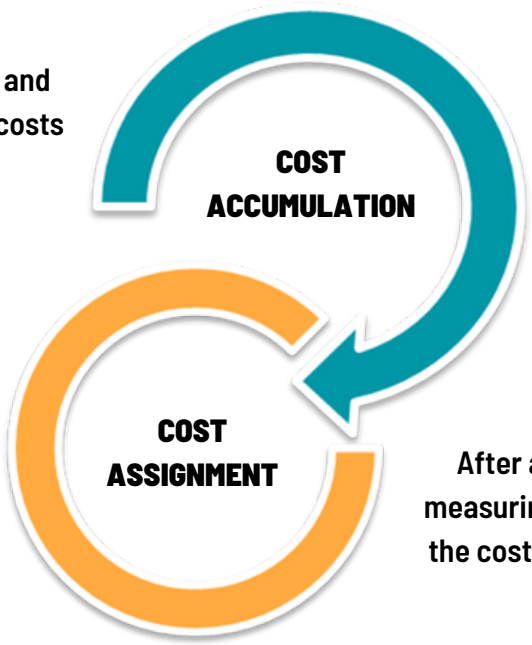
2. What is the relationship between financial accounting and cost and management accounting?

3. Define cost accounting

4. Explain the following basic concept of cost accounting:
   i. Incremental Cost
   ii. Sunk Cost
   iii. Opportunity Cost

INTRODUCTION

Recognition and recording of costs



After accumulating and measuring production costs, the cost will assigned to the product

PURPOSES

Assigning costs to products, allocating costs for cost of goods sold and stock valuation for internal and external profit determination

Providing relevant cost information for decision making

Distiguishing between controllable and uncontrollable costs for the purpose of planning and control.

COST FOR STOCK VALUATION AND PROFIT REPORTING

Costs are classified by their nature and this involves classifying costs as direct, indirect, product and period costs

In manufacturing companies, the final product represents the cost object.

It is important to differentiate costs between direct and indirect elements of manufacturing cost and product and period costs

COST FOR STOCK VALUATION AND PROFIT REPORTING

NAMES OF COMPANY
THE STATEMENT OF COST FOR THE YEAR ENDED .....

	RM	RM
Direct Material:		
Opening Stock of raw material	XXX	
Add: Purchase of raw material	XXX	
Less: Closing stock of raw material	(XXX)	
Value of raw material consumed		XXX
Add: Direct wages/direct labor		XXX
Add: **Direct Expenses**		
Royalty		XXX
Hire a special machine		XXX
PRIME COST		**XXX**
Add: Factory Overhead		
Indirect wages	XXX	
Rent and rates of the factory	XXX	XXX
Add: Work in Progress (opening)		XXX
Less: Work in Progress (closing)		(XXX)
PRODUCTION / FACTORY COST		**XXX**
Add: Administration Overhead		
Clerk salary	XXX	
Stationary	XXX	
Sales and Distribution Overhead		
Sales expenses	XXX	
Promotion	XXX	XXX
Add: Finished Goods (Opening)		XXX
Less: Finished Goods (closing)		(XXX)
TOTAL COST		**XXXX**
Profit		XXX
Sales		**XXX**

MANUFACTURING COST

PRIME COST

NON -MANUFACTURING COST

PRODUCT COST

Product costs are the costs incurred during the manufacturing process. Directly related to the production of a product or service intended for sale.

Example : Direct materials, direct labour & factory overhead

DIRECT MATERIAL

Direct Material is the material that is measured and charged directly to the cost of the product.

DIRECT WAGES

Cost for skilled or unskilled workers who are involved directly in production. Carpenters and machine operators are treated as direct wages because there people who work directly on the materials and actually made the product.

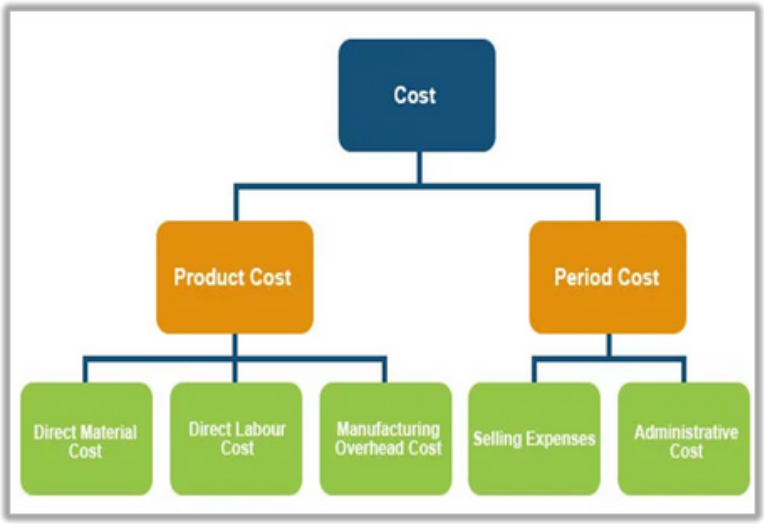
DIRECT EXPENSES

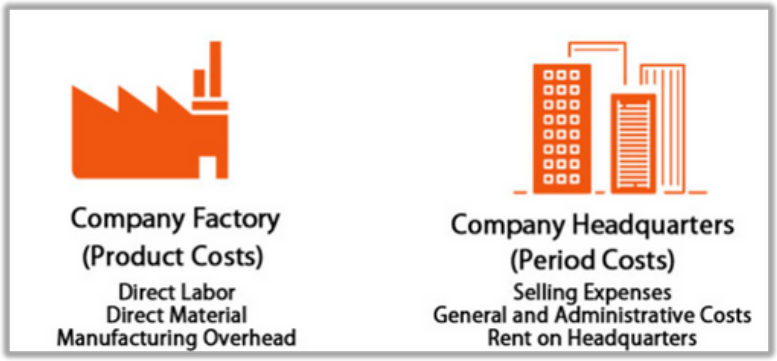
Included any expenditure other than direct material or direct wages are directly incurred on a specific cost unit. Example: Hiring a special equipment for a particular production order or product.

PERIOD COST

Period costs are the costs that your business incurs that are not directly related to production levels. These expenses have no relation to the inventory or production process but are incurred on a regular basis, regardless of the level of production. Period costs are typically divided into two categories: administrative costs and selling costs.

Example : office expenses, insurance expenses, advertising, salaries, utilities, professional fees





COST ACCUMULATION FOR PURPOSE OF DECISION MAKING

The information obtained from the cost and management accounting system that helps the decision-maker to select the best course of action.

The type of cost and revenue information used for decision making is more forward-looking, compared to the cost information used for inventory valuation.

This is because only costs and revenue which react to changes in level of activity are considered essential for decision making.

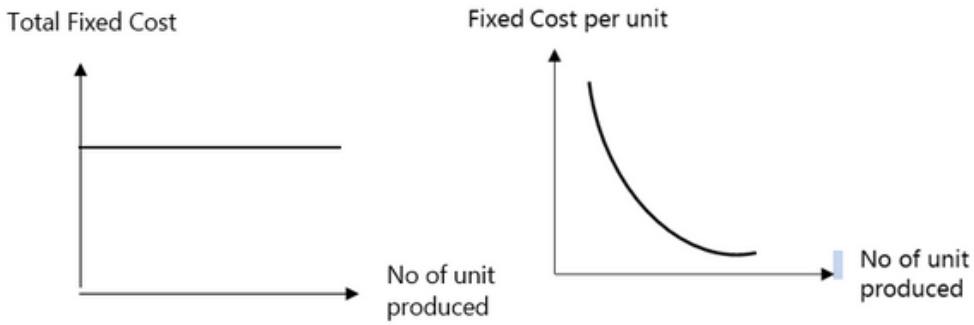
FIXED COST

Remains unchanged regardless of the level activity or the outcome of a decision under consideration.

Example : Supervisors' salaries, factory rent, depreciation of plant and machinery

If the total fixed cost is RM 50,000 per month, then the unit fixed cost will be as follows:

Unit produced	Fixed cost per unit (RM)
0	50 000
1	50 000
10	5 000
100	50
1000	5



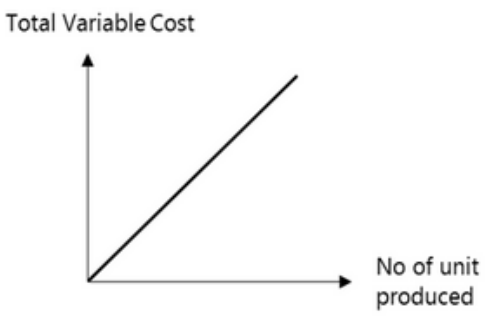
VARIABLE COST

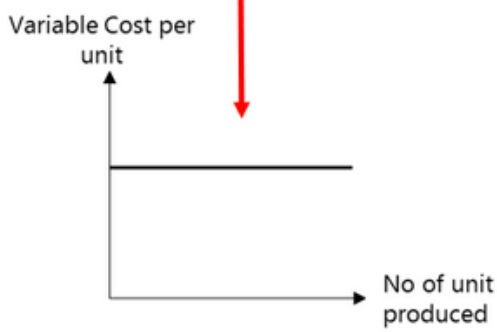
Variable costs are dependent on production output. The variable cost of production is a constant amount per unit produced. In short term, variable cost change in direct proportion to the level of production output

Example : Direct materials, direct wages, direct expenses, variable overhead expenses

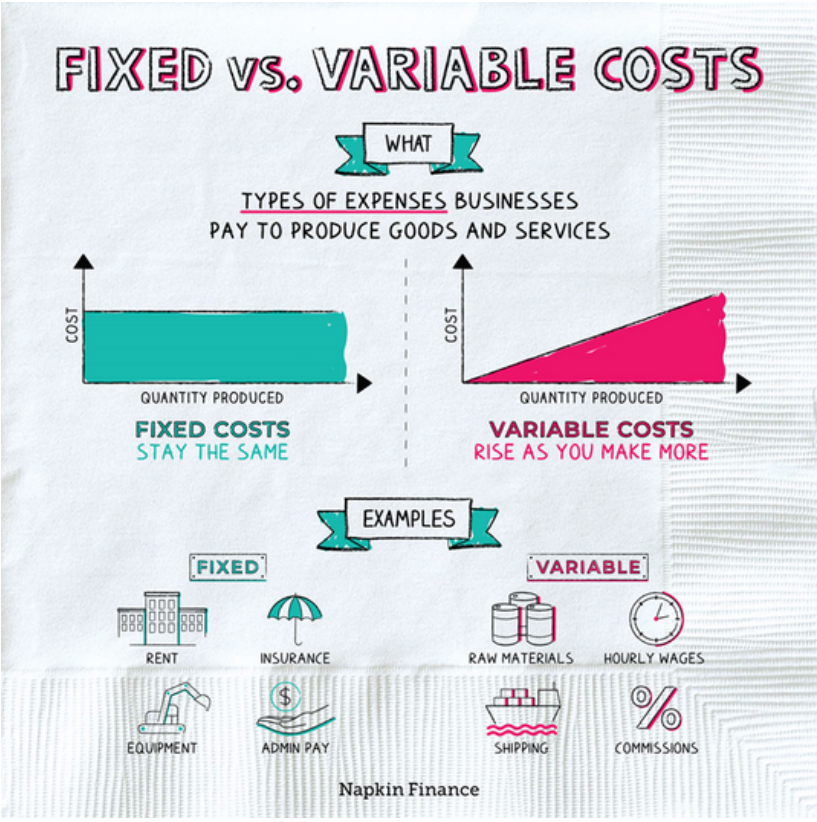
The following information related to variable cost at different production output levels.

Total variable Cost (RM)	Unit produced	Variable cost per unit
25 000	5 000	RM 5
50 000	10 000	RM 5
75 000	15 000	RM 5





VARIABLE COST



Fixed Costs VS Variable Costs

	FIXED COST	VARIABLE COST
Definition	Costs that do not change in relation to production	Costs that vary / change depending on the company's production volume
Nature	Fixed costs are time related. i.e. they remain constant for a period of time	Variable costs are volume-related and change with the changes in output level.
When production Increase	Total Fixed costs stay the same	Total Variable costs increase
When Production Decrease	Total fixed costs stay the same	Total variable costs decrease
Also known as	Overhead costs, period costs or supplementary costs.	Referred to as prime costs or directs costs as it directly affects the output level.
Examples	Rent, Advertising, Insurance, Depreciation, Telephone and internet costs, Loan payments	Direct Materials (i.e. kilograms of wood, tons of cement), Direct Labour (Labour hours), Taxes, Commissions on sales

Fixed Costs VS Variable Costs

Example 1.1

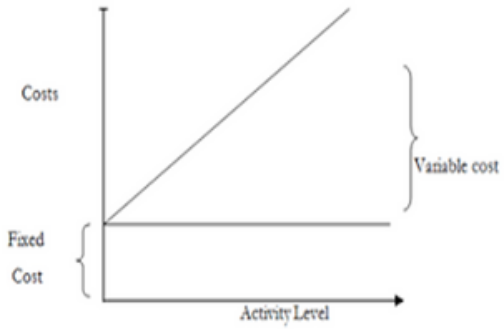
The following table shows various costs incurred by a manufacturing company:

Cost	Fixed	Variable
Depreciation of executive jet	/	
Cost of shipping finished goods to customers		/
Wood used in manufacturing furniture		/
Sales manager's salary	/	
Electricity used in manufacturing furniture		/
Packing supplies for shipping product		/
Sand used in manufacturing concrete		/
Supervisor's salary	/	
Advertising costs	/	
Executive life insurance	/	

SEMI - VARIABLE COST

Semi variable cost have the characteristics of fixed costs and variable costs, both. These costs vary with production but are not indirectly proportioned to volume. Although semi-variable costs are neither wholly fixed not wholly variable in nature, they must ultimately be separated into fixed and variable components for the purpose of planning and control. .

Example : telephone charges, indirect material, indirect labour



HIGH LOW METHOD

Method of estimating cost behaviour by comparing the total cost associated with two different level of outputs (CIMA)

Example 1.2

The maintenance costs of equipment in a factory for three months from January to March 2019 are shown below:

	HOURS WORKED	TOTAL COST (RM)
January	200	3 600
February	240	4 160
March	450	7 100

Required:

Using the high-low method, estimate maintenance costs if 400 hours of service activities are performed.

STEP 1 **Calculate Variable Cost per unit**

Compute the difference in cost and volume between the highest and lowest volume.

	Cost	*Hours*
Highest	*RM 7 100*	*450 hours*
Lowest	*RM 3 600*	*200 hours*
Difference	***RM 3 500***	***250 hours***

Variable Cost per hour = Total Cost / Hours
= RM 3 500 / 250 hours
= **RM 14 per hour**

HIGH LOW METHOD

STEP 2 Calculate Total Variable Cost (TVC)

Total variable costs can be calculated by multiplying cost per unit with this chosen number of maintenance costs.

For example = 200 hours
Variable cost = Variable cost per hour x hours
= RM 14 per hour x 200 hour
= **RM 2 800**

STEP 3 Determine Total Fixed Cost

	HOURS WORKED	TOTAL COST (RM)
January	200	3 600
February	240	4 160
March	450	7 100

Total Cost (TC)	=	Total Fixed Cost (TFC) + Total Variable Cost (TVC)
RM 3 600	=	TFC + RM 2 800
RM 3600 - RM 2 800	=	TFC
RM 800	=	TFC

HIGH LOW METHOD

STEP 4 Calculate total costs at 400 hours of activity

Required:

Using the high-low method, estimate maintenance costs if 400 hours of service activities are performed.

Total Cost (TC)	=	Total Fixed Cost (TFC) + Total Variable Cost (TVC)
TC	=	RM 800 + [RM 14 per hour x 400 hours]
	=	RM 800 + RM 5 600
	=	**RM 6 400**

COST ACCUMULATION FOR PURPOSE OF PLANNING & CONTROL

For planning and control purposes, costs can be broadly classified as being controllable or non-controllable

CONTROLLABLE COST

The cost which is within the control of any manager.
Eg: production wastage, production efficiency and product reworks. •With proper planning and controls, production managers are able to reduce controllable cost without compromising product quality.

NON-CONTROLLABLE COST

Costs which are beyond the control of any manager.
For planning purposes, these costs which are unavoidable are treated as fixed.


LET'S DO
SOME
TEST!

MULTIPLE CHOICE QUESTION

LET'S DO IT!

1 Direct cost incurred can be identified with _____.
A. each department.
B. each unit of output.
C. each month.
D. each executive.

2 Overhead cost is the total of _____.
A. all indirect costs.
B. all direct costs.
C. indirect and direct costs.
D. all specific costs.

3 Costing refers to the techniques and processes of _____.
A. ascertainment of costs.
B. allocation of costs.
C. apportion of costs.
D. distribution of costs.

4 Cost accounting was developed because of the _____.
A. limitations of the financial accounting.
B. limitations of the management accounting.
C. limitations of the human resources accounting.
D. limitations of the double entry accounting.

5 Wages paid to a labourer who was engaged in production activities can be termed as
A. direct cost.
B. indirect cost.
C. sunk cost.
D. imputed cost.

6 Direct expenses are also called _____.
A. major expenses.
B. chargeable expenses.
C. overhead expenses.
D. sundry expenses.

7 Indirect material used in production is classified as
A. office overhead.
B. selling overhead.
C. distribution overhead.
D. production overhead.

8 Warehouse rent is part of _____.
A. prime cost.
B. factory cost.
C. distribution cost.
D. production cost.

9 Indirect material scrap is adjusted along with _____.
A. prime cost.
B. factory cost.
C. labour cost.
D. cost of goods sold.

10 Prime cost includes
A. direct materials, direct wages and indirect expenses.
B. indirect materials, indirect labour and indirect expenses.
C. direct materials, direct wages and direct expenses.
D. direct materials, indirect wages and indirect expenses.

11 Total of all direct cost is termed as
A. prime cost.
B. work cost.
C. cost of sales.
D. cost of production.

12 Depreciation of plant and machinery is part of _____.
A. factory overhead.
B. selling overhead.
C. distribution overhead.
D. administration overhead.

13 Which of these is not an objective of Cost Accounting.

A. Ascertainment of cost.
B. Determination of Selling Price.
C. Cost Control and Cost reduction.
D. Assisting shareholders in decision making.

14 Cost unit is defined as:

A. Unit of quantity of product, service or time in relation to which costs may be ascertained or expressed.
B. A location, person or an item of equipment or a group of these for which cost ascertained and used for cost control.
C. Centres having the responsibility of generating and maximising profits.
D. Centres concerned with earning an adequate return on investment.

15 Fixed cost is a cost:

A. Which changes in total in proportion to changes in output.
B. Which partly fixed and partly variable in relation to output.
C. Which do not change in total during a given period despise changes in output.
D. Which remains same for each unit of output.

16 Conversion cost includes cost of converting _____ into _____.

A. raw material, WIP.
B. raw material, finished goods.
C. WIP, finished goods.
D. finished goods, saleable goods.

17 Sunk Costs are:

A. relevant for decision making.
B. not relevant for decision making.
C. cost to be incurred in future.
D. future costs.

18 Calculate the prime cost from the following information:

Direct material purchased : RM100,000
Direct material consumed : RM90,000
Direct labour : RM60,000
Direct expenses : RM20,000
Manufacturing overheads : RM30,000

A. RM180,000
B. RM200,000
C. RM170,000
D. RM210,000

19 _____ is the process of determining and accumulating the cost of product or activity.

A. Cost accounting
B. Financial accounting
C. Cost control
D. Cost audit

20 The direct material costs are added into direct manufacturing costs, to calculate

A. discuss costs
B. prime costs
C. resale costs
D. merchandise costs

QUESTION 1

Classify each of the following as either Fixed (F), Variable (V) or Semi-variable (SV) costs.

a) Factory supervisors' salary
b) Direct Labour
c) Factory Rent
d) Depreciation on factory equipment
e) Direct Materials
f) Maintenance of machinery
g) Royalty payments
h) Factory Utilities
i) Sales Commission
j) Telephone Charges.

QUESTION 2

Aspro Bhd manufactures scientific calculators. In January, Aspro produced 4 000 calculators with the following costs:

	RM
Direct materials	40,000
Direct Labour	18,000
Manufacturing overheads	32,000

There is no opening or closing stock of work in process during the period.

Required:

a) Calculate the total product costs for the month of January.
b) Calculate the cost per unit of calculator.

QUESTION 3

The total cost of maintenance at Dhaim Sdn Bhd consists of both fixed and variable costs. The following information related to the last four months:

	HOURS WORKED	TOTAL COST (RM)
Month 1	9,300	115,000
Month 2	9,200	113,600
Month 3	9,400	116,000
Month 4	9,600	116,800

Required:

Using the high-low method, estimated the total cost for Dhaim Sdn Bhd if 10,000 hours were worked in Month 5.

QUESTION 4

During the first four months of 2011, activities in terms of machine hours in the assembly department of machine hours in the assembly department of Automotive Sdn Bhd is as follows:

	MACHINE HOURS	TOTAL COST (RM)
January	6,000	60,000
February	7,000	66,000
March	6,700	63,000
April	5,000	54,000

a) By using the high-low method, compute the variable cost per hour and total fixed cost.

b) If it is anticipated that 5,500 machine hours of work will be needed in May, calculate the total costs in the month of May.

c) If the machine hours increase by 50%, will the variable costs also increase by 50%?

QUESTION 5

Exist Manufacturing Company submits the following information on 31 December 2002:

Sales for the year	2,750,000
Inventories at the beginning of the year:	
Finished goods	70,000
Work-in-Progress	40,000
Purchase of the materials	1,100,000
Raw material:	
Beginning	30,000
Closing	40,000
Direct labour	650,000
Factory overhead was 60% of the direct labour cost	
Inventories at the end of the year:	
Work in Progress	60,000
Finished Goods	80,000
Others expenses for the years:	
Selling expenses 10% of sales	
Administrative expenses 5% of sales	

Based from the above, prepare a Statement of Cost.

QUESTION 6

Encorp Manufacturing Co. produces 1000 sets of table and chair. The information are as follows:

	RM
Advertising	10,000
Machine maintenance	3,000
Factory insurance	6,000
Direct material	135,000
Depreciation of factory equipment	300,000
Depreciation of office equipment	6,000
Office supplies	2,500
Factory utilities	15,000
Directors remuneration	60,000
Direct wages	240,000
Supervisor (salary)	48,000
Administrative salary	20,000

Prepare a Statement of Cost that shows clearly the prime cost, Production cost and Total Cost

QUESTION 7

Below are the balance of the accounts of Tadmax Sdn Bhd for the year ended 31st December 2017.

	RM
Direct labour	15,500
Direct expenses	17,000
Sales	165,000
Carriage inwards	1,000
Raw material	77,500
Opening stock:	
Raw Material	7,500
Work in progress	2,500
Finishes goods	5,500
Closing stock:	
Raw Material	6,000
Work in progress	1,800
Finished goods	5,800
Rent	16,000
Telephone	5,000
Salesman commission	900
Depreciation of van (used for sales activities)	500
Office clerk salary	1,700
Royalty	5,000

Additional Information:

- Rental is divided between factory and office [60:40]
- Telephone is provided for 30 office staffs and 20 factory workers
- The company manufactured 25 000 units products during the year
- Advertising costs is calculated as RM 0.50 per unit sold during the year
- Royalty is based on units sold.

Prepare a Statement of Cost that shows clearly the prime cost, Production cost and Total Cost

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e ISBN 978-967-2762-26-3

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