



Cost Accounting

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OBJECTIVE OF THE SUBJECT

To enable the students to know the importance of costing and to understand the basic concepts.

UNIT – I

Definition, Scope and nature of cost accounting - cost concepts - classification - objectives and advantages - demerits of cost accounting - methods and techniques - cost unit - cost centres - cost sheet.

Sacrificed resource to obtain something



Process of ascertaining costs



Process of accounting for costs



Practice of costing and cost accounting



COST, COSTING, COST ACCOUNTING AND COST ACCOUNTANCY

**Cost
means**

The amount of expenditure (actual or notional) incurred on, or attributable to, a given thing, but the interpretation of the term depends on a number of factors like nature of business or industry. Moreover, it is difficult to determine an exact cost or a true cost because no figure of cost is true under all circumstances and for all purposes.

The classifying, recording and appropriate allocation of expenditure for the determination of the costs of products or services; the relation of these costs to sales values; and the ascertainment of profitability. In general, it is understood as process for determining cost.

**Costing
means**

Cost Accounting

Cost Accounting is usually considered as the next step to costing. It involves meticulously accurate analyzing, standardising, forecasting and comparing relevant costing data so as to interpret and report various concern areas to management. Its scope includes preparation of budgets, determination of standard costs based on technical estimates, identifying variances and reasons there of, etc...

*Cost Accountancy envisages application of costing and cost accounting in a business setup. It includes determination of selling price and profitability in addition to forecasting of expenses and future probable incomes. It facilitates management with cost control initiatives, ascertainment of profitability and informed decision making. Besides, costing and cost accounting, the following are also covered under cost accountancy: **Cost Reduction** is aimed at achieving real and permanent reduction in the unit cost of goods produced or services rendered without compromising the quality or suitability. **Cost Control** refers to search for better and more economical ways of completing the current operations. It simply identifies and prevents waste within the existing environment. **Cost Audit** includes the verification of cost accounts and a check on their adherence to the cost accounting principles, plans, procedures and objectives.*

Cost Accountancy

OBJECTIVES OF COST ACCOUNTING

A) To ascertain the Costs under different situations using different techniques and systems of costing

B) To determine the selling prices under different circumstances

C) To determine and control efficiency by setting standards for Materials, Labour and Overheads

D) To determine the value of closing inventory for preparing financial statements of the concern

(E) To provide a basis for operating policies which may be determination of Cost Volume relationship, whether to close or operate at a loss, whether to manufacture or buy from market, whether to continue the existing method of production or to replace it by a more improved method of production....etc

SCOPE OF COST ACCOUNTANCY

The scope of Cost Accountancy is very wide and includes the following:-

- (a) Cost Ascertainment: The main objective of Cost Accounting is to find out the Cost of product /services rendered with reasonable degree of accuracy.*
- (b) Cost Accounting: It is the process of Accounting for Cost which begins with recording of expenditure and ends with preparation of statistical data.*
- (c) Cost Control: It is the process of regulating the action so as to keep the element of cost within the set parameters.*
- (d) Cost Reports: This is the ultimate function of Cost Accounting. These reports are primarily prepared for use by the management at different levels. Cost reports helps in planning and control, performance appraisal and managerial decision making.*
- (e) Cost Audit: Cost Audit is the verification of correctness of Cost Accounts and check on the adherence to the Cost Accounting plan. Its purpose is not only to ensure the arithmetic accuracy of cost records but also to see the principles and rules have been applied correctly.*

NATURE OF COST ACCOUNTING

- ❁ *Cost accounting is a special branch of accounting having its own specific significance based on double entry system.*
- ❁ *It ascertains cost of products and services through the process of accumulation, classification, analysis and recording.*
- ❁ *It determines the cost of incomplete work or job.*
- ❁ *The extensive use of this system involves application of statistical data, control methods & techniques and determining profitability.*
- ❁ *This system provides measures for control and guidance for various levels of management.*
- ❁ *Helpful in decision making process.*

COST CONCEPT

The term 'cost' does not have a definite meaning and its scope is extremely broad and general. It is, therefore, not easy to define or explain this term without leaving any doubt concerning its meaning. Cost accountants, economists and others develop the concept of cost according to their needs because one complete description of 'cost' to suit all situations is not possible.

According to Cambridge International Dictionary of English, cost means 'the amount of money needed to buy, do or make something.' However, some authoritative definitions of cost are given below:

- 1. Cost is 'the amount of expenditure (actual or notional), incurred or attributable to a given thing.' (CIMA, London)*
- 2. 'A cost is the value of economic resources used as a result of producing or doing the things costed.' (W M Harper)*

CLASSIFICATION OF COST

The cost-classification is the process of grouping costs according to their characteristics.

1. According to Elements: The cost is classified into (i) Direct cost, and (ii) Indirect cost according to elements, viz., materials, Labour and Expenses.

2. According to Functions : The cost is classified into the following:

- Production Cost, or Manufacturing Cost, or Factory Cost,*
- Administration Cost,*
- Selling Cost,*
- Distribution Cost.*

3. According to Nature. The cost is classified into the following:

- Fixed Cost is “a cost which tends to be unaffected by variations in volume of output.*
- Variable Cost is “a cost which tends to vary directly with volume of output.*
- Semi-fixed or Semi-variable Cost is ‘a cost which is partly variable.’*

4. According to Controllability:

- ❖ *Controllable cost.* This is a cost which can be influenced by the action of a specified member of an undertaking.
- ❖ *Uncontrollable Cost.* It is the cost which cannot be influenced by the action of a specified member of an undertaking, such as fixed costs.

5. According to Normality: The cost is classified into

- (i) *Normal cost*, and (ii) *Abnormal cost*
- *Normal cost.* It is the cost at a given level of output in the condition at which that level of output is normally attained.
- *Abnormal cost.* It is a cost which is beyond normal cost.

6. According to Relevance to Decision-making and Control.

- *Shut-down Cost.* A cost which will be required to be incurred even though a plant is closed or shut-down for a temporary period, e.g., the cost of rent, rates, depreciation, maintenance expenses etc.

- **Sunk Cost.** A cost which has been incurred in the past or sunk in the past and is not relevant to the particular decision-making. E.g. written down book value of the plant.
- **Opportunity Cost:** The costs which are related to the sacrifice made or the benefits foregone are opportunity costs.
- **Imputed Cost.** It is a hypothetical cost required to be considered to make costs comparable. Interest on one's own capital.
- **Out-of-Pocket Cost.** A cost which will have to be paid to outsiders as against costs such as depreciation, which do not require any cash payment.
- **Replacement Cost.** It is the cost of replacing a material or assets, by purchase from the current market.
- **Marginal Cost.** Marginal cost refers to the increase or decrease in total cost caused due to increase or decrease in output by one single unit.

- **Differential Cost.** The change in total cost due to the change in method or technique of production or change in level of production is called differential cost.
- **Standard Cost.** Standard cost is a predetermined cost or estimate which is compared with the actual cost in order to determine variance and carry out an analysis of variance for cost control.
- **Relevant Cost.** The relevant costs are those costs which aid in making specific management decisions.

7. Product Cost & Period Cost: The product cost is the total of cost that is associated with a unit of product. The cost in forming the product viz., direct material, direct labor, factory overhead constitute the product cost. Period cost, on the other hand, are costs that tend to be unaffected by changes in level of activity during a given specific time period. E.g., Selling & distribution cost

ADVANTAGES OF COST ACCOUNTING

(i) A cost system reveals unprofitable activities, losses or inefficiencies occurring in any form such as:

(a) Wastage of man power, idle time and lost time.

(b) Wastage of material in the form of spoilage, excessive scrap etc., and

(c) Wastage of resources,

e.g. inadequate utilization of plant, machinery and other facilities.

(ii). Cost Accounting locates the exact causes for decrease or increase in the profit or loss of the business. It identifies the unprofitable products or product lines so that these may be eliminated or alternative measures may be taken.

(iii). Cost Accounts furnish suitable data and information to the management to serve as guides in making decisions involving financial considerations.

(iv) Cost Accounting is useful for price fixation purposes. Although sale price is generally related more to economic conditions prevailing in the market than to cost, the latter serves as a guide to test the adequacy of selling prices.

(v). With the application of Standard Costing and Budgetary Control methods, the optimum level of efficiency is set.

(vi) Cost comparison helps in cost control. Comparison may be period to period, of the figures in respect of the same unit or factory or of several units in an industry by employing Uniform Costs and Inter- Firm Comparison methods. Comparison may be made in respect of cost of jobs, process or cost centres.

(vii). A cost system provides ready figures for use by the Government, wage tribunals and boards, and labour and trade unions.

(viii) When a concern is not working to full capacity due to various reasons such as shortage of demands or bottlenecks in production, the cost of idle capacity can readily worked out and revealed to the management.

(ix) Introduction of a cost reduction programme combined with operations research and value analysis techniques leads to economy.

(x) Marginal Costing is employed for suggesting courses of action to be taken. It is a useful tool for the management for making decisions.

(xi). Determination of cost centres or responsibility centres to meet the needs of a Cost Accounting system, ensures that the organizational structure of the concern has been properly laid responsibility can be properly defined and fixed on individuals.

(xii) Perpetual inventory system which includes a procedure for continuous stock taking is an essential feature of a cost system.

(xiii) The operation of a system of cost audit in the organization prevents manipulation and fraud and assists in furnishing correct and reliable cost data to the management as well as to outside parties like shareholders, the consumers and the Government

LIMITATIONS OF COST ACCOUNTING

- *Cost Accounting is costly to operate: It involves heavy expenditure to operate. The benefits derived by operating the system are more than the cost.*
- *Cost Accounting involves many forms and statements: It involves usage of many forms and statements which leads to increase of paper work.*
- *Costing may not be applicable in all types of Industries: Existing methods of cost accounting may not be applicable in all types of industries. Cost accounting methods can be devised for all types of industries, and services.*

- ***It is based on Estimations:** Costing system relies on predetermined data and therefore it is not reliable. Costing system estimates costs scientifically based on past and present situations and with suitable modifications for the future. This leads to accurate cost figures based on which management can initiate decisions. But for the predetermined costs, cost accounting also becomes another 'Historical Accounting'.*
- ***It is not an exact science:** Like any others accounting system, it is not an exact science but an art that has developed through theories and practices.*
- ***Bias Judgments:** Many judgments are biased and depend on individual discretion.*
- ***Difference in opinion:** Different views are held by different cost accounts about the items to be includes in cost.*

METHODS OF COSTING

The fundamental principles of cost ascertainment remain the same but the methods of analysing and presenting these costs differ from industry to industry. Broadly, there are two main methods used to determine costs viz. Job Cost Method and Process Cost Method. However, the different methods of costing can be further bifurcated and can be explained in detail as follows:

JOB COSTING *This method is used for tracing specific costs to individual jobs especially where production is not highly repetitive. The cost ascertainment is for specific jobs or orders which are not comparable with each other. Job costing is commonly used in printing press, automobile garage, repair shops, etc.*

CONTRACT COSTING Principally, there is no difference between job and contract costing but it is convenient to prepare and maintain separate contract accounts when large scale contracts are carried out at different sites like in the case of building construction, ship builders, etc. A contract is a big job while a job is a small contract.

BATCH COSTING In this method of costing, a batch of similar products is considered as one job and the cost of the complete batch is ascertained. Thereafter, the cost of each unit is determined. Pharmaceutical industries, brick manufacturing companies generally use this method.

PROCESS COSTING If a product passes through different stages, each distinct and well-defined, with the output of one process becoming the input for the other, it is desirable to know the cost of production at each stage. Process costing is employed to ascertain the same. The system of costing is suitable for the extractive industries, e.g., chemical manufacture, paints, foods, explosives, soap making etc.

OPERATION COSTING The procedure of operation costing is broadly the same as for process costing except that cost unit is an operation instead of a process. For large undertakings involving a number of operations, it is important to compute the cost of each operation. For example, the manufacturing of handles for bicycles will make use of operation costing as it involves many operations like cutting steel sheets into proper strips, moulding, machining and finally polishing

UNIT COSTING (OUTPUT COSTING OR SINGLE COSTING) Under this method of costing, cost of a single product produced by a continuous manufacturing process is computed in addition to amount of each element of cost. The method is suitable in industries such as flour mills, paper mills, cement manufacturing etc.

OPERATING COSTING Also known as service costing, this method is employed to ascertain the cost of services rendered like transport companies, electricity companies, or railway companies.

The total expenses regarding operation are divided by the units as may be appropriate (e.g., total number of passenger-kms. in case of bus company) and cost per unit of service is calculated.

DEPARTMENTAL COSTING Departmental Costing aims to ascertain the cost of output of each department of the company separately.

MULTIPLE COSTING (COMPOSITE COSTING) Application of more than one method of costing for the same product is done under multiple costing. Herein, the costs of different sections of production are combined after finding out the cost of every part manufactured. It is applicable where a product comprises of many assembled parts, e.g., motor cars, engines, machine tools, typewriters, radios, cycles etc.

TECHNIQUES OF COSTING

In addition to the above stated methods, the following techniques of costing are used by management for the purpose of managerial decision-making and controlling costs.

MARGINAL COSTING

Marginal costing has been defined as 'the accounting system in which variable costs are charged to cost units and the fixed costs of the period are written-off in full against the aggregate contribution.' Fixed overheads are excluded on the ground that in cases where production varies, the inclusion of fixed overheads may give misleading results.

DIRECT COSTING

The practice of charging all direct costs to operation, process or products, excluding all indirect costs to be written off against profits in the period in which they arise, is referred to as direct costing. Direct costing The technique considers some fixed costs as direct costs in appropriate circumstances, thus differentiating it from marginal costing.

ABSORPTION COSTING

The Institute of Cost and Management Accountant of India defines absorption costing as —a method of costing by which all direct costs and applicable overheads are charged in products or cost centres for finding out the total cost of production. Absorbed cost includes production cost as well as administrative and other costs. Absorption costing does not make any difference between variable and fixed cost in the calculation of profits. It charges all costs, both variable and fixed, to operations, products or processes.

UNIFORM COSTING

Uniform costing refers to a technique of costing wherein standardised principles and methods of cost accounting are employed by a number of different companies and firms, thus, facilitating inter-firm comparisons, establishment of realistic pricing policies etc.

ACTIVITY BASED COSTING

It is a technique of —cost attribution to cost units on the basis of benefits received from indirect activities e.g. ordering, setting up, assuring quality. In other words, it is a method of assigning organisation's resource costs through activities (called cost drivers) to the products and services. It is generally used by a company having products that differ in volume and complexity of production for the purpose of apportionment of overhead costs.

Financial & Cost Accounting

No.	Basis	Financial Accounting	Cost Accounting
1.	Objective	Financial performance and position	Ascertain cost and cost control
2.	Costs and profits	Shows overall costs and profit / loss	Shows details for each product, process, job, contract, etc
3.	Control / Report	Emphasis on reporting	Emphasis on control and reporting
4.	Decision making	Limited use	Designed for decision making
5.	Responsibility	Does not fix responsibility	Can effectively fix responsibility
6.	Time frame	Focus on historical data	Focus on present and future
7.	Type of reports	General reports like P&L Account, Balance Sheet, Cash Flow Statement	Can generate special reports and analysis
8.	Legal need	Statutory requirement	Voluntary, except for some cases
9.	Transactions	Records external transactions	Records internal and external transactions
10.	Reader	Everybody	Internal management
11.	Formats	Standard, as per law	Tailor made
12.	Access	Everybody, except for some	Very limited access
13.	Unit of value	Monetary	Monetary and physical

Differences Between Management And Cost Accounting



vs



Basis	Management accounting	Cost Accounting
Objectives	Its objective is to assist managers providing accounting information for decision-making.	Its objective is to determine and record the cost of production of goods and services.
Scope	It has broad scope, and includes financial and cost accounting.	Its scope is limited in cost determination and record.
Sources of data	It uses both quantitative and qualitative data	It uses the quantitative data only.
Accounting principles	No specific principles like accounting and cost accounting.	Certain principles and procedures are followed in cost determination and allocation.
Nature	It uses past and present data in the projection of future.	It uses both past and present data and figure.