

**27**

COST ACCOUNTING : AN INTRODUCTION

After passing your senior secondary examination, if you set up a small manufacturing unit, say manufacturing of packing boxes, a problem will arise what price of each box you should quote to the buyer. Many factors are considered while fixing the price of a product/item such as competitors' price etc. One of the basic factors is the cost of its production. Cost is essential not only to fix price but also to ascertain the margin of profit. Knowledge of the cost determination is also necessary to keep a check on the cost of product/control on wastages, etc. The accounting used to study the various aspects of cost is known as cost accounting. In this lesson, you will learn about meaning, importance, limitations etc. of cost accounting.



OBJECTIVES

After studying this lesson, you will be able to:

- state the meaning and scope of cost accounting;
- explain the objectives of cost accounting;
- differentiate between cost accounting and financial accounting;
- state importance of cost accounting;
- explain limitations of cost accounting.

27.1 MEANING AND SCOPE OF COST ACCOUNTING

Cost accounting is the process of determining and accumulating the cost of product or activity. It is a process of accounting for the incurrence and the control of cost. It also covers classification, analysis, and interpretation of cost. In other words, it is a system of accounting, which provides the information about the ascertainment, and control of costs of products, or services. It measures the operating efficiency of the enterprise. It is an



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internal aspect of the organisation. Cost Accounting is accounting for cost aimed at providing cost data, statement and reports for the purpose of managerial decision making. The Institute of Cost and Management Accounting, London defines “Cost accounting is the process of accounting from the point at which expenditure is incurred or committed to the establishment of its ultimate relationship with cost centres and cost units. In the widest usage, it embraces the preparation of statistical data, application of cost control methods and the ascertainment of profitability of activities carried out or planned”.

Costing includes “the techniques and processes of ascertaining costs.” The ‘Technique’ refers to principles which are applied for ascertaining costs of products, jobs, processes and services. The ‘process’ refers to day to day routine of determining costs within the method of costing adopted by a business enterprise.

Costing involves “the classifying, recording and appropriate allocation of expenditure for the determination of costs of products or services; the relation of these costs to sales value; and the ascertainment of profitability”.

Scope of Cost Accounting

The terms ‘costing’ and ‘cost accounting’ are many times used interchangeably. However, the scope of cost accounting is broader than that of costing. Following functional activities are included in the scope of cost accounting:

1. *Cost book-keeping*: It involves maintaining complete record of all costs incurred from their incurrence to their charge to departments, products and services. Such recording is preferably done on the basis of double entry system.
2. *Cost system*: Systems and procedures are devised for proper accounting for costs.
3. *Cost ascertainment*: Ascertaining cost of products, processes, jobs, services, etc., is the important function of cost accounting. Cost ascertainment becomes the basis of managerial decision making such as pricing, planning and control.
4. *Cost Analysis*: It involves the process of finding out the causal factors of actual costs varying from the budgeted costs and fixation of responsibility for cost increases.



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5. *Cost comparisons:* Cost accounting also includes comparisons between cost from alternative courses of action such as use of technology for production, cost of making different products and activities, and cost of same product/ service over a period of time.
6. *Cost Control:* Cost accounting is the utilisation of cost information for exercising control. It involves a detailed examination of each cost in the light of benefit derived from the incurrence of the cost. Thus, we can state that cost is analysed to know whether the current level of costs is satisfactory in the light of standards set in advance.
7. *Cost Reports:* Presentation of cost is the ultimate function of cost accounting. These reports are primarily for use by the management at different levels. Cost Reports form the basis for planning and control, performance appraisal and managerial decision making.

Objectives of cost accounting

There is a relationship among information needs of management, cost accounting objectives, and techniques and tools used for analysis in cost accounting. Cost accounting has the following main objectives to serve:

1. Determining selling price,
2. Controlling cost
3. Providing information for decision-making
4. Ascertaining costing profit
5. Facilitating preparation of financial and other statements.

1. Determining selling price

The objective of determining the cost of products is of main importance in cost accounting. The total product cost and cost per unit of product are important in deciding selling price of product. Cost accounting provides information regarding the cost to make and sell product or services. Other factors such as the quality of product, the condition of the market, the area of distribution, the quantity which can be supplied etc., are also to be given consideration by the management before deciding the selling price, but the cost of product plays a major role.

2. Controlling cost

Cost accounting helps in attaining aim of controlling cost by using various techniques such as Budgetary Control, Standard costing, and inventory control. Each item of cost [viz. material, labour, and expense]



Notes

is budgeted at the beginning of the period and actual expenses incurred are compared with the budget. This increases the efficiency of the enterprise.

3. Providing information for decision-making

Cost accounting helps the management in providing information for managerial decisions for formulating operative policies. These policies relate to the following matters:

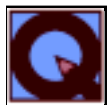
- (i) Determination of cost-volume-profit relationship.
- (ii) Make or buy a component
- (iii) Shut down or continue operation at a loss
- (iv) Continuing with the existing machinery or replacing them by improved and economical machines.

4. Ascertaining costing profit

Cost accounting helps in ascertaining the costing profit or loss of any activity on an objective basis by matching cost with the revenue of the activity.

5. Facilitating preparation of financial and other statements

Cost accounting helps to produce statements at short intervals as the management may require. The financial statements are prepared generally once a year or half year to meet the needs of the management. In order to operate the business at high efficiency, it is essential for management to have a review of production, sales and operating results. Cost accounting provides daily, weekly or monthly statements of units produced, accumulated cost with analysis. Cost accounting system provides immediate information regarding stock of raw material, semi-finished and finished goods. This helps in preparation of financial statements.



INTEXT QUESTIONS 27.1

Fill in the blanks with correct word/words.

- (i) process of accounting for the incurrence of cost and the control of cost.
- (ii) The objective of determining the of products is of main importance in cost accounting.



- (iii) Cost accounting provides information regarding the cost to make and product or services.
- (iv) Cost accounting helps the management in providing information for decisions for formulating operative policies.
- (v) A system provides immediate information regarding stock of raw material, semi-finished and finished goods.

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27.2 DIFFERENCE BETWEEN FINANCIAL ACCOUNTING AND COST ACCOUNTING

After studying financial accounting and cost accounting, you can understand the difference between these two accounting systems. Therefore, difference between financial accounting and cost accounting is as follows:

Table 27.1 Differences between financial accounting and cost accounting

Basis	Financial Accounting	Cost accounting
(i) Objective	It provides information about the financial performance and financial position of the business.	It provides information of ascertainment of cost to control cost and for decision making about the cost.
(ii) Nature	It classifies records, presents and interprets transactions in terms of money.	It classifies, records, presents, and interprets in a significant manner the material, labour and overheads cost.
(iii) Recording of data	It records Historical data.	It also records and presents the estimated/budgeted data. It makes use of both the historical costs and pre-determined costs..
(iv) Users of information	The users of financial accounting statements are shareholders, creditors, financial analysts and government and its agencies, etc.	The cost accounting information is used by internal management at different levels.
(v) Analysis of costs and profits	It shows the profit/ loss of the organisation.	It provides the details of cost and profit of each product, process, job, contracts, etc.
(vi) Time period	Financial Statements are prepared for a definite period, usually a year.	Its reports and statements are prepared as and when required.
(vii) Presentation of information	A set format is used for presenting financial information.	There are not any set formats for presenting cost information.



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In spite of the above differences, both financial and cost accounting are in agreement regarding actual cost data and product costing analysis. Values of stock and cost of goods produced and sold are the main examples. For the preparation of the position statement, financial accountant receives the necessary data from the cost accountant.

Importance of Cost accounting

The limitation of financial accounting has made the management to realise the importance of cost accounting. The importance of cost accounting are as follows:

1. Importance to Management

Cost accounting provides invaluable help to management. It is difficult to indicate where the work of cost accountant ends and managerial control begins. The advantages are as follows :

Helps in ascertainment of cost

Cost accounting helps the management in the ascertainment of cost of process, product, Job, contract, activity, etc., by using different techniques such as Job costing and Process costing.

Aids in Price fixation

By using demand and supply, activities of competitors, market condition to a great extent, also determine the price of product and cost to the producer does play an important role. The producer can take necessary help from his costing records.

Helps in Cost reduction

Cost can be reduced in the long-run when cost reduction programme and improved methods are tried to reduce costs.

Elimination of wastage

As it is possible to know the cost of product at every stage, it becomes possible to check the forms of waste, such as time and expenses etc., are in the use of machine equipment and material.

Helps in identifying unprofitable activities

With the help of cost accounting the unprofitable activities are identified, so that the necessary correct action may be taken.



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Helps in checking the accuracy of financial account

Cost accounting helps in checking the accuracy of financial account with the help of reconciliation of the profit as per financial accounts with the profit as per cost account.

Helps in fixing selling Prices

It helps the management in fixing selling prices of product by providing detailed cost information.

Helps in Inventory Control

Cost furnishes control which management requires in respect of stock of material, work in progress and finished goods.

Helps in estimate

Costing records provide a reliable basis upon which tender and estimates may be prepared.

2. Importance to Employees

Worker and employees have an interest in which they are employed. An efficient costing system benefits employees through incentives plan in their enterprise, etc. As a result both the productivity and earning capacity increases.

3. Cost accounting and creditors

Suppliers, investor's financial institution and other moneylenders have a stake in the success of the business concern and therefore are benefited by installation of an efficient costing system. They can base their judgement about the profitability and prospects of the enterprise upon the studies and reports submitted by the cost accountant.

4. Importance to National Economy

An efficient costing system benefits national economy by stepping up the government revenue by achieving higher production. The overall economic developments of a country take place due to efficiency of production.

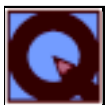
5. Data Base for operating policy

Cost Accounting offers a thoroughly analysed cost data which forms the basis of formulating policy regarding day to day business, such as:



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- (a) Whether to make or buy decisions from outside?
- (b) Whether to shut down or continue producing and selling at below cost?
- (c) Whether to repair an old plant or to replace it?



INTEXT QUESTIONS 27.2

Write against each of the following indicating the party i.e. management, employees and creditors, benefitted from cost accounting :

1. Using budgetary control and standard costing, costing used to control material cost, labour cost, etc.
2. Installation of an efficient costing system results in the increase in productivity and earnings capacity.
3. Studies and reports submitted by the cost accountant enables judging the profitability and prospects of the enterprise.
4. It enables to check the wastage in term of time and expenses.

27.3 LIMITATIONS OF COST ACCOUNTING

Like other branches of accounting, cost accounting is not an exact science but is an art which has developed through theories and accounting practices based on reasoning and common sense. These practices are not static but changing with time. Cost accounting lacks a uniform procedure. There is no stereotyped system of cost accounting applicable to all industries. There are widely recognised cost concepts but understood and applied differently by different industries. Cost accounting can be used only by big enterprises. The limitations of cost accounting are as follows:

- It is expensive because analysis, allocation and absorption of overheads require considerable amount of additional work.
- The results shown by cost accounts differ from those shown by financial accounts. Preparation of reconciliation statements frequently is necessary to verify their accuracy. This leads to unnecessary increase in workload.



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- It is unnecessary because it involves duplication of work. Some industrial units are functioning efficiently without any costing system.
- Costing system itself does not control costs. If the management is alert and efficient, it can control cost without the help of the cost accounting. Therefore it is unnecessary.



INTEXT QUESTIONS 27.3

Write in one sentence how in the following cases it is a limitation of cost accounting :

1. It is expensive.

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2. It increases the workload

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3. It is unnecessary for cost control.

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WHAT YOU HAVE LEARNT

- Cost accounting is the process of determining and accumulating the cost of product or activity.
- There is a relationship among information needs of management, cost accounting objectives, and techniques and tools used for analysis in cost accounting. Cost accounting has the following main objectives:

Determining selling price,

Controlling cost

Providing information for decision-making



Notes

Ascertaining costing profit

Facilitating preparation of financial and other statements.

- Difference between Financial accounting and Cost accounting:

After studying financial accounting and cost accounting, you can understand the difference between these two accounting systems.

Objective	Nature
Recording of data	Accounting system
Users of information	Analysis of costs and profits
	Presentation of information

- **Importance of Cost accounting**

Importance to Management:

Importance to Employees

Cost accounting and creditors

Importance to National Economy

- **Limitations of cost accounting**

It is expensive

The results shown by cost accountant differ from those shown by financial accountant.

It is unnecessary because it involves duplication of work.



TERMINAL QUESTIONS

1. State the meaning and scope of cost accounting.
2. Explain the objectives of cost accounting.
3. Differentiate between cost accounting and financial accounting
4. What is the importance of cost accounting in a production unit?
5. State the limitation of cost accounting.



ANSWER TO INTEXT QUESTIONS



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Intext Question 27.1

- (i) Cost accounting (ii) cost (iii) sell
(iv) managerial (v) cost accounting

Intext Question 27.2

1. Management 2. Employees 3. Creditors
4. Management

Intext Question 27.3

1. Analysis, allocation etc. of cost requires additional work
2. Preparation of reconciliation statements
3. Management can control cost without the help of cost accounting

Do you know?



Why don't animals get HIV?

If you look at the full form of HIV, you will see that it is 'HUMAN' Immunodeficiency Virus. It is very specific to humans. Studies have shown that HIV does not survive in any other animal other than human beings. It supposedly originated among primates in Africa. Non human primates carried the virus without suffering from the disease.