Introduction into Cost Accounting

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Learning Objectives:

- Introduction
- Meaning of cost accounting.
- Relationship between cost accounting, management accounting & financial accounting.
- Limitations of financial accounting.
- Scope of cost accounting.
- Objectives of cost accounting.
- Advantages of cost accounting.
- Limitations of cost accounting.
- General principles of cost accounting.
- Cost- Analysis, Concepts, Classification And Cost Sheet.
- Elements of cost.

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An Introduction to Cost Terms

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Costs and Cost Objects:

Cost

- a resource sacrificed or foregone to achieve a specific objective.

Cost Object

- any product, machine, service or process for which cost information is accumulated.
- cost objects can vary in size from an entire company, to a division or program within the company, or down to a single product or service.

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Direct and Indirect Costs:

Direct Cost

- A cost which is related to a particular cost objective and can be traced to it in an economically feasible way.

Indirect Cost

- A cost which is related a particular cost objective but cannot be traced to it in an economically feasible way.

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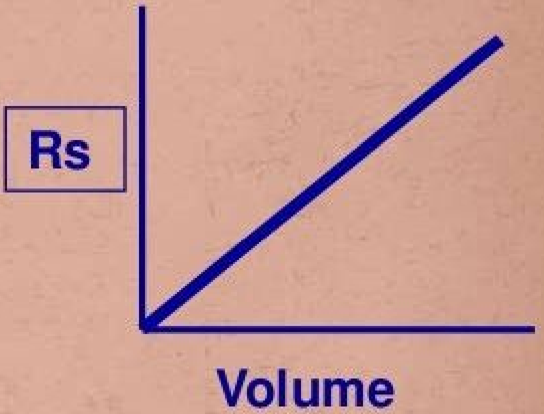
Variable and Fixed Costs:

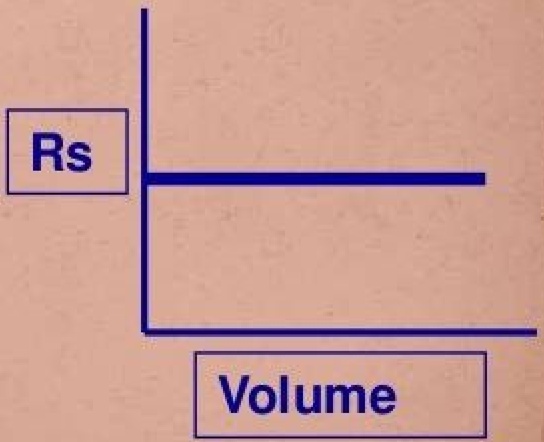
Variable Cost

- a cost which is constant per unit but changes in total in proportion to changes in the output
- materials (parts), fuel costs for a trucking company



Fixed Cost

- **a cost which does not change in total as volume changes but changes on a per-unit basis as the cost driver increases and decreases**
- **amortization, insurance**



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Total Costs and Unit Costs:

Unit Cost (or Average Cost)

- Total cost / number of units

Average cost

= Total manufacturing costs / Number of units produced

= Rs980,000 / 10,000

= Rs98 per unit

- **Unit or average costs must be interpreted with caution**
- **As volume increases, the unit or average cost falls as the fixed costs are spread over a larger number of units**

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Definition:

Chartered Institute Of Management Accountants (CIMA London) Defines cost accounting as;

"Costing is the technique and process of ascertaining cost"

CIMA Chartered Institute of Management Accountants

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Cost Accounting:

- *Cost accounting* 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 the purpose of control and guidance of management.

Cost Accounting:

- Cost accounting is that branch of accounting which measures and reports information relating to the cost of acquiring and utilizing resources.
- Cost accounting provides information for both management and financial accounting.
- Cost management describes the approaches and activities of managers in short-run and long-run planning and control decisions.
- These decisions increase value of customers and lower costs of products and services.
- Cost & management accounting is an integral part of a company's strategy.

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Cost Accounting:

- Financial accounting provide information to external parties i.e.
  - Investors
  - Creditors
  - Regulators/govt.
- Managerial accounting provide information to internal users such as
  - Managers
- Cost accounting provide information to both internal and external users
  - Product cost information

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Relationship of Financial Accounting, Management Accounting, and Cost Accounting

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LIMITATIONS OF FINANCIAL ACCOUNTING

- *No clear idea of operating efficiency:* Financial accounting does not give a clear picture of operating efficiency when prices are rising or decreasing on account of inflation or trade depression.

- *Not helpful in the price fixation:* In financial accounting costs are not available as an aid in determining prices of the products, services, production order and lines of products.

- *No control on cost:* It does not provide for proper control of materials and supplies, wages, labour and overheads.

- *Provides only historical information:* Financial accounting is mainly historical and tells about the cost already incurred. It does not provide day to day cost information to management for making effective plans for the coming year and the period after that as financial data are summarized at the end of the accounting period.

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Scope of cost accounting:

The scope of cost accounting is very wide and includes the following;

❖*Cost ascertainment:* It deals with the collection and analysis of expenses, the measurement of production of the different products at the different stages of manufacture and the linking up of production with the expenses. For linking up of production with the expenses the different techniques of costing such as Marginal cost technique, the total cost technique, direct cost technique etc. have been evolved.

❖*Cost accounting:* It is the process of accounting for cost which begins with recording of expenditure and ends with the preparation of statistical data.

❖*Cost control:* Cost control is the guidance and regulation by executive action of the costs of operating an undertaking. It aims at *guiding* the actual performance towards the line of targets; *regulates* the actuals if they deviate or vary from the targets; this guidance and regulation is done by an *executive* action.

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Objectives of cost accounting:

The following are the main objectives of cost accounting:

- ❖To ascertain the cost per unit of the different products manufactured by a business concern;
- ❖To provide a correct analysis of cost both by process or operations and by different elements of cost;
- ❖To disclose sources of wastage whether of material, time or expense or in the use of machinery and tools.
- ❖To provide requisite data and serve as a guide for fixing prices of products manufactured or services rendered;
- ❖To help in the preparation of budget and implementation of budgetary control;
- ❖To guide management in the formation and implementation of incentive bonus plans based on productivity and cost saving;
- ❖To organize the cost reduction programmes with the help of different departmental managers;
- ❖To find out costing profit or loss by identifying with revenues the costs of those products or services by selling which the revenues have resulted;

Advantages of cost accounting:

The main advantages of cost accounting are as follows;

- ❖Profitable and unprofitable activities are disclosed;
- ❖It enables a concern to measure the efficiency and then to maintain and improve it;
- ❖It provides information upon which estimates and tenders are based;
- ❖It guides future production policies;
- ❖It helps in increasing profits;
- ❖It enables periodical determination of profits or losses;
- ❖It furnishes reliable data for comparing costs in different periods;
- ❖The exact cause of a decrease or an increase in profit or loss can be detected;
- ❖A sound business concern with a good system of costing can attract more investors;
- ❖Helpful to the government;
- ❖Represents efficiency of public enterprises;

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Limitations of Cost accounting:

1. The system is more complex:
2. It is expensive:
3. Inapplicability of costing method and technique.
4. Not suitable for small scale units:
5. Lack of Accuracy:
6. Lacks social Accounting:
7. Need preparation of frequent reconciliation to verify accuracy.
8. Duplication of Work:
9. Use of Secondary Data:
10. Does not control Cost by itself:
11. It is based on estimation and previous data:
12. It only bring out the cost of goods or services.
13. It serves the information need of the management:
14. Not useful for determining the tax liabilities:

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General principles of cost accounting:

1) Cause and effect relationship; cause & effect relationship should be established for each item of cost.

2) Charge of cost only after its incurrence; cost should include only those costs which have been actually incurred. For example unit cost should not be charged with selling cost while it is still in factory.

3) Past costs should not form part of future costs; past cost (which could not be recovered in past)should not be recovered from future costs.

4) Exclusion of abnormal costs from cost accounts; All cost incurred because of abnormal reasons (like theft, negligence) should not be taken into consideration while computing the unit cost.

5) Principle of double entry should be followed preferably;

Elements of cost:

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Elements of cost:

By grouping of the above elements of cost, the following divisions of cost are obtained:

1. Prime cost = Direct material + Direct labour + Direct expenses
2. Works or Factory cost = Prime cost + works or factory overheads
3. Cost of Production = Works cost + Administration overheads
4. Total cost or cost of sales = Cost of Production + Selling and Distribution overheads

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Elements of Cost:

Direct Material :-

Identify in the product

Easily measure & directly charge to the product

e.g. Timber in furniture making

Categories

- raw material
- Specifically purchased for specific job or process
- Parts or components purchased.

  e.g. tyres for cycles
- Primary Packing material

  to protect finished product

  for easy handling inside the factory.

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Direct labour :-

labour engaged in

- converting raw material into finished goods
- Altering the construction
- Actual Production
- Composition of Product

i.e. labour which can be attributed to a particular job, product or process

Exception :- Where the cost is not significant like

wages of trainees- their labour though directly spent on product is not treated as direct labour

Test:-

- Easily Identify
- Feasible to Identify

Overheads :- It may be defined as the aggregate of the cost of indirect materials, indirect labour and such other expenses including services as can't conveniently be charged direct to specific cost unit.

Categories:-

- Manufacturing Overheads
- Administration of machines
- Selling & distribution of machines

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Cost Sheet or statement of cost

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Cost Sheet:

It is a statement designed to show the output of a particular accounting period along with breakup of cost.

- It is a memorandum statement
- It does not form part of double entry cost accounting records.
- It discloses the total cost and cost per unit.
- It helps

  To fix Selling Price.

  To submit quotation price.

  To Control cost.

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- COST SHEET

	Total Cost	Cost Per unit
Direct Materials Direct labour Prime Cost		
Add: Works Overheads Works Cost		
Add: Administration overheads Cost of Production		
Add: Selling & Distribution Overheads Total Cost or Cost of Sales		

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THANK YOU