Introduction

Cost Accounting is a branch of accounting and has been developed due to limitations of financial accounting. Financial accounting is primarily concerned with record keeping directed towards the preparation of Profit and Loss Account and Balance Sheet. It provides information regarding the profit and loss that the business enterprise is making and also its financial position on a particular date. The financial accounting reports help the management to control in a general way the various functions of the business but it fails to give detailed reports on the efficiency of various divisions. The limitations of Financial Accounting which led to the development of cost accounting are as follows.

Limitations of Financial Accounting

1. No clear idea of operating efficiency: Sometimes profits in an organization may be less or more because of inflation or trade depression and not due to efficiency or inefficiency. But financial accounting does not give a clear reason for profit or loss.

2. Weakness not spotted out by collective results: Financial Accounting shows the net result of an organization. When the profit and loss account of an organization, shows less profit or a loss, it does not give the reason for it or it does not show where the weakness lies.

3. Does not help in fixing the price: In Financial Accounting, we get the total cost of production but it does not aid in determining prices of the products, services, production order and lines of products.

4. No classification of expenses and accounts: In Financial Accounting, we don't get data relating to costs incurred by departments, processes separately or per unit cost of product lines, or cost incurred in various sales territories. Further expenses are not classified as direct or indirect, controllable and uncontrollable overheads and the value added in each process is not reported.

5. No data for comparison and decision making: It does not supply useful data to management for comparison with previous period and for taking various financial decisions as introduction of new products, replacement of labour by machines, price in normal or special circumstances, producing a part in the factory or buying it from outside market, production of a product to be continued or given up, priority accorded to different products, investment to be made in new products or not etc.

6. No control on cost: Financial Accounting does not help to control materials, supplies, wages, labour and overhead costs.

7. Does not provide standards to assess the performance: Financial Accounting does not help in developing standards to assess the performance of various persons or departments. It also does not help in checking that costs do not exceed a reasonable limit for a given quantum of work of the requisite quality

. 8. Provides only historical information: Financial Accounting records only the historical costs incurred. It does not provide day-to-day cost information to the management for making effective plans for the future.

9. No analysis of losses: It does not provide complete analysis of losses due to defective material, idle time, idle plant and equipment etc.. In other words, no distinction is made between avoidable and unavoidable wastage.

10. Inadequate information for reports: It does not provide adequate information for reports to outside agencies such as banks, government, insurance companies and trade associations. 11. No answer for certain questions: Financial Accounting will not help to answer questions like:(a) Should an attempt be made to sell more products or is the factory operating to capacity? (b) if an order or contract is accepted, is the price obtainable sufficient to show a profit? (c) if the manufacture or sale of product A were discontinued and efforts make to increase the sale of B, what would be the effect on the net profit? (d) Why the profit of last year is of such a small amount despite the fact that output was increased substantially

DEFINITION

The costing terminology of C.I.M.A, London defines cost accounting as "the process of accounting for costs from the point at which expenditure is incurred or committed to the establishment of its ultimate relationship with cost centers and cost units. In its widest usage, it embraces the preparation of statistical data, the application of cost control methods and the ascertainment of profitability of activities carried out or planned". Wheldon defines cost accounting as "classifying, recording and appropriate allocation of expenditure for determination of costs of products or services and for the presentation of suitably arranged data purposes of control and guidance of management". It is thus a formal mechanism by means of which costs of products or services are ascertained and controlled.

Objectives of Cost Accounting

Following are the main objectives of cost accounting are the following.

1. To ascertain cost

2. To control cost

3. To determine selling price

4.to ascertain profitability on each activity

5. to prepare financial account

6. to measure efficiency

7. to assist management for decision making

8. to control and reduce wastage

COST ACCOUNTING AND FINANCIAL ACCOUNTING

Both financial accounting and cost accounting are concerned with systematic recording and presentation of financial data. Financial accounting reveals profits and losses of the business as a whole during a particular period, while cost accounting shows, by analysis and localization, the unit costs and profits and losses of different product lines. The main difference between financial accounting and cost accounting are summarized below.

1. Financial accounting aims at safeguarding the interests of the business and its proprietors and others connected with it. This is done by providing suitable information to various parties, such as shareholders or partners, present or prospective creditors etc. Cost accounting on the other hand, renders information for the guidance of the management for proper planning, operation, control and decision making.

2. Financial accounts are kept in such a way as to meet the requirements of the Companies Act, Income Tax Act and other statues. On the other hand cost accounts are generally kept voluntarily to meet the requirements of the management. But now the Companies Act has made it obligatory to keep cost records in some manufacturing industries.

3. Financial accounting emphasizes the measurement of profitability, while cost accounting aims at ascertainment of costs and accumulates data for this very purpose

4. Financial accounts disclose the net profit and loss of the business as a whole, whereas cost accounts disclose profit or loss of each product, job or service. This enables the management to eliminate less profitable product lines and maximize the profits by concentrating on more profitable ones.

5. Financial accounting provides operating results and financial position usually gives information through cost reports to the management as and when desired.

6. Financial accounts deal mainly with actual facts and figures, but cost accounts deal partly with facts and figures, but cost accounts deal with facts and figures and partly with estimates.

7. In case of financial accounts stress is on the ascertainment and exhibition of profits earned or losses incurred in the business. On account of this reason in financial accounts, the transactions are recorded, classified and analyzed in a subjective manner i.e. according to the nature of expenditure. In cost accounts the emphasis is more on aspects of planning and control and therefore transactions are recorded in an objective manner.

8. Financial accounts are concerned with external transactions i.e. transactions between the business concern on one side and third parties on the other. These transactions form the basis for payment or receipt of cash. While cost accounts are concerned with internal transactions which do not form the basis of payment or receipt of cash.

9. The costs are reported in aggregate in financial accounts but costs are broken into unit basis in cost accounts.

10. Financial accounts do not provide information on the relative efficiencies of various workers, plants and machinery while cost accounts provide valuable information on the relative efficiencies of various plants and machinery.

11. In financial accounts stocks are valued at cost or market price whichever is less, whereas stocks are valued at cost price in cost accounts.

Importance of Cost Accounting

Following are the importance of cost accounting:

a) Costing as an aid to management:- Cost accounting provides invaluable aid to management. It provides detailed costing information to the management to enable them to maintain effective control over stores and inventories

b) Costing as an aid to Creditors.

Investors, banks and other money lending institutions have a stake in the success of the business concern are therefore benefitted immensely by the installation of an efficient system of costing. They can base their judgment about the profitability and future prospects of the enterprise on the costing records.

c) Costing as an aid to employees. Employees have a vital interest in their employer's enterprise in which they are employed. They are benefited by a number of ways by the installation of an efficient system of costing. They are benefited, through continuous employment and higher remuneration by way of incentives, bonus plans, etc.

d) Costing as an aid to National Economy

An efficient system of costing brings prosperity to the business enterprise which in turn brings prosperity to the business enterprise which in turn results in stepping up of the government revenue. The overall economic development o f a country takes place as a consequence of increase in efficiency of production. Control of costs, elimination of wastages and inefficiencies led to the progress of the industry and, in consequence of the nation as a whole.

Cost units- The Chartered Institute of Management Accountants, London, defines a unit of cost as "a unit of quantity of product, service or time in relation to which costs may be ascertained or expressed".

The forms of measurement used as cost units are usually the units of physical measurements like number, weight, area, length, value, time etc.

Following are some examples of cost unit.

Industry/product Cost unit basis

Automobile Numbers

Brick works per 1000 bricks

Cement per Tonne

Chemicals Litre, gallon, kilogram, ton

Steel Tonne

Sugar Tonne

Transport Passenger-kilometre, tonne kilometer Cost centre – According to Chartered Institute of Management Accountants, London, cost centre means "a location, person or item of equipment (or group of these) for which costs may be ascertained and used for the purpose of cost control". Cost centre is the smallest organizational subunit for which separate cost collection is attempted. Thus cost centre refers to one of the convenient unit into which the whole factory organization has been appropriately divided for costing purposes. Each such unit consists of a department or a sub-department or item of equipment or , machinery or a person or a group of persons.

Profit centre– A profit centre is that segment of activity of a business which is responsible for both revenue and expenses and discloses the profit of a particular segment of activity. Profit centres are created to delegate responsibility to individuals and measure their performance.

Difference between Profit centre and Cost centre

The various points of difference between Profit centre and cost centre are as follows. Cost centre is the smallest unit of activity or area of responsibility for which costs are collected whereas a profit centre is that segment of activity of a business which is responsible for both revenue and expenses.

(i) Cost centres are created for accounting conveniences of costs and their control whereas as a profit centre is created because of decentralization of operations i.e., to delegate responsibility to individuals who have greater knowledge of local conditions etc.

(ii) Cost centers are not autonomous whereas profit centres are autonomous.

(iii) A cost centre does not have target cost but efforts are made to minimize costs, but each profit centre has a profit target and enjoys authority to adopt such policies as are necessary to achieve its targets.

(iv) There may be a number of cost centres in a profit centre in a profit centre as production or service cost centres or personal or impersonal but a profit centre may be a subsidiary company within a group or division in a company.

Types, Methods and Techniques of Costing

The general fundamental principles of ascertaining costs are the same in every system of cost accounting, but the methods of analysis and presenting the costs vary from industry to industry. Different methods are used because business enterprises vary in their nature and in the type of products or services they produce or render. Basically, there are two principal methods of costing, namely (i) Job Costing, and (ii) Process costing.

1. Job costing: It refers to a system of costing in which costs are ascertained in terms of specific jobs or orders which are not comparable with each other. Industries where this method of costing is generally applied are Printing Process, Automobile Garages, Repair Shops, Shipbuilding, House building, Engine and Machine construction, etc. Job Costing includes the following methods of costing:

(a) Contract Costing: Although contract costing does not differ in principle from job costing, it is convenient to treat contract cost accounts separately. The term is usually applied to the costing method adopted where large scale contracts at different sites are carried out, as in the case of building construction.

(b) Bach Costing: This method is also a type of job costing. A batch of similar products is regarded as one job and the cost of this complete batch is ascertained. It is then used to determine the unit cost of the articles produced. It should, however, be noted that the articles produced should not lose their identity in manufacturing operations. (c) Terminal Costing: This method is also a type of job costing. This method emphasizes the essential nature of job costing, ie, the cost can be properly terminated at some point and related to a particular job.

(d) Operation Costing: This method is adopted when it is desired to ascertain the cost of carrying out an operation in a department, for example, welding. For large undertaking, it is frequently necessary to ascertain the cost of various operations.

2. Process Costing: Where a product passes through distinct stages or processes, the output of one process being the input of the subsequent process, it is frequently desired to ascertain the cost of each stage or process of production. This is known as process costing. This method is used where it is difficult to trace the item of prime cost to a particular order because its identity is lost in volume of continuous production. Process costing is generally adopted in textile industries, chemical industries, oil refineries, soap manufacturing, paper manufacturing, tanneries, etc.

3. Unit or single or output or single output costing: This method is used where a single article is produced or service is rendered by continuous manufacturing activity. The cost of the whole production cycle is ascertained as a process or series of processes and the cost per unit is arrived at by dividing the total cost by the number of units produced. The unit of costing is chosen according to the nature of the product. Cost statements or cost sheets are prepared under which various items of expenses are classified and the total expenditure is divided by total quantity produced in order to arrive at unit cost of production. This method is suitable in industries like brick-making, collieries, flour mills, cement manufacturing, etc. this method is useful for the assembly department in a factory producing a mechanical article eg. Bicycle.

4. Operating Costing: This method is applicable where services are rendered rather than goods produced. The procedure is same as in the case of single output costing. The total expenses of the operation are divided by the units and cost per unit of services is arrived at. This method is employed in Railways, Road Transport, Water supply undertakings, Telephone services, Electricity companies, Hospital services, Municipal services, etc.

5. Multiple or Complete Costing: Some products are so complex that no single system of costing is applicable. It is used where there are a variety of components separately produced and subsequently assembled in a complex production. Total cost is ascertained by computing component costs which are collected by job or process costing and then aggregating the costs through use of the single or output costing system. This method is applicable to manufacturing concerns producing Motor Cars, Aeroplanes, Machine tools, Type-writers, Radios, Cycles, Sewing Machines, etc.

6. Uniform Costing: It is not a distinct method of costing by itself. It is the name given to a common system of costing followed by a number of firms in the same industry. This helps in comparing performance of one firm with that of another.

7. Departmental Costing: When costs are ascertained department by department, the method is called "Departmental

ELEMENTS OF COST

1. Prime cost = Direct Materials + 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

The difference between the cost of sales and selling price represents profit or loss.

1. Direct Materials are those materials which can be identified in the product and can be conveniently measured and directly charged to the product. For example, bricks in houses, wood in furniture etc. Hence all raw materials, materials purchased specifically for a job or process like glue for book making, parts or components purchased or produced like batteries for radios and tyres for cycles, and primary packing materials are direct materials.

2. Indirect Materials are those materials which cannot be classified as direct materials. Examples are consumables like cotton waste, lubricants, brooms, rags, cleaning materials, materials for repairs and maintenance of fixed assets, high speed diesel used in power generators etc.

3. Direct Labour is all labour expended in altering the construction, composition, confirmation or condition of the product. Thus direct wages means the wages of labour which can be conveniently identified or attributed wholly to a particular job, product or process or expended in converting raw materials into finished goods. Thus payment made to groups of labourers engaged in actual production, or carrying out of an operation or process, or supervision, maintenance, tools setting, transportation of materials, inspection, analysis etc is direct labour

. 4. Direct Expenses are expenses directly identified to a particular cost centre. Hence expenses incurred for a particular product, job, department etc are direct expenses. Example royalty, excise duty, hire charges of a specific plant and equipment, cost of any experimental work carried out especially for a particular job, travelling expenses incurred in connection with a particular contract or job etc.

5. Overheads may be defined as the aggregate of the cost of indirect materials, indirect labour and such other expenses including services as cannot conveniently be charged direct ot specific cost units. Overheads may be sub-divided into (i) Manufacturing Overheads; (ii) Administration Overheads; (iii) Selling Overheads; (iv) Distribution Overheads; (v) Research and Development Overheads.

Cost sheet or Statement of Cost: When costing information is set out in the form of a statement, it is called “Cost Sheet”. It is usually adopted when there is only one main product and all costs almost are incurred for that product only. The information incorporated in a cost sheet would depend upon the requirement of management for the purpose of control. Specimen of Cost Sheet or Statement of Cost

	Total Cost	Cost per Unit Rs.
Direct Materials	xxx	xxx
Direct Labour	xxx	xxx
Direct expences	xxx	xxx
Prime cost	xxx	xxx
Add: Works Overheads	xxx	xxx
Works Cost	xxx	xxx

Add: Administrative Overheads	xxx	xxx
Cost of Production	xxx	xxx
Add: Selling andDistribution Overheads	xxx	xxx
Total Cost or Cost of Sales	xxx	xxx

.