

## Chapter 1

### Introduction to Cost Accounting

#### Introduction:

Cost accounting is a form of managerial accounting that aims to capture a company's total cost of production by assessing the variable costs of each step of production as well as fixed costs, such as a lease expense. Cost accounting is not GAAP-compliant, and can only be used for internal purposes

#### ACCOUNTING

It is an art of recording classifying summarizing and interpreting the accounting results to the needed parties.

#### BRANCHES OF ACCOUNTING

It is broadly classified as

- Financial Accounting
- Cost Accounting
- Management Accounting

#### FINANCIAL ACCOUNTING

It is an art of recording classifying summarizing and interpreting the accounting results to the needed parties (external users) through profit & loss account and balance sheet.

#### LIMITATIONS OF FINANCIAL ACCOUNTING

- It shows only overall performance not individual performance
- It is historical in nature
- No performance appraisal
- No material control system
- No labour cost control
- No proper classification of cost
- No analysis of cost individually
- Inadequate information for price fixation
- No cost comparison
- Fails to supply useful data to management

## COST

According to CIMA of UK "Cost is the amount of expenditure incurred or attributable to a given thing".

According to cost accounting standards of ICWA of India

"Cost is a measurement in monetary terms of the amount of resources used for the purpose of production of goods or rendering services".

## COSTING

It means determining cost by using any method like arithmetic process memorandum statements etc.

## COST ACCOUNTING

According to CIMA of UK

"It is the process of accounting for cost from the point at which expenditure is Incurred or committed to the establishment of its ultimate relationship with cost centre and cost unit".

### What Is Cost Accounting?

Cost accounting is a managerial accounting process that involves recording, analyzing, and reporting a company's costs. Cost accounting is an [internal process used only by a company](#) to identify ways to reduce spending.

Cost accounting is helpful because it can identify where a company is spending its money, how much it earns, and where money is being wasted or lost.

## COST ACCOUNTANCY

According to CIMA of UK

"The application of costing and cost accounting principles methods and techniques to the science art and practice of cost control and the ascertainment of profitability".

## OBJECTIVES AND FUNCTIONS OF COST ACCOUNTING

The main objectives are

- Ascertainment of cost
- Control of cost
- Guide to business policy
- Determination of selling price
- Measuring and improving performance.

### Cost accounting

"It is the process of accounting for cost from the point at which expenditure is incurred or committed to the establishment of its ultimate relationship with cost centre and cost unit".

### Financial Accounting

It is an art of recording classifying summarizing and interpreting the accounting results to the needed parties (external users) through profit & loss account and balance sheet.

### Types of Costs in Cost Accounting

Businesses can incur many [types of costs](#) depending on their industry. Here are a few of the most common costs involved in cost accounting.

#### Direct Costs

A [direct cost](#) is a cost directly tied to a product's production and typically includes direct materials, labor, and distribution costs. Inventory, raw materials, and employee wages for factory workers are all examples of direct costs.

#### Indirect Costs

Indirect costs can't be directly tied to the production of a product and might include the electricity for a factory.

#### Variable Costs

Costs that increase or decrease with production volumes tend to be classified as [variable costs](#). A company that produces cars might have the steel involved in production as a variable cost.

#### Fixed Costs

[Fixed costs](#) are the costs that keep a company running and don't fluctuate with sales and production volumes. A factory building or equipment lease would be classified as fixed costs.

#### Operating Costs

[Operating costs](#) are the costs to run the day-to-day operations of the company. However, operating costs—or operating expenses—are not usually traced back to the manufactured product and can be fixed or variable.

## Difference Between Cost Accounting and Financial Accounting

Basis	Financial accounting	Cost accounting
<b>Purpose</b>	To prepare P&L A/C & balance sheet for reporting to external users.	To provide detailed cost information to management (internal users)
<b>Statutory requirement</b>	Accounts are prepared according to legal requirements of companies act and income tax act.	Maintenance of these accounts is voluntary except in certain industries.
<b>Analysis of cost and profit</b>	It reveals the profit or loss of the business as a whole for a particular period	It shows the detailed cost and profit data for each product line department process etc.
<b>Periodicity of reporting</b>	Financial reports are prepared periodically usually on an annual basis.	Cost reporting is a continuous process and may be on daily weekly monthly basis
<b>Control aspects</b>	It only involved in recording of financial transactions and does not attach importance to control aspects.	It provides for a detailed system of controls with the help of certain techniques like standard costing and budgetary control.
<b>Historical and pre-determined cost</b>	It is concerned with historical records	It is concerned not only with historical cost but also with pre determined cost.
<b>Format of presenting information</b>	It has a single uniform format	It has a varied forms of presenting cost information.
<b>Types of transactions recorded</b>	It records only external transactions like purchases, sales.	It not only records external transactions but also internal and inter- departmental transactions.
<b>Types of statements prepared</b>	P&L NC and balance sheet is prepared generally	Reports like report on loss of materials, idle time report, variance report etc.

## STEPS IN INSTALLATION OF A COSTING SYSTEM.

- Primarily investigations should be made relating to the technical aspects of the business.
- The organizational structure of the business should be studied.
- Examine the method of purchase storage and issue of materials
- Examine the existing method of remunerating labour
- Design an appropriate forms and accounting records to involve minimum clerical labour and expenditure
- The size and layout of the factory should be studied.
- The costing system should be effective in cost control and cost reduction • It should be simple and easy to operate.
- It should be economical
- It should be introduced gradually.
- Practical difficulties
- Lack of support of top management
- Resistance from the accounting staff
- Non-cooperation of working and supervisory staff
- Shortage of trained staff

## ESSENTIALS OF A GOOD COST ACCOUNTING SYSTEM

- Suitability

The method of costing adopted should be suitable to the industry i.e., job or process costing

- Specially designed system.  
The cost accounting system should be designed according to the requirements of a business because a readymade costing system cannot be suitable for every business.
- Support of executives  
In order to make cost system as successful we must get full support from executives of various departments and everyone should participate in it.
- Clearly defined cost centres  
It is said that there should be well defined cost centres and responsibility centres built.
- Controllable cost  
Controllable and non-controllable cost of each responsibility centre should be separately shown.
- Integration with financial accounts.
- Continuous education

- Prompt and accurate report
- Avoid unnecessary details.

## ADVANTAGES OF COST ACCOUNTING

### A) Advantages to management

- It helps in cost control
- It helps in decision making
- It guides in fixing selling price
- It reveals profitable and unprofitable activities
- It helps in inventory control
- It helps in formulating policies
- It helps in cost reduction
- It reveals idle capacity
- It checks the accuracy of financial accounts • It prevents frauds and manipulations.

### B) Advantages to workers

It is benefited as introduction of incentive plans from which productivity and earnings for workers is increased.

### C) Advantages to society

It leads to lower the cost of production from which it is able to lower the prices of products and services.

### D) Advantages to government agencies and others

A cost system produces ready figures for use by government trade unions wage tribunals etc in problems like price fixing wage level fixation settlement of industrial disputes etc.

## LIMITATIONS OR OBJECTIONS AGAINST COST ACCOUNTING

### • It is unnecessary

It is argued that maintenance of cost records is not necessary and it involves duplication of work

### • It is expensive

It is argued that installation of a costing system is quite expensive and only large concerns can afford.

### • It is inapplicable

It is argued that modern method of costing are not applicable to many types of industries

### • It is a failure

It argues that it doesn't produce the desired results

## PRIME COST

It is the aggregate of direct material cost, direct labour cost and direct expenses.

## OVERHEADS

It is the aggregate of indirect material cost, indirect labour cost and indirect expenses. They are divided into production overhead, office overhead and selling overhead.

### ➤ Production overhead

It is also called factory, work or manufacturing overheads. These are those overheads which are concerned with the production function. It includes indirect materials, indirect labour wages and indirect expenses in producing goods or services.

### ➤ Office and administration overheads

This is the indirect expenditure incurred in general administrative function i.e., formulating policies, planning and controlling functions

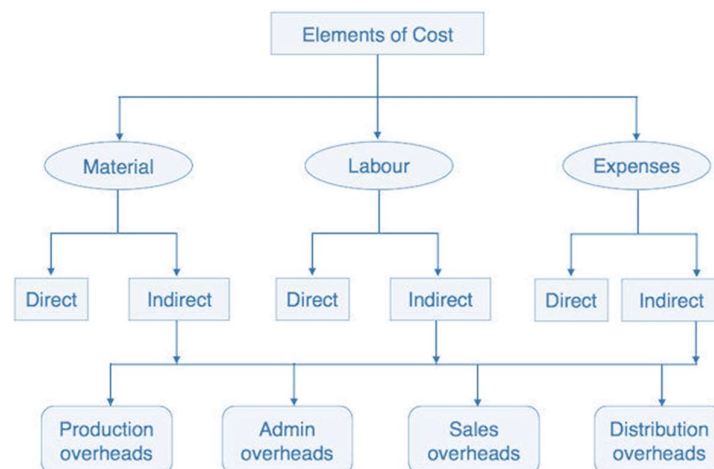
### ➤ Selling and distribution overheads

It is the cost of promoting sales and retaining customers or the cost of seeking to create and stimulate demand and of securing orders.

## COST SHEET

It is a periodical statement of cost designed to show in details the various elements of cost of goods produced like prime cost, factory cost and total cost.

## ELEMENTS OF COST



**A) Direct cost****Direct materials**

It is that which can be easily identified with cost unit.

**Direct labour**

It is the labour which can be easily identified with cost unit.

**Direct expenses**

It is the expense which can be easily identified with cost unit

**B) Indirect cost****Indirect material**

It is that which cannot be easily identified with cost unit

**Indirect labour**

It is that which cannot be easily identified with cost unit

**Indirect expense**

Indirect expenses are those that aren't directly accountable to processes that contribute to the creation of products or services.

**Format of cost sheet**

Particulars	Total cost (Rs.)	Cost per unit (Rs)
Opening stock of raw material		
Add: purchases		
Add: carriage inward		
Add: octroi, custom duty and other expenses on purchases		
Less: closing stock of direct raw materials		
Cost of direct material consumed		
Direct wages		
Direct expenses		
<b>PRIME COST</b>		
Add: factory /works overhead		
Indirect materials		
Indirect wages		



Leave wages		
Overtime premium		
Fuel and power		
Coal		
Factory rent and taxes		
Insurance		
Factory lighting		
Supervision		
Work stationery		
Canteen and welfare expenses		
Repairs		
Haulage		
Works salaries		
Depreciation on plant and machinery		
Works expenses		
Gas and water		
Drawing office salaries		
Technical director's fees		
Laboratory expenses		
Works telephone expenses		
Internal transport expenses		
Less: sale of scrap		
Add :opening stock of work in progress		
Less :closing stock of work in progress		
Add: office and administration overheads		
<b>WORKS COST</b>		
Office salary		
Office rent and rates		
Office stationery and printing		
Sundry office expenses		
Depreciation and repairs of office equipment		

Depreciation of office furniture

Subscript to trade journals

Office lightings

Establishment charges

Director's travelling expenses

Postage

Legal charges

Audit fees

### COST OF PRODUCTION

Add: opening stock of finished goods

Less: closing stock of finished goods

### COST OF GOODS SOLD

Add: selling and distribution overheads

Advertising

Showroom expenses

Bad debts

Salesmen salary and expenses

Packing expenses Carriage outward

Commission

Counting house salaries

Cost of catalogues

Expenses of delivery vans

Collection charges

Travelling expenses

Cost of tenders

Warehouse expenses

Cost of mailing literature

Sales manager's salary

Sales director's fees

Sales office expenses

Depreciation and repairs of delivery vans		
Expenses of sales branches		
Profit	COST OF SALES/TOTAL COSTSALES	

Items excluded from cost

- Cash discount
- Interest paid
- Preliminary expenses written off
- Goodwill written off
- Provision for taxation
- Provision for bad debts
- Transfer to reserve • Donations
- Income tax paid
- Dividend paid
- Profit or loss on sale of fixed assets
- Damages payable at law etc.,