Certified Cost Accountant
VS-1125

V-Skills Certifications

A Government of India
&
Government of NCT Delhi Initiative

V-Skills

Skills for a secure future

1. INTRODUCTION TO COST AND MANAGEMENT ACCOUNTING

1.1. Concepts of Cost

Cost is the amount of resource given up in exchange for some goods or services. The resources given up are money or money's equivalent expressed in monetary units.

The Chartered Institute of Management Accountants, London defines cost as "the amount of expenditure (actual or notional) incurred on or attributable to a specified thing or activity".

This activity of a firm may be the manufacture of a product or the rendering of a service which involves expenditure under various heads, e.g., materials, labour, other expenses, etc. A manufacturing organization is interested in ascertaining the cost per unit of the product manufactured while an organization rendering service, e.g., transport undertaking, canteen, Electricity Company, municipality, etc., is interested in ascertaining the costs of the service it renders. In its simplest form, the cost per unit is arrived at by dividing the total expenditure incurred by the total units produced or the quantum of service rendered. But this method is applicable if the manufacturer produces only one product. If the manufacturer produces more than one product, it becomes imperative to split up the total expenditure between the various products so that the cost of each product can be ascertained separately.

For a consumer cost means price for management cost means 'expenditure incurred' for producing a particular product or rendering a particular service. The process of ascertaining the cost is known as costing. It consists of principles and rules governing the procedure of finding out the costs of goods/ services. It aims at ascertaining the total cost and also per unit cost. For instance, in transport companies the total cost for the period is ascertained and used to find out the cost per passenger/mile. i.e. the cost of carrying one passenger for one mile. It provides for analysis of expenditure in such a way that the management gets complete idea about even the smallest item of cost.

It is also important to note here that there is no such thing as an exact cost or true cost because no figure of cost is true in all circumstances and for all purposes. Most of the costing information is based on estimates; for example, the amount of overheads is generally estimated in advance; it is distributed over cost units, again on an estimated basis using different methods. Many items of cost of production are handled in an optional manner which may give different costs for the same product without going against the accepted principles in any way. Depreciation is one such item, the amount of which will vary in accordance with the method of depreciation being used. Thus, to arrive at an absolutely correct cost may be quite difficult unless one waits for a long time by which time the costing information may lose all its value.

1.2. Costing, Cost Accounting and Cost Accountancy

Costing

Costing is the techniques and processes of ascertaining costs. These techniques consist of principles and rules which govern the procedure of ascertaining cost of products or services. The techniques to be followed for the analysis of expenses and the processes of different products or services differ from industry to industry.

The main object of costing is the analysis of financial records, so as to subdivide expenditure and to allocate it carefully to selected cost centers, and hence to build up a total cost for the departments, processes or jobs or contracts of the undertaking.

Cost Accounting

Cost accounting may be regarded as a specialized branch of accounting which involves classification, accumulation, assignment and control of costs.

The Costing terminology of **C.I.M.A.** London defines cost accounting as

The establishment of budgets, standard costs and actual costs of operations, processes, activities or products, and the analysis of variances, profitability or the social use of funds".

Cost accounting is different from costing in the sense that the former provides only the basis and information for ascertainment of costs. Once the information is made available, costing can be carried out arithmetically by means of memorandum statements or by method of integral accounting.

1.3. Objectives of Cost Accounting

Cost accounting aims at systematic recording of expenses and analysis of the same so as to ascertain the cost of each product manufactured or service rendered by an organisation. Information regarding cost of each product or service would enable the management to know where to economies on costs, how to fix prices, how to maximize profits and so on. Thus, the main objects of cost accounting are the following

- ✓ To analyze and classify all expenditures with reference to the cost of products and operations
- ✓ To arrive at the cost of production of every unit, job, operation, process, department or service and to develop cost standard.
- ✓ To indicate to the management any inefficiencies and the extent of various forms of waste, whether of materials, time, expenses or in the use of machinery, equipment and tools Analysis of the causes of unsatisfactory results may indicate remedial measures.
- ✓ To provide data for periodical profit and loss accounts and balance sheets at such intervals, e.g., weekly, monthly or quarterly, as may be desired by the management during the financial year, not only for the whole business but also by departments or individual products. Also, to explain in detail the exact reasons for profit or loss revealed in total, in the profit and loss account.
- ✓ To reveal sources of economies in production having regard to methods, types of equipment, design, output and layout. Daily, weekly, monthly or quarterly information may be necessary to ensure prompt and constructive action.
- ✓ To provide actual figures of cost for comparison with estimates and to serve as a guide for future estimates or quotations and to assist the management in their price-fixing policy.
- ✓ To show, where standard costs are prepared, what the cost of production ought to be and with which the actual costs which are eventually recorded may be compared.
- ✓ To present comparative cost data for different periods and various volumes of output.

- ✓ To provide a perpetual inventory of stores and other materials so that interim profit and loss account and balance sheet can be prepared without stock taking and checks on stores and adjustments are made at frequent intervals. Also to provide the basis for production planning and for avoiding unnecessary wastages or losses of materials and stores
- ✓ To provide information to enable management to make short-term decisions of various types, such as quotation of price to special customers or during a slump, make or buy decision, assigning priorities to various products, etc.

1.4. Importance of Cost Accounting

The limitations of financial accounting have made the management to realize the importance of cost accounting. Whatever may be the type of business, it involves expenditure on labour, materials and other items required for manufacturing and disposing of the product. The management has to avoid the possibility of waste at each stage. It has to ensure that no machine remains idle, efficient labour gets due incentive, by-products are properly utilized and costs are properly ascertained. Besides the management, the creditors and employees are also benefited in numerous ways by installation of a good costing system. Cost accounting increases the overall productivity of an organization and serves as an important tool, in bringing prosperity to the nation. Thus, the importance of cost accounting can be discussed under the following headings

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 inventory, to increase efficiency of the organization and to check wastage and losses. It facilitates delegation of responsibility for important tasks and rating of employees. For all these, the management should be capable of using the information provided by cost accounts in a proper way. The various advantages derived by the management from a good system of costing are as follows:

- ✓ **Cost accounting helps in periods of trade depression and trade competition:** In periods of trade depression, the organization cannot afford to have losses which pass unchecked. The management must know the areas where economies may be sought, waste eliminated and efficiency increased. The organization has to wage a war not only for its survival but also continued growth. The management should know the actual cost of their products before embarking on any scheme of price reduction. Adequate system of costing facilitates this.
- ✓ **Cost accounting aids price fixation:** Although the law of supply and demand to a great extent determines the price of the article, cost to the producer does play an important role. The producer can take necessary guidance from his costing records in case he is in a position to fix or change the price charged.
- ✓ **Cost accounting helps in making estimates:** Adequate costing records provide a reliable basis for making estimates and quoting tenders.
- ✓ **Cost accounting helps in channelizing production on right lines:** Proper costing information makes it possible for the management to distinguish between profitable and non-profitable activities. Profits can be maximized by concentrating on profitable operations and eliminating non-profitable ones.
- ✓ **Cost accounting eliminates wastages:** As cost accounting is concerned with detailed break-up of costs, it is possible to check various forms of wastages or losses.

- **Cost accounting makes comparisons possible:** Proper maintenance of costing records provides various costing data for comparisons which in turn helps the management in formulation of future lines of action.
- **Cost accounting provides data for periodical profit and loss account:** Adequate costing records provide the management with such data as may be necessary for preparation of profit and loss account and balance sheet at such intervals as may be desired by the management.
- **Cost accounting helps in determining and enhancing efficiency:** Losses due to wastage of materials, idle time of workers, poor supervision, etc., will be disclosed if the various operations involved in the production are studied carefully. Efficiency can be measured, costs controlled and various steps can be taken to increase the efficiency.

- **Cost accounting helps in inventory control:** Cost accounting furnishes control which management requires in respect of stock of materials, work-in-progress and finished goods.

1.5. Scope of Cost Accounting

The Scope of Cost Accounting Is Very Wide and Includes:

- **Cost Ascertainment:** The main function of cost accounting is the ascertainment of cost of product or services rendered. It includes collection, analysis of expenses and measurement of production at different stages of manufacture. The collection, analysis and measurement requires different methods of costing for different types of production such as Historical costs, Standard costs, Process cost, Operation cost etc. It can be done in two ways, namely
  - Post Costing, where the ascertainment of cost is done based on actual information as recorded in financial books.
  - Continuous Costing, where the process of ascertainment is of a continuous nature i.e. where cost information is available as and when a particular activity is completed, so that the entire cost of a particular job is available the moment it is completed.
- **Control of Costs:** In the era of competition, the goal of every business is to sustain; in costs at the lowest point with efficient operating conditions. To sustain, it is essential to examine each individual item of cost in the light of the services or benefits obtained so that maximum utilization of the money expended or- it may be recovered. This requires planning and use of standard for each item of cost for locating deviations, if any, and taking remedial measures.
- **Proper matching of cost with revenue**: In cost accounting manager prepares monthly or quarterly statements to reflect the cost and income data identified with the sale of that period.
- **Aids to Management Decision-making:** Decision-making is a process of choosing between two or more alternatives, based on the resultant outcome of the various alternatives. A Cost Benefit Analysis also needs to be done. All this can be achieved through a good cost accounting system

1.6. Classification of Costs

The different bases of cost classification are:
- By time (Historical, Pre-determined)
- By nature or elements (Material, Labour and Overhead)
- By degree of traceability to the product (Direct, Indirect)
- Association with the product (Product, Period)
- By Changes in activity or volume (Fixed, Variable, Semi-variable)

- ✓ By function (Manufacturing, Administrative, Selling, Research and development, Pre-production)
- ✓ Relationship with accounting period (Capital, Revenue)
- ✓ Controllability (Controllable, Non-controllable)
- ✓ Cost for analytical and decision-making purposes (Opportunity, Sunk, Differential, Joint, Common, Imputed, Out-of-pocket, Marginal, Uniform, Replacement).
- ✓ Others (Conversion, Traceable, Normal, Avoidable, Unavoidable, Total)

Classification on the Basis of Time

- ✓ **Historical Costs:** These costs are ascertained after they are incurred. Such costs are available only when the production of a particular thing has already been done. They are objective in nature and can be verified with reference to actual operations.
- ✓ **Pre-determined Costs:** These costs are calculated before they are incurred on the basis of a specification of all factors affecting cost. Such costs may be:
    - ✓ **Estimated costs:** Costs are estimated before goods are produced; these are naturally less accurate than standards.
    - ✓ **Standard costs:** This is a particular concept and technique. This method involves:
        - ✓ Setting up predetermined standards for each element of cost and each product;
        - ✓ Comparison of actual with standard to find variation;
        - ✓ Pin-pointing the causes of such variances and taking remedial action

Obviously, standard costs, though pre-determined, are arrived with much greater care than estimated costs.

By Nature or Elements

There are three broad elements of costs:

Material: The substance from which the product is made is known as material. It can be direct as well as indirect.

Direct material: It refers to those materials which become a major part of the finished product and can be easily traceable to the units. Direct materials include:

- ✓ All materials specifically purchased for a particular job/process.
- ✓ All material acquired and latter requisitioned from stores.
- ✓ Components purchased or produced.
- ✓ Primary packing materials.
- ✓ Material passing from one process to another.

Indirect material: All material which is used for purposes ancillary to production and which can be conveniently assigned to specific physical units is termed as indirect materials. Examples, oil, grease, consumable stores, printing and stationary material etc

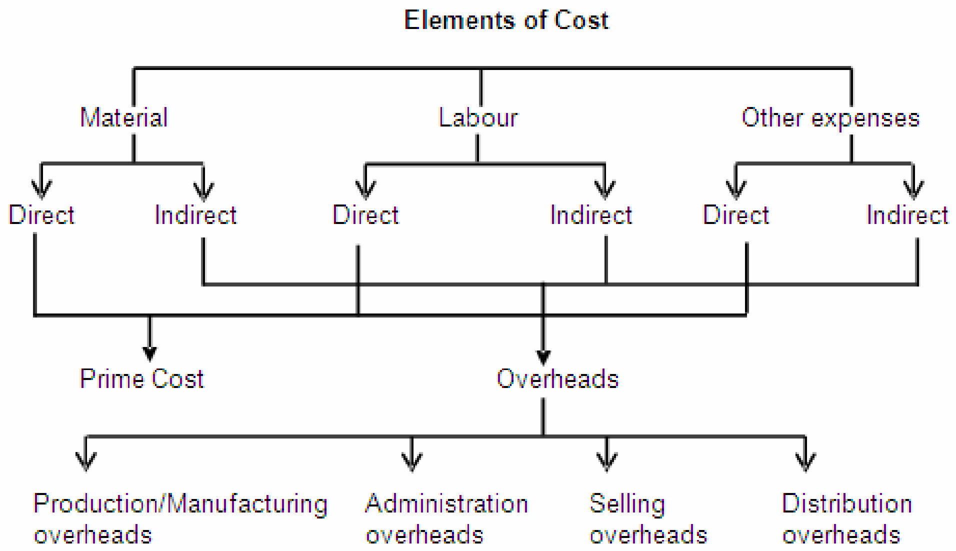
Labour: Labour cost can be classified into direct labour and indirect labour.

- ✓ **Direct labour:** It is defined as the wages paid to workers who are engaged in the production process whose time can be conveniently and economically traceable to units of products. For example, wages paid to compositors in a printing press, to workers in the foundry in cast iron works etc.
- ✓ **Indirect labour:** Labour employed for the purpose of carrying tasks incidental to goods or services provided, is indirect labour. It cannot be practically traced to specific units of output. Examples, wages of store-keepers, foreman, time-keepers, supervisors, inspectors etc

Expenses: Expenses may be direct or indirect.

- ✓ **Direct expenses:** These expenses are incurred on a specific cost unit and identifiable with the cost unit. Examples are cost of special layout, design or drawings, hiring of a particular tool or equipment for a job; fees paid to consultants in connection with a job etc.
- ✓ **Indirect expenses:** These are expenses which cannot be directly, conveniently and wholly allocated to cost centre or cost units. Examples are rent, rates and taxes, insurance, power, lighting and heating, depreciation etc.

It is to be noted that the term overheads has a wider meaning than the term indirect expenses. Overheads include the cost of indirect material, indirect labour and indirect expenses. Overheads may be classified as (a) production or manufacturing overheads, (b) administration overheads, (c) selling overheads, and (d) distribution overheads.
The various elements of cost can be illustrated by the following chart:



By Degree of Traceability to the Products

Cost can be distinguished as direct and indirect.

- ✓ **Direct Costs:** The direct costs are those which can be easily traceable to a product or costing unit or cost center or some specific activity, e.g. cost of wood for making furniture. It is also called traceable cost.
- ✓ **Indirect Costs:** The indirect costs are difficult to trace to a single product or it is uneconomic to do so. They are common to several products, e.g. salary of a factory manager. It is also called common costs.

Costs may be direct or indirect with respect to a particular division or department. For example, all the costs incurred in the Power House are indirect as far as the main product is concerned but as regards the Power House itself, the fuel cost or supervisory salaries are direct. It is necessary to know the purpose for which cost is being ascertained and whether it is being associated with a product, department or some activity.

Direct cost can be allocated directly to costing unit or cost center. Whereas indirect costs have to be apportioned to different products, if appropriate measurement techniques are not available. These may involve some formula or base which may not be totally correct or exact.

Association with the Product

Cost can be classified as product costs and period costs.

- ✓ **Product Costs:** Product costs are those which are traceable to the product and included in inventory values. In a manufacturing concern it comprises the cost of direct materials, direct labour and manufacturing overheads. Product cost is a full factory cost. Product costs are used for valuing inventories which are shown in the balance sheet as asset till they are sold. The product cost of goods sold is transferred to the cost of goods sold account.
- ✓ **Period Costs:** Period costs are incurred on the basis of time such as rent, salaries, etc.; include many selling and administrative costs essential to keep the business running. Though they are necessary to generate revenue, they are not associated with production; therefore, they cannot be assigned to a product. They are charged to the period in which they are incurred and are treated as expenses.

Selling and administrative costs are treated as period costs for the following reasons:
- ✓ Most of these expenses are fixed in nature.
- ✓ It is difficult to apportion these costs to products equitably.
- ✓ It is difficult to determine the relationship between such cost and the product.
- ✓ The benefits accruing from these expenses cannot be easily established.

The net income of a concern is influenced by both product and period costs. Product costs are included in the cost of the product and do not affect income till the product is sold. Period costs are charged to the period in which they are incurred.

By changes in Activity or Volume

Costs can be classified as fixed, variable and semi-variable cost.

- ✓ **Fixed Costs:** The Chartered Institute of Management Accountants, London, defines fixed cost as “the cost which is incurred for a period, and which, within certain output and turnover limits, tends to be unaffected by fluctuations in the levels of activity (output or turnover)”.

These costs are incurred so that physical and human facilities necessary for business operations can be provided. These costs arise due to contractual obligations and management decisions. They arise with the passage of time and not with production and are expressed in terms of time. Examples are rent, property-taxes, insurance, supervisors’ salaries etc.

- ✓ **Variable Cost:** Variable costs are those costs that vary directly and proportionately with the output e.g. direct materials, direct labour. It should be kept in mind that the variable cost per unit is constant but the total cost changes corresponding to the levels of output. It is always expressed in terms of units, not in terms of time.

Management decisions can influence the cost behavior patterns. The concept of variability is relative. If the conditions upon which variability was determined changes, the variability will have to be determined again.

- ✓ **Semi-fixed (Semi-Variable) costs:** Such costs contain fixed and variable elements. Because of the variable element, they fluctuate with volume and because of the fixed element; they do not change in direct proportion to output. Semi-variable costs change in the same direction as that of the output but not in the same proportion. Depreciation is an example; for two shifts working the total depreciation may be only 50% more than that for single shift working. They may change with comparatively small changes in output but not in the same proportion.

Functional Classification of Costs

A company performs a number of functions. Functional costs may be classified as follows:

- ✓ **Manufacturing/production Costs:** It is the cost of operating the manufacturing division of an undertaking. It includes the cost of direct materials, direct labour, direct expenses, packing (primary) cost and all overhead expenses relating to production.
- ✓ **Administration Costs:** They are indirect and cover all expenditure incurred in formulating the policy, directing the organisation and controlling the operation of a concern, which is not related to research, development, production, distribution or selling functions.
- ✓ **Selling and Distribution Cost:** Selling cost is the cost of seeking to create and stimulate demand e.g. advertisements, market research etc. Distribution cost is the expenditure incurred which begins with making the package produced available for dispatch and ends with making the reconditioned packages available for re-use e.g. warehousing, cartage etc. It includes expenditure incurred in transporting articles to central or local storage. Expenditure incurred in moving articles to and from prospective customers as in the case of goods on sale or return basis is also distribution cost.
- ✓ **Research and Development Costs:** They include the cost of discovering new ideas, process, and products by experiment and implementing such results on a commercial basis.
- ✓ **Pre-production Cost:** When a new factory is started or when a new product is introduced, certain expenses are incurred. There are trial runs. Such costs are termed as pre-production costs and treated as deferred revenue expenditure. They are charged to the cost of future production.

Relationship with Accounting Period

Costs can be capital and revenue. Capital expenditure provides benefit to future period and is classified as an asset. On the other hand, revenue expenditure benefits only the current period and is treated as an expense. As and when an asset is written off, capital expenses to that extent becomes cost. Only when capital and revenue is properly differentiated, the income of a particular period can be correctly determined. It is not possible to distinguish between the two under all circumstances.

Controllability

Cost can be Controllable and Non-Controllable.

- ✓ **Controllable Cost:** The Chartered Institute of Management Accountants defines controllable cost as "cost which can be influenced by its budget holder".
- ✓ **Non-Controllable Cost:** It is the cost which is not subject to control at any level of managerial supervision.

The difference between the terms is very important for the purpose of cost accounting, cost control and responsibility accounting.

A controllable cost can be controlled by a person at a given organizational level. Controllable costs are not totally controllable. Some costs are partly controllable by one person and partly by another e.g., maintenance cost can be controlled by both the production and maintenance manager. The term "controllable costs" is often used to mean variable costs and non-controllable costs as fixed.

Costs for Analytical and Decision Making Process

- ✓ **Opportunity Costs:** Opportunity cost is the cost of selecting one course of action and the losing of other opportunities to carry out that course of action. It is the amount that can be received if the asset is utilized in its next best alternative.
- ✓ **Sunk Costs:** A sunk cost is one that has already been incurred and cannot be avoided by decisions taken in the future. As it refers to past costs, it is called unavoidable cost. The National Association of Accountants (USA) defines a sunk cost as "an expenditure for equipment or productive resources which has no economic relevance to the present decision making process". This cost is not useful for decision making as all past costs are irrelevant. CIMA defines it as the past cost not taken into account in decision making.

  It has also been defined as the difference between the purchase price of an asset and its salvage value.

- ✓ **Marginal Costs:** It is the aggregate of variable costs, i.e., prime cost plus variable overheads. Thus, costs are classified as fixed and variable.

1.7. Cost Centre and Cost Unit

A cost accountant has to ascertain cost by cost centre or cost unit or by both.

Cost Centre

According to the Chartered Institute of Management Accountants, London, cost centre means, "a production or service location, function, activity or item of equipment whose costs may be attributed to cost units". Cost centre is the smallest organisational sub-unit for which separate cost collection is attempted. Thus cost centre refers to one of the convenient unit into which the whole factory organisation 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. For example, although an assembly department may be supervised by one foreman, it may contain several assembly lines. Sometimes each assembly line is regarded as a separate cost centre with its own assistant foreman.

Cost Centers may be classified as follows:

- ✓ **Productive, Unproductive and Mixed Cost Centers:** Productive cost centers are those which are actually engaged in making the products the raw materials are handled here and converted into saleable products. In such centers both direct and indirect costs are incurred, machine shops, welding shops, and assembly shops are examples of production cost centers in an engineering factory. Service or unproductive cost centers do not make the products but are essential aids to the productive centers. Examples of such service centers are those of administration, repairs and maintenance, stores and drawing office departments. Mixed cost centers are those which are engaged some on productive and other lines on service works.
- ✓ **Personal and Impersonal Cost Centre:** A personal cost centre consists of a person or a group of persons. An impersonal cost centre is one which consists of a department, plant or item of equipment (or group of these).
- ✓ **Operation and Process Cost Centre:** In case a cost centre consists of those machines and/or persons which carry out the same operation is termed as operation cost centre. If a cost centre consists of a continuous sequence of operations it is called process cost centre.

The determination of a suitable cost centre is very important for ascertainment and control of cost. The manager in charge of a cost centre is held responsible for control of cost of his cost centre.

Cost Unit

The Chartered Institute of Management Accountants, London, defines a unit of cost as "a unit of product or service in relation to which costs are ascertained". A cost unit is a devise for the purpose of breaking up or separating costs into smaller sub-divisions. These smaller sub-divisions are attributed to products or services to determine product cost or service cost or cost of time spent for a particular job etc. We may for instance determine the cost per ton of steel, per ton kilometer of a transport service or cost per machine hour. The forms of measurement used as cost units are usually the units of physical measurements like number, weight, area, length, value, time etc. Unit selected should be unambiguous, simple and commonly used.

1.8. Methods 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.

- ✓ **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 press, automobile garage, repair shop, ship-building, house building, engine and machine construction, etc.
- ✓ **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.
- ✓ **Batch 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.

- ✓ **Terminal Costing:** This method is also a type of job costing. This method emphasizes the essential nature of job costing, i.e. the cost can be properly terminated at some point and related to a particular job.
- ✓ **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 undertakings, it is frequently necessary to ascertain the cost of various operations.
- ✓ **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 trade 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.
- ✓ **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 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 e.g., bicycle.
- ✓ **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 service is arrived at. This method is employed in railways, road transport, water supply undertakings, telephone services, electricity companies, hospital services, municipal services, etc.
- ✓ **Multiple or Composite 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, aero planes, machine tools, type-writers, radios, cycles, sewing machines, etc.
- ✓ **Departmental Costing:** When costs are ascertained department by department, the method is called "Departmental Costing". Usually, for ascertaining the cost of various goods or services produced by the department, the total costs will have to be analyzed, say, by the use of job costing or unit costing.

1.9. Techniques of Costing

The following techniques of costing are used by the management for controlling costs and making managerial decisions:

- ✓ **Historical (or Conventional) Costing:** It refers to the determination of costs after they have been actually incurred. It means that cost of a product can be calculated only after its production.

This system is useful only for determining costs, but not useful for exercising any control over costs. It can serve as guidance for future production only when conditions continue to be the same in future.

- ✓ **Standard Costing:** It refers to the preparation of standard costs and applying them to measure the variations from standard costs and analyzing the variations with a view to maintain maximum efficiency in production. What is done in this case is that costs of each article are determined before-hand under current and anticipated conditions, but sometimes they are determined before-hand under normal or ideal conditions. Then actual costs are compared with the pre-determined costs and deviations known as variances are noted down. Thereafter, the reasons for the variances are ascertained and necessary steps are taken to prevent their recurrence.
- ✓ **Marginal Costing:** It refers to the ascertainment of marginal costs by differentiating between fixed costs and variable costs and the effect on profit of the changes in volume or type of output. In this case, only the variable costs are charged to products or operations while fixed costs are charged to profit and loss account of the period in which they arise.
- ✓ **Uniform Costing:** A technique where standardized principles and methods of cost accounting are employed by a number of different companies and firms is termed as uniform costing. This helps in comparing performance of one firm with that of another.
- ✓ **Direct Costing:** The practice of charging all direct costs to operations, process or products leaving all indirect costs to be written off against profits in the period in which they arise, is termed as direct costing.
- ✓ **Absorption Costing:** The practice of charging all costs both variable and fixed to operation, process or products or process is termed as absorption costing.
- ✓ **Activity Based Costing:** In a business organization, Activity-Based Costing (ABC) is a method of assigning the organization's resource costs through activities to the products and services provided to its customers. It is defined as a technique of cost attribution to cost units on the basis of benefits received from indirect activities, e.g. ordering, setting up, and assuring quality. ABC involves identification of costs with each cost driving activity and making it as the basis of apportionment of costs over different products or jobs on the basis of the number of activities required for their completion. It is basically used for apportionment of overheads costs in an organisation having products that differ in volume and complexity of production. Under this technique, the overhead costs of the organisation are identified with each activity which is acting as a cost driver i.e. the cause for incurrence of overhead cost. Such cost drivers may be purchase orders issued, quality inspections, maintenance requests, material receipts, inventory movements, power consumed, machine time, etc. Having identified the overhead costs with each cost centre, cost per unit of cost driver can be ascertained. The overhead costs can be assigned to jobs on the basis of number of activities required for their completion

1.10. Installation of a Costing System

A cost accounting system is a system that accumulates costs, assigns them to cost objectives and reports cost information. It ascertains product profitability and helps management in planning and control of business operations.

A system has to be designed to suit the needs of an organisation. Costing can be employed in any industry whether it is manufacturing industry or other industries like public utility, public services, construction companies, agriculture, mining etc.

As a system designer, the cost accountant should be able to perceive the needs of the management at various levels and design such a system as will meet those needs promptly, effectively and efficiently. The "needs" are concerned with the following:

- ✓ **The objective:** The system will naturally differ according to what is expected from the costing system. The system will be simple if the objective is merely to fix prices; it will have to provide detailed information if the aim is to measure efficiency, control, etc. If the law requires installation of the costing system, the legal requirements must obviously be kept in mind.
- ✓ **Decision-Making Points:** The levels of management which require information will determine the quantum and format of information that the costing system will have to provide. The periodicity of the various reports will be similarly determined.
- ✓ **Significant Operations:** Costing must obviously pay greater attention to those areas which account for the bulk of expenditure. Mostly, it is production but, in quite a few cases, selling and distribution, accounts for greater expenditure than production; in such a case the system must devote greater care to selling and distribution.
- ✓ **Uncontrollable Items:** Sometimes the law provides for a certain course of action; for example sugar must be packed in new gunny bags. Costing must not try to change this. Sometimes managements may decide to adopt a particular course for various reasons, for example, purchasing an item only from a particular firm. Obviously, it will be no use trying to alter this.

To install a sound costing system in an organization is not an easy task. The costing for each firm must be so designed as to meet its earlier needs. It should be ensured first that the following pre-requisites for installing a sound costing system are present in the organization:

- ✓ The organizational set up should be clear cut regarding authority and responsibility of different individuals.
- ✓ The management of the organization should extend full support to the system.
- ✓ The co-operation of the members of the staff and of the workers in general should be ensured. They should have the real spirit and enthusiasm to operate the system.
- ✓ If financial records can yield all the necessary costing information, it is not necessary to have a separate costing department. Usually, however, a separate costing department is essential or desirable but its strength will depend upon the needs of the management and the volume and complexity of transactions or events to be recorded and handled.

The following are the essential considerations which would govern the installation of a sound costing in an organization in general:

Executive Side: The memorandum and articles, organization chart, delegation of powers etc.
Accounting Side: Financial accounting records, last audited accounts etc.
Internal Control Side: The existing forms, registers, number of copies etc.

Technical side and Others

- ✓ The size, layout and organisation of the factory should be studied.
- ✓ The methods of purchase, receipt, storage and issue of materials should be examined and modified if necessary.
- ✓ The method of paying wages should be studied.

- ✓ The management requirements and their attitude towards cost accounting should be kept in view.
- ✓ The cost of installing and operating the system should be economical.
- ✓ The nature, method, process and stages of production, the quantities and qualities of each product should be examined.
- ✓ The system should suit the organization.
- ✓ Forms and records should involve minimum clerical work and cost.
- ✓ The system should enable prompt reporting to the various levels of management.
- ✓ The system should so designed that cost can be effectively controlled.
- ✓ The staff in the cost accounting department should have the ability to produce required cost data. The persons using the reports should be able to understand and use the information.
- ✓ The adoption of cost accounting systems and practices followed by other firms in the industry facilitates inter unit and inter-firm comparisons.
- ✓ A suitable unit of cost should be selected so that the cost is meaningful. For example, in a steel mill, the unit is "tone" and in a company producing refrigerators, the unit is each refrigerator. In a transport company, the unit is "tone-km" i.e., the effort in hauling one tone of goods for one kilometer.
- ✓ External factors e.g. government regulations affect the frequency, volume and structure of the cost accounting system.

Any proposed changes should suit other departments and should dislocate production schedule. Other points to be noted are:

- ✓ **Accuracy:** Cost accounts must be accurate and correct otherwise they will prove to be misleading.
- ✓ **Equity:** Allocation of indirect expenses to a particular class of output, department or job should be fair and equitable.
- ✓ **Simplicity:** As cost accountants are highly analytical, there is a tendency towards complexity. Needless, elaboration should be scrupulously avoided and care must be taken to keep them as simple as possible. Careful choice should be made of the cost unit i.e. the quantity for which cost will be computed e.g. tone of steel, a kg. of yarn etc.
- ✓ **Elasticity:** The cost accounting system should be elastic and capable of adapting itself to altered circumstances.
- ✓ **Comparability:** The records must be maintained in such a manner that the result of one period can be compared with the results of any other period. The records of the past must act as a guide for the future.
- ✓ **Promptness:** Prompt recording of the relevant figures in analytical form is the sine qua non of costing. Arrangements should be made for the prompt supply of records by the various departments relating to raw material, stores, labour etc., and the data thus obtained, are promptly analyzed and recorded.
- ✓ Observance of instructions: The costing staff must carefully obey the instructions given to them and even slight deviations must be permitted.
- ✓ **Periodical results:** In order to derive maximum benefit, it is advisable to have the results prepared periodically so that actual cost can be compared with estimated costs.
- ✓ **Reconciliation with financial accounts:** The whole system should be so maintained as to make reconciliation with financial accounts easy and simple.

1.11. Difference between Financial Accounting and Cost 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:

- ✓ 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.
- ✓ 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 management. But now the Companies Act has made it obligatory to keep cost records in some manufacturing industries.
- ✓ Financial accounting emphasizes the measurement of profitability, while cost accounting aims at ascertainment of costs and accumulates data for this very purpose.
- ✓ 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.
- ✓ Financial accounting provides operating results and financial position usually gives information through cost reports to the management as and when desired.
- ✓ Financial accounts deal mainly with actual facts and figures, but cost accounts deal partly with facts and figures and partly with estimates.
- ✓ In case of financial accounts stress is on the ascertainment and exhibition of profits earned or losses incurred in the business. In cost accounts the emphasis is more on aspects of planning and control.
- ✓ Financial accounting is concerned with historical records, while cost accounting is concerned with historical cost but also with pre-determined cost
- ✓ 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.
- ✓ The costs are reported in aggregate in financial accounts but costs are broken into unit basis in cost accounts.
- ✓ 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.
- ✓ Financial reports (profit and loss account and balance sheet) are prepared periodically – quarterly,
- ✓ Half yearly or annual basis. But cost reporting is a continuous process and may be daily, weekly, monthly etc.

1.12. Difference between Financial Accounting and Management Accounting

Financial accounting and management accounting both appear to be similar in as much as both study the impact of business transactions and events of the enterprise and report and interpret the results thereof. Both provide information for internal as well as external use. But management accounting, although having its roots in financial accounting differs from the latter in the following respects

- ✓ Financial accounting deals with the business transactions and events for the enterprise as a whole. Management accounting, in addition to the study of events in relation to the enterprise as a whole takes organisation in its various units and segments and attempts to trace the impact and effect of the business transactions and events through its various divisions and sub-divisions. Thus, while the financial statement - profit and loss account, balance sheet and cash flow statements reveal the overall performance and position of the enterprise. Management accounting reports emphasize on the details of operational costs, inventories, products, process and jobs. It traces the effect and impact of the business transactions and events on costs, inventories, processes, jobs and products.
- ✓ Financial accounting is attached more with reporting the results and position of the business to persons and authorities other than management - Government, creditors, investors, owners, etc. At times, financial accounting follows window-dressing tactics in order to project a better than actual image of the enterprise. Management accounting is concerned more with generating information for the use of internal management and hence the information reflects the real or really expected position.
- ✓ Financial accounting is necessarily historical. It records and analyses business events long after they have taken place. Management accounting analyses the events as they take place and also anticipates such events for the future. Thus, it uses data which generally has relevance to the future.
- ✓ Since financial accounting data is historical in nature, it is more precise than the management accounting data, which generally reflects the expected future, and hence could only be estimation. This provides the necessary rapidity to management accounting information.
- ✓ The periodicity in reporting financial accounts is much wider than in case of management accounting. In financial accounting, generally, results are reported on year to year basis. In management accounting, weekly, fortnightly and even monthly reporting is used.
- ✓ Financial accounting has to be governed by the "generally accepted principles". This is so because, it has to cater for the informational needs of the outsiders. It has to stick to the generally accepted methods of presentation of such information. Regarding the contents and form of information, financial accounting has to abide by the legal provisions also. Management accounting has not to worry about such legal and/or conventional constraints and the "generally accepted principles". It is free to formulate its own rules, procedures and forms, because the information it generates is solely for internal consumption. In management accounting fixed assets may be stated at appraisal values, overhead costs may be omitted from inventories or revenues may be recorded before realization. Generally accepted principles of financial accounting do not permit such accounts. What is important in management accounting is the usefulness of the information for managerial functions rather than its general acceptability. The form and content of management accounting information differs according to the needs and purpose.

- ✓ Financial accounting is a must in case of joint stock companies to meet the statutory provisions of company law and tax laws. Even in case of sole proprietorship and partnership firms financial accounting becomes a necessity for tax purposes. Management accounting, on the other hand, is entirely optional and its forms and contents depend upon the outlook of the management.
- ✓ Financial statements prepared under financial accounting consist of monetary information only. Management accounting statements in addition to monetary information also consist non-monetary information, viz., quantities of materials consumed, and number of workers, quantities produced and sold and so on.
- ✓ Financial statements are required to be published and audited by statutory auditors. Management accounting statements are for internal use and thus neither published nor audited

Certifications

Accounting, Banking & Finance
- Certified AML- KYC Compliance Officer
- Certified Business Accountant
- Certified Commercial Banker
- Certified Equity Research Analyst
- Certified Foreign Exchange Professional
- Certified Hedge Fund Manager
- Certified Merger and Acquisition Analyst
- Certified Tally 9.0 Professional
- Certified Treasury Markets Professional
- Certified Wealth Manager

Foreign Trade
- Certified Export Import (Foreign Trade) Professional

Hospitality
- Certified Restaurant Team Member (Hospitality)

Human Resources
- Certified HR Compensation Manager
- Certified HR Staffing Manager
- Certified Human Resources Manager
- Certified Performance Appraisal Manager

Logistics & Supply Chain Management
- Certified International Logistics Professional
- Certified Logistics & SCM Professional
- Certified Purchase Manager

Law
- Certified IPR & Legal Manager

Life Skills
- Certified Business Communication Specialist
- Certified Public Relations Officer

Media
- Certified Advertising Manager
- Certified Advertising Sales Professional

Office Skills
- Certified Data Entry Operator
- Certified Office Administrator

Project Management
- Certified Project Management Professional

Real Estate
- Certified Real Estate Consultant

Information Technology
- Certified Android Apps Developer
- Certified ASP.NET Programmer
- Certified Basic Network Support Professional
- Certified Business Intelligence Professional
- Certified C# Professional
- Certified CAD Professional
- Certified Cloud Computing Professional
- Certified Computer Fundamentals (MS Office) Professional
- Certified Core Java Developer
- Certified CSS Designer
- Certified Data Mining and Warehousing Professional
- Certified DHTML & Javascript Developer
- Certified Django Developer
- Certified DTP operator
- Certified E-commerce Professional
- Certified E-Governance Professional
- Certified Enterprise Applications Integration Specialist (Biztalk)
- Certified Ethical Hacking and Security Professional
- Certified Facebook Apps Developer
- Certified Grid Computing Professional
- Certified Hadoop and Mapreduce Professional
- Certified HTML Designer
- Certified HTML5 Developer
- Certified iPhone Apps Developer
- Certified IT Support Professional
- Certified J2ME Programmer
- Certified Joomla Developer
- Certified Linux Administrator
- Certified Magento Professional
- Certified MySQL DB Administrator
- Certified Network Security Professional
- Certified Open Source CMS (Drupal) Professional
- Certified PHP Professional
- Certified PL/SQL Developer
- Certified Python Professional
- Certified Router Support Professional
- Certified Selenium Professional
- Certified SEO Professional
- Certified Software Quality Assurance Professional
- Certified Software Security Professional
- Certified Software Testing Professional
- Certified SQL Server 2008 Programmer
- Certified WiMax(4G) Professional
- Certified Wordpress Developer
- Certified XML Developer

Sales, BPO
- Certified Telesales Executive

Contact us at:
V-Skills
011-473 44 723 or info@vskills.in
Intelligent Communication Systems India Limited
DSIIDC Administrative Building,
Okhla Industrial Estate-III, New Delhi-110020
www.vskills.in