

# **COST ACCOUNTING**

( For Undergraduate Classes)

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# **COST ACCOUNTING**

## **SYLLABUS**

**UNIT-1- INTRODUCTION:** Meaning and definition of cost, costing, cost accounting and cost accountancy; objectives, advantages and limitations of cost accounting, differences between cost accounting and financial accounting.

**UNIT-2-**Elements of cost, classification of cost, cost centre, cost unit, problems on preparation of cost sheet, tenders and quotations.

**UNIT-3- Materials-** Classification and codification of materials, functions of purchase department, stores department-stores records, techniques of inventory control-stock levels, EOQ, ABC analysis, Material losses-types and treatment , Pricing of Materials- problems on LIFO, FIFO and weighted average price.

**UNIT-4- Labour:** Methods of time keeping and time booking; methods of remuneration-time rate, piece rate, Halsey and Rowan Plan, Idle time-causes and treatment, overtime, labour turnover-causes, measurement and treatment; problems on Halsey method, Rowan plan, Merick differential piece rate system, FW Taylors differential piece system.

**UNIT-5- Overheads:** Meaning, Nature, methods of classification of overheads, allocation and apportionment-problems on primary distribution, secondary distribution, repeated distribution methods. Methods of absorption of overheads- problems on Machine Hour Rate only. Activity based costing –Meaning, purpose, benefits, stages, relevance in decisionmaking.

**Introduction:**

Cost accounting is a branch of accounting. It has been developed because of the limitations of financial accounting.

Financial accounting is mainly concerned with keeping of records to show the financial information about the profit or loss of a business for a year and the financial position of the business as at the end of the year. But the management of every enterprise requires a lot of cost information. It requires periodical information, not only about the total costs of producing and selling its products, but also about the costs of its products at different processes or stages of production. It requires information about the various elements of cost, such as materials cost, labour cost and overhead costs, which constitute the cost of production and sale. It should have information to know whether losses and wastes occur in any line of activity so that corrective steps may be taken to minimise them. It should also have necessary cost data for planning and decision-making. It should have even prior estimates of costs for ascertaining whether the actual costs are within what they should have been. Above all, the above cost information should be available to the management as frequently as possible, while the work is in progress.

The information provided by the financial accounting is not of much help to the management for these purposes. **Hence, cost accounting has been developed as a separate or special branch of accounting to serve the various purposes of management.**

**COST****Definition and Meaning of Cost:**

In ordinary language, cost means price. Even the Oxford Dictionary defines cost as the price paid for something. But, in cost accounting, cost is considered different from price.

Gordon Shillinglaw defines the term 'cost' as "the resources that have been or must be sacrificed to attain a particular objective".

The I.C.M.A., London has defined cost as "the amount of expenditure (actual or notional) incurred on or attributable to a specified thing or activity".

In the words of Anthony and Welsh, "Cost is a measurement, in monetary terms, of the amount of resources used for some purpose".

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According to W.H. Harper, “Cost is the value of economic resources used as a result of producing or doing the thing costed”.

The Committee on Cost Terminology of the American Accountancy Association has defined the term ‘cost’ as “the foregoing, measured in monetary terms, incurred or potentially to be incurred to achieve a specific objective” .

Cost is also defined as “an exchange price, i.e., foregoing, a sacrifice made to secure benefit.”

From the above definitions, it is clear that cost means the total amount of expenditure, actual or notional, paid and outstanding, incurred on a particular thing, say, on the production and sale of some goods or on the provision of some service or on the completion of some work. In other words, cost is the sum total of all the expenditures incurred in producing and selling a product or in rendering a service or in performing a job. For instance, for the making of a wooden table, money has to be spent on materials like wood, nails and polish, wages to carpenter and other expenses, such as the rent and lighting charges of the workshop. The total sum spent on materials like wood, nails and polish, wages to carpenters and other expenses, such as the rent and lighting charges of the workshop constitutes the cost of the wooden table.

In the context of expenditure or expenses incurred on the production and sale of an article, on the provision of a service or on the completion of a work, it may be noted that the expenses may be **actual or notional**. The expenses are actual, if cash outlay (i.e., expenditure in cash) is involved, and the same is shown in accounting records. On other hand, if the expenses do not involve any cash outlay, and so, are not shown in accounting records, but yet are taken into consideration for the purpose of comparison and managerial decisions, they are considered **notional expenses**. For instance, the cost of materials purchased for money, the wages paid to workers and the other expenses paid in cash constitute the **actual expenses**. On the other hand, the costs of land and buildings, labour and capital owned by the proprietor and supplied to the business free of charge constitute the **notional expenses**.

### **Importance of Cost in Cost Accounting:**

Cost is an important factor in cost accounting. Cost data about a product, a service or a job is useful in several respects. **The important uses of cost data are:**

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- (a) Cost is one of the factors taken into account in the fixation of the price of a product, a service or a job.
  - (b) Actual cost is the basis of making an estimate of the probable cost of a product, service or job at a future date.
  - (c) Cost is an essential factor for ascertaining the profit of a product, service or job.
  - (d) Cost data about a product, service or job throws light on the wastage and losses that arise in the production and sale of a product or provision of a service or performance of a job.
  - (e) Cost data is helpful in evaluating the efficiency of a concern.
  - (f) The behavior of cost in relation to the scale of operations helps a firm in determining the optimum level of operations.
  - (g) Cost data is helpful in choosing from among alternative courses of action.
  - (h) It is helpful in deciding whether to sell a product in semi-finished form or to process it further and sell it in finished form.
  - (i) Cost data is helpful in taking ‘**make or buy**’ decisions (i.e., to decide whether it is profitable to make a component within the concern or buy the same from outside).
  - (j) It is helpful in deciding whether to buy an asset or to hire or lease it.

## **COSTING**

### **Definition of Meaning of Costing:**

**Stanbus has defined costing as “The process of determining the cost of doing something, i.e., the cost of manufacturing an article, rendering a service or performing a function.”**

**The Institute of Cost and Management Accountants (I.C.M.A.) London, also has defined the term ‘costing’ as “the technique and process of ascertaining costs.”**

**From these definitions, it is clear that costing is the technique (i.e., the body of principles and rules) and the process (i.e., the routine procedure) for determining (i.e., ascertaining) the cost of a product, service or job. In other words, it is the process or the procedure followed for the ascertainment of the cost of a product, service or job, and the principles and rules which govern the process**

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of ascertainment of costs. In short, costing is the systematic procedure of ascertaining the cost of a product, service or job.

**Scope of Costing:**

Costing, in its general sense or narrow sense, has a very narrow scope. It covers mere cost finding or cost ascertainment. Cost finding or cost ascertainment means finding or ascertaining the cost of a product, service or job.

## **COST ACCOUNTING**

**Definition and Meaning of Cost Accounting:**

Wheldon has defined cost accounting as “the classifying, recording and appropriate allocation of expenditure for the determination of the costs of products or services; and for the presentation of suitably arranged data for purposes of control and guidance of the management.”

According to Van Sickle, ‘Cost accounting is the science of recording and presenting business transactions pertaining to the production of goods and services, whereby these records become a method of measurement and a means of control.’”

In the “Terminology of Cost Accountancy” published by the Institute of Cost and Management Accountants, London, cost accounting is defined as “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 centres and cost units. In its widest usage, it embraces preparation of statistical data, the application of cost control methods and the ascertainment of the profitability of activities carried out or planned.”

From these definitions, it is very clear that cost accounting is the process of accounting for costs, which begins with the recording of costs and ends with the preparation of statistical data, for cost finding, cost control, ascertainment of profitability and internal reporting for managerial decisions. In other words, cost accounting is the formal or special accounting mechanism for cost finding, cost control, ascertainment of profitability of activities carried out or planned, and reporting (i.e., presentation) of cost data to the management for decision-making. In short, cost accounting is the formal system of accounting for costs by means of which costs of products or services are ascertained and controlled.

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### Nature of Cost Accounting:

**The nature of cost accounting can be clearly understood from its characteristics. The chief characteristics of cost accounting are:**

- (a) Cost accounting is a science, i.e., an organised body of knowledge with certain principles and rules.
- (b) The principles of cost accounting have been developed over a period of time by experience. **In the words of Bigg, “Costing is an empirical science, that is to say the rules which govern it are largely conditioned by the operations, personnel and policy of the undertaking with respect to which its techniques are to be applied.”**
- (c) The principles, rules and techniques of cost accounting are not static. They are dynamic, changing with the passage of time.
- (d) Although cost accounting is regarded as a science, it is not an exact science like mathematics, physics and chemistry, as its principles cannot be verified and proved by controlled experiments.
- (e) As cost accounting is operated by human beings, who have feelings and emotions, cost accounting can very well be called a **behavioural science**.
- (f) Cost accounting is not only a science, but also an art. Cost accounting is an art, in the sense that the application of the principles of cost accounting requires skills and efforts and practice on the part of the cost accountant.

### Scope of Cost Accounting:

In the initial stages, cost accounting was concerned with mere accumulation of historical costs and presentation of the same for the sole purpose of cost finding or cost ascertainment. But with the passage of time, the scope of cost accounting has widened. Today, the scope of costing has become very wide.

Not only the scope of cost accounting has widened, the extent of application of cost accounting also has become wider. In the beginning, cost accounting was adopted only in manufacturing industries. Today, cost accounting is in use not only in manufacturing industries, but also in other undertakings like transport undertakings, printing industry, Government undertakings, banks, insurance companies, hospitals, educational institutions, etc.

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**As stated above, today, the scope of cost accounting has become wider. Cost accounting covers four aspects. They are:**

- (1) Cost ascertainment**
- (2) Ascertainment of profitability**
- (3) Cost presentation**
- (4) Cost control**

**(a) Cost ascertainment:**

One of the important aspects of cost accounting is cost finding or cost ascertainment. Cost ascertainment means finding or ascertaining the cost of a product, service or job. For the ascertainment of the cost of a product, service or job, first, the various expenses incurred are collected and analysed (i.e., classified). Then, the production at different stages is measured. Finally, the production is linked up with the expenses (i.e., the analysed expenses are related to the product, service or job) and the cost of the product, service or job is ascertained. The collection and analysis of expenses is done by adopting **certain systems of costing, such as historical costing, estimated costing and standard costing**. The measurement of production at different stages is made by adopting **certain methods or types of costing, such as single or output costing, job costing, contract costing, process costing, etc.** The linking up of production with the analysed expenses is done by adopting **certain techniques of costing, such as absorption costing, marginal costing, standard costing, etc.**

**(b) Ascertainment of profitability:**

Ascertainment of profitability means the determination of the actual profit of each product or service. It also includes the determination of the potentiality to make profit on each product or service. Cost accounting, through its recorded and analysed cost data, helps in the ascertainment of the profitability of each product, service or activity.

**(c) Cost presentation :**

Cost presentation refers to the reporting of cost data to the various levels of management to help them in their managerial decisions. It involves the presentation of the right cost data to the right personnel at the right time in the right form. For efficient cost presentation or reporting, various printed forms and statements are, generally, used.

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**(d) Cost control:**

**Cost control means regulation, by executive action, of actual cost of operating an undertaking. In other words, it means making the actual costs conform to planned costs. In short, it is the function of keeping actual cost within prescribed limits.**

**Cost control involves the following steps:**

- (i) Setting up of targets for expenses and production performance.
- (ii) Measurement of actual expenses and production performance from time to time, while the work is in progress.
- (iii) Comparing the actual with the standards to find out the variances (i.e., variations), if any.
- (iv) Analysing the reasons for the variances.
- (v) Taking up remedial or corrective steps to eliminate the variances and to make the actual costs and performance conform to the standard costs and performance.

Cost control can be effected through two main methods of control, viz., **budgetary control and standard costing.**

**Differences between Costing and Cost Accounting:**

In actual practice, the terms '**costing**' and '**cost accounting**' are often used interchangeably. But for technical and academic purposes, these two terms can be distinguished. **The main technical and academic differences between costing and cost accounting are as follows:**

1. Costing is the technique and process of ascertaining costs, whereas cost accounting is the formal or special accounting mechanism by which costs are ascertained.
2. Costing lays emphasis on the principles and rules for cost ascertainment, whereas cost accounting lays emphasis on the formal accounting mechanism (i.e., procedure) for cost ascertainment.
3. Costing, i.e., ascertainment of cost, can be done through any means, say, through mental arithmetic, through memorandum statements or through formal or special accounting system. But cost accounting implies cost ascertainment only through the formal or special accounting system.
4. Generally, costing, i.e., cost finding, is based upon cost accounting.