

**MARUDHAR KESARI JAIN COLLEGE FOR WOMEN  
(AUTONOMOUS)  
PG and Research Department of Commerce**

<b>Core Course – Cost Accounting-I</b>	<b>23UCM 51</b>
<b>UNIT-I: Nature and Scope of Cost Accounting</b>	
Definition-Nature and Scope – Principles of Cost Accounting – Cost Accounting and Financial Accounting - Cost Accounting Vs Management Accounting Installation of Costing System – Classification of Costs– Cost Centre– Profit Centre.	
<b>Learning Objectives :</b> To understand the basic concepts and methods of Cost Accounting.	
<b>Course Outcome:</b> The students can able to understand,Remember and recall the various concepts of cost accounting.	

### Introduction

The period 1880 AD- 1925 AD saw the development of complex product designs and the emergence of multiactivity diversified corporations like DuPont, General Motors etc. It was during this period that scientific management was developed which led the accountants to convert physical standards into Cost Standards, the latter being used for variance analysis and control.

During the World War I and II the social importance of Cost Accounting grew with the growth of each country's defence expenditure. In the absence of competitive markets for most of the materials required for war, the governments in several countries placed cost-plus contracts under which the price to be paid was cost of production plus an agreed rate of profit. The reliance on cost estimation by parties to defence contracts continued after World War II.

In addition to the above, the following factors have made accountants to find new techniques to serve the industry :-

- i) Limitations placed on financial accounting
  - ii) Improved cost consciousness
  - iii) Rapid industrial development after industrial revolution and world wars
- Growing competition among the manufacturers
- iv) To control galloping price rise, the cost of computing the precise cost of product/service
  - v) To control cost several legislations passed throughout the world and India too such as Essential Commodities Act, Industrial Development and Regulation Act...etc

Due to the above factors, the Cost Accounting has emerged as a specialized discipline from the initial years of 20th century i.e after World War I and II.

In India, prior to independence, there were a few Cost accountants, and they were qualified mainly from I.C.M.A. (now CIMA) London. During the Second World War, the need for developing the profession in the country was felt, and the leadership of forming an Indian Institute was taken by some members of Defence Services employed at Kolkata. However, with the enactment of the Cost and Works Accountants of India Act, 1959, the Institute of Cost and Works Accountants of India (Now called as The Institute of Cost Accountants of India) was established at Kolkata. The profession assumed further importance in 1968 when the Government of India introduced Cost Audit under section 233(B) of the Companies Act, 1956. At present it is under Section 148 of the Companies Act, 2013.

Many times we use Cost Accounting, Costing and Cost Accountancy interchangeably. But there are differences among these terms. As a professional, though we use interchangeably we must know the meaning of each term precisely.

**Cost Accounting:** Cost Accounting may be defined as “Accounting for costs classification and analysis of expenditure as will enable the total cost of any particular unit of production to be ascertained with reasonable degree of accuracy and at the same time to disclose exactly how such total cost is constituted”.

Thus Cost Accounting is classifying, recording an appropriate allocation of expenditure for the determination of the costs of products or services, and for the presentation of suitably arranged data for the purpose of control and guidance of management.

Cost Accounting can be explained as follows :-

Cost Accounting is the process of accounting for cost which begins with recording of income and expenditure and ends with the preparation of statistical data.

It is the formal mechanism by means of which cost of products or services are ascertained and controlled.

Cost Accounting provides an analysis and classification of expenditure as will enable the total cost of any particular unit of product / service to be ascertained with reasonable degree of accuracy and at the same time to disclose exactly how such total cost is constituted. For example it is not sufficient to know that the cost of one pen is ₹ 25/- but the management is also interested to know the cost of material used, the amount of labour and other expenses incurred so as to control and reduce its cost.

It establishes budgets and standard costs and actual cost of operations, processes, departments or products and the analysis of variances, profitability and social use of funds.

Thus

Cost Accounting is a quantitative method that collects, classifies, summarises and interprets information for product costing, operation planning and control and decision making.

**Costing: Costing is defined as the technique and process of ascertaining costs.**

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

- |                                   |   |  |
|-----------------------------------|---|--|
| (1) Prime Cost                    | = | Direct Materials + Direct Labour + Direct Expenses     |
| (2) Works Cost (Factory)          | = | Prime Cost + Factory Overhead                          |
| (3) Cost of Production            | = | Factory Cost + Office and Administrative Overhead      |
| (4) Cost of Sales (or) Total Cost | = | Cost of Production + Selling and Distribution Overhead |

## Materials Cost

Materials Costs refer to cost of materials which are the major substances used in production and are converted into finished goods and semi-finished goods. Materials are grouped as direct materials and indirect materials.

**Direct Materials:** Direct materials are those that form part of a product. Raw materials, semi-finished products, and finished products which can be identified with production of a product are known as direct materials. Sugar cane, cotton, oil seeds, wood etc. are examples of direct materials. The cost of materials involves conversion of raw materials into finished products.

**Indirect Materials:** Material costs, other than direct material cost are known as indirect material cost. Indirect materials cannot be identified with a particular unit of cost or product. Indirect materials are indirectly used for producing the products. Lubricating oil, consumable stores, fuel, design, layout etc. are examples of indirect material cost.

## Labour Cost

In actual production of the product, labour is the prime factor which is physically and mentally involved. The payment of remuneration of wages is made for their effort. The labour costs are grouped into (a) Direct Labour and (b) Indirect Labour.

**Direct Labour:** Direct labour cost or direct wages refer to those specifically incurred for or can be readily charged to or identified with a specific job, contract, work order or any other unit of cost are termed as direct labour cost. Wages for supervision, wages for foremen, wages for labourers who are actually engaged in operation or process are examples of direct labour cost.

**Indirect Labour:** Indirect labour is for working general. The importance of the distinction lies in the fact that whereas direct labour can be identified with and charged to the job, indirect labour cannot be so charged and has therefore to be treated as part of the factory overheads to be included in the cost of production. Examples are salaries and wages of supervisors, storekeepers, maintenance labour etc.

## Expenses

All expenses are other than material and labour that are incurred for a particular product or process. They are defined by ICMA as 'the cost of service provided to an undertaking and the notional cost of the use of owned assets.' Expenses are further grouped into (a) Direct Expenses and (b) Indirect Expenses.

**Direct Expenses:** Direct expenses which are incurred directly and identified with a unit of output or process are treated as direct expenses. Hire charges of special plant or tool, royalty on product, cost of special pattern etc. are the examples of direct expenses.

**Indirect Expenses:** Indirect expenses are expenses other than indirect materials and indirect labour, which cannot be directly identified with a unit of output. Rent, power, lighting, repairs, telephone etc. are examples of indirect expenses.

## Overheads

All indirect material cost, indirect labour cost, and indirect expenses are termed as Overheads.

Overheads may also be classified into (a) Production or Factory Overhead (b) Office and Administrative Overheads (c) Selling Overhead and (d) Distribution Overhead.

**Production Overhead:** Production Overhead is also termed as Factory Overhead. Factory overhead includes indirect material, indirect labour and indirect wages which are incurred in the factory. For example, rent of factory building, repairs, depreciation, wages of indirect workers, etc.

**Office and Administrative Overhead:** Office and Administrative Overhead is the indirect expenditure incurred in formulating the policies, establishment of objectives, planning, organizing and controlling the operations of an undertaking. All office and administrative expenses like rent, staff salaries, postage, telegram, general expenses etc. are examples.

**Selling Overhead:** Selling Overhead is the indirect expenses which are incurred for promoting sales, stimulating demand, securing orders and retaining customers. For example, advertisement, salesmen's commission, salaries of salesmen etc.

**Distribution Overhead:** These costs are incurred from the time the product is packed until it reaches its destination. Cost of warehousing, cost of packing, transportation cost etc. are some of the examples of distribution overhead.

## OBJECTIVES AND FUNCTIONS OF COST ACCOUNTING

The main objectives of cost accounting are as follows:

1. **Ascertainment of cost.** This is the primary objective of cost accounting. In other words, the basic objective of cost accounting is to ascertain the cost of products and services. For cost ascertainment different techniques and systems of costing are used in different industries.
2. **Control and reduction of cost.** Cost accounting aims at improving efficiency by controlling and reducing cost. This objective is becoming increasingly important because of growing competition.
3. **Guide to business policy.** Cost accounting aims at serving the needs of management in conducting the business with utmost efficiency. Cost data provide guidelines for various managerial decisions like make or buy, selling below cost, utilisation of idle plant capacity, introduction of a new product, etc.
4. **Determination of selling price.** Cost accounting provides cost information on the basis of which selling prices of products or services may be fixed. In periods of depression, cost accounting guides in deciding the extent to which the selling prices may be reduced to meet the situation.
5. **Measuring and improving performance.** Cost accounting measures efficiency by classifying and analysing cost data and then suggest various steps in improving performance so that profitability is increased. In order to realise these objectives, the data provided by cost accounting may have to be reclassified, re-organised and supplemented by other relevant business data from outside the formal cost accounting system.

## COST ACCOUNTING AND FINANCIAL ACCOUNTING — COMPARISON

Both cost accounting and financial accounting are concerned with systematic recording and presentation of financial data. The two systems rest on the same principles concerning debit and credit and have the same sources of recording the transactions. But cost accounting is much more detailed than financial accounting. This is because in financial accounting profit or loss is ascertained for the business as a whole whereas in cost accounting detailed cost and profit data for various parts of business like departments, products, etc., are shown. This is explained in the following example :

Suppose a company is manufacturing three products — A, B and C. Under financial accounting and cost accounting the following types of statements are prepared.

Under Financial Accounting. A Profit and Loss Account is prepared to compute profit as shown below (data is assumed):

Financial Accounting	Cost Accounting
----------------------	-----------------

(a) It provides the information about the business in a general way, i.e. Profit and Loss Account, Balance Sheet of the business to owners and other outside partners.	(a) It provides information to the management for proper planning, operation, control and decision making.
(b) It classifies, records and analyses the transactions in a subjective manner, i.e. according to the nature of expense.	(b) It records the expenditure in an objective manner, i.e. according to the purpose for which the costs are incurred.
(c) It lays emphasis on recording a aspect without attaching any importance to control.	(c) It provides a detailed system of control for materials, labour and overhead costs with the help of standard costing and budgetary control.
(d) It reports operating results and financial position usually at the end of the year.	(d) It gives information through cost reports to management as and when desired.
(e) Financial Accounts are accounts of the whole business. They are independent in nature.	(e) Cost Accounting is only a part of the financial accounts and discloses profit or loss of each product, job or service.
(f) Financial Accounts records all the commercial transactions of the business and include all expenses i.e. Manufacturing, Office, Selling etc.	(f) Cost Accounting relates to transactions connected with Manufacturing of goods and services, means expenses which enter into production.
(g) Financial Accounts are concerned with external transactions i.e. transactions between business concern and third party.	(g) Cost Accounts are concerned with internal transactions, which do not involve any cash payment or receipt.
(h) Only transactions which can be measured in monetary terms are recorded.	(h) Non-Monetary information like No of Units/Hours etc are used.
(i) Financial Accounting deals with actual figures and facts only.	(i) Cost Accounting deals with partly facts and figures and partly estimates / standards.
(j) Financial Accounting do not provide information on efficiencies of various workers/ Plant & Machinery.	(j) Cost Accounts provide valuable information on the efficiencies of employees and Plant & Machinery.
(k) Stocks are valued at Cost or Market price whichever is lower.	(k) Stocks are valued at Cost only.
(l) Financial Accounting is a positive science as it is subject to legal rigidity with regarding to preparation of financial statements.	(l) Cost Accounting is not only positive science but also normative because it includes techniques of budgetary control and standard costing.

(m) These accounts are kept in such away to meet the requirements of Companies Act 2013 as per Sec 128 & Income Tax Act, 1961 Sec 44AA.	(m) Generally Cost Accounts are kept voluntarily to meet the requirements of the management, only in some industries Cost Accounting records are kept as per the Companies Act.
---	---

### **Cost Accounting and Management Accounting**

Management Accounting is primarily concerned with management. It involves application of appropriate techniques and concepts, which help management in establishing a plan for reasonable economic objective. It helps in making rational decisions for accomplishment of these objectives. Any workable concept or techniques whether it is drawn from Cost Accounting, Financial Accounting, Economics, Mathematics and Statistics, can be used in Management Accountancy. The data used in Management Accountancy should satisfy only one broad test. It should serve the purpose that it is intended for. A Management Accountant accumulates, summarizes and analysis the available data and presents it in relation to specific problems, decisions and day-to-day task of management. A Management Accountant reviews all the decisions and analysis from management's point of view to determine how these decisions and analysis contribute to overall organizational objectives. A Management Accountant judges the relevance and adequacy of available data from management's point of view.

The scope of Management Accounting is broader than the scope of Cost Accountancy. In Cost Accounting, primary emphasis is on cost and it deals with its collection analysis relevance interpretation and presentation for various problems of management. Management Accountancy utilizes the principles and practices of Financial Accounting and Cost Accounting in addition to other management techniques for efficient operations of a company. It widely uses different techniques from various branches of knowledge like Statistics, Mathematics, Economics, Laws and Psychology to assist the management in its task of maximising profits or minimising losses. The main thrust in Management Accountancy is towards determining policy and formulating plans to achieve desired objective of management. Management Accounting makes corporate planning and strategy effective.

From the above discussion we may conclude that the Cost Accounting and Management Accounting are interdependent, greatly related and inseparable.

### **Advantages of Cost Accounting**

Cost Accounting has manifold advantages, a summary of which is given below. It is not suggested that having installed a system of Cost Accounting, a concern will expect to derive all the benefits stated here, the nature and the extent of the advantages obtained will depend upon the type, adequacy and efficiency of the cost system.

installed and the extent to which the various levels of management are prepared to accept and act upon the advice rendered by the cost system.

The Cost Accounting System has the following advantages:-

1.  
A cost system reveals unprofitable activities, losses or inefficiencies occurring in any form such as (i) Wastage of manpower, (ii) idle time and lost time (iii) Wastage of material in the form of spoilage, excessive scrap etc., and Wastage of resources, e.g. inadequate utilization of plant, machinery and other facilities.
2. Cost Accounting locates the exact causes for decrease or increase in the profit or loss of the business. It identifies the unprofitable products or product lines so that these may be eliminated or alternative measures may be taken.
3.  
Cost Accounts furnish suitable data and information to the management to serve as guides in making decisions involving financial considerations.
4. Cost Accounting is useful for price fixation purposes. Although sale price is generally related more to economic conditions prevailing in the market than to cost, the latter serves as a guide to test the adequacy of selling prices.
5.  
With the application of Standard Costing and Budgetary Control methods, the optimum level of efficiency is set.
6. Cost comparison helps in cost control. Comparison may be period to period, of the figures in respect of the same unit or factory or of several units in an industry by employing Uniform Costs and Inter-Firm Comparison methods. Comparison may be made in respect of cost of jobs, process or cost centres.
7.  
A cost system provides ready figures for use by the Government, wage tribunals and boards, and labour and trade unions.
8. When a concern is not working to full capacity due to various reasons such as shortage of demands or bottlenecks in production, the cost of idle capacity can readily be worked out and reported to the management.
9. Introduction of a cost reduction programme combined with operations research and value analysis techniques leads to economy.
10. Marginal Costing is employed for suggesting courses of action to be taken. It is a useful tool for the management for making decisions.

11. Determination of cost centres or responsibility centres to meet the needs of a Cost Accounting system, ensures that the organizational structure of the concern has been properly laid responsibility can be properly defined and fixed on individuals.

12.

Perpetual inventory system which includes a procedure for continuous stock taking is an essential feature of a cost system.

13. The operation of a system of cost audit in the organization prevents manipulation and fraud and assists in furnishing correct and reliable cost data to the management as well as to outside parties like shareholders, the consumers and the Government.

### **Limitations of Cost Accounting system**

Like any other system of accounting, Cost Accountancy is not an exact science but an art which has developed through theories and accounting practices based on reasoning and commonsense. Many of the theories cannot be proved nor can they be disproved. They grown up in course of time to become conventions and accepted principles of Cost Accounting. These principles are by no means static, they are changing from day to day and what is correct today may not hold true in the circumstances tomorrow.

Large number of Conventions, Estimates and Flexible factors: No cost can be said to be exact as they incorporate a large number of conventions, estimations and flexible factors such as :-

- a. Classification of costs into its elements.
- b. Materials issue pricing based on average or standard costs.
- c. Apportionment of overhead expenses and their allocation to cost units/centres.
- d. Arbitrary allocation of joint costs.
- e. Division of overheads into fixed and variable.
- f. Cost Accounting lacks the uniform procedures and formats in preparing the cost information of a product/ service. Keeping in view this limitation, all Cost Accounting results can be taken as mere estimates.

## **ELEMENTS OF COST**

### **Introduction**

Elements of cost are necessary to have a proper classification and analysis of total cost. Thus, elements of cost provide the management with necessary information for proper control and management decisions. For this purpose, the total cost is analysed by the elements or nature of cost, i.e., material, labour and overheads. The various elements of costs may be illustrated as below:

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

(1) Prime Cost = Direct Materials + Direct Labour + Direct Expenses

(2) Works Cost (Factory) = Prime Cost + Factory Overhead

(3) Cost of Production = Factory Cost + Office and Administrative Overhead

(4) Cost of Sales (or) Total Cost = Cost of Production + Selling and Distribution Overhead

## **(I) Materials Cost**

Materials Costs refer to cost of materials which are the major substances used in production and are converted into finished goods and semi-finished goods. Materials are grouped as direct materials and indirect materials.

**Direct Materials:** Direct materials are those that form part of a product. Raw materials, semi-finished products, and finished products which can be identified with production of a product are known as direct materials. Sugar cane, cotton, oilseeds, woods etc. are examples of direct materials. The cost of materials involves conversion of raw materials into finished products.

**Indirect Materials:** Material costs, other than direct material cost are known as indirect material cost. Indirect materials cannot be identified with a particular unit of cost or product. Indirect materials are indirectly used for producing the products. Lubricating oil, consumable stores, fuel, design, layout etc. are examples of indirect material cost.

## **(II) Labour Cost**

In actual production of the product, labour is the prime factor which is physically and mentally involved. The payment of remuneration of wages is made for their effort. The labour costs are grouped into (a) Direct Labour and (b) Indirect Labour.

**(a) Direct Labour:** Direct labour cost or direct wages refer to those specifically incurred for or can be readily charged to or identified with a specific job, contract, work order or any other unit of cost are termed as direct labour cost. Wages for supervision, wages for foremen, wages for labours who are actually engaged in operation or process are examples of direct labour cost.

**(b) Indirect Labour:** Indirect labour is for work in general. The importance of the distinction lies in the fact that whereas direct labour can be identified with and charged to the job, indirect labour cannot be so charged and has therefore to be treated as part of the factory overheads to be included in the cost of production. Examples are salaries and wages of supervisors, store keepers, maintenance labour etc.

## **(III) Expenses**

All expenses are other than material and labour that are incurred for a particular product or process. They are defined by ICMA as "The cost of service provided to an undertaking and

the notional cost of these owned assets." Expenses are further grouped into (a) Direct Expenses and (b) Indirect Expenses.

**(a) Direct Expenses:** Direct expenses which are incurred directly and identified with a unit of output or process are treated as direct expenses. Hire charges of special plant or tool, royalty on product, cost of special pattern etc. are the examples of direct expenses.

**(b) Indirect Expenses:** Indirect expenses are expenses other than indirect materials and indirect labour, which cannot be directly identified with a unit of output. Rent, power, lighting, repairs, telephone etc. are examples of indirect expenses

#### **(IV) Overheads**

All indirect material cost, indirect labour cost, and indirect expenses are termed as overheads. Overheads may also be classified into (a) Production or Factory Overhead (b) Office and Administrative Overheads (c) Selling Overhead and (d) Distribution Overhead.

**(a) Production Overhead:** Production Overhead is also termed as Factory Overhead. Factory overhead includes indirect material, indirect labour and indirect wages which are incurred in the factory. For example, rent of factory building, repairs, depreciation, wages of indirect workers, etc.

**(b) Office and Administrative Overhead:** Office and Administrative Overhead is the indirect expenditure incurred in formulating the policies, establishment of objectives, planning, organizing and controlling the operations of an undertaking. All office and administrative expenses like rent, staff salaries, postage, telegram, general expenses etc. are examples.

**(c) Selling Overhead:** Selling Overhead is the indirect expenses which are incurred for promoting sales, stimulating demand, securing orders and retaining customers. For example, advertisement, salesmen's commission, salaries of salesmen etc.

**(d) Distribution Overhead:** These costs are incurred from the time the product is packed until it reaches its destination. Cost of warehousing, cost of packing, transportation cost etc. are some of the examples of distribution overhead.

#### **Following are the essentials of a good cost accounting system**

##### **(i) Simple to Operate:**

The cost accounting system should be simple to understand and operate so that persons involved may not be confused and follow wrong procedures or methods.

##### **(ii) Flexibility:**

The cost accounting system should be flexible to adopt new requirements based on changes occurring in the enterprise due to external conditions.

##### **(iii) Comparability:**

The costing system should be able to provide comparable data. Comparison can be between the figures of two or more periods of the same firm or between the figures of the firm and those of the competitors for a particular period or periods.

##### **(iv) Economy:**

The cost accounting system should justify the cost of operation through resultant benefits. The system should be operated with least cost.

##### **(v) Timeliness:**

The system must be capable of providing appropriate information in Time for decisions relating to cost control.

**(vi) Suitability to the Enterprise:**

The cost accounting system devised should be suitable to the nature of business done by the enterprise and it should fulfil the requirements of the business

**(vii) Minimum Changes in Current Setup:**

The existing system of Authority and responsibility, delegation etc., should not be disturbed. Changes in the organisational setup should be minimum possible.

**(viii) Minimum Clerical Work:**

The clerical work like filling up forms by workers and foremen should be minimum possible so that their basic work rhythm is not disturbed.

**(ix) Simplicity of Forms and their Standardisation:**

The forms used as part of the costing system should be minimum in number, standardised in format and simple to operate by the personnel so that required information is obtained in time.

**(x) Effective System to Control Materials and Wages:**

The system relating to purchase, receiving, inspection, storage and issue of materials should be effective. The method of pricing material issues should be appropriate to the situation in the firm.

**(xi) Procedure for Overheads:**

The routine prescribed for overheads should lead to proper allocation, apportionment and absorption of overheads.

**(xii) Reconciliation:**

Reconciliation of cost accounting with financial accounting is to be facilitated to reveal the reasons for difference in profits.

**(xiii) External Factors:**

The costing system should ensure compliance of statutory and legal requirements like cost audit, cost accounting rules etc.

**(xiv) Cost Accountant's Role:**

The responsibilities, and duties of the cost accountant should be clearly defined. He should have access to all the departments and divisions of the firm.

## **Steps Necessary to Install the Costing System**

**The following steps have to be carefully followed to install a costing system successfully:**

**(i) Objectives:**

While installing the cost accounting system the objectives of the system have to be finalised, like materials management, fixing selling prices, etc. The approach to install the system will depend on it; objectives.

**(ii) Organisation Structure of the Business:**

Organisation structure of the business determines the scope of authority and responsibility of each individual in the organisation. While installing the system, minor changes, if any, to be made in the structure for the advantage of management may be carried out.

**(iii) Type and Method of Costing:**

Nature of business decides the type of costing to be introduced. Examples are job costing, process costing, operating costing, unit costing, etc. For the purpose of cost control appropriate technique is to be introduced i.e., standard costing or budgetary control or any other appropriate technique.

**(iv) Cost Records and Books:**

It is to be decided whether separate set of cost and financial books are to be maintained or an integrated accounting system is to be followed. This depends on nature and size of the enterprise and the existing accounting system.

**(v) Technical Aspects:**

A detailed study of technical aspects of manufacturing process, operations, material control, labour control, wage disbursement, factor layout, etc., is of great significance. This will be helpful in preventing wastage of labour, material, etc., and designing effective procedures and forms.

**(vi) Control System:**

Cost accounting system would have to be designed to record and control different elements of cost in accordance with costing procedures and principles and the limitations imposed by the type of organisation that exists.

**(vii) Nature of Product and Business:**

Nature of the product and the type of business decide the emphasis of cost control. If the material forms major part of the total cost, emphasis is laid on material control. If labour constitutes major portion of the total cost, labour is to be controlled with special emphasis.

**(viii) Collection of Data:**

Cost data is the basis for decision making. An efficient system of collection and verification of the data is to be devised for prompt collection of cost data.

**(ix) Cooperation of Staff:**

Details of the system should be explained to the staff so that the cost accounting system can work efficiently by cooperation among the staff.

**(x) Organising the Cost Office:**

It is preferable to have a separate cost office which has access to the factory.

**Specific Considerations for Installing Costing System**

The specific considerations as distinct from general considerations to be kept in view while the installation of costing system are as follows:

1. **Size and Nature of Business:** In a business of big size, a detailed cost system is necessary while in a small business, the system should be within the requirements so that the expenses on the installation and its working may not out-weigh the utility. The cost system is good for business engaged in manufacturing or in service-rendering concerns but for others. Even in production enterprise like colliery where the production costs are all direct costs, the financial where the production costs are all direct costs, the financial accounts may be so designed as to obviate the need of any cost system, unless otherwise called for.
2. **Products:** the nature of product determines the method of costing to be applied. If the material content of the product is more valuable, the material cost records need be kept in comparatively more elaborate manner so as to make material cost control effective. Same is the position with regard to labour and overhead.
3. **Organisation:** The organizational set up for a costing system should be modelled that the control part is exercised by the Cost Accountant, as such; the present organizational set up of the costing department need close study to suggest necessary changes.
4. **Functional study:** The functional divisions of an undertaking based on cost are a) Manufacturing, b) Administration, and c) Selling & Distribution. A study of the present working of the different departments in necessary to suggest improvements.

**Cost Centers:** These are segments of a business where the focus is strictly on controlling expenses. The performance is measured not by profits, but by how well costs are contained.

For instance, a manufacturing plant is often considered a cost center because it incurs costs through production but does not directly generate revenue.

**Profit Centers:** In contrast, profit centers are involved in both generating revenue and incurring costs, thereby directly influencing the company's profitability. A classic example would be a sales division, which not only generates sales (revenue) but also incurs costs related to marketing and personnel.

### **Key Differences Between Profit Centers and Cost Centers**

The distinction between profit centers and cost centers lies at the heart of organizational structure and financial management. Profit centers are business units or departments within a company that are directly responsible for generating revenue. They have their own income statements and are evaluated based on their ability to produce profits. This autonomy allows profit centers to make decisions that directly affect their financial performance, such as pricing strategies, marketing efforts, and product development. For instance, a retail store within a larger corporation operates as a profit center, with its success measured by sales and profitability.

On the other hand, cost centers are units that do not directly generate revenue but are indispensable for the smooth functioning of the organization. These include departments like human resources, IT, and customer service. Their primary function is to manage and control costs while providing essential support services. Unlike profit centers, cost centers are evaluated based on their ability to operate within budgetary constraints and improve efficiency. For example, an IT department is a cost center that incurs expenses related to maintaining and upgrading technology infrastructure, which is crucial for the overall productivity of the company.

The management approach for these two types of centers also differs significantly. Profit centers are often given more autonomy to innovate and take risks, as their performance directly impacts the company's profitability. Managers of profit centers are incentivized to maximize revenue and minimize costs to boost their unit's financial performance. Conversely, cost centers are typically more tightly controlled, with a focus on cost reduction and efficiency improvements. Managers of cost centers are tasked with finding ways to deliver their services more effectively while adhering to budgetary limits.

### **Model Questions**

#### **SECTION-A**

1. What is Cost?
2. Define Cost Accounting
3. What do you understand by Cost Centre?
4. What is Direct Material?
5. What is meant by Profit Centre?
6. What is cost Centre?
7. Write note on Tender.

#### **SECTION-B**

8. What are the limitations of Cost Accounting?
9. What are the advantages of Cost Accounting?

10. What are the difference between Financial Accounting and Cost Accounting?
11. Explain The Scope of Cost Accounting.

### **SECTION- C**

12. What are the various elements of Cost? Explain
13. How Would you Classify the Cost
14. Differentiate Between Cost and Profit Centre

### **TEXT BOOKS:**

1. T.S. Reddy & Hari Prasad Reddy – Cost Accounting – Margham Publications, Chennai
2. A. Murthy and S. Gurusamy, Cost Accounting 2<sup>nd</sup> Edition, Vijay Nicole Imprints Private Ltd., Chennai.
3. A. Murthy and S. Gurusamy, Cost Accounting, Tata McGraw-Hill Publishing Company Ltd. New Delhi.
4. Tulsian P.C. – Cost Accounting – Tata McGraw Hills.

### **REFERENCE BOOKS:**

1. S.P. Jain and Narang – Cost Accounting – Kalyani Publishers, New Delhi
2. S.N. Maheswari – Principles of Cost Accounting – Sultan Chand & sons, New Delhi
3. S.P. Iyengar – Cost Accounting – Sultan Chand & Sons, New Delhi.