**Chapter 1**

**The nature of cost and managerial accounting**

**Nature and Scope of Cost Accounting**

In the modern business world, the nature and functioning of business organisations have become very complicated. They have to serve the needs of variety of parties who are interested in the functioning of the business. These parties constitute the owners, creditors, employees, government agencies, tax authorities, prospective investors, and last but not the least the management of the business. The business has to serve the needs of these different categories of people by way of supplying various information from time to time. In order to satisfy the needs of all these group of people a sound organisation of accounting system is very essential. In the ancient days the information required by those who were interested with a business organisation was met by practising a system of accounting known as financial accounting system. Financial accounting is mainly concerned with preparation of two important statements, viz., income statement (or profit and loss account) and positional statement (or Balance Sheet). This information served the needs of all those who are not directly associated with management of business. Thus financial accounting is concerned with external reporting as it provides information to external authorities. But management of every business organisation is interested to know much more than the usual information supplied to outsiders. In order to carry out its functions of planning, decision-making and control, it requires additional cost data. The financial accounting to some extent fails to provide required cost data to management and hence a new system of accounting which could provide internal report to management was conceived of.

**Q.1.** Name the parties interested in the functioning of the business.

**Ans.1.** These parties constitute the owners, creditors, employees, government agencies, tax authorities, prospective investors, and last but not the least the management of the business.

**Q.2.** Which accounting in the ancient days information required by interested parties was met?

**Ans.2.** In the ancient days the information required by those who were interested with a business organisation was met by financial accounting.

**Q.3.** Financial Accounting is mainly concerned with preparation of \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ and \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_.

**Ans.3.** Income statement (Profit and Loss Account)

Positional statement (Balance Sheet)

**Q.4.** The Financial Accounting to some extent \_\_\_\_\_\_\_\_\_\_ to provide required cost data to management.

**Ans.4.** Fails

**Q.5.** Financial Accounting is concerned with \_\_\_\_\_\_\_\_\_\_ reporting as it provides information to \_\_\_\_\_\_\_\_\_\_ authorities.

**Ans.5.** External

External

**Q.6.** Financial Accounting serves the need of all those parties who are not directly associated with management of business. **(True)**

**Q.7.** A new system of accounting which could provide internal report to management was conceived of. **(True)**

**NEED FOR COST ACCOUNTING**

The need for cost accounting arises owing to the following:

**To Overcome the Limitations of Financial Accounting**

Financial accounting records in an overall manner the results of the operations of a business, using conventional double entry book-keeping techniques. It suffers from the following limitations:

**(i) It provides only past data:** Financial accounting provide out of date information to management. But management is interested in current data but not past data as it does not serve any purpose to it.

**(ii) It reveals only overall result of the business:** Financial accounting does not provide data for each and every product, process, department or operation separately. Instead it provides the financial information in a summary form for the entire organization as a whole.

**(iii) It is static in nature:** Modern business is dynamic but not static. Financial accounting does not incorporate the changes that take place within the business.

**(iv) It fails to take into account the impact of price level change:** In the modern inflationary conditions the price level has significant impact over financial statement. Under financial accounting, assets are shown at the actual or historical cost. Consequently depreciation is also charged on actual or historical cost. This under charging of depreciation will distort the profit figure.

**(v) Possibility of manipulation of financial accounting:** Very often financial accounting is manipulated at the whims and fancies of management so as to project better image in the minds of prospective investors. The chief forms of manipulating the financial accounting assume the form of over or undervaluation of inventory, excessive or inadequate provision for depreciation, creation of secret reserves, etc.

**(vi) It fails to exercise control over resources:** Financial accounting fail to exercise control over materials, labour and other expenses incurred in a business enterprise. As a result, avoidable wastages and losses go unchecked under this system of accounting.

**(vii) It fails to provide adequate data for price fixation:** Financial accounting fail to provide adequate cost data on the basis of which selling price is fixed. In the absence of fixation of prices in advance, it is not possible to supply quotations to the prospective customers.

**(viii) It fails to provide adequate data for management in carrying out its functions:** Management of every organization relies heavily on adequate cost data for formulating policies and in decision-making process. But financial accounting fails to provide such useful cost data to management.

**(ix) It does not provide a basis for cost comparison:** Financial accounting does not help in cost comparison over a period of time or between two jobs or two operations. Thus a basis for judging the efficiency of a year with past year or worthfulness of two different jobs or operations cannot be appraised.

**(x) It does not make use of control techniques:** Financial accounting fail to make use of certain important cost control techniques such as budgetary control and standard costing. Thus financial accounting does not facilitate measuring the efficiency of the business with the help of control techniques.

**(xi) It fails to ascertain break-even point:** Financial accounting does not help in ascertaining the break-even point, i.e., the sale or output where the revenue equals the cost. Hence, the point of no-profit-no-loss cannot be made out under financial accounting.

**To Ensure Optimum Utilisation of Resources**

In today’s business world, the resources available are very scarce. Hence every business unit must strive hard to obtain maximum output with the available input. In order to ensure the optimum utilization of scarce resources, the value of input is measured against the value of output. This implies matching cost per unit of production against the value of output or selling price. But financial accounting does not provide the information relating to cost per unit of production. Hence the need for cost accounting was felt necessary.

**To Achieve Overall Efficiency of Business**

Every businessman will make constant effort to improve his business. In order to formulate suitable policy and sound decision, he has to know answers to certain questions such as (a) What is the maximum profit which a business can make. (b) Is the profit earned by it is more or less compared to the earlier years? (c) Which product line is making more profit? (d) Has too much capital is blocked in raw materials? (e) Whether the cost of production has gone up compared to earlier years? (f) Should the selling price require revision? Cost accounting serves as a useful tool in the hands of management in this direction. By analysing the cost of production of every unit, it helps management to know the answers to the above questions.

**Q.8.** Why did the need for Cost Accounting arise?

**Ans.8.** The need for cost accounting arose owing to the following:

(i) To Overcome the Limitations of Financial Accounting

(ii)To Ensure Optimum Utilisation of Resources

(iii)To Achieve Overall Efficiency of Business

**Q.9.** What are the limitations of Financial Accounting?

**Ans.9.** Financial Accounting suffers from the following limitations:

1. It provides only past data
2. It reveals only overall result of the business

(iii) It is static in nature

(iv)It fails to take into account the impact of price level change

(v) Possibility of manipulation of financial accounting

(vi)It fails to exercise control over resources

(vii)It fails to provide adequate data for price fixation

(viii)It fails to provide adequate data for management in carrying out its functions

(ix)It does not provide a basis for cost comparison

(x)It does not make use of control techniques

(xi)It fails to ascertain break-even point

**Q.10.** Financial accounting provides only past data. **(True)**

**Q.11.** Financial accounting reveals only overall result of the business. **(True)**

**Q.12.** Financial accounting is dynamic in nature. **(False)**

**Ans.12.** Financial accounting is static in nature.

**Q.13.** Financial accounting takes into account the impact of price level change. **(False)**

**Ans.13.** Financial accounting fails to take into account the impact of price level change.

**Q.14.** Financial accounting is manipulated at the whims and fancies of management so as to project better image in the minds of prospective investors. **(True)**

**Q.15.** Financial accounting keeps control over resources. **(False)**

**Ans.15.** Financial accounting fails to exercise control over resource.

**Q.16.** Financial accounting provides adequate data for price fixation. **(False)**

**Ans.16.**Financial accounting fails to provide adequate data for price fixation.

**Q.17.** Financial accounting fails to provide adequate data for management in carrying out its functions. **(True)**

**Q.18.** Financial accounting provides a basis for cost comparison. **(False)**

**Ans.18.**Financial accounting does not provide a basis for cost comparison.

**Q.19.** Financial accounting does not make use of control techniques. **(True)**

**Q.20.** Financial accounting ascertains break-even point. **(False)**

**Ans.20.**Financial accounting fails to ascertain break-even point.

**Q.21.** In today’s business world, the resources available are very\_\_\_\_\_\_\_\_.

**Ans.21.** scarce

**Q.22.**Every business unit must strive hard to obtain \_\_\_\_\_\_\_\_\_\_ output with the available input.

**Ans.22.** Maximum

**Q.23.**In order to ensure the optimum utilization of \_\_\_\_\_\_\_\_ resources, the value of input is measured against the value of output.

**Ans.23.** Scarce

**Q.24.** Financial accounting does not provide the \_\_\_\_\_\_\_\_\_ relating to cost per unit of production.

**Ans.24.** Information

**Q.25.**Every businessman makes \_\_\_\_\_\_\_\_\_ effort to improve his business.

**Ans.25.** Constant

**Q.26.**In order to formulate suitable policy and sound decision, every businessman has to know \_\_\_\_\_\_\_\_\_\_ to certain questions.

**Ans.26.** Answers

**DEFINITION AND SCOPE OF COST ACCOUNTANCY**

The terminology of cost accountancy published by the Institute of Cost and Management Accountants, London defines cost accountancy as “the application of costing and cost accounting principles, methods and techniques to the science, art and practice of cost control and the ascertainment of profitability. It includes the presentation of information derived the reform for the managerial decision-making.”

On analysis of the above definition, the following features of cost accountancy become evident:

**(a)** “Cost accountancy” is used in the broadest sense when compared to “cost accounting” and “costing”. This is so because cost accountancy is concerned with the formulation of principles, methods and techniques to be applied for ascertaining cost and profit.

**(b)** Having ascertained ‘cost’ and ‘profit’, cost accountancy is concerned with presentation of information to management. To enable management to carry out its functions, reports must be promptly made available at the right time, to the right person and in a proper form.

**(c)** The information so provided is to serve the purpose of managerial decision-making such as introducing a new line of product, replacement of manual labour by machines, make or buy decisions, etc.

**Q.27.** What is the definition of Cost accounting?

**Ans.27.** “The application of costing and cost accounting principles, methods and techniques to the science, art and practice of cost control and the ascertainment of profitability. It includes the presentation of information derived the reform for the managerial decision-making.”

**Q.28.** “Cost accountancy” is used in the broadest sense when compared to “cost accounting” and “costing”. **(True)**

**Q.29.** Cost accountancy is not concerned with the formulation of principles, methods and techniques to be applied for ascertaining cost and profit. **(False)**

**Ans.29.** Cost accountancy is concerned with the formulation of principles, methods and techniques to be applied for ascertaining cost and profit.

**SCOPE OF COST ACCOUNTANCY**

The scope of any subject refers to the various areas of study included in that subject. As regards the scope of cost accountancy is concerned, it has vast scope. The following topics fall under the purview of cost accountancy: (1) Costing, (2) Cost Accounting, (3) Cost Control Techniques, (4) Budgeting and (5) Cost Audit.

**1. Costing**

The terminology of ICMA, London, defines costing as “the technique and process of ascertaining the cost.” According to the revised terminology of ICMA, London, “Costing is the process of determining the costs of products, services or activities.”

The above definition is very significant in as much as it carries the main theme of cost accountancy. This definition emphasizes two important aspects, viz.

**(a) The technique and process of costing:** The technique of costing involves two distinct steps, namely, (i) collection and classification of costs according to various elements and (ii) allocation and apportionment of the expenses which cannot be directly charged to production. As a process, costing is concerned with the routine ascertainment of cost with a formal procedure.

**(b) Ascertainment of cost:** It involves three steps, viz. (i) collection and analysis of expenses, (ii) measurement of production at different stages and (iii) linking up of production with the expenses. To achieve the first step, costing has developed different systems such as Historical, Estimated and Standard Cost. For achieving the second step, costing has developed different methods such as single or output costing. Job costing, contract costing, etc. Finally, for achieving the last step costing has developed important techniques such as Absorption Costing, Marginal Costing and Standard Costing.

**2. Cost Accounting**

Kohler in his dictionary for Accountants defines cost accounting as “that branch of accounting dealing with the classification, recording, allocation, summarization and reporting of current and prospective costs.” Mr. Wheldon defines cost accounting as “the classifying, recording and appropriate allocation of expenditure for the determination of the costs of products or services, the relation of these costs to sales values, and the ascertainment of profitability.”

The above definitions reveal the following aspects of cost accounting:

**(a) Cost classification:** This refers to grouping of like items of cost into a common group.

**(b) Cost recording:** This refers to posting of cost transactions into the various ledgers maintained under cost accounting system.

**(c) Cost allocation:** This refers to allotment of costs to various products or department.

**(d) Cost determination or cost finding:** This refers to the determination of the cost of goods or services by informal procedure, i.e., procedures that do not carry on the regular process of cost accounting on a continuous basis.

**(e) Cost reporting:** This refers to furnishing of cost data on a regular basis so as to meet the requirements of management.

**Q.30.** Scope of any subject refers to the various areas of study included in that subject. **(True)**

**Q.31.** As regards the scope of cost accountancy is concerned, it has\_\_\_\_ scope.

**Ans.31.** Vast

**Q.32.** What is the definition of Costing?

**Ans.32.** “Costing is the process of determining the costs of products, services or activities.”

**Q.33**. Write down the definition of Cost accounting?

**Ans.33.** Cost accounting is “that branch of accounting dealing with the classification, recording, allocation, summarization and reporting of current and prospective costs.”

**Q.34.** Differentiate between Cost Accountancy, Costing and Cost Accounting.

**Ans.34.** Difference between Cost Accountancy, Costing and Cost Accounting

|  |  |  |  |
| --- | --- | --- | --- |
| **Points of**  **Differences** | **Cost Accountancy** | **Costing** | **Cost Accounting** |
| 1. Scope | Cost accountancy is broadest in its scope. | It is broader in its scope. | It is narrow in its scope. |
| 2. Function | It is concerned with formulation of costing principles, methods and techniques to be adopted by a business. | It is concerned with ascertainment of cost. | It is concerned with recording of cost. |
| 3. Periodicity of  Functioning | It is a starting point. | It begins where accountancy ends cost. | It begins where costing ends. |
| 4. Persons  Involved | The persons involved are experts in the field of cost accountancy such as management accountant. | The person involved is cost accountant. | The persons involved are cost clerks. |

**3. Cost Control**

According to Kohler, cost control represents the employment of management devices in the performance of any necessary operation so that pre-established objectives of quality, quantity and time may be attained at the lowest possible outlay for goods and services. The terminology published by ICMA, London, defines cost control as “The guidance and regulation by executive action of the cost of operating an undertaking.” According to this definition, cost control aims at guiding the actual towards the lines of target and regulates the actual if they deviate from the targets. This process will become clear by enumerating the steps involved in any cost control technique.

(a) Fixation of targets in terms of cost and production performance.

(b) Ascertaining the actual cost and production performance.

(c) Comparison of actual with the targets.

(d) Analysing the variance by causes and the person responsible for it.

(e) Taking remedial steps to set right unfavourable variations.

Cost control is exercised through a variety of techniques such as inventory control, quality control, budgetary control, standard costing, etc. The advantages of cost control are as follows:

(a) It helps in utilizing the resources to the full extent.

(b) It helps in reduction of prices which are benefited by customers.

(c) It helps in competing successfully in the market.

(d) It increases the profit earning capacity of the business.

(e) It increases the goodwill of the business.

**Q.35.** What are the steps in a cost control technique?

**Ans.35.** Followings are the steps involved in a cost control technique.

(a) Fixation of targets in terms of cost and production performance.

(b) Ascertaining the actual cost and production performance.

(c) Comparison of actual with the targets.

(d) Analysing the variance by causes and the person responsible for it.

(e) Taking remedial steps to set right unfavourable variations.

**Q.36.** What are the advantages of cost control?

**Ans.36.** The advantages of cost control are as follows:

(a) It helps in utilizing the resources to the full extent.

(b) It helps in reduction of prices which are benefited by customers.

(c) It helps in competing successfully in the market.

(d) It increases the profit earning capacity of the business.

(e) It increases the goodwill of the business.

**4. Budgeting**

Mr. Heiser in his book Budgeting—Principles and Practice, defines budget as “an overall blue print of a comprehensive plan of operations and actions expressed in financial terms. According to him budgeting process involves the preparation of a budget and its fullest use not only as a devise for planning and co-ordinating but also for control.”

**5. Cost Audit**

The terminology of ICMA, London, defines cost audit, as “the verification of the correctness of cost accounts and of the adherence to the cost accounting plan.”

**Q.37.** What do you mean by cost audit?

**Ans.37.** Cost audit mean “the verification of the correctness of cost accounts and of the adherence to the cost accounting plan.”

**NATURE OF COST ACCOUNTING**

The nature of cost accounting can be brought out under the following headings:

**1. Cost accounting is a branch of knowledge:** Though considered as a branch of financial accounting, cost accounting is one of the important branches of knowledge, i.e., a discipline by itself. It is an organised body of knowledge consisting of its own principles, concepts and conventions. These principles and rules vary from industry to industry.

**2. Cost accounting is a science:** Cost accounting is a science as it is a body of systematic knowledge relating to not only cost accounting but relating to a wide variety of subjects such as law, office practice and procedure, data processing, production and material control, etc. But it is to be admitted that it is not a perfect science as in the case of natural science.

**3. Cost accounting is an art:** Cost accounting is an art in the sense it requires the ability and skill on the part of cost accountant in applying the principles, methods and techniques of cost accountancy to various management problems. These problems include the ascertainment of cost, control of costs, ascertainment of profitability, etc.

**4. Cost accounting is a profession:** In recent years cost accounting has become one of the important professions which have become more challenging. This view is evident from two facts. First, the setting up of various professional bodies such as National Association of Accountants (NAA) in USA. The Institute of Cost and Management Accountants in UK, the Institute of Cost and Works Accountants in India and such other professional bodies both in developed and developing countries have increased the growing awareness of costing profession among the people. Secondly, a large number of students have enrolled in these institutes to obtain costing certificates and memberships for earning their livelihood.

**Q.38.** Though considered as a branch of financial accounting, cost accounting is one of the important branches of knowledge. **(True)**

**Q.39.** Cost accounting is a science as it is a body of systematic knowledge relating to not only cost accounting but relating to a wide variety of subjects. **(True)**

**Q.40.** Cost accounting is an art in the sense it requires the ability and skill on the part of cost accountant in applying the principles, methods and techniques of cost accountancy to various management problems. **(True)**

**MANAGEMENT ACCOUNTING AN INTRODUCTION**

Management accounting can be viewed as Management-oriented Accounting.

Basically it is the study of managerial aspect of financial accounting, "accounting in relation to management function". It shows how the accounting function can be re-oriented so as to fit it within the framework of management activity. The primary task of management accounting is, therefore, to redesign the entire accounting system so that it may serve the operational needs of the firm. If furnishes definite accounting information, past, present or future, which may be used as a basis for management action. The financial data are so devised and systematically developed that they become a unique tool for management decision.

**Q.41.** What is the primary task of Management Accounting?

**Ans.41.**The primary task of management accounting is, therefore, to redesign the entire accounting system so that it may serve the operational needs of the firm.

**Q.42.** What does Management Accounting furnish to the management?

**Ans.42.** Management Accounting furnishes definite accounting information, past, present or future, which may be used as a basis for management action.

**Q.43.** The financial data are so devised and \_\_\_\_\_\_\_\_\_\_\_\_ developed that they become a \_\_\_\_\_\_\_\_\_ tool for management decision.

**Ans.43.** Systematically

Unique

**DEFINITIONS OF MANAGEMENT ACCOUNTING**

The term “Management Accounting” covers all those services by which the accounting department can assist the top management and other departments in the formation of policy, control of execution and appreciation of effectiveness. This definition points out that management is entrusted with the primary task of planning, execution and control of the operating activities of an enterprise. It constantly needs accounting information on which to base its decision. A decision based on data is usually correct and the risk of erring is minimized. Management accounting is concerned with the accumulation, classification and interpretation of information that assists individual executives to fulfil organizational objectives.

The Report of the Anglo-American Council of Productivity (1950) has also given a definition of management accounting, which has been widely accepted. According to it, "Management accounting is the presentation of accounting information in such a way as to assist the management in creation of policy and the day to day operation of an undertaking".

An analysis of the above definition shows that management needs information for better decision-making and effectiveness. The collection and presentation of such information come within the area of management accounting. Thus, accounting information should be recorded and presented in the form of reports at such frequent intervals, as the management may want. These reports present a systematic review of past events as well as an analytical survey of current economic trends.

The usual approach is that, first of all, a thorough analysis of the whole managerial process is made, and then the information required for each area is explored, and finally, all the information, after analysis in terms of alternatives, is taken into consideration before arriving at a management decision.

**Q.44.** Management is entrusted with the primary task of planning, execution and control of the operating activities of an enterprise. **(True)**

**Q.45.** What is Management accounting?

**Ans.45.** Management accounting is concerned with the accumulation, classification and interpretation of information that assists individual executives to fulfil organizational objectives.

**Q.46.**Management does not need information for better decision-making and effectiveness. **(False)**

**Ans.46.** Management needs information for better decision-making and effectiveness.

**NATURE OF MANAGEMENT ACCOUNTING**

The term management accounting is composed of ‘management’ and 'accounting'. The word ‘management’ here does not signify only the top management but the entire personnel charged with the authority and responsibility of operating an enterprise. The task of management accounting involves furnishing accounting information to the management, which may base its decisions on it. It is through management accounting that the management gets the tools for an analysis of its administrative action and can lay suitable stress on the possible alternatives in terms of costs, prices and profits, etc.

The word 'accounting' used in this phrase should not lead us to believe that it is restricted to a mere record of business transactions i.e., book keeping only. As it draws its raw material from several other disciplines like costing, statistics, mathematics, financial accounting, etc., it can be called an interdisciplinary subject.

The subject of management reveals the processes involved in the art of managing, knowledge of Economics assists in the determination of optimum output in the forecasting of sales and production, etc., and also makes it possible to analyze management action in terms of cost revenues, profits, growth, etc.

Management accounting has no set principles such as the double entry system of bookkeeping. In place of generally accepted accounting principles, the philosophy of cost benefit analysis is the core guide of this discipline. It says that no accounting system is good or bad but is can be considered desirable so long as it brings incremental benefits in excess of its incremental costs.

Since management accounting is managerially oriented, its data is selective in nature. It focuses on potential opportunities rather than opportunities lost. The data is operative in nature catering to the operational needs of a firm. It details events, monetary and non-monetary.

Management accounting is highly sensitive to management needs. However, it assists the management and does not replace it. It represents a service phase of management rather than a service to management from management accountant. It is rather highly personalized service. Finally, it can be said that the management accounting serves as a management information system and so enables the management to manage better.

**Q.47.** What is the task of Management Accounting?

**Ans.47.** The task of management accounting involves furnishing accounting information to the management, which may base its decisions on it.

**Q.48.** The term management accounting is composed of ‘management’ and 'accounting'. **(True)**

**Q.49.** The subject of management reveals the \_\_\_\_\_\_\_\_\_\_\_involved in the art of managing.

**Ans.49.** Processes

**Q.50.**Knowledge of \_\_\_\_\_\_\_\_\_\_\_\_ assists in the determination of optimum output in the forecasting of sales and production.

**Ans.50.** Economics

**Q.51.** Management accounting has set principles such as the double entry system of bookkeeping. **(False)**

**Ans.51.** Management accounting has no set principles such as the double entry system of bookkeeping.

**Q.52.** Management accounting is highly sensitive to \_\_\_\_\_\_\_\_\_\_needs.

**Ans.52.** Management

**Q.53.** Management accounting serves as a management information system and so enables the management to manage better. **(True)**