Suddhananda School of Management & Computer Science

LECTURE NOTE ON

SUB CODE- MBPC1005

COST & MANAGEMENT ACCOUNTING NOTES

2nd Semester

MBA

by

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MODULE I: Introduction to Cost & Management Accounting

Meaning of Cost Accounting

Cost Accounting is a specialized branch of accounting that deals with the systematic recording, classification, analysis, and allocation of costs incurred in the process of producing goods or rendering services. It provides detailed cost information to management, enabling them to control costs, improve efficiency, and support rational decision-making.

In modern business organizations, cost accounting plays a crucial role in understanding how resources are consumed and how efficiently they are being utilized in different stages of production and operations.

Definition in Simple Terms

Cost Accounting refers to the process of identifying, measuring, recording, and analyzing all costs associated with production or service activities in order to determine the total and per-unit cost of output and assist management in cost control and decision-making.

Core Process of Cost Accounting

The process of cost accounting can be broadly understood through four main stages:

- **Recording of Costs**: All expenses such as materials, labour, and overheads are recorded in a systematic manner.
- **Classifying Costs**: Costs are grouped based on their nature (fixed, variable), function (production, administration), or traceability (direct, indirect).
- **Analyzing Costs**: The recorded cost data is examined to understand cost behavior, trends, and deviations from standards.
- **Allocating Costs**: Costs are assigned to specific products, departments, or cost centers based on their usage or benefit.

Purpose of Cost Accounting

The primary objective of cost accounting is to provide reliable cost information for managerial use. Its key purposes include:

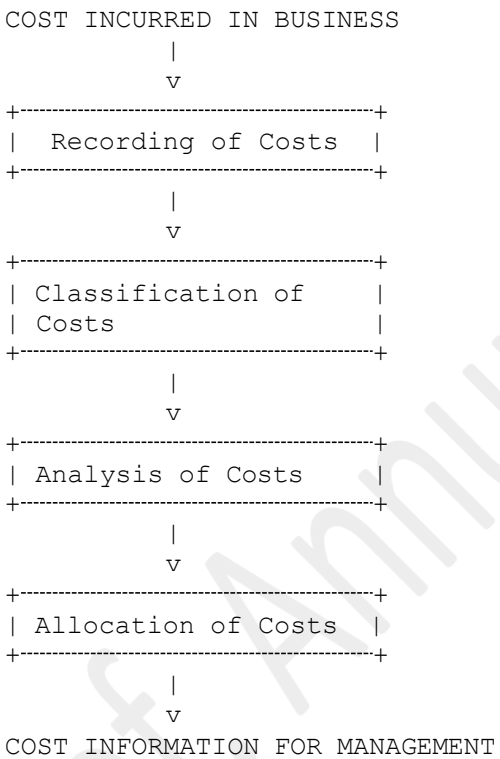
- Determining the accurate cost of products and services
- Assisting in fixing selling prices and profit margins
- Controlling unnecessary expenditure and wastage
- Improving operational efficiency
- Supporting managerial decision-making such as budgeting and planning

Importance in Business

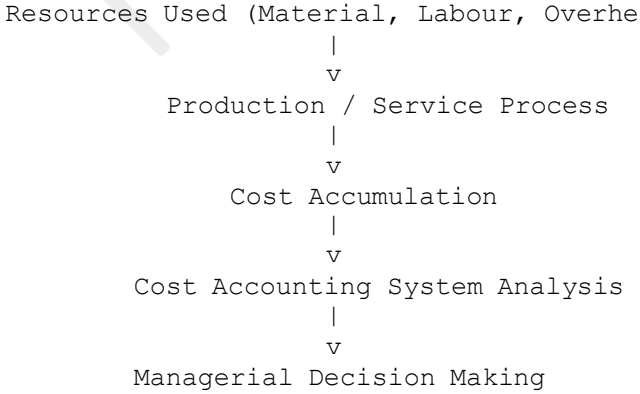
Cost accounting acts as a **management information system** within an organization. It helps managers to:

- Monitor cost performance of different departments
- Compare actual costs with standard or budgeted costs
- Identify areas of inefficiency and take corrective actions
- Ensure optimum utilization of resources

Diagram: Flow of Cost Accounting Process



Functional Flow in Organization



Illustrative Example

Consider a manufacturing company producing mobile phones. Cost accounting helps the organization to:

- Calculate the cost of components like screen, battery, and processor
- Determine labour cost involved in assembly
- Assign factory overheads like electricity and rent
- Finally compute the total and per-unit cost of each mobile phone

This information helps the company decide:

- Selling price
- Profit margin
- Cost reduction strategies

Meaning of Management Accounting

Management Accounting is an important branch of accounting that focuses on providing relevant financial and non-financial information to managers for effective planning, decision-making, and controlling business operations. Unlike financial accounting, which is primarily concerned with external reporting, management accounting is **internal and decision-oriented** in nature.

It acts as a bridge between accounting information and managerial action by transforming raw financial data into meaningful reports that support strategic and operational decisions.

Definition in Simple Terms

Management Accounting refers to the process of identifying, measuring, analyzing, interpreting, and communicating accounting information to managers so that they can plan, evaluate, and control business activities effectively.

Core Functions of Management Accounting

Management Accounting primarily supports three major managerial functions:

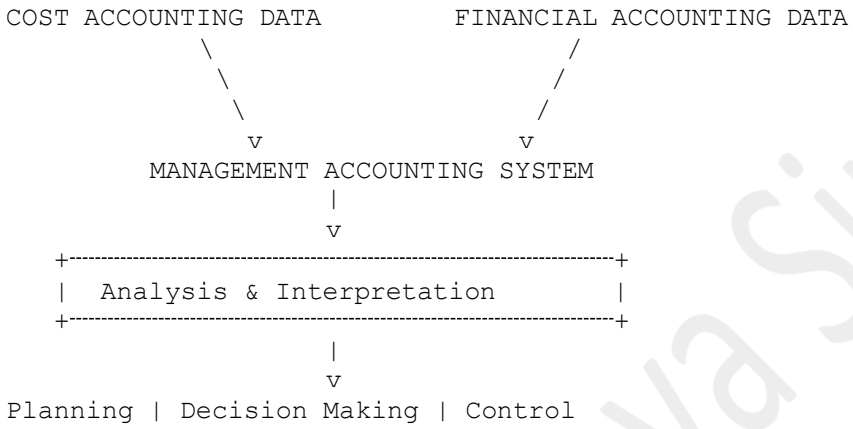
- **Planning**: It helps in preparing future plans such as budgets, forecasts, and strategic goals.
- **Decision Making**: It provides analytical tools for choosing the best alternative among various options.
- **Control**: It compares actual performance with planned performance and highlights deviations for corrective action.

Sources of Information

Management Accounting depends on both internal and external accounting systems:

- **Cost Accounting Data**: Provides detailed cost-related information such as product cost, overheads, and cost behavior.
- **Financial Accounting Data**: Provides summarized financial statements like Profit & Loss Account and Balance Sheet.

Flow of Information in Management Accounting



Role in Managerial Functions

Management accounting plays a vital role in supporting management at all levels:

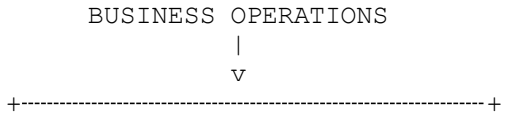
- Helps in setting organizational goals and policies
- Assists in budgeting and forecasting future performance
- Provides performance reports for different departments
- Supports cost control and profit improvement strategies

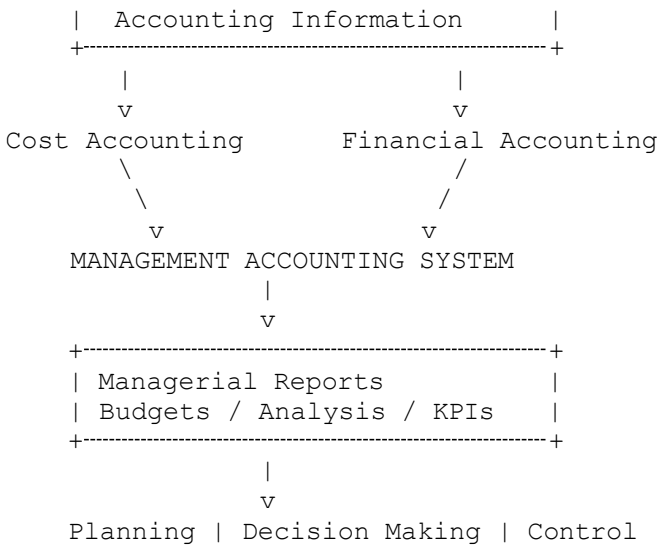
Importance of Management Accounting

Management accounting is essential because it:

- Converts complex financial data into simple managerial reports
- Helps management take quick and informed decisions
- Improves efficiency and profitability of operations
- Supports strategic planning and long-term growth
- Enables comparison between planned and actual performance

Functional Framework Diagram





Example for Better Understanding

Consider a company manufacturing air conditioners:

Management accounting helps managers to:

- Decide the production quantity based on demand forecasts
- Analyze whether to outsource compressor production or manufacture in-house
- Prepare monthly budgets for raw materials and labor
- Compare actual production cost with budgeted cost to identify inefficiencies

This enables the company to improve profitability and operational efficiency.

Difference Between Financial Accounting, Cost Accounting & Management Accounting

Accounting systems in an organization are broadly classified into **Financial Accounting, Cost Accounting, and Management Accounting**. Each system serves a different purpose, caters to different users, and provides information in a distinct form. Understanding their differences is essential to appreciate how accounting supports both external reporting and internal decision-making.

Overview of Three Accounting Systems

- **Financial Accounting** focuses on recording and reporting financial transactions for external stakeholders.
- **Cost Accounting** concentrates on determining and controlling the cost of products and services.
- **Management Accounting** provides analytical information for managerial planning, decision-making, and control.

Each system complements the others and together forms a complete accounting information system.

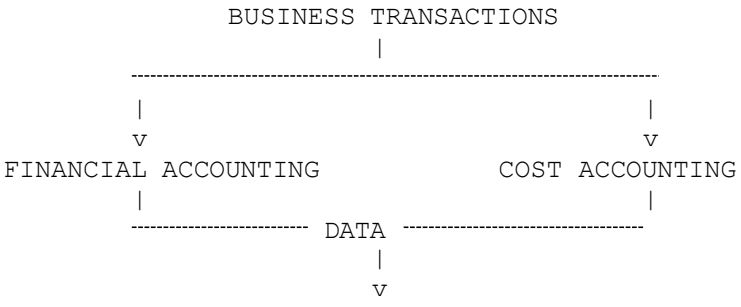
Detailed Comparison

Basis	Financial Accounting	Cost Accounting	Management Accounting
Purpose	To provide financial information for external reporting	To determine and control cost of production	To support managerial decision-making
Primary Users	Investors, creditors, government, public	Internal management	Top and middle-level management
Nature of Data	Historical and monetary data	Cost-related and analytical data	Analytical, financial and non-financial data
Time Orientation	Past-oriented	Past and present-oriented	Future-oriented
Scope	Whole organization	Product, process, department-wise cost	Decision areas like planning, control, forecasting
Legal Requirement	Mandatory for companies	Not mandatory	Not mandatory
Reporting Format	Financial statements (P&L, Balance Sheet)	Cost sheets, cost reports	Budgets, forecasts, performance reports
Focus Area	Profitability of entire business	Cost per unit and cost control	Efficiency, planning, and strategy

Interrelationship Among the Three Systems

Although different in purpose, these systems are closely related. Cost accounting provides detailed cost data to both financial accounting and management accounting. Financial accounting provides overall financial results, while management accounting uses data from both to assist in decision-making.

Diagram: Relationship of Accounting Systems



```
        MANAGEMENT ACCOUNTING SYSTEM
                        |
                        v
Planning | Decision Making | Control
```

Key Differences Explained (In Simple Words)

- Financial Accounting tells **"How much profit did we make?"**
- Cost Accounting tells **"What is the cost of producing a product?"**
- Management Accounting tells **"What should we do next to improve performance?"**

Illustrative Example

Consider a manufacturing company producing laptops:

- **Financial Accounting** prepares the final profit and loss statement showing total profit earned.
- **Cost Accounting** calculates the cost of each laptop including materials, labor, and overheads.
- **Management Accounting** analyzes whether the company should reduce production cost, increase price, or launch a new model.

Types of Cost

Cost plays a crucial role in every business organization as it helps in understanding how resources are consumed during the production and distribution of goods and services. For effective cost control and managerial decision-making, costs are classified into different categories based on their **nature, behavior, and function**.

This classification helps management to analyze costs in a more structured manner and take appropriate financial decisions.

1. Classification Based on Nature of Cost

Under this classification, costs are divided according to the **type of expense incurred** in the production process.

(a) Material Cost

Material cost refers to the cost of all raw materials used in the production of goods. It forms the basic component of total production cost.

- Includes raw materials, components, and consumables
- Directly linked with production output
- Example: Steel used in automobile manufacturing

(b) Labour Cost

Labour cost represents the remuneration paid to employees for their contribution in the production process.

- Includes wages, salaries, overtime, and incentives
- Direct labour is involved in production activities
- Example: Salary of machine operators in a factory

(c) Expenses

Expenses refer to all other costs incurred apart from material and labour costs.

- Includes factory rent, electricity, maintenance, etc.
- Can be direct or indirect in nature
- Example: Power consumption in manufacturing units

2. Classification Based on Cost Behavior

Cost behavior refers to how costs change in relation to changes in production or activity level.

(a) Fixed Cost

Fixed costs remain constant regardless of the level of production.

- Do not change with output level
- Incurred even if production is zero
- Example: Factory rent, insurance premium

Even if production increases or decreases, fixed cost remains unchanged in total (but per unit cost changes).

(b) Variable Cost

Variable costs vary directly with the level of production.

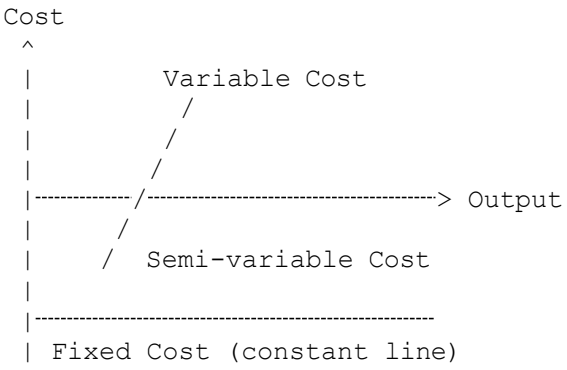
- Increase when production increases
- Decrease when production decreases
- Example: Raw materials, direct labour

(c) Semi-variable Cost

Semi-variable costs contain both fixed and variable elements.

- Partly fixed and partly variable
- Change with production but not in direct proportion
- Example: Telephone bills, electricity charges

Diagram: Cost Behavior Pattern



3. Classification Based on Function

This classification is based on the **purpose for which the cost is incurred** in an organization.

(a) Production Cost

Production cost refers to all costs incurred in the manufacturing of goods.

- Includes material, labour, and factory overheads
- Also called manufacturing cost
- Example: Cost of producing a chair in a furniture factory

(b) Selling Cost

Selling cost is incurred to promote and sell the finished products.

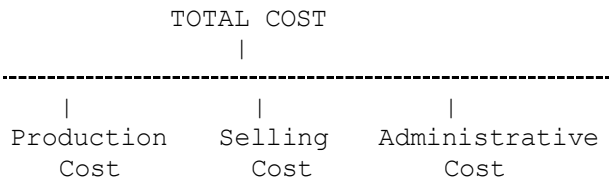
- Includes advertising, distribution, and sales commission
- Helps in increasing sales volume
- Example: Advertisement of a mobile phone brand

(c) Administrative Cost

Administrative costs are related to the general management of the business.

- Includes office salaries, stationery, and administrative expenses
- Not directly linked with production or sales
- Example: Salary of company managers and accountants

Diagram: Functional Classification of Cost



Importance of Cost Classification

Proper classification of costs helps in:

- Better cost control and cost reduction
- Accurate product costing
- Effective managerial decision-making
- Budget preparation and performance analysis

Illustrative Example

In a shoe manufacturing company:

- **Material Cost** → Leather, rubber
- **Labour Cost** → Workers stitching shoes
- **Fixed Cost** → Factory rent
- **Variable Cost** → Glue used per shoe
- **Production Cost** → Entire manufacturing cost
- **Selling Cost** → Advertisement and showroom expenses

Methods and Techniques of Costing

Cost accounting employs different **methods and techniques** depending on the nature of industry, type of production, and managerial requirements. While **methods of costing** determine how costs are accumulated and assigned, **techniques of costing** are used for analysis, control, and decision-making.

Together, they form an essential framework for understanding and managing cost efficiently in an organization.

5. Methods of Costing

Meaning

Methods of costing refer to the specific ways in which costs are **collected, measured, and assigned to products, jobs, processes, or services**. The selection of a method depends mainly on the nature of production and business operations.

(a) Job Costing

Job costing is a method where costs are collected for **each individual job, order, or project separately**.

- Suitable for customized or special orders

- Each job is treated as a separate cost unit
- Costs are accumulated for material, labour, and overheads for each job

Example: Printing press, repair workshop, custom furniture manufacturing

Key Idea: One job = One cost sheet

(b) Process Costing

Process costing is used where production is **continuous and uniform**, and output passes through multiple processes.

- Costs are accumulated for each process
- Total cost is divided by number of units produced
- Suitable for mass production industries

Example: Cement, sugar, chemicals, oil refining

Key Idea: One process = One cost center

(c) Contract Costing

Contract costing is applied in industries where work is carried out on **large-scale contracts or projects**.

- Each contract is treated as a separate cost unit
- Long-term projects involving large investment
- Work progress is monitored through stages

Example: Construction of roads, bridges, buildings

Key Idea: One contract = One cost unit

(d) Service Costing

Service costing is used in organizations that provide **services instead of physical goods**.

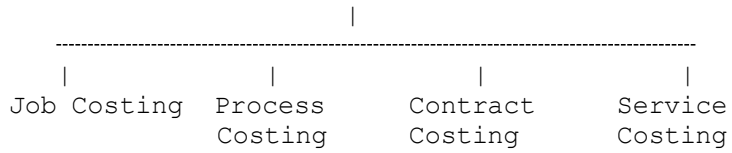
- Focus is on cost of providing service
- Cost unit varies (per passenger, per patient, per km)

Example: Transport services, hospitals, canteens

Key Idea: Cost of service delivered is measured

Diagram: Methods of Costing

METHODS OF COSTING



6. Techniques of Costing

Meaning

Techniques of costing refer to the **methods used for analyzing costs and assisting management in decision-making, control, and planning**. Unlike methods of costing, techniques are not related to cost accumulation but to **cost analysis and managerial control**.

(a) Marginal Costing

Marginal costing is a technique where only **variable costs are considered for decision-making**, while fixed costs are treated as period costs.

- Helps in profit planning and decision-making
- Focuses on contribution (Sales – Variable Cost)
- Useful in pricing and production decisions

Example decisions:

- Make or buy
- Product mix selection

Key Idea: Only variable cost is relevant for decisions

(b) Standard Costing

Standard costing involves setting **pre-determined cost standards** and comparing them with actual costs.

- Helps in cost control and performance evaluation
- Variances are analyzed to identify deviations
- Improves efficiency

Example: Standard cost of producing one unit = ₹100, actual = ₹110 → Variance analysis is done

Key Idea: Standard vs Actual comparison

(c) Budgetary Control

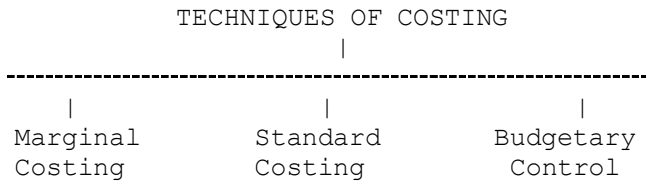
Budgetary control is a system of **preparing budgets and comparing them with actual performance** to control costs.

- Involves planning future income and expenses
- Helps in coordination and performance evaluation
- Includes different budgets like sales, production, cash, etc.

Example: If budgeted expense is ₹1,00,000 but actual is ₹1,20,000 → corrective action is taken

Key Idea: Planned vs Actual comparison

Diagram: Techniques of Costing



Importance of Methods & Techniques

- Helps in selecting appropriate costing system for industries
- Supports effective managerial decision-making
- Improves cost control and efficiency
- Enhances profitability of business
- Assists in planning and forecasting

Cost Classification

Cost classification is a fundamental concept in cost accounting that involves the **systematic grouping of costs based on common characteristics**. It helps management understand the nature and behavior of costs, enabling better planning, control, and decision-making.

By classifying costs in different ways, organizations can analyze cost structure more effectively and identify areas where cost efficiency can be improved.

Basis of Cost Classification

Costs can be classified on the following bases:

1. Classification Based on Nature

Under this classification, costs are grouped according to the **type of expenditure incurred** in the production process.

- **Material Cost** → Cost of raw materials used in production

- **Labour Cost** → Wages and salaries paid to employees
- **Expenses** → Other costs like rent, electricity, maintenance

This classification helps in identifying the basic components of total cost.

2. Classification Based on Function

Costs are grouped according to the **function or activity for which they are incurred**.

- **Production Cost** → Costs related to manufacturing goods
- **Selling Cost** → Costs incurred in selling and distribution
- **Administrative Cost** → Costs related to management and office operations

This helps in understanding cost distribution across different business functions.

3. Classification Based on Behavior

This classification is based on how costs **respond to changes in production volume**.

- **Fixed Cost** → Remains constant regardless of output
- **Variable Cost** → Changes directly with output
- **Semi-variable Cost** → Contains both fixed and variable elements

This classification is important for cost control and decision-making.

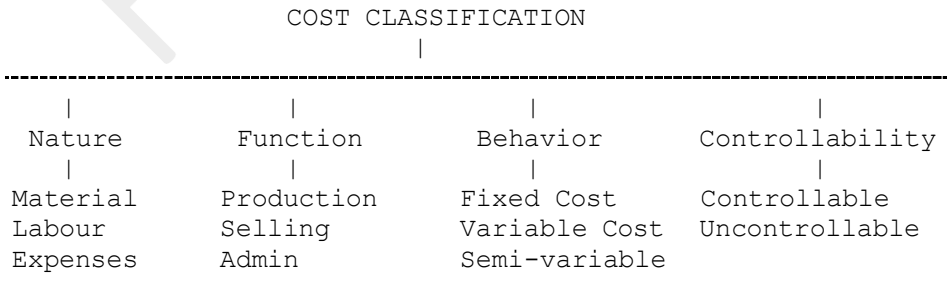
4. Classification Based on Controllability

Costs are classified based on whether they can be **controlled or influenced by management at a specific level**.

- **Controllable Cost** → Can be influenced by managers (e.g., material usage)
- **Uncontrollable Cost** → Cannot be controlled at a given level (e.g., government tax)

This helps in performance evaluation of managers and departments.

Diagram: Basis of Cost Classification



Important Concepts in Cost Accounting

Along with cost classification, certain key concepts form the foundation of cost accounting. These concepts help in assigning costs properly and evaluating performance at different levels of an organization.

1. Cost Centre

A **Cost Centre** is a specific location, department, or section of an organization where costs are incurred.

- It does not generate revenue directly
- Its main function is cost accumulation and control
- Helps in identifying cost responsibility

Example:

- Production department
- Maintenance department
- Stores department

Purpose: To control and monitor costs at departmental level

2. Cost Unit

A **Cost Unit** is the unit of product or service in relation to which costs are measured.

- It represents the measurable unit of output
- Helps in calculating cost per unit

Examples:

- Per unit (mobile phone, chair)
- Per kg (cement, sugar)
- Per km (transport services)

Purpose: To determine cost per unit of product or service

3. Profit Centre

A **Profit Centre** is a segment of an organization that is responsible for both **costs and revenues**, and thus for generating profit.

- Managers are responsible for profit performance
- Evaluates efficiency and profitability of divisions

Example:

- Retail branch of a company
- Product division

Purpose: To measure profitability of business units

4. Investment Centre

An **Investment Centre** is a business unit that is responsible for **costs, revenues, and investment decisions**.

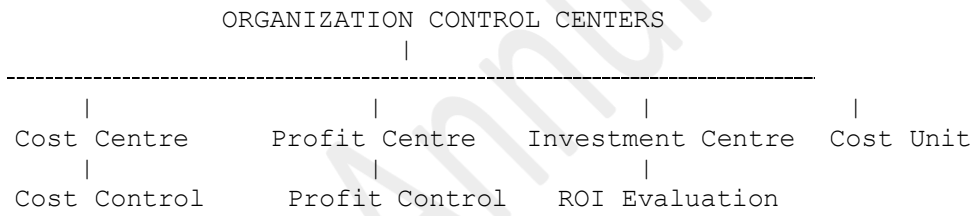
- Highest level of responsibility center
- Manager controls assets and investment decisions
- Performance measured using ROI (Return on Investment)

Example:

- Subsidiary company
- Large business division

Purpose: To evaluate performance based on profit and capital employed

Diagram: Responsibility Centers



Importance of These Concepts

These concepts are essential because they:

- Help in effective cost control
- Improve accountability in organizations
- Support managerial decision-making
- Assist in performance evaluation
- Help in decentralization of authority

Cost Sheet (Very Important Concept)

A **Cost Sheet** is a systematic statement that presents the **total cost of production and cost per unit of output** for a given period. It is one of the most important tools of cost accounting as it provides a clear picture of how the total cost is built up at different stages of production.

Cost sheet helps management in understanding cost structure, controlling expenses, and fixing selling prices in a competitive market.

Meaning

A Cost Sheet is a statement that **collects, classifies, and summarizes all costs** incurred in the production of goods or services and shows:

- Total cost of production
- Cost per unit of output
- Profit or loss earned during the period

Objectives of Cost Sheet

- To determine total cost of production
- To calculate cost per unit of output
- To analyze cost structure step-by-step
- To assist in fixing selling price
- To help in cost control and cost reduction

Format of Cost Sheet

A typical cost sheet is prepared in a **logical sequence of cost accumulation**:

Cost Sheet Structure

```
Direct Material
+ Direct Labour
+ Direct Expenses
= PRIME COST

+ Factory Overheads
= FACTORY COST

+ Administrative Overheads
= COST OF PRODUCTION

+ Selling & Distribution Overheads
= TOTAL COST (COST OF SALES)

+ PROFIT
= SELLING PRICE
```

Diagram: Flow of Cost Sheet

```
Direct Costs
    |
    v
Prime Cost
    |
    v
Factory Overheads
```

```
    |
    v
Factory Cost
    |
    v
Administrative Overheads
    |
    v
Cost of Production
    |
    v
Selling & Distribution Overheads
    |
    v
Total Cost
    |
    v
Profit
    |
    v
Selling Price
```

Explanation of Cost Elements

1. Prime Cost

Prime cost is the total of **direct costs**.

- Direct Material
- Direct Labour
- Direct Expenses

It represents the basic cost of production.

2. Factory Cost

Factory cost includes prime cost plus factory overheads.

- Includes production-related indirect expenses
- Example: Power, factory rent, depreciation

3. Cost of Production

Cost of production is obtained after adding administrative overheads to factory cost.

- Reflects total production cost before selling expenses

4. Total Cost

Total cost includes cost of production plus selling and distribution overheads.

- Represents complete cost of goods sold

5. Selling Price

Selling price is obtained by adding profit to total cost.

- Determines final price charged to customers

10. Total Cost & Unit Cost

Total Cost

Total cost refers to the **overall cost incurred in producing a given quantity of goods or services** during a specific period.

 It includes:

- Direct material
- Direct labour
- Overheads (factory, administrative, selling)

Formula:

```
Total Cost = Sum of all costs incurred
```

Unit Cost

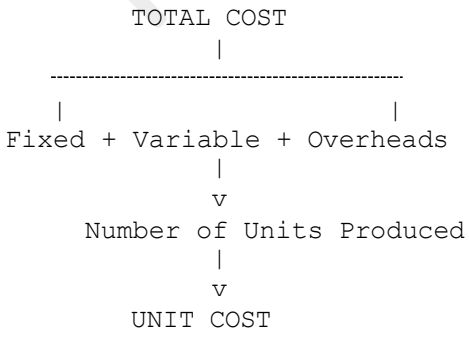
Unit cost refers to the **cost of producing one unit of output**.

It is calculated by dividing the total cost by the number of units produced.

Formula:

```
Unit Cost = Total Cost ÷ Number of Units Produced
```

Diagram: Total Cost vs Unit Cost



Illustrative Example

If a company produces 1,000 units of a product:

- Total Cost = ₹5,00,000
- Units Produced = 1,000

 Unit Cost = ₹5,00,000 ÷ 1,000 = ₹500 per unit

Importance of Cost Sheet

- Helps in determining selling price
- Provides detailed cost analysis
- Assists in cost control and cost reduction
- Useful for management decision-making
- Helps compare costs across different periods

MODULE II: Cost Accounting System

Material Cost Management

Material cost forms a **major portion of total production cost** in manufacturing and service organizations. In many industries, it contributes the highest share of total cost; therefore, efficient management of materials is essential for maintaining profitability and operational efficiency.

Material cost management involves the systematic planning, purchasing, storing, issuing, and controlling of materials in such a way that production is not interrupted and cost is minimized.

Objectives of Material Cost Management

The main objectives of material cost management are:

- To ensure **continuous and uninterrupted production** by maintaining adequate stock of materials
- To **minimize material cost** through efficient purchasing and usage
- To **avoid wastage, pilferage, and overstocking**
- To maintain **optimum inventory levels** in the organization
- To ensure proper utilization of available materials

Importance in Cost Accounting

Material cost control is crucial because:

- Materials directly affect the **cost of production**
- Inefficient material usage leads to **higher production cost and reduced profit**
- Proper control improves **inventory management and working capital efficiency**

Valuation of Material Issues

Material issue valuation refers to the method used to **determine the cost of materials issued from stores to production**. Since materials may be purchased at different prices at different times, a systematic method is required to assign cost fairly and consistently.

Need for Valuation Methods

- Purchase prices of materials fluctuate frequently
- Same material may be bought at different rates
- Proper valuation ensures accurate **cost determination and profit calculation**

Methods of Valuation of Material Issues

1. FIFO (First In First Out) Method

Meaning

FIFO stands for **First In First Out**, meaning that materials purchased first are assumed to be issued first for production purposes.

Working Principle

Under FIFO method:

- Oldest stock is used first
- New stock remains in inventory
- Issue price is based on earliest purchase cost

Diagram: FIFO Flow

```
Purchases (Old Stock) ---> Issued First ---> Production Use
New Purchases -----------> Stored ---------> Ending Stock
```

Key Features

- Old stock is issued before new stock
- Ending stock is valued at **latest purchase price**
- Simple and logical method
- Suitable in industries where **materials are perishable or price is rising**

Advantages of FIFO

- Easy to understand and operate
- Reflects actual physical flow of materials
- Ending inventory is shown at **current market price (more realistic)**
- Useful in industries with frequent price changes

Limitations of FIFO

- Cost fluctuations may affect profit calculation
- Not suitable for highly inflationary environments for cost control
- Requires proper tracking of purchase batches

Example (Conceptual)

If materials are purchased at:

- ₹10 per unit (old stock)
- ₹15 per unit (new stock)

Under FIFO:
First ₹10 stock is issued first
Ending stock consists of ₹15 units

Valuation of Material Issues (Continuation)

In cost accounting, material issue valuation is essential for determining the correct cost of production. Since materials are purchased at different prices over time, systematic methods are used to assign a fair cost to materials issued from stores. Two important methods are **LIFO (Last In First Out)** and **Weighted Average Method**.

2. LIFO (Last In First Out) Method

Meaning

LIFO stands for **Last In First Out**, which means that the materials **purchased most recently are assumed to be issued first** for production purposes.

In this method, the latest stock received in the store is issued first, while older stock remains in inventory.

Working Principle

Under the LIFO method:

- The most recent purchase price is used for issuing materials
- Older stock remains in closing inventory
- Cost of production reflects **recent market prices**

Diagram: LIFO Flow

```
Latest Purchases  ---> Issued First ---> Production Use
Old Stock         ---> Remains in Store ---> Ending Inventory
```

Key Features

- Latest materials are issued first
- Closing stock consists of older purchase prices
- Cost of production reflects **recent cost levels**
- Less commonly used in modern accounting systems

Limitations of LIFO

- Ending stock may not reflect current market value
- Complicates inventory tracking in rising or falling price conditions
- Not accepted under many modern accounting standards (IFRS)
- May distort profitability during price fluctuations

Example (Conceptual Understanding)

If materials are purchased at:

- ₹20 per unit (old stock)
- ₹30 per unit (latest stock)

Under LIFO:
₹30 stock is issued first
₹20 stock remains in closing inventory

LIFO method assumes that the most recently purchased materials are used first. Although it reflects current cost in production, it is less commonly used today due to its limitations in inventory valuation and financial reporting.

3. Weighted Average Method

Meaning

The Weighted Average Method is a technique in which the **cost of materials issued is calculated using an average price**, considering both quantity and cost of all available materials.

It provides a balanced cost by smoothing out price fluctuations over time.

Formula

```
Average Price = Total Cost of Materials ÷ Total Quantity of Materials
```

Working Principle

Under this method:

- All available stock is treated as a single pool
- A uniform average price is calculated
- Materials are issued at this average price
- Closing stock is also valued at the same average rate

Diagram: Weighted Average Concept

```
Purchase A (₹10) ---------\
                           \
Purchase B (₹15) --------> Total Pool of Materials ---> Average Price
                           /
Purchase C (₹20) ---------/
```

Key Features

- Smoothens price fluctuations
- Uses combined average of all purchases
- Issue price remains stable over time
- Suitable for industries with frequent price changes

Advantages

- Simple and logical to apply
- Reduces impact of price fluctuations
- Provides stable cost of production
- Useful for large-scale production industries

Limitations

- Requires recalculation after each purchase
- Does not reflect exact historical cost
- May not show precise cost control information
- Slightly complex in manual systems

Example (Conceptual)

If materials are purchased at:

- 100 units @ ₹10 = ₹1,000
- 100 units @ ₹20 = ₹2,000

Total cost = ₹3,000
Total quantity = 200 units

```
Average Price = 3000 ÷ 200 = ₹15 per unit
```

So, all issues will be valued at ₹15 per unit.

The Weighted Average Method provides a fair and balanced valuation of material issues by averaging out cost fluctuations. It is widely used in industries where material prices change frequently, as it ensures consistency and stability in cost calculation.

(FIFO vs LIFO vs Weighted Average)

Method	Basis	Stock Valuation	Use
FIFO	Oldest first	Latest price in closing stock	Rising prices
LIFO	Latest first	Old stock in closing inventory	Rarely used
Weighted Average	Average cost	Uniform average price	Stable industries

Inventory Control Techniques

Inventory control is a vital function of material management that ensures the **right quantity of materials is available at the right time and at minimum cost**. Efficient inventory control avoids both overstocking and stockouts, thereby improving production continuity and cost efficiency.

It is especially important because inventory involves a large portion of working capital in most organizations.

1. EOQ (Economic Order Quantity)

Meaning

EOQ refers to the **ideal or optimal order quantity** that a firm should purchase each time so that the **total inventory cost is minimized**.

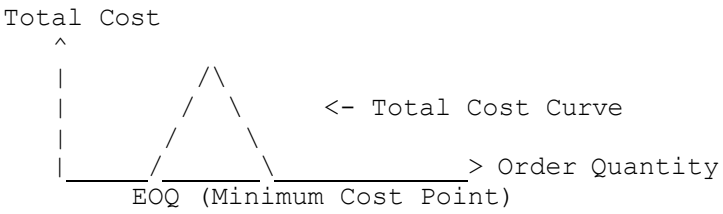
It balances two major costs:

- Ordering Cost (cost of placing orders)
- Carrying Cost (cost of holding inventory)

Objective of EOQ

- Minimize total inventory cost
- Avoid excess inventory and stock shortage
- Ensure smooth production process

Conceptual Diagram of EOQ



Key Idea

At EOQ point:
Ordering Cost = Carrying Cost
Total inventory cost is minimum

Importance

- Reduces inventory holding cost
- Prevents unnecessary capital blockage
- Ensures efficient purchasing decisions

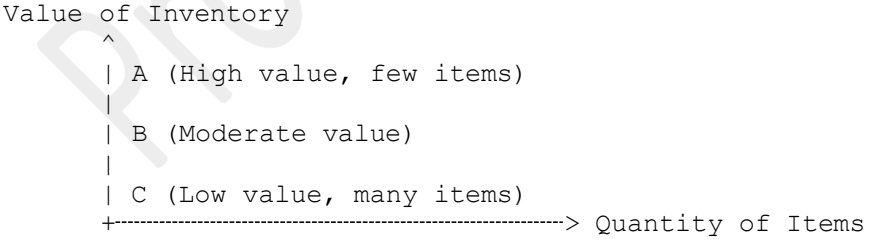
2. ABC Analysis

Meaning

ABC Analysis is a technique of **inventory classification based on value and importance**. Items are divided into three categories:

- **A-Class Items** → High value, low quantity
- **B-Class Items** → Moderate value and quantity
- **C-Class Items** → Low value, high quantity

Diagram: ABC Classification



Classification Details

A-Class Items

- 70–80% of total value
- 10–20% of items

- Require strict control and frequent monitoring

B-Class Items

- Moderate importance
- Balanced control measures

C-Class Items

- 5–10% of total value
- Large number of items
- Simple control methods

Importance of ABC Analysis

- Helps focus on high-value items
- Improves inventory control efficiency
- Reduces unnecessary management effort on low-value items

3. Stock Level Control

Stock levels are maintained to ensure that materials are available without interruption while avoiding overstocking.

(a) Minimum Level

Meaning:

The **lowest quantity of stock** that should always be maintained to avoid stockout.

- Below this level, production may stop
- Ensures safety against delays in supply

(b) Maximum Level

Meaning:

The **highest quantity of stock** that should be held at any time.

- Prevents overstocking
- Avoids unnecessary storage cost

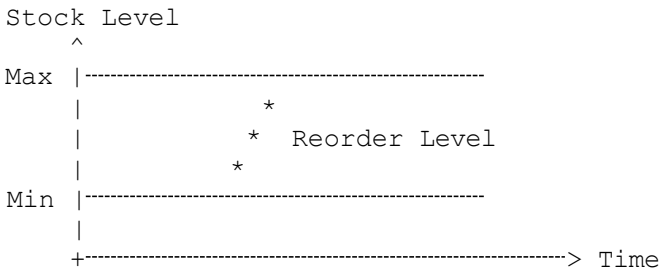
(c) Reorder Level

Meaning:

The level at which a **fresh order should be placed** to replenish stock.

- Ensures materials arrive before stock reaches minimum level

Stock Level Diagram



Importance of Stock Levels

- Prevents production stoppage
- Maintains optimum inventory
- Reduces storage cost
- Ensures timely availability of materials

OVERHEADS

Meaning

Overheads refer to **indirect costs** that cannot be directly traced to a specific product, job, or service. These costs are essential for running a business but are not directly involved in production.

Characteristics of Overheads

- Cannot be directly identified with a product
- Incurred for overall business operations
- Essential for production and administration
- Apportioned among cost units

Examples of Overheads

- Rent of factory or office
- Electricity and water charges
- Supervisor salaries
- Depreciation of machinery

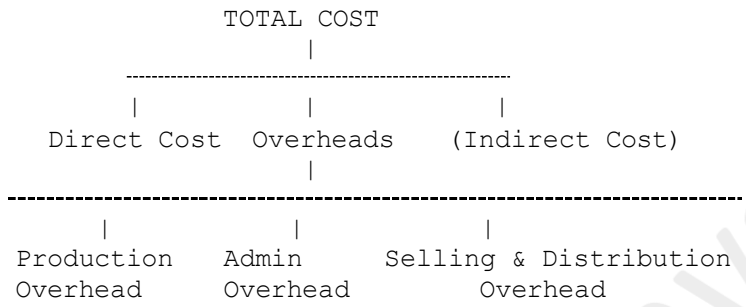
- Indirect labour costs

Classification of Overheads

Although not fully expanded here, overheads are generally classified into:

- Production Overheads
- Administrative Overheads
- Selling & Distribution Overheads

Diagram: Nature of Overheads



Importance of Overheads

- Helps in determining total cost of production
- Essential for pricing decisions
- Required for cost control and budgeting
- Supports managerial decision-making

Inventory control techniques such as EOQ, ABC analysis, and stock level management play a crucial role in optimizing material usage and minimizing cost. Similarly, overheads represent essential indirect costs that must be properly allocated for accurate cost determination and effective business management.

Types of Overheads

Overheads refer to **indirect costs** that cannot be directly identified with a specific product, job, or service. These costs are essential for running the business smoothly but are distributed among various cost units through appropriate methods.

For proper cost control and accurate product costing, overheads are classified into different types based on their function in the organization.

1. Production Overheads

Meaning

Production overheads are the **indirect costs incurred in the manufacturing process**. These costs are related to factory operations but cannot be directly traced to a specific product.

Examples

- Factory rent
- Indirect labour (supervisors, helpers)
- Factory electricity
- Depreciation of machinery
- Repairs and maintenance

Importance

Production overheads form a significant part of manufacturing cost and must be properly allocated to products for accurate cost determination.

2. Administrative Overheads

Meaning

Administrative overheads are the **indirect expenses incurred in managing and controlling the organization**.

Examples

- Office rent
- Salaries of administrative staff
- Accounting and audit expenses
- Office stationery
- Legal and professional fees

Importance

These costs are essential for overall business management but do not directly contribute to production or sales.

3. Selling & Distribution Overheads

Meaning

Selling and distribution overheads are the **costs incurred in promoting sales and delivering products to customers**.

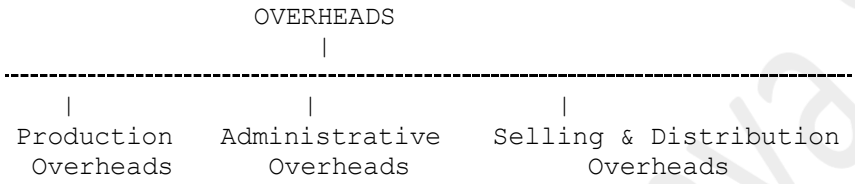
Examples

- Advertisement expenses
- Sales commission
- Packaging costs
- Delivery and transportation charges
- Warehousing expenses

Importance

These overheads play a key role in increasing sales volume and ensuring timely delivery of products to customers.

Diagram: Types of Overheads



6. Distribution of Overheads

The distribution of overheads refers to the process of **allocating and assigning indirect costs to cost centers and cost units** in a systematic manner. Since overheads cannot be directly traced to a product, they are distributed using logical and fair methods.

Step 1: Allocation

Meaning

Allocation is the **direct assignment of a specific overhead cost to a particular cost centre or department** when the cost is clearly identifiable.

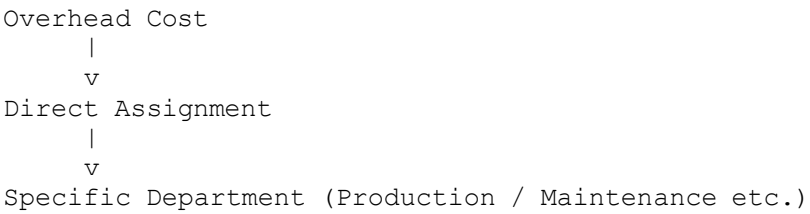
Key Features

- Direct and specific assignment
- No sharing or distribution involved
- Based on clear relationship with cost centre

Example

- Machine cost allocated directly to Production Department
- Salary of factory manager allocated to factory overhead

Diagram: Allocation



Step 2: Apportionment

Meaning

Apportionment is the **distribution of common overhead costs among different departments on a suitable and logical basis**.

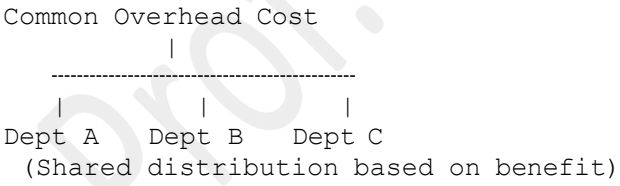
Key Features

- Used when cost cannot be directly assigned
- Based on logical basis of benefit received
- Shared among multiple departments

Basis of Apportionment

- Rent → Based on floor area occupied
- Electricity → Based on units consumed
- Depreciation → Based on machine usage

Diagram: Apportionment



Step 3: Absorption

Meaning

Absorption is the process of **charging the allocated and apportioned overheads to individual products or cost units**.

It ensures that each product bears a fair share of total overhead cost.

Key Features

- Final stage of overhead distribution
- Overheads are included in product cost
- Helps in determining total cost per unit

Diagram: Absorption Process

```
Allocated + Apportioned Overheads
                |
                v
        Cost Centres / Departments
                |
                v
        Products / Cost Units
```

Importance of Overhead Distribution

- Ensures accurate product costing
- Helps in fair cost allocation
- Supports pricing decisions
- Improves cost control and efficiency
- Assists in managerial decision-making

Overheads form an important part of total cost and must be carefully classified and distributed. Production, administrative, and selling & distribution overheads represent different functional areas of cost. The systematic process of allocation, apportionment, and absorption ensures that overhead costs are fairly assigned to products, enabling accurate cost determination and effective managerial control.

Primary & Secondary Distribution of Overheads

In cost accounting, overhead costs cannot be directly charged to a single product. Therefore, they are first collected and then distributed among various departments in a systematic manner. This distribution process is broadly divided into **Primary Distribution** and **Secondary Distribution**, depending on how far the cost is shared within the organization.

Primary Distribution of Overheads

Primary distribution refers to the process of **allocating and apportioning overhead costs to all departments of the organization**, including both production departments and service departments. At this stage, all indirect costs are identified and distributed on a suitable basis according to the benefit received by each department.

For example, factory rent may be distributed among different departments based on floor area occupied, while electricity expenses may be distributed based on consumption. The objective of primary distribution is to ensure that every department bears its fair share of common overhead costs.

In simple terms, primary distribution ensures that overheads are first assigned to all departments where they are incurred or benefited.

Secondary Distribution of Overheads

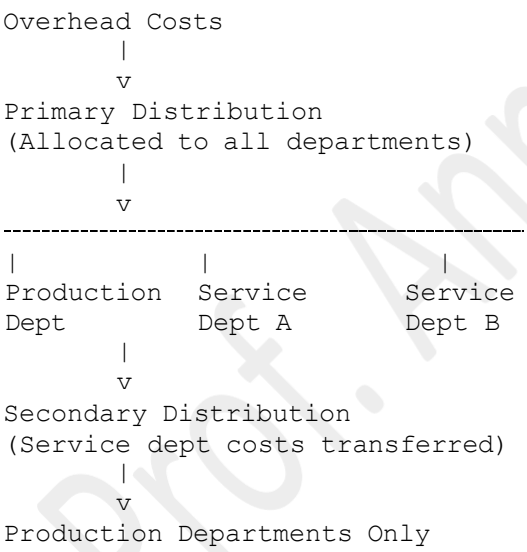
Secondary distribution takes the process one step further. After primary distribution, overhead costs are already assigned to both production and service departments. However, service departments do not directly contribute to production, so their costs need to be redistributed to production departments.

Thus, secondary distribution refers to the **reapportionment of service department costs among production departments only**. This is done because production departments are responsible for actual manufacturing and ultimately absorb all costs.

For instance, if the maintenance department or canteen department incurs costs, these are first assigned to them in primary distribution and later redistributed to production departments such as assembly or machining departments in the secondary stage.

This ensures that the final cost of production reflects all indirect expenses accurately.

Flow of Primary and Secondary Distribution



Methods of Absorption of Overheads

Once overheads are allocated and apportioned to production departments, the next step is to charge these overheads to individual products. This process is known as **overhead absorption**, and it ensures that each unit of output bears its fair share of indirect costs.

Different methods are used for absorption depending on the nature of production and the basis of cost distribution.

1. Machine Hour Rate Method

In industries where production is highly mechanized, overheads are absorbed based on machine usage. Under this method, the total overhead cost is divided by the total number of machine hours to determine the cost per machine hour. This rate is then applied to products based on the machine time used in their production.

This method is particularly useful in factories where machines play a dominant role in production.

2. Labour Hour Rate Method

When labour plays a major role in production, overheads are absorbed based on labour hours. The total overhead cost is divided by total labour hours worked to determine an overhead rate per labour hour. This rate is then applied according to the number of hours worked on each product.

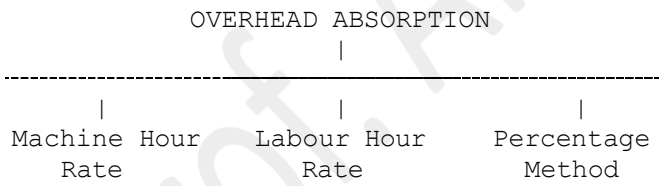
This method is suitable in labour-intensive industries such as handicrafts or assembly work.

3. Percentage Method

Under this method, overheads are absorbed as a percentage of direct labour cost or total cost. A predetermined percentage is calculated and applied to the cost base to determine the overhead charged to each product.

For example, if overheads are estimated at 20% of direct labour cost, then for every unit of labour cost incurred, 20% is added as overhead.

Overview of Absorption Methods



Over and Under Absorption of Overheads (Very Important Topic)

In cost accounting, overheads are usually absorbed into product cost on a **predetermined or estimated basis** before the actual overheads are known. This means that the overheads charged to production may not always match the actual overheads incurred at the end of the accounting period. The difference between absorbed overheads and actual overheads gives rise to **over absorption or under absorption of overheads**.

Over Absorption of Overheads

Over absorption occurs when the overheads charged to production are **more than the actual overheads incurred**. In such a situation, the cost of production is overstated because a higher amount of overhead has been included in the cost of products than what was actually spent.

For example, if a company estimates and absorbs ₹50,000 as factory overheads but the actual overhead incurred is only ₹45,000, then there is an over absorption of ₹5,000.

This situation generally indicates that overheads were overestimated or actual costs turned out to be lower than expected.

Under Absorption of Overheads

Under absorption is the opposite situation, where the overheads charged to production are **less than the actual overheads incurred**. This results in underestimation of product cost because the actual expenses are higher than what has been absorbed into cost.

For instance, if ₹40,000 is absorbed as overhead but the actual overhead incurred is ₹45,000, then there is an under absorption of ₹5,000.

This leads to understatement of cost and may affect profit calculations if not corrected properly.

□ Reasons for Over and Under Absorption

The occurrence of over or under absorption is mainly due to variations between estimated and actual figures. One of the common reasons is **incorrect estimation of overheads or production levels** at the beginning of the period. Another important factor is **seasonal fluctuations in production or expenses**, where costs vary significantly during different periods but absorption is based on uniform estimates.

Sometimes, changes in production efficiency, unexpected price changes, or idle capacity also contribute to this mismatch between absorbed and actual overheads.

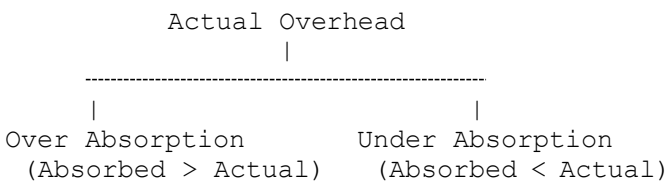
Treatment of Over and Under Absorption

At the end of the accounting period, it is necessary to adjust the difference between absorbed and actual overheads so that the cost accounts reflect the correct financial position. One common method is to transfer the difference to the **Costing Profit and Loss Account**, which ensures that profit is adjusted for the over or under absorbed amount.

Alternatively, in some cases, the difference may be carried forward and adjusted in the next accounting period, especially when the variation is small or temporary in nature. This helps in smoothing out cost fluctuations over time.

Conceptual Understanding Diagram

Actual Overhead vs Absorbed Overhead



Over and under absorption of overheads is a common occurrence in cost accounting due to the use of estimated rates for cost allocation. While over absorption leads to overstatement of cost and profit, under absorption results in understatement. Therefore, proper adjustment through costing profit and loss account or future period correction is essential to ensure accurate cost reporting and fair financial analysis.

MODULE III: Methods, Techniques & Management Tools

PART A: Costing Methods

Costing methods refer to the techniques used to **collect, classify, and assign costs** to products, jobs, processes, or services depending on the nature of production. Different industries adopt different methods because production systems and output characteristics vary significantly. These methods help in determining accurate cost, controlling expenses, and supporting managerial decision-making.

1. Job Costing

Job costing is a method in which costs are collected and recorded separately for each **individual job, order, or assignment**. It is used when production is not continuous and each job is performed according to specific customer requirements.

This method is widely used in industries where products or services are customized. Examples include printing presses, repair workshops, tailoring units, and custom furniture manufacturing. In such cases, each job is unique, and therefore a separate Job Cost Sheet is prepared to record all costs related to that particular job.

The main feature of job costing is that **each job is treated as a separate cost unit**, allowing management to determine the exact cost and profitability of each order.

2. Contract Costing

Contract costing is applied in industries where work is executed on a **large-scale, long-term contractual basis**, usually involving construction or infrastructure projects. Each contract is treated as a separate cost unit, and all costs related to that contract are accumulated separately.

 Common examples include:

- Road construction
- Bridges
- Buildings

- Dams

Since contracts often extend over long periods, certain special terms are used in contract costing. For example, **work certified** refers to the portion of work completed and approved by the client, while **retention money** refers to the amount withheld by the contractee until satisfactory completion of the project.

This method helps in tracking the progress, cost, and profitability of each contract individually.

3. Process Costing

Process costing is used in industries where production is **continuous, uniform, and standardized**, and the output passes through different stages or processes. In such industries, it is not possible to identify the cost of individual units separately.

 Typical industries include:

- Cement manufacturing
- Sugar production
- Chemical industries
- Oil refining

Under this method, costs are accumulated for each process, and then the total cost of each process is divided by the number of units produced to determine the cost per unit. Since production is continuous, output of one process becomes input for the next, making process costing suitable for mass production systems.

4. Joint Products and By-Products

In certain industries, a single production process results in more than one product. These outputs are classified as **joint products** and **by-products** based on their importance and value.

Joint products are those products that are produced simultaneously from the same raw material and are of **nearly equal importance and value**. Since they are all primary outputs of the process, costs are shared among them. A common example is milk processing, where products like butter and cream are produced simultaneously and are considered joint products.

By-products, on the other hand, are secondary or incidental products that arise during the production process but have **relatively lower value compared to the main products**. For example, in sugar manufacturing, sugar is the main product while molasses is obtained as a by-product. Although by-products are not the main objective of production, they still contribute additional income and must be properly accounted for.

Costing methods vary depending on the nature of production and industry requirements. Job costing is suitable for customized work, contract costing for large-scale projects, process costing for continuous production, and joint/by-product costing for industries producing multiple outputs from a single process. Proper selection and application of these methods ensure accurate cost determination, efficient cost control, and effective managerial decision-making.

PART B: SERVICE COSTING

Service costing refers to the method of cost determination used in organizations that provide **services instead of physical goods**. Unlike manufacturing industries, service organizations do not produce tangible products; instead, they deliver intangible services such as transportation, healthcare, catering, and similar activities. In such cases, the main objective of cost accounting is to determine the **cost per unit of service** so that proper pricing, cost control, and efficiency analysis can be achieved.

Service costing is essential because even though there is no production of goods, various costs like labour, fuel, maintenance, consumables, and administrative expenses are continuously incurred. Therefore, it becomes necessary to measure how efficiently these resources are being used in providing services.

Examples of Service Costing

Service costing is widely applied in organizations where output is not in physical units but in terms of services rendered. Some common examples include:

- Transport services (goods and passenger transport)
- Hospitals and healthcare services
- Canteens and catering services
- Hotels and hospitality services
- Educational institutions (in some costing systems)

Each service organization uses different cost units depending on the nature of service provided, such as per kilometre, per patient, per meal, or per room.

Transport Costing

Transport costing is one of the most important applications of service costing. It is used in organizations involved in the movement of goods or passengers, such as logistics companies, bus services, and delivery operators. In this method, all costs related to vehicle operation—such as fuel, driver wages, maintenance, depreciation, insurance, and road taxes—are collected and analyzed.

The total cost is then divided by appropriate service units to determine cost efficiency and pricing structure. Transport costing mainly focuses on two important cost measurements: cost per kilometre and cost per passenger.

Important Formulas in Transport Costing

The cost per kilometre is calculated by dividing the total cost of transport operations by the total number of kilometres run. This helps in understanding the operational efficiency of vehicles.

Similarly, cost per passenger is calculated by dividing the total cost by the number of passengers carried. This is especially useful in passenger transport systems like buses, where revenue depends on passenger occupancy.

Formula Representation

```
Cost per km = Total Cost ÷ Total Kilometres Run

Cost per passenger = Total Cost ÷ Number of Passengers
```

Importance of Service Costing

Service costing is highly important in service-based industries because it helps in determining the actual cost of providing services. It supports management in fixing service charges, controlling operational costs, and improving overall efficiency. It also helps in identifying underutilization of resources and improving profitability in service operations.

Service costing is a crucial branch of cost accounting that deals with the computation of cost in service organizations. By using suitable cost units such as kilometre, passenger, patient, or meal, organizations can accurately measure and control service costs. Transport costing is a key example that demonstrates how cost per service unit is calculated and used for effective managerial decision-making.

PART C: MARGINAL COSTING (VERY IMPORTANT)

Marginal costing is one of the most important techniques of cost accounting used for **managerial decision-making, planning, and control**. It focuses on analyzing costs based on their behavior, particularly distinguishing between **fixed costs and variable costs**. Under this system, only variable costs are considered for product costing and decision-making, while fixed costs are treated as period costs and are charged directly to the profit statement.

This approach is highly useful in short-term decision-making because it clearly shows how costs and profits change with changes in output or sales volume.

1. Meaning of Marginal Costing

Marginal costing is a technique in which decisions are taken based only on **variable cost behavior**. It assumes that fixed costs remain constant in the short run and therefore should not influence production or pricing decisions.

In simple terms, marginal costing helps management understand how much additional cost is incurred when one more unit is produced and how much contribution that unit generates toward fixed cost and profit.

2. Marginal Cost Equation

The relationship between sales, cost, and profit under marginal costing can be expressed in two important ways. One approach shows the overall profit structure, while the other highlights the concept of contribution.

Sales can be expressed as the sum of variable cost, fixed cost, and profit. This equation helps in understanding how total sales revenue is distributed among different cost components and profit.

Another important concept is **contribution**, which is calculated as the difference between sales and variable cost. Contribution is the amount available to cover fixed costs and generate profit.

Equations

```
Sales = Variable Cost + Fixed Cost + Profit

Contribution = Sales – Variable Cost
```

3. Profit Volume Ratio (P/V Ratio)

The Profit Volume Ratio is a key indicator used in marginal costing to measure the relationship between contribution and sales. It shows how much contribution is generated from each unit of sales.

A higher P/V ratio indicates better profitability because it means that a larger portion of sales is contributing towards fixed costs and profit.

Formula

```
P/V Ratio = (Contribution ÷ Sales) × 100
```

Interpretation

- Higher P/V ratio → Higher profitability
- Lower P/V ratio → Lower margin of safety

4. Break-even Point (BEP)

The Break-even Point is a critical concept in marginal costing. It represents the level of sales or production at which **total revenue equals total cost**, meaning there is neither profit nor loss.

At this point, the business is said to have covered all its fixed and variable costs completely.

Formulas

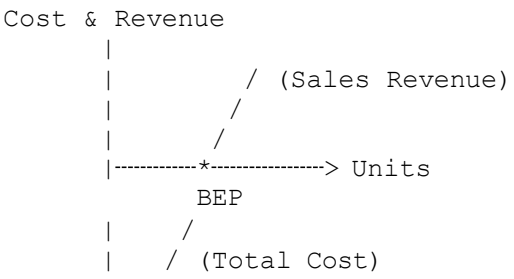
Break-even Point can be calculated in two ways depending on requirement:

```
BEP (Units) = Fixed Cost ÷ Contribution per unit
```

```
BEP (Sales) = Fixed Cost ÷ P/V Ratio
```

Break-even Chart (Conceptual Understanding)

The break-even chart is a graphical representation of cost, revenue, and profit behavior. On the horizontal axis (X-axis), units sold are shown, while on the vertical axis (Y-axis), cost and revenue are represented. The point where the total cost line intersects the sales revenue line is known as the break-even point.



At this intersection point, total cost equals total revenue.

5. Applications of Marginal Costing

Marginal costing is widely used in managerial decision-making because it provides clear and relevant cost information for short-term decisions.

(A) Make or Buy Decision

In this decision, management compares the cost of manufacturing a product internally with the cost of purchasing it from an external supplier. The decision is based purely on variable cost comparison, and the cheaper alternative is selected. This helps in reducing overall cost and improving efficiency.

(B) Product Mix Decision

When a company produces multiple products, marginal costing helps in deciding the best combination of products to maximize profit. Products that generate the highest contribution per limiting factor (such as machine hours or raw material availability) are given priority in production.

(C) Profit Planning

Marginal costing is also useful in planning profit levels. By increasing sales volume and improving contribution per unit, businesses can enhance overall profitability. It helps management understand how changes in sales affect profit.

Marginal costing is a powerful tool for managerial decision-making because it focuses on cost behavior and contribution analysis. Concepts such as contribution, P/V ratio, and break-even point help managers understand cost-profit relationships clearly. Its applications in make or buy

decisions, product mix optimization, and profit planning make it an essential technique in modern cost accounting.

PART D: BUDGETARY CONTROL

Budgetary control is an important tool of management accounting that focuses on **planning, coordination, and control of business activities through budgets**. It helps an organization to plan its income and expenditure in advance and compare actual performance with planned targets. In simple terms, it acts as a financial roadmap for the future operations of a business.

Budgetary control not only helps in setting financial goals but also ensures that resources are used efficiently and deviations from planned performance are identified and corrected on time.

1. Meaning of Budgetary Control

Budgetary control refers to the process of preparing budgets for various activities of the organization and continuously comparing them with actual results. The main purpose is to ensure that business operations are carried out according to the planned financial framework.

It involves planning future income and expenditure in a systematic manner so that management can achieve organizational objectives efficiently.

2. Types of Budgets

Budgets are prepared for different functions of an organization depending on its operational needs. A **sales budget** estimates expected sales for a given period and acts as the foundation for other budgets. Based on the sales forecast, a **production budget** is prepared to determine the level of output required.

A **cash budget** focuses on expected cash inflows and outflows, ensuring that the organization maintains sufficient liquidity to meet its obligations. A **cost budget** estimates expected costs for various activities, helping in cost control and performance evaluation.

All these functional budgets are finally integrated into a **master budget**, which presents a summarized financial plan for the entire organization and provides an overall view of expected performance.

Types of Budgets Overview

- Sales Budget
- Production Budget
- Cash Budget
- Cost Budget
- Master Budget

3. Flexible Budget

A flexible budget is a budget that is designed to **adjust according to different levels of activity or output**. Unlike a fixed budget, it does not remain constant; instead, it changes with variations in production or sales volume.

This type of budget is very useful for performance comparison because it allows management to compare actual results with a budget that is adjusted for actual activity levels. As a result, it provides a more realistic and meaningful analysis of efficiency and cost control.

ZERO BASED BUDGETING (ZBB)

Zero Based Budgeting is a modern budgeting approach in which every budgeting period starts from a **"zero base"**, meaning that no previous year's figures are taken as a reference. Instead, every expense must be justified afresh for each new budget period.

In ZBB, each activity is evaluated based on its necessity and contribution to organizational objectives. Only those activities that are justified and essential are approved and funded.

This approach ensures better cost control, eliminates unnecessary expenditures, and promotes efficient resource allocation.

Budgetary control is a powerful managerial tool that helps in planning, monitoring, and controlling organizational performance. By using different types of budgets such as sales, production, cash, and master budgets, organizations can effectively coordinate their activities. Flexible budgeting improves performance analysis, while Zero Based Budgeting ensures that every expense is justified, making the system more efficient and cost-effective.

PART E: STANDARD COSTING

Standard costing is an important technique of cost accounting used for **cost control and performance evaluation**. It involves setting predetermined cost levels for materials, labour, and overheads, which act as a benchmark against which actual performance is compared. This helps management identify deviations and take corrective actions to improve efficiency.

In simple terms, standard costing establishes what the cost **should be**, and compares it with what the cost **actually is**.

1. Meaning of Standard Costing

Standard costing refers to a system where costs are predetermined based on efficient operating conditions and are used as a standard or benchmark for measuring actual performance.

These standard costs are set scientifically using past data, engineering studies, and management expectations. They help in planning production costs in advance and controlling unnecessary expenditure during operations.

2. Standard Cost vs Budget

Although both standard costing and budgeting are used for planning and control, they differ in their focus and application.

A **budget** is generally prepared for the **total cost or revenue** of an organization for a specific period. It is mainly used as a planning tool for overall financial control.

On the other hand, **standard cost** is set for **per unit cost of production** and is mainly used as a control tool to measure efficiency at the operational level.

In essence, budgets provide a broad financial plan, whereas standard costs focus on detailed cost control per unit of output.

Comparison: Budget vs Standard Cost

Budget	Standard Cost
Total cost	Per unit cost
Planning tool	Control tool

3. Variance Analysis (VERY IMPORTANT)

Variance analysis is a key feature of standard costing. It involves comparing **actual costs with standard costs** and analyzing the differences (variances). These variances help management understand whether performance is favorable or unfavorable and identify the reasons behind deviations.

Variance analysis is commonly applied to material, labour, and sales costs.

Material Variance

Material variance analysis focuses on the difference between standard and actual material costs. It helps in understanding whether excess cost is due to price changes or inefficient usage of materials.

Material cost variance is further divided into **price variance** and **usage variance**. Price variance arises due to differences in actual and standard purchase price of materials, while usage variance occurs due to excess or inefficient consumption of materials during production.

Labour Variance

Labour variance measures the difference between standard and actual labour costs. It helps in evaluating workforce efficiency and wage rate control.

Labour variance is divided into **rate variance** and **efficiency variance**. Rate variance arises when actual wage rates differ from standard wage rates, whereas efficiency variance occurs when workers take more or less time than expected to complete a job.

Sales Variance

Sales variance analysis is used to evaluate the performance of sales activities. It compares actual sales with standard or budgeted sales to understand deviations in revenue.

It is mainly divided into **sales price variance**, which arises due to changes in selling price, and **sales volume variance**, which occurs due to differences in actual and expected sales quantity.

Standard costing is a powerful cost control technique that helps organizations maintain efficiency by comparing actual costs with predetermined standards. Through variance analysis of materials, labour, and sales, management can identify inefficiencies and take corrective actions. This system plays a crucial role in improving cost control, productivity, and overall profitability.

PART F: COST CONTROL & COST REDUCTION

Cost control and cost reduction are two important concepts in cost accounting that aim at improving efficiency and profitability of an organization. Though they are closely related, they differ in their approach and objective. Both are essential for maintaining competitiveness in today's business environment.

Cost Control

Cost control refers to the process of **regulating and monitoring costs to ensure that they remain within the predetermined limits or standards** set by the management. The main objective of cost control is to ensure that actual costs do not exceed the planned or budgeted costs.

In practice, cost control involves setting cost standards, comparing actual performance with these standards, and taking corrective actions whenever deviations occur. It focuses on maintaining efficiency and preventing unnecessary expenditure during the production process.

Cost control is a continuous process and is closely linked with tools such as budgets, standard costing, and variance analysis.

Cost Reduction

Cost reduction refers to a **permanent and real reduction in the per unit cost of production without compromising the quality, utility, or efficiency of the product or service**. Unlike cost control, which focuses on maintaining costs within limits, cost reduction focuses on finding new and innovative ways to reduce costs.

It is a dynamic approach that emphasizes improving production techniques, eliminating waste, increasing productivity, and adopting better technology or management practices.

Cost reduction should not affect the quality of the product; instead, it aims to achieve the same or better output at a lower cost.

□ Key Difference in Concept

Cost control is concerned with keeping costs within a defined boundary, while cost reduction is focused on achieving a lower cost level permanently through continuous improvement. In simple terms, cost control prevents overspending, whereas cost reduction actively works to reduce the cost structure of the organization.

Cost control and cost reduction are essential tools for effective cost management. While cost control ensures that expenses remain within planned limits, cost reduction focuses on achieving long-term savings without affecting quality. Together, they help organizations improve profitability, efficiency, and competitiveness in the market.

THANK YOU

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