Foundations of Accounting & Finance

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Lecture - 23

Cost, Costing and Cost Accounting

Introduction

In the first module, we spent a lot of time trying to understand the basic financial statements, the income statement, the balance sheet, and the cash flow statement. Now, we are moving to the next module, which we call cost and management accounting. When I say costing or cost accounting or management accounting, we are not moving one step forward; we are moving one step backward. In financial accounting, if a transaction occurs, we went ahead and recorded the transaction, then we prepared the profit and loss statement to determine whether we are making a profit or not by manufacturing and selling a product and this information will be used by most of the stakeholders.

Cost accounting information is predominantly used for decision making by the management of the entity. In financial accounting, you record the sale of a product at a particular price, indicating the revenue from the sale. But how do you even decide at what price you should sell the product? Before you even embark on selling a product, you need to know the cost of manufacturing that product and the other overhead costs that will be incurred. Then you can determine the mark up and the price at which you can sell the product.

You don't start setting up the place, manufacturing the product, and selling the product, only to realize later that you are making a loss. Therefore, prior to the event occurring, you try to back calculate what will be the cost of the product. You consider the cost of raw materials, labour, overheads, administrative costs, and selling and distribution costs associated with it. Then, you arrive at the total cost of the product, which you will eventually sell in the market.

So, what are we trying to do in cost and management accounting? In financial accounting, you enter the transaction in the financial statements after it has taken place. Here, before the transaction occurs, you are trying to determine the cost through cost or management accounting.

Decision making using cost or management accounting

Examples of various management decisions using cost accounting information includes:

- What is the optimal product mix?
- What are the specific products that needs to be manufactured?
- When will the organization or the product break even, and when will it not break even?
- How many units must be sold to achieve the desired level of profit?

Basic difference between financial and management accounting

The basic difference between financial and management accounting is in the users of information. Financial accounting primarily involves reporting information to external stakeholders, while management accounting is geared towards providing information for internal decision-making within the company. This includes furnishing necessary data for both top management and middle management to formulate plans and establish control systems. Essentially, management accounting is internal to the company.

In contrast, financial accounting is external, aimed at stakeholders outside the organization. Management accounting information remains confidential and is not intended for public or external consumption. Revealing such information could potentially give competitors an advantage in the market. Therefore, management accounting serves as a confidential resource for internal decision-making within the company.

To summarize, financial accounting records post-event information for both internal and external users, while management accounting focuses on pre-event data for internal decision-making within the company.

Purpose of cost classification

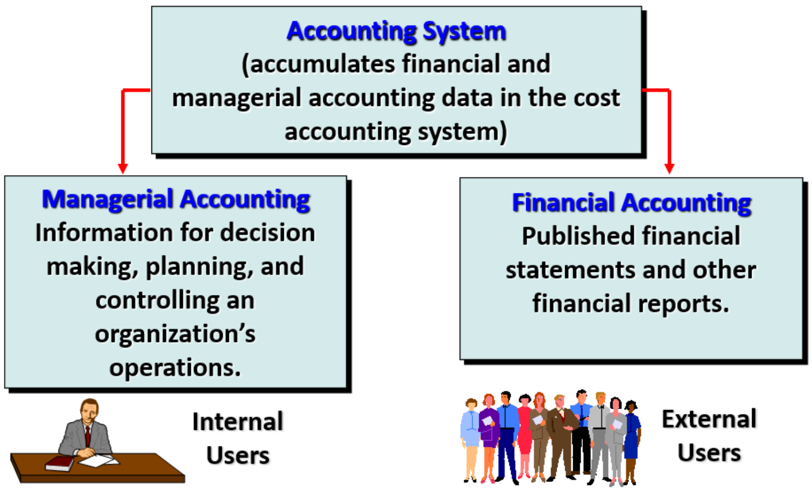
Following are the purpose of cost classification:

- Assigning costs to cost objects
- Accounting for costs in manufacturing or service companies
- Preparing financial statements
- Predicting cost behavior in response to changes in activity
- Making decisions

We classify the cost into various aspects. We categorize costs into different cost objects within manufacturing companies. Further, we analyze cost behavior to facilitate decision-making. As we progress, we will provide examples of cost sheets, illustrating the process of preparing financial statements.

Managerial versus financial accounting

An accounting system is a broad umbrella encompassing both financial and managerial accounting data. This information within the accounting system is typically divided into two main categories, as illustrated in the figure below:



On the right side, you'll find financial accounting, which primarily serves external stakeholders. Conversely, management accounting, is utilized internally by the organization. For instance, if a company aims to achieve a specific profit target in a given month across its three product lines, management accounting helps in strategizing the production mix. By analysing the cost behaviour and market conditions of each product, the company can determine the optimal quantities of Product A, Product B, and Product C to manufacture. Once these products are sold at predetermined prices, management accounting enables the company to assess whether the desired profit has been attained. This process aids in decision-making, planning, and cost control efforts.

If the company finds that it is not meeting its profit targets, management accounting allows for a deeper analysis to pinpoint the reasons. It helps to identify potential areas of overspending, such as material costs, labour expenses, factory overheads, administrative costs, or selling and distribution expenses. By categorizing and examining these costs, the company can implement corrective measures to improve profitability. Ultimately, cost accounting information is exclusively utilized by senior management for internal decision-making purposes.

Financial and Managerial Accounting: Key Differences

	Financial Accounting	Managerial Accounting
1. Users	External persons who make financial decisions	Managers who plan for and control an organization
2. Time focus	Historical perspective	Future emphasis
3. Verifiability versus relevance	Emphasis on objectivity and verifiability	Emphasis on relevance
4. Precision versus timeliness	Emphasis on precision	Emphasis on timeliness
5. Subject	Primary focus is on companywide reports	Focus on segment reports
6. Rules	Must follow GAAP / IFRS and prescribed formats	Not bound by GAAP / IFRS or any prescribed format
7. Requirement	Mandatory for external reports	Not Mandatory

In the table above, the differences between financial accounting and management accounting are outlined. For instance, let's consider the first difference regarding the perspective of time. Financial accounting is a historical perspective capturing data after events have occurred. However, for planning manufacturing and sales, understanding the costs involved is crucial, which is where management accounting comes in—it offers a forward-looking perspective. Financial accounting, on the other hand, remains rooted in the past.

Now, let's examine the aspect of verifiability versus relevance. Financial accounting undergoes external audits by independent auditors to ensure accuracy and reliability. In contrast, such audits are not mandatory for cost accounting data, prioritizing relevance over strict verification.

Next, let's focus on the concept of relevance with an example. Imagine you run a multi-product firm with a common expenditure, such as factory rent. Since the factory is utilized for manufacturing all three products, you must allocate this expense among them. The most suitable method for allocation depends on relevant criteria, such as sales value or the number of units produced. Management accounting focuses on dividing the common cost among the three products more precisely.

Financial accounting adheres to standards such as IFRS, IAS, and GAAP, ensuring uniformity and comparability across organizations. In contrast, cost accounting is not universally governed by these standards, though certain industries may be subject to specific regulations such as cost accounting record rules.

Lastly, let's address the requirements for financial and cost accounting. Financial accounting mandates the annual preparation and submission of financial statements. Conversely, there are no such obligatory requirements for cost accounting, which is primarily an internal tool utilized by companies for decision-making purposes, prepared as needed.

Advantages of Cost Accounting

- Reveals unprofitable activities
- locates exact causes of increase in decrease in p & L
- helps in decision making
- price fixation
- optimum level of efficiency
- cost control
- value of stock

An Introduction to Cost terms, classification and Purposes

How do we define cost? Typically, people would say that cost is simply the amount of expenditure, or the amount spent. Is this a correct definition of cost? Let's consider an example. Imagine I decide to quit my job today and purchase a retirement villa facing a beach in a coastal city. I spend my days relaxing and enjoying the view. However, after some time, I get bored. Fortunately, I have a talent for crafting toys using only my hands, without the aid of machinery.

I decide to utilize this skill and start making toys using materials like wire. I buy the necessary materials, return to my villa, and begin crafting toys while enjoying the seaside view. Now, when it comes to selling these toys, I decide that my profit requirement is 10% of the total cost of production. So, I add this profit margin to the cost of making the toy to determine the selling price.

Now, let's analyse the cost involved in manufacturing these toys. Some might say it includes the cost of materials, such as wire. Yes, that's correct. What about transportation costs for acquiring the materials? Yes, that's a valid cost too. But what about the cost of labour? Since I'm crafting the toys, myself using my own skills, there's no expense for hiring labour. I'm utilizing my time and abilities without employing anyone else.

So, where does the cost of labour come into play? There's no salary to consider, as I have quit my job and am not dependent on a regular income. As for rent for the place of production, I'm using my own courtyard at home, so there's no additional rental expense. Electricity consumption? Minimal, as the toys are crafted using hand tools, and the lighting would be on regardless of whether I'm crafting toys or not.

Therefore, the primary costs involved in manufacturing these toys include the cost of raw materials, transportation costs for acquiring those materials, advertising expenses, and packaging costs. But since I haven't borrowed money for this venture and am using my own funds, there's no interest expense to consider.

Definition of cost

Is cost solely about the amount spent? It seems so, but it's not quite that simple. When we talk about cost, we often refer to the amount spent. However, cost encompasses more than just expenditure. It also includes what we call notional cost. Now, what exactly is notional cost? It might sound confusing or even amusing at times. Let’s revisit the same toy example.

Revesting Toy examples

Let's revisit the toy example. Initially, I manufactured the toy, and it was so appealing that it attracted significant demand. Eventually, I received an order for manufacturing and supplying 10,000 toys. Realizing that producing such a large quantity would take me about 10 years if I manufacture alone, so I know I need to make changes.

I couldn't continue manufacturing in my courtyard, so I rented a space and hired lab or to assist with production. These were the immediate steps I took to meet the demand. However, these additions incurred additional costs beyond the initial raw material, transportation, and markup for profit.

After factoring in the costs of the rented space and lab or, my total cost came to 130 rupees per ton. Selling them at 99 rupees, as I had initially priced them, would result in a significant loss of 31 rupees per toy. This loss would be unsustainable, especially considering the volume of toys ordered.

This scenario illustrates the importance of accurately calculating costs and including all relevant expenses, not just those with immediate cash outflows. Cost includes both actual expenditures (cash outflow) and notional costs, which are expenses that can be attributed to a given activity or product. In this case, notional costs such as rent for the manufacturing space and lab or expenses need to be considered alongside the direct costs like raw materials and transportation.

1) ***Notional cost of Labour***

You might argue that there's no labour or cost involved because I'm personally crafting the toys. However, if I were to hire someone for this task, there would indeed be a labour or cost.

So, what exactly is the notional cost of labour? It's the hypothetical expense incurred if I were to employ someone to manufacture the toys. This raises the question: why not simply consider the salary I have forgone by leaving my job? The answer lies in the disparity between the skill required for teaching (my former profession) and the skill needed for toy manufacturing.

The salary I used to earn as a teacher doesn't reflect the skill level required for toy making. The skill set for toy manufacturing is distinct and would command a different salary. Therefore, the notional cost of labour represents the amount I would have paid someone with the necessary skill set to manufacture the toys. It is essential to consider this notional cost to accurately assess the total expenses involved in the production process.

2) ***Notional cost of rent***

Let me give you one more example to illustrate the concept of notional cost, focusing on rent. So, what exactly is the notional cost of rent? Imagine if I had hired a place to manufacture this toy. In such a scenario, there would have been a need to pay rent for the manufacturing facility. Now, one might suggest taking the rent I pay for my beach-facing villa as the cost. However, if I were to engage in the business of manufacturing toys, I wouldn't need a beach-facing house. Instead, I would require a small industrial shed located in an industrial area, providing sufficient space for toy production. Therefore, the cost associated with the shared industrial space I would have rented becomes the notional cost of rent.

Similarly, let's consider the notional cost of utilities. If I had rented space in an industrial area, I would have been responsible for utilities such as electricity and water. Calculating the amount, I would have paid for these utilities gives us another example of notional cost.

So, when we talk about cost in this context, it is essential to understand that it encompasses not only actual expenditures but also any costs that can be attributed to the production process. These may include expenses such as permits or licenses for large-scale operations. By considering both actual expenses and notional costs, we can arrive at a comprehensive understanding of the total cost involved in a particular endeavour.

In summary, cost means and includes all the costs that can is attributable plus any cash outflow pertaining to a particular given object or thing. In this example, I have illustrated this concept using the notional costs of rent and utilities in the context of manufacturing toys.

Summary

For a given object all the cost that can be attributed plus all the cash outflow that can be attributed to that is all what we call it as a cost. Cost means and includes actual plus notional, notional means attributable. Costing is just a technique of accounting for the cost that is accumulating the amount of cash outflow plus attributable or notional cost. Putting all these together is what we call it as cost accounting or costing.