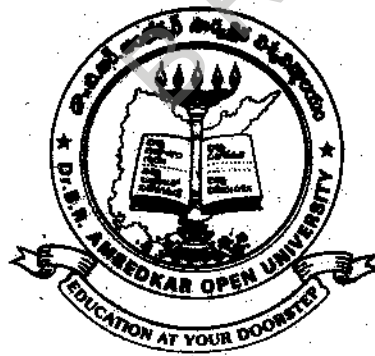


COST ACCOUNTANCY

BLOCK : I - III



Dr. B.R. AMBEDKAR OPEN UNIVERSITY
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PREFACE

This book deals with the topics in Cost Accountancy included in the syllabus for the Third Year B.Com. i.e., programme offered by the Dr.B.R.Ambedkar Open University. These topics generally cover the 'core' area of the subject to be studied in the Third Year of the Three Year Degree Course in Commerce (B.Com. i.e.). The syllabus for the sake of convenience is divided into Blocks, each of which comprises a number of Units. Each Block generally covers a specific area of the subject. The units are prepared by specialists in accordance with a format so designed as to enable the student to study and understand them without much difficulty. Each unit begins with aims and objectives followed by contents. At the end of each unit, model examination questions are given to test the student's comprehension of the subject matter. Technical terms with which the student may not generally be familiar are given at the end of each unit under the head "Glossary".

Cost Accountancy is a powerful managerial tool for decision making and control. In view of the practical use of the knowledge of Cost Accountancy to the students of Commerce. Cost Accountancy is offered as one of the optional courses in B.Com., Third year.

The course material for the sake of convenience is divided into 6 blocks, which are further divided into 28 units. Block one deals with the fundamental aspects of Cost Accountancy i.e., nature, scope, etc. The second block covers the important components of material and labour cost. While the third block is devoted to a detailed discussion on overheads. Block four deals with methods of costing and the cost control techniques are discussed under block five. Finally, the last block presents typical revisionary problems relating to blocks II-V in order to equip the student better.

The University hopes that this material will help the student to get acquainted with the principal issues in Cost Accountancy, which make for its distinctiveness and significance.

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BLOCK - I

COST ACCOUNTING : NATURE AND SCOPE

Unit - 1 : Introduction to Cost Accounting

Unit - 2 : Importance and Installation of Cost Accounting

Unit - 3 : Elements of Cost

BRAOU

UNIT - 1 : INTRODUCTION TO COST ACCOUNTING

Contents

- 1.0 Aims and Objectives
- 1.1 Introduction
- 1.2 Definition of Cost Accounting
- 1.3 Nature of Cost Accounting
- 1.4 Scope of Cost Accounting
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- 1.6 Distinction between Cost Accounting and Financial Accounting
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1.0 AIMS AND OBJECTIVES

This unit aims at introducing the meaning, definition, nature, scope and objectives of Cost Accounting

By the end of this unit, you will be able to :

- understand the meaning of Cost Accounting, its Nature and Scope
- list out the objectives of Cost Accounting
- distinguish between Cost Accounting and Financial Accounting
- distinguish between Cost Accounting and Management Accounting

1.1 INTRODUCTION

With the phenomenal development in the fields of transport and communication facilities, the world has become closer. Markets are widened. Competition has increased. The splendid strides made in the realms of science and technology and the incessant development in machinery and methods of production have led to diversification and mass production and distribution of manufactured goods. The growing complexities of modern industrial activities, the ever widening competition, the increasing demands from working class for higher wages and better working conditions, the emergence of innumerable substitutes, the intensive struggle for superiority in the business world the growing cost and quality consciousness among the consumer and the like, have made the tasks of management increasingly difficult. Besides these, the need for elimination of wastages of all types, reducing costs and attaining maximum efficiency at minimum costs, have created the necessity for the development and application of a well-directed, systematic and scientific approach at every level and in every aspect of industrial management. The financial

accounts by themselves could not provide proper, adequate and effective tools for evaluating operative efficiency, guiding decisions and formulating policies. Limitations in financial accounts necessitated the tremendous urge for and the creation and development of another branch of accountancy, namely "Cost Accountancy" which soon proved to be the most useful and indispensable managerial tool in this direction.

Cost accountancy is an expanded phase of financial accountancy. It is a dynamic, fascinating and growing subject. Though of recent origin, it has made rapid strides during the past few decades. Cost accountancy not only helps in ascertaining the cost of a product, process, job, contract or service, but also assists the management in controlling the costs and eliminating and preventing wastages and losses. It is a system of foresight and not a post-mortem examination. It provides the quantitative and qualitative information, which is invaluable of the management in carrying out efficiently its functions of planning, budgeting, decision-making, organising, controlling, pricing, evaluating operative efficiency, etc.

The techniques and procedures of this subject developed so fast to meet the expanding needs of business and the areas of operations so widened that it appears difficult to attempt a suitable definition for it which would bring all its aspects within its compass. Cost Accountancy includes (i) Costing, and (ii) Cost Accounting. In the following paragraphs definitions of above terms are dealt.

1.2 DEFINITION OF COST ACCOUNTING

One has to be very careful while using some of the terms like Cost, Costing, Cost Accounting, Cost Accounts and Cost Accountancy. They should not be confused and used interchangeably. Therefore, a thorough understanding and clear grasp of the definitions and meaning of these terms is highly essential and immensely useful.

Cost : The terminology published by the Institute of Cost and Management Accountants (I.C.M.A.), London, defines the word 'Cost' as "an expenditure incurred on or attributable to a given thing". Cost is the measure and sum of the expenditure. It represents a sacrifice, a foregoing or a release of something of a value. Cost refers to the expenditure and not the price. Costs are used for a variety of purposes, such as, pricing, periodic profit determination, cost control, etc.

Costing : The word 'Costing' is defined as "the technique and process of ascertaining costs." (I.C.M.A., London.) The technique in costing consists of principles and rules which govern the procedure of ascertaining costs of goods produced or services rendered. Costing is the day to day routine affair of ascertaining costs. The following types of costing techniques are used in industries for ascertaining and controlling the costs or products or services : Historical Costing, Standard Costing, Marginal Costing, Direct Costing, Absorption Costing and Uniform Costing.

Cost Accounting : Cost accounting is defined as "the process of accounting for cost from the point at which expenditure is incurred or committed to the establishment of its ultimate relationship with cost centres and cost units. In its widest usages, it embraces the preparation of statistical data, application of cost control methods and the ascertainment of profitability of activities carried out as planned." (I.C.M.A., London.) Cost accounting is thus the formal mechanism by means of which costs of products or services are ascertained.

Costing should not be confused with cost accounting. These are two different terms. While costing signifies the technique and process of ascertaining costs, cost accounting denotes the formal accounting system set up for recording costs. Costing can be carried out by the process of arithmetic, by means of memorandum statements or by the methods of integral accounts. But cost accounting denotes the formal mechanism by means of which costs are ascertained.

Cost Accounts : Cost accounts may be defined as "a system of recording in the form of accounts, the cost of material and stores consumed, labour expended and the works and administrative expenses incurred, so as to indicate the cost of total production or cost of each unit of production, process, job, contract, operation, etc." It is a highly specialised job and is done by a cost accountant.

Cost Accountancy : Cost accountancy is defined 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 there from for the purpose of managerial decision-making." (I.C.M.A, London.) Cost accountancy is the science, art and practice of a cost accountant. It is a science for the purpose of discharge of his duties. It is an art as it requires the ability and skill on the part of a cost accountant in applying the principles of cost accountancy to various managerial problems. Practice refers to the sustained effort on the part of the cost accountant in the field of cost accountancy. Cost accountancy includes costing, cost accounting, cost control, budgetary control and cost audit.

Cost Centres : The institute of Cost and Works Accountants of the U.K. defines Cost Centre as "a location, person, or item of equipment (or a group of these) for which costs may be ascertained and used for the purposes of cost control." A cost centre is an organisational segment or area of activity for which it is desirable to accumulate costs, but not to generate revenues. The accounting departments are almost universally considered cost centres as well as other staff functions. However, some companies consider all segments of the business as cost centres because their management feels that allocating revenues to individual company divisions or parts of a division is too arbitrary to permit a useful analysis of segment profits. The following are the types of cost centres usually found in a manufacturing company.

Personal Cost Centre

A cost centre which consists of a person or group of persons.

Impersonal Cost Centre

A cost centre which consists of a location of item of equipment (or a group of these).

Operation Cost Centre

A cost centre which consists of the machines and/or persons carrying out similar operations.

Process Cost Centre

A cost which consists of a specific process or a continuous sequence of operations.

Cost Units : The institute of Cost and Works Accountants of the U.K. has defined a cost unit as follows : "A unit of quantity of product, service or time (or a combination of these), in relation to which cost may be ascertained or expressed".

In the job costing method, cost unit is a single specific order; in batch costing it consists of a group of similar articles; and in contract costing, it consists of a single product. The cost units used in different industries cannot be uniform. The cost units and centres should be those which suit the business and which are readily understood and accepted by all concerned.

The following are a few examples of costs units :

Industry	Cost Unit
Building	: House or square foot of area
Chemical	: Tonne, pound or kilogram
Cement	: Tonne
Automobile	: Number

Steel	:	Tonne
Transport	:	Tonne - Kilometre, Passenger - Kilometre
Cable	:	Metre
Gas	:	Cubic foot or cubic metre
Nuts and bolts	:	Gross or some measure of standard weight
Power	:	Kilo-watt hour
Paper	:	Ream
Timber	:	Cubic foot.

Check Your Progress - I

I. What is Cost Accounting ?

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1.3 NATURE OF COST ACCOUNTING

In these days of growing competition it is necessary that a business concern should conduct its activities with utmost efficiency and with minimum possible wastage and losses. Such business concerns which do not strive continuously to improve the quality of their products or services and to bring down their costs and prices will sooner or later find themselves out of business. Efficient business concerns constantly maintain and improve quality and bring down their cost of their produces or services through Cost Accountancy.

Therefore implementation of Cost Accounting system is vital in industrial undertakings. However, it should not be taken for granted that costing is useful only in the case of industrial and business units. It is used in other non-manufacturing and non-business units also. Costing has an important role to play in almost every activity which involves expenditure of money, whether it is an industrial unit or a business house or an agricultural establishment or a charitable institution or a serviceable organisation or a government undertaking. Costing helps and assists in controlling costs, minimising wastages and losses and maximising operative efficiency.

As no two industrial undertakings or serviceable institutions are alike, even if they are in the same line of business activity (due to their own peculiarities) no single method of cost accounting would be suitable to all industrial concerns. The costing methods to be used differ from unit or unit and from industry to industry. The system of cost accounting to be adopted in a particular business unit must best suit the nature, conditions, needs and peculiarities of that unit. Thus, the system to be adopted will vary according to the nature of the business in question. Several methods of costing have been designed to suit the nature and needs of different business units.

1.4 SCOPE OF COST ACCOUNTING

Basically there are two principal methods of costing viz., 1. Job Costing, 2. Process Costing.

All other types of costing, are either variants of these two methods of just techniques which are used for particular purpose under specific conditions on specific occasions. The variations of Job Costing are : Batch Costing, Terminal or Contract Costing, Multiple Costing etc.,

The variants of process costing are : Operation Costing, Single or Output Costing, Operating Costing etc.,

The principal techniques of Costing are :

1. Marginal Costing
2. Standard Costing
3. Absorption Costing
4. Uniform Costing
5. Budgetary Control

1.5 OBJECTIVES OF COST ACCOUNTING

Cost accounting data provides invaluable help to the management in taking routine decisions, in determining the total cost, cost per unit and periodic profit, valuation of inventory, in carrying out the functions of planning, budgeting, organising, formulating policies and controlling of costs and the like.

The main objectives of cost accounting are :

1. To ascertain the cost of product(s) or service(s) and to determine the selling price : The main objective of cost accounting is to ascertain the total cost and cost per unit of different products manufactured and services rendered by an undertaking. The cost data provides the basis for the fixation of selling prices. Generally, competition determines the selling price. If the occasion demands, with the help of cost accounts, the management may quote prices even below total costs but above marginal costs, to increase sales.

2. To control costs : Another important objective and advantage of cost accounting is control of costs. This may be achieved with the help of budgets and standards set up for the guidance of the management and also by elimination of all types of wastages, by efficient inventory control and by improving operative efficiency.

3. To provide basis for the management of formulate policies and to carry out its functions efficiently : Cost accounting is designed and developed primarily to guide, assist and serve the management. It assists the management in conducting the business activities with utmost efficiency. To sum up, in the words of Blocker : "Cost accounting is to serve management in the execution of policies and in the comparison of actual and estimated results, in order that the value of each policy may be appraised and changed to the future conditions." (Blocker : Cost Accounting).

Cost accounting serves as the basis for formulating operating policies such as (a) determination of break-even point (a point where there will be no profit and no loss) (b) introduction of new product or new line of production (c) whether to shut down plant or operate at loss (d) replacement of existing machines for automation (e) whether to make or buy (f) utilisation of idle capacity (g) future expansion and development policies and capital outlays and so on

Cost accounting also assists the management in carrying out its functions of planning, budgeting, decision, making, organising, controlling, pricing and evaluating operative efficiency, etc.

4. To ascertain the profitable and unprofitable lines of activities.
5. To find the causes that lead to profits/losses.
6. To provide basis for the preparation of budgets.
7. To provide a reliable basis for the preparation of tenders or estimates.
8. To reveal losses or inefficiencies of any form (such as idle time, spoilage, under-utilisation of plant and machinery, poor planning, etc.)
9. To establish effective control over material, men and overheads.
10. To enable to check and control wastages of all types.
11. To assist in improving operative efficiency, not only the over-all efficiency, but efficiency at every point.
12. To establish an effective system of reporting.
13. To help in measuring the efficiency of wage system and to guide the management in the formulation and implementation of incentive bonus schemes based on productivity and cost saving.
14. To enable the management to know and plug the inefficiencies and weak points in the business activities.
15. To help the management in properly defining and fixing up of responsibilities on the employees.
16. To identify cost-centres and to meet the needs of cost accounting system.
17. To implement perpetual inventory system.
18. To prevent manipulating, pilferage, theft, misappropriations, etc., of materials and assist in furnishing correct and reliable cost data to the management.
19. To help in the valuation of inventory.
20. To help in the valuation of production.
21. To inculcate the habit of making calculations before taking decisions.
22. To provide an independent and most reliable check on the accuracy of financial accounts through reconciliation of profits as per cost accounts and financial accounts.
23. To provide ready figures relating to problems like price fixation, price control, tariff protection, wage level fixation, settlement of disputes etc. for use by the government, wage tribunals, trade unions, etc.

Thus the management will be able to derive all the benefits detailed above from a good system of cost accounting. (a) it attaches due importance to costing (b) it is willing to study and make use of the information compiled and presented by the costing department and (c) it is capable and willing to take prompt actions. However, the cost accounting system to be adopted should be simple, practicable, flexible and economical. The amount spent on installing and maintaining costing system should be well within the justifiable limits. Every care should be taken to design the costing system in such a way as to serve the purpose and the needs of the particular organisation.

Check Your Progress - 2

1. List out the main purposes of Cost Accounting

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1.6 DISTINCTION BETWEEN COST ACCOUNTING AND FINANCIAL ACCOUNTING

Accounting is the language of business. Accounting principles relating to debit and credit are there both in financial and cost accounts. But these two systems of accounts differ in their purpose and scope.

Financial accounts have specific purpose to serve and they are kept in a manner so as to meet the provisions of company law and to present correct figures to tax authorities. Financial accounts are primarily concerned with classification and recording of transactions directed towards the preparation of final accounts, whereas cost accounts are concerned with collection classification, analysis and presentation of costs for the guidance of management for proper planning, organisation, decision making, cost control and policy formulation and for efficient and successful management.

Both the systems of accounting treat costs. But, while the financial accounting does this very broadly, cost accounting does this in greater detail, resolving itself into an analysis involving most minute and scientific dissection and subdissection of elements of cost. For example, while financial accounts show whether the material purchased has been correctly accounted and paid for and whether the opening and closing balances of stock in terms of value are correctly arrived at, etc., cost accounts reveal matters such as whether the purchase was at all necessary or the material could be manufactured cheaply in the undertaking itself instead of purchasing, whether the quantity purchased and consumed was reasonable, whether wastage was normal, etc.

Financial accounts in the form of summarised statements of final accounts, no doubt bring to light the overall working and the result of the entire business, in a given period of time, but that much information is not sufficient for evaluation of the performance of the management. The information supplied by Profit and Loss Account or Balance Sheet is not adequate to answer certain questions such as : (a) how effectively is the capital employed? (b) which of the products earned more profits/incurred more losses and how much? (c) is the profit earned 'the optimum' that the undertaking could earn? (d) how does the profit compare with the counterparts in the earlier years or the profits made by similar enterprises in the same industry? (e) how to improve the profits? (f) are the expenses kept under minimum possible level and is there any scope to reduce the expenditure still? (g) are the wastages controlled and minimised? (h) do the selling prices need any revision? (i) is the capital locked up in inventories reasonable? and so on.

These are only a few among many questions for which the financial accounts cannot give reliable and accurate answers, which are mostly needed by the management, which strives constantly to improve its performance, formulate its correct policies and take right decisions right decisions at right times. Cost accounts help the management by indicating the reliable answers for the queries and thus they serve as an essential managerial tool in this direction.

Financial accounts no doubt give the cost of manufacture of products or rendering of services, but the information given will only be in totals and that too at the end of the accounting

period. No doubt they cover all transactions and give expenditure of the business concern in all its entirety, but they do not analyse the expenditure according to different products, departments or functions. They provide information only for a post-mortem analysis of past activities and do not fore-warn the management about the pitfalls and do not indicate the remedial measures to be taken.

Suppose a manufacturing concern produces three type of products : X, Y and Z. The financial accounts give the information in the following manner at the end of the accounting period:

Dr.	Amount Rs.		Amount Rs.	Cr.
To Material consumed	5,00,000	By Sales	16,00,000	
" Wages	3,00,000			
" Other expenses	4,00,000			
" Profit c/d	4,00,000			
	16,00,000		16,00,000	

Thus, the financial accounts reveal an apparently very satisfactory profit of Rs. 4,00,000 which represents 25 percent on sales. But this does not help to assess the relative profitability or otherwise of different products so that management can concentrate on those products showing higher profitability or investigate those showing loss. Further, it fails to provide detailed information relating to cost of production, sales and profit separately for the three types of products XY and Z, which can be obtained only from cost accounting records. In short, the management cannot take policy decisions on the basis of the above data supplied by financial accounts.

In contrast, cost accounts help in ascertaining the total costs of different products and provide the cost data as per details given below

	X Rs.	Y Rs.	Z Rs.	Total Rs.
Material consumed	1,20,000	2,00,000	1,80,000	5,00,000
Wages	70,000	1,30,000	1,00,000	3,00,000
Other overheads	80,000	2,50,000	70,000	4,00,000
Total Cost	2,70,000	5,80,000	3,50,000	12,00,000
Sales	4,50,000	4,80,000	6,70,000	16,00,000
Profit / Loss	1,80,000	1,00,000	3,20,000	4,00,000

Though the overall profit of the undertaking is of the order of Rs. 4,00,000, the cost records show that the product Y incurred loss to the tune of Rs. 1,00,000, a position which the financial accounts failed to reveal. Had this loss been not there, in case of product Y, the over all profit would have been Rs. 5,00,000 instead of Rs. 4,00,000. While product X made 40 percent profit and product Z about 48 percent profit on sales, product Y suffered loss to the extent of about 20.8 percent on sales (which comes to Rs. 1,00,000). Basing on this data the management may either investigate into the affairs of product Y and take suitable and adequate measures to improve the situation, or it may also decide whether or not to continue the manufacture of product Y.

Financial accounts neither reveal inefficiencies in material handling nor disclose effective and idle hours nor provide for proper control of materials and stores, labour and overheads. Cost

accounts do reveal inefficiencies inventory handling and provide inventory control procedure and also discuss effective and idle hours of work of men and machines.

Financial accounts do not provide detailed classification of expenditure and draw distinction between costs as fixed or variable, controllable and uncontrollable, etc., and do not provide any standards to measure the operative efficiency and to control costs. Cost accounts not only classify costs into fixed and variable and controllable and uncontrollable but also provide means to measure the operative efficiency and control costs with the help of standards and budgets.

Financial accounts neither properly guide and help price fixation nor provide adequate data for 'managerial decision'. They serve only the purpose of presenting periodical financial statements to shareholders, bankers, creditors and tax authorities. Cost accounts not only furnish detailed information for price fixation but also provide valuable and adequate data for managerial decision making and they mainly serve the needs of the management.

In financial accounting, stock is valued at cost or market price whichever is lower, whereas in cost accounting, stock is valued only at cost.

Financial accounts deal with all expenses (productive and non-productive), incomes, gains and actual facts and figures, whereas cost accounts deal with only such expenditure which is relating to production and total cost and deal partly with facts and figures and partly with intelligent estimates. Cost accounts do not deal with items of income or gains at all.

Financial accounts cannot give cost data for comparison of the present operative efficiency with that of past periods or with that of other concerns in the same industry, but the cost accounts can give this information with ease.

Thus, cost accounting has come into existence on account of certain inherent limitations and drawbacks of the financial accounting system and is therefore thriving successfully, in meeting the growing complexities and needs of the modern business enterprises.

1.7 DISTINCTION BETWEEN COST ACCOUNTING AND MANAGEMENT ACCOUNTING

It can be observed from the objectives of cost accounting that cost accounting is not mere recording and cost finding but an effective instrument for managerial control. Management accounting is accounting designed to give almost assistance to management in formulating policies and controlling their day-today operations.

By nature, management accounting refers to reports prepared to fulfil the needs of management. The accounting statements and reports in management accounting are situation-specific. That is, management accounting reports attempt to fill the information needs of managers with respect to a specific problem, situation, or decision.

Management accounting is not confined to the area of product costing, cost and price data. In management accounting, the objective is to have a data pool which will include any and all information that management may need.

1.8 SUMMING UP

In this unit we have presented the meaning, definition nature, scope and objectives of cost accounting. We have also discussed the distinction between cost accounting and financial accounting & accounting and management accounting

1.9 CHECK YOUR PROGRESS : MODEL ANSWERS

1. Cost Accounting is a formal mechanism by means of which costs of products or services are ascertained and controlled.

2. Ascertainment of costs

3. Determining Selling Price

4. Cost Control

5. Providing a basis for the management to formulate policies and to carry out its functions efficiently.

1.10 MODEL EXAMINATION QUESTIONS

A. Answer the following in 30 lines each.

1. What do you understand by Cost Accounting? In what way is it helpful to a manufacturer or a business man?

2. "A Cost-Accounting System" simply records costs for the purpose of fixing sale prices has only accomplished a small part of its mission." What other functions do costing achieve?

3. Define Cost Accounting and 'Cost Accountancy'. Discuss the objectives of Cost Accounting.

B. Answer the following in 15 lines each.

4. State the nature and scope of Cost Accounting

5. Explain the difference between Cost Accounting and Financial Accounting

6. Distinguish between Cost Accounting and Management Accounting.

1.11 RECOMMENDED BOOKS

1. Jain S.P. & Narang K.L. - 'Cost Accounting'
Kalyani Publishers, New Delhi.
2. Prasad N.K. - 'Principles and Practice of Cost Accounting'
Book Syndicate Pvt. Ltd., Kolkata.
3. Iyengar S.P. - Cost Accounting
Sultan Chand & Sons, New Delhi.
4. Bhar B.K. - Cost Accounting Methods and Problems'
Academic Publishers, Kolkata.
5. Jawahar Lal - Cost Accounting
Tata Mc. Graw-Hill Publishing Company Limited,
New Delhi.
6. P.T. Pattany Shetty &
D.R. Palekar : 'Cost Accounting' A Basic Approach,
R. Chand & Co. New Delhi.