is being successfully implemented in service industries and not-for-profit organisations with significant results.

To our professional colleagues who may find some of the explanations insufficiently pure, we can only emphasise that in our opinion costing is a complex and diverse subject that requires simplification at the outset if it is to be grasped by absolute beginners. Students who made earlier versions of this text a popular choice have vindicated us. There are many excellent texts to progress towards, this one is to ensure that the first step on the ladder is not too high from the ground.

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Chapter 1

What is cost accounting?

Chapter objectives

Having studied this chapter you should be able to:

- explain the meaning and purpose of cost accounting;
- understand how cost accounting arises out of the need to make business decisions;
- differentiate between cost accounting, management accounting and financial accounting;
- appreciate how raw data is transformed into information;
- be familiar with some costing terminology.

Introduction

The purpose of this chapter is to introduce the subject of cost accounting, to explain its relationship to management accounting and to differentiate it from financial accounting.

The survival of any business depends on its ability to settle its debts as they fall due (*liquidity*) and on having products or services that obtain revenues higher than the costs incurred in producing and selling them (*profitability*). The type of accounting which is concerned with recording transactions with outsiders and in determining what the business owns and what is owed to it (*assets*) in comparison to what it owes to the outsiders (*liabilities*) and to the owners of the business (*capital*) at any given time is termed financial accounting. Financial accounting matches the revenues earned in a period against the corresponding costs to measure the profitability of the business as a whole. Thus, financial accounting assists in maintaining liquidity and recording overall profits of the business. Reports based on financial accounting provide useful information to users, the majority of whom are outsiders, who may be interested in the business as a whole. For instance, shareholders and creditors are only concerned with the overall profitability and viability of the business, leaving managers to focus on the profitability of individual product or service lines, using cost and management accounting techniques.

Accounting is multidisciplinary, encompassing financial accounting, cost accounting, management accounting, finance and taxation. The focus of accounting has developed over time from recording financial transactions to comply with legal requirements and for the purpose of a periodic profitability statement (profit and loss account) and position statement of assets, liabilities and capital (balance sheet) to the provision of cost data to assist management in the planning and control of activities and for the purpose of decision making.

Information on the cost incurred in producing and selling individual products or services is not readily available from the financial accounting records. When a business produces different products or services, without such information its managers cannot make sensible decisions about controlling the costs and maximising the profits earned from a particular line of products or services. To obtain this information promptly, a mechanism of recording transactions within the business is required. Cost accounting provides such a mechanism to record the cost of resources used by an individual product/service line, either by identifying the direct connection (*cost allocation*) or by sharing out the common costs on a fair basis (*cost apportionment*).

The role of cost accounting, a discipline arising out of the costing and estimating practices in engineering, is vital to the modern business facing increasing competition. Advances in transportation technology have eroded the geographical barriers to competition, while advances in communication technology have increased consumer awareness about alternative suppliers and their pricing. Increasingly, businesses are facing the challenge of operating in a 'cost continuous' environment with little buffer to absorb poor cost management. Cost accounting assists in cost management by offering various techniques for control and reduction of the different types of costs incurred by a business. It also helps in making the best use of the available resources.

The discipline of management accounting emerged as a natural progression from cost accounting as the information requirements of business managers were better understood and increasingly catered for by accountants. Management accounting is more strategic in nature and encompasses various accounting disciplines such as cost accounting, financial accounting, taxation and financial management as well as behavioural psychology, management science and systems theory. It is beyond the scope of this text to consider management accounting at any depth, however, as management accounting employs cost accounting data there is an inevitable overlap between the two.

What is cost accounting?

Cost accounting is extensively used in a wide variety of businesses, including hospitals, local government, banking, retail and manufacturing. The cost accounting

system is the basis of an internal financial information system to assist managers to make business decisions. The types of business decision will vary with the nature of the organisation, but typically these could include:

- whether to provide a new service;
- whether to make or buy a product;
- the extent to which selling prices may be altered;
- whether to manufacture a new type of product;
- whether to increase the levels of service provided.

In an intensely competitive global marketplace, without an effective cost accounting system, it is doubtful whether a business could survive. The ability to determine the costs of products using product costing techniques, planning and controlling the enterprise using budgeting techniques and making decisions about the future of the organisation using appraisal techniques is paramount.

It is important to realise that no two businesses are the same. As a consequence there is no uniform costing system that can be implemented for all businesses. Appropriate cost accounting techniques may be selected from a range of techniques and applied according to circumstances.

There is no law or statute governing the application of costing techniques. Contrast this with financial accounting, where all limited companies are required by law to produce specific prescribed financial statements.

What are the commonly used techniques?

Cost accounting techniques arise because of specific information requirements by management. In some cases this could relate to how much a product costs to manufacture or how much a service costs to deliver. *Product costing/service costing* techniques address this question.

Budgeting techniques assist managers to quantify their future plans in monetary terms and enable comparisons of actual financial performance with planned. Where actual performance deviates from planned this may be recorded and subsequently investigated to ascertain the reasons why this is the case.

Management may also wish to evaluate the way a particular product/service has performed in the past to determine whether the organisation is making best use of the resources available to it, and would also be interested in the future performance of existing and new products or services. In making an assessment as to the viability of a particular product or service, the level of risk associated with it would also have to be assessed and this compared with the possible rewards from the venture, with due regard to management's attitude to differing levels of risk. *Appraisal* techniques assist management to address this matter.

The techniques introduced in subsequent chapters will be introduced under the broad headings of product costing, budgeting and appraisal. They arise primarily out of the requirement to address the information needs of the organisation and provide the data for subsequent analysis by management. These three headings reflect the activities of managers: they plan (budget), measure the results of their plans (record actual product/service costs) and assess the success of those plans (appraisal).

Diagrammatically the cost accounting techniques dealt with in this text are shown in Figure 1.

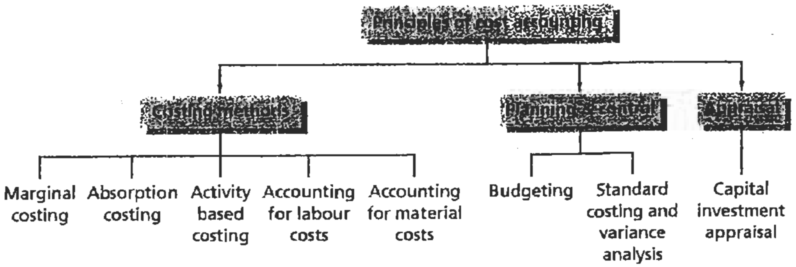

Figure 1 Cost accounting techniques dealt with in this text

The scope of cost accounting

As we have explained, cost accounting techniques arise because of specific information requirements by management. Examples of information required by management and information provided by a typical costing system are shown in Table below.

Specific costing information that could be provided to satisfy the information needs of managers

Information required by management	Costing information provided
Production planning	Cost per unit of production
Methods of production/service delivery	Cost per unit of output
Labour cost control	Labour cost per unit. Cost of downtime and idle time
Material cost control	Material cost per unit. Cost of scrap and wastage
Pricing decisions	Cost per unit of output
Make or buy	Costs at different activity levels
Profit planning	Costs at different activity levels

Summary

- Cost accounting comprises a range of techniques for the purpose of:
  - cost ascertainment,
  - cost control and cost reduction.
- Cost accounting systems and financial accounting systems are different.
  - Cost accounting is in effect for internal use. Financial accounting forms the basis of external reporting and is for stewardship purposes.
  - Cost accounting systems provide information to management for planning, control and decision making.
  - Financial accounting is concerned with types of expenditure for the purpose of an overall profitability statement and statement of assets and liabilities.
- Cost accounting is dealt with in this text within three broad headings of *product costing*, *budgeting* and *appraisal*.
  - They arise primarily out of the need to address the information needs of the organisation.
  - Costing information is not mutually exclusive. It may be used for many purposes.

Questions for review

1 What is the purpose of cost accounting?

2 Discuss the similarities and differences between cost accounting and financial accounting.

3 Discuss the types of information needs that have led to the development of:
   a Product costing techniques
   b Budgeting techniques
   c Appraisal techniques

4 Give *two* examples of where 'cost per unit of output' could satisfy management's information needs.

5 Give *three* examples of business decisions where cost accounting information could prove useful.