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All types of businesses, whether they provide services, manufacture products, or sell merchandise have costs, and thus, require cost accounting to track their activities. In a nutshell, cost accounting is the process that helps managers understand what it costs to run a business. Cost accounting keeps track of money spent on labor, maintenance, raw material, and supplies, among others, and then analyzes these costs to find ways to decrease or utilize them. This guide will offer you an in-depth explanation of what cost accounting represents, the different cost accounting methods, how you can set up the process for your small business accounting, and much more. Read along to learn about: What Is Cost Accounting? Cost accounting is the process of capturing, recording, and analyzing what it costs to produce or supply a product or service. This process will enable your business's management to make better financial decisions, eliminate inefficient costs, and budget accurately. Types of Costs There are three basic cost elements part of cost accounting: Material costs or inventory costs include the direct costs of materials used to produce or manufacture a product or service. They can be categorized into three different types of inventory: raw materials, work-in-progress, and the finalized good or service. Labor cost is the payroll of those employees that directly contribute to the maintenance, transportation, and production of the finished product or service. These costs, along with material costs, usually change based on the volume of the activity, so they're considered variable costs. Expenses and other overhead costs include costs of supplies, utilities, depreciation of equipment, advertising, rent, repairs, taxes, travel expenditures, and other ongoing operating expenses. These expenses are indirect, as they can't be traced to or identified with a specific cost unit, but they're still necessary for a business to carry out its profit-making activities. And because these costs don't change in relation to the production volume, they are also considered fixed costs. The Difference Between Cost Accounting and Financial Accounting Often, cost accounting overlaps with another type of accounting, known as financial accounting. How do these two differ from and relate to one another? As we've mentioned, cost accounting is the branch of accounting that deals with the costs of production - it examines the cost structure of a business and works on finding tactics to reduce these costs. Financial accounting, on the other hand, is concerned with the recording of all the financial data of a business into accounting reports. These accounting reports are meant to provide information about sales, expenses, assets, and liabilities, to interested third parties such as investors and creditors. So, the main difference between cost accounting and financial accounting relates to their respective target audiences. Financial accounting is meant for stakeholders outside the business, whereas cost accounting is meant for those on the inside, responsible for making critical decisions. Also, cost accounting aims to track and measure costs, while financial accounting uses reports to summarize all of the main financial activities of a business, like sales, revenue, equity, liabilities, expenses, and more. Now, cost accounting can contribute to the preparation of financial statements for financial accounting. The expenses, costs, and other information gathered through cost accounting make it easier for the generation of financial statements. Some elements such as material costs, labor costs, and inventory prices are shared between both accounting methods. If you want to learn more about financial accounting and how you can use it to generate financial statements for your business, then head over to our guide on financial reporting. Why Is Cost Accounting Important? Price Determination One of the main objectives of cost accounting is to determine your products' pricing. The rule is simple: the price you put on the product should cover the cost of production and generate profit. A business that sells fast food, for instance, should keep track of the cost of ingredients such as bread, fries, lettuce, tomatoes, ketchup, etc., and price the product based on these direct costs and other additional labor and overhead costs. Cost Control Cost accounting doesn't just help you stay on top of your costs - it also allows you to make (any necessary?) changes along the way. By analyzing your costs frequently, on a weekly or monthly basis, you can identify the areas where you can reduce costs, and take the necessary steps to act accordingly. For instance, a company can discover that a twelve-hour shift on a particular machine isn't necessary and that ten hours produce the same output. Budgeting Once you get a good idea of exactly how your business's money is spent, budgeting for the future becomes much easier. When you create your next budget, costs can be tracked and estimated in a way that helps maximize the business's profit. Types of Cost Accounting There are four main types of cost accounting: 1. Standard Cost Accounting With standard costing, rather than assigning the actual costs of direct materials, direct labor, and overhead expenses to a product, a business assigns specific "standard" costs. These standard costs are based on efficient use of materials and labor, under standard operating conditions, which is essentially the planned or budgeted amount for a product. Now, although standard costs are assigned to these products and services, the business will still have to pay the actual direct costs of material and labor. So, they will need to calculate the difference between the standard cost and the direct cost, to figure out whether or not they've been spending the planned amount. This is known as variance analysis. If the variance analysis determines that your costs are higher than expected, then the variance is unfavorable, and your business has generated less profit than expected. If the costs are less than the standard costs, the variance is favorable, and your business has generated more profit than anticipated. 2. Activity-Based Cost Accounting Activity-based costing (ABC) is a costing system that breaks down overhead and indirect costs, according to the actual consumption of each product and service. This method is typically used in the manufacturing industry, to make a better calculation of the true cost of production per unit. To illustrate how this method works, let's take a pharmaceutical company that produces two types of medicine. Medicine A is produced at a high volume through a mostly automated process that only consists of putting chemicals into processing equipment and waiting for the final product. Medicine B, on the other hand, is produced at a lower volume, as it requires a more manual setup and hands-on effort from the pharmaceutical staff. Considering these circumstances, activity-based costing assigns more overhead costs related to labor to medicine B and more overhead costs related to machine use to medicine A. 3. Lean Cost Accounting Lean cost accounting is a method that aims to eliminate waste, reduce error, speed up processes, and replace traditional costing methods with value-based pricing. So, lean accounting makes management decisions based on total value stream profits, rather than cost allocation. This method not only increases profits and generates less waste, but also encourages a lean company culture that promotes teamwork and communication. 4. Marginal Cost Accounting Marginal costing, also known as the cost-volume-profit analysis, is a costing method that comes in handy for short-term decisions. More specifically, marginal costing measures the difference in cost with every new additional unit of production. It's calculated by dividing the cost difference by the quantity difference, as shown in the formula below:  $MC = \Delta C / \Delta Q$  The goal of marginal costing is to determine at which point a business can reach economies of scale to optimize its production, and overall operations. Automate Cost Accounting with Online Software Nowadays, businesses rarely keep track of their costs by hand or through Excel spreadsheets, as these manual methods are outdated, time-consuming, and prone to many accounting errors. Instead, most companies save time and money by automating their finances through online, cloud accounting software. One of the best accounting software in today's marketplace is Deskera. Deskera is an intuitive, easy-to-use platform you can utilize to automate not just your costs, but almost every part of your accounting cycle. Deskera Books Dashboard Deskera allows you to quickly create drop-ship orders for your supplier directly from customer orders. All the product, quantity, and delivery address fields will be auto-populated. All you need to do is update the fulfillment status once the actual shipment is done - Deskera will take care of the rest. Deskera Sell Dashboard Then, from the Deskera's Buy dashboard, you can send payments to your suppliers within seconds, and easily organize and review bills and invoices on the go. Deskera also allows you to set up any recurring invoice payments, in just a few clicks. Deskera Buy Dashboard The best part? You can access the software and manage your costs from any device with an internet connection, by simply downloading the Deskera mobile app. Give Deskera a try right away through our completely free trial. No credit card details necessary. Key Takeaways And that's a wrap! We hope this guide answered all of your questions and helped you understand the basics behind cost accounting, and what makes the process so beneficial to your business. For a quick recap, here are some of the main points we've covered: Cost accounting tracks, records, and analyses the different costs of production that occur within a business. These costs fall under three main categories: material, labor, and overhead costs. The main goal of cost accounting is to determine the best pricing strategies for products and services. The process also helps businesses control and reduce costs, as well as estimate budgets for future financial activities. There are four main types of cost accounting strategies which include: standard, activity-based, lean, and marginal accounting. Cost accounting is a complex process that can't be handled manually through spreadsheets. That's why most businesses nowadays automate their cost accounting with online accounting software like Deskera. Related Articles #Accounting #Bookkeeping #Bookkeeping basics





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