

TULSIAN'S
INTRODUCTION
TO
COST ACCOUNTING

A Self-study Textbook

**To the Point
Approach**

Dr. P.C. TULSIAN

S. CHAND

TULSIAN'S

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TO
COST ACCOUNTING**

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TO

COST ACCOUNTING

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Preface

We are thankful to the readers to their response given to 1st Edition.

The complex nature of business has made the subject Cost Accounting extremely difficult for students and practitioners alike. This book attempts to present the concepts and theories of Cost Accounting in a simple and lucid manner. Appropriate examples have been provided throughout the book for better understanding of the topics discussed.

Salient Features

The book adopts a fresh and novel approach to the study of Cost Accounting keeping in view the specific requirements of candidates studying the subject 'Cost Accounting' for the first time. It has been written in a teach yourself style strictly following a student-friendly approach, and is essentially meant to serve as a tutor at home. Among the important features of this book include:

(a) Coverage

The book would essentially meet the requirements of all courses having Cost Accounting paper. Broadly the coverage would enable the reader in understanding:

- (i) How to ascertain the cost of:
 - Each job/order/contract where work is undertaken according to customer's specifications, with the help of job-costing method;
 - Each process/operation where standardized goods are produced with the help of process costing method;
- (ii) How to maintain Cost Accounts under Integral or Non-Integral System.
- (iii) How to reconcile the Cost and Financial Accounts.
- (iv) How to control the Cost with the help of techniques such as Budgetary Control & Standard Costing.
- (v) How to provide & use information for decision making in various areas such as Product mix, Pricing etc. with the help of Marginal Costing techniques.

(b) Pedagogical Features

- **Simple Language:** The Text is presented in the simplest language "meant to serve beginners".
- **Heading for each Paragraph:** Each paragraph has been arranged under a suitable heading for easy retention of concepts.
- **Tabular Form:** Wherever possible the text matter relating to a particular topic/sub-topic has been presented in a Tabular Form.
- **Eye-catching Screens:** All important equations, formulae, figures and practical steps have been presented in screen format to catch the eye.
- **Uniform Format of Chapter:** Each chapter has been uniformly organised under six headings, viz., Text supported by suitable Illustrations, Solved Problems, True/False Questions, Theoretical Questions and Practical Questions.

(c) Distinctive Features

- **50 Exhibits:** To acquaint students with various accounting treatment and formats.
- **300 Illustrations:** To aid better understanding of the text.

- **300 Solved Problems:** Along with necessary working notes and alternative solutions (if any).
- **150 Very Short Answer Type Questions:** To enable students to test their understanding of the subject.
- **150 Short Answer Type Questions:**
- **75 Essay Type Questions:**
- **300 Practical Questions:**

APPENDIX
REVISION ONE DAY BEFORE EXAMINATION

1. Tulsian's Revision Test Paper I (Based on Formulae)
2. Tulsian's Revision Test Paper II (Based on Methods)
3. Tulsian's Revision Test Paper III (Based on Accounting Treatment)

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Authors

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LEARNING OBJECTIVES

After studying this chapter, you should be able to understand:

- * Meaning of Cost
- * Meaning and Scope of Cost Accountancy
- * Meaning of Costing
- * Meaning of Cost Accounting
- * Difference Between Costing and Cost Accounting
- * Objectives of Cost Accounting
- * Distinction Between Financial Accounting and Cost Accounting
- * Major Limitations of Financial Accounting and How These are Overcome by Cost Accounting
- * Importance/Advantages of Cost Accounting
- * Limitations or Objections to Cost Accounting
- * Installation of Costing System
- * Cost Unit
- * Cost Centre
- * Cost Object
- * Responsibility Centre
- * Methods of Costing
- * Techniques of Costing
- * Distinction Between Cost Ascertainment and Cost Estimation
- * Cost Allocation, Cost Apportionment, Cost Absorption
- * Classification of Costs
- * Items Excluded from Cost Accounts
- * Cost Audit
- * Components of Total Cost
- * Cost Sheet
- * Format of Statement of Profit or Loss

1.0 MEANING OF COST

The term 'Cost' may be defined as a noun *or* as a verb as follows:

(a) As a noun	(a) The amount of expenditure (actual <i>or</i> notional) incurred on <i>or</i> attributable to specified thing <i>or</i> activity.
(b) As a verb	(b) To ascertain the cost of specified thing <i>or</i> activity.

1.2 Tulsian's Introduction to Cost Accounting

ICWA, India defines Cost as “*measurement, in monetary terms, of the amount of resources used for the purpose of production of goods or rendering services*”.

The word ‘Cost’ can rarely stand on its own and should be qualified as to its limitation (e.g., historical, variable etc.) and should be related to a particular thing or ‘activity’ (e.g., a given quantity or unit of goods produced or services performed).

The main **characteristics of cost** are:

- (a) The term ‘cost’ is not complete unless it is fully qualified as to its nature and limitation.
- (b) It does not represent the same contents under every situation.
- (c) No cost is true, exact or accurate under all circumstances. It is a flexible concept.
- (d) It may be ascertained in different ways by different persons.
- (e) It may vary with time, volume, firm, method or purpose.

It is necessary, therefore, that both who ascertain cost and who use it as a base for certain decisions, interpret the meaning and contents of cost in a similar manner.

1.1 Cost, Expense, Loss and Asset

Cost may be expired or unexpired. It is not the same thing as Expense, Loss and Asset which are explained here below.

(a) Expense	Expense is that portion of the cost which has been consumed during the current accounting period and which contributed to the revenue . It is also called expired cost. It is shown on the debit side of Income Statement. <i>For example</i> , depreciation on a machine, commission on sales.
(b) Loss	Loss is that portion of the cost which has been consumed during the current accounting period and which did not contribute to the revenue . It is shown on the debit side of Income Statement. <i>For example</i> , Loss of uninsured asset due to fire.
(c) Asset	Asset is that portion of the cost which has not been consumed during the current accounting period. It is also called unexpired cost . It is shown on the assets side of the Balance Sheet. <i>For example</i> , depreciated value of a machine (<i>i.e.</i> Cost – Depreciation till date).

2.0 MEANING AND SCOPE OF COST ACCOUNTANCY

2.1 Meaning of Cost Accountancy

CIMA, London, defines Cost Accountancy 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 therefrom for the purpose of managerial decision-making.*”

Thus, it is the science, art and practice of a cost accountant –

- (a) It is a **science** because it consists of systematic knowledge which a cost accountant must possess for proper discharge of his duties.
- (b) It is an **art** because it involves the application of knowledge and skill by the cost accountant in applying the principles, methods and techniques of cost accounting.
- (c) It is a **practice** because it requires constant efforts on the part of cost accountant in the field of cost accountancy, and the Cost Accountant has to keep himself continuously informed about the latest development in the profession.

2.2 Scope of Cost Accountancy

Cost Accountancy is broader in scope and comprises Costing, Cost Accounting, Cost Control, Cost Reduction and Cost Audit.

(a) Costing	Costing is the technique and process of ascertaining costs.
(b) Cost Accounting	Cost Accounting is the process of accounting for cost which begins with the incurrance of cost and ends with the control of cost.
(c) Cost Control	Cost Control involves the establishment of target performance, measuring actual performance, comparing actual performance against target performance and taking corrective action.
(d) Cost Reduction	Cost Reduction is the achievement of real and permanent reduction in the unit cost of products manufactured <i>or</i> services rendered without impairing their suitability for the use intended <i>or</i> diminution in the quality of the product.
(e) Cost Audit	Cost Audit is the verification of cost accounts and a check on the adherence to the Cost Accounting plan. <i>Thus</i> , it involves – <i>(i)</i> verification of cost accounting records, and <i>(ii)</i> examining these records to ensure that they adhere to the cost accounting principles, plans, procedures and objectives.

3.0 MEANING OF COSTING

CIMA, London, defines Costing as “*the technique and process of ascertaining costs.*”

Thus, Costing means determining the cost by any technique *or* process like memorandum records *or* formal records based on double entry system. It consists of principles and rules which are used for determining:

- (a) the cost of producing a product, *e.g.* computer, car.
- (b) the cost of providing a service, *e.g.* hotel, hospital, transport.
- (c) the cost of performing an activity, *e.g.* placing purchase orders, receiving deliveries of materials.

4.0 MEANING OF COST ACCOUNTING

Cost Accounting is the process of accounting for cost which begins with the incurrance of cost and ends with the control of cost. In other words, it is a formal system of accounting by means of which costs of products, services *or* activities are ascertained and controlled.

CIMA, London, defines Cost Accounting as “*the process of accounting 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 usage, it embraces the preparation of statistical data, application of cost control methods and the ascertainment of profitability of activities carried out or planned.*”

Thus, Cost Accounting embraces –

- (a) Collecting, classifying, recording, allocating and analysing the costs.
- (b) Preparation of periodical statements and reports for ascertaining and controlling costs.
- (c) Application of Cost Control methods,
- (d) Ascertainment of profitability of activities carried out *or* planned.

5.0 DIFFERENCE BETWEEN COSTING AND COST ACCOUNTING

Costing means determining the cost of products *or* services by any technique *or* process like memorandum records *or* formal records based on double entry system; on the other hand cost accounting is a formal system of accounting by means of which costs of products *or* services are ascertained and controlled.

1.4 Tulsian's Introduction to Cost Accounting

6.0 OBJECTIVES OF COST ACCOUNTING

The main objectives of cost accounting are as follows:

1. To Ascertain Cost	The basic objective of cost accounting is to ascertain the cost of a cost centre (<i>i.e.</i> , a location, person or item of equipment or group of these). Cost ascertainment is the process of determining costs after they have been incurred. Basically there are two methods of cost ascertainment – Job costing and Process costing. Different industries follow different methods of costing because of the differences in the nature of their activity.
2. To Control Cost	Cost Accounting aims at controlling costs by using various techniques such as Budgetary Control, Standard Costing, Inventory Control etc.
3. To Provide Information for Decision-Making	Cost Accounting aims at providing information for various managerial decisions like – (a) Whether to make or buy a component (b) Whether to retain or replace an existing machine (c) Whether to process further or not (d) Whether to shut down or continue operations
4. To Determine Selling Price	Cost Accounting provides cost information to determine the selling price of products or services. During the period of depression, it guides the management to decide 'How much reduction in selling price may be made to meet the situation?'
5. To Ascertain Costing Profit	Cost Accounting aims at ascertaining the costing profit or loss of any activity on an objective basis by matching cost with the revenue of that activity.

7.0 DISTINCTION BETWEEN FINANCIAL ACCOUNTING AND COST ACCOUNTING

Financial Accounting differs from Cost Accounting in the following respects:

Basis of Distinction	Financial Accounting	Cost Accounting
1. Objective	Its objective is to provide information about overall financial performance and financial position of the business.	Its objective is to ascertain cost, to control cost and to provide information for decision-making.
2. Analysis of Costs and Profit	It shows the overall profit/loss of the entire organisation.	It shows the detailed cost and profits for each product, process, job, contract, etc.
3. Emphasis—Control/Reporting	Its emphasis is on reporting and not on control.	Its emphasis is on control —control on material cost, labour cost and overheads.
4. Decision-Making	Financial accounts are of limited use in decision-making.	Cost accounts are basically designed to facilitate decision making in the areas of production, purchase, sales, etc.

5. Responsibility fixation	Financial accounts do not offer any effective help in responsibility fixation because various expenses are not identified as controllable and non-controllable.	Cost accounts effectively help in responsibility fixation . Responsibility centres are created on the basis of controllability of cost. Thus, they also facilitate delegation of authority.
6. Focus on Present/Future	Its focus is on historical data .	Its focus is on present and future data . It makes use of both the historical costs and pre-determined costs.
7. General vs Special reports	It generates general purpose reports like Income Statement, Balance Sheet, Cash Flow Statement.	It generates special purpose reports like Report on Defectives, Report on Spoilage, Idle Time Report.
8. Legal requirements	Financial accounts of companies have to meet requirements of the Companies Act and the Income Tax Act .	Preparation of cost records is voluntary , except in a few cases where the law makes it mandatory.
9. Transactions recorded	It mainly records external transactions with outsiders, like purchase of materials.	It records both external and internal transactions (like issue of material by store to production department, transfer of material from one job to another).
10. Persons interested	Virtually the whole world is interested in financial information – the top management, workers, the shareholders, lenders, prospective investors, the government.	Usually internal management at different levels is interested in costing information.
11. Format of presenting information	It usually uses an uniform format for presenting financial information.	It uses different formats for presenting cost information to meet the needs of management.
12. Access	Anybody can have access to financial statements of companies.	Outsiders generally have no access to cost records.
13. Monetary/ Non-monetary information	Only monetary information is recorded in financial records.	Both kinds of information (monetary and physical) are recorded in cost records.

8.0 MAJOR LIMITATIONS OF FINANCIAL ACCOUNTING AND HOW THESE ARE OVERCOME BY COST ACCOUNTING

Major Limitations of Financial Accounting	How these are overcome by Cost Accounting
1. Financial Accounting does not provide the information required by management for forecasting and planning .	The technique of budgeting enables the management to perform the function of forecasting and planning.

1.6 Tulsian's Introduction to Cost Accounting

Major Limitations of Financial Accounting	How these are overcome by Cost Accounting
2. Financial Accounting does not provide the information required by management for decision-making in various areas such as make <i>or</i> buy, shut down <i>or</i> continue, retain <i>or</i> replace etc.	The technique of marginal costing enables the management to perform the function of decision-making.
3. Financial Accounting does not provide the information required by the management for control and assessment of the performance of various costs and responsibility centres.	The techniques of budgeting and standard costing enable the management to perform the function of control and assessment.

9.0 IMPORTANCE/ADVANTAGES OF COST ACCOUNTING

The main advantages of cost accounting are as follows:

Advantages to Management	
1. Helps in Ascertainment of Cost	Cost Accounting helps in the ascertainment of cost of each product, process, job, contract, activity etc. by using different methods of costing such as Job Costing and Process Costing.
2. Helps in Control of Cost	It helps in the control of material costs, labour costs and overheads by using different techniques of control such as Standard Costing and Budgetary Control.
3. Helps in Decisions-Making	It helps the management in making various decisions such as – (a) Whether to make <i>or</i> buy a component (b) Whether to retain <i>or</i> replace an existing machine (c) Whether to process further <i>or</i> not (d) Whether to shut down <i>or</i> continue operations (e) Whether to accept orders below cost <i>or</i> not (f) Whether to expand <i>or</i> not (g) How much reduction in the selling price should be made in case of depression?
4. Helps in Fixing Selling Prices	It helps the management in fixing selling prices of products <i>or</i> services by providing detailed cost information.
5. Helps in Inventory Control	It helps in inventory control by using various techniques such as ABC analysis, Economic Order Quantity, Stock levels, Perpetual Inventory system and Continuous Stock Taking, Inventory Turnover Ratio etc.
6. Helps in Cost Reduction	It helps in the introduction of cost reduction programme and finding out new and improved methods to reduce costs.
7. Helps in Measurement of Efficiency	It helps in measurement of efficiency of operations through establishment of standards and variance analysis.
8. Helps in Preparation of Budgets	It helps in the preparation of various budgets such as Sales Budget, Production Budget, Purchase Budget, Man-Power Budget, Overheads Budget.

9. Helps in identifying Unprofitable Activities	It helps in identifying unprofitable activities so that the necessary corrective action may be taken.
10. Helps in identifying Material Losses	It helps in identifying material losses such as wastage, scrap, spoilage and defective through report on material losses so that the necessary corrective action may be taken.
11. Helps in identifying Idle Time and Labour Turnover	It helps in identifying idle time and labour turnover through the report on idle time and labour turnover so that the necessary corrective action may be taken.
12. Helps in identifying Idle Capacity	It helps in identifying idle capacity so that the necessary corrective action may be taken.
13. Helps in improving Productivity	It helps in improving productivity of materials and labour.
14. Helps in Cost Comparison	It helps in Cost Comparisons such as – (a) Comparison with Standard Figures Comparison of actual figures with standard or budgeted figures for the same period and the same firm; (b) Intra-firm Comparison Comparison of actual figures of one period with those of another period for the same firm; (c) Inter-firm Comparison Comparison of actual figures of one firm with those of another standard firm belonging to the same industry; and (d) Pattern Comparison Comparison of actual figures of one firm with those of industry to which the firm belongs.
15. Helps in checking the accuracy of Financial Accounts	It helps in checking the accuracy of financial accounts with the help of reconciliation statement prepared to reconcile the profit as per cost accounts with the profit as per financial accounts.
Advantages to Employees	An efficient costing system benefits employees by introducing incentive plans. As a result both the productivity and earnings increase.
Advantages to Society	An efficient costing system benefits the society by providing products and services at lower prices due to lower cost of production.
Advantages to National Economy	An efficient costing system benefits national economy by achieving higher production, higher productivity because progress of enterprises leads to the progress of the industry which lead to progress of the national economy.
Advantages to Government, its Agencies and Others	An efficient costing system helps government, its agencies (like Wage Tribunals) and others (like Chamber of Commerce and Industry) by providing required cost information. Such cost information is useful for price fixation, wage level fixation, settlement of industrial disputes, framing various policies etc.

10.0 LIMITATIONS OR OBJECTIONS TO COST ACCOUNTING

Objections against Cost Accounting	Arguments against Objections
1. It is unnecessary because it involves duplication of work. Many good enterprises are functioning without any costing system.	In the era of competition and globalisation, it is must to minimise the cost of each activity by eliminating all types of inefficiencies and losses at each activity. To ascertain in-efficiencies and losses, detailed cost infor-mation is required which is provided by cost accounting system.
2. It is expensive because the installation of cost accounting system involves additional cost.	It is not expensive if its benefits exceed its costs. For its economical operation, only minimum records may be maintained according to the need and use of each record.
3. It is inapplicable to many industries.	Though a single cost accounting system may not be applicable to all industries but a costing system may be specially designed to meet the needs of a specific industry.
4. It is a failure in some enterprises.	Failure of costing system in some enterprises is not a valid argument against its introduction in other enterprises. Failure of system need not be due to any fault in system but it may be due to the non-cooperation of employees or other reasons.
5. The results shown by cost accounts differ from those shown by financial accounts.	An integrated system of accounts eliminates

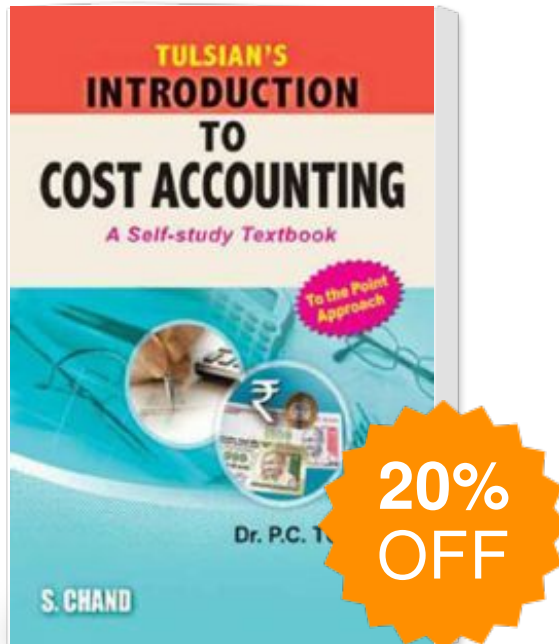
11.0 INSTALLATION OF COSTING SYSTEM

11.1 Factors to be Considered

The following factors should be considered before installing a costing system:

1. Nature of business	The costing system designer should consider the general nature of business to determine its suitability.
2. Objective	The designer should consider what is the objective of costing system? Whether to fix selling prices or control cost or both.
3. Organisation structure	Organisation structure should be studied to determine the manner in which costing system could be introduced without altering or extending the organisation appreciably.
4. Technical aspects	Technical aspects should be studied thoroughly by the designer.
5. Layout aspects	The size and layout of the organisation should be studied.
6. Methods and procedures	Existing methods and procedures for the purchases, receipts, inspection, storage, issue, return or transfer of materials should be studied.

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