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## NOTES

**Practice Notes**

**Cost and management account**

**Chapter - 1**

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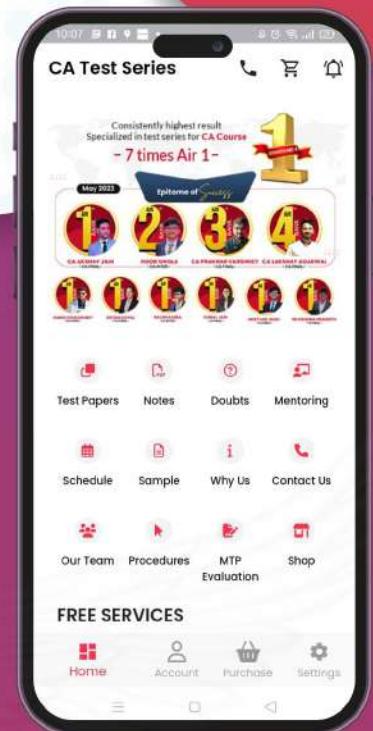


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**Practice notes**

**CHAPTER 1**

**INTRODUCTION TO COST AND MANAGEMENT ACCOUNTING**

**Multiple Choice Questions (MCQs)**

**1. .... Is anything for which a separate measurement is required.**

- (a) Cost unit
- (b) Cost object
- (c) Cost driver
- (d) Cost center

**Ans. (b)**

**2. Which of the following is true about Cost control:**

- (a) It is a corrective function
- (b) It challenges the set standards
- (c) It ends when targets achieved
- (d) It is concerned with future

**Ans. (c)**

**3. Cost units used in power sector is:**

- (a) Kilometer (K.M)
- (b) Kilowatt-hour (kWh)
- (c) Number of electric points
- (d) Number of hours

**Ans. (b)**

**4. Process Costing method is suitable for**

- (a) Transport sector
- (b) Chemical industries
- (c) Dam construction
- (d) Furniture making

**Ans. (b)**

**5. Which of the following is not true about the cost control and cost reduction:**

- (a) Cost control seeks to attain lowest possible cost under best conditions.
- (b) Cost control emphasises on past and present.
- (c) Cost reduction is a corrective function. It operates even when an efficient cost control system exists.
- (d) Cost control ends when targets are achieved.

**Ans. (a)**

**6. The advantage of using IT in Cost Accounting does not include:**

- (a) Integration of various functions
- (b) Stock needs to be reconciled with Goods Received Note
- (c) Reduction in multicity of documents
- (d) Customised reports can be prepared.

**Ans. (b)**

**7. A taxi provider charges minimum Rs. 80 thereafter Rs. 12 per kilometer of distance travelled, the behaviour of conveyance cost is:**

- (a) Fixed Cost
- (b) Semi-variable Cost
- (c) Variable Cost
- (d) Administrative cost.

**Ans. (b)**

**8. A Ltd. has three production department, and each department has two machines, which of the following cannot be treated as cost centre for cost allocation:**

- (a) Machines under the production department
- (b) Production departments
- (c) Both Production department and machines
- (d) A Ltd.

**Ans. (d)**

**9. Which of the following is an example of functional classification of cost:**

- (a) Direct Material Cost
- (b) Fixed Cost
- (c) Administrative Overheads
- (d) Indirect Overheads.

**Ans. (c)**

**10. Ticket counter in a Railway Station is an example of**

- (a) Cost Centre
- (b) Revenue Centre
- (c) Profit Centre
- (d) Investment Centre

**Ans. (b)**

**Theoretical Questions**

**Q 1. DESCRIBE THE MAIN OBJECTIVES OF INTRODUCTION OF A COST AND MANAGEMENT Accounting System in a manufacturing organization.**

**Ans. The main objectives of Cost and Management Accounting are explained as below:**

**(i) Ascertainment of Cost:** The main objective of Cost Accounting is accumulation and ascertainment of cost. Costs are accumulated, assigned and ascertained for each cost object. This cost object may be a unit, job, operation, process, department or service.

**(ii) Determination of Selling Price and Profitability:** The Cost Accounting System helps in determination of selling price and thus profitability of a cost object. Though in a competitive business environment selling prices are determined by external factors but cost accounting system provides a basis for price fixation and rate negotiation.

**(iii) Cost Control:** Maintaining discipline in expenditure is one of the main objectives of a good cost accounting system. It ensures that expenditures are in consonance with predetermined set standard and any variation from these set standards is noted and reported on continuous basis. To exercise control over cost, following steps are followed:

**(a) Determination of pre-determined standard or results:** Standard cost or performance targets for a cost object or a cost centre are set before that need to be achieved.

**(b) Measurement of actual performance:** Actual cost or result of the cost object or cost centre is measured. Performance should be measured in the same manner in which the targets are set i.e., if the targets are set up operation-wise, and then the actual costs should also be collected and measured operation-wise to have a common basis for comparison.

**(c) Comparison of actual performance with set standard or target:** The actual performance so measured is compared against the set standard and desired target. Any deviation (variance) between the two is noted and reported to the appropriate person or authority.

**(d) Analysis of variance and action:** The variance in results so noted is further analysed to know the reasons for variance and appropriate action is taken to ensure compliance in future. If necessary, the standards are further amended to take developments into account.

**(iv) Cost Reduction:** It may be defined "as the achievement of real and permanent reduction in the unit cost of goods manufactured or services rendered without impairing their suitability for the use intended or diminution in the quality of the product." Cost Reduction is an approach of management where cost of an object is believed to have a scope of



further reduction. No cost is termed as lowest and every possibility of cost reduction is explored. To do cost reduction, the following action is taken:

(a) Each activity within an entity is segmented to analyse and identify value added and non-value added activities. All non-value added activities are eliminated without affecting the essential characteristics of the product or process. Value Chain Analysis, a strategic tool, developed by Michael Porter, is one of the method to do value analysis.

(b) Conducting continuous research and study to know the most optimal way to manufacture a product or render a service. The three-fold assumptions involved in the definition of cost reduction may be summarised as under:

(a) There is a saving in unit cost.

(b) Such saving is of permanent nature.

(c) The utility and quality of the goods and services remain unaffected, if not improved.

(v) Assisting Management in Decision Making: Cost and Management Accounting by providing relevant information, assist management in planning, implementing, measuring, controlling and evaluating of various activities. A robust cost and management accounting system provides internal and external information to the industry which will be relevant for decision making.

## **Q 2. DISCUSS THE DIFFERENT COST CENTRES THAT ON ORGANIZATION CAN HAVE.**

**Ans. Cost Centres:** The responsibility centre which is held accountable for incurrence of costs which are under its control. The performance of this responsibility centre is measured against pre-determined standards or budgets. The cost centres are of two types:

(a) Standard Cost Centre and (b) Discretionary Cost Centre

(a) Standard Cost Centre: Cost Centre where output is measurable and input required for the output can be specified. Based on a well-established study, an estimate of standard units of input to produce a unit of output is set. The actual cost for inputs is compared with

the standard cost. Any deviation (variance) in cost is measured and analysed into controllable Types of Responsibility Centres Cost Centres Revenue Centres Profit Centres Investment Centres and uncontrollable cost. The manager of the cost centre is expected to comply with the standard and held responsible for adverse cost variances. The input-output ratio for a standard cost centre is clearly identifiable.

(b) Discretionary Cost Centre: The cost centre whose output cannot be measured in financial terms, thus input-output ratio cannot be defined. The cost of input is compared with allocated budget for the activity. Examples of discretionary cost centres are Research & Development department, Advertisement department where output of these department cannot be measured with certainty and co-related with cost incurred on inputs.

### **Q 3. DISCUSS COST CLASSIFICATION BASED ON VARIABILITY AND CONTROLLABILITY.**

#### **Ans. By Variability or Behaviour**

Based on this classification, costs are classified into three group's viz., fixed, variable and semi-variable.

**(a) Fixed costs**– These are the costs which are incurred for a period, and which, within certain output and turnover limits, tend to be unaffected by fluctuations in the levels of activity (output or turnover). They do not tend to increase or decrease with the changes in output. For example, rent, insurance of factory building etc., remain the same for different levels of production.

**(b) Variable Costs**– These costs tend to vary with the volume of activity. Any increase in the activity results in an increase in the variable cost and viceversa. For example, cost of direct material, cost of direct labour, etc.

**(c) Semi-variable costs**– These costs contain both fixed and variable components and are thus partly affected by fluctuations in the level of activity. Examples of semi variable costs are telephone bills, gas and electricity etc.

#### **By Controllability**

Costs here may be classified into controllable and uncontrollable costs.

**(a) Controllable Costs:** - Cost that can be controlled, typically by a cost, profit or investment centre manager is called controllable cost. Controllable costs incurred in a particular responsibility centre can be influenced by the action of the manager heading that responsibility centre. For example, direct costs comprising direct labour, direct material, direct expenses and some of the overheads are generally controllable by the shop floor supervisor or the factory manager.

**(b) Uncontrollable Costs** - Costs which cannot be influenced by the action of a specified member of an undertaking are known as uncontrollable costs. For example, expenditure incurred by say, the tool room is controllable by the foreman in-charge of that section but the share of the tool-room expenditure which is apportioned to a machine shop is not controlled by the machine shop foreman.

**Distinction between Controllable Cost and Uncontrollable Cost:** The distinction between controllable and uncontrollable costs is not very prominent and is sometimes left to individual judgement. In fact, no cost is uncontrollable; it is only in relation to a particular individual that we may specify a particular cost to be either controllable or uncontrollable.

#### Q 4. DISCUSS THE ESSENTIAL FEATURES OF A GOOD COST ACCOUNTING SYSTEM.

**Ans. Essential features of a good Cost Accounting System**

The essential features, which a good Cost Accounting System should possess, are as follows:

**(a) Informative and simple:** Cost accounting system should be tailor-made, practical, simple and capable of meeting the requirements of a business concern. The system of costing should not sacrifice the utility by introducing inaccurate and unnecessary details.

**(b) Accurate and authentic:** The data to be used by the cost accounting system should be accurate and authenticated; otherwise it may distort the output of the system and a wrong decision may be taken.

**(c) Uniformity and consistency:** There should be uniformity and consistency in classification, treatment and reporting of cost data and related information. This is required for benchmarking and comparability of the results of the system for both horizontal and vertical analysis.

**(d) Integrated and inclusive:** The cost accounting system should be integrated with other systems like financial accounting, taxation, statistics and operational research etc. to have a complete overview and clarity in results.

**(e) Flexible and adaptive:** The cost accounting system should be flexible enough to make necessary amendment and modifications in the system to incorporate changes in technological, reporting, regulatory and other requirements.

**(f) Trust on the system:** Management should have trust on the system and its output. For this, an active role of management is required for the development of such a system that reflects a strong conviction in using information for decision making.

**Q 5. DESCRIBE THE FACTORS WHICH ARE TO BE CONSIDERED BEFORE INSTALLING A SYSTEM OF COST ACCOUNTING.**

**Ans.** As in the case of every other form of activity, it should be considered whether it would be profitable to have a Cost Accounting System. Management of an organisation needs complete and accurate information to make decisions. A well-established costing system should provide all relevant information as and when required by management as well as various stakeholders. Before setting up a system of cost accounting the factors mentioned below should be studied:

**(a) Objective:** The objective of setting up the costing system, for example whether it is being introduced for fixing prices or for establishing a system of cost control.

**(b) Nature of Business or Industry:** The industry in which the business is operating. Every business or industry has its own uniqueness and objectives. According to its cost information requirement, cost accounting methods are followed. For example, an oil

refinery maintains process wise cost accounts to find out the cost incurred on a particular process, say in crude refinement process etc.

**(c) Organisational Hierarchy:** Costing system should fulfil the information requirements of different levels of management. Top management is concerned with the corporate strategy, strategic level management is concerned with marketing strategy, product diversification, product pricing etc. Operational level management needs the information on standard quantity to be consumed, report on idle time etc.

**(d) Knowing the product:** Nature of the product determines the type of costing system to be implemented. The product which has by-products requires costing system which accounts for by-products as well. In case of perishable or short self- life products, marginal costing is appropriate to know the contribution and minimum price at which products could be sold.

**(e) Knowing the production process:** A good costing system can never be established without the complete knowledge of the production process.

Cost apportionment can be done on the most appropriate and scientific basis if a cost accountant can identify degree of effort or resources consumed in a particular process. This also includes some basic technical know-how and process peculiarity.

**(f) Information synchronisation:** Establishment of a department or a system requires substantial amount of organisational resources. While drafting a costing system, information needs of various other departments should be taken into account. For example, in a typical business organisation accounts department needs to submit monthly stock statement to its lender bank, quantity wise stock details at the time of filing returns to tax authorities etc.

**(g) Method of maintenance of cost records:** The organization must determine beforehand the manner in which Cost and Financial Accounts could be inter-locked into a single integral accounting system and how the results of separate sets of accounts i.e. cost and financial, could be reconciled by means of control accounts.



**(h) Statutory compliances and audit:** Records are to be maintained to comply with statutory requirements and applicable cost accounting standards should be followed.

**(i) Information Attributes:** Information generated from the Costing system should possess all the attributes of useful information i.e. it should be complete, accurate, timely, relevant. to have an effective management information system (MIS).

**Q 6.DISCUSS the four different methods of costing along with their applicability to concerned industry.**

**Ans. The following table summarises the various methods of costing applied in different industries:**

Nature of Output	Method	Cost	Examples of Industries
A Series of Processes	Process costing or Operation Costing	For each process	Sugar
Construction of building	Contract Costing	For each contract	Real estate
Similar units of a Single Product, produced by Single Process	Unit or output or Single Costing	For the entire activity, but averaged for the output	Cold Drinks
Rendering of Services	Operating Costing	For all services	Hospitals
Customer	Job Costing	For each order/	Advertising

Specifications: single Unit		assignment/job	
Consisting of multiple varieties of activities and processes	Multiple Costing	Combination of any method	Car Assembly

**Q 7. STATE the method of costing and the suggested unit of cost for the following industries:**

- (a) Transport      (b) Power      (c) Hotel  
 (d) Hospital      (e) Steel      (f) Coal  
 (g) Bicycles      (h) Bridge Construction      (i) Interior Decoration  
 (j) Advertising      (k) Furniture      (l) Brick-works

**Ans.**

Nature of industries	Method of costing	Unit of cost
(a) Transport	Operating Costing	Passenger- kilometer
(b) Power	Operating Costing	Kilo- watt hour (kWh)
(c) Hotel	Operating Costing	Room/meal
(d) Hospital	Operating Costing	Patient day
(e) Steel	Single or Output Costing	Ton
(f) Coal	Single or Output Costing	Tonne/ton

(g) Bicycles	Multiple Costing	Number
(h) Bridge Construction	Contract Costing	Contract, job
(i) Interior Decoration	Job Costing	Chargeable hour, job, contract
(j) Advertising	Job Costing	Chargeable hour, job, contract
(k) Furniture	Job Costing	Chargeable hour, job, contract
(l) Brick-works	Single or Output Costing	1,000 bricks

**Q 8. WRITE a note on the following, indicating in which kinds of industries or undertakings, the different methods could be suitably applied:**

- (a) Single or Output Costing      (b) Batch Costing  
(c) Process Costing      (d) Operating Costing  
(e) Contract Costing      (f) Multiple Costing

**Ans. METHODS OF COSTING**

Different industries follow different methods of costing because of the differences in the nature of their work. The various methods of costing are as follows:

Methods	Description
<b>Single or Output Costing</b>	Under this method, the cost of a product is ascertained, the product being the only one produced like bricks, coals, etc.
<b>Batch Costing</b>	This method is the extension of job costing. A batch may represent a number of small orders passed through the factory in batch. Each

	batch here is treated as a unit of cost and thus separately costed. Here cost per unit is determined by dividing the cost of the batch by the number of units produced in the batch.
<b>Job Costing</b>	Under this method of costing, cost of each job is ascertained separately. It is suitable in all cases where work is undertaken on receiving a customer's order like a printing press, motor workshop, etc.
<b>Contract Costing</b>	Under this method, the cost of each contract is ascertained separately. It is suitable for firms engaged in the construction of bridges, roads, buildings etc.
<b>Process Costing</b>	Under this method, the cost of completing each stage of work is ascertained, like cost of making pulp and cost of making paper from pulp. In mechanical operations, the cost of each operation may be ascertained separately; the name given is operation costing.
<b>Operating Costing</b>	It is used in the case of concerns rendering services like transport, supply of water, retail trade etc.
<b>Multiple Costing</b>	It is a combination of two or more methods of costing outlined above. Suppose a firm manufactures bicycles including its components; the parts will be costed by the system of job or batch costing but the cost of assembling the bicycle will be computed by the Single or output costing method. The whole system of costing is known as multiple costing.