MBA-I / Sem. I
101 Managerial Accounting

UNIT – I:

Basic Concepts

DEFINITIONS

Definition by the American Accounting Association (Year 1966): "The process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of accounting".

Definition of Accounting Definition by the American Institute of Certified Public Accountants (Year 1961): "Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the result thereof"

- **Objectives of Accounting**

(i) **Providing Information to the Users for Rational Decision-making -** The primary objective of accounting is to provide useful information for decision-making to stakeholders such as owners, management, creditors, investors, etc. Various outcomes of business activities such as costs, prices, sales volume, value under ownership, return of investment, etc. are measured in the accounting process. All these accounting measurements are used by stakeholders (owners, investors, creditors/bankers, etc.) in course of business operation. Hence, accounting is identified as 'language of business'.

(ii) **Systematic Recording of Transactions** - To ensure reliability and precision for the accounting measurements, it is necessary to keep a systematic record of all financial transactions of a business enterprise which is ensured by bookkeeping. These financial records are classified, summarized and reposted in the form of accounting measurements to the users of accounting information i.e., stakeholder.

(iii) **Ascertainment of Results of above Transactions** 'Profit/loss' is a core accounting measurement. It is measured by preparing profit and loss account for a particular period. Various other accounting measurements such as different types of revenue expenses and revenue incomes are considered for preparing this profit and loss account. Difference between these revenue incomes and revenue expenses is known as result of business transactions identified as profit/loss. As this measure is used very frequently by stockholders for rational decision making, it has become the objective of accounting. For example, Income Tax Act requires that every business should have an accounting system that can measure taxable income of business and also explain nature and source of every item reported in Income Tax Return.

(iv) **Ascertain the Financial Position of Business** - 'Financial position' is another core accounting measurement. Financial position is identified by preparing a statement of ownership i.e., Assets and Owings i.e., liabilities of the business as on a certain date. This statement is popularly known as balance sheet. Various other accounting measurements such as different types of assets and different types of liabilities as existed at a particular date are considered for preparing the balance sheet. This statement may be used by various stakeholders for financing and investment decision.

(v) **To Know the Solvency Position Balance sheet and profit and loss account** prepared as above give useful information to stockholders regarding concerns potential to meet its obligations in the short run as well as in the long run.

Providing Information to the Users for Rational Decision-making
Systematic Recording of Transactions
Ascertainment of Results of above Transactions
Ascertain the Financial Position of Business
To Know the Solvency Position

Function of Accounting:

The main functions of accounting are as follows:

(a) Measurement: Accounting measures past performance of the business entity and depicts its current financial position

(b) Forecasting: Accounting helps in forecasting future performance and financial position of the enterprise using past data.

(c) Decision-making: Accounting provides relevant information to the users of accounts to aid rational decision making.

(d) Comparison & Evaluation: Accounting assesses performance achieved in relation to targets and discloses information regarding accounting policies and contingent liabilities which play an important role in predicting, comparing and evaluating the financial results.

(e) Control: Accounting also identifies weaknesses of the operational system and provides feedbacks regarding effectiveness of measures adopted to check such weaknesses.

(f) Government Regulation and Taxation: Accounting provides necessary information to the government to exercise control on die entity as well as in collection of tax revenues.

BOOK-KEEPING

As defined by Carter, ‘Book-keeping is a science and art of correctly recording in books-of accounts all those business transactions that result in transfer of money or money’s worth’. Book-keeping is an activity concerned with recording and classifying financial data related to business operation in order of its occurrence.

Book-keeping is a mechanical task which involves: = Collection of basic financial information. =Identification of events and transactions with financial character i.e., economic transactions. = Measurement of economic transactions in terms of money. = Recording financial effects of economic transactions in order of its occurrence. = Classifying effects of economic transactions. = Preparing organized statement known as trial balance. The distinction between book-keeping and accounting is given below: Distinction between Book-keeping and Accounting

Book-Keeping	Accounting
1. Output of book-keeping is an input for accounting.	1. Output of accounting permit informed judgments and decisions by the user of accounting information.
2. Purpose of book-keeping is to keep systematic record of transactions and events of financial character in order of its occurrence.	2. Purpose of accounting is to find results of operating activity of business and to report financial strength of business.
3. Book-keeping is a foundation of accounting.	3. Accounting is considered as a language of business.
4. Book-keeping is carried out by junior staff.	4. Accounting is done by senior staff with skill of analysis and interpretation.
5. Objects of book-keeping is to summarize the cumulative effect of all economic transactions of business for a given period by maintaining permanent record of each business transaction with its evidence and financial effects on accounting variable.	5. Object of accounting is not only bookkeeping but also analyzing and interpreting reported financial information for informed decisions.

ACCOUNTING – CLASSIFICATION

The various sub-fields of the accounting are:

1.	Financial Accounting	Determining the financial results for the period and the state of affairs on the last day the accounting period.	Stewardship Accounting
2.	Cost Accounting	Information generation for Controlling operations with a view to maximizing efficiency and profit.	Control Accounting
3.	Management Accounting	Accounting to assist management in planning and decision making.	Decision Accounting

(a) Financial Accounting - It is commonly termed as Accounting. The American Institute of Certified Public Accountants defines Accounting as "an art of recoding, classifying and summarizing in a significant manner and in terms of money, transactions and events which are in part at least of a financial character, and interpreting the results thereof."

(b) Cost Accounting - According to the Chartered Institute of Management Accountants (CIMA), Cost Accountancy is defined as "application of costing and cost accounting principles, methods and techniques to the science, art and practice of cost control and the ascertainment of profitability as well as the presentation of information for the purpose of managerial decision-making."

(c) Management Accounting - Management Accounting is concerned with the use of Financial and Cost Accounting information to managers within organizations, to provide them with the basis in making informed business decisions that would allow them to be better equipped in their management and control functions.

BASIC ACCOUNTING TERMS

In order to understand the subject matter clearly, one must grasp the following common expressions always used in business accounting. The aim here is to enable the student to understand with these often used concepts before we embark on accounting procedures and rules. You may note that these terms can be applied to any business activity with the same connotation.

(i) **Transaction:** It means an event or a business activity which involves exchange of money or money's worth between parties. The event can be measured in terms of money and changes the financial position of a person e.g. purchase of goods would involve receiving material and making payment or creating an obligation to pay to the supplier at a future date. Transaction could be a cash transaction or credit transaction. When the parties settle the transaction immediately by making payment in cash or by cheque, it is called a cash transaction.

In credit transaction, the payment is settled at a future date as per agreement between the parties.

(ii) **Goods/Services:** These are tangible article or commodity in which a business deals. These articles or commodities are either bought and sold or produced and sold. At times, what may be classified as 'goods' to one business firm may not be 'goods' to the other firm. e.g. for a machine manufacturing company, the machines are 'goods' as they are frequently made and sold. But for the buying firm, it is not 'goods' as the intention is to use it as a long term resource and not sell it. Services are intangible in nature which are rendered with or without the object of earning profits.

(iii) **Profit:** The excess of Revenue Income over expense is called profit. It could be calculated for each transaction or for business as a whole.

(iv) **Loss:** The excess of expense over income is called loss. It could be calculated for each transaction or for business as a whole.

(v) **Asset:** Asset is a resource owned by the business with the purpose of using it for generating future profits. Assets can be tangible and intangible. Tangible Assets are the Capital assets which have some physical existence. They can, therefore, be seen, touched and felt, e.g. Plant and Machinery, Furniture and Fittings, Land and Buildings, Books, Computers, Vehicles, etc. The capital assets which have no physical existence and whose value is limited by the rights and anticipated benefits that possession confers upon the owner are known as lntangible Assets. They cannot be seen or felt although they help to generate revenue in future, e.g. Goodwill, Patents, Trade-marks, Copyrights, Brand Equity, Designs, Intellectual Property, etc. Assets can also be classified into Current Assets and Non-Current Assets.

Current Assets – An asset shall be classified as Current when it satisfies any of the following:

(a) It is expected to be realised in, or is intended for sale or consumption in the Company's normal Operating Cycle,

(b) It is held primarily for the purpose of being traded,

(c) It is due to be realised within 12 months after the Reporting Date, or

(d) It is Cash or Cash Equivalent unless it is restricted from being exchanged or used to settle a Liability for at least 12 months after the Reporting Date.

Non-Current Assets – All other Assets shall be classified as Non-Current Assets. e.g. Machinery held for long term etc.

(vi) **Liability:** It is an obligation of financial nature to be settled at a future date. It represents amount of money that the business owes to the other parties. E.g. when goods are bought on credit, the firm will create an obligation to pay to the supplier the price of goods on an agreed future date or when a loan is taken from bank, an obligation to pay interest and principal amount is created. Depending upon the period of holding, these obligations could be further classified into Long Term on non-current liabilities and Short Term or current liabilities. Current Liabilities – A liability shall be classified as Current when it satisfies any of the following:

(a) It is expected to be settled in the Company's normal Operating Cycle,

(b) It is held primarily for the purpose of being traded,

(c) It is due to be settled within 12 months after the Reporting Date, or

(d) The Company does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date (Terms of a Liability that could, at the option of the counterparty, result in its settlement by the issue of Equity Instruments do not affect its classification) Non-Current Liabilities – All other Liabilities shall be classified as Non-Current Liabilities. E.g. Loan taken for 5 years, Debentures issued etc.

(vii) **Internal Liability**: These represent proprietor's equity, i.e. all those amount which are entitled to the proprietor, e.g., Capital, Reserves, Undistributed Profits, etc.

(viii) **Working Capital:** In order to maintain flows of revenue from operation, every firm needs certain amount of current assets. For example, cash is required either to pay for expenses or to meet obligation for service received or goods purchased, etc. by a firm. On identical reason, inventories are required to provide the link between production and sale. Similarly, Accounts Receivable generate when goods are sold on credit. Cash, Bank, Debtors, Bills Receivable, Closing Stock, Pre-payments etc. represent current assets of firm. The whole of these current assets from the working capital of a firm which is termed as Gross Working Capital.

Gross Working capital = Total Current Assets = Long term internal liabilities + long term debts + The current liabilities - The amount blocked in the fixed assets.

There is another concept of working capital. Working capital is the excess of current assets over current liabilities. That is the amount of current assets that remain in a firm if all its current liabilities are paid. This concept of working capital is known as Net Working Capital which is a more realistic concept. Working Capital (Net) = Current Assets – Currents Liabilities.

(iX) **Contingent Liability**: It represents a potential obligation that could be created depending on the outcome of an event. E.g. if supplier of the business files a legal suit, it will not be treated as a liability because no obligation is created immediately. If the verdict of the case is given in favour of the supplier then only the obligation is created. Till that it is treated as a contingent liability. Please note that contingent liability is not recorded in books of account, but disclosed by way of a note to the financial statements.

(x) **Capital:** It is amount invested in the business by its owners. It may be in the form of cash, goods, or any other asset which the proprietor or partners of business invest in the business activity. From business point of view, capital of owners is a liability which is to be settled only in the event of closure or transfer of the business. Hence, it is not classified as a normal liability. For corporate bodies, capital is normally represented as share capital.

(xi) **Drawings:** It represents an amount of cash, goods or any other assets which the owner withdraws from business for his or her personal use. e.g. if the life insurance premium of proprietor or a partner of business is paid from the business cash, it is called drawings. Drawings will result in reduction in the owners' capital. The concept of drawing is not applicable to the corporate bodies like limited companies.

(xii) **Net worth:** It represents excess of total assets over total liabilities of the business. Technically, this amount is available to be distributed to owners in the event of closure of the business after payment of all liabilities. That is why it is also termed as Owner's equity. A profit making business will result in increase in the owner's equity whereas losses will reduce it.

(xiii) **Non-current Investments:** Non-current Investments are investments which are held beyond the current period as to sale or disposal. e. g. Fixed Deposit for 5 years.

(xiv) **Current Investments**: Current investments are investments that are by their nature readily realizable and are intended to be held for not more than one year from the date on which such investment is made. e. g. 11 months Commercial Paper.

(xv) **Debtor:** The sum total or aggregate of the amounts which the customer owe to the business for purchasing goods on credit or services rendered or in respect of other contractual obligations, is known as Sundry Debtors or Trade Debtors, or Trade Payable, or Book-Debts or Debtors. In other words, Debtors are those persons from whom a business has to recover money on account of goods sold or service rendered on credit. These debtors may again be classified as under:

(a) **Good debts:** The debts which are sure to be realized are called good debts.

(b) Doubtful Debts: The debts which may or may not be realized are called doubtful debts.

(c) **Bad debts:** The debts which cannot be realized at all are called bad debts. It must be remembered that while ascertaining the debtors balance at the end of the period certain adjustments may have to be made e.g. Bad Debts, Discount Allowed, Returns Inwards, etc.

(xvi) **Creditor:** A creditor is a person to whom the business owes money or money's worth. e.g. money payable to supplier of goods or provider of service. Creditors are generally classified as Current Liabilities.

(xvii) **Capital Expenditure**: This represents expenditure incurred for the purpose of acquiring a fixed asset which is intended to be used over long term for earning profits there from. e. g. amount paid to buy a computer for office use is a capital expenditure. At times expenditure may be incurred for enhancing the production capacity of the machine. This also will be a capital expenditure. Capital expenditure forms part of the Balance Sheet.

(xviii) **Revenue expenditure:** This represents expenditure incurred to earn revenue of the current period. The benefits of revenue expenses get exhausted in the year of the incurrence. e.g. repairs, insurance, salary & wages to employees, travel etc. The revenue expenditure results in reduction in profit or surplus. It forms part of the Income statement.

(xix) **Balance Sheet:** It is the statement of financial position of the business entity on a particular date. It lists all assets, liabilities and capital. It is important to note that this statement exhibits the state of affairs of the business as on a particular date only. It describes what the business owns and what the business owes to outsiders (this denotes liabilities) and to the owners (this denotes capital). It is prepared after incorporating the resulting profit/losses of Income statement.

(xx) **Profit and Loss Account or Income Statement:** This account shows the revenue earned by the business and the expenses incurred by the business to earn that revenue. This is prepared usually for a particular accounting period, which could be a month, quarter, a half year or a year. The net result of the Profit and Loss Account will show profit earned or loss suffered by the business entity.

(xxi) **Trade Discount:** It is the discount usually allowed by the wholesaler to the retailer computed on the list price or invoice price. e.g. the list price of a TV set could be Rs. 15000. The wholesaler may allow 20% discount thereof to the retailer. This means the retailer will get it for Rs. 12000 and is expected to sale it to final customer at the list price. Thus the trade discount enables the retailer to make profit by selling at the list price. Trade discount is not recorded in the books of accounts. The transactions are recorded at net values only. In above example, the transaction will be recorded at Rs. 12000 only.

(xxii) **Cash Discount:** This is allowed to encourage prompt payment by the debtor. This has to be recorded in the books of accounts. This is calculated after deducting the trade discount. e.g. if list price is Rs. 15000 on which a trade discount of 20% and cash discount of 2% apply, then first trade discount of Rs.3000 (20% of Rs.15000) will be deducted and the cash discount of 2% will be calculated on Rs.12000 (Rs.15000 – Rs.3000). Hence the cash discount will be Rs.240 (2% of Rs.12000) and net payment will be Rs.11,760 (Rs.12,000 - Rs.240)

ACCOUNTING CONCEPTS AND CONVENTIONS

As seen earlier, the accounting information is published in the form of financial statements. The three basic financial statements are

(i) The Profit & Loss Account that shows net business result i.e. profit or loss for a certain periods

(ii) The Balance Sheet that exhibits the financial strength of the business as on a particular dates

(iii) The Cash Flow Statement that describes the movement of cash from one date to the other. As these statements are meant to be used by different stakeholders, it is necessary that the information contained therein is based on definite principles, concrete concepts and well accepted convention. Accounting principles are basic guidelines that provide standards for scientific accounting practices and procedures. They guide as to how the transactions are to be recorded and reported. They assure uniformity and understandability. Accounting concepts lay down the foundation for accounting principles. They are ideas essentially at mental level and are self-evident. These concepts ensure recording of financial facts on sound bases and logical considerations. Accounting conventions are methods or procedures that are widely accepted. When transactions are recorded or interpreted, they follow the conventions. Many times, however, the terms-principles, concepts and conventions are used interchangeably. Professional Accounting Bodies have published statements of these concepts. Over years, many of these concepts are being challenged as outlived. Yet, no major deviations have been made as yet. Path breaking ideas have emerged and the accounting standards of modern days do require companies to record and report transactions which may not be necessarily based on concepts that are in vogue for long. It is essential to study accounting from the basic levels and understand these concepts in entirety.

A. BASIC ASSUMPTIONS

(a) Business Entity Concept This concept explains that the business is distinct from the proprietor. Thus, the transactions of business only are to be recorded in the books of business.

(b) Going Concern Concept This concept assumes that the business has a perpetual succession or continued existence.

(c) Money Measurement Concept According to this concept only those transactions which are expressed in money terms are to be recorded in accounting books.

(d) The Accounting Period Concept Businesses are living, continuous organisms. The splitting of the continuous stream of business events into time periods is thus somewhat arbitrary. There is no significant change just because one accounting period ends and a new one begins. This results into the most difficult problem of accounting of how to measure the net income for an accounting period. One has to be careful in recognizing revenue and expenses for a particular accounting period. Subsequent section on accounting procedures will explain how one goes about it in practice.

(e) The Accrual Concept The accrual concept is based on recognition of both cash and credit transactions. In case of a cash transaction, owner's equity is instantly affected as cash either is received or paid. In a credit transaction, however, a mere obligation towards or by the business is created. When credit transactions exist (which is generally the case), revenues are not the same as cash receipts and expenses are not same as cash paid during the period. Today's accounting systems based on accrual concept are called as Accrual system or mercantile system of accounting.

B. BASIC PRINCIPLES

(a) Realization Concept This concept speaks about recording of only those transactions which are actually realized. For example Sale or Profit on sales will be taken into account only when money is realized i.e. either cash is received or legal ownership is transferred.

(b) Matching Concept It is referred to as matching of expenses against incomes. It means that all incomes and expenses relating to the financial period to which the accounts relate should be taken in to account without regard to the date of receipts or payment.

(c) Full Disclosure Concept As per this concept, all significant information must be disclosed. Accounting data should properly be clarified, summarized, aggregated and explained for the purpose of presenting the financial statements which are useful for the users of accounting information. Practically, this principle emphasizes on the materiality, objectivity and consistency of accounting data which should disclose the true and fair view of the state of affairs of a firm.

(d) Duality Concept According to this concept every transaction has two aspects i.e. the benefit receiving aspect and benefit giving aspect. These two aspects are to be recorded in the books of accounts.

(e) Verifiable Objective Evidence Concept Under this principle, accounting data must be verified. In other words, documentary evidence of transactions must be made which are capable of verification by an independent respect. In the absence of such verification, the data which will be available will neither be reliable nor be dependable, i.e., these should be biased data. Verifiability and objectivity express dependability, reliability and trustworthiness that are very useful for the purpose of displaying the accounting data and information to the users.

(f) Historical Cost Concept Business transactions are always recorded at the actual cost at which they are actually undertaken. The basic advantage is that it avoids an arbitrary value being attached to the transactions. Whenever an asset is bought, it is recorded at its actual cost and the same is used as the basis for all subsequent accounting purposes such as charging depreciation on the use of asset, e.g. if a production equipment is bought for Rs. 1.50 crores, the asset will be shown at the same value in all future periods when disclosing the original cost. It will obviously be reduced by the amount of depreciation, which will be calculated with reference to the actual cost. The actual value of the equipment may rise or fall subsequent to the purchase, but that is considered irrelevant for accounting purpose as per the historical cost concept. The limitation of this concept is that the balance sheet does not show the market value of the assets owned by the business and accordingly the owner's equity will not reflect the real value. However, on an ongoing basis, the assets are shown at their historical costs as reduced by depreciation.

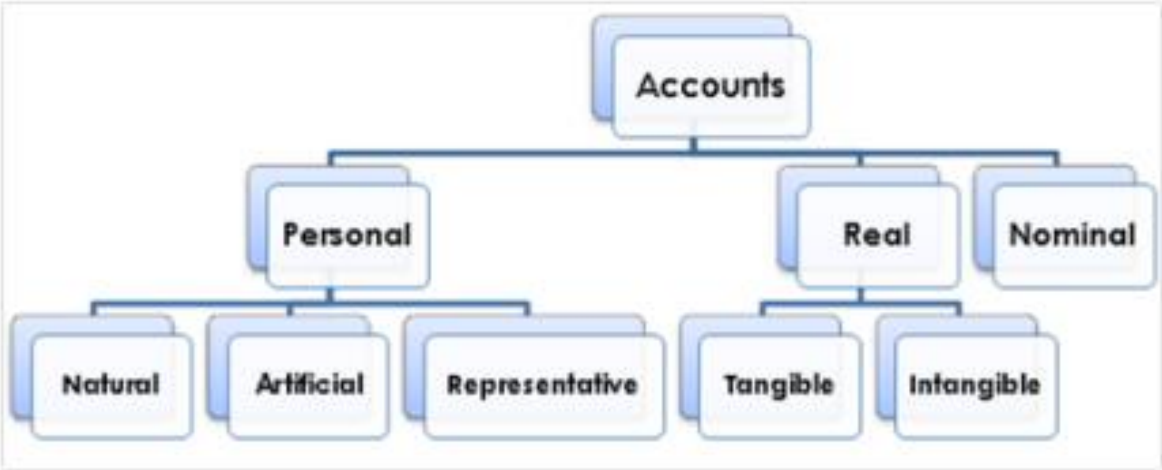
(g) Balance Sheet Equation Concept Under this principle, all which has been received by us must be equal to that has been given by us and needless to say that receipts are clarified as debits and giving is clarified as credits. The basic equation, appears as :- Debit = Credit Naturally every debit must have a corresponding credit and vice-e-versa. So, we can write the above in the following form – Expenses + Losses + Assets = Revenues + Gains + Liabilities And if expenses and losses, and incomes and gains are set off, the equation takes the following form

Asset = Liabilities

or,

Asset = Equity + External Liabilities i.e., the Accounting Equation.

TYPES OF ACCOUNTS



(1) **Personal Account**:

As the name suggests these are accounts related to persons.

(a) These persons could be natural persons like Suresh's A/c, Anil's a/c, Rani's A/c etc.

(b) The persons could also be artificial persons like companies, bodies corporate or association of persons or partnerships etc. Accordingly, we could have Videocon Industries A/c, Infosys Technologies A/c, Charitable Trust A/c, Ali and Sons trading A/c, ABC Bank A/c, etc.

(c) There could be representative personal accounts as well. Although the individual identity of persons related to these is known, the convention is to reflect them as collective accounts. e.g. when salary is payable to employees, we know how much is payable to each of them, but collectively the account is called as 'Salary Payable A/c'. Similar examples are rent payable, Insurance prepaid, commission pre-received etc. The students should be careful to have clarity on this type and the chances of error are more here.

(2) **Real Accounts:**

These are accounts related to assets or properties or possessions. Depending on their physical existence or otherwise, they are further classified as follows:-

(a) Tangible Real Account – Assets that have physical existence and can be seen, and touched. e.g. Machinery A/c, Stock A/c, Cash A/c, Vehicle A/c, and the like.

(b) Intangible Real Account – These represent possession of properties that have no physical existence but can be measured in terms of money and have value attached to them. e.g. Goodwill A/c, Trade mark A/c, Patents & Copy Rights A/c, Intellectual Property Rights A/c and the like.

(3) **Nominal Account:**

These accounts are related to expenses or losses and incomes or gains e.g. Salary and Wages A/c, Rent of Rates A/c, Travelling Expenses A/c, Commission received A/c, Loss by fire A/c etc.

Type of Account	Golden Rules
Real Account	*Debit what comes into the business *Credit what goes out from the business
Personal Account	*Debit the receiver *Credit the giver
Nominal Account	*Debit the expense or loss of the business *Credit the income or gain of the business

Problem No. 1

Ascertain the debit and credit from the following particulars under Modern Approach.
(a) Started business with capital.
(b) Bought goods for cash.
(c) Sold goods for cash.
(d) Paid salary.
(e) Received Interest on Investment.
(f) Bought goods on credit from Mr. Y
(g) Paid Rent out of Personal cash.

Solution:

	Effect of Transaction	Account	To be debited/Credited
(a)	Increase in Cash Increase in Capital	Cash A/c Capital A/c	Debit Credit
(b)	Increase in Stock Decrease in Cash	Purchase A/c Cash A/c	Debit Credit
(c)	Increase in Cash Decrease in Stock	Cash A/c Sale A/c	Debit Credit
(d)	Increase in Expense Decrease in Cash	Salary A/c Cash A/c	Debit Credit
(e)	Increase in Cash Increase in Income	Cash A/c Interest A/c	Debit Credit
(f)	Increase in Stock Increase in Liability	Purchase A/c Y A/c	Debit Credit
(g)	Increase in Expense Increase in Liability	Rent A/c Capital A/c	Debit Credit

Problem No.2

Journalise the following transactions in the books of Mr. Roy
2015
April
1 He started business with a capital of – Plant ₹ 10,000, Bank ₹ 8,000, Stock ₹ 12,000
2 Bought furniture for resale ₹ 5,000
Bought furniture for Office decoration ₹ 3,000
3 Paid rent out of personal cash for ₹ 2,000
8 Sold furniture out of those for resale ₹ 6,000
12 Paid Salary to Mr. X for ₹ 1,200
15 Purchased goods from Mr. Mukherjee for cash ₹ 3,000
18 Sold goods to Mr. Sen on credit for ₹ 8,000
20 Mr. Sen returned goods valued ₹ 1,000
22 Received cash from Mr. Sen of ₹ 6,500 in full settlement
28 Bought goods from Mr. Bose on credit for ₹ 5,000
30 Returned goods to Mr. Bose of ₹ 500 and paid to Mr. Bose ` 4,000 in full settlement.

In the Books of Mr. Roy
Journal Entries

Date	Particulars	L. F.	Debit (₹)	Credit (₹)
2015 Aprl.1	Plant A/c Dr. Bank A/c Dr. Stock A/c Dr. To, Capital A/c [Being Plant, Bank, Stock introduced to the business]		10,000 8,000 12,000	 30,000
2	Purchase A/c Dr. To, Bank A/c [Being furniture purchased for resale] Furniture A/c Dr. To, Bank A/c [Being furniture purchased for office decoration]		5,000 3,000	 5,000 3,000
3	Rent A/c Dr. To, Capital A/c [Being rent paid out of personal cash]		2,000	 2,000
8	Cash A/c Dr. To, Sales A/c [Being furniture out of those meant for resale are sold]		6,000	 6,000
12	Salary A/c Dr. To, Bank A/c [Being salary paid to Mr. X]		1,200	 1,200
15	Purchase A/c Dr. To, Cash A/c [Being goods purchased]		3,000	 3,000
18	Mr. Sen A/c Dr. To, Sales A/c [Being goods sold on credit to Mr. Sen]		8,000	 8,000
20	Returns Inward A/c Dr. To, Mr. Sen A/c [Being goods returned from Mr. Sen]		1,000	 1,000
22	Cash A/c Dr. Discount Allowed A/c Dr. To, Mr. Sen A/c [Being cash received from Mr. Sen in full settlement]		6,500 500	 7,000
28	Purchase A/c Dr. To, Mr. Bose A/c [Being goods purchased from Mr. Bose on credit]		5,000	 5,000
30	Mr. Bose A/c Dr. To, Cash A/c To, Returns Outward A/c To, Discount Received A/c [Being goods returned to Mr. Bose and paid cash in full settlement]		5,000	 4,000 500 500

UNIT – II:

Financial Statements

Meaning of Financial Statements:

The financial statements of a company reflect a true picture of its financial performances. They depict not only profits and losses, but also assets and liabilities. It is only at the end of all accounting processes that we can generate these statements. Let's take a look at the objectives of financial statements along with their features.

Financial statements are basically reports that depict financial and accounting information relating to businesses. A company's management uses it to communicate with external stakeholders. These include shareholders, tax authorities, regulatory bodies, investors, creditors, etc.

These statements basically include the following reports:

1. Balance sheet
2. Profit and Loss statement
3. Statement of cash flow
4. Income sheet

Nature of Financial Statements

Financial statements are prepared using facts relating to events, which are recorded chronologically. Thus, we have to first record all these facts in monetary terms. Then, we have to process them using all applicable rules and procedures. Finally, we can now use all this data to generate financial statements.

Based on this understanding, the nature of financial statements depends on the following points:

1. **Recorded facts:** We need to first record facts in monetary form to create the statements. For this, we need to account for figures of accounts like fixed assets, cash, trade receivables, etc.
2. **Accounting conventions:** Accounting Standards prescribe certain conventions applicable in the process of accounting. We have to apply these conventions while preparing these statements. For example, the valuation of inventory at cost price or market price, depending on whichever is lower.
3. **Postulates:** Apart from conventions, even postulates play a big role in the preparation of these statements. Postulates are basically presumptions that we must make in accounting. For example,

the going concern postulate presumes a business will exist for a long time. Hence, we have to treat assets on a historical cost basis.

4. **Personal judgments:** Even personal opinions and judgments play a big role in the preparation of these statements. Thus, we have to rely on our own estimates while calculating things like depreciation.

Now that we understand the meaning and nature of financial statements, a glance at their objectives would be appreciable.

Objectives of Financial Statements

Stakeholders of a company heavily rely on financial statements to understand its functioning. They portray the true state of affairs of the company. Here are some objectives of financial statements:

- These statements show an accurate state of a company's *economic assets and liabilities*. External stakeholders like investors and authorities generally do not possess this information otherwise.
- They help in predicting the extent of a company's *capacity to earn profits*. Shareholders and investors can use this data to make their financial decisions.
- These statements depict the *effectiveness of a company's management*. How well a company is performing depends on its profitability, which these statements show.
- They even help readers of these statements know the *accounting policies* used in them. This helps in understanding statements more comprehensively.
- These statements also provide information relating to the company's *cash flows*. Investors and creditors can use this data to predict the company's liquidity and cash requirements.
- Finally, they explain the *social impact of businesses*. This is because it shows how the company's external factors affect its functioning.

Difference between Trading and Profit and Loss Account

The following points of difference exist between the Trading and Profit and Loss Account

Parameters	Trading Account	Profit and Loss Account
Meaning	Trading account used to find the gross profit/loss of the business for an accounting period	Profit and loss account or Income statement is used to find the net profit/loss of the business for an accounting period
Timing	Trading Account is prepared first and then profit and loss account is prepared.	Profit/Loss Account is prepared after the trading account is prepared.
Purpose	For knowing the gross profit or gross loss of a business	For knowing the net profit or net loss of a business
Stage	It is the first stage in the creation of the final account.	it is the second stage in the creation of the final account.
Dependency	It is not dependent on trial balance	It is dependent on trading account
Transfer of Balance	The balance in the form of Gross loss or Gross Profit of the trading account will be transferred to the Profit and Loss Account	The balance in the form of Net loss or Net Profit of the profit and loss account will be transferred to the Balance Sheet

Trading and Profit and Loss Account Format

Trading and Profit and Loss Account format is represented separately as follows:

Format for Trading Account

Trading account for the year ended……….

To opening stock		xxx	By Sales	xxxx	
To purchases	xxxx		Less returns	xx	
Less returns	xxx			--------	xxxx
	-------------	xxxx	By closing stock		xxx
To Direct expenses:			By gross loss (if loss)		xxx
Carriage inward		xxx			
Freight		xxx			
Octroi		xxx			
Dock dues		xxx			
Excise duty		xxx			
Royalty		xxx			
Motive power		xx			
Coal, gas, water		xxx			
Factory expenses		xxx			
To Gross Profit (if profit)		xxx			
		xxxxx			xxxxx

Format for Profit and Loss Account

Profit & Loss Account

Dr. (For the year ended…) Cr.

Particulars	Amount	Particulars	Amount
To Gross loss b/d	Xxx	By Gross Profit b/d	Xxx
To Salaries	Xxx	By Discount Received	Xxx
To Office rent, rates and taxes	Xxx	By Commission Received	Xxx
To Printing & stationery	Xxx	By Bank Interest	Xxx
To Telephone expenses	Xxx	By Rent received	Xxx
To Postage & telegram	Xxx	By Dividend on shares	Xxx
To Discount Allowed	Xxx	By Interest earned on debentures	Xxx
To Insurance	Xxx	By Profit on sale of asset	Xxx
To Audit Fees	Xxx	By Net loss	Xxx
To Electricity charges	Xxx		
To Repairs & renewals	Xxx		
To Depreciation	Xxx		
To Advertisement	Xxx		
To Carriage Outwards	Xxx		
To Bad Debts	Xxx		
To Provision for Bad debts	Xxx		
To Selling commission	Xxx		
To Bank Charges	Xxx		
To Interest on loans	Xxx		
To Loss on sale of asset	Xxx		
To Net Profit	Xxx		
	XXX		XXX

Format for Balance Sheet

Balance Sheet of ....
as on ....

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Sundry creditors		xxx	Cash in hand		xxx
Bills payable		xxx	Cash at bank		xxx
Bank overdraft		xxx	Bills receivable		xxx
Outstanding expenses		xxx	Sundry debtors		xxx
Mortgage loans		xxx	Investments		xxx
Reserve fund		xxx	Closing stock		xxx
Capital	xxx		Prepaid expenses		xxx
Add: Net profit (or)			Furniture & fittings		xxx
Less: Net loss	xxx		Plant & machinery		xxx
	xxx		Land & buildings		xxx
Less: Drawings	xxx		Business premises		xxx
	xxx		Patents & trade marks		xxx
Less: Income tax	xxx		Good will		xxx
		xxx			
		xxx			xxx

Financial Statement with Adjustments (Journal Entries)

Effect of Adjustment

Before we start seeing all the adjustments one by one, some matters must be considered at the time of adjustment:

- Accounting for items mentioned in the trial balance will be carried out only once i.e. in one account only whether in the Trading A/c, Profit and Loss A/c, or Balance Sheet.
- Accounting for items given outside the trial balance in adjustments will be carried out twice or at two places or two accounts.

Now we will see all the adjustments one by one:

1. Closing Stock:

The number of goods that remain unsold at the end of the financial year is called closing stock. It is valued at cost price or market price whichever is less.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Closing Stock A/c Dr. To Trading A/c			

Adjustment:

If Closing Stock is given outside the trial balance: Usually closing stock is given outside the trial balance. In such case, two entries are passed-

- In the Cr. side of the Trading A/c.
- In the Assets side of the Balance Sheet.

If Closing Stock is given inside the trial balance: If Closing Stock is given in the trial balance then it will be recorded only once in the Assets side of the Balance Sheet.

2. Outstanding Expenses:

Outstanding expenses are those expenses that are related to the same accounting period of which accounts are being made but are not yet paid.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Expenses A/c Dr. To Outstanding Expenses A/c			

Adjustment:

If Outstanding Expense is given outside the trial balance: In such case, two entries will be passed-

- Will be added in the concerned item (expense) at the Dr. side of Trading A/c or Profit & Loss A/c.

- Will be shown in the liabilities side of the balance sheet.

If Outstanding Expense is given inside the trial balance: It will be only shown on the liabilities side of the Balance Sheet. (Because it is a Representative Personal A/c which has a Cr. balance)

3. Prepaid Expenses:

Such expenses which are concerned with the next financial year but have been paid in the current year are called prepaid expenses.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Prepaid Expenses A/c Dr. To Expenses A/c			

Adjustment:

If Prepaid Expenses is given outside the trial balance: In such, case two entries will be passed-

- Will be deducted from the related Expenses A/c in the Dr. side of the Trading A/c or Profit & Loss A/c
- Will be shown in the Assets side of the Balance Sheet (Because it is a Representative Personal A/c the benefit of which will be received in the next year)

If Prepaid Expenses is given inside the trial balance: It will only be shown in the Assets side of the Balance Sheet. (Because it is a Representative Personal A/c and has a Dr. balance)

4. Accrued Income:

Such an income that has been earned but not yet received in the current financial year is called Accrued Income.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Accrued Income A/c Dr. To Income A/c			

Adjustment:

If Accrued Income is given outside the trial balance: In such case, two entries will be passed-

- Will be added to the related Income A/c in the Cr. side of Profit & Loss A/c.

- Will be shown in the Assets side of the Balance Sheet or added to the concerned source in the Assets side of the Balance Sheet.

If Accrued Income is given inside the trial balance: It will only be shown on the Assets side of the Balance Sheet.

5. Unearned Income:

Such an income that has not been earned as yet but has been received in advance is called Unearned Income.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Income A/c Dr. To Unearned Income A/c			

Adjustment:

If Unearned Income is given outside the trial balance: In such cases, two entries will be passed-

- Will be deducted from the related Income A/c in the Cr. side of the Profit & Loss A/c
- Will be shown in the Liabilities side of the Balance Sheet.

If Unearned Income is given inside the trial balance: It will only be shown in the Liabilities side of the Balance Sheet.

6. Interest on Capital:

Sometimes there is a provision of interest being given on the capital brought in by the proprietor or partners. Interest on Capital is a loss to the business while profit for the proprietor.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Interest on Capital A/c Dr. To Capital A/c			

Adjustment:

If Interest on Capital is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Dr. side of the Profit & Loss A/c.

- Amount of Interest on Capital is added to the Capital A/c in the Liabilities side of the Balance Sheet.

If Interest on Capital is given inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

7. Interest on Drawings:

Money or Goods withdrawn by the proprietor from the business for personal use is called drawings. Drawings are a sort of loan taken by the proprietor from the business. Sometimes proprietor has to pay interest on his drawings which is called Interest on Drawings.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Drawings A/c Dr. To Interest on Drawings A/c			

Adjustment:

If Interest on Drawings is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Cr. side of the Profit & Loss A/c. (It is a kind of income for the business)
- Amount of Interest on Drawings is added to the Drawings A/c and deducted from the Capital A/c in the Liabilities side of the Balance Sheet.

If Interest on Drawings is given Inside the trial balance: It will only be shown in the Cr. side of the Profit & Loss A/c.

8. Interest on Deposits:

The interest received on the amount deposited in the Bank is called Interest on Deposits. It is an income for the firm.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Bank Deposits A/c Dr. To Interest on Deposits A/c			

Adjustment:

If Interest on Deposits is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Cr. side of the Profit & Loss A/c. (It is income for the business)
- Amount of Interest on Deposits is added to the Bank Deposits in the Assets side of the Balance Sheet.

If Interest on Deposits is given Inside the trial balance: It will only be shown in the Cr. side of the Profit & Loss A/c.

9. Interest on Loan:

If money is invested in the business by taking a loan then interest has to be paid on that loan. If Interest has not been paid in the same financial year then this is called Outstanding Interest. So, the entries will be the same as **Outstanding Expenses (** Point No. 2 of Adjustments of this Article **)**

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Interest on Loan A/c Dr. To Outstanding Interest A/c			

Adjustment:

If Interest on Loan is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Dr. side of the Profit & Loss A/c.
- Amount of Interest on Loan is added to the Loan A/c in the Liabilities side of the Balance Sheet.

If Interest on Loan is given Inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

10. Proprietor's Salary:

If the proprietor work in the firm, the firm has to a pay salary to the proprietor. The proprietor's salary is an expense to the firm.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Proprietor's salary A/c Dr. To Capital A/c			

Adjustment:

If Proprietor's Salary is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Dr. side of the Profit & Loss A/c.
- Amount of Proprietor's Salary is added to the Capital A/c in the Liabilities side of the Balance Sheet.

If Proprietor's Salary is given Inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

11. Depreciation:

Reduction in the value of fixed assets due to wear and tear caused by continuous use or any other reason is called Depreciation. It is a loss to the business.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Depreciation A/c Dr. To Fixed Assets A/c			

Adjustment:

If Depreciation is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Dr. side of the Profit & Loss A/c.
- Amount of Depreciation is deducted from the concerned Fixed Assets in the Assets side of the Balance Sheet.

If Depreciation is given Inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

12. Appreciation:

Sometimes the value of Fixed Assets increases due to a change in the price level, such an increase is called Appreciation. It is a type of income for the business.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Fixed Assets A/c Dr. To Appreciation A/c			

Adjustment:

If Appreciation is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Cr. side of the Profit & Loss A/c.
- Amount of Appreciation is added to the concerned Fixed Assets in the Assets side of the Balance Sheet.

If Appreciation is given Inside the trial balance: It will only be shown in the Cr. side of the Profit & Loss A/c.

13. Bad Debts:

A businessman sells his goods on cash as well as on credit. The buyers to whom the goods are sold on credit are called Debtors. These are also known as Book Debts. When a debtor is unable to pay off his debts due to any reason then such debts are called irrecoverable or Bad Debts. It is a loss to the business.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Bad Debts A/c Dr. To Debtors A/c			

Adjustment:

If Bad Debts is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Dr. side of the Profit & Loss A/c.
- Amount of Bad Debts is deducted from the Debtors in the Assets side of the Balance Sheet.

If Bad Debts is given Inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

14. Provision for Bad & Doubtful Debts:

Even after deducting the bad debts from the debtors, all the remaining debtors cannot be considered as Good Debtors. We may have doubts about some of the debtors that whether they will be able to pay their debts or not, for such doubtful debtors a provision for a certain amount from the current year's profit is made so that next year the amount which remains unrecovered can be adjusted from the provision.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Profit & Loss A/c Dr. To Provision for Bad & Doubtful Debts A/c			

Adjustment:

If Provision for Bad & Doubtful Debts is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Dr. side of the Profit & Loss A/c.
- Amount of Provision for Bad & Doubtful Debts is deducted from the Debtors in the Assets side of the Balance Sheet.

If Provision for Bad & Doubtful Debts is given inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

15. Bad Debts Recovered:

Sometimes the amount earlier written as Bad Debts is now recovered, it is considered as a gain to the business.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Cash A/c Dr. To Bad Debts Recovered A/c			

Adjustment:

If Bad Debts Recovered is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Cr. side of the Profit & Loss A/c or case of Bad Debts already given then it is deducted from Bad Debts in the Dr. side of the Profit & Loss A/c.
- Amount of Bad Debts Recovered is added to Cash A/c in the Assets side of the Balance Sheet.

If Bad Debts Recovered is given inside the trial balance: It will only be shown in the Cr. side of the Profit & Loss A/c or in e of Bad Debts already given then it is deducted from Bad Debts in the

Dr. side of the Profit & Loss A/c.

16. Provision for Discount on Debtors:

Almost all businessmen provide discounts to their debtors to encourage them to make prompt payments. Provision for Discount on Debtors is created in the same way as the provision for bad & doubtful debts because at the end of the year there will undoubtedly be some debtors who will be provided da iscount to receive prompt payments next year.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Profit & Loss A/c Dr. To Provision for Discount on Debtors A/c			

Adjustment:

If Provision for Discount on Debtors is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Dr. side of the Profit & Loss A/c.
- Amount of Provision for Discount on Debtors is deducted from the Debtors in the Assets side of the Balance Sheet.

If Provision for Discount on Debtors is given inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

17. Provision for Discount on Creditors:

Like the way we provide discounts to our debtors, in the same way, our creditors provide a discount to us for receiving prompt payments. Discount received is a gain for the business.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Provision for Discount on Creditors A/c Dr. To Profit & Loss A/c			

Adjustment:

If Provision for Discount on Creditors is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Cr. side of the Profit & Loss A/c.

- Amount of Provision for Discount on Creditors is deducted from the Creditors A/c in the Liabilities side of the Balance Sheet.

If Provision for Discount on Creditors is given inside the trial balance: It will only be shown in the Cr. side of the Profit & Loss A/c.

18. Loss of Insured Goods and Assets:

Sometimes businessman faces the loss of Goods or Assets due to fire, flood, earthquake, etc. This type of loss is called abnormal loss. Mostly all the goods and assets are insured.

(I) Accounting treatment of loss of Insured Goods: Such losses are classified into three categories:

A} Insurance Company doesn't accept the claim-

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
(i)	Loss by Accident/Fire/Theft A/c Dr. To Purchases A/c			
(ii)	Profit & Loss A/c Dr. To Loss by Accident/Fire/Theft A/c			

Adjustment:

If Loss by Accident/Fire/Theft is given outside the trial balance: In such case, two entries will be passed-

- Will be shown in the Cr. side of the Trading A/c. [By Goods Lost] [At the total amount of loss]
- Will be shown in Dr. side of Profit & Loss A/c. the [At the actual amount of Loss]

If Loss by Accident/Fire/Theft is given inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

B} Insurance company partially accepted the claim-

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
(i)	Loss by Accident/Fire/Theft A/c Dr. Insurance Company A/c Dr. To Purchases A/c		[Actual Amount of Loss] [Value of Claim Accepted]	[Total Amount of Loss]
(ii)	Profit & Loss A/c Dr. To Loss by Accident/Fire/Theft A/c			

Adjustment:

If Loss by Accident/Fire/Theft is given outside the trial balance: In such case, three entries will be passed-

- Will be shown in the Cr. side of the Trading A/c. [By Goods Lost] [At the total amount of loss]
- Will be shown in Dr. side of Profit & Loss A/c. [At the actual amount of Loss]
- Will be shown in the Assets side of the Balance Sheet. [By Insurance Claim] [Value of Claim Accepted]

If Loss by Accident/Fire/Theft is given inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

C} Insurance Company fully accept the claim-

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Insurance Company A/c Dr. To Purchases A/c		[Value of Claim Accepted]	[Total Amount of Loss]

Adjustment:

If Loss by Accident/Fire/Theft is given outside the trial balance: In such case, two entries will be passed-

- Will be shown in the Cr. side of the Trading A/c. [By Goods Lost] [At the total amount of loss]

- Will be shown in the Assets side of the Balance Sheet. [By Insurance Claim] [Value of Claim Accepted]

If Loss by Accident/Fire/Theft is given inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

(II) Accounting treatment of loss of Insured Assets: Such losses are classified into three categories:

A} Insurance Company doesn't accept the claim-

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
(i)	Loss by Accident/Fire/Theft A/c Dr. To Particular Assets A/c			
(ii)	Profit & Loss A/c Dr. To Loss by Accident/Fire/Theft A/c			

Adjustment:

If Loss by Accident/Fire/Theft is given outside the trial balance: In such case, two entries will be passed-

- Will be shown in Dr. side of Profit & Loss A/c. [At the actual amount of Loss]
- Will be deducted from the Particular Asset in the Assets side of the Balance Sheet. [At the full amount of loss]

If Loss by Accident/Fire/Theft is given inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

B} Insurance company partially accepted the claim-

Journal Entry:

Date	Particulars		LF	Amount(Dr.)	Amount(Cr.)
(i)	Loss by Accident/Fire/Theft A/c Insurance Company A/c To Particular Assets A/c	Dr. Dr.		[Actual Amount of Loss] [Value of Claim Accepted]	[Total Amount of Loss]
(ii)	Profit & Loss A/c To Loss by Accident/Fire/Theft A/c	Dr.			

Adjustment:

If Loss by Accident/Fire/Theft is given outside the trial balance: In such case, three entries will be passed-

- Will be shown in Dr. side of Profit & Loss A/c. [At the actual amount of Loss]
- Will be deducted from the Particular Asset in the Assets side of the Balance Sheet. [At the full amount of loss]
- Will be shown in Assets side of the Balance Sheet. [By Insurance Claim] [Value of Claim Accepted]

If Loss by Accident/Fire/Theft is given inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

C} Insurance Company fully accept the claim-

Journal Entry:

Date	Particulars		LF	Amount(Dr.)	Amount(Cr.)
	Insurance Company A/c To Particular Assets A/c	Dr.		[Value of Claim Accepted]	[Total Amount of Loss]

Adjustment:

If Loss by Accident/Fire/Theft is given outside the trial balance: In such case, two entries will be passed-

- Will be shown in Assets side of the Balance Sheet. [By Insurance Claim] [Value of Claim Accepted]
- Will be deducted from the Particular Asset in the Assets side of the Balance Sheet. [At the full amount of loss]

If Loss by Accident/Fire/Theft is given inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

19. Goods are given away as Charity or Free Sample:

Sometimes Goods are given as charity or free sample. In accounting terms, it is considered as loss.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Charity/Free Sample A/c Dr. To Purchases A/c			

Adjustment:

If Charity/Free Sample is given outside the trial balance: In such case, two entries will be passed-

- Will be shown in the Dr. side of the Profit & Loss A/c
- Amount of Goods given as Charity/Free Sample will be deducted from Purchases A/c in the Trading A/c

If Charity/Free Sample is given inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

20. Goods used for Personal Purpose:

Sometimes proprietors withdraw goods from the business for personal use. Business treat those goods as Drawings.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Drawings A/c Dr. To Purchases A/c			

Adjustment:

If Goods used for Personal Purpose is given outside the trial balance: In such case, two entries will be passed-

- Amount of Goods used for Personal Purpose (Drawings) will be deducted from Purchases A/c in the Trading A/c
- Amount of Goods used for Personal Purpose (Drawings) will be added to Drawings then deducted from Capital A/c in the Liabilities side of Balance Sheet.

21. Use of Goods in Business:

When a trader uses a portion of goods purchased for the business then that portion of goods becomes Assets for the business.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Assets A/c (Name) Dr. To Purchases A/c			

Adjustment:

If Use of Goods in Business is given outside the trial balance: In such case, two entries will be passed-

- Amount of Goods used in Business will be deducted from Purchases A/c in the Trading A/c
- Amount of Goods used in Business will be shown as an Asset in the Assets side of the Balance Sheet.

22. Manager's Commission on Profit:

Sometimes the Manager in the firm asks for a commission on the Gross Profit or Net Profit. It is an expense to the business.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Profit & Loss A/c Dr. To Manager's Commission A/c			

Adjustment:

If Manager's Commission is given outside the trial balance: In such case, two entries will be passed-

- Will be shown in the Dr. side of the Profit & Loss A/c
- Amount of Manager's Commission is shown as an Outstanding Liability in the Liabilities side of the Balance Sheet.

23. Deferred Revenue Expenditure:

Sometimes there are certain expenses the benefit of which is received for some years but the payment is made in the current financial year itself. If the total burden of such expenses is put on the current financial year then it would be wrong as the profits will be reduced while the benefit out of such expense will be received for some years. Thus, such expenses are divided equally for an estimated period of receiving benefits.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Profit & Loss A/c Dr. To Deferred Revenue Expenditure A/c		[Amt belonging to this year]	

Adjustment:

If Deferred Revenue Expenditure is given outside the trial balance:

- Will be shown in the Dr. side of the Profit & Loss A/c
- The remaining amount of the Deferred Revenue Expenditure [For future years] is shown as an asset in the Assets side of the Balance Sheet.

24. Contingent Liabilities:

Contingent Liability is such a liability that is not a liability on the date of preparing the Balance Sheet but in the future due to some specific turn of events become a liability.

Accounting Treatment: No record is kept in the books of accounts for the contingent liability, it should be mentioned as a NOTE below the Balance Sheet.

25. Sale of Goods on Sale or Return Basis:

When Goods are sold as Sale or Return Basis then this should not be treated as an actual sale till the customer gives his approval. If such a sale has been already entered in the sales book then an adjustment entry should be made to rectify the error made.

Journal Entry:

SALE

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
(i)	Sales A/c Dr. To Debtors A/c		[At Selling Price]	
(ii)	Closing Stock A/c Dr. To Trading A/c		[At Cost Price]	

Adjustment:

If Sale of Goods on Sale or Return Basis is given outside the trial balance: In such case, four entries will be passed-

- The amount will be deducted from Sales A/c in the Cr. Side of the Trading A/c.[At Selling Price]
- The amount will be deducted from Debtors on the Assets side of the Balance Sheet.[At Selling Price]
- The amount will be added to Closing Stock in the Cr. side of the Trading A/c.[At Cost Price]
- The amount will be added back to Closing Stock in the Assets side of the Balance Sheet.[At Cost Price]

26. Goods in Transit:

Sometimes ordered goods are dispatched by the supplier but not received till the date of preparing the Balance Sheet. We have to make an adjustment entry in such a case.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Goods in Transit A/c Dr. To Creditors A/c			

Adjustment:

If Goods in Transit is given outside the trial balance: In such case, two entries will be passed-

- Will be shown in the Assets side of the Balance Sheet.
- Added to the Creditors A/c in the Liabilities side of the Balance Sheet.

If Goods in Transit is given inside the trial balance: It will only be shown in the Assets side of the Balance Sheet.

Problem No. 1

The following balances were extracted from the books of Akshay Desai as on 31st March 2019. Prepare Trading & Profit and Loss Account for the year ended on 31st March 2019 and the Balance Sheet as on that date after taking into account the following adjustments:

		Debit	Credit
Akshay's Capital	L	-	1,65,000
Akshay's Drawings	(-)	12,225	-
Opening Stock	TD	1,00,000	-
Bills Receivable	A	12,500	-
Purchases	TD	1,37,500	-
Sales	TC	-	2,00,000
Bills Payable	L	-	30,000
Return Outward	(-)	-	2,250
Return Inward	(-)	2,500	-
Plant & Machinery	A	50,000	-
Loose Tools	A	12,500	-
Patents	A	12,500	-
Sundry Debtors	A	62,500	-
Sundry Creditors	L	-	70,000
Cash at Bank	A	38,775	-
Salaries & Wages	PD	15,000	-
Repairs & Renewals	PD	3,750	-
Insurance	PD	1,500	-
Power & Fuel	TD	1,750	-
Printing & Stationery	PD	1,000	-
Miscellaneous Expenses	PD	3,250	-
Total		467250	4,67,250

Adjustments:

1. Closing stock was worth ₹ 65000/-.
2. Depreciate Plant and Machinery by 5% and Patents by 15%
3. Revalue Tools ₹ 10,000/-.
4. Provide for outstanding expenses as follows:
   a) Salaries ₹ 1250/-. b) Wages ₹ 500/-.
5. Insurance paid in advance to the extent of ₹ 375/-.

Solution:

1. **Closing stock** was worth ₹ 65000/-. TC A

2. **Depreciate** Plant and Machinery by 5% and Patents by 15%

   (Less) PD

3. **Revalue Tools** ₹ 10,000/-.

   - Dep. 12500 – 10000 = **2500** (Less) Tools PD (as a depreciation)

4. Provide for outstanding expenses as follows:
   b) Salaries ₹ 1250/-. b) Wages ₹ 500/-.

   Outstanding (Add) L

5. Insurance **paid in advance** to the extent of ₹ 375/-.

   (Less) A

In the books of Mr. Akshay

Trading & Profit and Loss Account (as on 31/03/2019)

Particulars	Amount (`)	Amount (`)	Particulars	Amount (`)	Amount (`)
To Opening Stock		100,000	By Sales		
			(–)Return Inward		
To Purchases			By closing stock		
(–) Return Outward					
To Power & Fuel					
To Gross Profit c/d					

Particulars	Amount (`)	Amount (`)	Particulars	Amount (`)	Amount (`)
To Salary & Wages			By Gross Profit b/d		
Add- Outstanding	1250		By Net Loss		
To Repairs & Renewals					
To Insurance					
Less: Prepaid					
To Miscellaneous Exps.					
To Printing & Stationary					
To Depreciation:					
Plant & Machinery					
Tools					
Patents					
To RDD					

Balance Sheet of as on 31.12.2019

Liabilities	Amount (`)	Amount (`)	Liabilities	Amount (`)	Amount (`)
Capital			Cash in Bank		
			Plant & Machinery		
			Less: 5% Dep.		
Less: Drawings			Loose Tools		
			Less: Dep.		
			Patents		
Less: Net Loss			Less : Dep. 15%		
Bills Payable			Sundry Debtors		
Sundry Creditors			Less: RDD 5%		
Outstanding salaries & wages			Bills Receivable		
			Closing Stock		
			Prepaid Insurance		

UNIT III

Cost Accounting

Basic Concepts of Cost Accounting:

Cost Accounting may be defined as "Accounting for costs classification and analysis of expenditure as will enable the total cost of any particular unit of production to be ascertained with reasonable degree of accuracy and at the same time to disclose exactly how such total cost is constituted".

Thus Cost Accounting is classifying, recording an appropriate allocation of expenditure for the determination of the costs of products or services, and for the presentation of suitably arranged data for the purpose of control and guidance of management.

Cost Accounting can be explained as follows :- Cost Accounting is the process of accounting for cost which begins with recording of income and expenditure and ends with the preparation of statistical data. It is the formal mechanism by means of which cost of products or services are ascertained and controlled. Cost Accounting provides analysis and classification of expenditure as will enable the total cost of any particular unit of product / service to be ascertained with reasonable degree of accuracy and at the same time to disclose exactly how such total cost is constituted. For example it is not sufficient to know that the cost of one pen is ` 25/- but the management is also interested to know the cost of material used, the amount of labour and other expenses incurred so as to control and reduce its cost. It establishes budgets and standard costs and actual cost of operations, processes, departments or products and the analysis of variances, profitability and social use of funds.

Thus Cost Accounting is a quantitative method that collects, classifies, summarises and interprets information for product costing, operation planning and control and decision making.

Objectives of Cost Accounting:

The following are the main objectives of Cost Accounting :-

(a) To ascertain the Costs under different situations using different techniques and systems of costing

(b) To determine the selling prices under different circumstances

(c) To determine and control efficiency by setting standards for Materials, Labour and Overheads

(d) To determine the value of closing inventory for preparing financial statements of the concern

(e) To provide a basis for operating policies which may be determination of Cost Volume relationship, whether to close or operate at a loss, whether to manufacture or buy from market, whether to continue the existing method of production or to replace it by a more improved method of production....etc

Scope of Cost Accountancy:

The scope of Cost Accountancy is very wide and includes the following:-

(a) Cost Ascertainment: The main objective of Cost Accounting is to find out the Cost of product / services rendered with reasonable degree of accuracy.

(b) Cost Accounting: It is the process of Accounting for Cost which begins with recording of expenditure and ends with preparation of statistical data.

(c) Cost Control: It is the process of regulating the action so as to keep the element of cost within the set parameters.

(d) Cost Reports: This is the ultimate function of Cost Accounting. These reports are primarily prepared for use by the management at different levels. Cost reports helps in planning and control, performance appraisal and managerial decision making.

(e) Cost Audit: Cost Audit is the verification of correctness of Cost Accounts and check on the adherence to the Cost Accounting plan. Its purpose is not only to ensure the arithmetic accuracy of cost records but also to see the principles and rules have been applied correctly. To appreciate fully the objectives and scope of Cost Accounting, it would be useful to examine the position of Cost Accounting in the broader field of general accounting and other sciences. i.e Financial Accounting, Management Accounting, Engineering and Service Industry.

Advantages of Cost Accounting:

Cost Accounting has manifold advantages, a summary of which is given below. It is not suggested that having installed a system of Cost Accounting, a concern will expect to derive all the benefits stated here, the nature and the extent of the advantages obtained will depend upon the type, adequacy and efficiency of the cost system installed and the extent to which the various levels of management are prepared to accept and act upon the advice rendered by the cost system. The Cost Accounting System has the following advantages:-

(i) A cost system reveals unprofitable activities, losses or inefficiencies occurring in any form such as (a) Wastage of man power, idle time and lost time. (b) Wastage of material in the form of spoilage, excessive scrap etc., and (c) Wastage of resources, e.g. inadequate utilization of plant, machinery and other facilities.

(ii) Cost Accounting locates the exact causes for decrease or increase in the profit or loss of the business. It identifies the unprofitable products or product lines so that these may be eliminated or alternative measures may be taken.

(iii) Cost Accounts furnish suitable data and information to the management to serve as guides in making decisions involving financial considerations.

(iv) Cost Accounting is useful for price fixation purposes. Although sale price is generally related more to economic conditions prevailing in the market than to cost, the latter serves as a guide to test the adequacy of selling prices.

(v) With the application of Standard Costing and Budgetary Control methods, the optimum level of efficiency is set.

(vi) Cost comparison helps in cost control. Comparison may be period to period, of the figures in respect of the same unit or factory or of several units in an industry by employing Uniform Costs and Inter- Firm Comparison methods. Comparison may be made in respect of cost of jobs, process or cost centres.

(vii) A cost system provides ready figures for use by the Government, wage tribunals and boards, and labour and trade unions.

(viii) When a concern is not working to full capacity due to various reasons such as shortage of demands or bottlenecks in production, the cost of idle capacity can readily worked out and repealed to the management.

(ix) Introduction of a cost reduction programme combined with operations research and value analysis techniques leads to economy.

(x) Marginal Costing is employed for suggesting courses of action to be taken. It is a useful tool for the management for making decisions.

(xi) Determination of cost centres or responsibility centres to meet the needs of a Cost Accounting system, ensures that the organizational structure of the concern has been properly laid responsibility can be properly defined and fixed on individuals.

(xii) Perpetual inventory system which includes a procedure for continuous stock taking is an essential feature of a cost system.

(xiii) The operation of a system of cost audit in the organization prevents manipulation and fraud and assists in furnishing correct and reliable cost data to the management as well as to outside parties like shareholders, the consumers and the Government.

Cost Centre

CIMA defines a cost centre as "a location, a person, or an item of equipment (or a group of them) in or connected with an undertaking, in relation to which costs ascertained and used for the purpose of cost control". The determination of suitable cost centres as well as analysis of cost under cost centres is very helpful for periodical comparison and control of cost. In order to obtain the cost of product or service, expenses should be suitably segregated to cost centre. The manager of a cost centre is held responsible for control of cost of his cost centre. The selection of suitable cost centres or cost units for which costs are to be ascertained in an undertaking depends upon a number of factors such as organization of a factory, condition of incidence of cost, availability of information, requirements of costing and management policy regarding selecting a method from various choices.

Cost centre may be production cost centres operating cost centres or process cost centres depending upon the situation and classification. Cost centres are of two types-Personal and Impersonal Cost Centre. A personal cost centre consists of person or group of persons. An impersonal cost centre consists of a location or item of equipment or group of equipments. In a manufacturing concern, the cost centres generally follow the pattern or layout of the departments or sections of the factory and accordingly, there are two main types of cost centres as below :-

(i) Production Cost Centre: These centres are engaged in production work i.e engaged in converting the raw material into finished product, for example Machine shop, welding shops...etc

(ii) Service Cost Centre: These centres are ancillary to and render service to production cost centres, for example Plant Maintenance, Administration...etc The number of cost centres and the size of each vary from one undertaking to another and are dependent upon the expenditure involved and the requirements of the management for the purpose of control.

(iii) Responsibility Centre: A responsibility centre in Cost Accounting denotes a segment of a business organization for the activities of which responsibility is assigned to a specific person. Thus a factory may be split into a number of centres and a supervisor is assigned with the responsibility of each centre. All costs relating to the centre are collected and the Manager responsible for such a cost centres judged by reference to the activity levels achieved in relation to costs. Even an individual machine may be treated as responsibility centre for cost control and cost reduction.

(iv) Profit Centre Profit centre is a segment of a business that is responsible for all the activities involved in the production and sales of products, systems and services. Thus a profit centre encompasses both costs that it incurs and revenue that it generates. Profit centres are created to delegate responsibility to individuals and measure their performance. In the concept of responsibility accounting, profit centres are sometimes also responsible for the investment made for the centre. The profit is related to the invested capital. Such a profit centre may also be termed as investment centre.

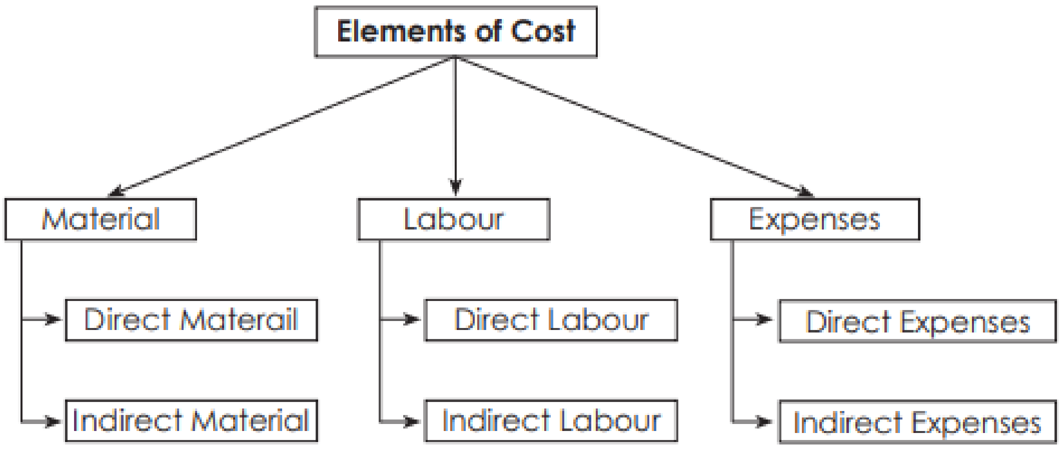
Cost Unit:

Cost Unit is a device for the purpose of breaking up or separating costs into smaller sub divisions attributable to products or services. Cost unit can be defined as a ‘Unit of product or service in relation to which costs are ascertained’. The cost unit is the narrowest possible level of cost object. It is the unit of quantity of product, service of time (or combination of these) in relation to which costs may be ascertained or expressed. We may, for instance, determine service cost per tonne of steel, per tonne-kilometre of a transport service or per machine hour. Sometimes, a single order or contract constitutes a cost unit which is known as a job. A batch which consists of a group of identical items and maintains its identity through one or more stages or production may also be taken as a cost unit.

A few examples of cost units are given below:

Industry / Product	Cost Unit
Automobile	Number of vehicles
Cable	Metres / kilometres
Cement	Tonne
Chemicals / Fertilizers	Litre / Kilogram / tonne
Gas	Cubic Metre
Power - Electricity	Kilowatt Hour
Transport	Tonne-Kilometre, Passenger-Kilometre
Hospital	Patient Day
Hotel	Bed Night
Education	Student year
Telecom	Number of Calls
BPO Service	Accounts handled
Professional Service	Chargeable Hours

Elements of Cost:



Direct Material + Direct Labour + Direct Expenses = Prime Cost

Indirect Material+ Indirect Labour + Indirect Expenses = Overheads

Direct Material Cost

Direct material cost can be defined as 'The Cost of material which can be attributed to a cost object in an economically feasible way'. Direct materials are those materials which can be identified in the product and can be conveniently measured and directly charged to the product. Thus, these materials directly enter the product and form a part of the finished product. For example, timber in furniture making, cloth in dress making, bricks in building a house. The following are normally classified as direct materials:-

(i) All raw materials, like jute in the manufacture of gunny bags, pig iron in foundry and fruits in canning industry.

(ii) Materials specifically purchased for a specific job, process or order, like glue for book binding, starch powder for dressing yarn.

(iii) Parts or components purchased or produced, like batteries for transistor-radios.

(iv) Primary packing materials like cartons, wrappings, card-board boxes, etc.

Indirect Material Cost

Materials, the costs of which cannot be directly attributed to a particular cost object. Indirect materials are those materials which do not normally form a part of the finished product.

These are:

(i) Stores used in maintenance of machinery, buildings, etc., like lubricants, cotton waste, bricks and cements.

(ii) Stores used by the service departments, i.e., non-productive departments like Power House, Boiler House and Canteen, etc., and (

(iii) Materials which due to their cost being small, are not considered worthwhile to be treated as direct materials.

Direct Labor / Employee Cost

The cost of employees which can be attributed to a cost object in an economically feasible way.

In simple words, it is that labor which can be conveniently identified or attributed wholly to a particular job, product or process or expended in converting raw materials into finished goods. Wages of such labour are known as direct wages. Thus it includes payment made to the following groups of labour:

(i) Labour engaged on the actual production of the product or in carrying out of an operation or process.

(ii) Labour engaged in adding the manufacture by way of supervision, maintenance, tool setting, transportation of material etc.

(iii) Inspectors, analysts etc., specially required for such production.

Indirect Labour/ Employee Cost

The labour / employee cost which cannot be directly attributed to a particular cost object. The wages of that labour which cannot be allocated but which can be apportioned to or absorbed by cost centres or cost units is known as Indirect Labour. In other words paid to labour which are employed other than on production constitute indirect labour costs. Example of such labour are: charge-hands and supervisors; maintenance workers; men employed in service departments, material handling and internal transport; apprentices, trainees and instructors; clerical staff and labour employed in time office and security office.

Direct or Chargeable Expenses

Direct expenses are expenses relating to manufacture of a product or rendering a service which can be identified or linked with the cost object other than direct material cost and direct employee cost. Direct expenses include all expenditure other than direct material or direct labour that is specifically incurred for a particular product or process. Such expenses are charged directly to the particular cost account concerned as part of the prime cost.

Examples of direct expenses are: (i) Excise duty; (ii) Royalty; (iii) Architect or Supervisor’s fees; (iv) Cost of rectifying defective work; (v) Travelling expenses to the city; (vi) Experimental expenses of pilot projects; (vii) Expenses of designing or drawings of patterns or models; (viii) Repairs and maintenance of plant obtained on hire; and (ix) Hire of special equipment obtained for a contract.

Overhead

Overheads comprise of indirect materials, indirect employee cost and indirect expenses which are not directly identifiable or allocable to a cost object. Overheads may defined as the aggregate of the cost of indirect material, indirect labour and such other expenses including services as cannot conveniently be charged directly to specific cost units. Thus overheads are all expenses other than direct expenses. In general terms, overheads comprise all expenses incurred for or in connection with, the general organization of the whole or part of the undertaking, i.e., the cost of operating supplies and services used by the undertaking and includes the maintenance of capital assets.

Prime Cost

The aggregate of Direct Material, Direct Labour and Direct Expenses. Generally it constitutes 50% to 80% of the total cost of the product, as such, as it is primary to the cost of the product and called Prime Cost.

Cost Object

Cost object is the technical name for a product or a service, a project, a department or any activity to which a cost relates. Therefore the term cost should always be linked with a cost object to be more meaningful. Establishing a relevant cost object is very crucial for a sound costing system. The Cost object could be defined broadly or narrowly. At a broader level a cost object may be named as a Cost Centre, whereas at a lowermost level it may be called as a Cost Unit.

CLASSIFICATION OF COST

Classification of cost is the arrangement of items of costs in logical groups having regard to their nature or purpose. Items should be classified by one characteristic for a specific purpose without ambiguity.

As per Cost Accounting Standard 1 (CAS-1), the basis for cost classification is as follows:

(a) Nature of expense

(b) Relation to Object – Traceability

(c) Functions / Activities

(d) Behaviour – Fixed, Semi-variable or Variable

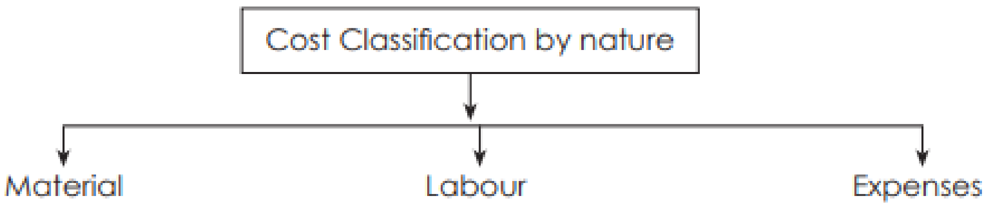
(e) Management decision making

(f) Production Process

(g) Time Period

(a) Classification by Nature of Expense

Costs should be gathered together in their natural grouping such as Material, Labour and Other Direct expenses. Items of costs differ on the basis of their nature. The elements of cost can be classified in the following three categories. 1. Material 2. Labour 3. Expenses



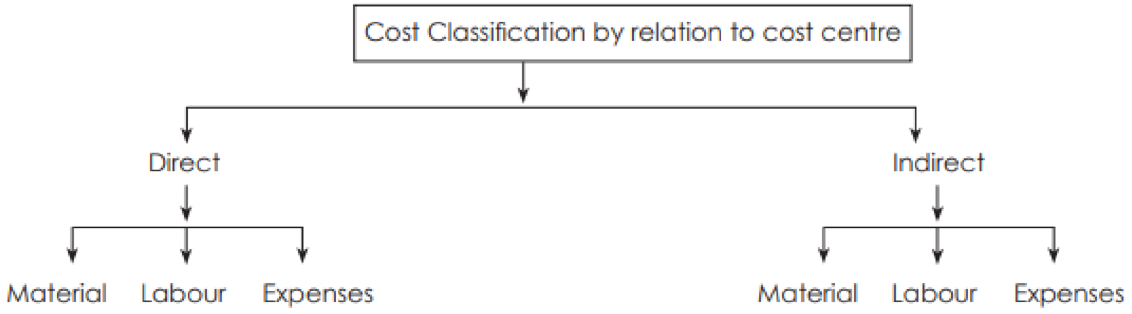
Material Cost: Material cost is the cost of material of any nature used for the purpose of production of a product or a service. It includes cost of materials, freight inwards, taxes & duties, insurance ...etc directly attributable to acquisition, but excluding the trade discounts, duty drawbacks and refunds on account of excise duty and vat.

Labour Cost: Labour cost means the payment made to the employees, permanent or temporary for their services. Labour cost includes salaries and wages paid to permanent employees, temporary employees and also to the employees of the contractor. Here salaries and wages include all the benefits like provident fund, gratuity, ESI, overtime, incentives...etc

Expenses: Expenses are other than material cost or labour cost which are involved in an activity.

(b) Classification by Relation to Cost Centre or Cost Unit:

If expenditure can be allocated to a cost centre or cost object in an economically feasible way then it is called direct otherwise the cost component will be termed as indirect.



Direct Material Cost: Cost of material which can be directly allocated to a cost centre or a cost object in an economically feasible way.

Direct labour Cost: Cost of wages of those workers who are readily identified or linked with a cost centre or cost object.

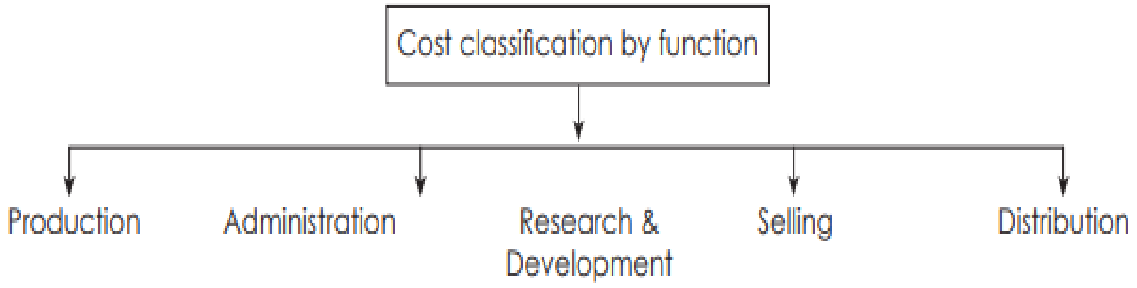
Direct Expenses: Expenses other than direct material and direct labour which can be identified or linked with cost centre or cost object. Direct Material + Direct labour + Direct Expenses = Prime Cost

Indirect Material: Cost of material which cannot be directly allocable to a particular cost centre or cost object.

Indirect Labour : Cost of wages of employees which are not directly allocable to a particular cost centre.

Indirect expenses: Expenses other than of the nature of material or labour and cannot be directly allocable to a particular cost centre. Indirect Material + Indirect Labour + Indirect Expenses = Overheads

(c) Classification by Functions:



i) Production or Manufacturing Costs: Production cost is the cost of all items involved in the production of a product or service. These refer to the costs of operating the manufacturing division of an undertaking and include all costs incurred by the factory from the receipt of raw materials and supply of labour and services until production is completed and the finished product is packed with the primary packing.

The followings are considered as Production or Manufacturing Costs:- (1) Direct Material (2) Direct Labour (3) Direct Expenses and (4) Factory overhead, i.e., aggregate of factory indirect material, indirect labour and indirect expenses. Manufacturing cost can also be referred to as the aggregate of prime cost and factory overhead.

ii) Administration Costs: Administration costs are expenses incurred for general management of an organization. These are in the nature of indirect costs and are also termed as administrative overheads. For understanding administration cost, it is necessary to know the scope of administrative function.

Administrative function in any organization primarily concerned with following activities :-

(1) Formulation of policy

(2) Directing the organization and

(3) Controlling the operations of an organization. But administrative function will not include control activities concerned with production, selling and distribution and research and development.

Therefore, administration cost is the cost of administrative function, i.e., the cost of formulating policy, directing, organizing and controlling the operations of an undertaking (Administrative cost will include the cost of only those control operations which are not related to production, selling and distribution and research and development. In most of the cases, administration cost includes indirect expenses of following types:

(1) Salaries of office staff, accountants, directors

(2) Rent, rates and depreciation of office building

(3) Postage, stationery and telephone

(4) Office supplies and expenses

(5) General administration expenses.

(iii) Selling & Distribution Costs:

Selling costs are indirect costs related to selling of products are services and include all indirect costs in sales management for the organization. Distribution costs are the costs incurred in handling a product from the time it is completed in the works until it reaches the ultimate consumer. Selling function includes activities directed to create and stimulate demand of company's product and secure orders. Distribution costs are incurred to make the saleable goods available in the hands of the customer. Following are the examples of selling and distribution costs: (1) Salaries and commission of salesmen and sales managers. (2) Expenses of advertisement, insurance. (3) Rent, rates, depreciation and insurance of sales office and warehouses. (4) Cost of insurance, freight, export, duty, packing, shipping, etc., (5) Maintenance of Delivery vans.

iv) Research & Development Costs:

Research & development costs are the cost for undertaking research to improve quality of a present product or improve process of manufacture, develop a new product, market research...etc. and commercialization thereof. R&D Costs comprises of the following:-

(1) Development of new product.

(2) Improvement of existing products.

(3) Finding new uses for known products.

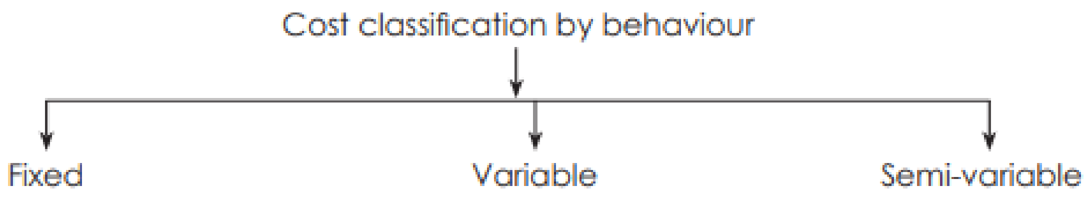
(4) Solving technical problem arising in manufacture and application of products.

(5) Development cost includes the costs incurred for commercialization / implementation of research findings.

v) Pre-Production Costs: These are costs incurred when a new factory is in the process of establishment, a new project is undertaken, or a new product line or product is taken up but there is no established or formal production to which such costs may be charged. Preproduction costs are normally treated as deferred revenue expenditure and charged to the costs of future production.

(d) Classification based on Behaviour

Fixed, Semi-variable or Variable Costs are classified based on behaviour as fixed cost, variable cost and semi-variable cost depending upon response to the changes in the activity levels.



Fixed Cost: Fixed cost is the cost which does not vary with the change in the volume of activity in the short run. These costs are not affected by temporary fluctuation in activity of an enterprise. These are also known as period costs. Example: Rent, Depreciation...etc.

Variable Cost: Variable cost is the cost of elements which tends to directly vary with the volume of activity. Variable cost has two parts (i) Variable direct cost (ii) Variable indirect costs. Variable indirect costs are termed as variable overheads. Example: Direct labour, Outward Freight...etc.

Semi-Variable Costs: Semi variable costs contain both fixed and variable elements. They are partly affected by fluctuation in the level of activity. These are partly fixed and partly variable costs and vice versa. Example: Factory supervision, Maintenance...etc.

(e) Classification based on Costs for Management

Decision Making Ascertainment of cost is essential for making managerial decisions. On this basis costing may be classified into the following types.

Marginal Costing: Marginal Cost is the aggregate of variable costs, i.e. prime cost plus variable overhead. Marginal cost per unit is the change in the amount at any given volume of output by which the aggregate cost changes if the volume of output is increased or decreased by one unit. Marginal Costing system is based on the system of classification of costs into fixed and variable. The fixed costs are excluded and only the marginal costs, i.e. the variable costs are taken into consideration for determining the cost of products and the inventory of work-in-progress and completed products.

Differential Cost: Differential cost is the change in the cost due to change in activity from one level to another.

Opportunity Cost: Opportunity cost is the value of alternatives foregone by adopting a particular strategy or employing resources in specific manner. It is the return expected from an investment other than the present one. These refer to costs which result from the use or application of material, labour or other facilities in a particular manner which has been foregone due to not using the facilities in the manner originally planned. Resources (or input) like men, materials, plant and machinery, finance etc., when utilized in one particulars way, yield a particular return (or output). If the same input is utilized in another way, yielding the same or a different return, the original return on the forsaken alternative that is no longer obtainable is the opportunity cost. For example, if fixed deposits in the bank are proposed to be withdrawn for financing project, the opportunity cost would be the loss of interest on the deposits. Similarly when a building leased out on rent to a party is got vacated for own purpose or a vacant space is not leased out but used internally, say, for expansion of the production programme, the rent so forgone is the opportunity cost.

Replacement Cost: Replacement cost is the cost of an asset in the current market for the purpose of replacement. Replacement cost is used for determining the optimum time of replacement of an equipment or machine in consideration of maintenance cost of the existing one and its productive capacity. This is the cost in the current market of replacing an asset. For example, when replacement cost of material or an asset is being considered, it means that the cost that would be incurred if the material or the asset was to be purchased at the current market price and not the cost, at which it was actually purchased earlier, should be take into account.

Relevant Costs: Relevant costs are costs which are relevant for a specific purpose or situation. In the context of decision making, only those costs are relevant which are pertinent to the decision at hand. Since we are concerned with future costs only while making a decision, historical costs, unless they remain unchanged in the future period are irrelevant to the decision making process.

Imputed Costs: Imputed costs are hypothetical or notional costs, not involving cash outlay computed only for the purpose of decision making. In this respect, imputed costs are similar to opportunity costs. Interest on funds generated internally, payment for which is not actually made is an example of imputed cost. When alternative capital investment projects are being considered out of which one or more are to be financed from internal funds, it is necessary to take into account the imputed interest on own funds before a decision is arrived at.

Sunk Costs: Sunk costs are historical costs which are incurred i.e. sunk in the past and are not relevant to the particular decision making problem being considered. Sunk costs are those that have been incurred for a project and which will not be recovered if the project is terminated. While considering the replacement of a plant, the depreciated book value of the old asset is irrelevant as the amount is sunk cost which is to be written-off at the time of replacement.

Normal Cost & Abnormal Cost: Normal Cost is a cost that is normally incurred at a given level of output in the conditions in which that level of output is achieved. Abnormal Cost is an unusual and typical cost whose occurrence is usually irregular and unexpected and due to some abnormal situation of the production.

Avoidable Costs & Unavoidable Costs: Avoidable Costs are those which under given conditions of performance efficiency should not have been incurred. Unavoidable Costs which are inescapable costs, which are essentially to be incurred, within the limits or norms provided for. It is the cost that must be incurred under a programme of business restriction. It is fixed in nature and inescapable.

Uniform Costing: This is not a distinct system of costing. The term applies to the costing principles and procedures which are adopted in common by a number of undertakings which desire to have the benefits of a uniform system. The methods of Uniform Costing may be extended so as to be useful in inter-firm comparison.

Engineered Cost: Engineered Cost relates to an item where the input has an explicit physical relationship with the output. For instance in the manufacture of a product, there is a definite relationship between the units of raw material and labour time consumed and the amount of variable manufacturing overhead on the one hand and units of the products produced on the other. The input-output relationship can be established the form of standards by engineering analysis or by an analysis of the historical data. It should be noted that the variable costs are not engineered cost but some administration and selling expenses may be categorized as engineered cost.

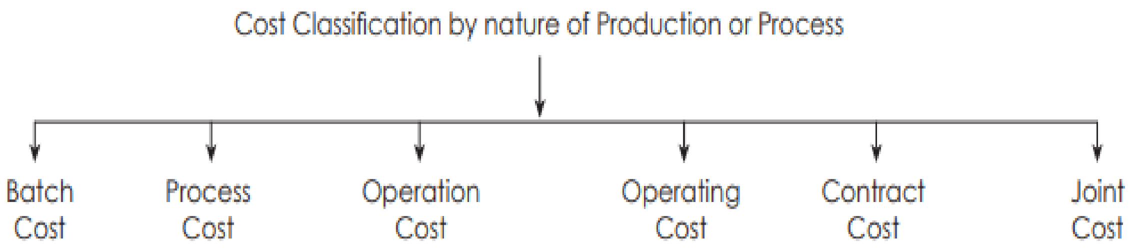
Out-of-Pocket Cost: This is the portion of the cost associated with an activity that involve cash payment to other parties, as opposed to costs which do not require any cash outlay, such as depreciation and certain allocated costs. Out-of-Pocket Costs are very much relevant in the consideration of price fixation during trade recession or when a make-or-buy decision is to be made.

Managed Cost: Managed (Programmed or Discretionary) Costs all opposed to engineering costs, relate to such items where no accurate relationship between the amount spent on input and the output can be established and sometimes it is difficult to measure the output. Examples are advertisement cost, research and development costs, etc.,

Common Costs: These are costs which are incurred collectively for a number of cost centres and are required to be suitably apportioned for determining the cost of individual cost centres. Examples are: Combined purchase cost of several materials in one consignment, and overhead expenses incurred for the factory as a whole.

Controllable and Non-Controllable Costs: Controllable Cost is that cost which is subject to direct control at some level of managerial supervision. Non-controllable Cost is the cost which is not subject to control at any level of managerial supervision.

(f) Classification by nature of Production or Process:



Batch Costing: Batch Costing is the aggregate cost related to a cost unit which consists of a group of similar articles which maintains its identity throughout one or more stages of production. In this method, the cost of a group of products is ascertained. The unit cost is a batch or group of identical products instead of a single job, order, or contract. This method is applicable to general engineering factories which produces components in convenient economical batches.

Process Costing: When the production process is such that goods are produced from a sequence of continuous or repetitive operations or processes, the cost incurred during a period is considered as Process Cost. The process cost per unit is derived by dividing the process cost by number of units produced in the process during the period. Process Costing is employed in industries where a continuous process of manufacturing is carried out. Costs are ascertained for a specified period of time by departments or process. Chemical industries, refineries, gas and electricity generating concerns may be quoted as examples of undertakings that employ process costing.

Operation Cost: Operation Cost is the cost of a specific operation involved in a production process or business activity. The cost unit in this method is the operation, instead of process. When the manufacturing method consists of a number of distinct operations, operation costing is suitable.

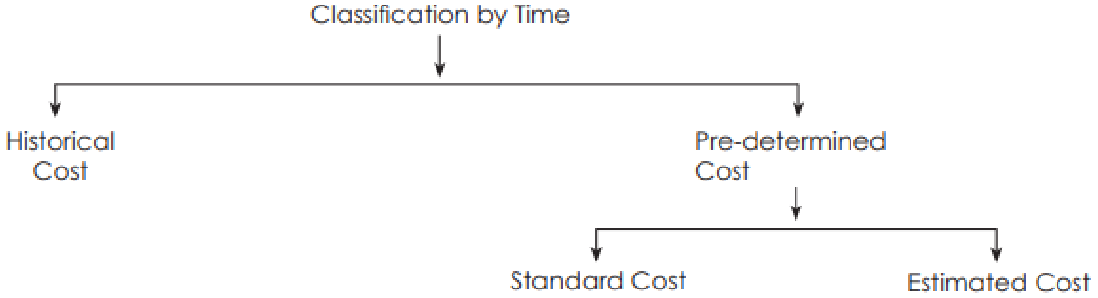
Operating Cost: Operating cost is the cost incurred in conducting a business activity. Operating cost refer to the cost of undertakings which do not manufacture any product but which provide services. Industries and establishments like power house, transport and travel agencies, hospitals, and schools, which undertake services rather than the manufacture of products, ascertain operating costs. The cost units used are Kilo Watt Hour (KWH), Passenger Kilometer and Bed in the hospital....etc. Operation costing method constitutes a distinct type of costing but it may also be classed as a variant of Process Cost since costs in this method are usually compiled for a specified period.

Contract Costing: Contract cost is the cost of contract with some terms and conditions between contractee and contractor. This method is used in undertakings, carrying out, building or constructional contracts like constructional engineering concerns, civil engineering contractors. The cost unit here is a contract, which may continue over more than one financial year.

Joint Costs: Joint costs are the common cost of facilities or services employed in the output of two or more simultaneously produced or otherwise closely related operations, commodities or services. When a production process is such that from a set of same input two or more distinguishably different products are produced together, products of greater importance are termed as Joint Products and products of minor importance are termed as By-products and the costs incurred prior to the point of separation are called Joint Costs. For example in petroleum industry petrol, diesel, kerosene, naphtha, tar is produced jointly in the refinery process.

By-product Cost: By-product Cost is the cost assigned to by-products till the split-off point.

(g) Classification by Time:



Historical Costs: Historical Costs are the actual costs of acquiring assets or producing goods or services. They are post-mortem costs ascertained after they have been incurred and they represent the cost of actual operational performance. Historical Costing follows a system of accounting to which all values are based on costs actually incurred as relevant from time to time.

Predetermined Costs: Pre-determined Costs for a product are computed in advance of production process, on the basis of a specification of all the factors affecting cost and cost data. Predetermined Costs may be either standard or estimated.

Standard Costs: A predetermined norm applies as a scale of reference for assessing actual cost, whether these are more or less. The Standard Cost serves as a basis of cost control and as a measure of productive efficiency, when ultimately posed with an actual cost. It provides management with a medium by which the effectiveness of current results is measured and responsibility of deviation placed. Standard Costs are used to compare the actual costs with the standard cost with a view to determine the variances, if any, and analyse the causes of variances and take proper measure to control them.

Estimated Costs: Estimated Costs of a product are prepared in advance prior to the performance of operations or even before the acceptance of sale orders. Estimated Cost is found with specific reference to product in question, and the activity levels of the plant. It has no link with actual and hence it is assumed to be less accurate than the Standard Cost.

A specimen of cost sheet is given below:

Name of the company

COST SHEET

For the year ended .... Units: ....

Particulars	₹	Total Cost ₹	Cost per Unit ₹
Direct Material		×××	××
Direct Labour		×××	××
Direct Expense		×××	××
(1) Prime Cost		×××	××
Add: Works Overhead:			
Indirect Materials	××		
Indirect Labour	××		
Factory Rent and Rates	××		
Factory Lighting	××		
Factory Insurance	××		
Foreman's Salary	××		
Drawing office salaries	××		
Depreciation on Plant & Machinery	××		
Works office expenses	××		
Works Manager's Salary	××		
Consumable stores	××		
Motive power	××		
Repairs on Plant & Machinery	××		
Fuel and Power	××		
Any other factory/works expenses	××	×××	××
(2) Works Cost		×××	××
Add: Office and Administration overhead:			
Office Rent and Rates	××		
Office Lighting	××		
Office Stationery	××		
Depreciation on Furniture	××		
Office salaries	××		
Legal charges	××		
Bank charges	××		
Printing and Stationery	××		
Postage and Telephone	××		
Office cleaning	××		
Counting house salaries	××		
Director's fees	××		
Audit fees	××		
Sundry office expenses	××	×××	××
(3) Cost of Production		×××	××
Add: Selling and Distribution overhead:			
Advertising	××		
Salesmen's salaries	××		
Commission	××		
Branch office expenses	××		
Carriage outwards	××		
Bad Debts	××		
Travelling Expenses	××		
Show room expenses	××		
Warehouse expenses	××		
Depreciation and repairs of Delivery Van	××		
Expenses for participating in an exhibition	××		
Market Research	××		
Other Selling Expenses	××	×××	××
(4) Total Cost (Cost of Sales)		×××	××
Profit		×××	××
Sales		×××	××

Formulas:

(1) Prime Cost is the aggregate of Direct materials, Direct Labour and Direct Expenses.

Prime Cost = Direct Materials + Direct Labour + Direct Expenses

(2) Works Cost is the aggregate of prime cost and works overhead. It consists of the total of all items of cost incurred in the manufacturing of a product.

Works Cost = Prime Cost + Works Overhead.

(3) Cost of production includes works cost and administration overheads. Production is not deemed to be complete without the managerial and office expenses.

Cost of production = Works Cost + Office and Administration Overheads

(4) Cost of Sales (Total Cost) is the aggregate of all expenses attributable to it. It comprises cost of production plus selling and distribution overheads.

Cost of Sales = Cost of production + Selling and Distribution overheads

When profit is added to the cost of sales, sales can be found out. Usually selling prices are fixed on the basis of cost of sales. It ensures that all the costs are recovered and any desired profit is also obtained.

Cost Sheet Proforma – Simple, Comparative, Detailed and Production Account

Simple Cost Sheet:

Cost Sheet for the month of

Particulars	*Cost per Unit (Rs)*	*Total Cost (Rs)*
Direct material consumed	—	—
+ Direct – labour	—	—
+ Other Direct expenses	—	—
Prime Cost	—	—
+ Factory cost	—	—
+ Other factory overhead	—	—
+ opening. stock of WIP	—	—
– Closing stock of WIP	—	—
Work Cost/Factory cost	—	—
+ Administative or office expenses	—	—
Total cost of production	—	—
+ opening. stock of finished goods	—	—
– Closing stock of finished goods	—	—
Cost of goods sold	—	—
+ Selling expenses	—	—
+ Distribution expenses	—	—
Cost of sales	—	—
+ Profit/Loss	—	—
Sales	—	—

UNIT IV

Short Term Business Decision Techniques

MARGINAL COST AND MARGINAL COSTING

Marginal cost is defined as cost of producing one additional unit. Thus, marginal cost is the amount by which total cost changes when there is a change in output by one unit.

Marginal Cost means Variable Cost. Marginal cost per unit remains unchanged irrespective of the level of activity or output. Marginal cost is the sum total of direct material cost, direct labour cost, variable direct expenses and all variable overheads. Under Marginal Costing technique, only variable costs are charged to cost units, the fixed costs attributable to a relevant period are written off in Costing Profit & Loss Account against the contribution for that period. Under Marginal Costing Technique, fixed costs are treated as period costs.

Marginal Costing is also known as:

• Contributory Costing

• Variable Costing

• Comparative Costing

❖ ABSORPTION COSTING

Under Absorption Costing Technique, both variable cost and fixed costs are charged to cost units. Under Absorption Costing Technique, fixed cost is treated as product cost. In short, the cost of a finished unit in inventory will include direct materials, direct labour, and both variable and fixed manufacturing overhead.

Absorption Costing is also known as:

• Full Costing

• Full Absorption Method

❖ STOCK VALUATION

Value of closing stock under Absorption Costing Technique will be higher as compared to value of closing stock under Marginal Costing Technique because of fixed cost element.

ADVANTAGES OF MARGINAL COSTING

• Simplified Pricing Policy Since marginal (variable) cost per unit remains constant from period to period over a short span of time, firm's decisions on pricing policy can be taken.

• Proper recovery of overheads Overheads are recovered in costing on the basis of pre-determined rates. Under marginal costing technique, fixed overheads are excluded and hence there will be no problem of under or over recovery of overheads.

• Shows RealisticProfit Under Marginal costing technique, the stock of finished goods and work-in-progress are carried on variable cost basis and the fixed expenses are written off to profit and loss account. This shows the true profit of the period.

• How much to produce Marginal costing helps in the preparation of break-even analysis which shows the effect of increasing or decreasing production activity on the profitability of the company.

• Helps in decision making Marginal costing helps the management in taking a number of business decisions like make or buy, discontinuance of a particular product, replacement of machines etc.

LIMITATIONS OF MARGINAL COSTING

• Sales staff may make mistake of marginal cost for total cost and sell at a price which will result in loss or los profits. Hence, sales staff should be cautioned while giving marginal cost.

• Overheads of fixed nature cannot be altogether excluded particularly in large contracts, while valuing the work-in-progress.

• Some of the assumptions regarding the behaviour of various costs are not necessarily true in realistic situation. For example: the assumption that fixed cost will remain static throughout is not correct.

• Marginal cost ignores time factor and investment. The marginal cost of two jobs may be the same but the time taken for their completion and the cost of machines used may differ. The true cost of a job which takes longer time and uses costlier machine would be higher. This fact is not disclosed by marginal costing.

❖ DECISION MAKING AREAS OF MARGINAL COSTING

• Fixation of Selling price

✓ Under normal circumstances

✓ Under special market (export market) or a special customer

✓ During recession

✓ At marginal cost or below marginal cost.

• Decisions relating to most profitable product mix

✓ Selection of optimal product mix

✓ Substitution of one product with another

✓ Discontinuing or dropping of a product line

• Acceptance or rejection of a specialoffer

• Decisions relating to make or buy

• Retaining or replacing a machine

• Expanding or Contracting

❖ COST-VOLUME-PROFIT ANALYSIS AND ITS OBJECTIVES

It is a technique that may used by the management to evaluate how costs and profits are affected by changes in the volume of business activities. Managers are quite often faced with decisive situations involving sales level, sales mix, selling prices and the right combination of these factors that will produce acceptable profits. As a result of change in operating conditions or change in economic environmental factors, the value of and the relationship among these variables also change. Cost Volume Profit analysis is the analysis of three variables i.e. cost, volume and profit. Such an analysis explores the relationship between costs, revenue, activity levels and the resulting profit. It aims at measuring variation in cost and volume. Importance of CVP analysis

- The behaviour of cost in relation to volume.
- Volume of production or sales, where the business will break even.
- Sensitivity of profits due to variation in output.
- Amount of profit for a projected sales volume.
- Quantity of production and sales for a targeted profit level. An understanding of CVP analysis is extremely useful to management in budgeting and profit planning. It elucidates the impact of the following on the net profit:

- Changes in selling prices
- Changes in volume of sales
- Changes in variable cost • Changes in fixed cost

❖ ASSUMPTIONS OF COST VOLUME PROFIT (BREAK EVEN) ANALYSIS

- All costs are easily classified into fixed costs and variable costs.
- Both revenue and cost functions are linear over the range of activity under consideration.
- Prices of output and input remains unchanged.
- Productivity of the factors of production will remain the same.
- The state of technology and the process of production will not change.
- There will be no significant change in the levels of inventory.

• The company manufactures a single product.

• In case of a multi-product company, the sales mix will remain unchanged.

❖ PROFIT VOLUME RATIO The Profit volume (PV Ratio) is the relationship between contribution and sales. It is also termed as contribution to sales ratio. Significance of PV Ratio • PV Ratio is considered to be the basic indicator of the profitability of the business.

• The higher the PV Ratio, the better it is for a business. In the case of a firm enjoying steady business conditions over a period of years, the PV Ratio will also remain stable and steady.

• If PV Ratio is improved, it will result in better profits. Improvement of PV Ratio

• By reducing the variable cost

• By increasing the selling price

• By increasing the share of products withhigher PV Ratio in the overall sales ratio

Uses of PV Ratio

• To compute the variable costs for any volume of sales

• To measure the efficiency or to choose a most profitable product line. The overall profitability of the firm can be improved by increasing the sales or output of a product giving a higher PV Ratio

• To determine break-even point and the level of output required to earn a desired profit • To decide more profitable sales-mix

❖ MAIN USES OF BREAK EVEN CHART

Break even chart facilitates:

• Break even point

• Margin of safety

• Angle of incidence

- Sales required to earn desired amount of profit
- Fixed Cost, Variable Cost, Total Cost, Sales, Profit at various levels of operations.
- Inter firm comparisons
- Change in sales volume
- Change in Selling price
- Change in Variable Cost
- Change in fixed cost

❖ STATE THE LIMITATIONS OF BREAK EVEN ANALYSIS

- All costs cannot be separated into variable and fixed costs with accuracy.
- Fixed costs may change because of change in management policy or after a range of activity.
- Selling price may change because of increase or decrease in output, market demand &supply, competition etc.
- In case of multiple products, the sales mix need not necessarily be constant.
- Entire production need not necessarily be sold in practise
- Time value of money is ignored.

❖ ANGLE OF INCIDENCE It is the angle of intersection between total sales line and total cost line drawn in the case of break even chart. It indicates the rate at which profits are earned. The larger the angle, the higher the rate of profit or vice versa.

❖ KEY FACTOR OR LIMITING FACTOR Key factor is a factor which limits the activities of an undertaking. The extent of its influence must first be assessed while preparing functional budgets and taking decisions about the profitability of the product.

Some of the examples of key factor are:

• Shortage of Raw Material

• Shortage of Labour

• Plant Capacity available (Machines)

• Sales Capacity Available

• Cash Available

Formulas:

P/V ratio = $\frac{Sales-Variable\ Cost}{Sales} = \frac{Contribution}{Sales} = \frac{Fixed\ Cost+Profit}{Sales}$

Break-Even Point Sales X P/V ratio = Fixed Cost (Profit is zero at BEP)

Contribution = Sales X P/V ratio

P/V ratio = $\frac{Change\ in\ Profit}{Change\ in\ Sales} = \frac{Change\ in\ Contribution}{Change\ in\ Sales} = \frac{Fixed\ Cost}{BEP\ Sales}$

BEP Sales (₹) = $\frac{Fixed\ Cost}{Profit-Volume\ Ratio}$

BEP Sales (Units) = $\frac{Fixed\ Cost}{Contribution\ per\ unit}$

(Break-even Sales + Margin of Safety Sales) X P/V Ratio = Contribution

Total Sales = Brea-even Sales + Margin of Safety Sales

Margin of Safety Sales X P/V ratio = Profit

Margin of Safety Ratio = $\frac{Margin\ of\ Safety\ Sales}{Total\ Sales}$

Cash BEP = $\frac{Cash\ Fixed\ Cost}{Contribution\ per\ unit}$

Profit = Sales – Variable Cost – Fixed Cost

Contribution = Sales – Variable Cost = Fixed Cost + Profit = Fixed Cost –Loss

Marginal Costing Equation

	BEP SALES	XXX
+	MOS SALES	XXX
	TOTAL SALES	**XXX**
-	VARIABLE COST	(XXX)
	CONTRIBUTION	**XXX**
-	FIXED COST	(XXX)
	PROFIT	**XXX**

Calculation of BEP Sales

1. In Rupees = $\frac{\text{FIXED COST}}{\text{PROFIT VOLUME RATIO}}$
2. In Units = $\frac{\text{FIXED COST}}{CONTRIBUTION\ PER\ UNIT}$

Calculation of MOS Sales

1. In Rupees = $\frac{PROFIT}{PROFIT\ \ VOLUME\ \ RATIO}$
2. In Units = $\frac{\text{PROFIT}}{\text{CONTRIBUTION PER UNIT}}$

Calculation of Total Sale

1. Total Sale s = BEP Sales + MOS Sales

Calculation of Variable Cost per unit

1. Variable Cost per unit = $\frac{\text{TOTAL VARIABLE COST}}{\text{TOTAL PRODUCED UNITS}}$

2. Variable Cost per unit = $\frac{\text{CHANGE IN TOTAL COST}}{\text{CHANGE IN TOTAL PRODUCED UNITS}}$

Calculations of Contribution

1. Contribution = Total Sales X P/V Ratio
2. Contribution = Total Sales – Total Variable Cost
3. Contribution = Fixed Cost + Profit
4. Contribution = Fixed Cost – Loss

Calculation of Fixed cost

1. Fixed Cost = BEP Sales X P/v Ratio
2. Fixed Cost = Contribution – Profit
3. Fixed Cost = Contribution + Loss

Calculation of Profit

1. Profit = MOS Sales X P/v Ratio

Equation No. 2

	BEP Sales (In % to Total Sales)	XXX
+	MOS Sales (In % to Total Sales)	XXX
	Total Sales	100%

MOS Ratio = $\frac{\text{MOS SALES}}{\text{TOTAL SALES}}$ X 100

UNIT V

Exercising Control – Budgetary Control and Standard Costing

Introduction:

A budget is an accounting plan. It is a formal plan of action expressed in monetary terms. It could be seen as a statement of expected income and expenses under certain anticipated operating conditions. It is a quantified plan for future activities - quantitative blue print for action. Every organization achieves its purposes by coordinating different activities. For the execution of goals efficient planning of these activities is very important and that is why the management has a crucial role to play in drawing out the plans for its business. Various activities within a company should be synchronized by the preparation of plans of actions for future periods. These comprehensive plans are usually referred to as budgets. Budgeting is a management device used for short-term planning and control. It is not just accounting exercise.

Meaning and Definition:

Budget:

According to CIMA (Chartered Institute of Management Accountants) UK, a budget is "A plan quantified in monetary terms prepared and approved prior to a defined period of time, usually showing planned income to be generated and, expenditure to be incurred during the period and the capital to be employed to attain a given objective."

In a view of Keller & Ferrara, "a budget is a plan of action to achieve stated objectives based on predetermined series of related assumptions."

G.A.Welsh states, "A budget is a written plan covering projected activities of a firm for a definite time period."

One can elicit the explicit characteristics of budget after observing the above definitions. They are…

- It is mainly a forecasting and controlling device.
- It is prepared in advance before the actual operation of the company or

project.

- It is in connection with definite future period.
- Before implementation, it is to be approved by the management.
- It also shows capital to be employed during the period.

Budgetary Control:

Budgetary Control is a method of managing costs through preparation of budgets. Budgeting is thus only a part of the budgetary control. According to CIMA, "Budgetary control is the establishment of budgets relating to the responsibilities of executives of a policy and the continuous comparison of the actual with the budgeted results, either to secure by individual action, the objective of the policy or to provide a basis for its revision."

The main features of budgetary control are:

1. Establishment of budgets for each purpose of the business.
2. Revision of budget in view of changes in conditions.
3. Comparison of actual performances with the budget on a continuous basis.
4. Taking suitable remedial action, wherever necessary.
5. Analysis of variations of actual performance from that of the budgeted performance to know the reasons thereof.

Objectives of Budgetary Control:

Budgeting is a forward planning. It serves basically as a tool for management control; it is rather a pivot of any effective scheme of control.

The objectives of budgeting may be summarized as follows:

1. Planning: Planning has been defined as the design of a desired future position for an entity and it rests on the belief that the future position can be attained by uninterrupted management action. Detailed plans relating to production, sales, raw-material requirements, labour needs, capital additions, etc. are drawn out. By planning many problems estimated long before they arise and solution can be thought of through careful study. In short, budgeting forces the management to think ahead, to foresee and prepare for the anticipated conditions. Planning is a constant process since it requires constant revision with changing conditions.

2. Co-ordination: Budgeting plays a significant role in establishing and maintaining coordination. Budgeting assists managers in coordinating their efforts so that problems of the business are solved in harmony with the objectives of its divisions. Efficient planning and business contribute a lot in achieving the targets. Lack of co-ordination in an organization is observed when a department head is permitted to enlarge the department on the specific needs of that department only, although such development may negatively affect other departments and alter their performances. Thus, co-ordination is required at all vertical as well as horizontal levels.

3. Measurement of Success: Budgets present a useful means of informing managers how well they are performing in meeting targets they have previously helped to set. In many companies, there is a practice of rewarding employees on the basis of their accomplished low budget targets or promotion of a manager is linked to his budget success record. Success is determined by comparing the past performance with previous period's performance.

4. Motivation: Budget is always considered a useful tool for encouraging managers to complete things in line with the business objectives. If individuals have intensely participated in the preparation of budgets, it acts as a strong motivating force to achieve the goals.

5. Communication: A budget serves as a means of communicating information within a firm. The standard budget copies are distributed to all management people provide not only sufficient understanding and knowledge of the programmes and guidelines to be followed but also give knowledge about the restrictions to be adhered to.

6. Control: Control is essential to make sure that plans and objectives laid down in the budget are being achieved. Control, when applied to budgeting, as a systematized effort is to keep the management informed of whether planned performance is being achieved or not.

Advantages of Budgetary control:

In the light of above discussion one can see that, coordination and control help the planning. These are the advantages of budgetary control. But this tool offer many other advantages as follows:

1. This system provides basic policies for initiatives.
2. It enables the management to perform business in the most professional manner because budgets are prepared to get the optimum use of resources and the objectives framed.
3. It ensures team work and thus encourages the spirit of support and mutual understanding among the staff.
4. It increases production efficiency, eliminates waste and controls the costs.
5. It shows to the management where action is needed to remedy a position.
6. Budgeting also aids in obtaining bank credit.
7. It reviews the present situation and pinpoints the changes which are necessary.
8. With its help, tasks such as like planning, coordination and control happen effectively and efficiently.
9. It involves an advance planning which is looked upon with support by many credit agencies as a marker of sound management.

Limitations of Budgetary control:

1. It tends to bring about rigidity in operation, which is harmful. As budget estimates are quantitative expression of all relevant data, there is a tendency to attach some sort of rigidity or finality to them.

2. It being expensive is beyond the capacity of small undertakings. The mechanism of budgeting system is a detailed process involving too much time and costs.

3. Budgeting cannot take the position of management but it is only an instrument of management. 'The budget should be considered not as a master, but as a servant.' It is totally misconception to think that the introduction of budgeting alone is enough to ensure success and to security of future profits.

4. It sometimes leads to produce conflicts among the managers as each of them tries to take credit to achieve the budget targets.

5. Simple preparation of budget will not ensure its proper implementation. If it is not implemented properly, it may lower morale.

6. The installation and function of a budgetary control system is a costly affair as it requires employing the specialized staff and involves other expenditure which small companies may find difficult to incur.

Essentials of Effective Budgeting:

1) Support of top management: If the budget structure is to be made successful, the consideration by every member of the management not only is fully supported but also the impulsion and direction should also come from the top management. No control system can be effective unless the organization is convinced that the management considers the system to be important.

2) Team Work: This is an essential requirement, if the budgets are ready from "the bottom up" in a grass root manner. The top management must understand and give enthusiastic support to the system. In fact, it requires education and participation at all levels. The benefits of budgeting need to be sold to all.

3) Realistic Objectives: The budget figures should be realistic and represent logically attainable goals. The responsible executives should agree that the budget goals are reasonable and attainable.

4) Excellent Reporting System: Reports comparing budget and actual results should be promptly prepared and special attention focused on significant exceptions i.e. figures that are significantly different from expected. An effective budgeting system also requires the presence of a proper feed-back system.

5) Structure of Budget team: This team receives the forecasts and targets of each department as well as periodic reports and confirms the final acceptable targets in form of Master Budget. The team also approves the departmental budgets.

6) Well defined Business Policies: All budgets reveal that the business policies formulated by the higher level management. In other words, budgets should always be after taking into account the policies set for particular department or function. But for this purpose, policies should be precise and clearly defined as well as free from any ambiguity.

7) Integration with Standard Costing System: Where standard costing system is also used, it should be completely integrated with the budget programme, in respect of both budget preparation and variance analysis.

8) Inspirational Approach: All the employees or staff other than executives should be strongly and properly inspired towards budgeting system. Human beings by nature do not like any pressure and they dislike or even rebel against anything forced upon them.

Classification of Budget

Based on time

Long-term Budget: The budget designed by the management for a long-term, i.e. three to ten years is called as long-term budget.

Short-term Budget: As the name suggests, the budget which is prepared for a period ranging from 1 to 2 years, is called short-term budget.

Based on Capacity

Fixed Budget: The budget created for a fixed activity level, i.e. the budget remains constant regardless of the level of activity, is called as fixed budget. Fixed Budget is prepared for a fixed or standard volume of activity. They do not change with the change in the volume of activity. These budgets are prepared well in advance. They are not helpful for making comparison. According to I.C.M.A. “a fixed budget is a budget designed to remain unchanged irrespective of the level of activity actually attained”. Fixed budget is normally prepared when activities can fairly be forecast with reasonable certainty.

Flexible Budget: The budget which changes with the change in the level of activity is a flexible budget. It identifies the fixed cost, semi-variable cost and variable cost, to show the expected results at different volumes. The I.C.M.A. defines flexible budget as, “a budget which is designed to change in accordance with the level of activity attained”. Basically, the idea of a flexible budget is that there shall be some standard of expenditure for varying levels of output. Flexible budgetary control has been developed with the objective of changing the budget figures progressively to correspond to the actual output. The preparation of budgets necessitates the analysis of all overheads into fixed, variable and semi- variable costs.

The I.C.M.A. defines the above costs as follows:

Fixed cost: a cost which tends to be unaffected by variation in volume of output.

Variable cost: a cost that tends to vary directly with the volume of output.

Semi-variable: a cost which partly fixed and partly variable.

Based on Scope

Functional Budget: The budget which is concerned with the business functions is called as functional budget. It can be further classified as:

Sales Budget: Sales budget is used to determine the quantity of anticipated sales and the expected selling price per unit.

Production Budget: It is prepared to indicate the production for the specified period and is expressed in the units of outputs produced.

Materials Budget: The budget prepared to show the quantities of direct material and raw material required to manufacture the finished product.

Purchase Budget: Purchase budget is designed to estimate the quantity and value of different items to be bought at different points of time, considering the production schedule and inventory required.

Cash Budget: The budget highlights the cash needed by the business in a specified period, taking into account all the receipts and payments of the business. The cash budget is a forecast of the cash position for a period and represents the cash receipts and payments and the estimated cash balance each month of the budget period. This budget is practically the nerve center of the whole budgetary control system since the most carefully prepared budgets are incapable of fulfillment if adequate cash is not available at the proper time. The main functions of this budget may be summarised as follows:

- It ensures that sufficient cash is available to meet the requirements of the organisation.
- It reveals any expected shortage of cash so as to enable the management to arrange for cash in time by means of bank overdraft or loan etc.
- It reveals any expected surplus of cash available for investment outside the business.
- This budget is prepared after all the functional budgets have been drawn up.

Cash Budget of a business concern can be prepared by Receipts and payments Method, Adjusted Profit and Loss Method and Balance Sheet Method. But the Receipts and Payments Method is the most popular method and is commonly used by business concerns. Under this method, cash budget is prepared just like a summarized cash book. For the purpose of preparing cash budget, all types of 'Cash Receipts' or 'Cash Inflows' (including opening balance of cash/bank) are to be estimated in a logical manner period-wise, keeping in view the past figures, existing trends and expected changes in future.

Apart from those discussed above, there are other functional budgets also, i.e. plant utilization budget, direct material usage budget, factory overhead budget, production cost budget, cost of goods sold budget, selling and distribution cost budget, administration expenses budget, etc.

Master Budget: Once all the functional budgets are created, then the financial officer will prepare a master budget. It is an integrated budget that reflects the estimated profit and loss and financial position using Budgeted Profit & Loss Account and Budgeted Balance Sheet of the concern.

The Master Budget is one that projects the activities of the business during the budget period. It commonly takes the form of budgeted Profit and Loss Account and Balance Sheet. It is prepared by the Budget Officer, and incorporates the details shown in the subsidiary budgets. Master Budget that consolidates an organization's overall plans for a shorter span of time is usually prepared on an annual basis.

The Master Budget is an integrative tool that cuts across divisional boundaries to, coordinate the firm's diverse activities. A Master budget takes the macro view of the business enterprise and coordinates sales with production, raw materials, manpower, machinery and other resources. Based on Receipts and Expenditure

Capital Budget: The budget takes into account the estimated capital receipts and expenditure of the business for a specified period.

Revenue Budget: The budget that covers all the revenue receipts and expenses of a particular financial year is a revenue budget. A budget acts as a map for the future economic activities of the business, which are prepared as per the policies of the different organizational functions. It aims at making optimum utilization of the capital and other resources of the organization.

- **Standard Costing**

Standard Cost

Standard Cost as defined by the Institute of Cost and Management Accountant, London"is the Predetermined Cost based on technical estimate for materials, labour and overhead for a selected period of time and for a prescribed set of working conditions." Standard Costing

Chartered Institute of Management Accountants England defines Standard Costing as"the Preparation and use of standard costs, their comparison with actual costs and the analysis of variances to their causes and points of incidence." Advantages of Standard Costing

Advantages of standard costing :

(1) It guides the management to evaluate the production performance. (2) It helps the management in fixing standards. (3) Standard costing is useful in formulating production planning and price policies. (4) It guides as a measuring rod for determination of variances. (5) It facilitates eliminating inefficiencies by taking corrective measures. . Limitations of

Standard Costing

Besides all the benefits derived from this system, it has a number of limitations whicharegiven below:

(1) Standard costing is expensive and a small concern may not meet the cost.

(2) Due to lack of technical aspects, it is difficult to establish standards.

(3) Standard costing cannot be applied in the case of a- concern where non-standardise dproducts are produced.

(4) Fixing of responsibility is' difficult. Responsibility cannot be fixed in the case of uncontrollable variances.

(5) , Frequent revision is required while insufficient staff is incapable of operating this system. Differences : Though Standard Costing and Budgetary Controls are aims at the maximum efficiencies and Marginal Cost, yet there are some basic differences between the two from the objectives of using the two costs.

Budgetary Control	Standard Costing
(1) Budgets are projections of financial accounts.	(1) Standard Costing is a projection of cost accounts.
(2) As a statement of both income and expenses it forms part of budgetary control.	(2) Standard costing is not used for the purpose of forecasting.
(3) Budgets are estimated costs. They are "what the cost will be."	(3) Standard Cost are the "Norms" or "what cost should be."
(4) It is applied to any industry engaged in mass production.	(4) It is applicable to concern engaged in construction work.
(5) It is a part of accounting system and standard costing variances are recorded in the books of accounts.	(5) It is not a part of accounting system because it is based on statistical facts and figures.

VARIANCE ANALYSIS

Standard Costing guides as a measuring rod to the management for determination of "Variances" in order to evaluate the production performance. The term "Variances" maybe defined as the difference between Standard Cost and actual cost for each element of cost incurred during a particular period. The term "Variance Analysis" may be defined as the process of analyzing variance by subdividing the total variance in such a way that management can assign responsibility for off-Standard Performance. The variance may be favorable variance or unfavorable variance. When the actual performance is better than the Standard, it resents "Favorable Variance." Similarly, where actual performance is below the standard it is called as "Unfavorable Variance." Variance analysis helps to fix the responsibility so that management can ascertain

(a) The amount of the variance

(b) The reasons for the difference between the actual performance and budgeted performance

(c) The person responsible for poor performance

(d) Remedial actions to be taken

Types of Variances: Variances may be broadly classified into two categories (A) Cost Variance and (B) Sales Variance. (A) Cost Variance: Total Cost Variance is the difference between Standards Cost for the Actual Output and the Actual Total Cost incurred for manufacturing actual output. The Total Cost Variance Comprises the following:

Direct Material Variances/ Material Cost Variances (MCV):

The Material Cost Variance is the difference between the Standard cost of materials for the Actual Output and the Actual Cost of materials used for producing actual output.

MCV = SC - AC OR MCV = (SQ x SP) - (AQ x AP)

Where, SC = standard cost; AC = actual cost; SQ = standard quantity; SP = standard price; AQ=actual quantity; AP = actual price.

(1**) Material Price Variance (MPV)** : MPV is the difference between the standard cost of actual quantity and actual cost for actual quantity.

MPV = (SP - AP) x AQ

(2) **Material Usage Variance (MUV):** MUV is the difference between the standard cost of standard quantity of material for actual output and the Standard cost of the actual material used. MUV = SP x (SQ - AQ)

(3) **Material Mix Variance (MMV) :** It is the portion of the material usage variance which is due to the difference between the Standard and the actual composition of mix. Material Mix Variance is calculated under two situations as follows :

(a) When Actual Weight and Standard Weight of Mix are equal :

(i) The formula is used to calculate the Variance:

MMV = SP x (SQ - AQ)

(ii) In case standard quantity is revised due to shortage of a particular category of materials, the formula will be changed as follows :

MMV = SP x (RSQ - AQ)

Where, RSQ = Revised standard quantity

(b) When Actual Weight and Standard Weight of Mix are different:

(i) The formula used to calculate the Variance is :

MMV = (Total weight of actual mix/ Total weight of standard mix X standard cost of standard mix) - standard cost of actual mix

(ii) In case the standard is revised due to the shortage of a particular category of materials, the alternative formula will be as follows:

MMV = (Total weight of actual mix/ Total weight of standard mix X standard cost of revised standard mix) - standard cost of actual mix

(2) Materials Yield Variance (MYV):

It is the portion of Material Usage Variance.

This variance arises due to spoilage, low quality of materials and defective production planning etc.

Materials Yield Variance may be defined as "the difference between the Standard Yield Specified and the Actual Yield Obtained." This variance may be calculated as under:

MYV = SR x (AY - SY)

Where, AY= Actual Yield, SY = Standard Yield and Standard Rate is calculated as follows:

Verification: 1. MCV = MPV + MUV

2. MUV = MMV + MYV

Notes- positive means favorable (F) and negative means adverse (A).

MATERIAL

Material cost variance =	SC – AC = (SQ*AQ) – (AQ*AP)
Material price variance =	AQ (SP – AP)
Material usage variance =	SP (SQ – AQ)
Material mix variance =	SP (RSQ – AQ)
Material yield variance =	(AY – SY for actual input) Standard material cost per unit of output
Material revised usage variance (calculated instead of material yield variance) =	[standard quantity – Revised standard for actual output quantity] * Standard price

LABOUR

Labour Cost variance =	SC – AC = (SH*SR) – (AH*AR)
Labour Rate variance =	AH (SR - AR)
Labour Efficiency or time variance =	SR (SH –AH)
Labour Mix or gang composition Variance =	SR(RSH-AH)
Labour Idle Time Variance =	Idle hours * SR
Labour Yield Variance =	[Actual Output – Standard output for actual input] **X** Standard labour cost/unit of output
Labour Revised Efficiency Variance (instead of LYV) =	[Standard hours for actual output – Revised standard hours] **X** Standard rate

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