ACCOUNTING FOR MANAGERS

UNIT-I Book-keeping and Accounting – Meaning – Definition – Objectives of Financial Accounting – Branches of Accounting: Financial, Cost and Management Accounting – Accounting Concepts and conventions – journal – Ledger – Trial Balance – Preparation of Final Accounts: Trading, Profit and Loss Account and Balance Sheet (problems) – Accounting Standards – Groups interested in Accounting Information – An Introduction to Tally Package – salient features – types of vouchers – reports generated by Tally.

MEANING:

Accounting is the ***systematic process of identifying, measuring, recording, classifying, summarising, interpreting and communicating*** financial information. Accounting gives information on:

- the resources available
- how the available resources have been employed and
- the results achieved by their use.

DEFINITION:

According to the American Accounting Association [AAA] "Accounting refers to ***the process of identifying, measuring and communicating*** economic information to permit informed judgments and decisions by users of the information".

EVOLUTION OF ACCOUNTING

In the earliest days of civilisation, accounting was done by stewards who managed the properties of wealthy people. They rendered accounts periodically to the owners of property. The stewardship accounting is said to be the root of accounting. Records of debit and credit were found in the 12th century itself.

In 1494, Luca Pacioli an Italian developed double-entry book-keeping system. Due to the industrial revolution in the 18th and 19th centuries, large scale operations were carried on and joint stock companies emerged as an important form of organisation which required separation of ownership from management. Hence, to safeguard the interest of owners and investors, the business establishments required detailed information about business which paved the way for development of comprehensive financial accounting information system.

In the 20th century, the need for analysis of financial information for managerial decision making caused emergence of Management Accounting as a separate branch of accounting.

FUNDAMENTALS OF ACCOUNTING

Assets:

Assets are those items that can be transformed into cash or that generates income for the enterprise shortly. It is useful in paying any expenses of the business entity or debt.

Liabilities:

Liabilities are the obligations that are rising out of previous transactions, which is payable by the enterprise, through the assets possessed by the enterprise.

Owner's Equity:

- Owner's equity is one of the 3 vital segments of a sole proprietorship's balance sheet and one of the main aspects of the ***accounting equation: Assets = Liabilities + Owner's Equity.***
- It depicts the owner's investment in the trade minus the owner's withdrawal from the trade + the net income since the business concern commenced.

ACCOUNTING TERMS

- **Business Transaction**: A Business transaction is an economic activity of business that changes its financial position.
- **Account:** It is a record of all business transactions relating to a particular person or item. It is a T Shaped proforma.
- **Capital:** It refers to the amount invested by the owner in a business. The amount invested could be in the form of cash, goods, etc.
- **Drawing**: Any cash or goods withdrawn by the owner for personal use made out of business funds are known as drawings.
- **Profit**: It is the excess of total revenue over total expense of a business. Profit =Revenue-Expenses.

- **Loss:** The excess of expenses over related revenue is known as loss. Loss= Expenses-Revenue.
- **Gain:** It is a monetary benefit resulting from events or transactions which are incidental to business like profit on sale of fixed assets.
- **Stock:** It includes goods unsold on a particular date.
- **Purchases:** It refers to the amount of goods bought by business for resale or use in production. It can be of cash or credit.
- **Purchase return:** When purchased goods are returned to suppliers, it is referred to as purchase return.
- **Sales**: It means transfer of goods or services for money in the normal course of business.
- **Sales return**: When customers return the goods sold to them it is known as sales returns.
- **Debtors:** It refers to those persons whose business has been sold goods on credit and payment has not been received yet.
- **Creditors:**It refers to those persons whose business buys goods on credit and payment has not been done yet.
- **Voucher**: A voucher is a written document which is created in support of a particular transaction. It may be in the form of a cash memo, invoice or receipt. Voucher is a necessary component of auditing.
- **Income:** It is the difference between revenue and expense.
- **Expense**: It is the amount used in order to produce and sell goods and services.
- **Discount:** It is the rebate given by the seller to the buyer. It is of 2 types: Cash Discount and Trade Discount.
- **Cash Discount**: When discount is allowed to customers for making prompt payment.It is always recorded in books of accounts.
- **Trade Discount**: This is a type of discount allowed by the sellers to their customers at a fixed percentage on the list price of goods. and also it is not entered in the books of accounts.
- **Bad Debts:** It refers to the amount that debtor has not paid even after repeated reminders and has no intention of paying in the future.

BOOKKEEPING, ACCOUNTING & ACCOUNTANCY

<u>Bookkeeping:</u>

- Book Keeping is a part of Accounting and it is the process of ***identifying, measuring, recording and classifying the financial transactions*** in a systematic manner.

- It is necessary to keep the record of business activity related to production, trade, service, expenditure and revenues to avoid confusion.
- The ***record keeping activity*** of business is known as Book Keeping.
- **Examples of Book Keeping:** Accounts Payable, Accounts Receivables, Managing Payroll etc…

Definition:

J.R.Batliboi defines "Book keeping is the art of recording business dealing in a set of books"

Accounting:

- Accounting is a wider concept and actually, it begins where Book Keeping ends. It involves the process of preparing and presenting the accounts of business unit.
- In addition to the functions of bookkeeping, accounting covers summarizing, analyzing interpreting and communicating the financial data to the users of financial statements.
- Accounting is known as language of business.
- Accounting includes Strategic planning, budgeting, auditing, income tax preparation, cost analysis, performance measurement, evaluation and preparing reports for decision making.

Accountancy:

- Accountancy refers to systematic knowledge of the principles and the techniques which are applied in Accounting.
- Bookkeeping is the base for Accounting & Accountancy also.
- Accountancy includes Bookkeeping & Accounting.

DIFFERENCE BETWEEN BOOKKEEPING AND ACCOUNTING

Parameters	**Bookkeeping**	**Accounting**
Scope	Bookkeeping involves identifying, measuring, recording & classifying financial transactions in the ledger accounts.	In addition to bookkeeping, Accounting also includes summarizing, interpreting and communicating the financial data to the users of financial statements.
Objective	The main aim is to maintain systematic records of financial	The main aim is to ascertain the profitability

	transactions.	and financial position of the business.
Stage	It is a primary stage of accounting	It is a second stage and begins where book-keeping ends.
Nature	This job is in routine and repetitive in nature.	This job is analytical in nature.
Level of skills	Bookkeeping does not require special skills. It is performed by Junior Staff.	It requires specialized skill to analyze, so it is performed by senior staff.

NATURE / CHARACTERISTICS OF ACCOUNTING / FINANCIAL ACCOUNTING:

(1) Identifying financial transactions and events

- Accounting records only those transactions and events which are of financial nature. So, first of all, such transactions and events are identified.

(2) Measuring the transactions

- Accounting measures the transactions and events in terms of money which are considered as a common unit.

(3) Recording of transactions

- Accounting involves recording the financial transactions inappropriate book of accounts such as Journal or Subsidiary Books.

(4) Classifying the transactions

- Transactions recorded in the books of original entry – Journal or Subsidiary books are classified and grouped according to nature and posted in separate accounts known as ‘Ledger Accounts’.

(5) Summarising the transactions

- It involves presenting the classified data in a manner and in the form of statements, which are understandable by the users.
- It includes Trial balance, Trading Account, Profit and Loss Account and Balance Sheet.

(6) Analysing and interpreting financial data

- Results of the business are analyzed and interpreted so that users of financial statements can make a meaningful and sound judgment.

(7) Communicating the financial data or reports to the users

- Communicating the financial data to the users on time is the final step of Accounting so that they can make appropriate decisions.

STEPS OF THE ACCOUNTING PROCESS / FUNCTIONS OF ACCOUNTING

Accounting process is the process of collecting, recording, classifying, summarising and communicating financial information to the users for judgement and decision-making. The following steps are involved in accounting process:

(1) **Identification:** It is the process of identifying and analysing business transactions.

(2)**Recording:** For recording, we use 'Journal' or Subsidiary Books.

(3) **Classification of transactions:** Classification means segregation of transactions on the basis of nature and posting them in a format known as Ledger Account.

(4) **Summarisation:** It includes preparation of Trial Balance and Financial Statements.

(5) **Analysis & Interpretation:** It includes an assessment of the financial reports and making some meaningful conclusions.

(6) **Communicating information to the users:** It includes sharing the financial reports and interprets results to the users of financial statements.

OBJECTIVES OF ACCOUNTING

To maintain a systematic record of business transactions

- Accounting is used to maintain a systematic record of all the financial transactions in a book of accounts.

- For this, all the transactions are recorded in chronological order in Journal and then posted to principle book i.e. Ledger.

To ascertain profit and loss

- Every businessman is keen to know the net results of business operations periodically.
- To check whether the business has earned profits or incurred losses, we prepare a “Profit & Loss Account”.

To determine the financial position

- Another important objective is to determine the financial position of the business to check the value of assets and liabilities. For this purpose, we prepare a “Balance Sheet”.

To provide information to various users

- Providing information to the various interested parties or stakeholders is one of the most important objectives of accounting.
- It helps them in making good financial decisions.

To assist the management

- By analysing financial data and providing interpretations in the form of reports, accounting assists management in handling business operations effectively.

ADVANTAGES OF ACCOUNTING

1. Provide information about financial performance

- Accounting provides factual information about financial performance during a given period of time. Like, profit earned or loss incurred over a period and financial position at a particular point of time.

2. Provide assistance to management

- Accounting helps management in business planning, decision making and in exercising control.For this, it provides financial information in the form of reports.

3. Facilitates comparative study

- By keeping systematic records and preparation of reports at regular intervals, accounting helps in making a comparison.

4. Helps in settlement of tax liability

- Systematic accounting records help in settlement of various tax liabilities. Such as – Income Tax, GST, etc.

5. Helpful in raising loan

- Banks and Financial Institutions grant a loan to the firm on the basis of appraisal of the financial statement of the firm.

6. Helpful in decision making

- Accounting provides useful information to the management for taking decisions.

LIMITATIONS OF ACCOUNTING

- **Accounting is not precise**: Accounting is not completely free from personal bias or judgment.
- **Accounting is done on historic values of assets:** Accounting records assets at their historical cost less depreciation. It does not reflect their current market value.
- **Ignore the effect of price level changes:** Accounting statements are prepared at historical cost. So changes in the value of money are ignored.
- **Ignore the qualitative information:** Accounting records only monetary transactions. It ignores the qualitative aspects.
- **Affected by window dressing:** Window dressing means manipulation in accounting to present a more favourable position of the business than the actual position.

BRANCHES OF ACCOUNTING

The following are the main branches of accounting;

(a) Financial accounting:

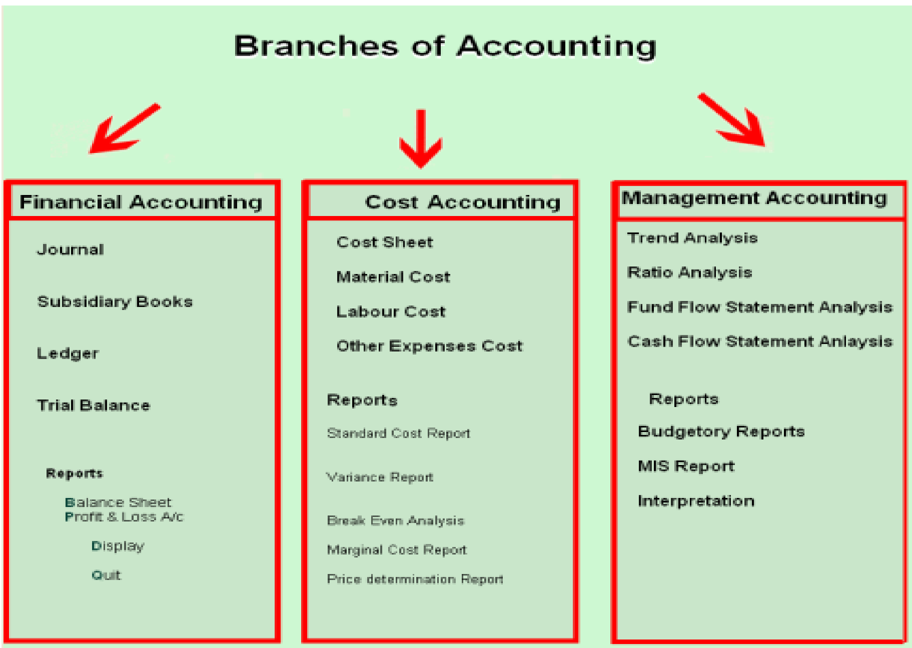
Financial Accounting is that branch of accounting which involves ***identifying, measuring, recording, classifying, summarising the financial transactions*** which ***ascertain the profit & financial position*** of business.

(b) Cost accounting:

Cost Accounting is that branch of accounting which is concerned with the ***process of ascertaining and controlling the cost of products or services***.

(c) Management accounting

Management accounting refers to that branch of accounting which is concerned with presenting the accounting information in such a way that helps the ***management in planning and controlling the operations of a business and in decision making.***



Objectives of Cost Accounting

The objective of the cost accounting is to determine the methods by which expenditure on materials, wages and overhead are recorded, classified and allocated. This is necessary so that the cost of products and services may be accurately ascertained. Thus, the following are the main objectives of cost accounting:

1. Ascertainment of the cost per unit of the different products that a business concern manufacturers.
2. To correctly analyze the cost of both the process and operations.

3. Disclosure of sources for wastage of material, time, expenses or in the use of the equipment and the preparation of reports which may be necessary to control such wastage.
4. Provide requisite data and help in fixing the price of products manufactured or services rendered.
5. Determination of the profitability of each of the products and help management in the maximization of these profits.
6. Exercise effective control of stocks of raw material, work-in-progress, consumable stores, and finished goods so as to minimize the capital invested in them.
7. Present and interpret data for management planning, decision-making, and control.
8. Help in the preparation of budgets and implementation of budgetary control.
9. Aid management in the formulation and implementation of incentive bonus plans on the basis of productivity and cost savings.
10. Organization of cost reduction programmes with the help of different departmental managers.
11. To provide specialized services for cost audit in order to prevent errors and frauds.
12. To facilitate prompt and reliable information to management.
13. Determination of costing profit or loss by linking the revenues to costs of those products or services by selling which the revenues have arisen.

OBJECTIVES OF FINANCIAL ACCOUNTING:

DIFFERENCE BETWEEN FINANCIAL ACCOUNTING, MANAGEMENT ACCOUNTING & COST ACCOUNTING:

Basis of Distinction	Cost Accounting	Management Accounting	Financial Accounting
1. **Meaning**	Cost Accounting is the process of accounting for costs, from the very starting till the end of the reporting period. Reports are prepared at the end of the period in order to ascertain where the cost can be reduced or controlled.	Management Accounting refers to the application of the accounting principles and financial management to create, protect, preserve and increase the value of an organization for its stakeholders.	Financial Accounting is the art of recording, classifying, and summarising the monetary transactions and events in a manner useful for the stakeholders to interpret the results thereof.
2. **Nature**	It records quantitative aspect only.	It records quantitative as well as qualitative aspects.	It records quantitative aspects only.
3. **Objective**	It basically records the cost of producing a product or providing a service in which the business primarily deals.	It is performed in order to help the management make decisions by providing the relevant information.	It is undertaken to prepare Profit and Loss Account and Balance Sheet for presentation to shareholders and other external users.
4. **Recording of Data**	Data is recorded using both, past and present figures.	It is focused on the projection of data for the future.	It records Historical data.
5. **Rules and Regulations**	It follows certain principles and procedures for recording costs.	It does not follow any specific rules and regulations.	It follows Accounting Principles, Accounting Standards and Indian Accounting Standards.
6. **Development**	It developed after the industrial revolution.	It developed to address the need of modern business world.	It developed before all other forms of accounting.
7. **Users of Information**	It is generally used by internal management.	The information accumulated through management accounting is used by owners, employees, creditors, researchers, etc.	It is used by shareholders, customers, regulatory authorities, etc.

ACCOUNTING CONCEPTS AND CONVENTIONS / GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAPs)

- Accounting principles, rules of conduct and action are described by various terms such as concepts, conventions, tenets, assumptions, axioms, postulates, etc.
- Accounting concepts are the assumptions which are essential to the practice of accounting and preparation of financial statements.

ACCOUNTING CONCEPTS

i) Business Entity concept / Separate Entity Concept:

- Business is treated as a separate entity distinct from that of the proprietor or owner.
- All transactions are recorded from the perspective of business, not from the owners.
- ***An example*** is a sole trader or proprietorship. The sole trader takes money from the business by way of 'drawings', money for their own personal use.

ii) Going concern concept:

- It is assumed that the business will continue to exist for a long period in future and the transactions are recorded in the books of business on the assumption that it is a continuing enterprise.

iii) Dual aspect concept:

- Each business transactions have two aspects - debit & credit i.e. benefit receiving and benefit giving aspect. The value of benefit received is equal to benefit given.
- It may be stated as ***" For every debit there is a credit"***

Assets = Liabilities + Capital

EG : *Issue an invoice to a customer. One part of the entry increases sales, which appears in the income statement, while the offset to the entry increases the accounts receivable asset in the balance sheet.*

iv)Cost concept:

- Assets purchased are normally entered in the accounting book at the cost at which they are purchased. The market value in immaterial.
- EG: The cost concept is a concept of accounting which states that the value of an asset will be calculated on the basis of historical cost or acquisition cost. Such as an asset purchased at 25 lac in 1999 and same cost will be shown in 2022 financial statement in all future years.

v) Money measurement concept:

Accounting records only those transactions which can be expressed in terms of money.

For example, a high level of customer support will likely lead to increased customer retention and a higher propensity to buy from the company again, which therefore impacts revenues.

vi) Realization concept:

The revenue is realized only when the sale is made.

EG: Your client may sell a customer a pair of shoes and agree to ship them to the customer's house. The customer pays when the item ships, but you can only record the transaction as revenue when the customer receives the shoes and the process is complete.

vii) Accrual concept:

As per this concept revenue is recorded when sales are made and it is immaterial whether cash received or not and same applies to expenses also. It provides more appropriate information about business enterprise as compared to cash basis.

EG: Record a commission in the period when the salesperson earns it, rather than the period in which he or she is paid it.

viii) Matching concept:

The revenues earned during an accounting period are matched with the cost associated withthe period to ascertain the profit earned.

EG: Imagine that a company pays its employees an annual bonus for their work during the fiscal year. The policy is to pay 5% of revenues generated over the year, which is paid out in February of the following year.

ix) Accounting period concept:

- It helps to measure the income generated during the specific accounting period which makesit possible to distribute it to the owners.
- The accounting period is normally considered to be a period of 12 months.
- EG: A company records its transactions from 1st January to 31st December every year and closes its financials. Here, the accounting period is one year, i.e., 1st January to 31st December.

ACCOUNTING CONVENTIONS

Accounting conventions are those customs, usage and traditions that are being followed by the accountants.

i) Convention of conservation:

- It is a policy of caution or “playing safe”. The essence of this principle is ‘anticipate no profit and provide for all possible losses’.

- This means that all prospective losses are taken into consideration. Window dressing in accounts is not permitted.

Convention of consistency:

- Accounting practice should remain unchanged for a fairly long time. And they should not be changed unless it becomes absolutely essential to change them.
- *Eg: Method of depreciation.*

Convention of material disclosure:

- Materiality means relative importance. All-important items and facts should be disclosed in accounting statements.
- Immaterial details should be ignored else the whole accounting process will become highly cumbersome and meaningless..

Convention of full disclosure:

- All accounting statements should be prepared honestly.
- This type of disclosure needs proper classification, summarization, aggregation and explanation of the numerous business transactions.

ACCOUNTING STANDARDS:

Accounting Standard (AS)

Meaning:

- Accounting Standard (AS) is a set of accounting policies or guidelines regarding the principles and methods of accounting.
- It is a set of practices and policies used to systematize bookkeeping and other accounting functions across firms.
- It covers the aspects of recognition, measurement, treatment, presentation and disclosure of accounting transactions in financial statements.

Definition:

According to T.P Ghosh <Accounting Standards are the policy documents issued by the recognized expert accounting body relating to various aspects of measurement, treatment and disclosure of accounting transactions and events.

AS 1	Disclosure of Accounting Policies
AS 2	Valuation of Inventories
AS 3	Cash Flow Statement
AS 4	Contingencies & Events occurring after Balance Sheet date
AS 5	Net profit or Loss for the Period, Prior period items & changes in accounting policies
AS 6	Depreciation Accounting
AS 7	Accounting for Construction Contracts
AS 8	Accounting for Research & Development
AS 9	Revenue Recognition
AS 10	Accounting for Fixed Assets
AS11	Accounting for effects in changes in Foreign Exchange Rates
AS 12	Accounting for Government Grants
AS 13	Accounting for Investments
AS 14	Accounting for Amalgamations
AS 15	Accounting for Retirement benefits in the Financial Statements of employers
AS 16	Borrowing Cost
AS 17	Segment Reporting
AS 18	Related Party Disclosure
AS 19	Leases
AS 20	Earnings Per Share
AS 21	Consolidated Financial Statements
AS 22	Accounting for taxes on income
AS 23	Accounting for Investments in Associates in consolidated financial statements
AS 24	Discontinuing Operations
AS 25	Interim Financial Reporting
AS 26	Intangible Assets
AS 27	Financial Reporting of Interests in Joint Ventures
AS 28	Impairment of Assets
AS 29	Provisions, Contingent Liabilities and Contingent assets

Importance/ Objectives/ Advantages/ Need of Accounting Standards

Brings Uniformity In Accounting System:

- Accounting Standards are the one that helps in bringing the uniformity in whole accounting. It means that all companies record the transactions in the same manner.
- For example, Accounting Standard-6 governs the whole depreciation accounting. All companies will be following AS-6 for matters concerned with depreciation.

Easy Comparability of Financial Statements:

- Accounting standards has made it simplified the comparison of different financial statements. Financial statements of two companies can be easily compared.
- If two companies are following different accounting system & format, comparison between them becomes quite difficult.

Assists Auditors:

- Accounting standards helps the auditors in performing their duties. It simplifies their task & makes it easy for them to perform their roles.
- If auditor assures that company has followed accounting standards, he can easily verify that all financial standards are fair & true.

Makes Accounting Informative Easy & Simple:

- Simplifying the whole accounting information is important advantage of accounting standards.
- It provides standard rules for each& every accounting transaction.
- It removes all complexity in the accounting process.

Avoids Frauds & Manipulations:

- Accounting standards plays an efficient role in preventing frauds in the accounting system.
- Frauds & any accounting data manipulation may adversely affect the organization.
- It becomes almost impossible to misrepresent & manipulate any financial data if the organizations follow accounting standards.

Provides Reliability To Financial Statements:

- Financial statements are important source of acquiring information regarding companies.
- Investors & different stakeholders depend on these statements and take important

decisions on the basis of this data.

- It is thus very important that these financial statements are true & fair. It is ensured by accounting standards that, these statements are real & trustworthy.

Measures Management Performance:

- Accounting standards make it easy in determining accountability of management. It makes it easy to measure the performance of management team & provide any suggestions.
- It helps in analysing management ability in maintaining solvency of the firm, increasing the company9s profit & various other important roles.
- It directs the management to adopt a particular accounting policy.

Increase the confidence of Investors:

- With the preparation of financial statements as per Accounting Standard window dressing of the statements can be reduced to a great extentwhich in turn will improve the confidence of investors.

Disclosure of Information:

- There are certain areas where important information is not required to be disclosed by law.
- But accounting standards may call for the disclosure of such information beyond that required by law.

Reduce confusion in Accounting Practitioners:

- On giving clear guidelines as to treatment of certain items, which can be treated differently, the accounting practitioners can follow one method which is most suitable for the situation as per the accounting standards.

Disadvantages of Accounting Standards

Difficulty between Choosing Alternatives:

- There are alternatives for certain accountingtreatments or valuations. Like for example, stocks can be valued by LIFO, FIFO, weighted averagemethod, etc.
- So choosing between these alternatives is a tough decision for the management.
- The ASdoes not provide guidelines for the appropriate choice.

Restricted Scope:

- Accounting Standards cannot override the laws or the statutes.
- They have to beframed within the confines of the laws prevailing at the time.

- That can limit their scope to provide thebest policies for the particular situation.

Pluralism:

- The existence of multiple accounting agencies for setting accounting standards is one of the disadvantages.
- In India, accounting standards setting is influenced by Accounting Standards Board of ICAI, Ministry of Corporate Affairs, Institute of Cost and Works Accountants of India, Securities and Exchange Board of India (SEBI).
- No one agency has jurisdiction over the entire area of accounting standards.

Conflict in Accounting Theories:

- There has been remarkable growth in accounting theories especially relating to income measurement, asset valuation, and capital maintenance.
- Though much of the developments has taken place abroad, (USA, UK, Canada, Australia, etc.), accounting in other countries has also been influenced.
- At present, there is not a single theory in accounting which commands universal acceptance and recognition.
- There is no best answer to the different terms like profit, wealth, distributable income, value, capital maintenance, and so forth.

Involves High Costs:

- Another disadvantage of following accounting standards is that it involves high costs. Implementing accounting standards in your accounting standards is too costly.
- Company need to change their entire procedures, upgrade their systems & provide their employees training accordingly.
- Companies need to monitor whether employees are correctly following standards. All these activities require large costs for bringing changes.

Time-Consuming:

- Another drawback of Accounting standards is that it is time-consuming.
- Implementation of accounting standards requires many steps to be followed to prepare financial report.
- It makes the process of preparing financial statements complex & time-consuming.

Not accepted around the world:

- The United States has yet to embrace the International Financial Reporting Standards, and certain other nations are also resisting.

- It complicates accounting for foreign-based firms doing business throughout the United States, as they must

Applicability of Accounting Standards

For the purpose of applicability of accounting standards, the enterprises are classified as;

- Level I entities.
- Level II entities.
- Level III entities.

Level I Enterprises – Non- corporate entities which fall in any one or more of the followingcategory, at the end of relevant accounting period.

- Entities whose equity or debt securities are listed or are in the process of listing on anystock exchange.
- Banks (including co-operative banks), financial institutions or entities carrying oninsurance business.
- All commercial, industrial and business reporting entities, whose turnover exceeds Rs. 50crores in the immediately preceding accounting year.
- All commercial, industrial and business entities having borrowings in excess of Rs. 10crores during the immediately preceding accounting year.
- Holding and subsidiary entities of any of the above.

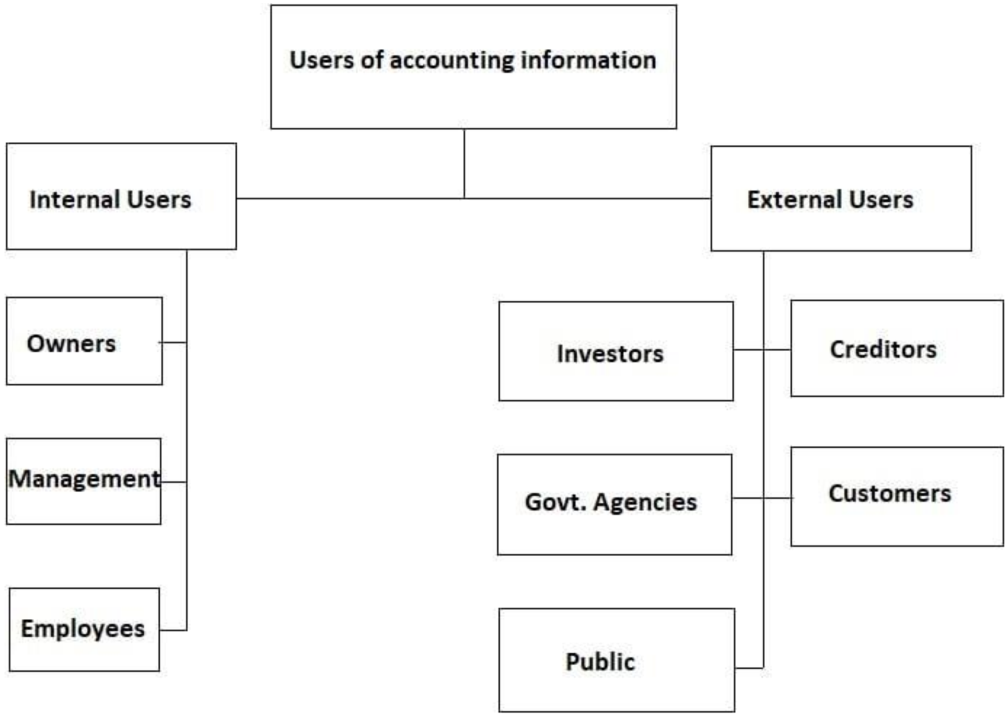
Level II Entities (SMEs) – Non-corporate entities which are not Level I entities but fall in anyone or more of the following categories:

- All commercial, industrial and business entities, whose turnover between Rs. 1 Crore - Rs. 50Crore in the immediately preceding accounting year.
- All commercial, industrial and business entities having borrowings ween Rs.1 Crore – Rs.10crore at any time during immediately preceding accounting year.
- Holding and subsidiary entities of any one of above.

Level III Entities (SMEs) – Non-corporate entities which are not covered under Level I andLevel II are considered as Level III entities.

GROUPS INTERESTED IN ACCOUNTING INFORMATION / USERS OF ACCOUNTING INFORMATION:

Groups may be categorised into internal users and external users.



(A) Internal Users

- **Business Owners**: Owners contribute capital in the business and thus they are exposed to maximum risk. So, they are always interested in the safety of their capital.
- **Management**: Accounting information is used by management for taking various decisions.
- **Employees**: Employees are interested in the financial statements to assess the ability of the business to pay higher wages and bonuses.

(B) **External U**sers

- **Banks and financial institutions:** Banks and Financial Institutions provide loans to business. So, they are interested in financial information to ensure the safety and recovery of the loan.
- **Investors:** Investors are interested to know the earning capacity of business and safety of the investment.
- **Creditors:** Creditors provide the goods on credit. So they need accounting information to ascertain the financial soundness of the firm.

- **Government:** The government needs accounting information to assess the tax liability of the business entity.
- **Researchers:** Researchers use accounting information in their research work.
- **Consumers:** They require accounting information for establishing good accounting control, which will reduce the cost of production.

INTRODUCTION TO TALLY:

Tally is a complete business solution for any kind of Business Enterprise. It is full fledged accounting software.

<u>Procedure for creating company in Tally</u>

- Double click on Tally icon on desktop. **Alt+F3 Company info**-Create company.
- **Accounts Only:** To maintain only the financial accounts of the company. Inventory (stock) managementis not involved in it.
- **Account with Inventory:** This is the default option, which allows maintaining both the financial accountof the company as well as the inventory of the company.
- **Select Company:** We can choose the company which is already created. Shortcut key - F1.
- **Shut Company:** It is used to close the company which is opened. Shortcut key - Alt+F1.
- **Alter:** It is used to make alterations in the company creation like name, date, maintain etc.
- **Quit:** Exits from Tally. 1. Click on quit button.
  2. Esc, Esc, Esc and enter.
  3. Ctrl+Q

Short cut keys

Alt+F3	Company information menu
Enter	To accept information typed into a field.
	To accept a voucher or master.
	To get a report with further details of an item in a report.
Esc	To remove what has been typed into a field.
	To exit a screen.
	To indicate you do not want to accept a voucher or master.
Ctrl+A	To accept a form wherever you use the key combination the screen or report

	will be accepted as it is on this screen.
Ctrl+Q	It quits the screen without making any changed to it.
Alt+C	To create a master at a voucher screen.
	When working within an amount field presses Alt+C to act as a calculator.
Alt+D	To delete a voucher.
	To delete a master.
Ctrl+Enter	To alter a master while making an entry or viewing report.
F2	Date
Alt+F2	Change period
Alt+F1	To see detail
F11	Features company
F12	Configuration options are applicable to all the companies in a data directory.
Ctrl+N	Calculator screen.
Ctrl+V	Voucher mode (Cr. Dr)
	Invoice mode (name of item, rate, quantity, and amount)

Gateway of tally-Accounts info-Group

Bank account	Direct income
Bank Od account	Indirect expense
Branch/division	Indirect Income
Capital account	Duties and tax
Cash in hand	Fixed asset Investment
Current asset	Loans and advance Loan (liability) Miscellaneous expenses
Current liability Deposit	Stock in hand
Direct expenses	Sundry debtor's
Provisions	Sundry creditors
Secured loan	Suspense
Retained earning	Unsecured account
Reserves and surplus	Purchase account
Sales account	

SALIENT FEATURES:

Main features of Tally are as under:-

- It maintains all the primary books of accounts, like Cash Book and Bank Book.
- Tally maintains all registers like Purchase Register, Sales Register and Journal Registers.
- Tally maintains all statement of accounts like Balance Sheet, Profit and Loss A/c and Trial Balance, Cash Flow(In cash flow statement we see the flow of cash i.e. the inflow and outflow of the cash) Stock Statement(In stock statement we maintain the proper record of all inventory) and Ratio Analysis.
- A Tally can maintain 'Outstation Reports'.
- It may provide complete bill-wise information of amounts receivable as well as payable either party-wise or group-wise.
- It can provide a report for a particular date or reports for any range of dates.
- It provides the facility of Bank Reconciliation.

REPORTS GENERATED BY TALLY.

Reports in Tally

Below are the variety of reports available in Tally by default and customised by us

Accounts Reports

General

- Group Summary
- Sales Register
- Purchase Register
- Journal Register
- Group Vouchers
- Day Book

Outstanding Reports (Receivables and Payables)

- Groups Outstandings
- Agewise Outstandings
- Ledgerwise Outstandings
- Billwise-Partywise outstandings
- Payment Performance Summary
- Overdue Receivables and Payables

Financial

- Balance Sheet
- Profit & Loss A/c
- Ratio Analysis
- Trial Balance

Banking

- Cash and Bank Book
- Bank Reconciliation
- Ledger Vouchers
- Receipts and Payments

Analysis

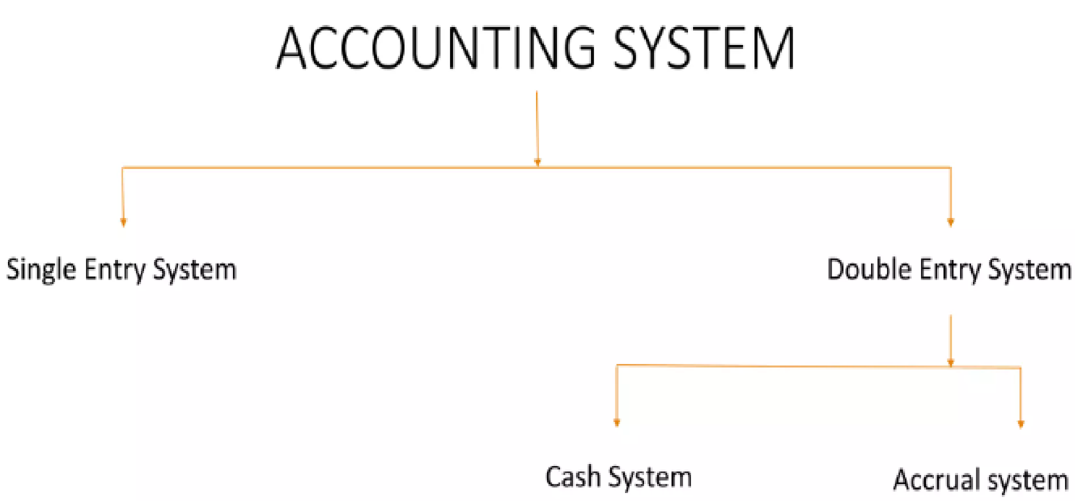
- Cash Flow Statements
- Fund Flow Statements

Inventory Reports

- Stock Summary
- Stock Item Vouchers
- Stock Group Summary
- Batch Report
- Sales Order Book
- Purchase Order Book
- Stock Transfers
- Physical Stock Register
- Negative Stock
- Negative Batch
- Stock Query
- Cost Estimation
- Item Cost Analysis
- Godown Summary
- Category Summary
- Sales Order Outstanding
- Purchase Order Outstanding
- Reorder Report
- Purchase Bill Pending
- Sales Bill Pending

- Statutory Reports
- Payroll Reports

ACCOUNTING SYSTEM:



Single Entry System:

A method of bookkeeping that recognizes only one side of a business transaction and usually consists only of a record of cash and personal accounts with debtors and creditors

Double entry system

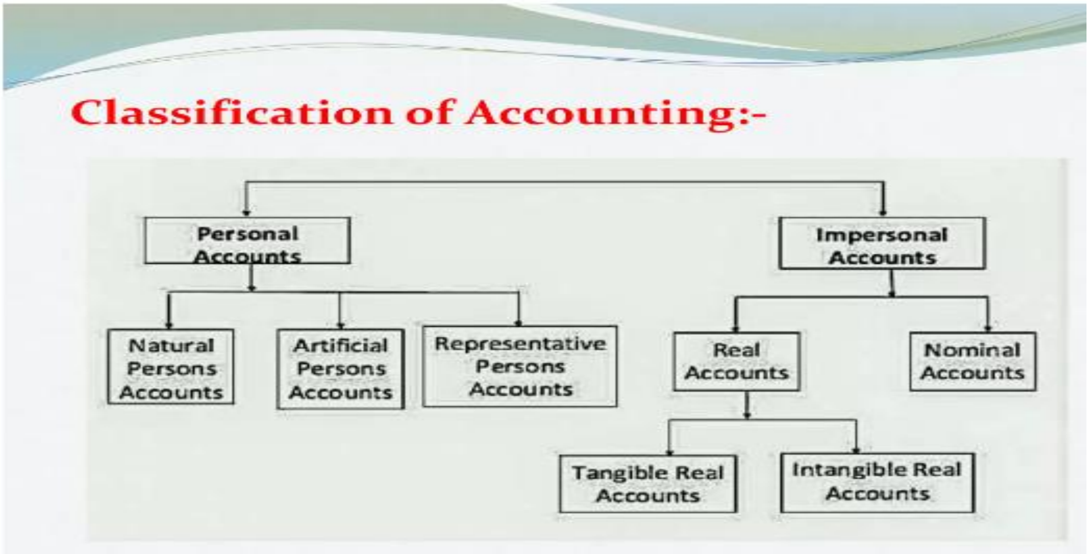
- Double entry system of Book keeping was originated by Luca Pacioli , an Italian Monk in 1494.
- It records the monetary transactions with equal debits & credits .Hence the total of all debit must be equal to the total of all credits.
- The basic principal of double entry system is each financial transaction has two components, i.e when company receives something it must pays something. i.e " ***For every debit there is a credit"***
- Under double entry system , books of accounts can be maintained in 2 ways;
    a) Cash accounting System
    b) Accrual Accounting system

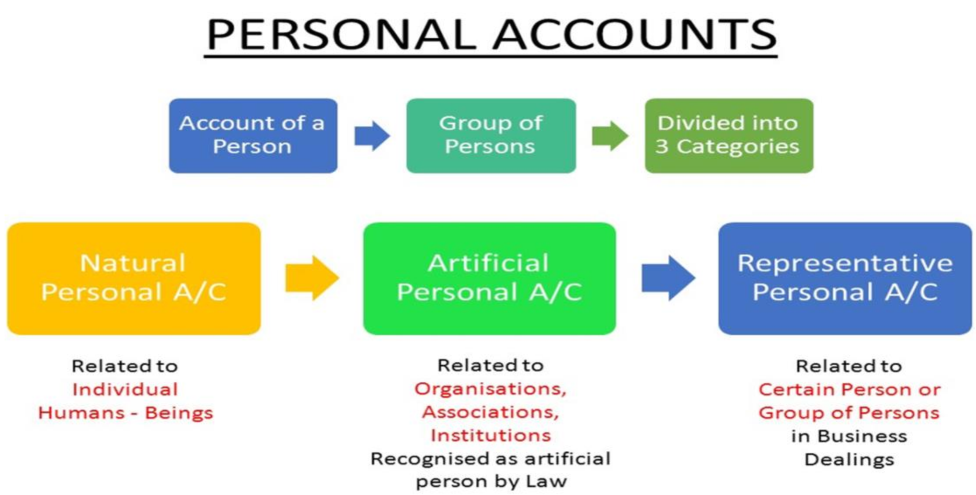
- **a) Cash accounting System** :
- Cash accounting is an accounting method where payment receipts are recorded during the period in which they are received, and expenses are recorded in the period in which they are actually paid.
- In other words, revenues and expenses are recorded when cash is received and paid, respectively.

b) Accrual Accounting system

- Under this method, revenue is accounted for when it is earned.
- Unlike the cash method, the accrual method records revenue when a product or service is delivered to a customer with the expectation that money will be paid in the future.
- In other words, money is accounted for before it's received.
- Likewise, expenses for goods and services are recorded before any cash is paid out for them.

CLASSIFICATION OF ACCOUNTING:

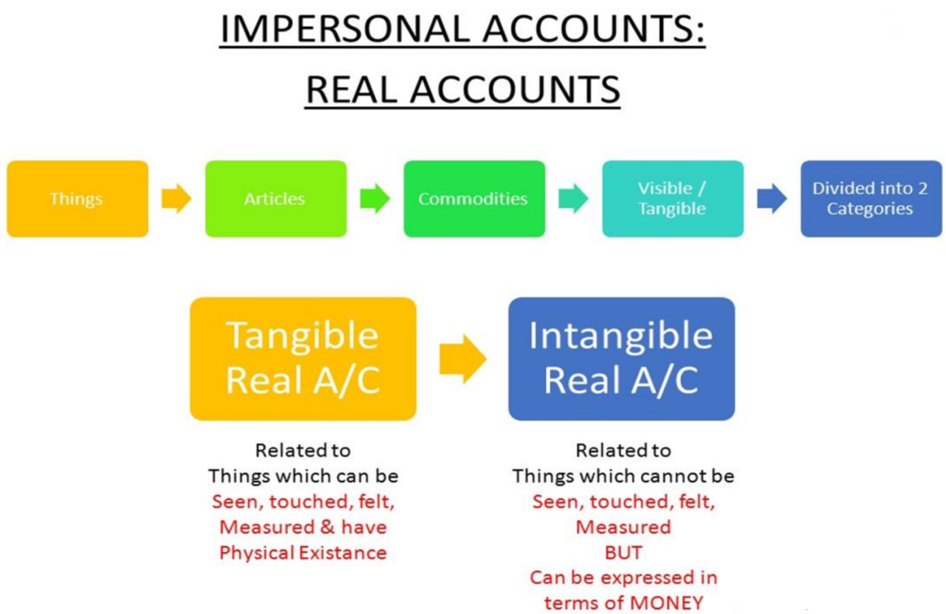




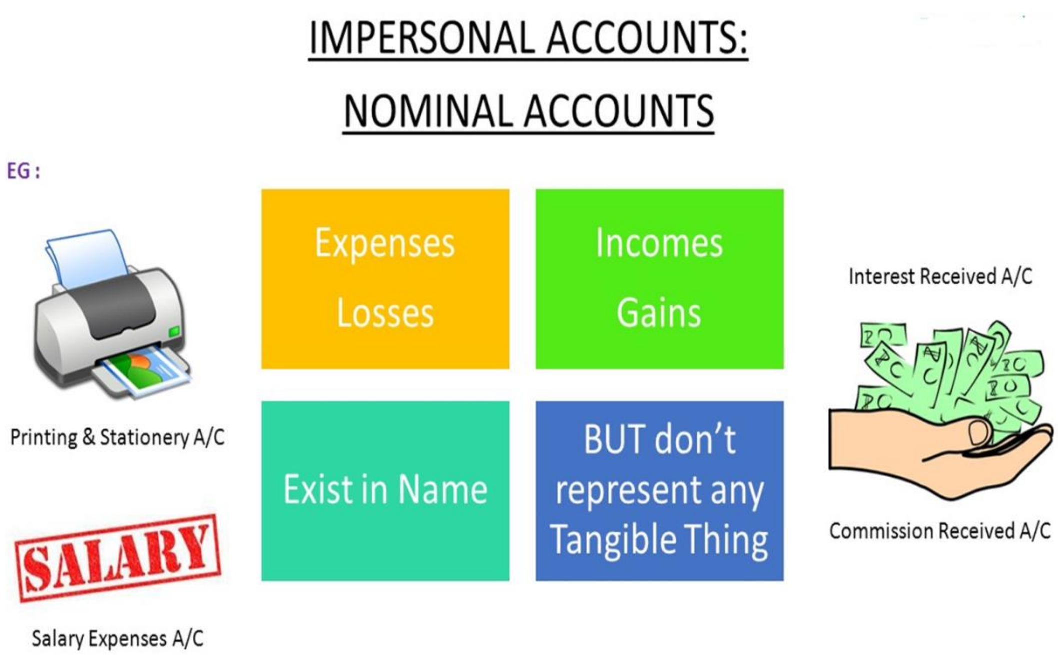
• **Examples of Natural Personal A/C:** Ram's A/C , Vinita's A/C , Suresh A/C

• **Examples of Natural Personal A/C:** ABC Ltd Co. A/C , Sports Club A/C , Rajkot Municipal Corporation A/C.

• **Examples of Natural Personal A/C:** Outstanding Expenses A/C , Outstanding income A/C ,Pre paid expenses A/C



- **Examples of Tangible Real A/C:** Cash A/C, Building A/C, Furniture A/c
- **Examples of Intangible Real A/C:** Patents , Good will , Trade marks



GOLDEN RULE OF ACCOUNTING

Double Entry Rule

Types of Account	Rules of Debit	Rules of Credit
Personal Accounts	*Debit the Receiver*	*Credit the Giver*
Real Accounts	*Debit what comes in*	*Credit what goes out*
Nominal Accounts	*Debit all expenses and losses*	*Credit all the incomes and gains*

LIST OF EXAMPLES – 3 TYPES OF ACCOUNTS

Account	Type	Comments
Plant & Machinery A/c	Real	Tangible asset
Investments A/c	Real	Intangible asset
Purchases A/c	Nominal	Expense for business
Creditor's A/c	Personal	Related to persons*
Accrued Income A/c	Personal	Related to persons*
Equipment A/c	Real	Tangible asset
Loan Taken A/c	Personal	Related to persons*
Outstanding Expense A/c	Personal	Related to persons*
Bank A/c	Personal	Related to persons*
Capital A/c	Personal	Related to persons*
Loose Tools A/c	Real	Tangible asset
Sales A/c	Nominal	Income for business
Goodwill A/c	Real	Intangible asset
Drawings A/c	Personal	Related to the owner
Payment of Expense A/c	Nominal	Reduction of expense
Prepaid Expense A/c	Personal	Related to persons*

Debtor's A/c	Personal	Related to persons*
Bad Debts Written Off A/c	Nominal	Loss for business
Bad Debts Recovered A/c	Nominal	Gain for business
Income Received in Advance A/c	Personal	Related to persons*
Cash A/c	Real	Tangible asset
Discount Received A/c	Nominal	Gain for business
Discount Allowed A/c	Nominal	Loss for business
Petty Cash A/c	Real	Tangible asset
Carriage Inwards A/c	Nominal	Expense for business
Depreciation A/c	Nominal	Non-cash Expense
Leasehold Property A/c	Real	Asset for the business
Interest on Drawings A/c	Nominal	Income for business
Interest on Capital A/c	Nominal	Expense for business
Trademark A/c	Real	Intangible asset
Bank Overdraft A/c	Personal	Related to persons*
Furniture A/c	Real	Tangible asset
Interest Paid A/c	Nominal	Expense for business
Bills Payable A/c	Personal	Related to persons*
Bills Receivable A/c	Personal	Related to persons*

Accounts	Nature of Accounts	Debited/Credited
(i) Rent Received A/c	Nominal	Credited
(ii) Machinery A/c	Real	Debited
(iii) Purchases A/c	Nominal	Debited
(iv) Capital A/c	Personal	Credited
(v) Rent Paid A/c	Nominal	Debited
(vi) Interest Received A/c	Nominal	Credited
(vii) Building A/c	Real	Credited
(viii) Discount Allowed A/c	Nominal	Debited
(ix) Sales A/c	Nominal	Credited

Journal

- Journal may be defined as a book which records monetary transactions at first as per the sequence of occurrence of Transactions.
- It contains record of business transactions in chronological order.
- Journal is the book of orginal entry or prime entry.

Characteristics of Journal

- Journal is the first step of double entry system. A transaction is recorded first of all in the journal.
- A transactions is recorded in journal as it takes place , therefore , Journal is also referred as Day book.
- Since transactions are recorded chronologically in a journal, so journal is also referred to as chronological Book.
- Narration is written below each entry to explain the details for passing the entry.
- Every transaction has two fold effects on double accounts indicating which is debited and which is credited.
- The amount is written in amount columns indicating as debit & credit columns respectively.

The Pro forma of journal is shown as follows:-

JOURNAL

Date	Particulars	L.F.	Debit (Amount)	Credit (Amount)
(1)	(2)	(3)	(4)	(5)

Date:- The date of the transaction on which it takes place.

Particulars:- The name of the accounts to the debited is written first, then the names of the accounts to be credited, and lastly the narration are entered.

L.F.(Ledger Folio):- In it entered the page numbers on which the various accounts appear in the ledger.

Debit (Amount):- The amount to be debited against the 'Dr.' Account is written along with the nature of currency.

Credit (Amount):- The amount to be credited against the 'Cr.' Account is written along with the nature of currency.

Journalizing steps:-

Some steps are followed in Journalizing:

(i) Find out what accounts are involved in business transaction.

(ii) Ascertain what is the nature of accounts involved?

(iii) Ascertain the golden rule of debit and credit is applicable for each of the accounts involved.

(iv) Find out what account is to be debited which is to be credited.

(v) Record the date of transaction in the "Date Column".

(vi) In the 'Particulars Column' along with the word 'Dr.' on the same line against the name of the account, the amount to be debited in the 'Debit Amount column'.

(vii) Record the name of the account to be credited in the next line preceded by the word 'To' at a few space towards right in the 'Particulars Column' and the amount to be credited in the 'Credit Amount Column' in front of the name of the account.

DIFFERENCE BETWEEN JOURNAL & LEDGER:

No	Journal	Ledger
1.	Journal is a subsidiary book of account. It is the store house of recording transactions.	Ledger is the permanent and final book of accounts. It is termed as the means of classified transactions.
2.	Transactions are recorded in journal in chronological order of dates just after their occurrences.	Transactions are posted in ledger in classified form from journal.
3.	Transactions are recorded in journal without considering their nature of classification.	Transactions are recorded in ledger in classified form under respective heads of accounts.
4.	In journal explanation of entries of transaction are shown.	In ledger explanations of entries of transactions are not needed.
5.	The format of journal contains five columns.	Generally the ledger account of 'T' form contains eight columns – four in left and four in right. But in statement format of ledger account contains six columns.
6.	Journal helps in preparing ledger accounts correctly.	The object of ledger is to know income and expenditures of different heads.
7.	Transactions are recorded in journal in chronological order of dates.	Ledger is prepared according to nature of accounts.
8.	The total results of transactions cannot be known from journal.	Results of particular head of accounts can be known from ledger.
9.	In journal ledger folio (L.F.) is written.	In ledger journal folio (J.F.) is written.
10.	Preparation of trial balance is not possible from journal.	Trial balance is prepared from ledger.

S. No.	Basis of Difference	Journal	Ledger
1.	Entry	Journal is the Book of Original entry.	Ledger is the Book of Secondary Entry.
2.	Record	Journal is the Book for Chronological record.	Ledger is the Book of analytical record.
3.	Classification of Data	The basis of recording in the journal is transaction.	The basis of posting in the ledger is Journal.
4.	Process of Recording	Process of recording in the Journal is known as journalizing.	Process of recording in the ledger is known as ledger posting.

Types of vouchers in Tally

There are broadly two voucher types in tally. They are accounting vouchers and inventory vouchers.

Accounting vouchers in Tally can be further classified as under.

1. Sales Voucher in Tally

Whenever you sell a product or service, you record sales entries. In tally, the sales are recorded through the sales voucher. It is one of the most widely used accounting vouchers in tally. There are two modes for accounting in sales vouchers- Invoice mode and Voucher mode. You can use either of them. You can print the copy of your invoice to the party in Invoice mode. In Voucher mode, you can record the transaction for statutory purposes where you don't need to print the invoice document.

2. Purchase Vouchers in Tally

Whenever you purchase a product or service, you record the purchase entry. In tally, this is recorded through the purchase voucher. It is also one of the most widely used vouchers in tally. There are two modes for accounting in purchase vouchers- Invoice mode and Voucher mode, as mentioned in the sales voucher. You can use either as you see fit. You can print the copy of your invoice to the party in Invoice mode. Whereas in Voucher mode, you can record the transaction for statutory purposes, and you don't need to print the invoice document. You can also change the mode of transaction like in the sales voucher in Tally.

3. Payment Voucher in tally

All the functions of a payment transaction are available in Tally. You can have all the necessary details like instrument number, Bank name, balance available, etc. After passing the entry in the payment voucher, you can also print the cheque. You can look at the list of cheques that need to be printed by going to Banking and clicking on Cheque Printing. Tally.ERP 9 supports around 500 banks from both India and foreign countries. After the payment is made, you can generate and share the payment receipt with your supplier and keep them updated regarding payments.

4. Receipt Voucher in Tally

When you receive payment, you can record that transaction in the receipt voucher. You will even get a prompt for the pending payments from your customers. You can record transactions when you receive the payment and select the correct mode to receive the payment- cash, cheque or other modes- and mention the relevant instrument number. With receipt vouchers, now you can maintain transparency of your sales with your clients effectively.

5. Contra Voucher in Tally

Contra Voucher is used when either side of the entry has cash, bank or multiple banks involved. Generally, any cash deposit, withdrawal, transfer amongst different accounts are recorded in a contra voucher. You can also generate a cash deposit slip and mention the denominations of the currency involved in such a transaction.

6. Journal voucher in Tally

This voucher can be used for multiple reasons. Some use it for sales, purchases, depreciation; any adjustment entry can also be done using this voucher in Tally. This voucher is available in both accounting and inventory vouchers in Tally. In inventory mode, the entry relating to the movement of goods can be passed.

7. Credit Note Voucher in Tally

Credit Note entry is passed when there is a sales return transaction. This voucher usually remains deactivated by default. You can activate it by pressing F11 and configuring features in invoicing. You can refer to the original sales invoice against which this entry is passed to keep track of such transactions. When a party is selected, you will come across the list of invoices against which this credit note voucher is used. Credit notes can also be used either in invoice mode or as voucher mode as could be used in Sales Voucher

8. Debit Note Voucher in Tally

Debit Note entry is passed when there is a purchase return transaction. This voucher is deactivated by default. You can activate it by pressing F11 and configuring its features. You can refer to the original purchase invoice against which this entry is passed for maintaining track of such transactions. When a party is selected, you will come across the list of invoices against which this Debit note voucher is used. Debit notes can also be used either in invoice mode or voucher mode as utilised in Purchase Voucher.

Inventory vouchers in Tally ERP 9

1. Physical Stock Verification Voucher in Tally

This voucher maintains the list of inventories in a company. Generally, businesses count physical stock verification periodically and keep a record of the same through this voucher. This helps to keep inventory control in check. You can mention the name, quantity, rates, godown, batch/ lot no, manufacturing date, expiry date, etc. You can easily find which godown has how many goods and of what value. This can help in management decision making and maintain the numbers in the physical inventory and accounting books.

2. Material In and Material Out Voucher

This voucher is widely used for those businesses where workers are involved. It helps to keep track of inventory sent and received from a worker. You can activate this voucher by pressing F11 and configuring features. You can mention details like the item's name, rate, and quantity for better records maintenance. You can monitor the periodicity for which the goods have been with the job worker and when they were received. This is necessary for GST compliance as well.

3. Delivery Note Voucher

This voucher is used to record the delivery of goods. It is also referred to as Delivery Challan. It also has additional features wherein you can enter the vehicle number, dispatch document number, bill of lading, and other details.

4. Receipt Note Voucher

This voucher is used to record the receipt of goods from the suppliers. It also has additional features wherein you can enter the vehicle number, dispatch document number, bill of lading, and other details.

5. Order vouchers in tally

Apart from Tally accounting voucher and Tally inventory vouchers, tally also provides order vouchers. They are purchase orders and sales order vouchers. They help in managing the whole transaction cycle of an order. You can even record post-dated sales and purchase order vouchers.

UNIT-II Capital and Revenue Expenditure – Deferred Revenue Expenditure – Capital and Revenue Receipts – Depreciation – Definition – Causes – Necessity of providing for depreciation – Methods of Calculating Depreciation: Straight Line Method and Written Down Value Method – Problems.

EXPENDITURE

Expenditure is basically spending of funds or money to avail services or for purchasing. Expenditure means spending on something. This can be a payment is cash or can also be the exchange of some valuable item in exchange for goods or services. Two types of expenditures are present on the basis of time durations, That is

1. Capital expenditures
2. Revenue expenditures

CAPITAL EXPENDITURES

- Capital Expenditure is the amount of money that a company spends on acquiring new assets.
- Capital expenditures are recorded as expenses in the period they were incurred and reported on the balance sheet under fixed assets, intangible assets and equity investments.
- Expenditure may be identified as a capital expenditure when Expenditure incurred for fixed assets land, building, plant, machinery, cost of installation of lights, fans, cost of erection of plant and machinery.

Examples of Capital Expenditure:

1. Cost of land, building, plant and machinery. 2. Cost of manufacture, purchase of furniture etc. 3. Purchase of vehicle, cars, vans etc. 4. Cost of good will, trademark, copyrights etc. 5. Preliminary expenses. etc.

REVENUE EXPENDITURES

- Revenue expenditure is the money spent on goods and services used to generate revenue.
- This type of expenditure is calculated **by subtracting the cost of goods sold from the total income** and then adding back in the price of goods sold.

Examples: Advertising expenses, Cost of goods sold **,** Salaries and wages **,**Rent expense, Depreciation of fixed assets, Discounts and allowances.

Difference between Capital Expenditure & Revenue Expenditure

	Capital Expenditure	Revenue Expenditure
Definition	Expenditure is incurred to acquire assets, and enhance the capacity of an existing asset resulting in increasing its lifespan	Expense incurred to maintain the day to day business activities
Tenure	Long term	Short term
Value Addition	Enhances the existing asset value	Does not enhance the existing asset value
Physical Presence	Has a physical presence except for intangible assets	Does not have a physical presence
Occurrence	Non-recurring in nature	Recurring in nature
Availability of Capitalisation	Yes	No
Impact on Revenue	Do not reduce business revenue	Reduce business revenue
Potential Benefits	Long-term benefits for business	Short-term benefits for business
Appearance	Appears as assets in the balance sheet and some portion in the income statement	Always appears in the income statement

DEFERRED REVENUE EXPENDITURE

Deferred revenue expenditure is an expenditure that is incurred in the current accounting period, but its benefits are incurred in the following or the future accounting periods. This expenditure might be written off in the same financial year or over a few years. Prepaid Expenses, Exceptional Losses, Services Rendered, Fictitious Asset are the example of Deferred revenue expenditure.

Eg: In the case of a startup company, the firm invests heavily in marketing and advertising initially. They do this to capture some position in the market and amongst competitors. This expense, done initially, reaps the benefits over several years.

Features or Characteristics of Deferred Revenue Expenditure

1. It is revenue in nature.
2. The benefit of this expenditure lasts for a period of more than one accounting year.
3. It pertains wholly or partly for the future years.
4. It is a huge amount of expense and thus, is deferred over a period of time.

Classification of Deferred Revenue Expenditure

1. **Expenses partly paid in advance:** It is when the firm derives a portion of the benefit in the current accounting year and will reap the balance in the future years. Thus, it shows the balance of the benefit that it will reap in future on the Assets of the Balance Sheet. For eg. Advertising expenditure.
2. **Expenditure in respect of services rendered:** Such expenditure is considered as an asset as it cannot be allocated to one accounting year. For example, discount on issue of debentures, the cost of research and experiments, etc.
3. **Amount relating to exceptional loss:** We treat the exceptional losses also as deferred revenue expenditure. For eg. Loss by earthquake or floods, loss by confiscation of property, etc.

Importance of Deferred Revenue Expenditure

Some of the importance is given below:

- **Matching Principle:** Deferred revenue expenditure helps in complying with the accounting principle of the matching concept. All Cost should be booked in the income statement only when relevant revenues can be booked and vice versa.

- **Ensures Correct Profit Is Disclosed:** Expenditures are getting deferred; as a result, the cost is not getting overstated. A portion of Cost is getting booked equivalent to benefits getting derived for the given period of time. This ensures that the correct profit is getting calculated and not getting understated.

- **Maintains the Earning Capacity:** Such expenditure helps the business in running mode. It works as a lubricant for business. It ensures that the public remains aware of a business's product or services, which will maintain the earning capacity of the business.

CAPITAL AND REVENUE RECEIPTS

Capital Receipts:

- Capital receipts are given when a company makes an asset.
- **Capital receipts** are amounts from sales of long-term investments or assets, such as land and buildings which are not part of the normal trading activities
- Capital receipts are payments for bigger items of expenditure, whereas revenue receipts are for day-to-day expenditure

Example:

Sale of assets, such as property or equipment, payment made to a business by an investor, loans from banks, venture capital funding, and loan payments

Revenue receipts

- **Revenue receipts** are amounts from sales of normal trading activities or asset sales that will be replaced in the near future. Revenue receipts are given to you every year as a tax statement.
- The revenue receipts are the receipts of money because of the sale of goods, rendering services, etc., and do not require the Government to spend money
- These receipts consist of revenue from taxes (such as sales tax, excise tax, service tax, customs duties, etc.), other non-tax revenue (such as interest receipts, revenue from public enterprises, etc.), and grants and loans given by other Governments and institutions
- **Example:** Sales invoices, Tax invoices, and Cash memos, gifts, donations, grants, fines, penalties, royalties, and interests

Difference between Capital Receipts & Revenue Receipts

BASIS FOR COMPARISON	CAPITAL RECEIPT	REVENUE RECEIPT
Meaning	Capital Receipts are the income generated from investment and financing activities of the business.	Revenue Receipts are the income generated from the operating activities of the business.
Nature	Non-Recurring	Recurring
Term	Long Term	Short Term
Shown in	Balance Sheet	Income Statement
Received in exchange of	Source of income	Income
Value of asset or liability	Decreases the value of asset or increases the value of liability.	Increases or decreases the value of asset or liability.

DEPRECIATION:

Meaning:

The meaning of the word depreciation is loss of the value through wear and tear or some other form of material deterioration.

Definition:

"Depreciation may be defined as the permanent decrease in the value of an asset through wear and tear in use or the passage of time."

CAUSES OF DEPRECIATION

1. Wear and Tear

Some assets physically deteriorate due to wear and tear in use. When an asset is constantly used for production, the asset wears out. More and more use of an asset, the greater would be the wear and tear. Physical deterioration of an asset is caused from movement, strain, friction, erosion, etc. For instance, building, machineries, furniture, vehicles, plant etc. The wear is general but primary cause of depreciation.

2. Lapse of time

There are certain assets like leasehold property, patents, copy-right etc. That is acquired for a particular period. After expire of the period, they are rendered useless i.e. their value ceases to exist. Thus their cost is written off over their legal life.

3. Obsolescence

Appearance of new and improved machines results in discarding of old machines. Thus New inventions, ***change in fashion and taste, market condition, Government policies etc***., are the causes to discard the value of an asset. But this is not the cause of depreciation and not depreciation in the real sense. A new machine performs the same function more quickly and cheaply than the existing machine. As such, existing machine may become out of date or outmoded or obsolete.

4. Exhaustion

Some assets are of wasting nature. For instance, ***quarries, mines, oil-well etc.*** It is reduction in the value of natural deposits as resource, have been extracted year after year. As such these assets are known as wasting sheets. The coalmine or oil well gets physically exhausted by the removal of its content.

5. Non-use

Machines which are idly lying, becomes less useful with the passage of time. Certain types of machines exposed to weather conditions, may have more depreciation from not using it then from its use.

6. Non-Maintenance

A good maintenance of machines will naturally increase its life. When there is no maintenance, there is more depreciated value. When there is good maintenance, there is longer life to the machines. The long life of machine depends upon good and skilled maintenance

7. Market Trend

The market price may fluctuate in case of certain assets, for instance, investments in gilt-edged securities. When the prices go down, the concerned assets may depreciate its value. In certain cases, accident causes diminution in the value of assets.

NEED FOR DEPRECIATION

Depreciation is provided for the assets with a view to achieve the following results:

1. **To ascertain the true Working Result**

Asset is an important tool on earning revenues. The assets get depreciated in their values, over a period of time due to many reasons. When the values decreases, this loss must be brought into account otherwise a true working result cannot be during each year. The basic need of depreciation is to ascertain the true income.

2. To Ascertain the True Value of Asset

The function of Balance sheet is to show the true and correct view of the state of affairs of a business. If no depreciation is charged and when assets are shown at the original cost year after year, Balance Sheet will not disclose the correct state or affairs of a business.

3.To Retain Funds for Replacement

- Assets used in the business need replacement after expiry of their service. It is always not possible to determine the useful life of assets.
- In certain cases, machine often becomes, obsolete long before it wears out because of rapid changes in tastes and technology. It is permanent loss in value of asset.
- When an asset is continuously used, a time will come when the asset is to be given up and hence its replacement is essential. Therefore, if no depreciation is charged against the profit, during the life time of the asset, it will be very difficult to find cash to replace the asset and if replaced it may cripple resources.
- Therefore, it is necessary to make provision and create funds to replace such assets, in proper time.

To Reduce Tax Liability

- Depreciation is a tax deductible expenses.
- As such, it is permitted by the prevailing taxation laws to be deducted from profit.
- Consequently, the owner of a business may avail himself of this benefit by charging depreciation to his profit and reducing his tax liability.

To present True Position

- Financial Position can be studied from the Balance Sheet and for the preparation of the Balance sheet fixed assets are required to be shown at their true value.
- If assets are shown in the Balance Sheet without any charge made for their use, (that is, depreciation) then their value must have been overstated in the Balance sheet and will not reflect the true financial position of the business.
- Therefore, for the purpose of reflecting true financial position, it is necessary that depreciation must be deducted from the asset and then at such reduced value may be shown in the Balance sheet.
- The companies Act of 1956 now makes it compulsory to write off depreciation on fixed assets before declaring dividend.

Consequences of not Providing for Depreciation

1. Profit will be overstated
2. Capital employed will be incorrect.
3. Valuation of assets will be understated

4. Cost of production will be understated.

5. Periodic expenses will be understated.

6. Capital depletion will take place.

7. Net worth will be overstated.

8. Correct sale price of price of products cannot be fixed.

9. No provision for replacement of assets.

10. A true working result cannot be known.

METHODS OF DEPRECIATION:

Straight-Line Method (SLM)

Declining Balance Method Formula:

i) ***Straight-Line Method (SLM)***

This is the simplest method of calculating used most of the time. In SLM, a constant depreciation amount is charged every year. First, corporations have to estimate the salvage (residual) value. The **salvage value** represents the cost the company expects to recover at the end of the machine's useful life. After deducting this residual value from the fixed asset cost, the value acquired is divided by the useful life of the **fixed assets**.

Advantages of the Written Down Value Method:

The following are the advantages of the Written Down Value Method:

1. There is same weightage on Profit and Loss Account of depreciation and repair expenses.

2. This method is easier than Straight Line Method.

3. In case of expansion and increase in assets, the depreciation can be computed easily by this method.

4. This method is acceptable by the Government under the Income Tax Act.

Disadvantages of the Written Down Value Method:

The following are the disadvantages of the Written Down Value Method:

1. In this method the value of the asset can never be zero.

2. It is a difficult task to ascertain the proper rate of depreciation.

3. There is no provision of interest on capital invested in use of assets.

Straight-Line Method Formula:

$$\text{Depreciation} = \frac{(\text{Cost of Fixed Asset} - \text{Salvage Value})}{\text{Useful Life of Fixed Asset}}$$

Declining Balance Method Formula:

In this method, the depreciated percentage is charged on the net book value of a fixed asset. This netbook value is the remaining balance of fixed asset cost after deducting the overall depreciation charged for the previous years. Thus, the depreciable value diminishes every year, and so does the depreciated expense.

$$\text{Depreciation} = (\text{Net Book Value} - \text{Salvage Value}) \times \text{Rate of Depreciation}$$

Advantages of the Written Down Value Method:

The following are the advantages of the Written Down Value Method:

1. There is same weightage on Profit and Loss Account of depreciation and repair expenses.
2. This method is easier than Straight Line Method.
3. In case of expansion and increase in assets, the depreciation can be computed easily by this method.
4. This method is acceptable by the Government under the Income Tax Act.

Disadvantages of the Written Down Value Method:

The following are the disadvantages of the Written Down Value Method:

1. In this method the value of the asset can never be zero.
2. It is a difficult task to ascertain the proper rate of depreciation.
3. There is no provision of interest on capital invested in use of assets.

iii) *Double Declining Balance Method*

This method works similar to the **declining balance method**; however, it charges double the depreciated rate on the fixed asset's balance or net book value. Therefore, it is also known as an **accelerated method**.

Double Declining Balance Method Formula:

$$\text{Depreciation} = (\text{Net Book Value} - \text{Salvage Value}) \times \text{Rate of Depreciation} \times 2$$

iv) Units of Production Method

Under this method, the fraction of the number of fixed asset units (machinery) produced per year and the total number of units generated in a lifetime is multiplied with the fixed asset cost to yield the depreciated expense of each year. Hence, if the production decreases, the depreciated cost also steeps down and vice versa.

Units of Production Method Formula:

$$\text{Depreciation Rate Per Unit} = \frac{\text{Fixed Asset Cost} - \text{Salvage Value}}{\text{Total number of units produced during the useful life}}$$

v) Sum-of-Years Digits Method

As the name indicates, this method takes the total useful years. Here the digits are arranged in descending order. Then the remaining number of useful years are divided by this sum and multiplied by 100 to get the depreciated rate for the particular year. Finally, the depreciated expense is computed by multiplying this rate with the remaining fixed asset cost after deducting the salvage value.

Sum-of-Years Digits Method Formula:

$$\text{Depreciation} = [\frac{\text{Useful Life Remaining}}{\text{Sum of Years Digits}} \times 100] \times \text{Depreciable Fixed Asset Value}$$

DIFFERENCE BETWEEN STRAIGHT LINE METHOD & WRITTEN DOWN VALUE METHOD:

S.No.	Points of difference	Straight line method	Written down value method
1	Basis of calculation	Depreciation is calculated on the original cost of the asset for all the years .	Depreciation is calculated on the written down value of the asset year after year.
2	Amount of depreciation	The amount of depreciation is the same for all the years.	The amount of depreciation goes on decreasing year after year.
3	Book value of the asset at the end of its life	The book value of the asset becomes zero when there is no scrap value or is equal to its scrap value at the end of its life.	The book value of the asset never becomes zero.
4	Computation of rate of depreciation	It is easy to calculate the rate of depreciation.	It is very difficult to calculate the rate of depreciation.

UNIT-III Financial Statements – Meaning – Types of financial Analysis – Techniques of Financial Analysis – Ratio Analysis – Profitability Ratios – Coverage Ratios – Turnover Ratios – Financial Ratios – Ratios to Financial Statement (problems) – uses and limitations of Ratio Analysis – Funds Flow Analysis (simple problems) – uses and limitations – Cash Flow Analysis (simple problems) – uses and limitations – Difference between funds flow and cash flow analysis

FINANCIAL STATEMENT ANALYSIS

It is defined as the process of identifying the financial strengths and weaknesses of a firm by adeptly establishing a relationship between the details of the Balance Sheet and the Profit & Loss Account of the enterprises.

It is a study of the relationship among various financial factors active in a business, as disclosed by a single set of statement. Moreover, a series of statements helps the analyses to study the trends of these factors.

OBJECTIVE OF FINANCIAL STATEMENTS

- Helps in preparing budgets
- Helps in analysing past performances with respect to current earnings and financial position
- Helps in projections
- Helps in inter- firm comparison
- To provide financial information regarding economic resources and obligations of a businessenterprise.
- To study solvency and liquidity
- To provide information about available resources
- To show strengths and weaknesses of the organisation
- To provide better insights to stakeholders for evaluation of organisation's performance

USERS OF FINANCIAL STATEMENTS

- Shareholders
- Investors:

- Lenders
- Management
- Public
- Government
- Labour and Trade Union

SOURCES OF FINANCIAL STATEMENT ANALYSIS

Financial statements are prepared on the basis of:

a) Recorded facts

b) Accounting conventions

c) Postulates

d) Personal judgements

e) Accounting standards and guidance notes

TECHNIQUES USED FOR FINANCIAL STATEMENT ANALYSIS

Following techniques are used for analyzing financial statements:

a) Comparative Statements

b) Common – Size Statements

c) Trend Analysis

d) Ratio Analysis

e) Fund Flow Analysis

f) Cash Flow Analysis

COMPARATIVE STATEMENTS

- A business concern compare its performance with such competing concerns to find out where it scores over its rivals and where it lags behind them.
- It also needs to compare its own past performance with its current performance to ascertain its progress or decline over the years.
- This is known as inter-period comparison.
- Such statement proves that "the accounts of one period are but an installment of the continuous history of a going concern".

COMMON SIZE STATEMENTS

- In common size financial statements, all items on the statement are expressed as a percentage of the base item. Common size statements are useful for seeing how significant the components of the individual items of the statements are.

- This facilitates comparison of two or more business entities with acommon base.

TREND ANALYSIS

Trend Analysis treats year 1 as the base year and compares the figures of all the years (year 2, year 3) with those of the base year to ascertain the trend in figures. Thus trend analysis of sales will reveal whether as compared to the base year, i.e. Year I, the sales show a trend of increase or decrease in subsequent years, i.e. Year 2, Year 2, Year 3 ….. And so on.

Trend Analysis is useful because:

(a) Trends show the direction (up or down) of the changes.
(b) Trends are easy to calculate and interpret.
(c) It is a quick method of analysis.
(d) It is more accurate because it is based on percentages and not absolute figures.

FUND FLOW ANALYSIS

Fund Flow Statement also referred to as statement of "Source and Application of Funds" presents the movement of funds and helps to understand the changes in the structure of assets, liabilities and equity capital.

CASH FLOW ANALYSIS

- The statement of cash flow reports the inflows (receipts) and outflows (payments) of cash and its equivalents of an organization during a particular period.
- It provides important information that compliments Statement of Profit & Loss and balance sheet.
- The statement of cash flow reports the cash receipts, cash payments, and net changes in cashresulting from operating, investing and financing activities of an enterprise during a period in a format that reconciles the beginning and ending of cash balances.

RATIO ANALYSIS

- A ratio shows the relationship between two numbers.
- Ratio analysis is the process of computing and presenting the relationships between the items in the financial statement.
- It is an important tool of financial analysis, because it helps to study the financial performance and position of a concern.

- Ratios show strengths and weaknesses of the business

OBJECTIVES OF RATIO ANALYSIS

- .To show the firm's relative strengths and weaknesses.
- To help to analyze the past performance of the firm and to make future projections.
- To allow interested parties like shareholders, investors, creditors and the government to analyze and make evaluation of certain aspects of firm's performance.
- To concentrate on inter-relationship among the figures appearing in the financial statements.
- To provide an easy way to compare present performance with the past.
- To depict the areas in which the business is competitively advantageous and disadvantageous.
- To determine the financial condition and performance of the firm.
- To help to make suitable corrective measures when the financial conditions and financialperformance are unfavourable to the firm.

ADVANTAGES OF RATIO ANALYSIS

Simplifies Financial Statements

Ratio analysis simplifies the comprehension of financial statements. Ratios tell the whole story ofchanges in the financial condition of a business.

Analyze Past and Forecast Future

It helps to analyze and understand the financial health and trend of a business, indicating past performance and making it possible to forecast the future trends.

Decision-Making and Cost Control

It serves as a useful tool in management control process for decision-making and cost control purpose.

Summaries Accounting Figures

It makes the accounting figures easy to understand and highlight the inter-relationship between various segments of the business.

Overall Profitability

Different users of accounting information make use of specific ratios to meet or satisfy their requirements. But the management is always interested in overall profitability and efficiency of the business enterprise.

Liquidity Position

The short-term creditors are more interested in the liquidity position of a firm in the sense that their money would be repaid on due dates. The ability of the firm to pay short-term obligations can be found by computing liquidity ratios.

Long term Solvency

This is required by long-term creditors, security analyst and the present and potential shareholders of the company. The help of capital structure ratios kept the above in assessing the financial status of the organization.

LIMITATIONS OF RATIO ANALYSIS

The ratio analysis is not a full-proof method in financial statement analysis. It suffers from a number of limitations. Some of the important one are:

Ratios ignore qualitative factors

Ratios are obtained from the figures expressed in monetary terms. In this way, qualitative factors, which may be important are ignored.

Trends are not the actual ratios

The different ratios calculated from the financial statements of a business enterprise for one single year are of limited value. It would be more useful to calculate the important figures in the case of income, dividends, working capital, etc., for a number of years. Such trends are more useful than absolute ratios.

Defective accounting information

The ratios are calculated from accounted data in the financial statements. It means if the information is defective then the calculation of ratios would be wrong. Thus, the deliberate omissions would affect the ratios too.

Change in accounting procedures

A comparison of result of two firms becomes difficult when we find that the firms are using different procedures related to certain items, such as inventory valuation and treatment of intangible assets.

Variations in general operating conditions

While interpreting the results based on ratio analysis, all business enterprises have to work within given general economic conditions, state of the industry in which the firms are operating and the position of the individual companies within the industry. For example, if the firm is forced by the government to sell their products at a fixed price, its comparison with other firms would become impossible.

Single ratio not sufficient

It is very necessary to take into account the combined effect of various ratios so that the results are correctly interpreted regarding the financial condition and the profit-making performance of the business. Each ratio plays a part in interpreting the financial statement.

The use of standard ratio

The financial statements represent historical data and, therefore, the ratios based on themwould only disclose what happened in the past.

CLASSIFICATION OF RATIOS

Profitability Ratios:

Profitability ratios gives some yardstick to measure the profit in relative terms with reference to sales, assets or capital employed. These ratios highlight the end result of business activities. The main objective is to judge the efficiency of the business.

Turnover Ratios or Activity Ratios:

These ratios are used to measure the effectiveness of the use of capital/assets in the business. These ratios are usually calculated on the basis of sales or cost of goods sold, and are expressed in integers rather than as percentages.

Financial Ratios or Solvency Ratios:

These ratios are calculated to judge the financial position of the organization from short-term as well as long-term solvency point of view.

Thus, it can be subdivided into:

(a) Short term Solvency Ratios (Liquidity Ratios)

(b) Long term Solvency Ratios (Capital Structure Ratios)

Market Test Ratios:

These are of course, some profitability ratios, having a bearing on the market value of the shares.

FINANCIAL RATIOS SOLVENCY RATIOS	**ACTIVITY RATIOS TURNOVER RATIOS**	**PROFITABILITY RATIOS**	**MARKET TEST RATIOS**
Short Term Solvency Ratios	Stock Turnover Ratio	Gross Profit Ratio	Earnings Per Share
Current Ratio	Debtors Turnover Ratio	Net Profit Ratio	Price Earnings Ratio
Liquidity Ratio	Creditors Turnover Ratio	Cash Profit Ratio	Dividend Payout
Cash Ratio	Fixed Assets Turnover Ratio	Return on Investment	Dividend Yield Ratio
Long Term Solvency Ratios	Total Assets Turnover Ratio	Return on Net Worth	
Debt Equity Ratio	Working Capital Turnover	Debt service Coverage	
Capital Gearing Ratio	Sales to Capital Employed	Operating Ratio	
Fixed Asset Ratio			
Proprietary Ratio			
Interest Cover			
Dividend Cover			

IMPORTANT ITEMS TO REMEMBER

Particulars	**Heads**
Profit and Loss Account (Credit Balance)	Reserves and Surplus
Profit and Loss Account (Debit Balance)	Fictitious Assets
Trade Investments	Investments
Government Securities	Investments
Government Bonds	Investments

Government Promissory Note Long Term Loans given	Investments Investments
Marketable Investments Short term investments Loose Tools Loans and advances given	Current Assets Current Assets Current Assets Current Assets
Proposed Dividend Provision for tax Unclaimed Dividend Short term loans	Current Liabilities Current Liabilities Current Liabilities Current Liabilities

Particulars	**Heads**
Carriage Inwards Custom Duty and Excise Duty	COGS COGS
Legal Expenses General Expenses	Office and Admn Exp Office and Admn Exp
Carriage outwards Trade Fair ExpensesNormal Bad Debts Discount allowed	Selling and DistrnExp Selling and DistrnExp Selling and DistrnExp Selling and DistrnExp
Abnormal Bad Debts	Finance Charges
Interest paid	Interest
Interest received Dividend received and Discount receivedBad Debts recovery	Non Operating Income Non Operating Income Non Operating Income
Preliminary Expenses w/off	Non Operating Expenses
Dividend paid	Appropriations

IMPORTANT FORMULAS

a.	Shareholders' Funds **Shareholders' Funds are also known as Owners Funds, Proprietors Funds, Net Worth**	Preference Share Capital + Equity Share Capital +Reserves and Surplus – Fictitious Assets
b.	Equity Shareholders Funds	Equity Share Capital + Reserves and Surplus – Fictitious Assets
c.	Capital Employed Capital Employed	Shareholders' Funds + Loan Funds Fixed Assets + Investments + Working Capital
d.	Working Capital	Current Assets – Current Liabilities
e.	COGS COGS	Sales – Gross Profit Opening stock + Purchases (including factoryexpenses) – Closing Stock

SHORT TERM SOLVENCY RATIOS

a.	Current Ratio	Current Assets / Current Liabilities
b.	Quick Ratio Quick Assets = CA – Stock – Prepaid ExpensesQuick Liabilities = CL – Bank Overdraft **Quick Ratio is also known as Liquid Ratio / Acid Test Ratio**	Quick Assets / Quick Liabilities
c.	Stock to Working Capital Ratio	Stock / Working Capital
d.	Absolute Cash Ratio	Cash + Bank + Short term Invs / Current Liability
e.	Defence Interval Ratio	Current Assets / Daily Operating Expenses

LONG TERM SOLVENCY RATIOS

a.	Debt Equity Ratio	LoanFunds / SH Funds
b.	Capital Gearing Ratio	Loan Funds + PSC / ESH Funds
c.	Proprietary Ratio **Total Assets will not include Fictitious Assets**	Proprietor Funds / Total Assets X 100

PROFITABILITY RATIOS

a.	Gross Profit Ratio	Gross Profit / Sales X 100
b.	Operating Ratio	COGS + O&A + S &D / Sales X 100
c.	COGS Ratio	COGS / Sales X 100
d.	Office Expense Ratio	O & A / Sales X 100
e.	Selling Expense Ratio	S & D / Sales X 100

f.	Net Profit Ratio	Net Profit before Tax X 100 Sales OR Net Profit after Tax X 100Sales

TURNOVER RATIOS

a.	Stock Turnover Ratio Stock Holding Period	COGS Average Stock Average Stock X 365/52/12 COGS
b.	Debtors Turnover Ratio Debtors Collection Period **Debtors include Bills Receivables**	Credit Sales Average Debtors Average Debtors X 365/52/12 Credit Sales
c.	Creditors Turnover Ratio Creditors Payment Period **Creditors include Bills Payables**	Credit Purchases Average Creditors Average Creditors X 365/52/12 _Credit Purchases

Note:

a) Turnover ratio will always be expressed in Times
b) Always remember whenever turnover ratios are asked, there will be Average in Denominator
c) Whenever Calculation of Average is not Possible, take closing in denominator

TURNOVER RATIOS (BASED ON SALES)

a.	Total Asset Turnover Ratio	Sales Average Total Assets
b.	Fixed Assets Turnover Ratio	Sales Average Fixed Assets
c.	Working Capital Turnover Ratio	Sales Average Working Capital
d.	Capital Employed Turnover Ratio	Sales Average Capital Employed
e.	Proprietors Fund Turnover Ratio	Sales Average Proprietors Funds

Note:

a) Turnover ratio will always be expressed in Times
b) Always remember whenever turnover ratios are asked, there will be Average in Denominator
c) Whenever Calculation of Average is not Possible, take closing figures in denominator

INCOME STATEMENT

Sales Less: Variable Cost	xx (xx)
Contribution Less: Fixed Cost	xx (xx)
EBIT (Earnings before interest and tax) Less: Interest	xx (xx)
EBT (Earnings before tax)Less: Tax	xx (xx)
NPAT (Net Profit after tax) Less: Preference Dividend	xx (xx)
Net Profit for Equity Shareholders Less: Equity Dividend	xx xx
Retained Earnings	xx

INVESTMENT RATIOS (RETURN RATIOS)

a.	Return on Capital Employed(Return on Total Assets) (Return on Investment)	$\frac{\text{EBIT}}{\text{Average Capital Employed}}$ X 100
b.	Return on Proprietor' Funds (Return on SH Funds)	$\frac{\text{NPAT}}{\text{Average Proprietors' Funds}}$ X 100
c.	Return on ESH Funds	$\frac{\text{Net Profit for ESH}}{\text{Average ESH Funds}}$ X 100
d.	Return on Equity Share Capital	$\frac{\text{Net Profit for ESH}}{\text{Average ESC}}$ X 100

Note:

a) Always remember whenever Return ratios are asked, there will be Average in Denominator
b) Whenever Calculation of Average is not Possible, take closing figures in denominator

MARKET TEST RATIOS

a.	Earnings per Share (EPS)	$\frac{\text{Net Profit for ESH}}{\text{No. of Equity Shares}}$
b.	Dividend Payout Ratio	$\frac{\text{Dividend Per Share (DPS)}}{\text{Earnings Per Share (EPS)}}$
c.	Retention Ratio	$\frac{\text{EPS – DPS}}{\text{EPS}}$
d.	Price Earnings Ratio (PE Ratio)	$\frac{\text{Market Price Per Share (MPS)}}{\text{Earnings Per Share (EPS)}}$
e.	Earnings Yield Ratio	$\frac{\text{EPS}}{\text{MPS}} \text{ X } 100$
f.	Dividend Yield Ratio	$\frac{\text{DPS}}{\text{MPS}} \text{ X } 100$

OTHER RATIOS

a.	Interest Coverage Ratio	$\frac{\text{EBIT}}{\text{Interest}}$
b.	Pref Dividend Coverage Ratio	$\frac{\text{NPAT}}{\text{Preference Dividend}}$
c.	Equity Dividend Coverage Ratio	$\frac{\text{Net Profit for ESH}}{\text{Equity Dividend}}$
d.	Debt Service Coverage Ratio	$\frac{\text{NPAT + Depreciation + Interest}}{\text{Interest + Installments on Loans}}$

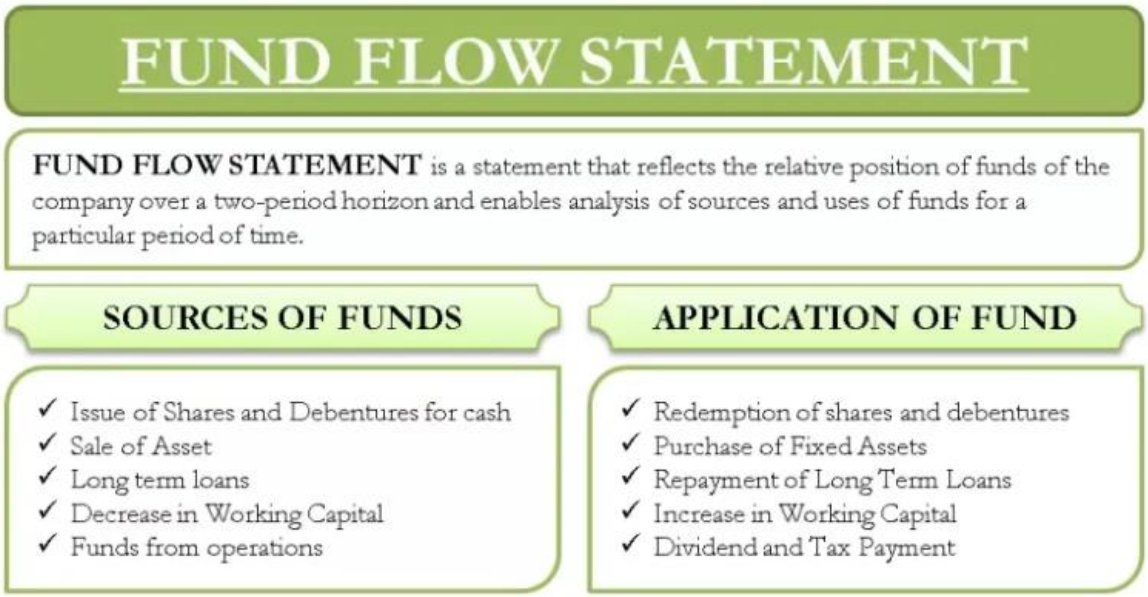
FUND FLOW STATEMENT:

Introduction:

- A fund flow statement is a statement prepared to analyse the reasons for changes in the financial position of a company between two balance sheets.
- It portrays the inflow and outflow of funds i.e. sources of funds and applications of funds for a particular period.

Definition:

According to Foulke : "A statement of sources and application of funds is a technical device designed to analyze the changes in the financial condition of a business enterprise between two dates".



Objectives:

The statement's main objective is to ascertain various sources from where the funds were raised and the specific manner in which they (Funds/Working Capital) were utilised between the dates of the two balance sheets.

- The statement draws special attention to the various sources and applications of "Working Capital" of a business organisation between the two dates representing two accounting periods.
- It highlights the financial Strengths and Weaknesses of a business organisation, which may be used as a management tool for future planning or taking corrective measures for the organisation's growth.
- It is an effective technique for measuring the reasons behind the changes in 'Working Capital'.
- In case of major deviations between the data of two Balance Sheets, it facilitates the management of the organisation in initiating necessary corrective measures.
- Investors may also use the 'Funds Flow Statement' of an organisation for taking a decision with regard to their investment in that organisation.
- It reflects detailed information in respect to the performance of the organisation with regard to its profitability, operational efficiency and financial affairs.
- The information gathered from the Funds Flow Statement of an organisation facilitates its management in formulating various policies, e.g. 'Dividend Policy', /Retention Policy', 'Investment Policy' etc.

- The financial consequences of various business transactions of an organisation are easy to evaluate with the help of its 'Funds Flow Statement'.
- It provides a detailed account of the movement of funds from different sources or uses of funds during a specific period

Advantages:

- Helps in the Analysis of Financial Operations
- Helps in the Formation of a Reasonable Dividend Policy
- Helps in the Proper Distribution of Resources
- Helps in Improving the Use of Working Capital
- Helps Knowing the Overall Creditworthiness of a Firm

Disadvantages:

- Fails to Disclose Cash Position
- Lack of Originality
- Historic in Nature
- Used Along with Financial Statements

Difference Between Fund Flow Statement and Balance sheet

Basis	Funds Flow Statement	Balance sheet
1. Meaning	It is the statement which shows the movement of funds into and out of business.	It is the statement which shows the financial position of business on a particular data.
2. Objectives	To find out the reasons for change in working capital.	To show the financial position of business on a particular date.
3. Nature	Dynamic	Static
4. Format	No specific format prescribed by companies Act.	Specific format Prescribed by companies Act,1956.
5. Sources	Prepared from the balance sheet of two dates	Prepared from the trail balance.
6. Users	Internal party i.e. Management	External parties i.e. investors, creditors , income tax department.
7. Legal obligations	No legal obligations	Every company is legally bound to prepare its balance sheet at the end of every financial year.

Difference between Funds Flow Statement and Cash Flow Statement		
Basis of Difference	**Funds Flow Statement**	**Cash Flow Statement**
1. Basis of Concept	It is based on a wider concept of funds, i.e. working capital	It is based on a narrow concept of funds, i.e. cash
2. Basis of Accounting	It is based on accrual basis of accounting.	It is based on cash basis of accounting.
3. Schedule of changes in working capital	Schedule of changes in working capital is prepared to show the changes in current assets and current liabilities.	No schedule of changes in working capital is prepared.
4. Method of Preparing	Funds flow statement reveals the sources and applications of funds. The net difference between sources and applications of funds represents net increase in working capital.	It is prepared by classifying all inflows and outflows in term of ing , investing and financing ies. The net difference represents t increase or decrease
5. Basis of Usefulness	It is useful in planning intermediate and long term financing.	It is useful in planning intermediate and long term financing.
6.Discription	It describes the reasons for change in working capital.	It describes the reasons for changes in cash and cash equivalent.

CASH FLOW STATEMENT

A cash flow statement is an important tool used to manage finances by tracking the cash flow for an organization. This statement is one of the three key reports (with the income statement and the balance sheet) that help in determining a company's performance.

Definition:

According to Indian Accounting Standard (AS-3) :

Cash flow means inflows and outflows of cash and cash equivalents. Cash comprises of cash in hand and demand deposits with banks. Cash equivalents are short-term, highly liquid investments which are readily convertible into cash.

Objectives of Cash Flow Statement:

The fundamental objective behind the preparation of the 'Cash Flow Statement' is to underline and emphasis the changes that have taken place in the 'Cash Position' during a specific period. The sources from where the cash was procured by an organisation and the uses, to which it (the cash) was put, are elaborated in the cash flow statement.

Other objectives for preparing cash flow statement are discussed in the following points :

1) Showing the Inflows and Outflows (sources and applications) of cash into/out of the business during a specific period.
2) Disclosing the 'Positive' and 'Negative features of 'Cash Management' undertaken by the organisation.
3) Facilitating the policy formulation by the management in respect of certain financial matters such as Dividend Policy.
4) Ascertaining the Liquidity Position of the business organisation.
5) Finding out the net changes having taken place in respect of 'Cash' and 'Cash Equivalents'.
6) Studying the trend regarding 'Cash Receipts' and 'Cash Payments'.
7) Finding out the 'Deviation of Cash' from 'Earnings'.
8) Assessing the Financial Position of the business enterprise in a more realistic manner and forecasting the 'Cash Position'.

Importance:

- **Gives details about spending:** A cash flow statement gives a clear understanding of the principal payments that the company makes to its creditors. It also shows transactions which are recorded in cash and not reflected in the other financial statements. These include purchases of items for inventory, extending credit to customers, and buying capital equipment.
- **Helps maintain optimum cash balance:** A cash flow statement helps in maintaining the optimum level of cash on hand. It is important for the company to determine if too much of its cash is lying idle, or if there's a shortage or excess of funds. If there is excess cash lying idle, then the business can use it to invest in shares or buy inventory. If there is a shortage of funds, the company can look for sources from where they can borrow funds to keep the business going.
- **Helps you focus on generating cash:** Profit plays a key role in the growth of a company by generating cash. But there are several other ways to generate cash. For instance, when a company

finds a way to pay less for equipment, it is actually generating cash. Every time it collects receivables from its customers quicker than usual, it is gaining cash.

- **Useful for short-term planning:** A cash flow statement is an important tool for controlling cash flow. A successful business must always have sufficient liquid cash to fulfill short-term obligations like upcoming payments. A financial manager can analyze incoming and outgoing cash from past transactions to make crucial decisions. Some situations where decisions have to be made based on the cash flow include forseeing cash deficit to pay off debts or establishing a base to request for credit from banks

Advantages of Cash Flow Statement:

1) It facilitates measurement of the business enterprise's ability to meet its fixed charges.

2) It is useful in bringing to the forefront the business enterprise's status with regard to its ‘Liquidity' and 'Solvency' during adverse conditions.

3) It is helpful in assessing the changes in 'Cash Position' between 'Profit & Loss Account' and 'Balance Sheet' items of two consecutive accounting periods.

4) Disclosures made by the 'Cash Flow Statement enables the management of a business enterprise to initiate preventive measures in financially difficult situations.

5) Identification of 'Discretionary Cash Flows' from business transactions becomes possible through 'Cash Flow Analysis'.

6) It facilitates listing out the 'Potential Financial Flows', which may be put to use during crisis conditions.

7) Cash Flow Statement reveals the information with regard to the availability of 'Cash'. Such information is very useful in deciding the quantum of 'Dividend' to be distributed to the shareholders or in extreme cases whether or not to skip a dividend payment altogether.

Disadvantages of Cash Flow Statement:

1) Non-Cash Transactions are Overlooked :

The entire focus of Cash Flow Statement is exclusively on the 'Inflows' and 'Outflows of cash. Non-Cash Transactions' like purchase of buildings by issuing shares/debentures to the vendors or issue of bonus shares are out of its purview.

2) Not a Substitute for an Income Statement:

An 'Income Statement' of a business organisation covers both 'Cash' and 'Non-Cash' items and reveals the 'Net Income'. 'Cash Flow Statement, on the other hand, takes into consideration only 'Cash Flows' and as such can show only 'Net Cash Flows' inflows or outflows. It cannot disclose the 'Net Profit/Loss' of the organisation.

3) Limited Use :

'Cash Flow Statement' has very limited use in isolation. Only when it is accompanied by other 'Financial Statements' like 'Balance Sheet' and 'Profit & Loss Account', it provides some meaningful and useful results.

4) Historical in Nature:

Preparation of 'Cash Flow Statement' involves rearranging other Financial Statements, viz. 'Balance Sheet' and 'Profit & Loss Account, which contain past data and are historical in nature. It would have been more useful and prospective in nature, when accompanied with 'Projected Cash Flow Statement'.

5) Ignoring the Accrual Concept:

Accrual concept, one of the basic accounting concepts, is totally ignored while preparing cash flow statement.

FUND FLOW PROBLEMS:

Problem 1:

From the following information relating to A Ltd., prepare Funds Flow Statement:

(Rs. '000)

	2003 Rs.	2004 Rs.		2003 Rs.	2004 Rs.
Share Capital	300	400	Cash	30	90
Reserve	100	50	Accounts Receivable	105	150
Retained Earnings	30	60	Inventories	150	195
Accounts Payable	45	135	Fixed Assets	190	210
	475	645		475	645

Additional Information :

(*a*) The company issued bonus shares for Rs. 50,000 and for cash Rs. 50,000.

(*b*) Depreciation written off during the year Rs. 15,000. (*B.Com. M.S.*)

SOLUTION :

SCHEDULE OF CHANGES IN WORKING CAPITAL

	2003	*2004.*	*Changes in Working Capital*	
			Increase	*Decrease*
	Rs.	*Rs.*	*Rs.*	*Rs.*
Current Assets:				
Cash	30,000	90,000	60,000	—
Accounts Receivable	1,05,000	150,000	45,000	—
Inventories	1,50,000	1,95,000	45,000	—
	2,85,000	4,35,000		
Less: Current Liabilities:				
Accounts Payable	45,000	1,35,000	—	90,000
Working Capital	2,40,000	3,00,000		
Increase in Working Capital	60,000	—	—	60,000
	3,00,000	3,00,000	1,50,000	1,50,000

FUND FLOW STATEMENT
for the year ended 31-12-2004

	Rs.		*Rs.*
Issue of Share	50,000	Purchase of Fixed Assets	35,000
Funds from Operation	45,000	Increase in Working Capital	60,000
	95,000		95,000

Workings :

FIXED ASSETS A/C

	Rs.		*Rs.*
To Balance b/d	1,90,000	By Adjusted P & L A/c (Depriciation)	15,000

To Cash (Purchase)	35,000	By Balance c/d	2,10,000
	2,25,000		2,25,000

SHARE CAPITAL A/C

	Rs.		Rs.
To Balance c/d	4,00,000	By Balance b/d	3,00,000
		By Cash	50,000
		By General Reserves (Bonus Shares)	50,000
	4,00,000		4,00,000

ADJUSTED PROFIT & LOSS A/C

	Rs.		Rs.
To Fixed Assets (Depreciations)	15,000	By Balance b/d	30,000
To Balance c/d	60,000	By Fund from Operation	45,000
	75,000		75,000

Problem 2: Ramco Cements presents the following information and you are required to calculate funds from operations

PROFIT AND LOSS ACCOUNT

	Rs.		Rs.
To Operation Expenses	1,00,000	By Gross Profit	2,00,000
To Depreciation	40,000	By Gain on Sale of Plant	20,000
To Loss on Sale of Building	10,000		
To Advertisement Suspense Account	5,000		
To Discount Allowed	500		
To Discount on Issue of Shares written off	500		
To Goodwill written off	12,000		
To Net Profit	52,000		
	2,20,000		2,20,000

SOLUTION :

CALCULATION OF FUND FROM OPERATIONS

	Rs.	Rs.
Net Profit (given)		52,000
Add : Non-fund or non-operating items which have been debited to Profit & Loss A/c :		
Depreciation	40,000	
Loss on Sale of Building	10,000	
Advertisement written off	5,000	
Discount written off	500	
Goodwill written off	12,000	67,500
		1,19,500
Less : Non-fund or non-operating items which have been credited to Profit & Loss A/c :		
Gain on Sale of Plant	20,000	20,000
FUNDS FROM OPERATIONS		99,500

Alternatively :

ADJUSTED PROFIT AND LOSS ACCOUNT

	Rs.		Rs.
To Depreciation	40,000	By Opening Balance	—
To Loss on Sale of Building	10,000	By Gain on Sale of Plant	20,000
To Advertisement Suspense A/c	5,000	By Funds from Operations (Balancing figure)	99,500
To Discount written off	500		
To Goodwill written off	12,000		
To Closing Balance	52,000		
	1,19,500		1,19,500

Problem 3:

The Balance Sheets of National Co. as on 31st December, 2003 and 31st December 2004 are as follows:

Liabilities & Capital	*2003 Rs.*	*2004 Rs.*	*Assets*	*2003 Rs.*	*2004 Rs.*
Share Capital	5,00,000	7,00,000	Land and Buildings	80,000	1,20,000
Profit & Loss	1,00,000	1,60,000	Plant and Machinery	5,00,000	8,00,000
General Reserve	50,000	70,000	Stock	1,00,000	75,000
Sundry Creditors	1,53,000	1,90,000	Debtors	1,50,000	1,60,000
Bills Payable	40,000	50,000	Cash	20,000	20,000
Expenses O/S	7,000	5,000			
	8,50,000	11,75,000		8,50,000	11,75,000

Additional Information:

(1) Rs. 50,000 depreciation has been charged on Plant and Machinery during 2004.

(2) A piece of Machinery was sold for Rs. 8,000 during the year 2004. It had cost Rs. 12,000; depreciation of Rs. 7,000 had been provided on it.

Prepare a Schedule of changes in Working Capital and a Statement showing the Sources and Application of Funds for 2004.

SOLUTION :

SCHEDULE OF CHANGES IN WORKING CAPITAL

Items	*2003* *Rs.*	*2004* *Rs.*	*Changes in Working Capital* *Increase Dr.* *Rs.*	*Decrease Cr.* *Rs.*
Current Assets :				
Stock	1,00,000	75,000	—	25,000
Debtors	1,50,000	1,60,000	10,000	—
Cash	20,000	20,000	—	—
	2,70,000	2,55,000	—	—
Current Liabilities :				
Sundry Creditors	1,53,000	1,90,000	—	37,000
Bills Payable	40,000	50,000	—	10,000
Expenses O/S	7,000	5,000	2,000	—
	2,00,000	2,45,000		
Working Capital	70,000	10,000		
Net Decrease in Working Capital		60,000	60,000	
	70,000	70,000	72,000	72,000

STATEMENT OF SOURCE AND APPLICATION OF FUNDS

for the year ended 31st December 2000

Sources	*Rs.*	*Applications*	*Rs.*
Funds from Operations (1)	1,27,000	Purchase of Land and Buildings	40,000
Issue of Shares	2,00,000	Purchase of Plant and Machinery (2)	3,55,000
Sale proceeds of Machinery	8,000		
Decrease in Working Capital	60,000		
	3,95,000		3,95,000

Workings :

(1) ADJUSTED PROFIT AND LOSS ACCOUNT

	Rs.		*Rs.*
To Plant & Machinery A/c (Depreciation of 2000)	50,000	By Balance b/d (Opening Balance)	1,00,000
To General Reserve (Transferred during 2000)	20,000	By Plant & Machinery (Profit on Sale)	3,000
To Balance c/d	1,60,000	By Funds from Operation (Balancing figure)	1,27,000
	2,30,000		2,30,000

(2) PLANT AND MACHINERY ACCOUNT

	Rs.		Rs.
To Balance b/d	5,00,000	By Bank (Sale of Machinery)	8,000
To Profit & Loss A/c (profit on sale)	3,000	By Profit & Loss A/c (Depreciation)	50,000
To Bank A/c (Purchase of Machinery & Plant (Balancing figure)	3,55,000	By Balance c/d	8,00,000
	8,58,000		8,58,000

Break-Even Analysis

The break-even point and break-even chart are two by-products of break-even analysis. In a narrow sense, it is concerned with the break-even point and in a broad sense, it is concerned with break-even chart. Break-even analysis is also known as cost volume profit analysis. The analysis is a tool of financial analysis whereby the impact on profit of the changes in volume price, costs and mix can be estimated with reasonable accuracy. Break-even point is equilibrium point or balancing point of no-profit no-loss. This is a point at which loss ceases and profit begins. This is a point where income is exactly equal to expenditure.

Break-Even Point. Break-even point is a point where the total sales are equal to total cost. In this point there is no profit or loss in the volume of sales. The formula to calculate break-even point is :

$$\text{B.E.P. (in units)} = \frac{\text{Total fixed cost}}{\text{Contribution per unit}}$$

or

$$= \frac{\text{Fixed cost}}{\text{Selling price per unit} - \text{Variable cost per unit}}$$

Illustration 3. From the following particulars calculate the break-even point :

Variable cost per unit	Rs. 12
Fixed expenses	Rs. 60,000
Selling price per unit	Rs. 18

(*B.Com. Calicut*)

Solution :

$$\text{B.E.P. (in units)} = \frac{\text{Fixed cost}}{\text{Contribution per unit}}$$

(Selling Price − Variable Cost = Contribution)

(Rs. 18 − Rs. 12 = 6)

Rs. 60,000 ÷ Rs.6 = 10,000 Units

B.E.P. Sales = 10,000 × Rs. 18 = **Rs. 1,80,000**

Illustration 4. A company estimates that next year it will earn a profit of Rs. 50,000. The budgeted fixed costs and sales are Rs. 2,50,000 and Rs. 9,93,000 respectively. Find out the break-even point for the company.

Solution :

$$\text{B.E.P. (in units)} = \frac{F \times S}{\text{Contribution}}$$

Contribution = S − V = F + P

F + P = Rs. 2,50,000 + Rs. 50,000 = Rs. 3,00,000

$$\text{B.E.P. Sales} = \frac{2{,}50{,}000 \times 9{,}93{,}000}{3{,}00{,}000}$$

$$= \textbf{Rs. 8,27,500}$$

Illustration 5. From the following particulars, find out the selling price per unit if B.E.P. is to be brought down to 9,000 units.

Variable cost per unit Rs. 75

Fixed expenses Rs. 2,70,000

Selling price per unit Rs. 100.

$\frac{2,70,000}{25}$

(B.Com. Calicut)

Solution :

Existing B.E.P. $\frac{2,70,000}{25}$

100−75 = 25

10,800 units

new sales price, if B.E.P. down

Let us assume that the contribution per unit at B.E. sales of 9,000 is x.

$$\text{B.E.P.} = \frac{\text{Fixed cost}}{\text{Contribution per unit}}$$

Contribution per unit is not known. Therefore

$$9{,}000 \text{ units} = \frac{2{,}70{,}000}{x}$$

$$9{,}000x = 2{,}70{,}000$$

$$x = 30.$$

Contribution is Rs. 30 per unit, in place of Rs. 25. Therefore, the selling price should have been Rs. 105, *i.e.*, Rs. 75 + Rs. 30.

Illustration 6. From the following data, calculate break-even point expressed in terms of units and also the new B.E.P., if selling price is reduced by 10%.

Fixed expenses :	
	Rs.
Depreciation	1,00,000
Salaries	1,00,000
Variable expenses :	
Materials	Rs. 3 per unit
Labour	Rs. 2 unit
Selling price	Rs. 10 per unit

(B. Com. (Pass) Delhi)

Solution :

$$\text{B.E.P.} = \frac{\text{Fixed cost}}{\text{Contribution per unit}}$$

$$= \frac{2{,}00{,}000}{5} = \textbf{40,000 units}$$

When the selling price is reduced by 10%, selling price becomes Rs. 10 – 1 = Rs. 9 per unit. So, Contribution = Rs. 9 – Rs. 5 = Rs. 4.

$$\text{B.E.P.} = \frac{\text{Fixed cost}}{\text{Contribution per unit}}$$

$$= \frac{2,00,000}{4} = \textbf{50,000 units}$$

Profit Volume Ratio

Profit volume ratio, which is popularly known as P/V Ratio, expresses the relationship of contribution to sales. Another name for this ratio is contribution-sales ratio or marginal-income ratio or variable-profit ratio. The ratio, expressed as a percentage, indicated the relative profitability of different products.

The formula for computing the P/V ratio is given below :

$$\text{P/V Ratio} = \frac{\text{Contribution}}{\text{Sales}} \text{ (or) } \frac{C}{S}$$

$$\text{or} = \frac{\text{Fixed Cost} + \text{Profit}}{\text{Sales}} \text{ (or) } \frac{F+P}{S}$$

$$\text{or} = \frac{\text{Sales} - \text{Variable Cost}}{\text{Sales}} \text{ (or) } \frac{S-V}{S}.$$

It can also be expressed in percentage. Normally, this ratio is expressed in percentage. When we know the P/V ratio, B.E.P. can be calculated, by using the formula :

$$\text{B.E.P. (Sales volume)} = \frac{\text{Fixed Cost}}{\text{P/V Ratio}} \text{ (or) } \frac{F}{\text{P/V Ratio}}$$

The profit of a business can be increased by improving P/V ratio. As such management will make efforts to improve the ratio. A higher ratio means a greater profitability and vice versa. So management will increase the P/V ratio :

(*a*) by increasing sales price per unit

(*b*) by decreasing variable costs

(*c*) by increasing the production of products which is having a high P/V ratio and vice versa.

P/V ratio is very important in decision-making. It can be used for the calculation of B.E.P. and in problems regarding profit sales relationship.

1. $\text{B.E.P.} = \frac{\text{Fixed cost}}{\text{P/V ratio}} = \frac{F}{\text{P/V ratio}}$
2. Fixed cost = B.E.P. × P/V ratio
3. Sales required in units to maintain a desired profit

$$\frac{\text{F.C.} + \text{Desired profit}}{\text{P/V ratio}} = \frac{F+P}{\text{P/V ratio}}$$

$$= \frac{\text{Required contributi}}{\text{New contribution per u}}$$

4. Contribution = Sales × P/V ratio
5. Variable costs = Sales (1 – P/V ratio)

Illustration 7. Marginal cost Rs. 2,400

Selling price Rs. 3,000

Calculate P/V ratio,

Solution :

$$\text{P/V Ratio} = \frac{\text{Contribution}}{\text{Sales}} \times 100 = \frac{\text{Rs. } 3{,}000 - \text{Rs. } 2{,}400}{\text{Rs. } 3{,}000} \times 100 = \frac{\text{Rs. } 600}{\text{Rs. } 3{,}000} \times 100 = \mathbf{20\%}$$

Illustration 8. The sales turnover and profits during two periods are as under :

Period I : Sales Rs. 20 lakhs ; Profit Rs. 2 lakhs

Period II : Sales Rs. 30 lakhs ; Profit Rs. 4 lakhs

Calculate P/V Ratio.

(*B. Com., Osmania*)

Solution :

$$\text{P/V Ratio} = \frac{\text{Change in profit}}{\text{Change in sales}} \times 100 = \frac{\text{Rs. } 4{,}00{,}000 - 2{,}00{,}000 \times 100}{\text{Rs. } 30{,}00{,}000 - \text{Rs. } 20{,}00{,}000}$$

$$= \frac{2{,}00{,}000}{10{,}00{,}000} \times 100 = \mathbf{20\%}$$

Illustration 9. The following data are obtained from the records of a company :

	First Year Rs.	*Second Year* Rs.
Sales	80,000	90,000
Profit	10,000	14,000

Calculate the break-even point.

(*B.Com., Calicut*)

Solution :

$$\text{B.E.P. (Sales)} = \frac{\text{Fixed cost}}{\text{P/V Ratio}}$$

$$\text{P/V Ratio} = \frac{\text{Change in profit}}{\text{Change in sales}} \times 100 = \frac{4{,}000}{10{,}000} \times 100 = 40\%$$

$$\text{Fixed cost} = \text{Contribution} - \text{Profit}$$

$$\text{Fixed cost} = 80{,}000 \times \frac{40}{100} - \text{Rs. } 10{,}000$$

$$= 32{,}000 - 10{,}000 = \text{Rs. } 22{,}000$$

$$\text{B.E.P. (Sales)} = \frac{22{,}000 \times 100}{40} = \mathbf{Rs.\ 55{,}000.}$$

Illustration 10. You are required to calculate the break-even point in the following case :

The fixed cost for the year is Rs. 80,000 ; variable cost per unit for the single product being made is Rs. 4.

Estimated sales for the period are valued at Rs. 2,00,000. The number of units involved coincides with the expected volume of output. Each unit sells at Rs. 20.

Calculate break-even point by applying important formulae.

(*C.A. Final*)

Solution :

	Per unit Rs.	*Total* Rs.
Sales	20	2,00,000
Variable cost	4	40,000
Contribution	16	1,60,000
Fixed cost		80,000
Profit		80,000

(1) Sales at B.E.P.

(a) $\text{B.E.P.} = \dfrac{F \times S}{S - V} = \dfrac{80{,}000 \times 2{,}00{,}000}{2{,}00{,}000 - 40{,}000} = \textbf{Rs. 1,00,000}$

(or)

(b) $\text{B.E.P.} = \dfrac{F}{1 - \dfrac{V}{S}} = \dfrac{80{,}000}{1 - \dfrac{40{,}000}{2{,}00{,}000}} = \dfrac{80{,}000}{1 - \dfrac{1}{5}} = 80{,}000 \times \dfrac{5}{4} = \textbf{Rs. 1,00,000}$

(or)

(c) $\text{B.E.P.} = \dfrac{F}{\text{P/V Ratio}}$

We have to find out P/V Ratio

$$\text{P/V Ratio} = \frac{\text{Contribution}}{\text{Sales}} = \frac{1{,}60{,}000}{2{,}00{,}000} = 80\%$$

$$\text{Sales} \times 80\% = 80{,}000 \; i.e., \text{F}.$$

$$\therefore \quad \text{Sales} = \frac{80{,}000 \times 100}{80} = \textbf{Rs. 1,00,000}$$

(or)

(d) $\text{B.E.P.} = \dfrac{F}{\text{C\% (Contribution \% on sales)}}$

$$= \frac{80{,}000 \times 100}{80} = \textbf{Rs. 1,00,000}$$

(2) Break-even Point in units :

(a) $\dfrac{\text{B.E. Sales}}{\text{S.P.}} = \dfrac{1{,}00{,}000}{20} = \textbf{5,000 units}$

(b) $\dfrac{F}{SP - V} = \dfrac{80{,}000}{20 - 4} = \dfrac{80{,}000}{16} = \textbf{5,000 units}$

(c) $\dfrac{F}{C} = \dfrac{80{,}000}{16} = \textbf{5,000 units}$

Margin of Safety

Margin of safety is an important concept in Marginal Costing approach. Total sales minus the sales at break-even point is known as the margin of Safety (M/S). That is, Margin of Safety is the excess of normal or actual sales over sales at break-even point. In other words, sales over and above break-even sales are known as Margin of Safety. The margin of safety refers to the amount by which sales revenue can fall before a loss is incurred.That is, it is the difference between the actual sales and sales at the break-even point. Break-even point can be compared to a Red Signal Point. If the Margin of Safety is large, it is a sign of soundness of the business and vice versa. The margin of safety serves as a guide, is a reliable indicator of the business strength and soundness. Margin of safety can be expressed in absolute sales amount or in percentage.

High margin of safety indicates the soundness of a business because even with substantial fall in sale or fall in production, some profit shall be made. Small margin of safety on the other hand is an indicator of the weak position of the business and even a small reduction in sale or production will adversely affect the profit position of the business.

Margin of safety can be increased by :

(a) Decreasing the fixed cost ;
(b) Decreasing the variable cost ;
(c) Increasing the selling price ;
(d) Increasing output and sales ;
(e) Changing to a product mix that improves P/V Ratio.

Margin of Safety : Actual Sales − Sales at BEP

$$\text{(OR)} = \frac{\text{Profit}}{\text{P/V Ratio}}$$

$$\text{(OR)} = \frac{\text{Profit}}{\text{Contribution}}$$

$$\text{As a percentage} = \frac{\text{Margin of Safety}}{\text{Total Sales}} \times 100$$

Illustration 11. From the following details find out (*a*) Profit Volume Ratio, (*b*) B.E.P., (*c*) Margin of safety.

	Rs.
Sales	1,00,000
Total costs	80,000
Fixed costs	20,000
Net Profit	20,000

Solution :

(*a*) $$\text{P/V ratio} = \frac{\text{Sales} - \text{Variable expenses}}{\text{Sales}} \times 100$$

$$= \frac{1,00,000 - 60,000}{1,00,000} \times 100 = 40\%$$

(*b*) $$\text{B.E.P.} = \frac{\text{Fixed cost}}{\text{P/V ratio}}$$

$$= \frac{20,000}{40\%} \text{ (or) } \frac{20,000 \times 100}{40}$$

$$= \textbf{Rs. 50,000}$$

(*c*) $$\text{Margin of safety} = \frac{\text{Profit}}{\text{P/V ratio}}$$

$$= \frac{20,000}{40\%}$$

$$= \frac{20,000 \times 100}{40}$$

$$= \textbf{Rs. 50,000.}$$

(or) Margin of Safety = Actual sales − Sales at BEP

$= 1,00,000 - 50,000 =$ **Rs. 50,000**

Illustration 12. The following information was obtained from a Company in a certain year

Sales	Rs. 1,00,000
Variable costs	Rs. 60,000
Fixed costs	Rs. 30,000

Find the P/V Ratio, break-even point and margin of safety.

(*B. Com., Bombay*)

Solution :

$$\text{P/V Ratio} = \frac{\text{S} - \text{V}}{5} \times 100 = \frac{1,00,000 - 60,000}{1,00,000} \times 100 = \mathbf{40\%}$$

$$\text{Break-even point} = \frac{F}{P/V\ Ratio} = \frac{30{,}000}{40\%} = \textbf{Rs. 75,000}$$

$$\text{Margin of safety} = \frac{Profit}{P/V\ Ratio} = \frac{10{,}000}{40\%} = \textbf{Rs. 25,000}$$

(OR) = Sales – **Break-even sales** = Rs. 1,00,000– Rs. 75,000

UNIT-V

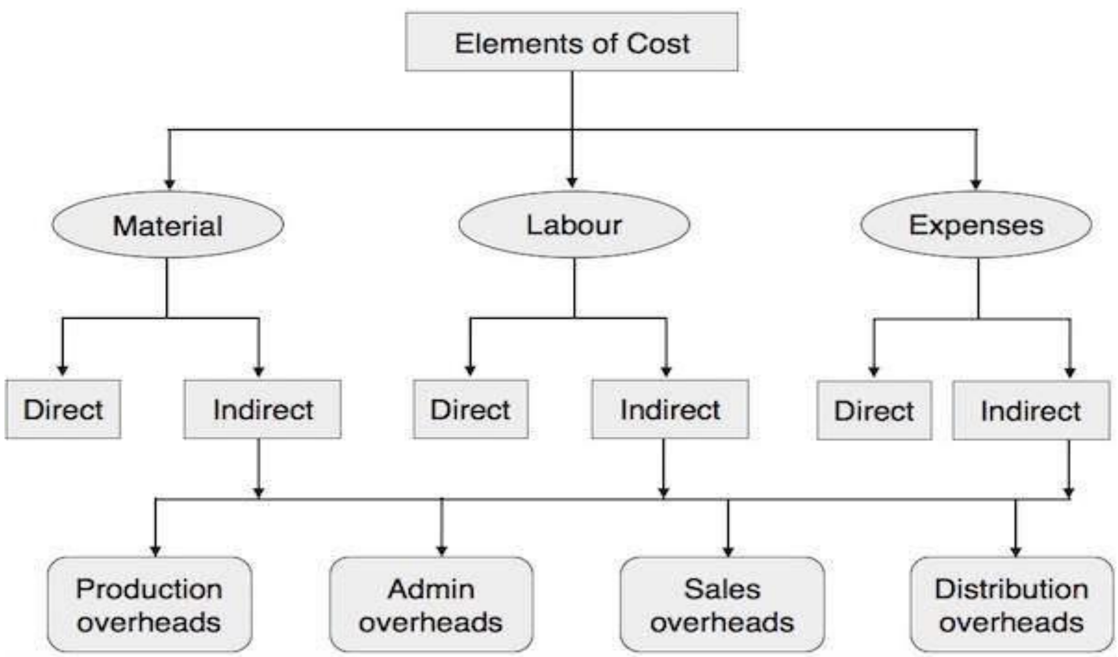
Concept of cost – Elements of Cost – Cost Accounting – Objectives – Cost Sheet (Problems) – classification of cost – Cost Unit and Cost Centre – Methods of Costing – Techniques of Costing.

ELEMENTS OF COST

The components or parts of total cost are termed as elements of cost. Cost can be divided into three main elements. They are: Materials, Labour and Expenses. Each of these can be further divided into direct and indirect. Accordingly cost can be classified into direct material, indirect material, direct labour, indirect labour, direct expenses and indirect expenses.

Elements of cost are three types:

1) Materials
2) Labour
3) Other Expenses



Direct Materials:

They are those materials which can be identified and can be measured and directly charged to a particular product.

Example: Timber in furniture making, bricks in building a house, paper used in note books, leather in shoe making cloth in garments, clay in bricks.

Indirect materials – These materials cannot be conveniently identified with indirect materials are - coal, lubricating oil, sand paper, soap, etc.

Direct Labour:

They are those Labours which can be conveniently identified or attributed wholly to aparticular job, product or process expended in converting raw materials into furnished goods.

Example: Wages paid to workers who are directly engaged in production

Indirect labour:

This cannot be identified with a particular cost unit. Indirect labor is not engaged in the production process directly but only this is indirectly and this assists in the production operations.

Examples of indirect labor are peon, supervisor, clerk, watchman etc.

Direct expenses:

Include all expenditure other than direct material or direct labour that are specificallyincurred for a particular product or Process.

Example: Excise duty, Royalty, cost of rectifying defective work, surveyor's fee, Expenses of designing or drawing a model.

Note: *The aggregate of direct material Direct labour and Direct Expenses are called prime cost. (Prime cost=Direct material + Direct labour + Direct expenses)*

Direct Material Cost	xxx
Direct Employees (labour) Cost	Xxx
Direct Expenses	Xxx
Prime Cost:	Xxxx

Indirect expenses:

All kinds of indirect costs, other than the indirect materials and indirect labor costs, are termed as indirect expenses. This cost cannot be directly identified with a particular job, process or identified with work order and is common to cost units and cost centers.

Examples of Indirect expenses - rent and rates, insurance, depreciation, power and lighting, cartage, advertising.

Overhead:

The Aggregate of indirect material, Indirect labour and Indirect expenses is termed as overhead. Overheads cannot be conveniently be charged to specific cost unit.

(Overheads = Indirect Materials + Indirect labour + Indirect Expenses)

Division of overheads:

Overheads are divided into 3 groups.

- Production overhead
- Administration overhead
- Selling and Distribution overhead.

Production overhead or works overhead or factory overhead:

It includes all indirect cost which is connected with the manufacture of a product.

It consists of 3 elements:

- ***Indirect material:*** Lubricants, soaps, Water powder, Cotton waste, thread.
- ***Indirect wages:*** Wages of supervisor, Salary of works manager, Foreman salary
- ***Indirect expenses:*** Factory rent, Rates, Deprecation on Machinery, Power light, heat, Insurance of factory building.

Administration overhead:

These are the expenses incurred in the management and administration of the business.

- ***Indirect Materials:*** Office forms, Stationery, Printing.
- ***Indirect Labour:*** Office manager salary, clerk salary, Audit fee
- ***Indirect Expenses:*** Rent & Rates of office building, Electric - legal charges Depreciation on office furniture

Selling and Distribution overheads:

Selling overheads are incurred in promoting and securing orders.

- ***Indirect Material:*** Printing & Stationery, order form.
- ***Indirect Labour:*** Salaries of Salesman,, Sales manager.

- ***Indirect Expenses:*** Advertisement, Showroom expenses,

<u>Distribution overheads:</u>

Distribution overheads are incurred from the time of the product is complete and put in storagefor dispatch until it reaches customer.

Example: Packing costs, salaries of despatch clerk, Warehouse Rent, Depreciation oh delivery van.

Cost Accounting:

Cost accounting is the branch of accounting which gives detailed cost information to management for various purposes.

COST ACCOUNTING:

It is a process of determining the costs of goods and services. It involves the recording, classification, allocation of various expenditures, and creating financial statements. This data is generally used in financial accounting.

OBJECTIVES OF COST ACCOUNTING:

The objective of the cost accounting is to determine the methods by which expenditure on materials, wages and overhead are recorded, classified and allocated. This is necessary so that the cost of products and services may be accurately ascertained. Thus, the following are the main objectives of cost accounting:

1. Ascertainment of Cost:

- It enables the management to ascertain the cost of product, job, contract, service or unit of production so as to develop cost standard.
- Costs may be ascertained, under different circumstances, using one or more types of costing principles— standard costing, marginal costing, uniform costing etc.

2. Fixation of Selling Price:

- Cost data is useful in the determination of selling price or quotations. Apart from cost ascertainment, the cost accountant analyses the total Cost into fixed and variable costs.
- This will help the management to fix the selling price; sometimes, below the total cost but above the variable cost.

3. Cost Control:

The Third objective of cost accounting is to control the cost so that the maximum and better production at minimum cost may be made possible. To achieve this objective, the techniques of budgetary control and standard costing are adopted.

4. Matching Cost with Revenue:

The profit of any activity can be ascertained by matching cost with the revenue of that activity. The purpose of this step is to determine profit or loss of any activity on an objective basis**.**

5. Providing Basis for Operating Policy:

Cost accounting is an essential tool for the management to formulate operating policies and to take business decisions like determination of cost-volume-profit relationship; whether to buy or to make an article, etc.

6. Reduction in Cost:

Costs are not only to be controlled but constant efforts are to be made for reducing them. Cost reduction implies real and permanent reduction in the unit cost of goods manufactured or service rendered without impairing their (products or goods) suitability for the use intended. Value analysis, time and motion study, standardisation, simplification, etc. are the major techniques of cost reduction.

COST SHEET:

Definition:

Cost sheet is - a document which provides for the assembly of the detailed cost of a cost centre or cost unit‖ - I.CM. A. London.

Cost sheet is a statement which is prepared at given Intervals of time and gives information regarding the element of cost incurred in production. It gives total cost and cost per unit of product manufactured during the period. Cost sheet is prepared under output or unit costing method.

Purposes:

1. It shows the total cost and cost per unit of production.
2. It shows the different elements of cost.
3. It facilitates comparisons with previous years.
4. It helps in the fixation of selling price.
5. It helps in the preparation of estimates for submission of tenders for contracts.

Specimen of a cost sheet for the period ended ……………………

		Total cost Rs.	**Cost per unit**
Opening stock of Raw material	XX		

Add: purchase of Raw material	XX		
	XX		
Less: closing stock of Raw material	XX		
Raw materials consumed		XXX	XXX
Direct Labour		XXX	XXX
Direct Expenses		XXX	XXX
Prime cost		**XXX**	**XXX**
Add: Factory overhead	XX		
Opening stock of work in progress	XX		
	XX		
Less: closing stock of work in progress	XX	XXX	
Work cost		**XXX**	**XXX**
Add: Office & Administration overhead		XXX	XXX
Cost of Production		**XXX**	**XXX**
Add: Opening stock of finished goods		XXX	
Less: Closing stockof finished goods		XXX	
Cost of goods sold		**XXX**	
Add Selling & Distribution overhead		XXX	XXX
Total cost		**XXX**	**XXX**
Add: Profit		**XXX**	**XXX**
Sales		**XXX**	**XXX**

Problem:1

From the following particulars of manufacturing of a company Prepare a statement showing a) Cost of materials used b) Prime cost c) works cost d) cost of production e) percentages of works expenses to wages, percentages of general expenses to works cost

Stock of material 1.1.1999	Rs.25000
Stock of finished goods 1.1.1999	Rs.51000
Purchase of materials	Rs.5,75,000
Production wages	Rs.3,90,000
Works overhead charges	Rs.86,000
Office and General charges	Rs.72,000
Stock of materials 31.12.1999	Rs.30,000
Stock of finished goods 31.12.1999	Rs.48,000
Sale of finished goods	Rs.12,20,000

Solution:

Cost Sheet for the year 31.12.1999

		Total cost Rs.
Opening stock of raw material	25000	
Add: purchase of material	575000	
	600000	
Less: closing stock raw materials	30000	
A) Raw material consumed		570000

Production wages		390000
B) Prime cost		**960000**
Add: Works overheads		86000
C) Works cost		**1046000**
Add: Office and general expenses		72000
D) Cost of production		**1118000**
Add: Opening stock of finished goods		51000
		1169000
Less: Closing stock of finished goods		48000
		1121000
Add: Selling and distribution overhead		**Nil**
Total cost		**1121000**
Profit (b.f.)		99000
Sales		**1220000**

Percentage of works expenses to wages **=** wages expenses / wages X 100

= 86000/390000 X 100 = 22.05%

Percentage of general expenses to work cost = General expenses / Works cost X 100

= 72000 / 1046000 X 100 = 6.88%

Problem: 2

Mr.Mithilesh Kumar furnished the following data relating to die manufacture of X Standardproduct during the month of April 2001.

Rawmaterial consumed Rs. 30,000

Direct Labour charges	Rs. 15,000
Machine hours worked	1500 hours.
Machine hour rate	Rs.8 Administrative overhead 30% on works cost
Selling overhead	75 paise per unit
Units produced	15000
Units sold 12000 of	Rs. 10 per unit

You are required to prepare a cost sheet from the above showing

a) Cost per unit b) Profit per unit sold and profit for the period.

Solution:Cost Sheet For the Period 2001 (Units produced = 15000)

	Total cost	**Cost per unit**
Raw material consumed 30000/ 15000 = Rs.2	30000	2.00
Direct labour charges	15000	1.00
Prime cost	**45000**	**3.00**
Add: Works overhead (1500hours X Rs.8)	12000	0.80
Works cost	**57000**	**3.80**
Add: Office& Administration overhead 30% on works cost 57000 X 30/ 100	17100	1.14
Cost of Production	74100	4.94
Less: closing stock 3000units X Rs.4.94	14820	---
Cost of goods sold for 12000 units*	59280	4.94

Add: selling overheads 75 paise per unit 12000 unitss X 75 paise	9000	0.75
Total ccost	68280	5.69
Profit for the period	51720	4.31
Sales 12000 units X Rs. 10	120000	10.00

Working:

15000units produced - 3000 units closing stock = 12000 units sold

Per unit = Total cost / Number of units

Profit per unit = 51720 / 12000units = Rs.4.31

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CLASSIFICATION OF COST

I. <u>Classification by Nature</u>

This is the analytical classification of costs. There are three broad categories as per this classification, namely Labor Cost, Materials Cost and Expenses. These heads make it easier to classify the costs in a cost sheet. They help ascertain the total cost and determine the cost of the work-in-progress.

- **Material Costs:** Material costs are the costs of any materials we use in the production of goods. We divide these costs further. ***For example***, let's divide material costs into raw material costs, spare parts, costs of packaging material etc.
- **Labor Costs:** Labor costs consists of the salary and wages paid to permanent and temporary employees in the pursuit of the manufacturing of the goods
- **Expenses:** All other expenses associated with making and selling the goods or services.

II. <u>Classification by Functions</u>

This is the functional classification of costs. The grouping of costs is according to the broad divisions of functions such as production, administration, selling etc.

- **Production Costs:** All costs concerned with actual manufacturing or construction of the goods
- **Commercial Costs:** Total costs of the operation of an enterprise other than the manufacturing costs. It includes the admin costs, selling and distribution costs etc.

III. <u>Classification by Traceability</u>

This classification is based on the degree of traceability to the final product of the firm.

- **Direct Costs:** So these are the costs which are easily identified with a specific cost unit or cost centers. Some of the most basic examples are the materials used in the manufacturing of a product or the labor involved with the production process.
- **Indirect Costs**: These costs are incurred for many purposes, i.e. between many cost centers or units. So we cannot easily identify them to one particular cost center. Take for example the rent of the building or the salary of the manager. We will not be able to accurately determine how to ascertain such costs to a particular cost unit.

iv. <u>Classification by Normality</u>

This classification determines the costs as normal costs and abnormal costs. The norms of normal costs are the costs that usually occur at a given level of output, under the same set of conditions in which this level of output happens.

- **Normal Costs:** This is a part of the cost of production and a part of the costing profit and loss. These are the costs that the firm incurs at the normal level of output in standard conditions.
- **Abnormal Costs:** These costs are not normally incurred at a given level of output in conditions in which normal levels of output occur. These costs are charged to the profit and loss account; they are not a part of the cost of production.

<u>v. Classification By variability or cost behaviour:</u>

- **Fixed costs or period costs** are those costs which remain fixed in total and do not increase or decrease when volume of production increases or decreases. But fixed cost per unit will change. Fixed cost per unit increases when the volume of production decreases and fixed cost per unit decreases when the volume of production increases. **Example:** Office & administration overhead like rent, salary.
- **Variable costs or product costs:** are those costs which vary in total indirect proportion to volume of production. When volume of output Increases total variable cost also increases

whenoutput decreases total variable cost also decreases. But the variable cost per unit remains fixed. **Example:** Direct material, direct labour, direct expenses and all variable overhead.

- **Semi-variable costs:** are those costs which are partly fixed and partly variable.

  Example: Telephone expenses, Electricity bill.

Vi. Classification by Time:

- **Historical Cost:** Historical cost is actual cost which are determined after these have been incurred.
- **Pre-determined costs :** Pre-determined costs are estimated or future costs which are ascertained in advance ofproduction, (costs are determined before the production take place)

Classification of Cost for Decision Making:

Opportunity Cost:

A benefit, profit, or value of something that must be given up to acquire or achieve something else.

- The following formula illustrates an opportunity cost calculation, for an investor comparing the returns on different investments:

(Opportunity Cost= Return on the best option not chosen – Return on the option chosen

Sunk Cost:

Sunk costs are all those costs which have been incurred by the company in the past time with no chance of its recovery in the future

The example of which includes research and development expenses incurred by the company before starting of the project, expenses on survey conducted for evaluating any proposal etc.

COST CENTRE & COST UNIT

COST CENTRE

Cost Center:

Definition:

Cost centre as, a location or a person or an item of equipment in or connected with an undertaking in relation to which cost may be ascertained and used for the purpose of cost control –ICMA

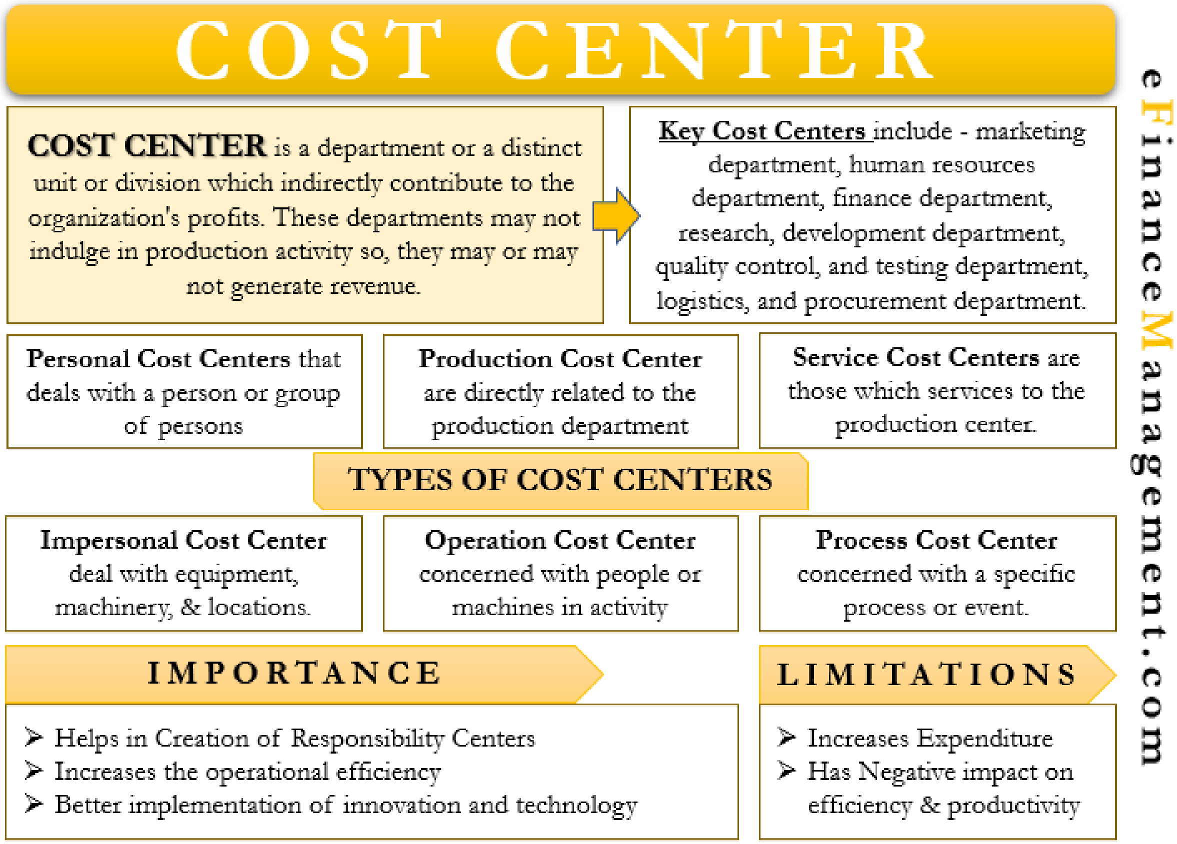
Meaning:

- The Cost Center is a department or a distinct unit or division within the framework of a company.
- These cost centers indirectly contribute to the organization's profits. For accounting, all expenses of that particular division are gathered at these cost centers' levels. These departments are not engaged in

production directly. They may assist in production or associated with other functions such as sales, marketing, human resources, research, development, etc.

- Many cost centers may not generate any revenue at all for the company. Therefore, they generate profits indirectly for the company.

Types of Cost Centres



Example for a Cost Center:

- Cost centers incorporate an organisation's Information Technology department, Human Resource department, and Accounting department.

- Manufacturing businesses ordinarily have a cost center for quality control. The client care focal point of a business just produces expenses or a cost, for example, telephone expenses and staff salaries, and is in this way a cost center.

Characteristics of a Cost Center:

- A cost center is a capacity inside an association that doesn't straightforwardly add to benefit yet at the same time costs cash to work, like the R and D, HR, or IT offices.

- The primary utilisation of a cost center is to follow real costs for correlation with a spending plan or a budget plan.
- A cost center, in a roundabout way, adds to an organisation’s benefit through functional excellence, client care, and upgrading the products and services’ value.
- The director for a cost center is just answerable for keeping costs in accordance with the financial plan and doesn’t bear any obligation in regards to income or speculation choices.

COST UNIT

- A cost unit is characterized as the unit of service, time, movement, product, or mix according to which cost is assessed.
- At the time of setting up the cost proclamations, statements, and records, a specific unit is needed to be chosen. It assists with distinguishing the expense precisely and allots the different costs.
- It helps the expense estimation interaction of the organisation and advances correlation.

Example of a Cost Unit:

- The cost unit of the steel business would be a ton, and the expense unit of the hotel business is a room. This is laid by the cost center.
- There are both basic units and complex units in cost units. A basic unit addresses a solitary standard estimation like a per piece, per meter, per kilogram, and so on. A complex unit utilizes a blend of two basic units like each per tone - kilometre, kilowatt-hour, and so forth.

DIFFERENCE BETWEEN COST CENTRE AND PROFIT CENTRE:

S.No	COST CENTRE	PROFIT CENTRE
1	It is the smallest unit of activity	It is the segment of activities of of a business.
2	Responsible to collect costs.	Responsible tor revenue & expenses.
3	They are not autonomous.	They are autonomous.
4	It is created for cost control.	It is created for decentralisation of operations.
5	It does not have target cost.	It has profit target.

DIFFERENCE BETWEEN COST CENTRE & COST UNIT:

Basis	Cost Center	Cost Unit
Concept	A cost center is a production or service location, function, activity,or item of equipment for which costs and revenues are accumulated.	This is the unit that is involved in tracking costs incurred by various departments of the company.
Basis	It is determined on the basis of the production nature and the kind of business of an organization.	Cost unit is usually based on industry standards and existing common practices.
Function	Cost center acts as an absorption point for the costs incurred in the business.	Cost unit is a measure of the cost absorbed. It represents and expresses the cost through a physical unit.
Sequence	The entire organization is divided into cost centers to get a hold on costs incurred department wise etc.	A cost unit can be a subdivision of a cost center. A cost center can consist of a group of cost units
Example	Cost center can be a company's accounting department, the information technology (IT) department etc.	A cost unit might be the accountancy team within the head office cost center, or a regional office within a country cost center etc.

COSTING:

Costing refers to the process and technique of determining costs. It involves analysis of the information so as to help management identify the cost of production and selling

METHODS OF COSTING

The method of costing refers to the techniques and process used in ascertainment of costof production. There are different methods of costing for different industries. There are two basic methods of costing. They are

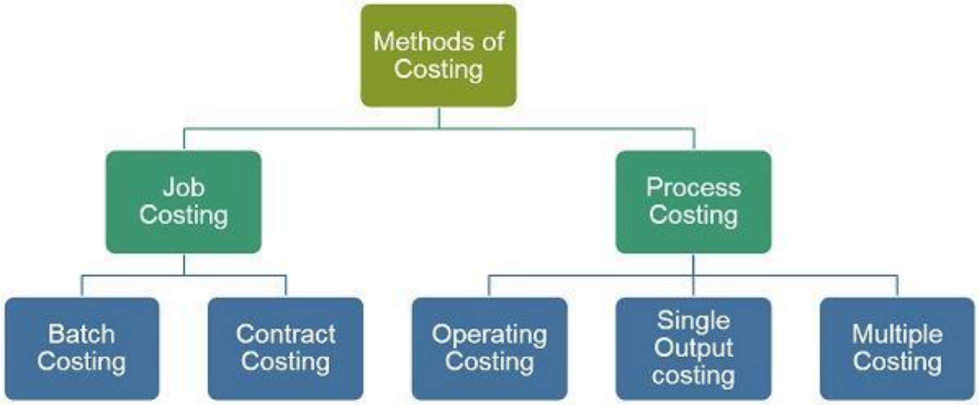
1) Job costing
2) Process costing

1) Job costing:

In this method costs are collected and accumulated for each job or work order separately. Each work is done according to customer's specification. Each job has a separate identity and makes a cost unit.

Examples:

This method is used by Printing press, Repair Shops, Foundries, General engineering workshops, Painting and decorating.



a) Batch costing:

This is an extension of job costing. A batch may represent a number of small orders passed through the factory in batch. Each batch is treated as. A cost unit and costs are accumulated for each batch separately.

Example: i) Biscuits manufacture, ii) garments manufacture, iii) Toys, iv) shoes iv) Bicycle spare parts.

b) Contract costing:

This method is based on principles of job costing. Contract is a big job a separate account is kept for individual contract.

Examples: This method is used by Construction work, ship building and constructional engineers etc.

2) Process costing:

In this method costs are separately collected and accumulated for each process. This is suitable for industries where product passes through different processes for completion. The finished product of one process becomes the raw material of the next process.

Examples: Textile mills, Chemical works, sugar mills, paper nulls, soap manufacturing.

a) **Operating costing:**

This is the application of process costing. This method is used to find out the cost of services rendered. This is suitable for industries which render services rather than producing goods.

Examples: Transport undertakings, power supply companies, hospitals, hotels.

b) Unit costing (or) Single output costing:

This method is used when production is uniform continuous and units are identical. It consists of only single product two or three types of similar products. This method is applied in the following types of industries.

PRODUCT NAME	COST UNIT
Brick works	One thousand
Coal mines	Per tone
Steel works	Per tone

c) Multiple Costing (Or) Composite Costing:

It is an application of more than one method of costing in respect of the same product. This method is used in industries where a number component parts are separately produced and assembled to product final product.

Example: i) Television, radio manufacturing ii) Scooter and other mo vehicles iii) Refrigerator manufacture iv) Locomotive works v) Automobiles vi) Airplanes vii) Manufacturing cycles

TECHNIQUES OF COSTING

Techniques imply the principles to be followed for ascertaining the cost of the products manufactured or services rendered. The various techniques of costing are:

i) Historical costing:

- It is comparison of all costs incurred after the process is performed.

- Historical costing permits the accurate calculation of costs afterwards but is of little use for forward planning purposes.

ii) Standard Costing

- A standard cost has been described as ***a predetermined cost,*** an ***estimated future cost*** and comparing them with recorded actual costs.
- Standard costs are often a part of a manufacturer's annual profit plan and operating budgets.
- It is the ***comparison between actual costs and standard costs***. The differences between the two are variances.
- The standards costs are pre-determined and such standard costs of materials, labor, overheads are calculated with scientific and technical analysis. They help set the benchmark for the whole industry.
- If the actual costs are greater than these standard costs, the variance is adverse. So we analyze the reason for this adverse variance and try and solve the root causes.

iii) Marginal Costing

- The marginal cost is the ***difference between fixed costs and variable costs***. It is used to ascertain the effect of changes in volume or type of output on profit.
- Fixed costs are unrelated to the levels of production. As the name suggests these costs remain the same irrespective of the production quantities.
- Variable costs change in relation to production levels. They are directly proportionate. The variable cost per unit, however, remains the same.
- Of all the available techniques of costing, marginal costing is most suitable for making decisions like how much material to buy, the correct product mix, fixing the selling price etc.
- As per this technique, the management may decide the number of units to be produced.
- **Example:** Suppose a toy unit is already producing 100 units of 'Dancing Monkey' toy, this technique will help the management understand that if the production is increased to 150, will it be profitable.

iv) Direct Costing

In this technique all the direct costs incurred for a particular product, process or project are charged to it and the indirect costs are written off to profit & loss.

v) Absorption Costing

The practice of charging all costs, both variable and fixed, to operation, processes, and product is known as Absorption Costing.

The technique of costing in which cost is ascertained after it is incurred.

In this fixed and variable costs are allocated to the units of costs and absorption of total overheads is carried out on the basis of activity level.

vi) Uniform Costing

It can be defined as the use of same costing principles and/or practices by several organisations in an industry for common control or comparison of costs.

In this technique same costing practices are followed across certain units to facilitate comparison.