Finance and Costing

Unit 1 Introduction to Financial Accounting

In India, during Chandragupta Maurya’s regime, Minister Kautilya wrote a book named ‘Arthashastra’, where in some references can be traced regarding the way of maintaining accounting records. Afterwards it was called as “Deshi Nama”.

In the earlier time of civilisation, accounting was done by agents who managed the properties of wealthy people. They prepared accounts periodically for the owners of property. The records of debit and credit were found in the 12th century itself.

In the year 1494, Luca De Bargo Pacioli, an Italian merchant introduced Double-Entry Bookkeeping 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 involved 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. Though accounting was individual centric in the initial stage of evolution of accounting, it has gradually developed into Social Responsibility Accounting in the 21st century. This is due to the vast growth in business activities as a result of development in various fields. Thus, accounting has become inevitable in the modern world for business.

Indian system maintains, records in Indian languages, such as Marathi, Hindi, Urdu, Gujrati etc. It is called Mahajani Deshinama system. In this system transactions are recorded or maintained in long books, known as Bahi-Khata and Kird.

This system of accounting is not based on Double Entry system of accounting. Thus, is not a scientific accounting system. Even today this system is used in India for small business organization

- Forms of Business Organisation;

Various forms of business organisations from which one can choose the right one includes;

(a) Sole proprietorship;
This form of business is particularly common in areas of personalized services such as beauty parlours, hair saloons and small scale activities like running a retail shop in a locality. the owner is personally responsible for payment of debts in case the assets of the business are not sufficient to meet all the debts

Features;
(i) Formation and closure: There is no separate law that governs sole proprietorship. Hardly any legal formalities are required to start a sole proprietary business, though in some cases one may require a license. Closure of the business can also be done easily. Thus, there is ease in formation as well as closure of business.

(ii) Liability: Sole proprietors have unlimited liability. This implies that they have to bring in Rs. 20,000 from their personal sources even if they have to sell her personal property to repay the firm’s debts.

(iii) Sole risk bearer and profit recipient: The risk of failure of business is borne all alone by the sole proprietor. However, if the business is successful, the proprietor enjoys all the benefits. He receives all the business profits which become a direct reward for his risk bearing.

(iv) Control: The right to run the business and make all decisions lies absolutely with the sole proprietor. He can carry out his plans without any interference from others

v) No separate entity: In the eyes of the law, no distinction is made between the sole trader and his business, as business does not have an identity separate from the owner. The owner is, therefore, held responsible for all the activities of the business.

(vi) Lack of business continuity: The sale proprietorship business is owned and controlled by one person, therefore death, insanity, imprisonment, physical ailment or bankruptcy of the sole proprietor will have a direct and detrimental effect on the business and may even cause closure of the business.

Merits;

Sole proprietorship offers many advantages;

(i) Quick decision making: A sole proprietor enjoys considerable degree of freedom in making business decisions. Further the decision making is prompt because there is no need to consult others. This may lead to timely capitalisation of market opportunities as and when they arise.

(ii) Confidentiality of information: Sole decision making authority enables the proprietor to keep all the information related to business operations confidential and maintain secrecy. A sole trader is also not bound by law to publish firm’s accounts.

(iii) Direct incentive: A sole proprietor directly reaps the benefits of his/her efforts as he/she is the sole recipient of all the profit. The need to share profits does not arise as he/she is the single owner. This provides maximum incentive to the sole trader to work hard.

(iv) Sense of accomplishment: There is a personal satisfaction involved in working for oneself. The knowledge that one is responsible for the success of the business not only contributes to self-satisfaction but also instils in the individual a sense of accomplishment and confidence in one’s abilities.

(v) Ease of formation and closure: An important merit of sole proprietorship is the possibility of entering into business with minimal legal formalities. There is no separate law that governs sole proprietorship. As sole proprietorship is the least regulated form of business, it is easy to start and close the business as per the wish of the owner.

Limitations;

(i) Limited resources: Resources of a sole proprietor are limited to his/ her personal savings and borrowings from others. Banks and other lending institutions may hesitate to extend a long term loan to a sole proprietor. Lack of resources is one of the major reasons why the size of the business rarely grows much and generally remains small.

(ii) Limited life of a business concern: The sole proprietorship business is owned and controlled by one person, so death, insanity, imprisonment, physical ailment or bankruptcy of a proprietor affects the business and can lead to its closure.

(iii) Unlimited liability: A major disadvantage of sole proprietorship is that the owner has unlimited liability. If the business fails, the creditors can recover their dues not merely from the business assets, but also from the personal assets of the proprietor. A poor decision or an unfavourable circumstance can create serious financial burden on the owner. That is why a sole proprietor is less inclined to take risks in the form of innovation or expansion.

(iv) Limited managerial ability: The owner has to assume the responsibility of varied managerial tasks such as purchasing, selling, financing, etc. It is rare to find an individual who excels in all these areas. Thus decision making may not be balanced in all the cases. Also, due to limited resources, sole proprietor may not be able to employ and retain talented and ambitious employees.

Though sole proprietorship suffers from various shortcomings, many entrepreneurs opt for this form of organisation because of its inherent advantages. It requires less amount of capital. It is best suited for businesses which are carried out on a small scale and where customers demand personalised services

(B)JOINT HINDU FAMILY BUSINESS;

It is owned by the members of undivided joint Hindu family and managed by the eldest member of the family known as KARTA. It is governed by the provisions of Hindu law. The basis of membership is birth in a particular family.

FEATURES

i. Formation – For a joint Hindu family business there should be at least two members in the family and some ancestral property to be inherited by them.

ii. Membership by birth –
There are two systems which govern membership
Dayabhaga System- It prevails in west Bengal and allows both male and female member to co-parcencers.
Mitakshara System- It prevails all over India except West Bengal and allows only male members to be coparceners.

Iii.Liability – Liability of Karta is unlimited but of all other members is limited to the extent of their share in property.

iv. Continuity – The business is not affected by death or incapacity of Karta in such cases the next senior male member becomes the Karta.

v. Minor members – A minor can also become full fledged member of Family business.

MERITS

i). Effective control- The Karta can promptly take decisions as he has the absolute decision making power.

Ii). Continued business existence- The death, Lunacy of Karta will not affect the business as next eldest member will then take up the position.

iii). Limited liability – The liability of all members except Karta is limited. It gives them a relief.

iv). Secrecy – Complete secrecy regarding business decisions can be maintained by Karta.

v). Loyalty and Co-operation: It helps in securing better co-operation and greater loyalty from all the members who run the business.

LIMITATION

i). Limited capital: There is shortage of capital as it is limited to the ancestral property.

ii).Unlimited liability of karta – It makes him less enterprising.

iii). Dominance of karta – Karta manages the business and sometimes he ignores the valuable advice of other members. This may cause conflict among the members and may lead to break down of the family limit.

iv). Hasty decisions: As karta is overburdened with work, he may take hasty and unbalanced decisions.

v). Limited managerial skills of karta also pose a serious problem. The Joint Hindu family business is on decline because of the diminishing no. of joint Hindu families in the country.

(C) PARTNERSHIP

Meaning: Partnership is a voluntary association of two or more persons who agree to carry on some business jointly and share its profits and losses.

FEATURES

i). Two or more persons: There must be at least two persons to form a partnership. The maximum no. of persons is 10 in banking business and 20 in non-banking business.

ii). Agreement: It is an outcome of an agreement among partners which may be oral or in writing.

iii). Lawful business- It can be formed only for the purpose of carrying on some lawful business.

iv). Decision making & control – Every partner has a right to participate in management & decision making of the organisations.

v) Unlimited liability – Partners have unlimited liability.

vi). Mutual Agency – Every partner is an implied agent of the other partners and of the firm. Every partner is liable for acts performed by other partners on behalf of the firm.

vii). Lack of continuity – Firms existence is affected by the death, Lunacy and insolvency of any of its partner. It suffers from lack of continuity.

MERITS

i). Ease of formation & closure – It can be easily formed. Only an agreement among the partners is required.

Ii). Larger financial resources – There are more funds as capital is contributed by no. of partners.

Iii). Balanced Decisions – As decisions are taken jointly by partners after consulting each other.

Iv). Sharing of Risks – In it, risk get distributed among partners which reduces anxiety, burden and stress on individual partner.

v). Secrecy – Secrecy can be easily maintained about business affairs as they are not required to publish their accounts or to file any report to the govt.

LIMITATIONS

i). Limited resources – There is a restriction on the number of partners and hence capital contributed by them is also limited.

Ii). Unlimited liability- The liability of partners is unlimited and they are liable individually as well as jointly. It may prove to be a big drawback for those partners who have greater personal wealth. They will have to repay the entire debt in case the other partners are unable to do so.

iii). Lack of continuity – Partnership comes to an end with the death, retirement, insolvency or lunacy of any of its partner.

Iv). Lack of public confidence – Partnership firms are not required to publish their reports and accounts. Thus they lack public confidence.

TYPES OF PARTNERS

General / Active Partner, Sleeping or Dormant Partner, Secret Partner, Nominal Partner, Partner by Estoppels, Partner by holding out.

D)Co-operative Society

A co-operative society is a voluntary association of persons of moderate means who unite together to protect & promote their common economic interests.

FEATURES

i). Voluntary association: Every one having a common interest is free to join a co-operative society and can also leave the society after giving proper notice.

ii). Legal status: Its registration is compulsory and it gives it a separate legal identity.

Iii). Limited liability: The liability of the member is limited to the extent of their capital contribution in the society.

Iv). Democratic control: Management & Control lies with the managing committee elected by the members by giving vote. Every member has one vote irrespective of the number of shares held by him.

v). Service motive: The main aim is to serve its members and not to maximize the profit.

vi). Bound by govt.'s rules: They have to be tide by the rules and regulations framed by govt. for them.

vii). Distribution of surplus: The profit is distributed on the basis of volume of business transacted by a member and not on the basis of capital contribution of members.

MERITS

i). Excise of formation: It can be started with minimum of 10 members. Registration is also easy as it requires very few legal formations.

Ii). Limited Liability: The liability of members is limited to the extent of their capital contribution.

Iii). Stable existence: Due to registration it is a separate legal entity and is not affected by the death, luxury or insolvency of any of its member.

Iv). Economy in operations: Due to elimination of middlemen and voluntary services provided by its members.

v). Government Support: Govt. provides support by giving loans at lower interest rates, subsidies & by charging less taxes.

Vi). Social utility: It promotes personal liberty, social justice and mutual cooperation. They help to prevent concentration of economic power in few hands.

LIMITATIONS

i). Shortage of capital – It suffers from shortage of capital as it is usually formed by people with limited means.

Ii). Inefficient management – Co-operative society is managed by elected members who may not be competent and experienced. Moreover, it can’t afford to employ expert and experienced people at high salaries.

Iii). Lack of motivation – Members are not inclined to put their best efforts as there is no direct link between efforts and reward.

Iv). Lack of Secrecy – Its affairs are openly discussed in its meeting which makes it difficult to maintain secrecy.

V). Excessive govt. control – it suffers from excessive rules and regulations of the govt. It has to get its accounts audited by the auditor and has to submit a copy of its accounts to registrar.

Vi). Conflict among members – The members are from different sections of society with different viewpoints. Sometimes when some members become rigid, the result is conflict.

TYPES OF CO-OPERATIVE SOCIETIES

Consumers co-operative Society, Producer’s Co-operative Society, Marketing Co-operative Society,Farmer’s Co-operative Society, Credit co-operative Society, Co-operative Housing Society.

E) JOINT STOCK COMPANY

Meaning – Joint stock company is a voluntary association of persons for profit, having a capital divided into transferable shares, the ownership of which is the condition of membership.

FEATURES

i). Incorporated association – The company must be incorporated or registered tender the companies Act 1956. Without registration no company can come into existence.

Ii). Separate Legal Existence – It is created by law and it is a distinct legal entity independent of its members. It can own property, enter into contracts, can file suits in its own name.

Iii). Perpetual Existence – Death, insolvency and insanity or change of members as no effect on the life of a company. It can come to an end only through the prescribed legal procedure.

Iv). Limited Liability – The liability of every member is limited to the nominal value of the shares bought by him or to the amt. guaranteed by him. Transferability of shares – Shares of public Co. are easily transferable. But there are certain restrictions on transfer of share of private Co. Common Seal- It is the official signature of the company and it is affixed on all important documents of company.

v). Separation of ownership and control – Management of company is in the hands of elected representatives of shareholders known individually as director and collectively as board of directors.

MERITS

i). Limited Liability – Limited liability of shareholder reduces the degree of risk borne by him.

Ii). Transfer of Interest – Easy transferability of shares increases the attractiveness of shares for investment.

Iii). Perpetual Existence – Existence of a company is not affected by the death, insanity, Insolvency of member or change of membership. Company can be liquidated only as per the provisions of companies Act.

Iv). Scope for expansion – A company can collect huge amount of capital from unlimited no. of members who are ready to invest because of limited liability, easy transferability and chances of high return.

v). Professional management – A company can afford to employ highly qualified experts in different areas of business management.

LIMITATIONS

i). Legal formalities – The procedure of formation of Co. is very long, time consuming, expensive and requires lot of legal formalities to be fulfilled.

Ii). Lack of secrecy – It is very difficult to maintain secrecy in case of public company, as company is required to publish and file its annual accounts and reports.

iii. Lack of Motivation – Divorce between ownership and control and absence of a direct link between efforts and reward lead to lack of personal interest and incentive.

iv. Delay in decision making – Red papism and bureaucracy do not permit quick decisions and prompt actions. There is little scope for personal initiative.

v. Oligarchic management – Co. is said to be democratically managed but actually managed by few people i.e. board of directors. Sometimes they take decisions keeping in mind their personal interests and benefit, ignoring the interests of shareholders and Co.

TYPES OF COMPANIES

On the basis of ownership, companies can be divided into two categories – Private & Public.

Concepts and Conventions of Accounting

Accounting is means of communicating the results of business operations to various parties interested in or connected with the business viz., the owners, creditors, investors, banks and financial institutions, Government and other agencies. Hence, it is rightly called as the language of business.

Importance of Accounting Concepts:

1) Reliable financial statements.
2) Uniformity in presentation.
3) Generally acceptable basis of measurement.
4) Proper information to all.
5) Valid and appropriate assumptions

Accounting concepts define the assumptions on the basis of which financial statements of a business entity are prepared.

Concepts are those basic assumptions and condition which form the basis upon which the accountancy has been laid.

Business entity concept
This concept assumes that, for accounting purposes, the business enterprise and its owners are two separate independent entities. Thus, the business and personal transactions of its owner are separate.

For example, when the owner invests money in the business, it is recorded as liability of the business to the owner. Similarly, when the owner takes away from the business cash/goods for his/her personal use, it is not treated as business expense.

Money measurement concept
This concept assumes that all business transactions must be in terms of money, that is in the currency of a country. In our country such transactions are in terms of rupees. Thus, as per the money measurement concept, transactions which can be expressed in terms of money are recorded in the books of accounts.

For example, sale of goods worth Rs.200000, Rent Paid Rs.10000 etc. are expressed in terms of money, and so they are recorded in the books of accounts. But the transactions which cannot be expressed in monetary terms are not recorded in the books of accounts.

Going concern concept
This concept states that a business firm will continue to carry on its activities for an indefinite period of time. Simply stated, it means that every business entity has continuity of life. Thus, it will not be dissolved in the near future. This is an important assumption of accounting, as it provides a basis for showing the value of assets in the balance sheet.

Accounting period concept
All the transactions are recorded in the books of accounts on the assumption that profits on these transactions are to be ascertained for a specified period. This is known as accounting period concept. Thus, this concept requires that a balance sheet and profit and loss account should be prepared at regular intervals. This is necessary for different purposes like, calculation of profit, ascertaining financial position, tax computation etc.

Accounting cost concept
It states that all assets are recorded in the books of accounts at their purchase price, which includes cost of acquisition, transportation and installation and not at its market price. It means that fixed assets like building, plant and machinery, furniture, etc are recorded in the books of accounts at a price paid for them.

Dual aspect concept
Dual aspect is the foundation or basic principle of accounting. It provides the very basis of recording business transactions in the books of accounts. This concept assumes that every transaction has a dual effect, i.e. it affects two accounts in their respective opposite sides. Therefore, the transaction should be recorded at two places. It means, both the aspects of the transaction must be recorded in the books of accounts. Thus, the duality concept is commonly expressed in terms of fundamental accounting equation :
Assets = Liabilities + Capital

Matching concept
The matching concept states that the revenue and the expenses incurred to earn the revenues must belong to the same accounting period. So once the revenue is realised, the next step is to allocate it to the relevant accounting period. This can be done with the help of accrual concept If the revenue is more than the expenses, it is called profit. If the expenses are more than revenue it is called loss. This is what exactly has been done by applying the matching concept.

Realisation concept
This concept states that revenue from any business transaction should be included in the accounting records only when it is realised. The term realisation means creation of legal right to receive money. Selling goods is realisation, receiving order is not. In other words, it can be said that : Revenue is said to have been realised when cash has been received or right to receive cash on the sale of goods or services or both has been created. The concept of realisation states that revenue is realized at the time when goods or services are actually delivered.

Accrual concept

The meaning of accrual is something that becomes due especially an amount of money that is yet to be paid or received at the end of the accounting period. It means that revenues are recognised when they become receivable. Though cash is received or not received and the expenses are recognised when they become payable though cash is paid or not paid. Both transactions will be recorded in the accounting period to which they relate.

ACCOUNTING CONVENTIONS

An accounting convention refers to common practices which are universally followed in recording and presenting accounting information of the business entity. Conventions denote customs or traditions or usages which are in use since long. To be clear, these are nothing but unwritten laws.

Consistency

The convention of consistency means that same accounting principles should be used for preparing financial statements year after year.

Full Disclosure

Convention of full disclosure requires that all material and relevant facts concerning financial statements should be fully disclosed. Full disclosure means that there should be full, fair and adequate disclosure of accounting information.

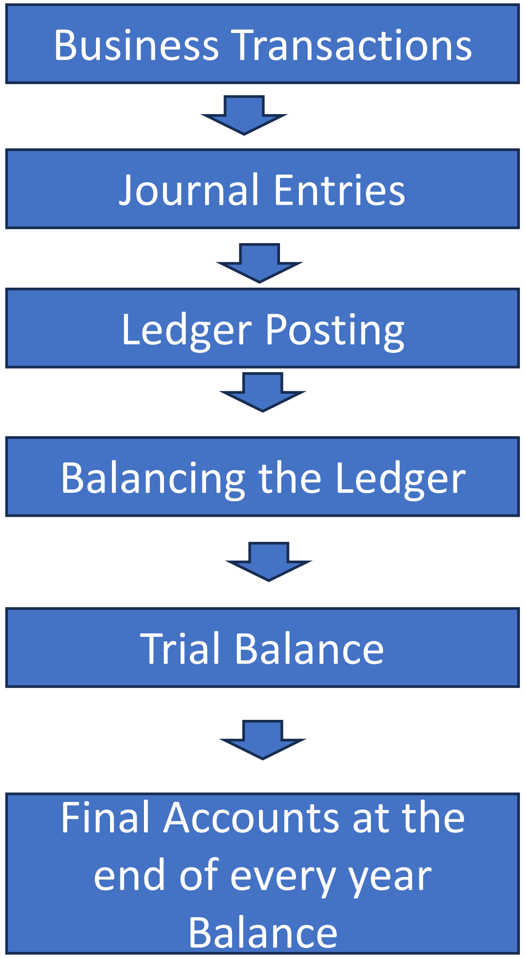
Materiality

The convention of materiality states that, to make financial statements meaningful, only material fact i.e. important and relevant information should be supplied to the users of accounting information.

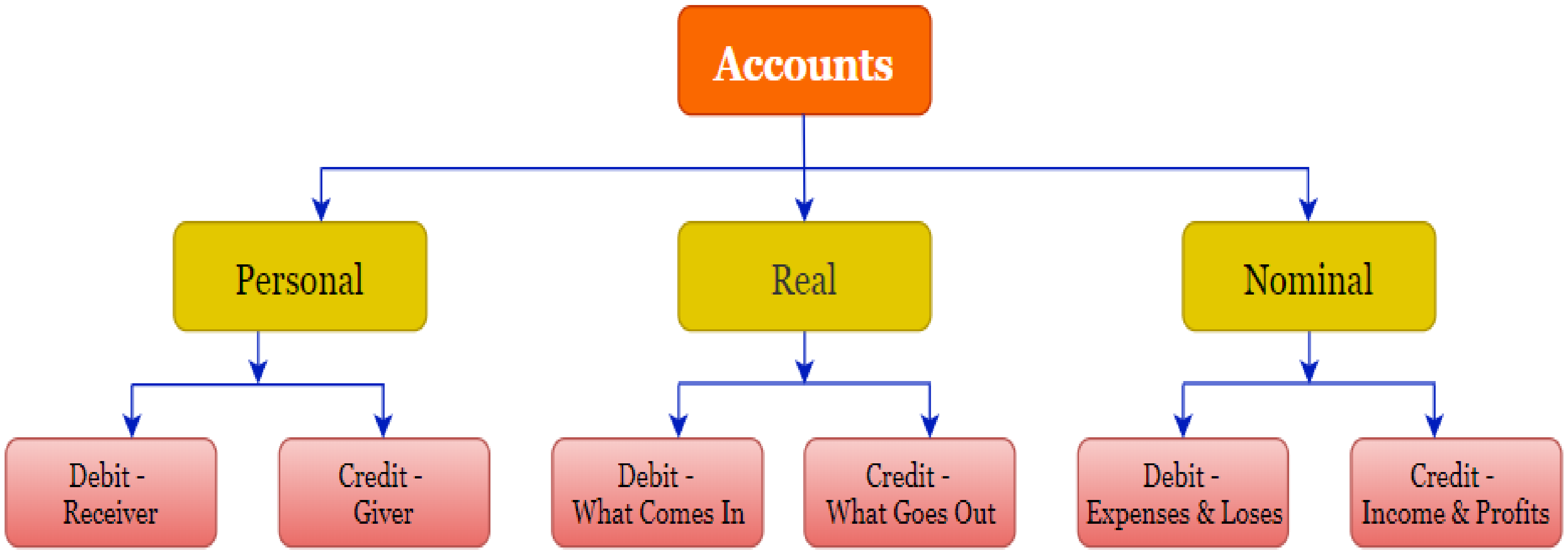
Conservatism
The main objective of this convention is to show minimum profit. Profit should not be overstated. If profit shows more than actual, it may lead to distribution of dividend out of capital.

ACCOUNTING PROCESS

The accounting process is the series of steps followed by the business entity to record the business financial transactions that include steps for collecting, identifying, classifying, summarizing, and recording the business transactions in the books of accounts of the company so that the financial statements of the entity can be prepared. The profits and the business's financial position can be known after regular intervals of time. The accounting process can be represented as below;



TYPES OF ACCOUNTS;



GOLDEN RULES OF ACCOUNTING;

Debit the receiver and credit the giver;

This golden rule applies to the personal account. When the business receives something, then the account must be debited and when the business gives something then the account must be credited as per this rule of accounting.

Debit what comes in and credit what goes out;

This golden rule applies to real accounts (also known as permanent accounts). Examples of real accounts include equity, asset, and liability accounts. When the business is acquiring something such as an asset, then the account of the business has to be debited. On the other hand, when the business is giving something out then the account will be credited.

Debit expenses and losses, credit income and gains;

This golden rule applies to nominal accounts (also known as temporary accounts). Examples of nominal accounts include expense, gain, loss, and revenue accounts. As per the rule, when the business incurs a loss or has an expense then you need to debit the account. If the business has a gain or earns an income then the account should have a credit.

JOURNAL ENTRIES;

Journal entries consist of the name of debit and name of credit involved in the financial transaction with a brief narration. Journal is a book in which the business transactions are first recorded in a chronological order i.e. Date wise in the order in which they take place.

The main thing that needs to be known about journal entries in accounting is that they all follow the double-accounting method.

LEDGER;

At the end of the particular period if we want to know what is the total amount spent on particular type of expense, or what is the amount payable to particular person /party? These types of questions cannot be answered easily through Journal. So to overcome these limitations of Journal we need Ledger.

Ledger is called as the main book of accounts. Once the transactions are recorded in Journal or Subsidiary books the next stage is the transfer of those transactions in their respective accounts opened in the Ledger.

“ A Ledger Account may be defined as a summary, statement of all the transactions relating to persons, assets, expenses or incomes which have taken place during a given period to time and shows their net effect”.
- **S. P. Jain, K. L. Narang –Advanced Accountancy**

TRIAL BALANCE AND FINANCIAL STATEMENTS OF SOLE PROPRIETOR;

Trial balance is an abstract or list of all the ledger accounts as on a specific date showing debit and credit balances of all Ledger Accounts. Usually, Trial Balance is prepared at the end of the financial year.

However it can be prepared periodicaly depending upon requirement of the business. It is prepared to ascertain the arithmetical accuracy of Books of Accounts.

Types of Trial Balance:

(1) Gross Trial Balance: In this type of Trial Balance total of debit side of a particular account is shown in the debit column of the Trial Balance and total of credit side of a particular account is shown in the credit column of the Trial Balance. It is not in common use as it does not disclose the balance of each account.

(2) Net Trial Balance: In this type of Trial Balance only the balances of each ledger account are shown against its name. If an account shows a credit balance then its balance is recorded in the credit amount column and vice versa. this Trial Balance is used in practice

Methods of preparing Trial Balance:

There are two methods of preparing Trial Balance;

(1) Vertical or Journal form of Trial Balance

Format of Vertical / Journal form of Trial Balance

Trial Balance as on...........

Sr. No.	Head of Accounts	L.F.	Debit (₹)	Credit (₹)

(2) Horizontal Form of Trial Balance

Format of Horizontal / Ledger form of Trial Balance

Trial Balance as on..............

Sr. No.	Debit Balances	L.F.	Amt (₹)	Sr. No.	Credit Balances	L.F.	Amt (₹)

Utility of a Trial Balance:

1) It shows balances of different Ledger accounts.

2) It proves arithmetical accuracy of Books of Accounts.

3) It helps to prepare Final Accounts of a business.

Financial Statements include;

1) Trading Account;

Trading Account is an account which gives the overall preview of all trading activities. The expenses and losses relating to trading activities are debited to this account and all outward movements of goods and stock of goods at the end of the year are recorded to the credit side of this account.

Specimen of Trading Account

Trading Account for the year ended ....

Dr. **Cr.**

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To Opening Stock		xxxx	By Sales	xxxx	
To Purchases	xxxx		Less : Sales Return (Return Inward)	xxxx	xxxx
Less : Purchase Return (Return outwards)	xxxx	xxxx	By Goods distributed as free sample		xxxx
To Direct Expenses		xxxx	By Goods taken by proprietor for personal use		xxxx
To Freight & Carriage Inward		xxxx	By Closing Stock		xxxx
To Custom Duty		xxxx	By Gross Loss c/d		xxxx
To Wages		xxxx			
To Coal, Gas, Fuel etc.		xxxx			
To Royalties		xxxx			
To Factory expenses		xxxx			
To Gross Profit c/d		xxxx			
		xxxx			xxxx

2) Profit and Loss Accounts;

This account is main Account of final Accounts which gives the final working results of business. It is prepared on the basis of indirect expenses and indirect incomes of the business concern. Profit and Loss Account is maintained to ascertain Net Profit or Net Loss.

The debit side of Profit and Loss Account includes all indirect expenses such as office or administrative expenses, financial expenses, selling or distribution expenses etc.

The credit side of profit and Loss Account includes indirect incomes like commission received, rent received, discount earned etc.

A specimen of Profit & Loss Account is given below :

Profit & Loss Account for the year ended...

Dr. **Cr.**

Particulars	Rs.	Particulars	Rs.
To Salaries	X	By Gross Profit b/d	X
To Rent, Rates & Taxes	X	By Discount earned	X
To Insurance	X	By Commission received	X
To Printing & Stationery	X	By Interest earned	X
To Legal Exp	X	By Profit on sale of assets	X
To Audit Fees	X		
To Discount allowed	X		
To Interest paid on Loans	X		
To Bad debts	X		
To Carriage outwards	X		
To Advertising expenses	X		
To Depreciation on assets	X		
To Loss due to fire	X		
To Net Profit	X		
[transferred to capital]			
	XX		**XX**

3) Balance Sheet;

Balance Sheet is a statement showing financial position of a business concern. Balance Sheet has no debit or credit side as it is a statement and not an account. Left hand side of Balance sheet is "Liability side"and Right hand side "Asset side".

Both sides of Balance Sheet should be of equal amount. A Balance sheet shows assets & liabilities of the business.

All Debit balances of Personal and Real Accounts are shown on the Asset Side and All Credit Balances of Personal Accounts are shown on Liability side. No Nominal Account will appear in the Balance Sheet

Balance Sheet of ..... as on .....
[According to Liquidity order]

Liabilities	Rs.	Assets	Rs.
Outstanding Expenses	X	Cash in hand	X
Sundry Creditors	X	Bank Balance	X
Bills Payable	X	Investments	X
Bank Overdrafts	X	Sundry Debtors	X
Loans	X	Bills Receivable	X
Capital	X	Outstanding Income	X
		Stock in trade	X
		Loose tools	X
		Prepaid Expenses	X
		Patents, Trade Marks	X
		Furniture	X
		Plant & Machinery	X
		Building	X
		Land	X
		Goodwill	X
	XXX		**XXX**

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The period 1880 AD- 1925 AD saw the development of complex product designs and the emergence of multi activity diversified corporations like Du Pont, General Motors etc. It was during this period that scientific management was developed which led the accountants to convert physical standards into Cost Standards, the latter being used for variance analysis and control.

During the World War I and II the social importance of Cost Accounting grew with the growth of each country’s defence expenditure. In the absence of competitive markets for most of the material required for war, the governments in several countries placed cost-plus contracts under which the price to be paid was cost of production plus an agreed rate of profit. The reliance on cost estimation by parties to defence contracts continued after World War II.

In addition the following factors have made accountants to find new techniques to serve the industry :-

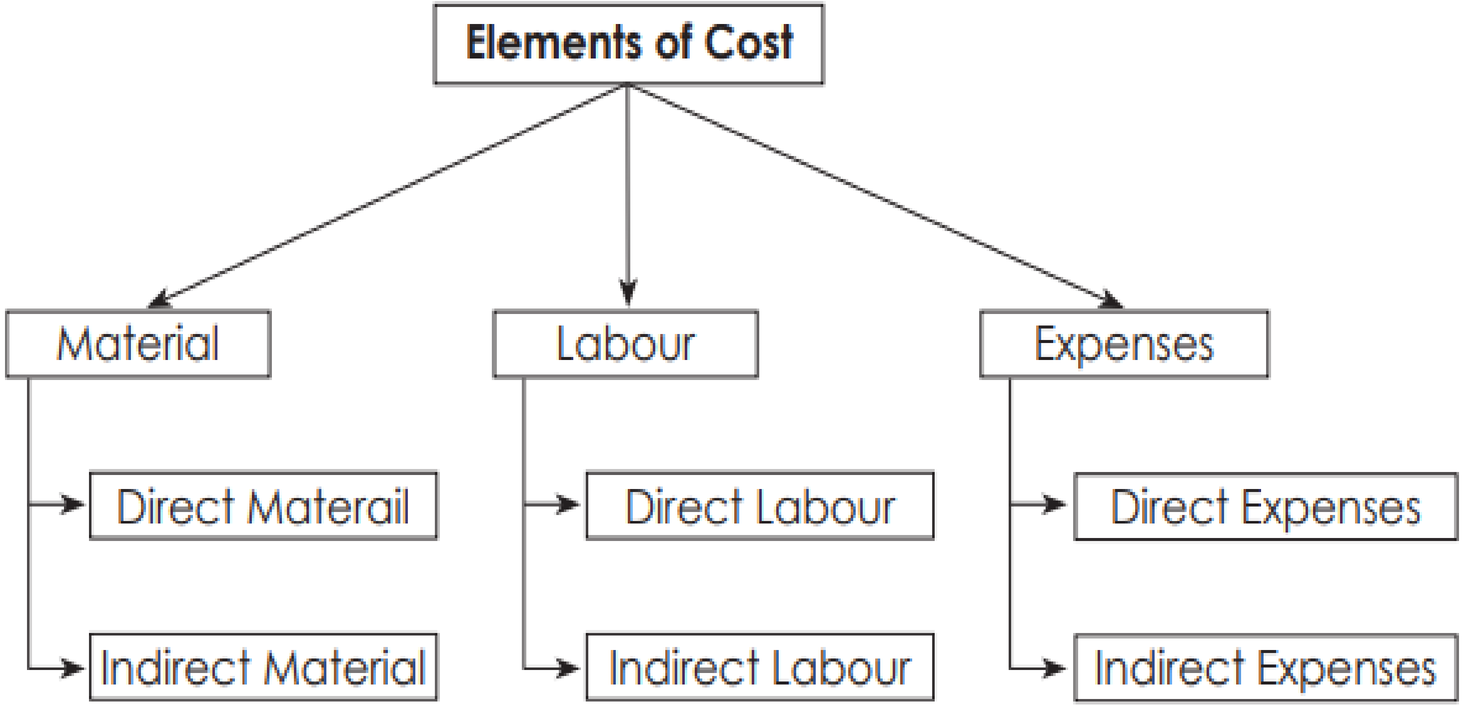
(i) Limitations placed on financial accounting.
(ii) Improved cost consciousness.
(iii) Rapid industrial development after industrial revolution and world wars.
(iv) Growing competition among the manufacturers.
(v) To control galloping price rise, the cost of computing the precise cost of product / service.
(vi) To control cost several legislations passed throughout the world and India too such as Essential Commodities Act, Industrial Development and Regulation Act... Etc

Cost;

Cost is defined as the amount of expenditure (actual or notional) incurred on or attributable to a given thing or to ascertain the cost of a given thing. Thus it is that which is given or in sacrificed to obtain something. The cost of an article consists of actual outgoings or ascertained charges incurred in its production and sale.

Cost is a generic term and it is always advisable to qualify the word cost to show exactly what it meant, e.g., prime cost, factory cost, etc. Cost is also different from value as cost is measured in terms of money whereas value in terms of usefulness or utility of an article.

Elements of Cost;



Direct Material + Direct Labour + Direct Expenses = Prime Cost

Indirect Material+ Indirect Labour + Indirect Expenses = Overhead

Elements of Cost;

Direct Material Cost;

Direct material cost can be defined as ‘The Cost of material which can be attributed to a cost object in an economically feasible way’. Direct materials are those materials which can be identified in the product and can be conveniently measured and directly charged to the product. Thus, these materials directly enter the product and form a part of the finished product.

Indirect Material Cost;

Indirect materials are those materials which do not normally form a part of the finished product. It has been defined as “materials which cannot be allocated but which can be apportioned to or absorbed by cost centres or cost units”.

Direct Labour / Employee Cost;

The cost of employees can be attributed to a cost object in an economically feasible way. In simple words, it is that labour which can be conveniently identified or attributed wholly to a particular job, product or process or expended in converting raw materials into finished goods.

Indirect Labour/ Employee Cost;

The labour / employee cost cannot be directly attributed to a particular cost object. The wages of that labour which cannot be allocated but which can be apportioned to or absorbed by cost centres or cost units is known as Indirect Labour.

Direct or Chargeable Expenses;

Direct expenses are expenses relating to manufacture of a product or rendering a service which can be identified or linked with the cost object other than direct material cost and direct employee cost.

Overhead;

Overheads comprise of indirect materials, indirect employee cost and indirect expenses which are not directly identifiable or allocable to a cost object.

Prime Cost;

The aggregate of Direct Material, Direct Labour and Direct Expenses is called Prime Cost.

Cost Object;

Cost object is the technical name for a product or a service, a project, a department or any activity to which a cost relates.

Cost Driver;

Cost Driver is an activity which is responsible for cost incurrence.

Classification of Costs and Overheads;

Types of costing have been designed to suit the needs of individual business conditions.

The basic principles underlying all these methods are the same i.e. to collect and analyze the expenditure according to the elements of costs and to determine the cost of each Cost Centre and or Cost Unit.

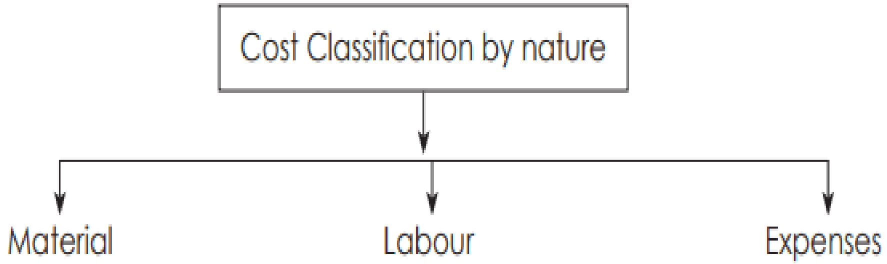
Classification of cost is the arrangement of items of costs in logical groups having regard to their nature or purpose.

Items should be classified by one characteristic for a specific purpose without ambiguity. Scheme of classification should be such that every item of cost can be classified.

As per the basis for cost classification is as follows;
(a) Nature of expense
(b) Relation to Object – Traceability
(c) Functions / Activities
(d) Behaviour – Fixed, Semi-variable or Variable
(e) Management decision making
(f) Production or Process
(g) Time Period

(a) Classification by Nature of Expense Costs should be gathered together in their natural grouping such as Material, Labour and Other Direct expenses. Items of costs differ on the basis of their nature. The elements of cost can be classified in the following three categories;

1. Material
2. Labour
3. Expenses



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

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

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

Cost Centre: Cost centre is “a location, a person, or an item of equipment (or a group of them) in or connected with an undertaking, in relation to which costs ascertained and used for the purpose of cost control”.

The determination of suitable cost centres as well as analysis of cost under cost centres is very helpful for periodical comparison and control of cost. In order to obtain the cost of product or service, expenses should be suitably segregated to cost centre. The manager of a cost centre is held responsible for control of cost of his cost centre.

The selection of suitable cost centres or cost units for which costs are to be ascertained in an undertaking depends upon a number of factors such as organization of a factory, condition of incidence of cost, availability of information, requirements of costing and management policy regarding selecting a method from various choices.

Cost centre will depend on the situation and classification and may be;

Production cost centres and;

Operating cost centres or process cost centres

Cost centres are of the following types;

Personal Cost Centre: Personal cost centre consists of person or group of persons.

Impersonal cost centre consists of a location or item of equipment or group of equipments.

Operational Cost Centre: Consists of machines or persons carrying on similar operations.

Process Cost Centre: Continuous sequence of operation.

Production Cost Centre: Actual production takes place and includes departments engaged in manufacturing and contributes to creating the finished product.

Cost Unit;

Unit of product, service or time in terms of which cost are ascertained or expressed. It is basically, a unit of quantity of product or service in relation to which costs may be ascertained or expressed.

Cost units are of following types;

Simple Unit: These use a single standard or unit of measurement of the goods manufactured.

Composite Unit or Complex Unit: These combine two simple units.

A few examples of cost units are given below:

Industry / Product	Cost Unit
Automobile	Number of vehicles
Cable	Metres / kilometres
Cement	Tonne
Chemicals / Fertilizers	Litre / Kilogram / tonne
Gas	Cubic Metre
Power - Electricity	Kilowatt Hour
Hospital	Patient Day
Hotel	Bed Night

- ✓ **Advantages of Cost Centre;**

1.Provides a clear understanding of the costs incurred by a specific department or division within a company. This allows for better budgeting and cost control.
2.Helps to identify inefficiencies and areas for cost reduction. By isolating the costs of a specific department or division, it becomes easier to identify areas where costs can be reduced.
3.Facilitates the allocation of costs to specific products or services. This allows for more accurate pricing and profitability analysis.
4.Provides a basis for performance evaluation and accountability. By measuring the costs incurred by a specific department or division, it becomes easier to evaluate the performance of that department or division.
5.Allows for better decision-making. By having a clear understanding of the costs incurred by a specific department or division, it becomes easier to make informed decisions about that department or division.

- ✓ **Disadvantages of Cost Centre;**

1. Time-consuming and resource-intensive to set up and maintain. Setting up and maintaining cost centres requires a significant investment of time and resources.
2. Difficult to accurately allocate costs. Allocating costs to specific departments or divisions can be challenging and may not always be accurate.
3.Can lead to a lack of focus on overall company performance. By focusing on the costs of specific departments or divisions, it can be easy to lose sight of the overall performance of the company.

- ✓ **Disadvantages of Cost Centre;**

4. Can lead to a lack of collaboration and cooperation. By isolating the costs of specific departments or divisions, it can lead to a lack of collaboration and cooperation among departments and divisions.

5. Can lead to a lack of flexibility. By isolating the costs of specific departments or divisions, it can make it more difficult to respond to changes in the business environment.

Cost per unit calculation is important because it can inform the company about the efficiency of its business operations. Then, if necessary, it can take appropriate steps to make operational improvements.

Cost per unit also helps the company decide what to charge for each product so they can be sure they are making a profit.

To be profitable, the company must ensure that its production cost is lower than the price at which it sells it to the customer.

Given the importance of cost unit calculations in determining business profits, most companies assign an individual or a team to handle their cost accounting.

The designated person or team may consider the different factors that are necessary for calculating the cost per unit and analyze these.

They may attempt to find out how they can reduce the overall production costs or at least avoid incurring any increased or additional expenses.

By lowering its production costs and not incurring any further expenses, the company can expect to gain more profit.

- ✓ **Advantages of using Cost units;**

1.Cost units allow for easy comparison of costs between different products or services.
2.They can also be used to determine the cost of producing a specific quantity of a product or service.
3.Cost units can be used to identify areas where costs can be reduced.
4.They can also be used to determine the price at which a product or service should be sold to make a profit.
5.Cost units can be used to help make budgeting and forecasting decisions.

- ✓ **Disadvantages of using Cost units;**

1.The cost of producing a product or service can be affected by many variables, and cost units may not take all of these into account.
2.They may not accurately reflect the true cost of a product or service, especially if the cost of certain inputs is not included.
3.Cost units may not be applicable to certain types of products or services that cannot be easily quantified.
4.They can be time-consuming and costly to calculate and maintain.
5.Cost units can be affected by inflation and other external factors, which can make them less accurate over time.

Preparation of Cost Sheet; Illustration(Amt in INR)

The following figures have been taken from the books of Marlex Ltd. as on 31.12.2022
Stock of Raw Materials on 1.1.2022 Rs. 35,000
Stock of Raw Materials on 31.12.2022 Rs. 5,000
Purchase of Materials Rs. 50,000
Factory Wages Rs. 45,000
Factory Expenses Rs. 17,500
Establishment Expenses Rs. 10,000
Finished Stock on 1.1.2022 Rs. 15,000
Finished stock on 31.12.2022 Rs. 7,500
Sales Rs. 2,00,000
The Company manufactured 4000 units during the year 2022. The company is required to quote for the price for supply of 1000 units during the year 2023. The cost of material will increase by 15% and factory labour will cost more by 10% in the year 2023.

Prepare a cost sheet showing the price to be quoted to give the same percentage of net profit on sales as was realized during 2022.

Cost Sheet for the Year 2022 (Amt in INR)

Opening Stock of Materials: 35,000 **+ Purchases 50,000** **85,000** **- Closing stock of Materials 5,000** **Materials Consumed for 4000 Units**	**80,000**	**20**
Factory Wages	45000	11.25
Prime Cost	1,25,000	31.25
Factory Expenses	17,500	4.37
Works Cost	1,42,500	35.62
Establishment Expenses	10,000	2.50
Cost of Production	1,52,500	38.12
Add: Opening Stock of finished goods	15,000	
	1,67,500	
Less: Closing stock of finished goods	7,500	
Cost of Sales	1,60,000	40
Profit	40,000	10
Sales	2,00,000	50

Quote for 1000 Units (Amt in INR)

Materials (20 x 1000)	**20,000**	
+ 15% increase	**3,000**	**23,000**
Factory wages (11.25 x 1000)	**11,250**	
10% increase	**1,125**	**12,375**
Prime Cost		**35,375**
Factory Expenses (4.375 x 1000)		**4,375**
Works Cost		**39,750**
Establishment Expenses (2.50 x 1000)		**2,500**
Total Cost		**42,250**
Profit (20% on Sale i.e., 25% of Cost)		**10,563**
Sales		**52,813**

Unit 3 Cost Control Techniques