

UNIT-IV

BASIC ACCOUNTING PRINCIPLES

Accounting Principles & Procedures

It's essential for any business to have basic accounting principles in mind to ensure the most accurate financial position. Your clients and stakeholders maintain trust within your company so recording reliable and certified information is key. What are the 5 basic principles of accounting? To better understand the principles, let's take a look at what they are.

1. Revenue Recognition Principle

When you are recording information about your business, you need to consider the revenue recognition principle. This is the period of time where **revenues** are recognized through the **income statement** of your company. In order for your revenues to be recognized in the period that the services were provided if you are on the accrual basis, If you are on the cash basis then, the revenues need to be recognized in the period the cash was received.

2. Cost Principle

Recording your assets when you purchase a product or service helps keep your business's **expenses** orderly. It's important to record the acquisition price of anything you spend money on and properly record depreciation for those assets.

3. Matching Principle

Expenses should be matched to the revenues recognized in the same accounting period and be recorded in the period the expense was incurred. If there is a period of time where revenue was recognized on sold products or services, then the cost of those things should also be recognized..

4. Full Disclosure Principle

The information on **financial statements** should be complete so that nothing is misleading. With this intention, important partners or clients will be aware of relevant information concerning your company.

5. Objectivity Principle

The accounting data should consistently stay accurate and be free of personal opinions. Make sure the data is also supported by evidence that can include vouchers, receipts, and invoices. Having an objective viewpoint, in this case, helps rely on financial results. For example, your viewpoint may not be objective if you once worked for the same company that you are now an auditor for because your relationship with this client might skew your work.

Double Entry: What It Means in Accounting and How It's Used

What Is Double Entry?

Double entry, a fundamental concept underlying present-day bookkeeping and accounting, states that every financial transaction has equal and opposite effects in at least two different accounts. It is used to satisfy the accounting equation:

$$\text{Asset} = \text{Liabilities} + \text{Equity}$$

The Basics of Double Entry

In the double-entry system, transactions are recorded in terms of debits and credits. Since a debit in one account offsets a credit in another, the sum of all debits must equal the sum of all credits. The double-entry system of bookkeeping standardizes the accounting process and improves the accuracy of prepared financial statements, allowing for improved detection of errors.

The Double-Entry Accounting System

Double-entry bookkeeping was developed in the mercantile period of Europe to help rationalize commercial transactions and make trade more efficient. It also helped merchants and bankers understand their costs and profits. Some thinkers have argued that double-entry accounting was a key calculative technology responsible for the birth of capitalism.

The accounting equation forms the foundation of the double-entry accounting and is a concise representation of a concept that expands into the complex, expanded and multi-item display of the balance sheet. The balance sheet is based on the double-entry accounting system where total assets of a company are equal to the total of liabilities and shareholder equity.

Essentially, the representation equates all uses of capital (assets) to all sources of capital (where debt capital leads to liabilities and equity capital leads to shareholders' equity). For a company keeping accurate accounts, every single business transaction will be represented in at least of its two accounts.

For instance, if a business takes a loan from a financial entity like a bank, the borrowed money will raise the company's assets and the loan liability will also rise by an equivalent amount. If a business buys raw material by paying cash, it will lead to an increase in the inventory (asset) while reducing cash capital (another asset). Because there are two or more accounts affected by every transaction carried out by a company, the accounting system is referred to as double-entry accounting.

This practice ensures that the accounting equation always remains balanced – that is, the left side value of the equation will always match with the right side value.

KEY TAKEAWAYS

Double-entry refers to an accounting concept whereby $\text{assets} = \text{liabilities} + \text{owners' equity}$.

In the double-entry system, transactions are recorded in terms of debits and credits.

Double-entry bookkeeping was developed in the mercantile period of Europe to help rationalize commercial transactions and make trade more efficient.

The emergence of double-entry has been linked to the birth of capitalism.

Real World Example of Double Entry

A bakery purchases a fleet of refrigerated delivery trucks on credit; the total credit purchase was \$250,000. The new set of trucks will be used in business operations and will not be sold for at least 10 years—their estimated useful life.

To account for the credit purchase, entries must be made in their respective accounting ledgers. Because the business has accumulated more assets, a debit to the asset account for the

cost of the purchase (\$250,000) will be made. To account for the credit purchase, a credit entry of \$250,000 will be made to notes payable. The debit entry increases the asset balance and the credit entry increases the notes payable liability balance by the same amount.

Double entries can also occur within the same class. If the bakery's purchase was made with cash, a credit would be made to cash and a debit to asset, still resulting in a balance.

Journal

Actually the word **JOURNAL** is derived from the French word **JOUR** which means a **DAY**. Therefore **JOURNAL** means a **DAILY RECORD**. It contains the daily record of business transactions. Journal is a book of primary entry or original entry because all the business transactions are recorded in the journal in the order of their occurrence i.e. chronological order. When you done with Journal you have to post them in Ledger & once ledger gets completed you have to create a Trial Balance & from this trial balance Final Accounts are made.

Journal Entry is primary step to record a business transaction in books of Accounts. When Accountant starts his work he must start with Journal entry.

There are two things :

1. 'Journal' or Day Book is a book where all transactions are recorded in chronological order,
2. 'Entry' means recording a transaction.

The journal entry can consist of several accounts / recordings, usually two - one Debit and another Credit.

Hence journal entry means recording a transaction in Journal or Day Book having two aspects viz., Debit and Credit.

Example ; Event - Received Rs. 1000 in cash from Mr. A.

To make Journal entry of this transaction we have to ascertain the accounts involved in this event.

So following two Accounts are involved, viz., 1.Cash A/C and 2. Mr A's A/C

Journal Entry ;

By Cash Account Debit - Rs. 1000

To Mr. A's Credit - Rs. 1000

A Journal Entry is used to record a business transaction in the accounting books of a business which is usually recorded in General Ledger as well as in Subsidiary Ledger. Journal Vouchers are used to adjust the debit and credit amounts with no involvement of cash or bank accounts. Thus, they are referred to as adjustment entries. Journal Voucher includes entries of discounts, brokerage, general expenses and expenses related to company i.e. Post and Courier Charges, Stationery, Telephone, Traveling Expenses etc.

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Ledger

Most often, if you say the word *ledger* to an accountant, they will immediately think of something called a *General Ledger* (or G/L for short), also called 'the books'.

Ultimately, all of the financial transactions of a company are contained in the general ledger, which serves as the basis for producing their financial statements.

Typically, there are three main financial statements;

- income statement (which measures profitability for a given period of time)
- balance sheet (which is a statement of the company's assets, liabilities and equity)
- statement of cash flows (which shows how cash is flowing in and out of a company during the period being reported)

The general ledger is made up a [chart of accounts](#), which segregates accounts into groups in a logical manner. Typically, there are six groups of accounts as follows:

- assets
- liabilities
- stockholders' equity
- revenue
- cost of sales
- operating expenses

When entries are made into the general ledger, they contain certain basic information such as:

- transaction date
- account name
- account number
- amount
- a designation if the entry is a debit or credit
- a literal description of the transaction

There are certain types of activities that are common to many all types of businesses, some of which are always present in all businesses. Accounts payable, would be one example of the latter. Every company must pay for operating expenses.

These activities are generally accounted for in 'subsidiary ledgers', which are designed to segregate numerous like transactions.

Examples of these subsidiary ledgers include (but are not limited to):

- accounts payable
- accounts receivable
- fixed assets
- cash management
- inventory management
- payroll
- journal entries

Subsidiary ledgers are, in a way, like the general ledger and typically contain massive amounts of detail specific to the type of transaction being processed. For example, an accounts payable subsidiary ledger would represent all of the invoices received and processed.

Details recorded in accounts payable would likely include things like:

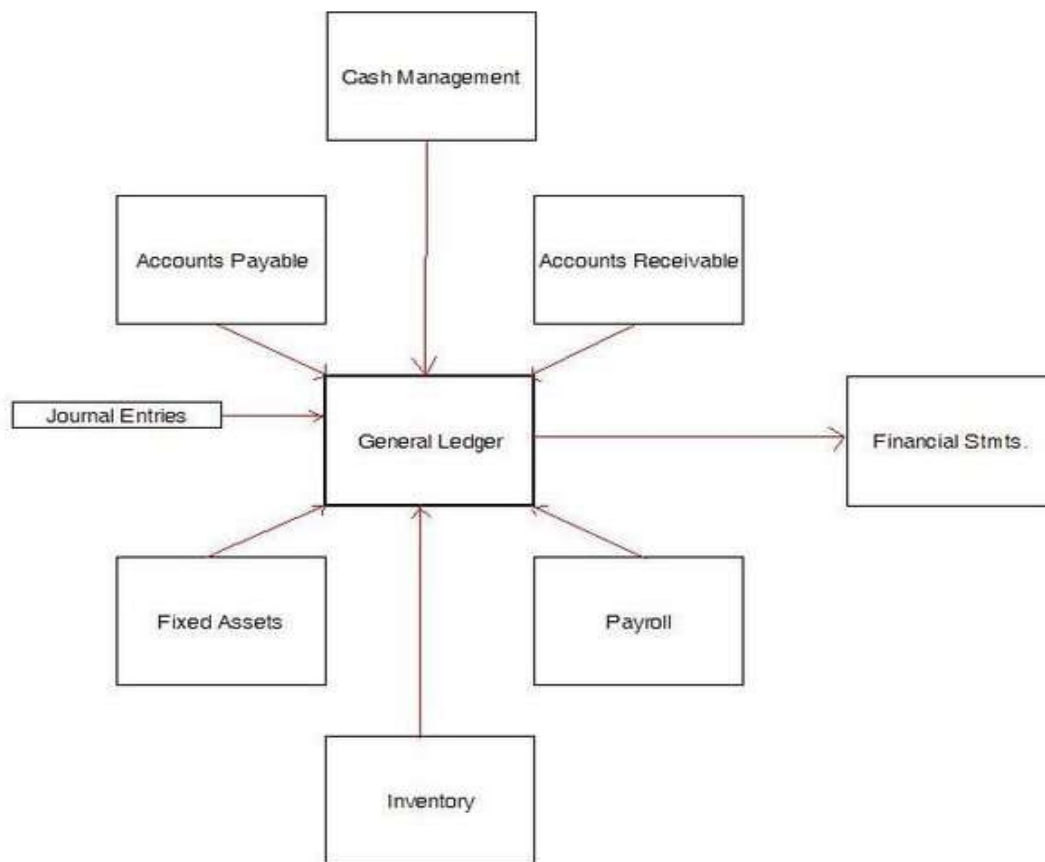
- vendor name
- vendor number
- invoice number
- invoice date
- purchase order number
- invoice amount
- payment terms
- discounts available
- and so forth

The other subsidiary ledgers (e.g. payroll, inventory, etc.) would record similar details appropriate for the type of transaction being processed.

Periodically, the details of the subsidiary ledgers are interfaced or transferred to the general ledger. This could be performed once a month, once a week or once a day. Different software systems do it differently and some higher end software packages will allow the company to choose the frequency of the interface.

Conceptually, the subsidiary ledgers should always be synchronous with the general ledger at each month end. Generally speaking, the interface to the general ledger is a summary entry and contain no details (otherwise the general ledger would be 100 miles thick, if printed out on paper). If details are needed about a particular G/L entry, then the subsidiary ledger records are queried.

Below is crude drawing (sorry, I have no artistic skills) of how information flows, based on what I've described above.



I could probably write several hundred more pages on the subject, but frankly my fingers are getting tired and I don't have the time or inclination. I think the above is a fair overview of what is meant by 'ledger'.

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What is the trial balance? Why is it prepared?

1. Trial Balance is a list of closing balances of ledger accounts on a certain date.
2. It is usually prepared at the end of an accounting period.
3. First step for preparation of financial statements.
4. You take all debit and credit Ledger balances.
5. Asset and expense accounts appear on the debit side
6. Liabilities, capital and income accounts appear on the credit side.
7. All debit balances appearing in the trial balance must equal to the sum of all credit balances, in case any difference you have to investigate why, and resolve before financial statements are prepared.

8. We must conclude that Trial balance assists in the identification and rectification of errors.

A trial balance is a list of all the accounts listing all the debits and credits. Its not released to outsiders. It includes all assets, liabilities, equity accounts, revenues and expenses and any contra account. Basically, all accounts.

Its prepared at the end of the month before adjustments are made in the books. It is a culmination of all the balances from the Posting Journal. It is used to see if all journal entries are posted correctly and uncover any posting errors.

Once the trial balance has been prepared, then you will move into the adjusting and closing process at the end of the month. All income statement accounts will be closed, earnings will be assessed, and the process will restart in the next month.

Cash Book

A Cash Book is a special journal which is used for recording all cash receipts and cash payments. If a cash book is maintained, there is no need for preparing a cash account in the ledger. However, the other aspects of the transactions will be recorded in the ledger. Cash Book serves dual role of journal as well ledger. Cash Book is the book of original entry (Journal) since transactions are recorded for the first time from the source documents. It is a ledger in the sense that it is designed in the form of Cash Account and records cash receipts on the debit side and cash payments on the credit side.

Trading Account

Features of Trading Account

- It is the first stage in the preparation of financial accounting statement of a trading concern.
 - It records only the net sales and direct cost of goods sold.
 - The balance of this account discloses the gross profit and gross loss.
- We transfer the balance of the trading account to the profit and loss account.

Two questions:

1. Where has the money come from?
2. Where did the money go?

Here is what a Balance Sheet looks like, broadly:

Where did the money come from?



Where did the money go?



Sources	₹	Applications	₹
Liabilities	80	Assets	100
Equity	20		
TOTAL	100	TOTAL	100

- The total of "sources" and "applications" is equal. Obviously.
- "Liabilities" is the money that you have borrowed from someone else. If you start a business with the bank's money, then the bank loan would be a liability.
- "Equity" is your own money. If you've invested in the business yourself, then here is your total amount invested.
- "Assets" represents all the places where your money is blocked. It could be an electric fan or a machine or even an advance given to your suppliers.

Liabilities vs. equity

Should you put your own money in the business or should you borrow? The benefit of borrowing is that you can start a business even if you don't have money. The bad thing is that you need to pay it back *even if you are not earning profit*.

Someone else's money →

My money →

Sources	₹
Liabilities	80
Equity	20
TOTAL	100

So which is better?

The ideal ratio depends on the business - in some cases, higher is acceptable while in other cases it is not. Anything too high means higher risk; and anything much low means too much own capital.

Share capital and net worth

We know that "equity" is the amount belonging to the owners. It has two parts:

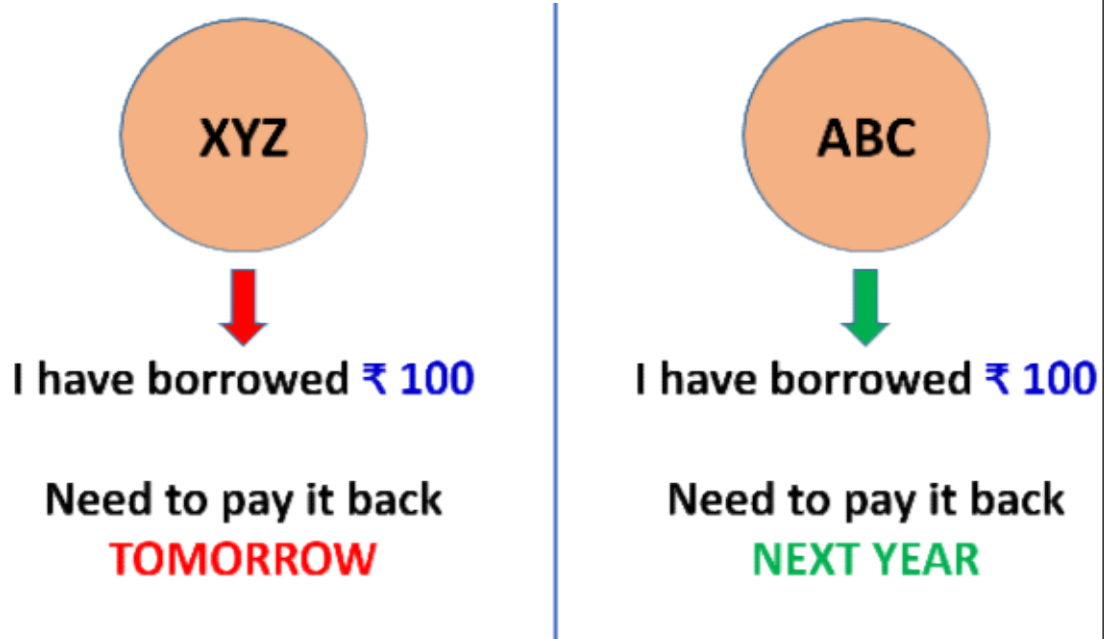
- The amount originally invested by the owners is called "capital"
- "Reserves" is the profit earned after investment, which belongs to the owners.



If a company has huge reserves, it means that it has earned many profits previously and thus can survive losses in the future. See these numbers on the Balance Sheet.

Current and non-current liabilities

We know that liabilities show the amount borrowed from others which needs to be paid back. The Balance Sheet also shows **when** it is to be given back. See these two firms -



One needs to repay the money tomorrow itself (called current liabilities), the other needs to pay it back after one year (called non-current liabilities). Which is better?

If you have many current liabilities, you should ask whether the company has enough cash to repay those liabilities. Where will the cash come from?

Current and non-current assets

We discussed that "assets" are those things where your money is currently blocked. You will get money out of these assets. Just like liabilities, the Balance Sheet also tells you **when** you will get the money out of your assets.

Just like the liabilities:

1. If you purchased a piece of land from the money, then it is **non-current asset** because you will not get the money back immediately.
2. But if your money is pending with the customer, it is a **current asset** because the customer can pay it back very soon.

Simple, right?

Working Capital

Now, just think -

1. Current assets are those which will give you money very soon
2. Current liabilities are those which you have to pay very soon

Therefore, the equation looks something like this -

Current Assets	100	Will be RECEIVED in next year
(-) Current Liabilities	80	Has to be PAID in next year
<hr/>		
Working Capital	20	Net Cash I'll get next year
<hr/>		

Now, should we aim for a higher working capital or lower?

- High working capital means that your cash generation next year will be higher
- But lower working capital might mean that you will generate cash this year itself

Working capital is an important number that is visible from the balance sheet. It helps us to understand how the company will perform over the next one year. If the working capital is negative, it might mean that the company needs to pay more money than it will generate over the next one year.

Since working capital is very important, companies show the current assets and current liabilities as a net number on the balance sheet. This is called "net current assets" - as is visible in any balance sheet.

Cash and Liquidity

Cash is a very important figure in the Balance Sheet. It shows how much money you actually have in your hand, right now. A lot of money is blocked in several places - such as land, machinery, or it is kept with your customers etc. - but cash is the money that you have with you right now.

Sometimes, you may not have cash but some other current assets which is almost like cash - such as liquid funds. This means that you can convert it into cash **whenever you want**. For the purpose of a balance sheet, this is also treated as cash.

Cash should not be very low, because you might need the money any time. But at the same time, it should not be very high also - because higher cash is useless - it is better to invest it into the business so as to make more money.

The trick is to find the right balance.

Analysis of the balance sheet

Now that you know the meaning of most of the terms, you can understand the business of the company using these tools -

- **Current Ratio** - it shows the current assets divided by current liabilities. If the answer is 2, this means that in the next one year, you will receive twice the amount of money that you have to pay
- **Debt to equity ratio** - it shows how much of the total money in your business is funded by your own pocket and how much is borrowed. If the ratio is 2, this means that you have borrowed twice the money that you have invested yourself
- **Debtor's days** - it shows how many days your customers take to pay the money back. This number should be as less as possible. It is calculated by dividing your debtors by total sales
- **Working capital turnover** - you get the money and invest it again - that is how business is done, right? The working capital turnover ratio shows how many times you get the money back in a year. It is calculated by dividing the turnover with working capital. This number is also higher the better.

There are many such analytical tools that can be applied on a Balance Sheet to understand it better. Some of these tools cannot be applied *only* on the Balance Sheet, you also need Profit & Loss account with it. Here

The Profit and Loss Statement

- The profit and loss statement is a financial statement that summarizes the revenues, costs, and expenses incurred during a specified period.
- The P&L statement is one of three financial statements every public company issues quarterly and annually, along with the balance sheet and the cash flow statement.
- When used together, the P&L statement, balance sheet, and cash flow statement provide an in-depth look at a company's financial performance together.
- Statements are prepared using cash or accrual method of accounting.
- It is important to compare P&L statements from different accounting periods, as any changes over time become more meaningful than the numbers themselves.

A profit and loss account is a general ledger account that must be closed every year when finalizing the financial statements.

During the year two types of accounts will be recognized. A **balance** sheet account (assets and liabilities), which will be disclosed in the **statement of financial position** and a **nominal** account (incomes and expenses) which will be disclosed on the **statement of total comprehensive income**.

Now, every debit must have a credit. When a balance sheet item is created, it is typically by debiting an asset account and crediting another asset or liability account. These transactions are capital in nature and will not be involved in profit and loss.

Some transactions with balance sheet accounts, however, will result in the creation of a nominal account. These transactions are incomes and expenses that we use to measure our profit for the year.

However, a nominal account, after it has been created is not allowed to exist in the following year. So at the end of every year it must be closed off to the profit and loss account which when balanced will be equal to your net profit for the year.

Net profit is effectively a summary of all incomes and expenses and is therefore also a nominal account so it must also be closed off. It will be closed to an **equity**, typically **retained earnings**. There are other equity accounts that it could go to such as **non-controlling interest, revaluation reserve, etc** however you need only familiarize yourself with retained earnings for the time being.

Now to address the elephant in the room, unless you are involved in the preparation or assurance of financial statements, you will never see these accounts as they do not exist in the balance sheet as we were required to close them off as described above. What you will see is a summary of these account totals on the statement of total comprehensive income.

Cost Accounting

According to Finance Strategists, cost accounting is concerned with the collection, processing, and evaluation of operating data in order to achieve goals relating to internal planning, control, and external reporting.

In this definition, examples of “operating data” include the cost of products, operations, processes, jobs, quantities of materials consumed, and labor time used.

Cost accounting helps to achieve cost control through the use of various techniques, including budgetary control, standard costing, and inventory control.

Cost accounting keeps track from beginning to end of all the costs of a product. They are tracked for each individual job; labor, materials, transportation or shipping, and overhead. Each cost area will usually have its own account number. This way a business can keep track of whether a product is cost effective or not. It can also show particular areas that are not efficient or too costly and affect profit.

What are the objectives of cost accounting?

According to **Dr. P.C. Tulsian** in his book **Introduction to cost accounting**, main objectives of cost accounting are as under:

1. **To ascertain cost:** The basic objective of cost accounting is to ascertain cost of cost center. Cost ascertainment is the process of determining costs after they have been incurred. Basically there are two methods of cost ascertainment - Job costing and Process costing. Different industries follow different methods of costing because of the difference in the nature of their activity.
2. **To control cost:** Cost accounting aims at controlling costs by using various techniques such as Budgetary control, Standard costing, Inventory control etc.
3. **To provide information for decision making:** Cost accounting aims at providing information for various managerial decisions
 - a. Whether to make or buy component
 - b. Whether to retain or replace an existing machine
 - c. Whether to process further or not
 - d. Whether to shut down or continue operations
4. **To determine selling price:** Cost accounting provides cost information to determine the selling price of products or services. During the period of depression, it guides the management to decide, “ How much reduction in selling price may be made to meet the situation? ”
5. **To ascertain costing profit:** Cost accounting aims at ascertaining the costing profit or loss of any activity on an objective basis by matching cost with the revenue of that activity.

Different type of cost

According to Finance Strategists, in the cost classification by relevance to decision-making and control, costs are classified based on whether they are relevant to managerial decisions. These costs are as follows:

1. Accounting costs

Accounting costs are those for which the entrepreneur pays direct cash for procuring resources for production. These include costs of the price paid for raw materials and machines, wages paid to workers, electricity charges, the cost incurred in hiring or purchasing a building or plot, etc. Accounting costs are treated as expenses. Chartered accountants record them in financial statements.

2. Economic costs

There are certain costs that accounting costs disregard. These include money which the entrepreneur forgoes but would have earned had he invested his time, efforts and investments in other ventures. For example, the entrepreneur would have earned an income had he sold his services to others instead of working on his own business

Similarly, potential returns on the **capital** he employed in his business instead of giving it to others, the output generated by his resources which he could have used for others' benefits, etc. are other examples of **economic** costs.

Economic costs help the **entrepreneur** calculate supernormal **profits**, i.e. profits he would earn above the normal profits by investing in ventures other than his.

Concept of Costs in terms of the Nature of Expenses

1. Outlay costs

The actual expenses incurred by the entrepreneur in employing inputs are called outlay **costs**. These include costs on payment of wages, rent, electricity or fuel charges, raw materials, etc. We have to treat them as general expenses for the business.

2. Opportunity costs

Opportunity costs are incomes from the next best alternative that is foregone when the entrepreneur makes certain choices.

For example, the entrepreneur could have earned a salary had he worked for others instead of spending time on his own business. These costs calculate the missed opportunity and calculate income that we can earn by following some other policy.

Concept of Costs in terms of Traceability

1. Direct costs

Direct costs are related to a specific process or product. They are also called traceable costs as we can directly trace them to a particular activity, product or process.

They can vary with changes in the activity or product. Examples of direct costs include manufacturing costs relating to production, customer acquisition costs pertaining to sales, etc.

2. Indirect costs

Indirect costs, or untraceable costs, are those which do not directly relate to a specific activity or component of the business. For example, an increase in charges of electricity or taxes payable on income. Although we cannot trace indirect costs, they are important because they affect overall profitability.

Concept of Costs in terms of the Purpose

1. Incremental costs

These costs are incurred when the business makes a policy decision. For example, change of product line, acquisition of new customers, upgrade of machinery to increase output are incremental costs.

2. Sunk costs

Sunk costs are costs which the entrepreneur has already incurred and he cannot recover them again now. These include money spent on advertising, conducting research, and acquiring machinery.

Concept of Costs in terms of Payers

1. Private costs

These costs are incurred by the business in furtherance of its own objectives. Entrepreneurs spend them for their own private and business interests. For example, costs of [manufacturing](#), production, sale, advertising, etc.

2. Social costs

As the name suggests, it is the society that bears social costs for private interests and expenses of the business. These include social resources for which the firm does not incur expenses, like atmosphere, water resources and environmental pollution.

Concept of Costs in terms of Variability

1. Fixed costs

Fixed costs are those which do not change with the volume of output. The business incurs them regardless of their level of production. Examples of these include payment of rent, taxes, interest on a loan, etc.

2. Variable costs

These costs will vary depending upon the output that the business generates. Less production will cost fewer expenses, and vice versa, the business will pay more when its production is greater. Expenses on the purchase of raw material and payment of wages are examples of variable costs.

Solved Examples on Concept of Costs

Question: Describe the nature of the following costs and give reasons for your answers.

Answer:

1. The cost incurred in advertising: This expense can be –

- Direct cost (traceable to sales)
- Sunk cost (not recoverable)
- Private cost (spent for business interests)
- Variable cost (will vary depending on the volume of output)

2. Income earned from a job: This expense can be –

- Economic cost (the person could earn more money by working for his business)
- Opportunity cost (same reason as above)

3. Rent paid for factory premises: This expense can be –

- Accounting cost (spent on procuring facilities for production)
- Direct cost (directly affects manufacturing)
- Outlay cost (spent on procuring access to input, i.e. factory)
- Private cost (used for private business interests)
- Fixed cost (does not change with variance in production levels)

Methods and Techniques of Costing

Methods of Costing:

Methods to be used for the ascertainment of cost of production differ from industry to industry. It primarily depends on the manufacturing process and also on the methods of measuring the departmental output and finished products.

Basically, there are two methods of costing (as per CIMA Terminology) viz.:

(i) Specific Order Costing (or Job/Terminal Costing) and

(ii) Operation Costing (or Process or Period Costing.)

Specific Order Costing is the category of basic costing methods applicable where the work consists of separate jobs, batches or contracts each of which is authorised by a specific order or contract. Job costing, batch costing and contract costing are included in this category.

Operation Costing is the category of basic costing methods applicable where standardized goods or services result from a sequence of repetitive and more or less continuous operations or process to which costs are charged before being averaged over units produced during the period.

All these methods are discussed briefly as under:

1. Job Costing:

Under this method, costs are collected and accumulated for each job, work order or project separately. Each job can be separately identified; so it becomes essential to analyse the cost according to each job. A job card is prepared for each job for cost accumulation. This method is applicable to printers, machine tool manufacturers, foundries and general engineering workshops.

2. Contract Costing:

When the job is big and spread over long periods of time, the method of contract costing is used. A separate account is kept for each individual contract. This method is used by builders, civil engineering contractors, constructional and mechanical engineering firms etc.

3. 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 hatch is treated as a unit of cost and separately costed. The cost per unit is determined by dividing the cost of the batch by the number of units produced in a batch. This method is mainly applied in biscuits manufacture, garments manufacture and spare parts and components manufacture.

4. Process Costing:

This is suitable for industries where production is continuous, manufacturing is carried on by distinct and well defined processes, the finished products of one process becomes the raw material of the subsequent process, different products with or without byproducts are produced simultaneously at the same process and products produced during a particular process are exactly identical.

ADVERTISEMENTS:

As finished products are obtained at the end of each process, it will be necessary to ascertain not only the cost of each process but also cost per unit at each process. A separate account is opened for each process to which all expenditure incurred thereon is charged.

The cost per unit is obtained by averaging the expenditure incurred on the process during a certain period. Hence, this is known as average costing. As the products are manufactured in a continuous process, this is also known as continuous costing. Process costing is generally followed in Textile Industries, Chemical Industries, Tanneries, Paper Manufacture etc.

5. One Operation (Unit or Output) Costing:

This is suitable for industries where manufacture is continuous and units are identical. This method is applied in industries like mines, quarries, oil drilling, breweries, cement works, brick works etc. In all these industries there is natural or standard unit of cost. For example, a barrel of beer in breweries, a tonne of coal in collieries, one thousand of bricks in brickworks etc.

The object of this method is to ascertain the cost per unit of output and the cost of each item of such cost. Here cost accounts take the form of cost sheets prepared for a definite period. The cost per unit is determined by dividing the total expenditure incurred during a given period by the number of units produced during that period.

6. Service (or Operating) Costing:

This is suitable for industries which render services as distinct from those which manufacture goods. This is applied in transport undertakings, power supply companies, municipal services, hospitals, hotels etc. This method is used to ascertain the cost of services rendered.

There is usually a compound unit in such undertakings, e.g., tonne kilometre (transport undertaking), kilowatt-hour (power supply) and patient day (hospitals).

7. Farm Costing:

It helps in calculation of total cost and per unit cost of various activities covered under farming. Farming activities cover agriculture, horticulture, animal husbandry (i.e., rearing of live-stocks), poultry farming, pisciculture (i.e., rearing of fish), dairy, sericulture (i.e. silkworm breeding), nurseries for growing and selling of seedlings and plants and rearing of fruits and flowers.

Farm costing helps to improve the farming practices to reduce cost of production, to ascertain the profit on each line of farming activity which ensures better control by management and to obtain loans from banks and other financial institutions as they give loans on the basis of proper cost accounting records.

8. (Multiple) Operation Costing:

Multiple operation method of manufacture consists of a number of distinct operations. It refers to conversion cost i.e., cost of converting the raw materials into finished goods. This method takes into consideration the rejections in each operation for calculating input units and cost. The different operations in machine screw are—stamps, knurl, thread and trim. The cost per unit is determined with reference to final output.

9. Multiple Costing:

It represents the application of more than one method of costing in respect of the same product. This is suitable for industries where a number of component parts are separately produced and subsequently assembled into a final product. In such industries each component differs from the others as to price, material used and process of manufacture undergone. So it will be necessary to ascertain the cost of each component.

For this purpose, process costing may be applied. To ascertain the cost of the final product batch costing may be applied. This method is used in factories manufacturing cycles, automobiles, engines, radios, typewriters, aeroplanes and other complex products. This method has been dropped from the latest CIMA Terminology.

Table Showing Cost Units and Methods of Costing for Different Industries/Enterprises

<i>Industry/Enterprise</i>	<i>Cost Unit</i>	<i>Method of Costing</i>
Steel/Cement	Tonne	Process Costing
Sugar	Tonne, Quintal	Process Costing
Textiles	Metres, Yards	Process Costing
Bicycle Manufacturing	Number	Multiple Costing
Aircraft	Number	Job Costing
Hospital/Nursing Home	Per bed occupied per day/out patient visit	Operating or Service Costing
Timber	Cubic Foot	Process Costing
Transport	Tonne Kilometer, Passenger Kilometer	Operating Costing
Chemical	Tonne, Kilogram	Process Costing
Readymade Garments	Numbers	Batch Costing
Building	House or Area or Square Feet	Job Costing or Contract Costing
Soft Drinks	Cases of 24 bottles each or per bottle of different weights	Process Costing
Confectionery	Per Kg.	Process Costing

Automobile	Number	Process Costing
Brickkiln	Per 1,000 Bricks	Output Costing
Case Making	Per Case	Job Costing
Coal	Per Tonne	Single or One Operation or Output Costing
Interior Decoration	Per Job	Job Costing
Pharmaceutical	Per 1,000 Tablets, Ampules	Batch Costing
Furniture	Per Unit	Multiple Costing
Advertising	Per Job	Job Costing
Oil Refining	Per Tonne/Quintal	Process Costing

Types or Techniques of Costing:

Following are the main types or techniques of costing for ascertaining costs:

1. Uniform Costing:

It is the use of same costing principles and/or practices by several undertakings for common control or comparison of costs.

2. Marginal Costing:

It is the ascertainment of marginal cost by differentiating between fixed and variable cost. It is used to ascertain the effect of changes in volume or type of output on profit.

3. Standard Costing:

ADVERTISEMENTS:

A comparison is made of the actual cost with a pre-arranged standard cost and the cost of any deviation (called variances) is analysed by causes. This permits management to investigate the reasons for these variances and to take suitable corrective action.

4. Historical Costing:

It is ascertainment of costs after they have been incurred. It aims at ascertaining costs actually incurred on work done in the past. It has a limited utility, though comparisons of costs over different periods may yield good results.

5. Direct Costing:

It is the practice of charging all direct costs, variable and some fixed costs relating to operations, processes or products leaving all other costs to be written off against profits in which they arise.

6. Absorption Costing:

It is the practice of charging all costs, both variable and fixed to operations, processes or products. This differs from marginal costing where fixed costs are excluded.

Any of the methods of costing like unit or output costing, service costing, process costing etc. can be used under any techniques of costing.

Format of Cost Sheet

A cost sheet is a statement prepared at periodical intervals of time, which accumulates all the elements of the costs associated with a product or production job. It is used to compile the margin earned on a product or job and forms the basis for the setting of prices on similar products in the future. We shall study the Cost Sheet Format in detail.

What is a Cost Sheet?

A Cost sheet is a memorandum statement that provides the estimated detailed costs in respect of a cost centre or a cost unit in a summarized manner. In a Cost Sheet, the elements of cost are arranged under different heads following a logical order. It depicts the detailed cost of the total output for a certain given period.

The cost sheet does not form part of the double-entry system. In it, additional columns can be added to indicate the cost per unit at different stages of production.

Cost Sheet Format

A Cost Sheet depicts the following facts:

1. Total cost and cost per unit for a product.
2. The various elements of cost such as prime cost, factory cost, production cost, cost of goods sold, total cost, etc.
3. Percentage of every expenditure to the total cost.
4. Compare the cost of any two periods and ascertain the inefficiencies if any.
5. Information to [management](#) for cost [control](#)
6. Calculate and summarize the total cost of the product.

Learn more about the [Meaning of Cost Accounting here](#) in detail.

Importance and Objectives of Cost Sheet

1. For calculating the total cost break-up

A cost sheet shows the break-up of the total cost into different elements, i.e. material, labour, overheads, etc. It also depicts the total cost and cost per unit of the units produced.

2. For determining the selling price

A cost sheet helps in determining the [selling price](#) of a product or of a service. The cost sheet ascertains cost at each stage of the product and also the total cost of the product, where a margin of profit is added and thus the selling price is ascertained.

3. It facilitates comparison

It helps in comparing the costs of the product over a period of time. This helps the organisation to investigate the reasons for increasing costs and also control them on the basis of them.

4. Facilitating managerial decision making

Preparation of cost sheet helps managers at various levels in their decision-making process such as

1. to produce or buy a [component](#),
2. what price of goods to quote in the tender,
3. whether to retain or replace an existing machine,
4. how to reduce [costs](#) and maximize profit.
5. identify and make decisions whether they need to continue with the product or not.

5. Preparation of budgets

Organizations can prepare a budget with the help of a cost sheet. We can prepare the budget by using the current or previous year's data.

Based on our existing cost sheet, we can make estimates of our costs for the next financial year. It helps to prepare and make the necessary arrangement of funds for costs of the next financial year

Elements of Cost

Prime Cost: It comprises direct **material**, direct wages, and direct expenses. Alternatively, the Prime cost is the cost of material consumed, productive wages, and direct expenses.

Factory Cost: Factory cost or works cost or manufacturing cost or production cost includes in addition to the prime cost the cost of indirect material, indirect labour, and indirect expenses. It also includes the amount or units of WIP or incomplete units at the end of the period.

Cost of Production: When Office and administration cost at the end of the period are added to the Factory cost, we arrive at the cost of production or cost of goods sold. Here, we make an adjustment for opening and Closing finished goods.

Total Cost: Total cost or alternatively cost of sales is the cost of production plus selling and distribution overheads.

Items excluded from Costs while preparing Cost Sheet

The following items of expenses, losses or incomes are excluded from the cost sheet:

- Related to capital assets
- appropriation of profits
- amortization of fictitious or intangible assets
- abnormal gains and losses or items of a purely financial nature

Examples of such items can be:

- loss on sale of fixed assets
- interest on capital
- discount on issue or redemption of shares or debentures
- expenses relating to the previous period
- cash discounts
- bad debts
- damages payable
- penalties and fines
- interest or dividend received on investments
- transfer fees received

- profit on the sale of fixed assets
- appropriation of profits such as income tax
- dividend paid
- transfer of profits to reserves or funds
- donations and charities
- excess provision for depreciation on fixed assets
- amortization of fictitious or intangible assets such as goodwill written off
- preliminary expenses written off
- patents, trademarks and copyrights written off
- capital issue expenses
- underwriting commission
- loss on the issue of shares and debentures written off

Proforma of A Cost Sheet

	PARTICULARS	AMOUNT	AMOUNT
			TOTAL
	DIRECT MATERIAL-PURCHASED		
ADD	OP STOCK OF RAW MATERIAL		
LESS	CL STOCK OF RAW MATERIAL		
	MATERIAL CONSUMED		
ADD	DIRECT WAGES		
ADD	DIRECT EXPENSES		
	PRIME COST		

ADD	WORKS OR FACTORY OVERHEADS		
	Factory Overheads		
ADD	OP STOCK OF WIP		
LESS	CL STOCK OF WIP		
	WORK COST		
ADD	ADMINISTRATION OR OFFICE OVERHEADS		
	COST OF PRODUCTION		
ADD	SELLING AND DISTRIBUTION OVERHEADS		
ADD	OP STOCK OF FG		
LESS	CL STOCK OF FG		
	COST OF SALES		
ADD	PROFIT MARGIN		
	SELLING PRICE		

Method of Preparation of Cost Sheet

Step I	<p>Prime Cost = Direct Material Consumed + Direct Labour + Direct Expenses</p> <p>Direct Material= Material Purchased + Opening stock of raw material-</p>
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	Closing stock of raw material.
Step II	Works Cost = Prime Cost + Factory Overheads (Indirect Material + Indirect Labour + Indirect Expenses)+opening Work in progress-Closing Work in progress
Step III	Cost of Production = Works Cost + Office and Administration overheads + Opening finished goods-Closing finished goods
Step IV	Total Cost = Cost of Production + Selling and Distribution Overheads
Profit	Sales – Total Cost

Solved Example for You

From the following information prepare a cost sheet.

Particulars	Amount
Direct material-purchased	80000
Direct material - Opening stock	20000
Direct material - Closing Stock	25000
Productive wages	22,000
Direct Expenses	5,000
Consumable stores	4000
Factory manager salary	15000

Unproductive wages	7000
Factory Overheads	12,000
Work-in-progress:	
Opening stock	13,000
Closing stock	7,000
Office and administration overheads	28,000
Opening stock of finished goods	5000
Closing stock of finished goods	10000
Selling and distribution overheads	33,000

Company desires a margin of 20% profit on the cost of sales

Ans.

COST SHEET FOR THE MONTH OF _____ FOR XYZ.

	PARTICULARS	AMOUNT	AMOUNT
			TOTAL
	DIRECT MATERIAL- PURCHASED	80,000.00	
ADD	OP STOCK OF RAW MATERIAL	20,000.00	
LESS	CL STOCK OF RAW MATERIAL	25,000.00	—
	MATERIAL CONSUMED	75,000.00	75,000.00
ADD	DIRECT WAGES		22,000.00
ADD	DIRECT EXPENSES		5,000.00
	PRIME COST		102,000.00
ADD	WORKS OR FACTORY OVERHEADS		

	Consumable stores	4,000.00	
	Factory manager salary	15,000.00	
	Unproductive wages	7,000.00	
	Factory Overheads	12,000.00	38,000.00
			140,000.00
ADD	OP STOCK OF WIP	13,000.00	
LESS	CL STOCK OF WIP	7,000.00	6,000.00
	WORK COST		146,000.00
ADD	ADMINISTRATION OR OFFICE OVERHEADS		28,000.00
	COST OF PRODUCTION		174,000.00

ADD	SELLING AND DISTRIBUTION OVERHEADS	33,000.00	33,000.00
			207,000.00
ADD	OP STOCK OF FG	5,000.00	
LESS	CL STOCK OF FG	10,000.00	—
	COST OF SALES		202,000.00
ADD	PROFIT MARGIN @ 20% ON COST OF SALES		40,400.00
	SELLING PRICE		242,400.00

Break Even Analysis

It is a financial calculation for determining the number/amount of products or services a company should sell to cover its costs (majorly the fixed costs). Break-even is a situation where you are neither making money nor losing money, but all your costs have been covered. This is the fulcrum point of the loss and profit of the company.

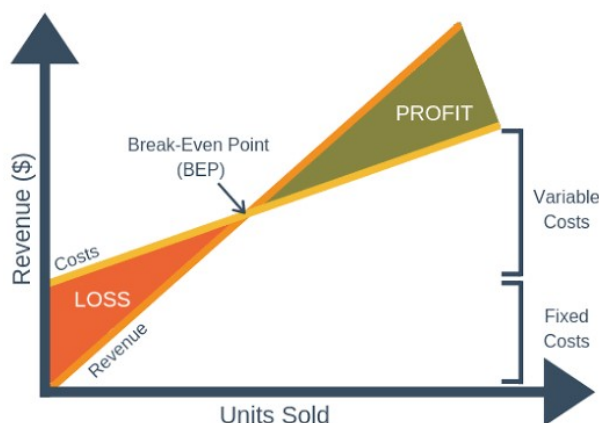
Consider the cashflow of any investment project that involves building some kind of infrastructure for a certain business function to be provided (a factory to produce and sell products, a software solution for a certain business process, a support organization to offer post-sales support).

For a long time at the beginning of the investment, the company has to keep on putting cash with no billing at all, so, the bottomline for this business function is negative. Some time later, the business function starts providing service, and with it, now there is some revenue, but still the inflow of cash to support the operation is larger than the total revenue. At some later point in time, the inflow of cash and the total revenue are equal, that is the break even

point, and typically from that moment on, the total revenue is larger than the inflow of cash, up to a later point in time when the inflow of investment money is no longer needed.

The break even analysis is a model that attempts to forecast how all this process of the inflow and outflow of cash will turn out over time, and since the turning point happens at the moment of break-even, that is why this process has that name.

This model has some caveats to consider, since you have inflows and outflows of cash over time, and you have to take into consideration the impact of time over those flows of cash, so, you have to calculate the Net Present Value (in relation to a certain date that signals the start of the investment project) of each and every flow of cash so that all amounts of money, with its sign (inflow is negative and outflow is positive) are comparable.



We need to know what are the types of costs that are involved in starting the business

- **Fixed cost:** It is also known as an overhead cost. It determines the level of production in terms of quantity. The fixed costs include interests, salaries, rent, depreciation cost, labour etc.
- **Variable cost:** The production costs that keep on fluctuating are known as variable costs. The costs of raw materials, packaging, fuel and miscellaneous can be referred to as variable in break-even analysis.

Break even analysis helps in determining at what point in the sale of products, the fixed cost involved is covered and the company starts registering profits.

Before the break even point is reached **Cost > Revenue**. After it is attained **Revenue > Cost**

Applications of Break Even Analysis

CAPACITY PLANNING

Sometimes management is faced with problem of deciding whether to expand plant capacity to meet increasing demand for the product or to continue with the same. The break even analysis *helps in understanding the impact of increasing in the output* of the firm fixed cost and profits.

CHOICE OF TECHNIQUE

BEA is useful guide in the *selection of most economical production process or equipment*. It gives comparative view of cost of using alternative techniques at different level of output. Generally simple and traditional process / equipment are more economical at low levels of output ,because they require minimum cost for operation. But at very high levels of output, highly sophisticated and expensive process/ equipment might be more profitable.

PRODUCT MIX DECISION

A multi-product firm to decide the relative proportion of different product in the total output. The objective here is to find out the best combination (mix) of the products that can maximise profits. BEA is *helpful in determining the most profitable product-mix*

PLANT SHUTDOWN DECISIONS

During recession and such other periods when demand falls considerably a firm is faced with problem of deciding whether to close down the plant temporarily or to continue production and sales at price that are not cover total cost. BEA *facilitates such a decision by differentiating shrunk cost from out of pocket costs*. Shrunk costs are fixed costs already incurred and which will be there even if the plant is shut down temporarily out of pocket cost are the expenses which need not be incurred if the production is stopped .

DROP OR ADD A PRODUCT

In course of product planning the management has to decide whether to add a product to existing product line . similarly management may feel that existing product has outlived its utility and should be deleted from the product line . BEA is useful in such decisions and *it indicates the impact of such decisions on the cost and revenue of the firm*

MAKE OR BUY DECISIONS

Management of a firm has to often take a decision whether to buy component or to manufacture it. For example an automobile manufacture can make spark plugs or buy them from the market . BEA can *enable the manufacturer to take a decision* of this type.