SUBJECT CODE: BTTM 701-18

SUBJECT TITLE: ACCOUNTING FOR MANAGERS

UNIT-1

Introduction to Accounting: Meaning and Definition, Types and Classification, Principles of accounting, Systems of accounting, Generally Accepted Accounting Principles (GAAP. Recording of transactions: Voucher system; Accounting Process, Journals, Subsidiary Books, Ledger, Cash Book, Bank Reconciliation Statement, Trial Balance. Depreciation: Meaning, need & importance of depreciation, methods of charging depreciation.

UNIT-2

Final Accounts: Meaning, Procedure for preparation of Final Accounts, Difference between Trading Accounts, Profit & Loss Accounts and Balance Sheet, Adjustments (Only four): Closing Stock, Prepaid Income and Expenses, Outstanding Income and Expenses, Depreciation.

UNIT-3

Cost Accounting, Cost Sheet/Tender/Marginal Costing & Break even Analysis, Budgetary Control.

UNIT-4

Financial Management – Meaning, aims, Nature, Scope, Objectives and functions of financial management. Sources of finance. Working Capital Management- Significance Classification, Factors

Introduction to Accounting - Meaning, Objectives

Origin and Growth Of Accounting

Accounting is as old as money itself. However, the act of accounting was not as developed as it is today because in the early stages of civilization, the number of transactions to be recorded were so small that each businessman was able to record and check for himself all his transactions. Accounting was practiced in India twenty three centuries ago as is clear from the book named "Arthashastra" written by Kautilya, King Chandragupta's minister. This book not only relates to politics and economics, but also explains the art of proper keeping of accounts.

However, the modern system of accounting based on the principles of the double entry system owes its origin to Luco Pacioli who first published the principles of the Double Entry System in

1494 at Venice in Italy. Thus, the art of accounting has been practised for centuries but it is only in the late thirties that the study of the subject 'accounting' has been taken up seriously

Definition of Accounting

Accounting can be defined as a process of reporting, recording, interpreting and summarising economic data. The introduction of accounting helps the decision-makers of a company to make effective choices, by providing information on the financial status of the business.

The American Institute of Certified Public Accountants (AICPA) had defined accounting as the "art of recording, classifying, and summarising in a significant manner and in terms of money, transactions and events which are, in part at least, of financial character, and interpreting the results thereof".

Today, accounting is used by everyone and a good understanding of it is beneficial to all. Accountancy acts as a language of finance. To understand accounting efficiently, it is important to understand the aspects of accounting.

- **Economic Events-** It is a consequence of a company has to undergo when the number of monetary transactions is involved. Such as purchasing new machinery, transportation, machine installation on-site, etc.
- **Identification, Measurement, Recording, and Communication-** The accounting system should be outlined in such a way that the right data is identified, measured, recorded and communicated to the right individual and at the right time.
- **Organization-**In refers to the size of activities and level of a business operation.
- **Interested Users of Information-** It is about communicating important financial information to the customers, according to which they will make the correct decision.

Fundamentals of Accounting/ Accounting Equation

- **Assets-** The economic value of an item which is possessed by the enterprise is referred to as Assets. To put it in other words, assets are those items that can be transformed into cash or that generates income for the enterprise shortly. It is useful in paying any expenses of the business entity or debt.
- **Liabilities-** The economic value of an obligation or debt that is payable by the enterprise to other establishment or individual is referred to as liability. To put it in other words, liabilities are the obligations that are rising out of previous transactions, which is payable by the enterprise, through the assets possessed by the enterprise.
- **Owner's Equity-** Owner's equity is one of the 3 vital segments of a sole proprietorship's balance sheet and one of the main aspects of the accounting equation:

  Assets = Liabilities + Owner's Equity.

  It depicts the owner's investment in the trade minus the owner's withdrawal from the trade + the net income since the business concern commenced.

What is the Accounting Equation?

The accounting equation is a basic principle of accounting and a fundamental element of the balance sheet

Balance Sheet -The balance sheet is one of the three fundamental financial statements. The financial statements are key to both financial modeling and accounting.. The equation is as follows:

Assets = Liabilities + Shareholder's Equity

This equation sets the foundation of double-entry accounting and highlights the structure of the balance sheet. Double-entry accounting is a system where every transaction affects both sides of the accounting equation. For every change to an asset account, there must be an equal change to a related liability or shareholder's equity account. It is important to keep the accounting equation in mind when performing journal entries.Journal Entries GuideJournal Entries are the building blocks of accounting, from reporting to auditing journal entries (which consist of Debits and Credits)

The balance sheet is broken down into three major sections and their various underlying items: Assets, Liabilities, and Shareholder's Equity.

Rearranging the Accounting Equation

The accounting equation can also be rearranged into the following form:

Shareholder's Equity = Assets – Liabilities

In this form, it is easier to highlight the relationship between shareholder's equity and debt (liabilities). As you can see, shareholder's equity is the remainder after liabilities have been subtracted from assets. This is because creditors – parties that lend money – have the first claim to a company's assets.

For example, if a company becomes bankrupt .Bankruptcy is the legal status of a human or a non-human entity (a firm or a government agency) that is unable to repay its outstanding debts, its assets are sold and these funds are used to settle debts first. Only after debts are settled are shareholders entitled to any of the company's assets to attempt to recover their investments.

Regardless of how the accounting equation is represented, it is important to remember that the equation must always balance

Objectives of Accounting

The main objectives of accounting are:

To maintain a systematic record of business transactions

- Accounting is used to maintain a systematic record of all the financial transactions in a book of accounts.
- For this, all the transactions are recorded in chronological order in Journal and then posted to principle book i.e. Ledger.

To ascertain profit and loss

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

To determine the financial position

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

To provide information to various users

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

To assist the management

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

Characteristics of Accounting:

The following attributes or characteristics can be drawn from the definition of Accounting:

(1) Identifying financial transactions and events

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

(2) Measuring the transactions

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

(3) Recording of transactions

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

(4) Classifying the transactions

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

(5) Summarising the transactions

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

(6) Analysing and interpreting financial data

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

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

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

What are the Different Branches(types) of Accounting?

The following are the main branches of accounting:

(a) Financial accounting:

Financial Accounting is that branch of accounting which involves identifying, measuring, recording, classifying, summarising the business transactions, i.e. it involves the steps from Identifying, Recording of transactions to Summarisation, and communicating the financial data.

(b) Cost accounting:

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

(c) Management accounting

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

d) Tax Accounting:

The branch of accounting which is used for tax purposes is called Tax accounting. Income tax and sales tax are computed on the basis of this accounting.

e) Social Responsibility Accounting:

The society provides the infrastructure and the facilities without which business cannot operate at all.Hence the business also has a responsibility to the society.

Steps of the Accounting Process:

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

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

(2)Recording: It is concerned with the recording of financial transactions in an orderly manner, soon after their occurrence In the proper books of accounts. For recording, we use 'Journal' or Subsidiary Books.

(3) Classification of transactions: It Is concerned with the systematic analysis of the recorded data so as to accumulate the transactions of similar type at one place. This function is performed by maintaining the ledger in which different accounts are opened to which related transactions are posted. Classification means segregation of transactions on the basis of nature and posting them in a format known as Ledger Account.

(4) Summarisation: It is concerned with the preparation and presentation of the classified data in a manner useful to the users. This function involves the preparation of financial statements such as Income Statement, Balance Sheet, and Statement of Changes in Financial Position, Statement of Cash Flow, and Statement of Value Added.

It includes preparation of Trial Balance and Financial Statements.

(5) Analysis & Interpretation: It includes an assessment of the financial reports and making some meaningful conclusions. Nowadays, the aforesaid three functions are performed by electronic data processing devices and the accountant has to concentrate mainly on the interpretation aspects of accounting. The accountants should interpret the statements in a manner useful to action. The accountant should explain not only what has happened but also (a) why it happened, and (b) what is likely to happen under specified conditions.

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

Define the term Bookkeeping, Accounting and Accountancy.	
Bookkeeping	Book Keeping is a part of Accounting and it is the process of identifying, measuring, recording and classifying the financial transactions.
Accounting	Accounting is a wider concept and actually, it begins where Book Keeping ends. It includes summarizing, interpreting and communicating the financial data to the users of financial statements.

Accountancy	Accountancy refers to systematic knowledge of the principles and the techniques which are applied in Accounting.

What is the Difference Between Bookkeeping and Accounting?

Parameters	Bookkeeping	Accounting
Scope	Bookkeeping involves identifying, measuring, recording & classifying financial transactions in the ledger accounts.	In addition to bookkeeping, Accounting also includes summarizing, interpreting and communicating the financial data to the users of financial statements.
Objective	The main aim is to maintain systematic records of financial transactions.	The main aim is to ascertain the profitability and financial position of the business.
Stage	It is a primary stage of accounting	It is a second stage and begins where book-keeping ends.
Nature of job	This job is routine and repetitive in nature.	This job is analytical in nature.
Level of skills	Bookkeeping does not require special skills. It is performed by Junior Staff.	It requires specialized skill to analyze, so it is performed by senior staff.

What are the Advantages of Accounting?

The following are the main advantages of accounting:

1. Provide information about financial performance

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

2. Provide assistance to management

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

3. Facilitates comparative study

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

4. Helps in settlement of tax liability

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

5. Helpful in raising loan

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

6. Helpful in decision making

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

What Are the Limitations of Accounting?

Following are the limitations of accounting:

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

Explain the Users of Accounting Information:

Users may be categorised into internal users and external users.

(A) Internal Users

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

(B) External Users

- **Banks and financial institutions:** Banks and Financial Institutions provide loans to business. So, they are interested in financial information to ensure the safety and recovery of the loan.
- **Investors:** Investors are interested to know the earning capacity of business and safety of the investment.

- **Creditors:** Creditors provide the goods on credit. So they need accounting information to ascertain the financial soundness of the firm.
- **Government:** The government needs accounting information to assess the tax liability of the business entity.
- **Researchers:** Researchers use accounting information in their research work.
- **Consumers:** They require accounting information for establishing good accounting control, which will reduce the cost of production.

Qualitative Characteristics of Accounting Information

Qualitative characteristics are the attributes of accounting information, which enhance its understandability and usefulness:

- **Reliability:** Reliability implies that the information must be free from material error and personal bias.
- **Relevance:** Accounting information must be relevant to the decision-making requirements of the users.
- **Understandability:** Information should be disclosed in financial statements in such a manner that these are easily understandable.
- **Comparability:** Both intra-firm and inter-firm comparison must be possible over different time periods.

Explain the System of Accounting

System of accounting

- There are following two systems of recording transactions in the books of accounts:
- Double Entry System
- Single Entry System

Double-entry system

- The double entry system is based on the Dual Aspect Principle.
- Every transaction has two aspects, ‘a Debit’ and ‘a credit’ of an equal amount.
- This system of accounting recognises and records both aspects of the transaction.

This is the more traditional and conventional system for recording transactions in financial accounting. This is a scientific method which has some rules and principles which must be followed. The basic essence of the double entry system is that every transaction will affect two accounts. This is known as the debit and credit rule – every credit entry, there must be a corresponding debit entry.

The double entry system is the one widely used and recognized in the accounting world. Some salient features of this system are,

- All three types of accounts are maintained in this system – real, nominal and personal
- The arithmetic accuracy of the financial records are verified by preparing the trial balance
- The system does not have many modifications.
- It allows for the preparation of the balance sheet which will reflect the financial position of the organization
- Easy to detect frauds and errors in this double entry system

Single entry system

- Under this system, both aspects are not recorded for all the transactions.
- Either only one aspect is recorded or both the aspects are not recorded for all the transactions.

This system is also known as a pure entry system. It does not follow the traditional dual recording format. Instead, in a single entry system, only a Cash Book will be maintained. All cash transactions will be recorded in the Cash Book. No other Ledgers find a place in this system. All transactions of personal nature are simply recorded in a rough book.

As you can notice, this method is not very scientific. So it is rarely used in the modern days. We use the single entry system only to prepare final accounts from records that are incomplete for some reason. Some other salient features of the single entry system are,

- Since only one cash book is kept, personal and business transactions will be recorded together
- Real and Nominal accounts will be ignored by this system
- Profit or Loss can be ascertained but we cannot represent the financial position of the organization
- No trial balance is prepared, so arithmetical accuracy of accounts cannot be verified

What Are the Advantages of the Double-entry System of Accounting?

Following are the main advantages of the double-entry system of accounting:

Scientific system

- As compared to the other systems, this system of recording transactions is more scientific and useful to achieve the objective of accounting.

A complete record of the transaction

- Since both the aspects of transactions are considered there is a complete recording of each and every transaction.
- Using these records we are able to compute profit or loss easily.

Checks arithmetical accuracy of accounts

- Under this system, by preparing a Trial Balance we are able to check the arithmetical accuracy of the records.

Determination of profit/loss and depiction of financial position

- Under this system by preparing 'Profit & Loss A/c' we get to know about the profit earned or loss incurred.
- By preparing the 'Balance Sheet' the financial position of the business can be ascertained, i.e. position of assets and liabilities is depicted.

Helpful in decision making

- Administration and management are able to take decisions on the basis of factual information under the double-entry system of accounting.

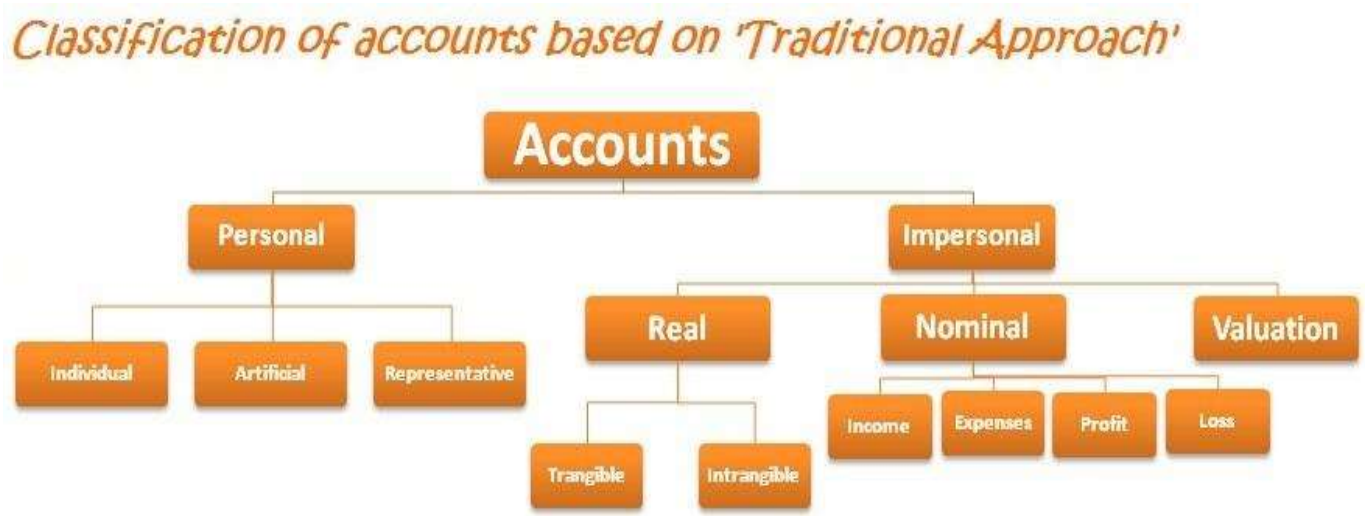
Q: State the differences between single entry and dual entry systems.

Ans:

Single Entry System	Double Entry System
It is fairly simple and uncomplicated in nature.	It is a more scientific and complex approach to accounting.
It is an incomplete recording of transactions	It is a complete record of the transactions
In this system, it is difficult to identify errors and possible frauds	Much easier to spot errors or detect fraud under this system.
Only two types of accounts are kept – personal and cash	All three types of accounts have to be maintained – Personal, Nominal and Real
This system is not suitable for tax purposes	System allows for easy determination of taxes

Does not allow for an ascertainment of the financial position of the organization at the end of the accounting period.	By using this system the financial position of the organization can be determined with accuracy

Classification of Accounting



Personal: In this segment, all persons, who are either give something or takes something, are placed

Individual – Individual personal accounts are for any living person like you & me. (Example: Ratan Tata A/c)

Artificial – Artificial personal accounts referred to any non living, but artificially created entity. (Example: Tata motors Pvt. ltd. A/c)

Representative – When an account indicates another person or group of persons, it is called a Representative personal account. Any prepaid or outstanding expenses accounts fall in this category. (Example: Salary payable A/c , Prepaid office rent A/c)

Impersonal: All other accounts, which are not personal accounts.

Real – Accounts of the asset. Also called 'Permanent account'.

Tangible: A real account with the physical entity is called 'Tangible real account', such as land, furniture, machinery, vehicles. These accounts are depreciated with time lapse, except 'Land'.

Intangible: You can not touch an intangible real account but it still has logical value, which can be measurable by money and it helps to increase the profitability of the business. (Example: Goodwill, patent, copyright, Trademark)

Nominal – Accounts of income, expense, profit and loss. Nominal accounts are the root causes of the financial performance of a business.

Income: Any account, which is a cause of inflow of assets without rising liability is called income. (Example: Sale A/c, Interest received A/c)

Expenses: Any account, which is a cause of outflow of assets without minimizing liability, is called income. (Example: Purchase A/c, Interest paid A/c)

Profit : Profit is the excess part of income over expenses, where incomes are greater than expenses. (Example: Profit on sales on machine a/c, Profit& loss A/c – in case of net profit)

Loss : Loss is the excess part of expenses over incomes, where incomes are less than expenses. (Example: Loss on sales on machine a/c, Profit& loss A/c – in case of net loss)

Valuation -When an account paired with another balance sheet account (Asset or Liability) to recognize the balance to be carried forward, is called ‘Valuation account’. Such accounts are linked with a ‘Provision for doubtful accounts’. (Example: ‘Provision for depreciation on furniture A/c’ which is linked to an asset account, say ‘Furniture A/c’. Another example is ‘Provision for tax A/c’ which is linked with a liability account, say ‘Tax payable A/c’.)

Multiple Choice Questions
Q.1- Which of the following is the first step in accounting?
a. Communicating to the interested parties. b. Analysing c. Measurement of transactions d. Identification & recording of Financial transactions and events
Q.2- Which of the following is not a business transaction?
a. Purchases of goods from Amit of `5,000 b. Paid salaries `250. c. Purchase a Car of `5,25,000 from his personal account. d. Purchase a Laptop of `50,500 for Business.
Answer key

1-d, 2-c

What Are the Generally Accepted Accounting Principles?

The Generally Accepted Accounting Principles (GAAP) are a set of rules, guidelines and principles companies of all sizes and across industries in the U.S. adhere to. In the U.S., it has been established by the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA). Irrespective of the type of company, the GAAP is at the core of all of the company's accounting transactions. It is used by businesses to organize and summarize the financial information into accounting records. What this article covers:

What Is GAAP?

GAAP is a set of rules used for helping publicly-traded companies create their financial statements. These rules form the groundwork on which more comprehensive, complex, and legalistic accounting rules are based. GAAP covers a wide array of topics such as financial statement presentation, liabilities, assets, equities, revenue and expenses, business combinations, foreign currency, derivatives and hedging and non-monetary transactions. Financial accounting information is based on historical data. To facilitate comparisons, the financial information must follow the generally accepted accounting principles. While the overall GAAP is specified by the Financial Accounting Standards Board, the Governmental Accounting Standards Board (GASB) specifies GAAP for state and local government. Compliance with GAAP as well as SEC is required by publicly traded companies.

What Are the Principles of Accounting?

The best way to understand the GAAP requirements is to look at the ten principles of accounting.

1. Economic Entity Principle

The business is considered a separate entity, so the activities of a business must be kept separate from the financial activities of its business owners.

2. Monetary Unit Principle

The monetary unit assumption means that only transactions in U.S. dollar amounts can be included in accounting records. It's important to note that accountants ignore the effects of inflation on the recorded dollar amounts.

3. Time Period Principle

The business activities may be reported in short, distinct time intervals which may be weeks, months, quarters, a calendar year or fiscal year. The time interval has to be identified in the

headings of the financial statements such as the income statement, statement of cash flow and stockholders' equity statement.

4. Cost Principle

The cost principle mentions the historical cost of an item. This refers to cash or cash equivalent that was paid to purchase an item in the past. This asset amount is adjusted for inflation. The historical cost is reported on the financial statements.

5. Full Disclosure Principle

All information that is relative to the business and is important to a lender or investor must be disclosed in the content of the financial statements or in the notes to the statements. This is the reason that numerous footnotes are attached to financial statements

6. Going Concern Principle

This accounting principle refers to the intent of a business to carry on its operations and commitments into the foreseeable future and not to liquidate the business.

7. Matching Principle

The matching principle requires that businesses use the accrual basis of accounting and match business income to business expenses in a given time period. For example, the commissions for sales should be recorded in the same accounting period that sales income was made (and not when they were paid).

8. Revenue Recognition Principle

Under the accrual basis of accounting, the revenues must be reported on the income statement in the period in which it is earned. This means that as soon as a product is sold, or the service has been performed, the revenues are recognized. This is regardless of whether the money is received or not.

9. Materiality Principle

The materiality principle refers to the misstatement in accounting records when the amount is insignificant or immaterial. Because of the materiality principle, financial statements usually show amounts rounded to the nearest dollar.

10. Conservatism Principle

If accountants are unsure about how to report an item, conservatism principle calls for potential expenses and liabilities to be recognized immediately. It directs the accountant to anticipate the losses and choose the alternative that will result in less net income and/or less asset amount. For example, potential lawsuits may be regarded as losses and are reported but potential gains from other sources are not.

What Are the 10 Principles of GAAP?

There are ten principles that can help you understand the mission of the GAAP standards and rules.

1. Principle of Regularity

The principle states that the accountant has complied with the GAAP rules and regulations.

2. Principle of Consistency

The accountants should enter all items in exactly the same way that it has been fixed. By applying similar standards in the reporting process, accountants can avoid errors or discrepancies. If the standards are changed or updated, the accountants are expected to fully disclose and explain the reasons behind the changes.

3. Principle of Sincerity

As per this principle, the accountant should provide the correct depiction of the financial situation of a business.

4. Principle of Permanence of Method

The focus of this principle is that there should be a consistency in the procedures used in financial reporting.

5. Principle of Non-Compensation

The full details of the financial information should be disclosed including negatives and positives. This should be done without the expectation of debt compensation by an asset or revenue by an expense.

6. Principle of Prudence

The financial data representation should be done “as it is” and not based on any speculation.

7. Principle of Continuity

The principle assumes that the business will continue its operations in the future.

8. Principle of Periodicity

The accounting entries are distributed across the suitable time periods.

9. Principle of Full Disclosure

While creating the financial reports, the accountants must strive for full disclosure.

10. Principle of Utmost Good Faith

This principle presupposes that the parties remain honest in transactions. While the GAAP principles are used by large companies while reporting their financial information, if you believe your small business may eventually be subject to GAAP, you may want to adopt the standard early on.

International Financial Reporting Standards (IFRS)

International Financial Reporting Standards (IFRS) are common rules that have been set, in order to ensure consistency, transparency, and comparability in financial statements across the globe. The primary role of IFRS is to specify how companies must maintain and report their accounts, defining types of transactions, and other events with financial impact.

How does IFRS differ from GAAP?

Here are the major differences between IFRS and GAAP:

IFRS	**GAAP**
IFRS is used in more than 110 countries around the world, including the EU and many Asian and South American countries.	GAAP, on the other hand, is only used in the United States
Principle-based	Rules-based
Allows revaluation of the following assets to fair value if fair value can be measured reliably: inventories, property, plant & equipment, intangible assets, and investments in marketable securities	Revaluation is prohibited except for marketable securities
Allows impairment losses to be reversed for all types of assets except goodwill	Prohibits reversals of impairment losses for all types of assets
Long-lived assets are initially valued at cost, but can later be revalued up or down to market value	Long-lived assets, such as buildings, furniture and equipment, are valued at historical cost and depreciated appropriately

When accounting principles were first set forth?

Accounting principles concepts were introduced when double-entry bookkeeping established a T-ledger with matched entries for assets and liabilities, way back in the 15-16th century. Experts and studies have also shown that the introduction of double-entry accounting techniques at the period acted as a catalyst for the growth of commerce and capitalism

ACCOUNTING EQUATION

An Accounting equation is based on the dual concept of accounting, according to which, every transaction has two aspects namely Debit and Credit. It means that every transaction in accounting affects both Debit (DR.) and Credit (Cr.) side equally.

Total assets of the business firm are financed through the funds raised from either the outsiders (which consists generally Creditors and lenders) or the Owners (which is called Capital).According to Business entity concept, Business is separate legal entity from its owner thus the amount invested by the owner in the business is liability of the business is called Capital. Accounting equation thus referred to a equation in which total assets is always equal to total Liabilities (i.e. Capital + Liabilities)

Assets = Capital + Liabilities

ANALYSIS OF BUSINESS TRANSACTIONS
Business transactions may affect either both sides of the equation or one side of the equation but the ultimate effect must be equal on both sides. All the effects are as follows:-

1. Transaction affecting both sides of the equation: A. Commenced business with Cash Rs. 3,00,000.

Assets			=	Capital + Liabilities
	Cash			Capital
Transactions	3,00,000		=	3,00,000

Explanation:- As Cash is invested by the owner, it should be shown in Capital (anything which is bring in by the owner is termed as Capital) & Business is receiving asset in the form of cash, it is to be shown in the Assets side as Cash.
B. Bought goods from Ram Rs. 30,000
Effect

Assets			=	Capital + Liabilities
	Cash Goods			Capital Creditors
Old Equation	3,00,000 + –		=	3,00,000 + –
Transactions	0 + 30,000		=	0 + 30,000
N.E.	3,00,000 + 30,000		=	3,00,000 + 30,000

Explanation:- As goods is purchased on credit, one effect is that it should be shown in the assets side as Goods & other effect is that goods are purchased on credit so it is to be shown in Liabilities as Creditors..
C. Sold goods (costing Rs. 10000) for cash at Rs. 13000 Effect

Assets			=	Capital + Liabilities
	Cash Goods			Capital Creditors

Old Equation	3,00,000 + 30,000		=	3,00,000 + 30,000
Transactions	+13000 + 10,000		=	+ 3000 + 30,000
N.E.	3,13,000 + 20,000		=	3,03,000 + 30,000

Explanation:- The transaction will affect both sides as cash has been received so it is to be added back in cash (Rs 13,000) & Goods are to be reduced by 10,000 as goods has been sold also profit of Rs. 3,000 Is to be added back in the Capital. Net effect will remain same for both sides

D. Paid to creditors Rs. 20,000

Assets			=	Capital + Liabilities
	Cash Goods			Capital Creditors
Old Equation	3,13,000 + 20,000		=	3,03,000 + 30,000
Transactions	– 20000 + 0		=	+ 3000 + 20,000
N.E.	2,93,000 + 20,000		=	3,03,000 + 10,000

Explanation:- The transaction will affect both sides as cash has been paid so it is to be deducted from cash as well from creditors as payment made to them.

· Transaction related to Expenses

All the expense or Losses is to be borne by the owner although business has a separate legal entity from its owner as He/She is the person who has taken risk to do business.

E. Rent paid Rs. 5,000.

Effect

Assets			=	Capital + Liabilities
	Cash Goods			Capital Creditors
Old Equation	3,13,000 + 20,000		=	3,03,000 + 10,000
Transactions	– 5,000 + 0		=	– 5000 + 0
N.E.	2,88,000 + 20,000		=	2,98,000 + 10,000

Explanation:- The transaction will affect both sides as cash has been paid so it is to be reduced as well as Capital is to be reduced because expense is to be born by the owner

· Transaction related to Income

Income or Profit is the reward for taking risk, as risk is taken by the owner so it is to be added in Capital.

F. Commission received Rs. 8,000.
Effect

Assets			=	Capital + Liabilities
	Cash Goods			Capital Creditors
Old Equation	2,88,000 + 20,000		=	2,98,000 + 10,000
Transactions	+ 8,000 + 0		=	+8000 + 0
N.E.	2,96,000 + 20,000		=	3,06,000 + 10,000

Explanation:- The transaction will affect both sides as cash has been received so it is to be added back in cash as well as in Capital.
· Transaction related to Accrued/outstanding Income

Income is to be added back into the capital but as it is not received should be shown in the Assets Side as accrued Income because it meant to be received in this financial year.

A. Accrued Interest Rs. 10,000
Effect

Assets		=	Capital + Liabilities
	Cash Goods Occurred		Capital Creditors
	Income		
Old Equation	2,88,000 + 20,000 + –	=	3,06,000 + 10,000
Transactions	+ 8,000 + 0 + 10,000	=	+10,000 + 0
N.E.	2,96,000 + 20,000 + 10,000	=	3,06,000 + 10,000

Explanation:- The transaction will affect both sides as Accrued Income has been added back to the capital & as it is not received so it is to be shown in the assets side as an asset.
· Transaction related to Prepaid or Advance Income

As Income received in advance so it does not belong to the current financial year, so it cannot be added back to the Capital. It is an amount which is received by the business firm for the future course of activity till the activity does not happen. It is the Liability of the business.

Assets		=	Capital + Liabilities
	Cash Goods Occurred		Capital Creditors Prepaid
	Income		Rent
Old Equation	2,96,000 + 20,000 + 10,000	=	3,06,000 + 10,000 +
Transactions	+ 5,000 + 0 + 0	=	+10,000 + 0 + 5,000
N.E.	3,01,000 + 20,000 + 10,000	=	3,06,000 + 10,000 + 5,000

Explanation:-The transaction will affect both sides as Prepaid Income is a Liability should be shown in the Liability side & Cash received by the business should be added back to the Cash column of assets side.

2. Transaction affecting one side of the equation:
(I) Transaction affecting Assets side of the equation:
· Transaction related to Prepaid or Advance Expense

As Expense paid in advance it does not belong to the current financial year, so it can not be deducted from Capital. It is an amount which is paid by the business firm for the future course of activity till the activity does not happen. It is the Assets of the business.

A. Prepaid insurance paid Rs. 4,000
Effect

Assets		=	Capital + Liabilities
	Cash Goods Accrued Prepaid		Capital Creditors Prepaid
	Income Expense		Rent
Old Equation	3,01,000 + 20,000 + 10,000 –	=	3,06,000 + 10,000 + 5,000
Transactions	– 4,000 + 0 + 0 + 4,000	=	+ 0 + 0 + 0

N.E.	2,97,000 + 20,000 + 10,000 + 4,000	=	3,06,000 + 10,000 + 5,000

Explanation:- The transaction will affect both sides as Prepaid expense is a Asset should be shown in the Assets side & Cash paid by the business should be deducted from Cash column of assets side.

B. Purchased Machinery for Cash Rs. 80,000

Effect

Assets		=	Capital + Liabilities
	Cash Goods Accrued Prepaid Machinery		Capital Creditors Prepaid
	Income Expense		Rent
Old Equation	2,97,000 + 20,000 + 10,000 + 4,000 –	=	3,06,000 + 10,000 + 5,000
Transactions	– 80,000 + 0 + 0 + 0 80,000	=	+ 0 + 0 + 0
N.E.	2,17,000 + 20,000 + 10,000 + 4,000 80,000	=	3,06,000 + 10,000 + 5,000

Explanation:- The transaction will affect one side as cash has been paid for purchase of machinery & Machine is a fixed asset so it is separately shown in the asset side as well as cash is to be reduced.

(II) Transaction affecting Liability side of the equation:

· Transaction related to outstanding Expense

As Expense not paid yet or Outstanding but belongs to current financial year so it is deducted from Capital & business has to pay it in near future so it is the liability of the firm.

A. Salary outstanding Rs. 8,000

Effect

Assets		=	Capital + Liabilities
	Cash Goods Accrued Prepaid Machinery		Capital Creditors Prepaid Outstanding
	Income Expense		Rent Exp
Old Equation	2,17,000 + 20,000 + 10,000 + 4,000 + 80,000	=	3,06,000 + 10,000 + 5,000
Transactions	– 0 + 0 + 0 + 0 + 80,000	=	– 8,000 + 0 + 0 + 8,000

N.E.	2,17,000 + 20,000 + 10,000 + 4,000 + 80,000	=	3,06,000 + 10,000 + 5,000 + 8,000

Explanation:- The transaction will affect Liability side as outstanding expense is a Liability should be shown in the Liability side & Expense should be deducted from Capital

· Transaction related to Interest on Capital

As interest on capital is the Expense of business it should be shown or deducted in the capital as well as interest of capital is the amount which is to be given to the owner as capital is the amount which is invested by the owner, therefore it is to be added back to Capital.

A. Interest on Capital Rs. 10,000

Assets		=	Capital + Liabilities
	Cash Goods Accrued Prepaid Machinery		Capital Creditors Prepaid Outstanding
	Income Expense		Rent Exp
Old Equation	2,17,000 + 20,000 + 10,000 + 4,000 + 80,000	=	3,06,000 + 10,000 + 5,000 + 8,000
Transactions	– 0 + 0 + 0 + 0 + 0	=	– 10,000
			+ 10,000 + 0 + 0 + 0
N.E.	2,17,000 + 20,000 + 10,000 + 4,000 + 80,000	=	3,06,000 + 10,000 + 5,000 + 8,000

Explanation:-The transaction will affect Liability side as Interest of Capital should be added back & deducted from Capital as both of them belong to the owner.

· Transaction related to interest on Drawing

As interest on Drawing is the Income of business it should be shown or added back in the capital as well as interest of Drawing is the amount which is to be given by the owner to the business so it is treated as drawing and deducted from the Capital.

A. Interest on Drawing Rs. 1,000
Effect

Assets		=	Capital + Liabilities
	Cash Goods Accrued Prepaid Machinery		Capital Creditors Prepaid Outstanding
	Income Expense		Rent Exp

Old Equation	2,17,000 + 20,000 + 10,000 + 4,000 + 80,000	=	3,06,000 + 10,000 + 5,000 + 8,000
Transactions	– 0 + 0 + 0 + 0 + 0	=	– 1,000
			+ 1,000 + 0 + 0 + 0
N.E.	2,17,000 + 20,000 + 10,000 + 4,000 + 80,000	=	3,06,000 + 10,000 + 5,000 + 8,000

Explanation:- The transaction will affect Liability side as Interest of Drawing should be added back & deducted from Capital as both of them belong to the owner.
· Transaction related to Drawing

As Drawing is the amount withdrawn by the owner from business so it is to be deducted from Capital & also from the Cash.

A. Owner withdrew cash of Rs. 10,000

Assets		=	Capital + Liabilities
	Cash Goods Accrued Prepaid Machinery		Capital Creditors Prepaid Outstanding
	Income Expense		Rent Exp
Old Equation	2,17,000 + 20,000 + 10,000 + 4,000 + 80,000	=	3,06,000 + 10,000 + 5,000 + 8,000
Transactions	– 10,000 + 0 + 0 + 0 + 0	=	– 1,000 + 0 + 0 + 0
N.E.	2,17,000 + 20,000 + 10,000 + 4,000 + 80,000	=	3,06,000 + 10,000 + 5,000 + 8,000

Explanation:- The transaction will affect both sides as Drawing should be deducted from Capital & also deducted from Cash as withdraw by owner.

RULES OF DEBIT & CREDIT

Every business transaction affects two or more accounts. An account is a summarised record of a transaction at one place relating to a particular head. An account is divided into two parts i.e. debit Credit. Debit refer to the left side of an account and Credit refers to the right side of an account

Approaches for the rules of Debit & Credit

1. Traditional Approach

Under this approach, all ledger accounts are mainly classified into two categories:-

(I) Personal Accounts: It includes all those accounts which are related to any person i.e. Individuals, firms, companies, Banks etc. This can further classified into three categories:-

1. Natural Persons: All the accounts of human beings / Persons are included such Ram A/C, Shyam A/C etc.
2. Artificial Persons: This includes all such accounts which are treated as persons in the eyes of law & have separate legal entity such as Reliance Ltd., XYZ Ltd.
3. Representative Persons: This includes all such accounts which represents some persons such as Capital (Represent Owner) Outstanding Salary (Represent Employee)
(II) Impersonal Accounts: It includes all those accounts which are not related to any person this can be classified as :-
1. Real Accounts: Under this all accounts related to assets are included (except Debtors). These can be Tangible i.e. Machinery, Furniture , Building, Cash etc. and Intangible I.e. Goodwill, Trade Mark, Patents Rights etc.
2. Nominal Accounts : this includes all the accounts related to Expenses/Losses & Incomes / Gains e.g. Salary, Rent, Commission received etc. they are used to record the transaction in the books of accounts.
Rules of Debit/Credit under Traditional Approach

Classification of Accounts	Rules of Dr./ Cr.
Personal Accounts (All Personal Accounts)	Debit the receiver, Credit the Giver
Real Account	Debit what Comes In, Credit whats Goes Out
Nominal Account	Debit all Losses/Expenses, Credit all Income / Gains.

SOURCE DOCUMENTS
A written document which provides evidence of the transactions is called the Source Documents. Source document is the first evidence of a transaction which takes place such as Cash Memo, Bill or Invoice, Receipt, Pay-in-slip, cheques, Debit-Note & Credit -Note.

(a) Invoice (Bill): An invoice is prepared by Seller at the time of sale of goods on credit. It contains details such as the goods sold, the party to whom goods are sold, sales amount, date etc.
(b) Cash Memo : It is prepared by the Seller at the time of Sale of goods on Cash. It contains details such as goods sold, quantity, amount received, date etc.
(c) Pay-in-Slip : It is used to deposit cash or cheque into bank. It has a counterfoil which is returned to the depositor with the Signature of the authorized person.
(d) Receipt: it is used when a customer give cash to the Business firm. It is an acknowledgement of payment or cash received by a firm.
(e) Cheque : A cheque is a order in writing, drawn upon a specified banker and payable on demand.
(f) Debit Note : it is prepared when a buyer returned goods to seller or when purchased return transaction is entered in the books of accounts. It is prepared by the buyer of the goods.
(g) Credit Note : it is prepared when a seller received goods from buyer or when Sales return transaction is entered in the books of accounts. It is prepared by the Seller of the goods.

VOUCHER

A voucher is a document evidencing a business transaction. Recording in books of accounts is done on the basis of vouchers. It is an accounting evidence of a business transaction.

Classification of Accounting Vouchers

Vouchers	Further classification	Purpose
Cash Vouchers	Debit Vouchers Credit Vouchers	To show Cash Payment To show Cash Receipt
Non Cash Voucher	Transfer Voucher	To show Transactions not involving cash

CASH VOUCHERS

Cash voucher is prepared to record all the transactions which involve cash either in the form of receipt or payment. Thus cash vouchers are further classified into Debit Voucher & Credit Voucher.

Format of Credit Voucher

M/s Pratibha Furnitures **180, Nai Sarak, Delhi**	
Voucher No . ……. Date…….	
DEBIT ……. ……. ……. Total	Amount (In Rs.)
Signature Manager Signature Accountant	

Transfer Voucher/Non-Cash Voucher

This type of vouchers are prepared in those transactions which do not involve Cash. Such as Credit Sales, Credit Purchases, Bad Debts, Depreciation charged etc.

Transfer Voucher

M/s Shyam Traders **156, Subhash Nagar, New Delhi**	
Voucher No . ……. Date…….	
DEBIT : -……. ……. ……. Total	Amount (In Rs.)
CREDIT : – ……. ……. ……. Total	Amount (In Rs.)
Signature Manager Signature Accountant	

JOURNAL

The first book in which the transactions of a business unit are recorded is called Journal. Here, business transactions are recorded in chronological order i.e. in the order in which they occur. Each record in a journal is called an entry. As a journal is the first book in which entries are recorded, it is also known as a book of original entry.

FORMAT OF JOURNAL

Date	Particulars	L.F.	Amount (Rs.) Dr.	Amount (Rs.) Cr.

Ledger Folio (L.F.): Ledger Folio is the page No. of Ledger on which the Debit A/C & Credit A/C are to be posted.

TYPES OF ENTRIES

1. Simple Entry: It is that entry in which only two accounts are affected i.e. one account is debited and another account is credited with an equal amount.

2. Compound Entry : It is that entry in which more than two accounts are involved. Compound Entries can further be classified into single compound entry and double compound entry.

In **Single Compound Entry** several accounts are to be debited and only one account is to be credited or only one account is to be debited and several accounts are to be credited.

3. Opening Entry: The entry passed to record the closing balances of the previous year is called opening entry. While passing an opening entry, all assets accounts are debited and all liabilities accounts are credited.

Transaction related to Goods

1	Goods purchased for cash Purchase A/c Dr. To Cash A/c (Being goods purchased for cash)	2	Goods purchased from ram on Credit Purchase A/c Dr. To Ram (Being goods purchased from Ram on credit)
3	Goods sold for cash Cash A/C Dr. To Sales A/c (Being goods sold for cash)	4	Goods sold on credit to Mohan Mohan Dr. To Sales A/c (Being goods sold to Mohan on credit)
5	Withdrawal of goods by owner for personal use Drawings A/c Dr. To Purchase A/c (Being goods withdrawn by owner for personal use)	6	Goods distributed as free samples Advertisement A/c Dr. To Purchase A/c (Being goods distributed as free samples)

7	Goods given as charity Charity A/c Dr. To Purchases A/c (Being goods given as charity)	8	Goods lost by fire/flood/theft etc. Loss by fire/theft A/c Dr. To Purchase A/c (Being goods lost by fire/flood/theft)

Note : Purchases A/c is credited in the above mentioned entries at S. No. 5 to 8 because the goods are going out of our business on cost and it is not a sale hence, deducted from the purchases A/c.

Transaction related to Bank

1	Cash deposited into the bank Bank A/c Dr. To Cash A/c (Being cash deposited to Bank)	2	Cash withdrawn for office use Cash A/c Dr. To Bank A/c (Being cash withdrew from bank for office use)
3	When cheque is received from the customer and deposited into the bank the same day. Bank A/c Dr. To Customer's personal A/c (Being cheques deposited into bank)	4	Cash withdrawn for personal use by the owner. Cash A/c Dr. To Bank A/c (Being cash withdrew for personal use)
5	When cheque is received from the customer and not deposited into the bank the same day. No Entry	6	When above cheque (Point 4) is deposited later into bank Bank A/c Dr. To Customer's personal A/c (Being cheques deposited into a bank received from ……. On ……)

7	When payment is made through cheque Personal A/c Dr. To Bank A/c (being payment made to ..... by cheque)	8	When expense is paid through cheque. Expense A/c Dr. To Bank A/c (Being expense paid by cheque)
9	When interest is allowed by the bank. Bank A/c Dr. To Interest A/c (Being interest allowed by bank)	10	When the Bank charges for the services provided. Bank Charges A/c Dr. To Bank A/c (Being Bank charges deducted)

Note:- Bank A/C will be debited if the amount is deposited/credited by bank & Bank A/C will be credited if the amount is withdrawn/debited by bank.
Note:- Cash also will be debited if business receives it & Credited if Business paid it.
Transaction related to Expense or Income

1	Expense paid by bank / Cash by the Business Expense A/c Dr. To Cash / Bank A/c (Being expense paid by cash/Bank)	2	Expense is outstanding during a Current F.Y. Expense A/c Dr. To Outstanding Exp. A/c (Being expense is due but not paid)
3	Expense paid in advance Prepaid Expense A/c Dr. To Cash/Bank A/c (Being expense paid in advance by cash/ Bank)	**4**	Income received in Cash/Bank Cash/Bank A/c Dr. To Income A/c (Being Income received in cash / bank)
5	Income due but not received Outstanding Income A/c Dr. To Income A/c (Being Income due but not received)	**6**	Income received in cash/Bank in advance. Cash/Bank A/c Dr. To Prepaid Income A/c (Being income received in advance)

Transaction related to Expense or Income

1	When Assets is purchased in Cash/Bank Assets A/c Dr. To Cash / Bank A/c (Being Assets purchased in cash/Bank)	2	Depreciation charged on assets Depreciation A/c Dr. To Assets A/c (Being Depreciation charged on assets @ .... %)
3	Assets Sold by the business Cash/Bank A/C Dr. To Assets A/c (Being Assets sold in cash/Bank)	**4**	Liability arises when businesses raise funds. Cash/Bank A/c Dr. To Liability A/c (Being fund raised)
5	Payment of Liability Liability A/c Dr. To Cash/Bank A/c (Being Liability paid in Cash/Bank)		

Some other Journal Entries

1	Bad Debts (when Debtors fail to pay due) Bad Debts Dr. To Debtors A/c (Being amount Bad Debts)	2	Bad Debts Recovered Cash / Bank A/c Dr. To Bad Debts Recovered A/c (Being bad debts recovered)

3	Debtors Become insolvent Cash/Bank A/c Dr. (Amt. Received) Bad Debts Dr. (Amt. not rec.) To Debtors A/C (the due amt) (Being Debtors become insolvent could pay only ..... paise in a Rupees)	**4**	Interest on Capital Interest on Capital A/c Dr. To Capital A/c (Being Interest on capital credited by business in capital A/c)
5	Interest on drawing Capital A/C Dr. To Interest on Drawing A/c (Being interest on Drawing charged by business from capital A/c)		

Entries related to central sales Tax (CST)

a	Central sales Tax (CST) collected on sales Cash A/c Dr. To Sales A/c To Central sales tax A/c (Being Sales Tax deposited into Govt. A/c)	b	When Central sales tax is deposited in Govt. A/c Central sales tax A/c Dr. To Cash A/c (Being Sold goods & Sales Tax Collected)

Journal Entries related to VAT (value added Tax),

a	When VAT is paid on purchases sales Purchases A/c Dr. VAT (Paid) A/c Dr. To Cash A/c Being goods purchase & VAT paid on purchase)	b	When VAT is collected at the time of sales. Cash A/c Dr. To Sales A/c To VAT (collected) A/c (Being Sold goods & VAT collected on sales)
c	When VAT is paid to the Government. VAT (collected) A/c Dr. To VAT (Paid) A/c To Cash A/c (Being VAT paid to Govt.)		

Note:- In the last entry insurance paid for the whole year that why insurance for 11 month is treated as prepaid & insurance for the month of January is treated as expense.

BOOKS OF ORIGINAL ENTRY/SPECIAL PURPOSE BOOKS

As the business grows and the number of transactions increases, it becomes necessary for the business to divide the recording work. The books maintained are illustrated below:

Transactions	Further classification	Subsidiary Books Maintained
Cash & Bank Related Transactions	Only Cash Cash & Bank Transactions Cash payment of small amount	Simple Cash Book Double Column Cash book Petty Cash Book
Transaction Other than Cash & Bank	Credit Sale Credit Purchases Sales Returns/ Returns Inward Purchases Returns /Returns outward	Sales Book Purchases Book Sales returns Book

	Any other transaction	Purchases Returns Book Journal Proper

Advantages of Maintaining Subsidiary Books

· Division of work

· Leads to Specialization

· Easy to maintain Ledger

· Check on frauds

· Easy to fix responsibility

· Quick availability of required information.

Cash Book

Cash book shows all the transactions related to cash receipt and payments. Cash books serve two purposes. First, all the cash transactions are recorded for the first time in a cash register. It became a Book of original entries. Second, there is no need to prepare Cash a/c in a ledger ; it also plays the role of Principal Book.

All business dealings ultimately resolve themselves into cash transactions, therefore, recording of cash transactions in a separate book becomes necessary. To keep record of all receipts and payments of money in business, a cash book is maintained.

Cash book with regard to the nature of business and the manner in which the cash is dealt with. Money receipts are entered on the debit side and payments are shown on the credit side.

There are three distinct types of Cash Book, and each business could get its cash book ruled in a manner as would suit its own requirements. Thus the Cash Book may be ruled so as to possess.

– Cash and Discount columns only on both sides or

– Cash, Bank and Discount columns on both sides or

– Bank and Discount columns only on both sides.

Simple Cash Book

All the cash receipts are shown in left hand side i.e. Debit side and all the cash payments are shown in right hand side i.e. Credit Side.

Points to Remember

· Cash in hand/opening balanced of cash is shown in Dr. side of the Cash book as "To Balance b/d"

· Only transactions of cash receipts and payments are recorded in this book.

· This book never shows a credit balance because one can't pay more than the cash one has.

Notes: One can draw the following conclusions:
1. In a Simple Cash Book only cash receipts and cash payments are recorded. Credit transactions are not recorded. Purchases from Mohan of Rs. 5,000 on 15th Jan is a credit purchase hence, is not recorded in the Cash Book.
2. The debit side is always bigger than the credit side since the payments can never exceed the available cash. This is true even for daily balances.
3. It is like an ordinary account.

CASH BOOK WITH DISCOUNT COLUMN

Where cash discounts are allowed and received respectively, additional columns are provided on the debit side for discount allowed and on the credit side for discount received. The discount columns in the cash book are not parts of the cash book but are memoranda (provisional) columns because the discount account is a nominal account while the cash account is a real account. On balancing the cash book, the discount columns are singly totaled but not balanced.

CASH BOOK WITH DISCOUNT AND BANK COLUMN

In this case the Cash Book is ruled with there amount columns on either side of the cash book namely, "Discount, cash and Bank". Cash columns in such a case will record actual cash received on the debit side and payments on the credit side. Cheques received should be entered on the debit side of the bank column when it is deposited in the bank. The payments by cheques should be entered on the credit side in the bank column and also when cash is withdrawn from the bank.

IMPORTANT ENTRIES

1. Contra Entries : These entries affect cash and bank columns both at the same time. To indicate contra entry "C" is mentioned in the L.F column of the cash Book. Following two cases result in Contra entries.
(2) Entries relating to cheques :
(a) When any payment is made by cheque : It will reduce the bank balance and thus bank column will be credited.
(b) When any payment is received in the form of cheque and no information about its deposit into bank is given. In this case it is assumed that the cheque is deposited into the bank on the same day, when it is received & so bank A/c will be debited.
(c) When any payment is received in the form of cheque and it is deposited into bank on some other day i.e. when two dates, one for the receipt of cheque and the other for deposit. In this case no entry is to be recorded at the time of receiving the cheque. Entry is to be made when a cheque is deposited in the bank, as bank column debited.

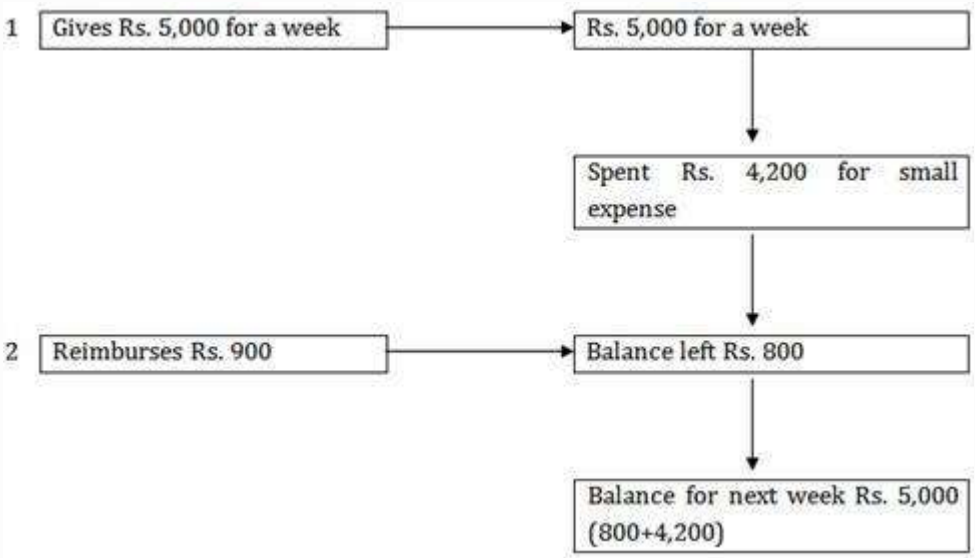
Petty Cash Book

Business has to incur small expenses which are repetitive in nature. To save the time and efforts of the head cashier, the business appoints a petty cashier. He is entrusted with the duty of paying these expenses.

Imprest System of Petty Cash Book
Under this system, Head cashier gives a fixed amount to the petty cashier for a definite period. At the end of given period, Head cashier reimburses the amount actually spent by the petty cashier resulting the same amount with petty cashier which he had in the beginning of the period

This can be illustrated as under.

Head Cashier Petty Cashier



Advantage of Petty Cash Book
· Saving of time and efforts of Head cashier

· Control on Petty expenses.

· Less chances of fraud.

SPECIAL PURPOSE SUBSIDIARY BOOKS
Purchases Book
In this book, only those transactions are recorded which are related to credit purchases of goods in which the business deals in. Recording is made on the basis of Bills/ Invoices issued by the Suppliers.

Transactions not recorded in purchases Book
· Purchases of goods for cash.

· Purchases of Assets meant for long term, not for resale.

Note:-
1. Transaction of Aug. 5 is related to credit purchases of furniture i.e. an Asset.
2. On Aug. 17, goods bought for cash, Hence both the transactions are not recorded in Purchases Book.
Sales Books/Sales Journal

In this book, transactions for credit sales of goods are recorded. The source documents for this book is a duplicate copy of invoice/bills issued to the customers.

Transactions not recorded in Sales Book
Sales of goods for cash

Sales of Assets.

Note:-
1. Transaction of Julyl5 is related to sale of asset,
2. Sale of Rama Furniture is made for cash, hence not recorded in the Sales Book.
PURCHASES RETURNS/RETURNS OUTWARD BOOK
This book includes only those transactions which are related to returns of goods bought on credit. The goods may be returned due to various reasons such as goods bought being defective, supply of inferior quality goods etc. Entries in this book are made on the basis of Debit Note. A Debit note contains the name of the supplier to whom good are returned, details of goods returned

Sales Returns Book
This book includes all the returns by customers of credit sales of goods. The Credit Note is used The Credit Note is used for recording entries in this book. The credit note contains the details of customers and goods returned.

The Ledger:
A ledger is a principal book that contains all the accounts (Assets Accounts, Liabilities Accounts, Capital Accounts, Revenue Accounts, Expenses Accounts) to which the transactions recorded in the books of original entry are transferred. As the ledger is the ultimate destination of all transactions, the ledger is called the "Book of Final Entry".

Format of Ledger

Name of the Account

Dr. **Cr.**

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)

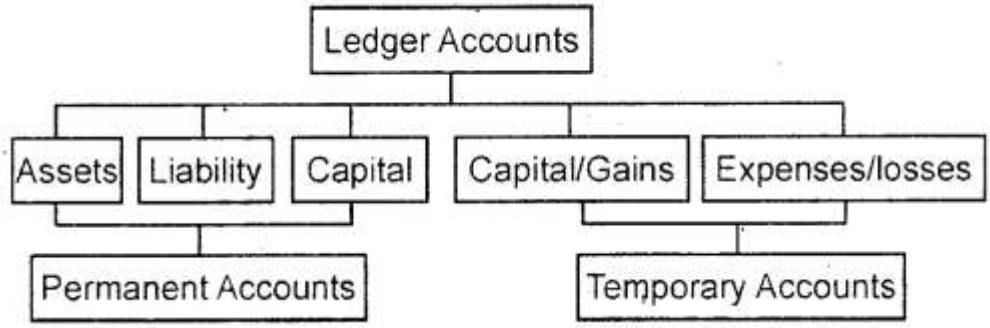
1. Name of the Account: The name of the item is written at the top of the format as the title of the account. The title of the account ends with the suffix 'Account'.
2. Dr./Cr.: Dr. means Debit side of the account that is left side and Cr. means Credit side of the account i.e. right side.
3. Date: Year, Month, and Date of transactions are posted in chronological order in this column.

4. Particulars: The name of the item with reference to the original book of entry is written on the debit/credit side of the account.
5. Journal Folio: It records the page number of the original book of entry on which relevant transaction is recorded.
6. Amount: This column records the amount in numerical figure, corresponding to what has been entered in the amount column of the original book of entry.

The distinction between Journal and Ledger:

Journal	Ledger
1. The Journal is the book of the first entry (original entry).	1. The ledger is the book of secondary entry.
2. It is a book for chronological records.	2. It is a book for analytical records.
3. It is prepared on the basis of source documents of transactions.	3. It is prepared on the basis of the journal.
4. Process of recording in the Journal is called Journalising	4. The process of recording in the ledger is known as posting.
5. Narration is written for each entry.	5. No narration is given

Classification of Ledger Accounts:



All permanent accounts are balanced and carried forward to the next accounting period. The temporary accounts are closed at the end of the accounting period by transferring them to the trading and profit and loss accounts. This classification is also relevant for preparing financial statements.

BANK RECONCILIATION STATEMENT

Bank Reconciliation Statement is prepared to reconcile the difference between the bank Balance shown by the Cash Book and Bank Pass Book.

LEARNING OBJECTIVES

1. Meaning of Bank Reconciliation statement.
2. Causes of Differences in Bank Balance as per Cash Book and Pass Book.
3. Importance of Bank Reconciliation Statement.
4. Procedure of preparation of bank Reconciliation statement
5. Preparation of Adjusted Cash Book.

Definition: A schedule showing the items of difference between the bank statement and the bank column of Cash Book is known as Bank Reconciliation Statement.

Causes of Differences in Cash Book and pass Book

(A) Transactions recorded in Cash Book but not in Pass Book.
(B) Transactions recorded in Pass Book but not in Cash Book.
(C) Other transaction errors.

(A) Transactions recorded in Cash Book but not in Pass Book

(i) Cheques issued but not presented for payment in the bank.
(ii) Cheques deposited or paid into the bank for collection but not yet credited by the bank.
(iii) Cheques deposited but dishonored.
(iv) Working Debit or credit entered

(B) Transactions recorded in Pass Book but not in Cash Book :-

(i) Interest allowed by the Bank
(ii) Interest on overdraft, bank charges and commission etc. charges by Bank.
(iii) Direct deposit by the customers into Bank.
(iv) Interest, dividend etc. collected by the Bank.
(v) Direct payment made by the Bank on behalf of customer as per standing instruction.

(C) Other transactions :-

(i) Error in totaling or balancing of Cash Book.
(ii) Transactions recorded twice in Cash Book.
(iii) Transactions recorded twice in Pass Book.

(iv) Error of recording by wrong amount.
(v) Error of recording in wrong side like Debit instead of credit and vice-versa.

Need and importance

· It helps in locating and rectifying the errors or omissions committed either by the firm or by the bank.

· Customer becomes sure of the correctness of the bank balance shown by the cash book.

· Facilitates the preparation of amended or revised Cash Book.

· Reduces the chances of fraud by the staff of the firm or bank.

· Helps in keeping a track of the cheques deposited for collection.

Procedure of preparing Bank Reconciliation Statement

A Bank Reconciliation Statement is prepared when we get the duly completed Pass Book from the Bank.

1. First of all tally the Debit side entries of the cash book with the Credit side entries of the Pass Book and vice versa.
2. Tick the items appearing in both the books.
3. Unticked items will be the points of differences.
4. A BRS is then prepared by taking either the balance as per Cash Book or Pass Book as a starting point.

Important points

1. If the Starting point is Cash Book Balance then the ending point will be Pass Book Balance.
2. If the starting point is Pass Book Balance then the ending point will be the Balance as per Cash Book.
3. Debit Balance as per Cash Book or Credit Balance as per Pass Book, means that the firm has that much amount of deposit at the bank ->also called favorable balance -> write the amount under + items.
4. Credit Balance as per Cash Book or Debit Balance as per Pass Book, means that this much amount has been withdrawn in excess of deposit -> also called overdraft or unfavorable balance -> write the amount under items.

Method of preparing BRS starting with the Balance/overdraft as per Bank Column of Cash Book.

Bank Reconciliation Statement as on . . . .

PARTICULARS	+ ITEM	– ITEM
Balance as per Cash Book **Add :-** Items Credit in Pass Book but not recorded in Cash Book. **Add : –** Items debit in Cash Book but not recorded in Pass Book. **Less :-** Item debit in Pass Book but not recorded in Cash Book. **Less :-** Items credit in Cash Book but not recorded in Pass Book.		

Total	**P**	**M**
Balance as per Pass Book (P – M) =		

Note:

· If the total of Plus Items is more than the total of () items – >Difference is Credit Balance or favorable balance as per Pass Book.

· Where as if the – items total is more than the + items total > Difference is Debit Balance or overdraft as per Pass Book.

· If BRS is started with Balance as per Cash Book then the ending point is Balance as per Pass Book and Vice-Versa.

· Debit balance of Cash Book means favorable balance or – Balance

· Debit balance of Pass Book means unfavorable balance or – balance.

· Credit balance of Pass Book means favorable balance or + balance

Ready Reference

Items which increase the pass Book Balance or decreases the Cash Book Balance)

1. Cheques issued but not yet presented.
2. Credits made by the bank for Interest.
3. Amount directly deposited by the customers in our bank A/c.
4. Interest and dividend collected by the bank.
5. Cheques paid into the bank but omitted to be recorded in the Cash – Book.

Items which, decreases the pass Book Balance or increase the Cash Book Balance)

1. Cheques sent to the bank for collection but not yet credited by the – bank.
2. Cheques paid into the bank but dishonoured.
3. Direct payments made by the bank.
4. Bank charges, commission etc. debited by the bank.
5. Cheques issued but omitted to be recorded in the Cash Book.

Explanation

1. Balance as per Cash Book means favourable Balance, hence + Item.. If nothing (i.e. Debit or Credit) is written the Balance given, it is treated as favourable.
2. Cheques were deposited into the bank for Rs. 5,000 but credited by the bank for Rs. 1,000 in the month of July, implies that cheques for Rs. 4,000 (5,000-1,000) are entered in the Cash Book but not in the Pass Book Increasing the Cash Book Balance by Rs. 4,000 as compared to PassBook. Hence to get pass Book Balance from the Cash Book Rs. 4,000 will have to be deducted.
3. Cheques issued but not presented for payment till 31st July is for Rs. 13800 entered more on the credit side of Cash Book as compared to Passbook -> Cash book Balance is less by Rs. 13,800 as compared to Passbook -> Item
4. (a) Bank charges of Rs. 150 entered in the Pass Book -> decrease the Balance of Pass Book. To reach Pass Book Balance from Cash Book Balance, this item has to be deducted i.e. minus item.

(b) Interest credited by the Bank Rs. 400 interest in Pass Book Increases the, balance of Pass Book, hence to reach the Balance from cash book and this item is to be added + item.
5. Direct deposit by a customer Rs. 2,500 Increase the Pass Book Balance plus item.
6. Payment made by the bank for insurance premium decreases the Pass Book Balance Minus Item.
7. Items total Rs. 36,700 is more than-item total Rs. 5,350 by Rs. 31,350. Hence the difference of Rs. 31,350 will be + item i.e. Favourable Balance or Cr. balance as per Pass Book.

Important points :

· Starting and Ending points are reversed compared to Example No. 1. Hence + items (x) items are interchanged.

· Favourable balance whether of Cash Book or Pass Book is always a + items

· If + items total is more the-items total then the difference in the two totals is always a favourable Balance

· Where as if + items total is less than the – items total then the difference in the two totals is overdraft.

Important points

· Overdraft whether as per Cash Book or Pass Book is always a (-) item.

· Starting and Ending points are interchanged as compared to Example No. 2 hence + items and (-) are also interchanged.

· Here (-) items total is more as compared to (+) items total, therefore, the difference in the two balances is a negative item i.e. overdrafts as per Cash Book.

Amended Cash Book Method

Introduction: So far we have studied the preparation of Bank Reconciliation Statement simply by reconciling the causes of differences between the Cash Book and Pass Book. In actual practice adjustments are done in the Cash Book by comparing the Bank column of Cash Book with the Bank Statement and after that, B.R. Statement is prepared. It is called the Amended Cash Book Method.

Procedure

1. Adjusted Cash book prepared starting with the Balance of the Cash Book given in the question.
2. All errors that have been committed in the Cash Book will have to be rectified by passing adjusting entries in the Cash Book.

Usual of General Errors are

(a) Overcosting or Undercosting of Debit/Credit Column of Cash – Book.
(b) Cheques deposited or Issued but omitted to be entered in the Cash Book.
(c) Incorrect amount (if any) entered in the Cash Book.
(d) Entries on the correct side or in the wrong column of Cash Book.
(e) Any amount recorded twice in the Cash Book.
3. Certain amounts for which the Bank has debited our A/c will be recorded on the Credit side of the Cash Book. Such items are
(a) Interest charged by the bank on overdraft, etc.

(b) Debits made by the bank for the bank charges, commission etc.
(c) Direct payments made by the Bank on behalf of the A/c holder.
(d) Cheques sent for collection but dishonoured.
4. Cash Book is then balanced: and the new Balance of the Cash book is taken as the starting point for preparing the B.R. Statement.
Important:
It should be noted that the following items must not be recorded in the Amended Cash Book.

· Cheques deposited into the Bank but not yet credited by the Bank.

· Cheques Issued but yet not presented for payment.

POINTS TO REMEMBER
· Amended or adjusted Cash Book is started with the given balance of the bank as per Cash Book.

· Closing Balance of the adjusted Cash Book is the opening balance of bank Reconciliations statements.

· Entry for the dishonour of the cheques of Rs. 200 is not done.

(a) In the Cash Book as it was dishonoured after 31st Dec.
(b) In Bank Reconciliation Statement it is included in the adjustment (Rs. 3,100-2,500)

What is the accounting cycle?

The accounting cycle is a series of steps used by an accounting department to document and report a company's financial transactions. The cycle follows financial transactions from when they occur to how they affect financial documents. The accounting cycle happens every accounting period or reporting period for which financial documents are prepared.

The final step—the closing process—can occur as a “soft close” throughout the fiscal year, but a “hard close” only happens at the end of the fiscal year.

A “soft close” closes the general ledger for that accounting period so that new journal entries can’t be booked. This occurs so that financial documents can be prepared for that period without the account balances changing.

The hard close process moves transactions from temporary accounts—accounts on the income statement—to permanent accounts, which are accounts on the balance sheet. This process is important as it guarantees precision and accuracy throughout a company's fiscal years.

The eight steps of the accounting cycle

The accounting cycle consists of eight steps that accountants should follow to record transactions and check for data accuracy. Steps one through seven occur every accounting period—regardless of length—while step eight only occurs at the end of the fiscal year:

1. Analyze transactions

The first step in the accounting cycle is to analyze events to determine if they are "transactions" and what their impact is. Transactions include any company purchases that were made, debts paid, debts acquired or revenue acquired from sales. Events that are not considered transactions include creating purchase orders and signing contracts. Transactions are the starting point from which the rest of the accounting cycle will follow.

Example: *A company receives $300 in sales on their software products. This is the starting point of the accounting cycle for this transaction.*

2. Record journal entries

The next step in the accounting cycle is to record these financial transactions as journal entries. This should be done by following a chronological order. You need to understand the impact of the transaction—from step one—to create the journal entry.

A journal entry has a debit and a credit which relates to how a transaction affects different accounts. Whether an account is debited or credited is determined by how the balance of that account is tracked.

For example, cash and receivable accounts have debit balances—increased with debits, decreased with credits—and revenue accounts have credit balances—increased with credits, decreased with debits. The person entering the transaction data into the journal entries must make sure that the debits and credits are balanced.

Example: *The $300 transaction is entered based on the date it occurred to align with the chronological order of the other transaction entries. A $300 cash sale will involve a Debit of $300 to Cash and a Credit of $300 to Sales Revenue.*

3. Post entries to the general ledger

A ledger account is a collection of all journal entries that debit or credit that account. The general ledger is the master set of all ledger accounts. The general ledger keeps track of a company's entire financial activity. When you post to the general ledger, you record a summary of the activity for each ledger account.

Example: *If today's transactions included a cash sale of $300, a cash sale of $200 and a cash refund of $100, then the summarized Cash transactions would be a debit of $400. Companies differ in how they track refunds, but let's assume the summarized Sales*

Revenue transactions would be a credit of $500 with a summary of a debit of $100 recorded in Sales Returns and Allowances—a "contra account," which means it offsets a regular revenue account and has a debit balance.

4. Prepare an unadjusted trial balance

At the end of each accounting period, a company's accounting department should enter the data from the ledger accounts into a trial balance. This trial balance is also called "the unadjusted trial balance" because it is prepared before adjusting entries—step six—being entered.

The unadjusted trial balance is prepared so that accountants can catch any errors that may have occurred during the initial stages of the accounting cycle. A trial balance is considered successful if the debit account balances equal the credit account balances. Even if the unadjusted trial balance is balanced, you must conduct step five as other errors may have occurred.

Example: *To keep this simple, let's prepare a trial balance for one day while ignoring Cost of Goods Sold. To prepare the trial balance, you need to compile data from all ledger accounts. Let's say the company also had $700 in credit sales—a debit of $700 to Accounts Receivable and a credit of $700 to Sales Revenue—and bought $200 of inventory on credit from a vendor—a credit of $200 to Accounts Payable and a debit of $200 to Inventory.*

Taking into account the information from before, you have debit balances of $400 (Cash), $700 (Accounts Receivable), $200 (Inventory) and $100 (Sales Refunds and Allowances). You have credit balances of $1,200 (Sales Revenue) and $200 (Accounts Payable). This gives you total debits of $1,400 and total credits of $1,400. Real trial balances will involve numerous accounts.

5. Check accuracy of worksheets

This step is required when the debits and credits of a trial balance are not equal. The transaction data entered into past journal entries must be reviewed to find the error. Another error may include posting to the wrong accounts. For this error, debits and credits will equal, but an accountant will notice unusual account activity or balances. To fix these errors, you will need to enter journal entries to reverse the incorrect entries and enter the correct ones.

Example: *If the accountant conducts a trial balance and finds that there are $900 in debits and $1,200 in credits, they must go through previous journal entries to identify the missing $300 amount. Most accounting software will not allow unbalanced journal entries to post; however, to manually find these types of errors, you can either look at entries*

individually or compare corresponding accounts—like Accounts Receivable and Sales Revenue—to try to find obvious mistakes.

6. Record adjusting entries

This step requires the usage of the matching principle to organize company transactions into the appropriate accounting periods. Adjustments are grouped into Deferrals and Accruals. Using the matching principle, accountants can examine deferrals and accruals to determine if they will be factored into a company's total revenue or unearned revenue for the fiscal period. A common deferral is a prepaid expense—for example, rent—and a common accrual is a payable expense such as salary and wages.

Example: *In January, the company pays $12,000 in rent for the whole year ($1,000 a month). The original journal entry was a $12,000 debit to Rent Expense and a $12,000 credit to Cash. At the end of the accounting period (in this case, a month), the adjusting entry would be an $11,000 debit to Prepaid Rent and an $11,000 credit to Rent Expense. This reflects that only $1,000 of rent was actually used in January. For the remaining eleven accounting periods, the adjusting entry will be a $1,000 debit to Rent Expense and a $1,000 credit to Prepaid Rent.*

The accountant could also have done two journal entries in January: (1) a $12,000 debit to Prepaid Rent and a $12,000 credit to Rent Expense, and (2) a $1,000 debit to Rent Expense and a $1,000 credit to Prepaid Rent. Entry #1 fixes the incorrect entry while Entry #2 records the correct transaction. Technically, as long as the net effect is that, as of January 31, $11,000 is in Prepaid Rent and only $1,000 is in Rent Expense, then either method is fine.

7. Organize financial statements

Once all adjusting entries are completed and you ensure the debits and credits still balance, then you can prepare the Adjusted Trial Balance as well as the financial statements. Financial statements are prepared in this order: Income Statement, Statement of Retained Earnings, Balance Sheet and Statement of Cash Flows.

Once the Adjusted Trial Balance is finalized, the balance for each account is reported on the Income Statement, the Statement of Retained Earnings or the Balance Sheet. No individual account from the Adjusted Trial Balance will be on more than one of these. The Adjusted Trial Balance does list the beginning balance for Retained Earnings, but this specific number only appears at the beginning of the Statement of Retained Earnings and not directly on the Balance Sheet.

The order that you prepare the financial documents is important because the net income from the Income Statement will be used to prepare the Statement of Retained Earnings, and the ending balance on the Statement of Retained Earnings will be used to prepare

the Balance Sheet. The Statement of Cash Flows is prepared last because it uses information from the first three statements.

Example: *Let's say your income statement shows Total Revenues of $1000 and Total Expenses of $500. Your Net Income is Total Revenues - Total Expenses = $500. This $500 is moved to Retained Earnings at the end of the fiscal year during the closing process.*

Let's say your beginning Retained Earnings balance is $200. The Adjusted Trial Balance would list this $200 balance for Retained Earnings. For the Statement of Retained Earnings, you start with $200. You add $500 from net income. Assuming the company did not pay dividends, the ending balance for Retained Earnings is $700.

The ending balance for Retained Earnings is then used to prepare the Balance Sheet. It will appear under the Equity section.

The Statement of Cash Flows takes information from the other statements to characterize cash flows as "inflows" or "outflows." These flows are then categorized as Operating, Investing, or Financing.

8. Close temporary accounts

The last stage of the accounting cycle is the closing of temporary accounts. Accounts that appear on the Income Statement are temporary accounts that are closed out—also referred to as "zeroed out"—at the end of the fiscal year. The balances from these accounts are moved to permanent accounts on the Balance Sheet. The main purpose of zeroing out the income statement accounts is to allow for revenues and expenses to be tracked anew each fiscal year.

During the fiscal year, you can also do a "soft close." If you prepare financial statements monthly, then February's books will be closed during the beginning of March, which will prevent new journal entries from being entered with a February post date. If you prepare financial statements quarterly, then you may keep the books open for three months at a time. Soft closes do not permanently close the books, so entries can still be entered after close with management's approval. Temporary accounts are not zeroed out for soft closes.

Example: *At the end of the fiscal year, the accountant will debit the total of all revenue accounts with a corresponding credit to Retained Earnings. The accountant will also credit the total of all expense accounts with a corresponding debit to Retained Earnings. The net effect to Retained Earnings should equal the net income—an overall increase to Retained Earnings—or net loss—an overall decrease to Retained Earnings—for the fiscal year. You can check the accuracy of your journal entries by comparing the numbers to the financial statements that you prepared in step seven.*

How is the accounting cycle different from the budget cycle?

The accounting cycle and budget cycle differ in their timing and focus. The accounting cycle records and reports past company transactions, whereas the budget cycle analyzes the direction and aspirations of a company to project future transactions.

Another way to differentiate between these terms is to consider the accounting cycle as part of a process that allows a company to share its financial documents with external stakeholders, whereas the budget cycle is part of a process used internally among company officials to determine the costs associated with future company activities.

Timing of the Accounting Cycle

One accounting cycle happens every accounting period. The accounting period is defined as the time period for which financial documents are prepared. This could be monthly, quarterly or yearly depending on the company's needs. A fiscal year is the company's tax reporting year, which can be a calendar year or any 12-month period. If the accounting period is a year, then it can also be called a “fiscal year.”

For example, the government uses a fiscal year of October 1 to September 30. For the government, Fiscal Year 21 (usually denoted as FY21) runs from October 1, 2020 to September 30, 2021. If the government uses monthly accounting periods, then Period 1 of FY21 would be October 2020. Period 4 of FY21 would be January 2021. If the accounting period is quarterly, Q1 of FY21 would cover October 1, 2020 to December 31, 2020. Q4 of FY21 would cover July 1, 2021 to September 30, 2021.

Companies may use more than one accounting period, but it is important to remember that the accounting period is reporting transactions for that time period only. For example, the SEC requires publicly traded companies to file financial statements quarterly, so these companies will have quarterly accounting periods to meet this requirement. Companies must also file yearly tax forms with the IRS, so these companies will have yearly accounting periods to meet this requirement.

Definitions of Depreciation

Some important definitions of depreciation are given below.

Depreciation may be defined as a gradual deterioration in value due to use.

— R.G William

Depreciation may be defined as the measure of the exhaustion of the effective life of an asset from any cause during the given period.

— Spicer and Pegler

It is a matter of common knowledge that all fixed assets such as plants, machinery, tools, buildings, leaseholds, furniture etc., gradually diminish in value as they get older and become worn out by constant use in the business.

— J.R.Batboi

In practice, the term depreciation is commonly used in a very wide sense, covering diminution in the values of assets caused by outside fluctuations in realisable and replacement values, and also the amortization of the cost of an asset over the period of its use.

— De Paula and De Paula

Depreciation is the diminution in the financial value of the asset owing to wear and tear, effluxion of time, obsolescence or similar cause, the suggestion being other that of gradual deterioration than sudden loss or diminution in value.

— L.C.Cropper

Depreciable Asset

Depreciable assets mean, the assets whose expected useful life is limited but are expected to provide their services for more than one accounting year and are held by the company for the purpose of production or administration rather than resale.

Scrap Value

Every asset has some scrap value, also known as residual value, i.e. the amount at which the asset can be resold at the end of its expected useful life. Therefore, the amount charged as depreciation should be such that it will reduce the book value of the depreciable asset to its residual value, at the end of its useful life.

Characteristics of Depreciation

A careful examination of various definitions of depreciation reveals the following characteristics.

1. Depreciation is calculated on the value of the depreciable assets like building, plant, machinery, furniture, loose tools etc.

2. It is a permanent and continuous decrease in the value of an asset.

3. Depreciation is caused due to use, efflux of time, obsolescence etc.

4. Depreciation is charged to spread the cost of an asset over its useful life.

Depreciable Assets

According to Accounting Standards issued by the Institute of Chartered Accountants of India depreciable assets are assets which:

- are expected to be used during more than one accounting period,
- have a limited useful life and,
- are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.
-

Meaning of Useful Life

Accounting to AS 6, useful life is either:

- The period over which a depreciable asset is expected to be used by the enterprise or,
- The number of similar units expected to be obtained from the use of the asset by the enterprise.

Depreciable Amount

Depreciable amount of an asset is its historical cost, or any other amount substituted for historical cost in financial statements minus the estimated residual value at the end of useful life. Historical cost includes:

- Purchase price

- Initial delivery and handling cost
- Installation cost
- Professional fees paid to architects, engineers etc.
- Financial cost like interest on deferred credit or borrowed funds for acquisition of fixed assets for the period up to the completion of construction or acquisition of fixed assets. After the assets are ready for use such financing costs should not be included.
- Expenditure incurred on start-up and commissioning of the project including expenditure on test runs and experimental production.

Administrative and other overheads are excluded from the historical cost of fixed assets.

Causes of Depreciation

Causes of depreciation may be of two: internal causes and external causes.

Internal Causes of Depreciation

Wear and tear, exhaustion, depletion, deterioration etc.. causes depreciation of assets which are internal in nature.

1. Wear and tear

Assets diminish in their value as they are constantly used in the organization. The difference between the value of an asset when it was bought and its value being used for sometime represents wear and tear. Although assets are kept in working conditions, a time comes when only scrap value remains.

2. Exhaustion

Assets are bound to lose their value as time progresses. Consequently, productivity declines. Assets exhaust their value and are found useless after the elapse of a certain fixed period. It is true that assets have their definite age.

3. Depletion

Natural resources such as mines, quarries and oil wells are of a wasting character. As a result of gradual exhaustion, the value of wasting assets declines. They are consumed gradually. The process of earning income through extraction causes depletion of wasting assets.

DETERIORATION

Deterioration means erosion in value of those assets which have a very short life. Proper repairs and maintenance of these assets cause an additional loss by way of deterioration.

External Causes of Depreciation

Factors external to causes of depreciation include passage of time, obsolescence, permanent fall in market value and weather and accidental elements. These factors are not connected to the asset. Even then they cause depreciation.

1. Passage of time

The utility of some fixed assets is confined to a time frame. Assets like leasehold property become useless after a period. Relevant statutes may limit the period for which an organization can use assets in the production process. Assets like trademark, patents lose their value with the passage of time.

2. Obsolescence (OUT OF FASHION)

Obsolescence implies the chance of an asset becoming out of fashion. This is a loss arising on account of new invention, technological changes, improvement in production methods, legal restraints etc. These factors make it economical to replace the assets though they are still usable. Market changes are also a disturbing factor. For example, the demand for a product or service falls to such a level that it is no longer viable to continue with that product or service.

3. Permanent fall in the market value

Assets like investments lose their value due to a downfall in their market value. It is only the permanent fall in the value of assets. Temporary shrinkage in the value of assets should be ignored for depreciation calculation.

4. Weather and accidental elements

Assets lose their value due to weather, rain, sunshine or any accident like fire, earthquake, flood, tidal forces or similar other disasters. The effect of these factors enters into calculating depreciation.

Objects of Providing Depreciation

Occurrence of depreciation is unavoidable. For a true and fair view of accounts, assets are restated at the balance sheet date. Investment decisions rest on depreciation. The objects and necessity of providing for depreciation are briefly described.

1. True cost of production
2. Correct income
3. True and fair view of financial position
4. Compliance procedures
5. Assets replacement
6. Keeping capital intact
7. Tax planning

1. To compute true cost of production

In cost terminology, overhead charges include all indirect costs. Depreciation is one among them. The asset engaged in production loses its value due to physical wear and tear. The said reduction in value of assets would be included in the cost of production. As a revenue expense its inclusion gives true cost of production.

2. To determine correct income

Depreciation is a charge included in the profit and loss account. True and correct profit can be arrived at only by charging depreciation. Depreciation is not visible. It is never paid to an outside party. Yet, it is desirable to charge depreciation on the fixed assets as these assets are used for earning profit. Depreciation must be deducted from the income earned to calculate a correct income.

3. To show a true and fair view of financial position

A balance sheet reveals the financial position of its entity. Fixed assets should appear in the balance at their correct value. If assets are shown without any charge for depreciation, their value would be overstated. Consequently, the balance sheet will not show the correct state of business. Assets stated at their written down value will give a correct picture.

4. For legal compliance

The cost of non-compliance would always be heavy. It is compulsory under the Companies Act to provide for depreciation for dividend payment. No dividend shall be declared or paid out of profits before depreciation. Whether profits are sufficient or insufficient for dividend payment, depreciation must be provided for. Provision for depreciation ensures that dividend is paid out of profits.

5. To meet replacement cost

Occurrence of depreciation is gradual and not sudden. So, ample time is available to plan for replacement of existing assets at a future date. It is wiser to replace an asset than to incur additional expenditure on its maintenance and repair. By way of provision for depreciation the initial cost of the equipment is spread equitably over its period of usefulness. Amount of depreciation gets accumulated during the asset's working life. It provides necessary funds so that replacement can be effected without financial strain.

6. To keep capital intact

Keeping the capital intact has always been the focal point in business. The amount of depreciation charged against every year's profit should be appropriate. Omission or understatement of depreciation results in inflated profit. If any dividend is distributed out of inflated profit, it would be an incorrect return on capital. It will cause the value of the business to decrease. Capital should be kept intact.

7. To plan tax liability

Tax planning is the legitimate right of every assessee. Depreciation can be used as a tax saving device. It is an admissible expense while computing income from business. Income tax liability is reduced by claiming depreciation. A suitable depreciation policy is always essential to minimize tax liability.

Factors Affecting Depreciation Calculation

Certain factors enter into consideration for determining depreciation. They are Value of assets, Estimated working life, Repairs and renewal, Addition and extension, Scrap value, Loss of interest on capital invested and Legal provisions. They are briefly discussed as below.

1. Value of Assets

Value of depreciable asset is the cost of the same asset that represents its money outlay or its equivalent in connection with its acquisition, installation and commissioning as well as for additions to improvements thereof. An increase or decrease in long term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors may cause changes in the historical cost of a depreciable asset.

2. Estimated working Life

Working life is determined by

- Legal or contractual limits such as the expiry dates of related leases.
- Extraction or consumption.
- Extent of use and physical deterioration on account of wear and tear which again depends upon operational factors like number of shifts for which the asset is to be used, repair and maintenance policy of the enterprise.

3. Repairs and Renewals

Repairs and renewals keep the assets in good working condition. A well maintained asset yields good results over its stipulated life. If it is poorly maintained, it will become useless after a short period. So, repairs and renewals are an important consideration while determining the amount of depreciation.

4. Additions and Extensions

Additions and extensions are normally made to existing assets like plants and buildings. The purpose is to increase their capacity. Expenditures on additions and extensions are of capital nature. The dates of incurrence of such expenditures are considered to ascertain depreciation.

5. Residual Value

Scrap value of an asset represents the amount which the assets will fetch when discarded. Residual or scrap value of the assets should be deducted from their original cost.

6. Obsolescence

An asset is likely to become outdated due to change in technology. The possibility of an asset going out of fashion should be carefully weighed while calculating the amount of depreciation.

7. Loss of Interests

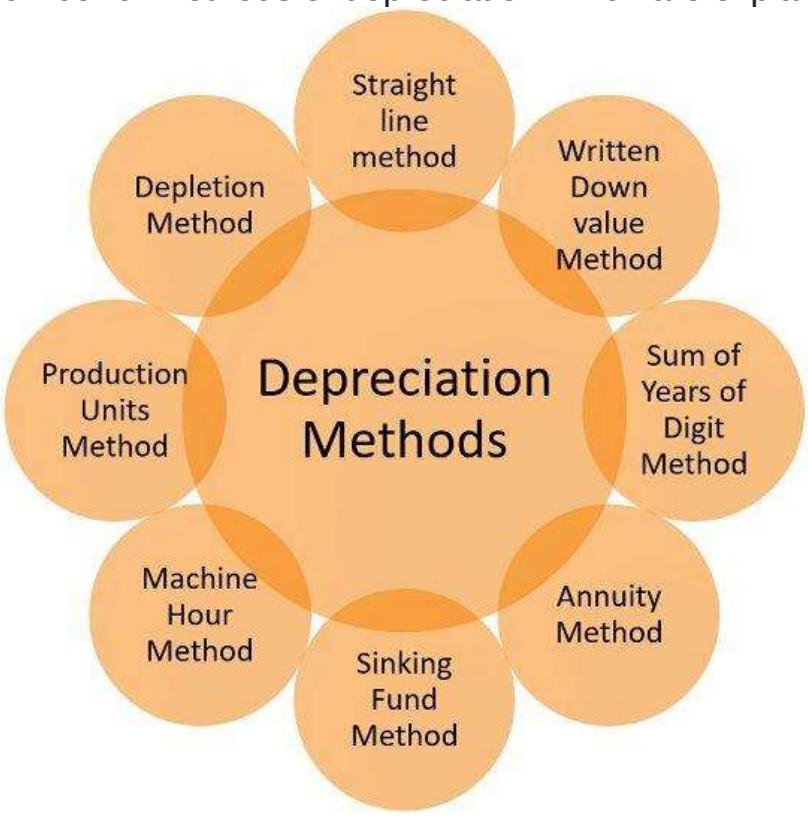
The purchase of an asset involves a heavy sum. It may be alternatively invested elsewhere. So, capital involved in the purchase of an asset implies a loss of interest on alternative investment.

8. Legal Requirements

Provision for depreciation on assets is subject to the Income Tax Act and Companies Act. Their legal provisions do enter into calculation of depreciation.

Methods of Providing Depreciation

There are a number of methods of depreciation which are explained as under:



1. **Straight Line Method**: Also known as Fixed Installment Method, an equal amount is charged as depreciation every year throughout the working life of the asset, with the view of reducing the cost of the asset to zero, at the end of its economic life.
2. **Written Down Value Method**: In this method, a fixed percentage of the written down value of the depreciable asset is charged as depreciation, so that the value of the asset equals its break-up value at the end of its working life. This method is also known as the diminishing value method, reducing balance method.
3. **Sum of Years of Digit Method**: This method is a variation of a written down value method and is used to accelerate the depreciation.
4. **Annuity Method**: This method is mainly concerned with the cost recovery and a uniform rate of return on any depreciable asset. In the annuity method, along with the value of the asset, interest lost over its life is also written off.
5. **Sinking Fund Method**: Under this method, a certain amount is written off as depreciation every year and placed to the credit of the sinking fund account. Further, Government Securities are purchased with the equivalent amount and the interest received, is reinvested and credited to the sinking fund account.
6. **Machine Hour Method**: When a record of actual running hours of each machinery is kept, the calculation of depreciation is based on hours machines worked.
7. **Production Units Method**: In this method, the depreciation is ascertained by making a comparison of actual production with the estimated production.
8. **Depletion Method**: As the name suggests, the depletion method is used when there is the exhaustion of natural resources like oil reserves, coal deposits and so on.

Depreciation is a non-cash expenditure, and so, it does not result in cash outflow from the business. Moreover, it does not create funds, rather it highlights the fact that a fixed amount should be retained from the profits, for the replacement of assets, to continue operations.

Bank Reconciliation Statement

Businesses maintain cash books to record both cash as well as bank transactions.

A Cashbook has a cash column that shows cash available with the business and a bank column that shows cash at the bank.

Bank also keeps an account for every customer in their books. All the deposits are recorded on the credit side of the customer’s account and withdrawals are on the debit side of their account. An account statement is sent regularly to the customers by the bank.

Sometimes the bank balances as per the cash book and bank statement doesn’t match. In case the balance available in the passbook doesn’t match

the bank column of the cash book, the business should identify the reasons for the same.

It is important to reconcile the differences. For reconciling the balances as shown in the Cash Book and passbook a reconciliation statement is prepared known as Bank Reconciliation Statement or BRS.

In other words, BRS is a statement that is prepared for reconciling the difference between balances as per the cash book's bank column and passbook on a given date.

Why Prepare a BRS?

It's not compulsory to prepare a BRS and there's no fixed date for preparing BRS.

BRS is prepared on a periodical basis for checking that bank related transactions are recorded properly in the cash book's bank column and also by the bank in their books. BRS helps to detect errors in recording transactions and determining the exact bank balance as on a specified date.

How to prepare a BRS

- The first step is to compare opening balances of both the bank column of the cash book as well as bank statement; these could be different due to un-credited or unpresented cheques from a previous period.
- Now, compare the credit side of the bank statement with the debit side of the bank column of the cash book and the debit side of the bank statement with the credit side of the bank column of the cash book. Place a tick against all the items appearing in both the records.
- Analyze the entries both in the bank column of the cash book as well as the passbook and look for entries that have been missed to be posted in the bank column of the cash book. Make a list of such entries and make the necessary adjustments in the cash book.
- Correct if any mistakes or errors appear in the cash book.
- Calculate the corrected and revised balance of the cash book's bank column.
- Now, start the bank reconciliation statement with an updated cash book balance.
- Add the unpresented cheques (cheques which are issued by the business firm to its creditors or suppliers but not presented for payment – Expense)

and deduct uncredited cheques (Cheques paid into the bank but not yet collected – Income).

- Make all the necessary adjustments for the bank errors. In case the bank reconciliation statement begins with the debit balance as per the bank column of the cash book, add all the amounts erroneously credited by the bank and deduct all the amounts erroneously credited by the bank. Do vice-versa in case it starts with the credit balance.
- The resultant figure must be equal to the balance as per the bank statement.

Benefits of preparing a BRS

Accounting errors could lead to circumstances that are more than just embarrassing when the cheques bounce or companies start getting annoying calls from creditors or suppliers for payments that are already released.

Bank reconciliations assist you in spotting fraud and reducing the risk of transactions that could cause penalties and late fees. BRS offers several advantages to a business which includes:

- Detecting errors: A bank reconciliation helps you in spotting accounting errors that are common to every business. These mistakes include errors such as addition and subtraction, missed payments and double payments.
- Tracking Interest and Fee: Banks might add interest payments, fees or penalties to your account. Monthly bank reconciliation allows you to add or subtract such amounts in your books.
- Detecting Fraud: You may not be able to prevent employees from stealing your money once, however, you could prevent it in future. Bank reconciliation statement helps you in detecting and spotting fraudulent transactions. It is advisable to employ an independent person to perform the reconciliations for preventing the accounting employee from falsifying your books and reconciliations.
- Tracking Receivables: BRS allows you to confirm all your receipts, assisting you to avoid awkward situations and also identifying entries for receipts that you didn’t deposit.

Tips to ensure efficient BRS

1. Firstly, it's essential to have all the required documentation and information in hand. That means, if all the required documentation and information are at your disposal you get a better view of things.
2. Avoiding common errors, such as:

- An error relating to duplication of entries.
- Not accounting for a transaction that would cause a difference equal to the missed amount
- Errors while entering commas and dots, which cause discrepancies that could be of significant value. For instance, instead of entering INR 2,401.30, entering INR 240.13.
- Transposition errors while entering figures in the books. For instance, instead of entering INR 221,200, entering INR 212,200.

3. Banks can make mistakes too: It is possible that your bank might have committed a mistake. They might debit incorrect amounts from your account or credit deposits that don't belong to you. For this reason, in case you find errors for which you don't find any explanations, or for which you're in doubt, the best thing is to consult your bank.

4. Reconciling items: Listing differences and reconciling them and then forgetting it is possible. In case differences keep on accumulating with no action taken, your bank reconciliation would become meaningless. It is needed that a constant check is kept on the reconciled transactions so that they are reflected in the right way in the bank column of the cash book and in the bank statement.

Bank Reconciliation Example – 1

Markson's & Co. has a balance as per pass book of $1,000 as on 31st March 2019. It has a balance as per Cash Book as on 31st March 2019 of $1050. Further details are as follows:

- A cheque of $300 was deposited, but not collected by the bank.
- Bank charges of $50 were recorded in Passbook, but not in Cash Book.
- Cheques worth $200 were issued, but not presented for payment.
- Bank interest of $100 was recorded in Passbook, but not in Cash Book.

Solution:

Bank Reconciliation Statement of Markson's & Co. as on 31st March 2019

Profit and loss Appropriation A/C for the year ended 31.12.2009

Particulars	Amount (Rs)	Amount (Rs)	Particulars	Amount (Rs)	Amount (Rs)
To New reserves		**10000**	By balance b/d		**55000**
To dividend proposed		**12000**	By p/L A/c		**9350**
To balance c/d		**42350**			
		64350			**64350**
			By balance b/d		**42350**

Bank Reconciliation Example – 2

Wright Inc. has a balance in a Passbook of $10,000 as on 31st December 2018. These are the other details:

1. Three cheques of $2,000, $1,500 and $2,500 were deposited in the bank on 30th December 2018 but were recorded in the bank statement in January 2019.
2. Cheque of $500 issued on 31st December 2018 was not presented for payment.
3. A dividend of $1,000 on stocks was credited in the Bank Account, but not recorded in the Cash Book.
4. A direct deposit of $400 was made in a Bank Account by a customer, which was not recorded in the Cash Book.
5. Bank charges of $100 were entered only in Bank Passbook
6. Balance as per Cash Book on 31st December 2018 was $14,200.

Solution:

Bank Reconciliation Statement of Wright Inc. as on 31st December 2018

Particulars	**Amount (in $)**	**Amount (in $)**
Balance as per Passbook		10,000
Add: Cheques deposited, but not collected by bank ($2,000+$1,500+$2,500)	6,000	
Bank charges recorded only in Bank Passbook	100	6,100
Less: Cheque issued, but not presented for payment	500	
Dividends collected by bank	1,000	
Direct deposit not recorded in Cash Book	400	(1,900)
Balance as per Cash Book		**14,200**

Unit 2 Final Account

Final Accounts Meaning

Final accounts are those accounts that are prepared by a joint stock company at the end of a fiscal year. The purpose of creating final accounts is to provide a clear picture of the financial position of the organisation to its management, owners, or any other users of such accounting information.

Final account preparation involves preparing a set of accounts and statements at the end of an accounting year. The final account consists of the following accounts:

1. Trading and Profit and Loss Account
2. Balance Sheet
3. Profit and Loss Appropriation account

Objectives of Final Account preparation

Final accounts are prepared with the following objectives:

1. To determine profit or loss incurred by a company in a given financial period
2. To determine the financial position of the company
3. To act as a source of information to convey the users of accounting information (owners, creditors, investors and other stakeholders) about the solvency of the company.

Steps in the Process of Finalization of Accounts

A. For Trading Concerns:

1. Trading Account.

2. Profit and Loss Account.

3. Balance Sheet.

B. For Manufacturing and Trading Concerns:

1. Manufacturing Account.

2. Trading Account.

3. Profit and Loss Account.

4. Balance Sheet.

Preparation of Financial Statements

Profitability Statement – This statement is related to a complete accounting period. It shows the outcome of business activities during that period in a summarized form. The activities of any business will include purchase, manufacture, and sell.

Balance Sheet – Business needs some resources which have longer life (say more than a year).

Such resources are, therefore, not related to any particular accounting period, but are to be used over the useful life thereof. The resources do not come free. One requires finance to acquire them. This funding is provided by owners through their investment, bank & other through loans, suppliers by way of credit terms. The Balance Sheet shows the list of resources and the funding of the resources i.e. assets and liabilities (towards owners and outsiders). It is also referred to as sources of funds (i.e. liabilities & capital) and application of funds (i.e. assets). Let us discuss these statements in depth.

Trading Account: It is an account which is prepared by a merchandising concern which purchases goods and sells the same during a particular period. The purpose of it is to find out the gross profit or gross loss which is an important indicator of business efficiency.

The following items will appear in the debit side of the Trading Account:

(i) Opening Stock: In case of trading concern, the opening stock means the finished goods only. The amount of opening stock should be taken from Trial Balance.

(ii) Purchases: The amount of purchases made during the year. Purchases include cash as well as credit purchase. The deductions can be made from purchases, such as, purchase return, goods withdrawn by the proprietor, goods distributed as free samples etc.

(iii) Direct expenses: it means all those expenses which are incurred from the time of purchases to making the goods in suitable condition. This expenses includes freight inward, octroi, wages etc.

(iv) Gross profit: If the credit side of trading A/c is greater than the debit side of trading A/c gross profit will arise.

The following items will appear in the credit side of Trading Account:

(i) Sales Revenue: The sales revenue denotes income earned from the main business activity or activities. The income is earned when goods or services are sold to customers. If there is any return, it should be deducted from the sales value. As per the accrual concept, income should be recognized as soon as it is accrued and not necessarily only when the cash is paid for. The Accounting standard 7 (in case of contracting business) and Accounting standard 9 (in other cases) define the guidelines for revenue recognition. The essence of the provisions of both standards is that revenue should be recognized only when significant risks and rewards (vaguely referred to as ownership in goods) are transferred to the customer. For example, if an invoice is made for sale of goods and the term of sale is door delivery; then sale can be recognized only on getting the proof of delivery of goods at the door of the customer. If such proof is pending at the end of the accounting period, then this transaction cannot be taken as sales, but will be treated as unearned income.

(ii) Closing Stocks: In case of trading business, there will be closing stocks of finished goods only. According to the convention of conservatism, stock is valued at cost or net realizable value whichever is lower.

(iii) Gross Loss: When the debit side of the trading account is greater than the credit side of the trading account, gross loss will appear.

Profit and Loss Account:

The following items will appear in the debit side of the Profit & Loss A/c:

(i) Cost of Sales: This term refers to the cost of goods sold. The goods could be manufactured and sold or can be directly identified with goods.

(ii) Other Expenses: All expenses which are not directly related to main business activity will be reflected in the P & L component. These are mainly the Administrative, Selling and distribution expenses. Examples are salary to office staff, salesmen commission, insurance, legal charges, audit fees, advertising, free samples, bad debts etc. It will also include items like loss on sale of fixed assets, interest and provisions.

(iii) Abnormal Losses: All abnormal losses are charged against Profit & Loss Account. It includes stock destroyed by fire, goods lost in transit etc.

The following items will appear in the credit side of Profit & Loss A/c:

(i) Revenue Incomes: These incomes arise in the ordinary course of business, which includes commission received, discount received etc.

(ii) Other Incomes: The business will generate incomes other than from its main activity. These are purely incidental. It will include items like interest received, dividend received, etc The end result of one component of the P & L A/c is transferred over to the next component and the net result will be transferred to the balance sheet as addition in owners' equity. The profits actually belong to the owners of the business. In case of company organizations, where ownership is widely distributed, the profit figure is separately shown in the balance sheet.

Balance Sheet: Horizontal format of Balance Sheet is also used by the business other than company

A. Liabilities

(a) Capital: This indicates the initial amount the owner or owners of the business contributed. This contribution could be at the time of starting business or even at a later stage to satisfy requirements

of funds for expansion, diversification etc. As per business entity concept, owners and business are distinct entities, and thus, any contribution by owners by way of capital is liability.

(b) Reserves and Surplus: The business is a going concern and will keep making profit or loss year by year. The accumulation of these profit or loss figures (called as surpluses) will keep on increasing or decreasing owners' equity. In case of non-corporate forms of business, the profits or losses are added to the capital A/c and not shown separately in the balance sheet of the business.

(c) Long Term or Non-Current Liabilities: These are obligations which are to be settled over a longer period of time say 5-10 years. These funds are raised by way of loans from banks and financial institutions. Such borrowed funds are to be repaid in installments during the tenure of the loan as agreed. Such funds are usually raised to meet financial requirements to procure fixed assets. These funds should not (d) Short Term or Current Liabilities: A liability shall be classified as Current when it satisfies any of the following :

• It is expected to be settled in the organisation's normal Operating Cycle,

• It is held primarily for the purpose of being traded,

• It is due to be settled within 12 months after the Reporting Date, or

• The organization does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date (Terms of a Liability that could, at the option of the counterparty, result in its settlement by the issue of Equity Instruments do not affect its classification)

Current liabilities comprise of :

(i) Sundry Creditors - Amounts payable to suppliers against purchase of goods. This is usually settled within 30-180 days.

(ii) Advances from customers – At times customers may pay advance i.e. before they get delivery of goods. Till the business supplies goods to them, it has an obligation to pay back the advance in case of failure to supply. Hence, such advances are treated as liability till the time they get converted to sales.

(iii) Outstanding Expenses: These represent services procured but not paid for. These are usually settled within 30–60 days e.g. phone bill of Sept is normally paid in Oct.

(iv) Bills Payable: There are times when suppliers do not give clean credit. They supply goods against a promissory note to be signed as a promise to pay after or on a particular date. These are called bills payable or notes payable.

(v) Bank Overdrafts: Banks may give fund facilities like overdraft whereby business is permitted to issue cheques up to a certain limit. The bank will honour these cheques and will recover this money from business. This is a short term obligation.

B. Assets

In accounting language, all debit balances in personal and real accounts are called assets. Assets are broadly classified into fixed assets and current assets.

(a) Fixed Assets: These represent the facilities or resources owned by the business for a longer period of time. The basic purpose of these resources is not to buy and sell them, but to use for future earnings. The benefit from use of these assets is spread over a very long period. The fixed assets could be in tangible form such as buildings, machinery, vehicles, computers etc, whereas some could be in intangible form viz. patents, trademarks, goodwill etc. The fixed assets are subject to wear and tear which is called depreciation. In the balance sheet, fixed assets are always shown as "original cost less depreciation".

(b) Investments: These are funds invested outside the business on a temporary basis. At times, when the business has surplus funds, and they are not immediately required for business purposes, it is prudent to invest it outside business e.g. in mutual funds or fixed deposits. The purpose is to earn a reasonable return on this money instead of keeping them idle. These are assets shown separately in the balance sheet. Investments can be classified into Current Investments and Non-current Investments. On-current Investments are investments which are restricted beyond the current period as to sale or disposal.

Whereas, current investments are investments that are by their nature readily realizable and are intended to be held for not more than one year from the date on which such investment is made.

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

• It is expected to be realised in, or is intended for sale or consumption in the organisation's normal Operating Cycle,

• It is held primarily for the purpose of being traded,

• It is due to be realised within 12 months after the Reporting Date, or

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

Current assets comprise of:

(i) Stocks: This includes stock of raw material, semi-finished goods or WIP, and finished goods. Stocks are shown at lesser of the cost or market price. Provision for obsolescence, if any, is also reduced. Generally, stocks are physically counted and compared with book stocks to ensure that there are no discrepancies. In case of discrepancies, the same are adjusted to P & L A/c and stock figures are shown as net of this adjustment.

(ii) Debtors: They represent customer balances which are not paid. The bad debts or a provision for bad debt is reduced from debtors and the net figure is shown in the balance sheet.

(iii) Bills receivables: Credit to customers may be given based on a bill to be signed by them payable to the business at an agreed date in future. At the end of the accounting period, the bills accepted but not yet paid are shown as bills receivables.

(iv) Cash in Hand: This represents cash actually held by the business on the balance sheet date. This cash may be held at various offices, locations or sites from where the business activity is carried out. Cash at all locations is physically counted and verified with the book balance. Discrepancies if any are adjusted.

(v) Cash at Bank: Dealing through banks is quite common. Funds held as balances with banks are also treated as current assets, as it is to be applied for paying to suppliers. The balance at the bank as per books of accounts is always reconciled with the balance as per bank statement, the reasons for differences are identified and required entries are passed.

(vi) Prepaid Expenses: They represent payments made against which services are expected to be received in a very short period.

(vii) Advances to suppliers: When amounts are paid to suppliers in advance and goods or services are not received till the balance sheet date, they are to be shown as current assets.

This is because advances paid are like the right to claim the business. Please note that both current assets and current liabilities are used in day-to-day business activities. The current assets minus current liabilities are called working capital or net current assets. The following report is the usual horizontal form of the balance sheet. Please note that the assets are normally shown in descending order of their liquidity. Also, capital, long term liabilities and short term liabilities are shown in that order

The format of a final account is represented as follows:

Q. Following is the Trial Balance of Rajesh Ltd., Gurgaon as on 31.12.2009.

Particulars	Debit (Rs)	Credit(Rs)
Share capital		80000
(8000 shares of Rs. 10/- each)		
Stock on 1.1.2009	51000	—
Purchases and sales	220000	330000
Returns	3800	—
General Expenses	1800	—
Wages	12000	—
Salaries	18700	—
Travelling Expenses	3200	—
Advertisement	1550	—
Rent and Taxes	4900	—
Discount Received	—	2200
Bank Interest	850	—
Bad Debts	2500	—
Buildings	95000	—
Plant and machinery	98000	—
Sundry Debtors and Creditors	45000	55500
Loan	—	25000
Cash	1400	—
Reserve Fund	—	23000
Preliminary Expenses	11000	—
Profit and Loss Account (Cr.)	—	55000
	570700	570700

Adjustments:

1. Transfer Rs. 10000 to Reserve Fund.
2. Provide depreciation on buildings at 5%.
3. Stock on 31.12.2009 was valued at Rs. 12000.
4. Dividend at 15% on share capital is provided.
5. Depreciation on Plant and Machinery at 10%.

Prepare Trading, Profit and Loss Account, Profit and Loss Appropriation Account and Balance Sheet in the prescribed form.

Solution:

The solution will be as follows:

Trading and Profit and Loss Account for the year ended 31.12.2009

Particulars	Amount (Rs)	Amount (Rs)	Particulars	Amount (Rs)	Amount (Rs)
To opening stock		51000	By sales	330000	
To Purchases	220000		Less: Returns	3800	
To Less: Returns	__	220000			326200
			By Closing stock		12000
To Wages		12000			
To Gross profit c/d		55200			
		338200			338200
To salaries		18700	By trading A/C		55200
To general expenses		1800	Gross profit b/d		
To travelli8ng expenses		3200	To discount received		2200
To advertisement		1550			
To rent and taxes		4900			
To bank interest		850			
To bad debts		2500			
To depreciation on plant and machinery		9800			
To depreciation on building		4750			
To net profit c/d		9350			
		57400			57400

Profit and loss Appropriation A/C for the year ended 31.12.2009

Particulars	Amount (Rs)	Amount (Rs)	Particulars	Amount (Rs)	Amount (Rs)
To New reserves		**10000**	By balance b/d		**55000**
To dividend proposed		**12000**	By p/L A/c		**9350**
To balance c/d		**42350**			
		64350			**64350**
			By balance b/d		**42350**

Balance sheet for the year ended 31.12.2009

Liabilities	Amount	Amount	Assets	Amount	Amount
Share capital			Fixed assets		
Authorized capital		—	Buildings	95000	
Issued and subscribed			Less depreciation	4750	
capital					90250
Called up and paid up capital (8000 share of Rs.10/- each)	80000		Plant and machinery	98000	
			Less depreciation	9800	
Less calls in arrears					
		80000			88200
Reserves and surplus			Investments		—
Reserve fund	23000		Current assets and loans advances		
Add: New reserve	10000				12000
		33000	Closing stock		45000
		42350	Sundry debtors		1400
P/L appropriation A/c (surplus)		—	Cash		
Secured loans		25000	Miscellaneous expenses and losses		
Unsecured loans			Preliminary expenses		11000
Current liabilities and provisions					
Current liabilities					
Sundry creditors		55500			
Provisions					
Proposed dividend		12000			
		57400			57400

What is a Trading Account?

In the income statement, using the trading account you can analyze the gross result, i.e. profit (loss) for the period. You can easily open a trading account online in a few steps.

Scrutinize the results of trading activities to determine the profit earned, or loss suffered on any trading transaction.

The trading account is distributed in two parts mainly debit and credit. The debit part indicates direct expenses and the credit part is direct incomes. The direct expenses include costs spent by the organization, the expenses include fuel, power, freight, insurance, carriage inward, consumption of stores, etc. Whereas direct incomes include costs earned from activities after the sale of goods.

What is a Profit & Loss Account?

With a profit and loss account you can get a financial statement you can analyze operating and non-operating revenues and expenses incurred, during an accounting period. You can learn about profit earned or loss sustained by the business.

After the trading account, the profit and loss accounts are created using the trial balance. This balance of the trading account is transferred to the profit and loss account. With this balance, further expenses and losses are debited while profits and gains are credited to the account.

ONE can analyze gains and expenses to calculate net profit and loss. When debit exceeds credit, it is a net loss and when the credit exceeds debit it is considered as profit.

Difference between trading account and profit and loss account

The following table showcases a comparison between a trading account and a Profit & loss account.

Trading Account	Profit & Loss Account

The trading account gives information related to trading activities	In Profit and Loss account you can determine the profit made by your business and loss sustained by the same
You can calculate gross profit and loss for the period	You can calculate net profit and loss for a given period
The Trading account balance is transferred to the profit and loss account	The Profit and Loss account balance is transferred to capital account in the balance sheet
You can get a summary of all direct revenue and direct expenses.	Profit & Loss account gives summary of all operating and non-operating incomes and expenses.
It is prepared before Profit & Loss account	Profit & Loss account is prepared after the trading account
The trading account is independent of the trial balance as it is the final statement	Profit and Loss account is dependent on the trading account
All the expenses related to goods sold, sales and other direct expenses are accounted for in the trading account.	In Profit and Loss account all the indirect expenses such as administrative cost, selling costs are accounted against gross profit and other incomes generated
With a trading account, you can discover various possible activities to increase profitability. You can compare trading accounts of consecutive periods to identify these steps.	With a Profit and Loss account you can determine steps to be taken for betterment of the overall business. You can compare net results of consecutive periods to identify these steps.
Records receipts and payments done in cash and cheques only	Records incomes and gains related to the current year only
The trading account balance indicates cash in hands or cash at the bank	The profit and loss account balance indicates surplus or deficit

It does not start with balance of any account	It always starts with the balance of trading account
Formula: Gross profit % = Gross profit / Net sales	Formula: Net profit = Gross profit – Expenses + Other income

This way with the help of trading and profit and loss accounts the business can calculate the gross and net profit of the business and further utilize it to expand the business.

Frequently Asked Questions on Final Account

What are the components of final accounts?

The components of final accounts are :

1. Trading account
2. Profit and loss account
3. Profit and loss appropriation account

For manufacturing companies, a manufacturing account is prepared in addition to all the other accounts.

How many types of final accounts are there?

There are generally three types of final accounts and they are:

1. Trading account
2. Profit and loss account
3. Balance sheet

What are the different stages of the final account of the company?

Different stages of final account of a company are:

1. Prepare trial balance
2. Adjusting the trial balance
3. Preparing adjusted trial balance

4. Prepare financial statements
5. Closing the books

How do you calculate final accounts?

Final accounts can be calculated as follows:

1. Make a list of trial balance items and adjustments
2. Record debit items on expense side of P and L account or assets side in balance sheet
3. Record credit items on the income side of trading P and L account or liabilities side of the balance sheet.
4. Balance the profit and loss account and determine profit or loss from the trial balance
5. Add any profit obtained to the capital on the liabilities side of the balance sheet.
6. Make a total of the balance sheet.

Give an example of the final account?

Profit and loss account is an example of a final account.

FINANCIAL STATEMENTS (WITH ADJUSTMENTS)

Trading A/c, Profit & Loss A/c and Balance Sheet.These financial statements are prepared with the help of a given Trial Balance. It is possible that the expenses given in the Trial Balance may not be the total expenses for that accounting year for which trial balance has been prepared. Similarly a portion or part of the expenses given in the Trial Balance may relate to future year(s).

If Financial Statements are prepared with the help of such a Trial balance, they will not present a correct picture of the business. The income statement will not show correct net profit or net loss. Similarly the Balance sheet will not show the correct financial picture of the business.

So, before preparing the financial statement, it is necessary to find out the items of expenses which relate to the current year but have not been paid. Similarly it is necessary to find out the items of expenses which relate to the future year but have been paid or received during the current year.

Therefore, it becomes necessary to make some 'adjustments' in respect of some items of expense and income. These are called accounting adjustments.

NEED FOR ACCOUNTING ADJUSTMENTS

Accounting adjustments are required because of the following purposes:

i) To know the correct net profit or net loss of the business for an accounting year.
ii) To know the correct financial position of the business.
iii) To record the expenses which have become due but have not been paid
iv) To record the expenses which have been paid in advance for future year(s)
v) To provide for depreciation on fixed assets.

TYPES OF ADJUSTMENTS

The number and nature of adjustments will differ from business to business.

i) Closing Stock
ii) Outstanding Expenses
iii) Prepaid Expenses
iv) Depreciation on Fixed assets

i) Closing Stock

Closing stock is the stock of goods which remains unsold at the end of the accounting year. This item is, normally, not shown inside the Trial balance. It appears outside the trial balance as additional information. For example the books of Mr. X showed the value of closing stock as on 31.3.2012 `30,000. The accounting treatment of closing stock in the financial statements of Mr. X., will be as follows:

(a) The following adjustment entry will be passed at the end of the year:

31.3.2012	Closing Stock A/c Dr. To Trading A/c (For Closing stock transferred to Trading A/c)	30,000	30,000

(b) Trading A/c of Mr. X for the year ending 31.3.2012

Dr. Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
		By Closing Stock	30,000

(c) **Balance Sheet of Mr. X as on 31.3.2012**

Liabilities	Amount (₹)	Assets	Amount (₹)
		Closing Stock	30,000

Note : If Closing stock is given inside the Trial balance, the above mentioned adjustment entry will not be passed and the closing stock will not be shown on the credit side of Trading A/c. The closing stock will be shown on the assets side of Balance Sheet only.

ii) Outstanding Expenses

An expense which relates to the current year but has not been paid till the end of the accounting year is known as outstanding expenses such as Factory rent, Wages, Salaries, Office rent, Telephone charges etc. for current year may not have been paid till the end of the accounting year, for example the books of accounts of Mr. X showed that, Wages paid during the year 2011-2012 ` 45,000. Wages outstanding for the year 2011-2012 ` 5,000.

The accounting treatment of wages outstanding in the books of Mr.X will be as follows:

(a) The adjustment entry will be:

31.3.2012	Wages A/c Dr. Wages outstanding A/c (For wages outstanding for the year 2011-12)	5,000	5,000

(b) **Trading A/c of Mr. X for the year ending 31.3.2012**

Dr. Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
Wages : 45,000 (+) Wages O/S : 5,000	50,000		

(c) **Balance Sheet of Mr. X as on 31-3-2012**

Liabilities	Amount (₹)	Assets	Amount (₹)
Wages Outstanding	5,000		

Let us take another example, regarding outstanding salary which affects the net profit.

Example: The books of accounts of Mr.X showed the following: Salaries for the year 2011-12 already paid during the year ` 1,00,000. Salaries for 2011-12 due but not paid till 31-3-12 ` 10,000. Its accounting treatment in the books of Mr.X will be as follows

(a) Adjustment entry will be as under:

31.3.2012	Salaries A/c Dr. To Salaries outstanding A/c (For salary outstanding for the year 2011-12)	10,000	10,000

(b)

Profit & Loss A/c for Mr.X
For the year ending 31-3-2012

Particulars	Amount (₹)	Particulars	Amount (₹)
To Salaries : 1,00,000 (+) Salaries O/S : 10,000	1,10,000		

(c)

Balance Sheet
as on 31-3-2012

Liabilities	Amount (₹)	Assets	Amount (₹)
SalariesOutstanding	10,000		

iii) Prepaid Expenses

Sometimes, a part of the expenses given in the trial balance may relate to future year(s). Such part of expenses is known as 'Prepaid Expenses' or 'Expense paid in Advance' such as, out of the salaries paid during the current year, a part may relate to next accounting year. Similarly factory rent, wages, office rent, insurance premium, taxes, etc. may be prepaid in some cases. For example the books of accounts of Mr.X showed the following:

Total salaries paid during the accounting year 2011-2012 ` 2,00,000 out of which ` 25,000 relates to the next accounting year, i.e, 2012-13. The

accounting treatment, of prepaid salaries in the books of Mr. X will be as follows:

(a) Adjustment entry for prepaid salaries will be as under:

31.3.2012	Prepaid Salaries A/c Dr. To Salaries A/c (For salaries paid in advance for next year 2012-13)	25,000	25,000

(b)

Profit & Loss A/c for Mr.X
for the year ending31-3-2012

Particulars	Amount (₹)	Particulars	Amount (₹)
To Salaries : 2,00,000 (-)Prepaid Salaries : 25,000	1,75,000		

(c)

Balance Sheet of Mr.X
as on 31-3-2012

Liabilities	Amount (₹)	Assets	Amount (₹)
		Prepaid Salaries	25,000

iv) Depreciation on Fixed Assets

The value of fixed assets such as Plant and Machinery, Building, Furniture, Computers, Motor Vehicles, etc. goes on decreasing or reducing every year due to their use, wear and tear. This decrease in the value of assets is called depreciation. Depreciation is an expense like any other expense of the business. Depreciation on various fixed assets is shown on the debit side of P&L A/c. The amount of depreciation on fixed assets is deducted from the concerned or related asset on the asset side of the Balance Sheet. For example the books of accounts of Mr. X showed the following:

The value of Plant and Machinery is 5,00,000 as on 31-3-2012 and value of Furniture is 50,000 as on 31-3-2012. Depreciation is to be charged on these assets

@10% p.a. The accounting treatment of depreciation in the financial statements of Mr. X, will be as follows :

(a) Entry for charging depreciation will be as under:

31-3-2012	Depreciation A/c Dr. To Plant&Machinery A/c To Furniture A/c (For depreciation charged on Plant and Machinery and Furniture @10% for one year)	55,000	 50,000 5,000

(b) **Profit & Loss A/c for Mr. X for the year ending 31-3-2012**

Dr. Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Depreciation on Plant & Machinery Furniture	 50,000 5,000		

(c) **Balance Sheet of Mr.X as on 31-3-2012**

Liabilities	Amount (₹)	Assets		Amount (₹)
		Plant & Machinery	5,00,000	
		(-) Dep.	50,000	4,50,000
		Furniture	50,000	
		(-) Dep.	5,000	45,000

Important key points to remember

Necessary adjustments are required at the time of preparation of financial statements in order to ascertain the correct profit and financial position of the business.

• Closing stock is the stock of goods which remains unsold at the end of an accounting year. Adjustment is done in Trading Account and Balance Sheet.

• Outstanding Expenses refer to the expenses relating to the current year but which have not been paid during the current year. Adjustments are done in Trading Account, Profit and Loss Account and Balance Sheet.

• Prepaid Expenses or expenses paid in advance refer to those expenses which relate to the future year. Adjustments are done in trading accounts, profit & loss accounts and balance sheets.

• Depreciation on fixed Assets refers to Decrease in the value of fixed assets due to their use, wear and tear. Adjustment is done in profit and loss accounts and balance sheets.

Fill in the blanks

i. Closing stock is shown on the ..... side of the Balance sheet.
ii. Outstanding Expenses are shown on the ..... side of the Balance Sheet.
iii. Prepaid expenses are shown on the ..... side of the Balance sheet.
iv. Depreciation is shown on the..... side of profit and loss A/c.
v. Closing stock is shown on the asset side of.....
vi. The decrease in the value of fixed assets due to their use is called.....
vii. Adjustments are made to know the correct.....of a business.
viii. Outstanding wages shown on the..... of the .....
ix. Outstanding office Rent will be shown on the.....side of.....and ..... side of Balance sheet.
x. Profit and Loss A/c is prepared to know .....of an accounting year

(i) asset(ii) Liability (iii) Asset (iv) Debit (v) Balance Sheet (vi) Depreciation (vii) Financial position (viii) Liability side, Balance Sheet (ix) Debit side Trading A/c, Liability (x) Profit or Losses

Final Accounts

- **Final accounts** include income statements (trading and profit and loss account) as well as balance sheets.
- **Income statement** shows the profits earned during a year. Profits are the difference between incomes and expenses. In the Indian context of a sole trader, profits may be gross profit or net profit.
- **Gross profit** is the difference between sales and expenses directly incurred to make these sales: Cost of Goods sold.
- **Cost of Goods sold**= Opening stock of finished goods Purchases +Direct expenses (wages, carriage inward, etc.) –Closing stock
- **Net profits**= Gross profit –Indirect expenses + indirect incomes
- **Balance sheet** is the portrait of the financial position of a business at an instance of time. It shows Assets, Liabilities and Capital.
- Here students shall apply the concept of Realization, Matching Concept, Conservatism, etc. to arrive at profits.
- Now students should revise the concept of accounting equation
  Assets=Liabilities +Capital
  When there is profits during year, that profit comes in the form of cash or debtors (sales of credit), then accounting equation shall become:

Assets + Δ Assets = Liabilities +Capital +Profits

Profits is the difference between Income and expenses

Therefore:

Assets + Δ Assets = Liabilities +Capital + Income – Expenses
Assets (with greater amount)= Liabilities + Capital + Income- Expenses
Assets + Expenses = Liabilities + Capital + Income

Rules of Debiting and Crediting
Increase in Left hand side debited
Decrease in Left hand side credited
Income in Right hand side credited
Decrease in Right hand side debited

Trading and Profit and Loss A/c
For the year ended ……..

Particular	**Amount**	**Particulars**	**Amount**
To Opening Stock To Purchases less returns To wages To carriage inward To import duties To Octroi To Gross Profits C/d		By Sales less returns By closing stock	
(Indirect Expenses) To Depreciation To Carriage outward To Financial Expenses To selling and distribution expenses To administrative Expenses To net profits c/d		By Gross Profits B/d	

Balance Sheet of ……..
As on ……..

Liabilities	**Assets**
Current Liabilities	**Current Assets**
Creditors	Cash
Bills Payable	Bank
Outstanding expenses	Debtors
Capital	B/R
Opening Capital	Closing Stock
Add: Net profits	Prepaid Expenses
Less: Drawings	**Fixed Assets**
	Loose tools
	Vehicles
	Plant and Machinery
	Land and Building

It can be in following order:

Balance Sheet of ……..
As on ……..

Liabilities	**Assets**
Capital	**Fixed Assets**
Opening Capital	Land and Building
Add: Net profits	Plant and Machinery
Less: Drawings	Vehicles
Current Liabilities	Loose tools

Creditors Bills Payable Outstanding expenses	**Current Assets** Cash Bank Debtors B/R Closing Stock Prepaid Expenses

Balance Sheet of ……..
As on ……..

Liabilities	**Assets**
Capital Opening Capital Add: Net profits Less: Drawings	**Fixed Assets** Land and Building Plant and Machinery Vehicles Loose tools **Working Capital** **Current Assets** **Less: Current Liabilities**

Where these items be stated:

Productive Wages Factory rent and taxes Factory lighting Factory heating Motive power Director' fees Factory cleaning Sundry office expenses Office stationery Loose tools written off Bank changes Commission on sales Income Tax (Drawings) Creditors Salary of staff Life Insurance (Drawings) Loan from Bank		Rent and taxes(office) Water supply(works) Factory insurance Office insurance Legal expenses Rent of warehouse Bad debts Advertising Sales department's salaries Upkeep of delivery vans Cash Bank Debtors Bills Receivables Opening Stock Purchases Capital	

Answers

Productive Wages	Trading	Rent and taxes(office)	P&L
Factory rent and taxes	Trading	Water supply(works)	Trading
Factory lighting	Trading	Factory insurance	Trading
Factory heating	Trading	Office insurance	P &L
Motive power	Trading	Legal expenses	P & L
Director' fees	P&L	Rent of warehouse	P &L
Factory cleaning	Trading	Bad debts	P & L
Sundry office expenses	P&L	Advertising	P&L
Office stationery	P & L	Sales department's salaries	P &L
Loose tools	Assets	Upkeep of delivery vans	P &L
Bank changes	P & L	Cash	Assets
Commission on sales	P & L	Bank	Assets
Income Tax (Drawings)	-capital	Debtors	Assets
Creditors	Liabilities	Bills Receivables	Assets
Salary of staff	P &L	Opening Stock	Trading
Life Insurance (Drawings)	-capital	Purchases	Trading
Loan from Bank	Liabilities	Capital	Liabilities

There are certain adjustments which need to be incorporated

- Closing stock: Unexpired Cost
- Outstanding expenses: expenses still payable
- Accrued Income: Income earned but not received
- Prepaid Expenses: expenses paid in advance
- Income received in advance
- Depreciation
- Bad debts
- Provision for Bad debts
- Provision for anticipated losses

Item	Accounting Entry	Reasons	Effect on Final accounts
Closing stock	Closing Stock A/c Dr. To Trading account	Closing stock is unexpired cost of assets There should be decrease in expenses	Closing stock as assets in B/S Closing stock credited in Trading account
Outstanding Expenses	Particular expenses Dr. To Outstanding exp.	Increase in expenses Increase in Liabilities	Add in particular expenses Show as Liabilities
Accrued Income	Accrued Income Dr. To Income	Increase in assets Increase in Income	Shown as Assets Added in Income
Prepaid Expenses	Prepaid Expenses Dr. To Expenses A/c	Increase in assets Decrease in expenses	Show as assets Less from expenses

Income received in advance	Income A/c Dr. To income received in advance	Decrease in Income Increase in Liabilities	Less from Income Show as Liabilities
Depreciation	Depreciation A/c Dr. To Particular Assets	Increase in Expenses Decrease in assets	Show as expenses Less from assets
Bad Debts	Bad Debts a/c Dr. To Debtors A/c	Increase in expenses Decrease in debtors	Show as expenses Less from debtors
Provision for Bad debts	Profit and Loss A/c To Provision for B/d	Increase in expenses Increase in liabilities	Show as expenses Less from assets
Provision for contingencies	Profit and Loss A/c Dr. To Provision for contingencies /tax	Increase in expenses Increase in liabilities	Show as expenses Show as liabilities

Regarding accounting cycle:
First transactions are recorded in Journal or Subsidiary Books
Second transactions are classified into ledger into different accounts
Accounts are balanced and trial balance is prepared
There are certain events that have been left and need to be recorded after end of accounting period, these are called adjustments
Then Final accounts are prepared

Question 1: The following balances of accounts were found as on March 31, 2021. You are required to prepare final accounts:

Particulars	Amount	Particulars	Amount
Opening stock	10,000	Capital	2,00,000
Purchases	2,05,00	Sales	4,00,000
Wages (*)	0	Purchase return	5,000
Salaries	20,000	Dividend received	10,000
Carriage inward	12,000	Loan from bank (10%)*	1,00,000
Bad debts	8,000	Discount received	5,000
Discount allowed	5,000	Creditors	1,30,000
Director' fees	6,000	Bills Payable	30,000
Sundry office expenses	4,000		
Office stationery	6,000		
Loose tools (*)	4,000		
Bank charges	60,000		
Commission on sales	4,000		
	6,000		
Land and Building	1,00,00		
Plant and Machinery (*)	0		

Vehicles	2,00,00		
Cash	0		
Bank	60,000		
Debtors	30,000		
Rent *	40,000		**8,80,000**
	60,000		
	40,000		
	8,80,00		
	0		

Following adjustments are required to be made:

a. Closing stock Rs. 20,000
b. Depreciate Plant and Machinery by 10%, vehicle by 20%, loose tools by 25%
c. Outstanding wages are Rs. 10,000
d. Prepaid rent Rs. 5,000
e. Interest on Bank loan is payable Rs. 10,000

Trading and Profit and Loss A/c
For the year ended March 31, 2021

Particulars	Amount	Particulars	Amount
To Opening stock	10,000	By Sales	4,00,000
To Purchases 2,05,000		By Closing Stock	20,000
Less: Returns (5,000)	2,00,000		
To Wages 20,000			
Add: Outstanding 10,000	30,000		
To Carriage inward	8,000		
To Gross Profit C/d	1,72,000		
	4,20,000		**4,20,000**
To Salaries	12,000		
To Bad debts	5,000	By Gross Profits B/d	1,72,000
To Discount allowed	6,000	By Dividend received	10,000
To Director' fees	4,000	By Discount received	5,000
To Sundry office expenses	6,000		
To Office stationery	4,000		
To Bank charges	4,000		
To Commission on sales	6,000		
To Depreciation:			
a. Loose tools	15,000		
b. Plant	20,000		
c. Vehicle	12,000		
	10,000		
To Interest on Loan			
To Rent 40,000	35,000		
Less: Prepaid Rent (5,000)	48,000		

To Net Profits C/d	1,87,000		**1,87,000**

Balance Sheet
As On March 31, 2021

Liabilities	Amount	Assets	Amount
Current Liabilities		**Current Assets**	
Creditors	1,30,000	Cash	30,000
Bills Payable	30,000	Bank	40,000
Outstanding wages	10,000	Debtors	60,000
Bank Loan 1,00,000	1,10,000	Closing Stock	20,000
Add: Interest 10,000		Prepaid Expenses	5,000
Capital		**Fixed Assets**	
Opening Capital 2,00,000		Loose tools 60,000-15,000	45,000
Add: Net profits 48,000	2,48,000	Vehicles 60,000-12,000	48,000
		Plant and Machinery 2,00,000-20,000	1,80,000
		Land and Building	1,00,000
	5,28,000		5,28,000

Question 2: From the following, prepare final accounts of Mr. Ramesh for the year ended March 31, 2021. You are required to prepare final accounts.

Particulars	Amount	Particulars	Amount
Opening stock	40,000	Capital	2,00,000
Purchases	3,60,00	Sales	5,00,000
Wages (*)	0	Discount received	20,000
Salaries (*)	40,000	Creditors	1,50,000
Director' fees	50,000		
Sundry office expenses	5,000		
Office stationery	5,000		
Bank charges	14,000		
Commission on sales	6,000		
	20,000		
Land and Building	1,00,00		
Plant and Machinery (*)	0		
Cash	1,00,00		
Bank	0		
Debtors	60,000		
	30,000		**8,70,000**
	40,000		

	8,70,000		

Following adjustments are required to be made:

a. Closing stock Rs. 60,000
b. Depreciate Plant and Machinery by 10%,
c. Outstanding wages are Rs. 20,000
d. Prepaid salaries Rs. 10,000
e. Bad debts written off Rs. 6,000
f. Further provision for bad debts to be provided 5%.

Trading and Profit and Loss A/c
For the year ended March 31, 2021

Particulars	Amount	Particulars	Amount
To Opening stock	40,000	By Sales	5,00,000
To Purchases	3,60,000	By Closing Stock	60,000
To Wages 40,000			
Add: Outstanding 20,000	60,000		
To Gross Profit C/d	1,00,000		
	5,60,000		**5,60,000**
To Salaries 50,000			
Less: Prepaid: (10,000)	40,000	By Gross Profits B/d	1,00,000
To Director' fees	5,000	By Dividend received	20,000
To Sundry office expenses	5,000	By Discount received	
To Office stationery	14,000		
To Bank charges	6,000		
To Commission on sales	20,000		
To Depreciation:			
a. Land and Building	5,000		
b. Plant	10,000		
	6,000		
To Bad Debts	1,700		
To Provision for Bad debts 5% (40,000-6,000)	7,300		
To Net Profits C/d			
	1,20,000		**1,20,000**

Balance Sheet
As On …….

Liabilities	Amount	Assets	Amount
Current Liabilities		**Current Assets**	
Creditors	1,50,000	Cash	60,000
Outstanding wages	20,000	Bank	30,000
Capital		Debtors 40,000	
Opening Capital 2,00,000		Less : Bad debts (6,000)	

Add: Net profits 7,300	2,07,300	Less: Prov. For B/d (1,700) Closing Stock Prepaid Expenses **Fixed Assets** Plant and Machinery 1,00,000 Less: Depreciation (10,000) Land and Building 1,00,000 Less: Depreciation (5,000)	32,300 60,000 10,000 90,000 95,000
	3,77,300		3,77,300

Final accounts-2

Question 1 Following is the trial balance of X at 31st December, 2021 and it is desired to prepare final statement of accounts showing the results of the transactions for the year :-

	Debit (Rs.)	*Credit (Rs.)*
Capital account		4,000
Plant and machinery	5,000	
Office furniture & fittings	260	
Stock 1st January, 2009	4,800	
Motor vans	1,200	
Sundry debtors	4,570	
Cash in hand	40	
Cash at bank	650	
Wages—factory	15,000	
Wages—office	1,400	
Purchases	21,350	
Sales		48,000
Bills receivable	720	
Bills payable		560
Sundry creditors	5,200	
Returns inwards	930	
Provision for doubtful debts		250
Drawings	700	
Returns outwards		550
Rent	600	
Factory lighting and heating	80	
Telephone	35	
Insurance	30	
Advertising	565	
General expenses		100
Bad debts	250	
Discounts allowed		650
Discounts received		370
	58,930	58,930

The following adjustments are to be made :

1. Stock 31st December, 2021 Rs. 5,200.
2. Rent due but not paid upto 31st December, 2021 Rs. 200.
3. Three months factory lighting and heating due but not paid Rs. 30.
4. Insurance paid in advance Rs. 10.
5. 10% depreciation to be written off plant & machinery.
6. 5% depreciation to be written off furniture.

7. 25% depreciation to be written off motor vans.
8. Write off further bad debts Rs. 70.
9. The provision for doubtful debts to be increased to Rs. 300.
10. Discounts of 2.5% on debtors and creditors are to be anticipated.
11. Bills receivable Rs. 100, not yet due, were discounted on 31st December 2021

TRADING AND PROFIT & LOSS ACCOUNT OF MR. X
for the year ending 31st Dec. 2021

		`			`
To Opening stock		4,800	By Sales	48,000	
To Purchases	21,350		Less returns	930	47,070
Less returns	550	20,800			
To Factory wages		15,000	By Closing stock		5,200
To Factory lighting and heating	80				
Add Outstanding	30	110			
To Gross profit c/d		11,560			
		52,270			52,270
To Office wages		1,400	By Gross profit b/d		11,560
To Bad debts :-			By Discount received		370
w/ff during the year	250		By Provision for discount on creditors		130
Add w/off on 31-12-09	70				
new provision	300				
	620				
Less old provision	250	370			
To Rent :-Paid	600				
Add Outstanding	200	800			
To Telephone		35			
To Insurance :- paid	30				
Less prepaid	10	20			
To Advertising		565			
To General expenses		100			
To Discount allowed		650			
To Depreciation :-					
Plant & machinery	500				
Furniture	13				
Motor vans	300	813			
To Provision for discount on debtors		105			
To Net profit transferred to capital account		7,202			
		12,060			12,060

BALANCE SHEET OF MR. X
as at 31st December 2021

Liabilities		`	*Assets*			`
Sundry creditors	5,200		Cash in hand			40
Less provision for discount	130	5,070	Cash at bank			650
Bills payable		560	Sundry debtors :-		4,570	
Capital :-			Less :			
Opening balance	4,000		w/off on 31-12-86	70		
Add net profit	7,202		new provision	300		
	11,202		provision of discount on debtors	105	475	4,095

Less drawings	700	10,502	Closing stock		5,200
Outstanding expenses :-			Office furniture and fittings	260	
Rent	200		Less depreciation	13	247
Lighting & heating	30	230	Plant and machinery	5,000	
			Less depreciation	500	4,500
			Motor vans	1,200	900
			Less depreciation	300	
			Bills receivable		720
			Prepaid insurance		10
		16,362			16,362

Note. There is a contingent liability of Rs. 100 for bills not yet matured.

Question 2. On 31st March, 2021 the following trial balance was extracted from the books of Mr. A.

	Dr. `		*Cr. `*
Plant & Machinery	78,000	Capital	50,000
Furniture	2,000	Sales	1,77,000
Purchases	60,000	Return Outwards	750
Return Inwards	1,000	Discount	800
Opening Stock	30,000	Sundry Creditors	25,000
Discount	425	Provision for Bad Debts	525
Sundry Debtors	45,000		
Salaries	7,550		
Manufacturing Wages	10,000		
Carriage Outward	1,200		
Rent & Taxes	10,000		
Advertisement	2,000		
Cash & Bank	6,900		
	2,54,075		2,54,075

Prepare Trading and Profit & Loss Account for the year ended and a balance sheet as on 31st March, 2021 after taking into consideration the following :

(i) Closing stock was valued at Rs. 34,220, (ii) Provision for bad debts is to be kept at Rs. 500,
(iii) Allow interest on capital @ 5% per annum, (iv) Furniture costing Rs. 1,680 was sold for Rs. 60 in exchange of new furniture. The net invoice of Rs. 920 was passed through purchases book,
(v) Depreciate plant and machinery @ 10% p.a., (vi) Proprietor used goods worth Rs. 5,000 for personal use and distributed goods worth Rs. 2,000 as samples.

Solution

Trading and Profit and Loss Account of Mr. A

Dr. **For the year ended on 31st March, 2021** **Cr.**

Particulars		`	*Particulars*		`
To Opening Stock		30,000	By Sales	1,77,000	
To Purchases	60,000		Less : Return Inwards	(1,000)	1,76,000
	Less :		By Closing Stock		34,220
Return Outwards	(750)				
	Less : Purchase				
of furniture	(920)				
	Les				
s : Drawings	(5,000)				
	Less :	51,330			
Free Samples	(2,000)				
To Manufacturing Wages		10,000			
To Gross Profit c/d		1,18,890			
		2,10,220			2,10,220
To Discount		425	By Gross Profit b/d		1,18,890
To Salaries		7,550	By Discount		800

To Carriage Outward		1,200	By Provision for Bad Debts	25
To Rent and Taxes		10,000		
To Advertisement				
	+			
Free Samples	2,000			
		4,000		
	2,000			
To Loss on Sale of furniture (1,680-60)		1,620		
To Provision for Bad debts :				
New Provision	500			
–Old Provision	525			
Carried to Credit Side	(25)			
To Depreciation on Plant and Machinery		7,800		
To Interest on Capital		2,500		
To Net Profit tfd. To Capital		84,620		
		1,19,715		1,19,715

Balance Sheet of Mr. A as on 31st March, 2021

Liabilities		`	*Assets*		`
Sundry Creditors :			Cash and Bank		6,900
Capital		25,000	Sundry Debtors	45,000	
Opening	50,000		– Prov. For Bad Debts	(500)	44,500
+ Profit	84,620		Stock		34,220
+ Int. on Capital	2,500		Furniture	2,000	
–Drawings	(5,000)	1,32,120	–Sold	(1,680)	
			+ New (60 + 920)	980	1,300
			Plant and Machinery	78,000	
			– Depreciation	(7,800)	70,200
		1,57,120			1,57,120

Question 3 From the following figures extracted from the books of Raj, you are required to prepare a Trading Account and Profit & Loss Account for the year ended 31st March, 2021 and a Balance Sheet as on that date after making the necessary adjustments :

	(Rs. in '000)		*(Rs. in '000)*
Raj's Capital	22,880	Wages	3,520
Raj's Drawings	1,320	Sundry Creditors	24,400
Plant & Machinery	9,900	Gas and Fuel	297
Freehold Property	6,600	Bad Debts	66
Purchases	11,000	Freight	990
Returns Outwards	110	Loose Tools on 1st April, 2020	220
Salaries	1,320	Factory Lighting	286
Office Expenses	715	Provision for Doubtful Debts	88
Office Furniture	550	Interest on Loan to Sham	110
Discount (Dr.)	132	Cash in Hand	264
Sundry Debtors	2,926	Sales	23,144
Loan to Sham @ 10% per annum, balance	4,400	Input CGST	50,000
on 1st April, 2020		Input SGST	50,000
Cash at Bank	2,926	Output CGST	40,000
Bills Payable	550	Output SGST	40,000
Stock on 1st April, 2020	3,850		

Adjustments : -

(i) Stock on 31st March, 2021 was valued at Rs. 7,260 thousand ; (ii) Depreciate plant and machinery by $33\frac{1}{3}$ %, furniture by 10% and freehold property by 5% ; (iii) Loose tools were valued at ` 176 thousand on 31st March, 2021 ; and (iv) Of the sundry debtors, Rs. 6 thousand are bad and should be written off. Maintain a provision of 5% on sundry debtors for doubtful debts.

Solution

Trading and Profit and Loss Account

Dr. **For the year ended on 31st March, 2021** **Cr.**

Particulars		`	*Particulars*		`
To Opening Stock		38,50,000	By Sales		2,31,44,000
To Purchases	1,10,00,000		By Closing Stock		72,60,000
–Returns Outwards	(1,10,000)	1,08,90,000			
To Wages		35,20,000			
To Gas and Fuel		2,97,000			
To Freight		9,90,000			
To Factory Lighting		2,86,000			
To Gross Profit c/d		1,05,71,000			
		3,04,04,000			3,04,04,000
To Salaries		13,20,000	By Gross Profit b/d		1,05,71,000
To Office Expenses		7,15,000	By Interest on Loan :		
To Discount		1,32,000			
			Paid	1,10,000	
To Prov. For Bad Debts :					4,40,000
			+ Accrued	3,30,000	
Bad Debts	66,000				
	+				
Further Bad debts	6,000				
	+				
New Provision					
	(29,26,000–				
6,000) · 5/100	1,46,000				
	–	1,30,000			
Old Provision	(88,000)				
To Depreciation on :					
Plant and Machinery	33,00,000				
Furniture	55,000				
Freehold Property	3,30,000				
Loose Tools (2,20,000–1,76,000)	44,000	37,29,000			
Net Profit transferred. to Capital		49,85,000			
		1,10,11,000			1,10,11,000

Balance Sheet of Mr. Raj
as on 31st March, 2021

Liabilities	`	*Assets*	`
Sundry Creditors	2,44,00,00	Cash in hand	2,64,000

		0			
Bills Payable		5,50,000	Cash at Bank		29,26,000
Capital :			Sundry Debtors	29,36,000	
				–	
Opening	2,28,80,000		Further Bad Debts	(6,000)	
				–New	27,74,000
+ Profit	49,85,000		Provision for D/D	(1,46,000)	
		2,65,45,00	Stock		72,60,000
– Drawings	(13,20,000)	0			
			Loan to Sham		44,00,000
			Loose Tools	2,20,000	
			–Depreciation	(44,000)	1,76,000
			Furniture	5,50,000	
			–Depreciation	(55,000)	4,95,000
			Plant and Machinery	99,00,000	
			–Depreciation	(33,00,000)	66,00,000
			Freehold Property	66,00,000	
			–Depreciation	(3,30,000)	62,70,000
			Accrued Interest		44,000
			Input CGST (5,00,00,000 –4,00,00,000)		1,00,00,00
					0
			Input SGST (5,00,00,000–4,00,00,000)		1,00,00,00
					0
		5,14,95,00			5,14,95,00
		0			0

Question No 4 Prepare Trading and Profit and Loss Account and Balance Sheet as on 31st March, 2021 from the following balances of Mr. A :

	`		`
Capital Account	41,000	Drawings	5,000
Creditors – Trade	30,000	Purchases	1,71,000
Creditors – Expenses	6,800	Carriage inwards	1,500
Rent Received	600	Wages	23,000
Purchases Returns	4,000	Power	9,000
Sales	2,89,600	Rent and Insurance	19,900
Bad Debts Provision 1st April, 2018	600	Salaries	34,400
Advertising Development	8,000	Discount Received	1,800
Goodwill	5,000	General Charges	8,600
Plant and Machinery	20,000	Sales Returns	600
Travellers' Samples	2,700	Travellers' Commission	2,890
Stock on 1-4-2020	32,000	Travellers' Salaries	9,000
Debtors	14,600	Discount Allowed	5,000
Cash at Bank	2,000		
Cash at Hand	210		

Adjustments :

Closing stock was Rs. 23,000, but there has been a loss by fire on March, 20, 2021, to the extent of Rs. 20,000, not covered by insurance. Depreciate Plant and Machinery by 10% and Travellers' Samples by 33 $\frac{1}{3}$ %. Increase Bad Debts Provision to Rs. 2,000. Write 50 percent of the Advertising Development Account. Annual premium on insurance expiring on 1st June, 2021 was Rs. 1,200.

Solution

Trading and Profit and Loss Account of Mr. A
Dr. for the year ended on 31st March, 2021 Cr.

Particulars		`	*Particulars*		`
To Opening Stock		32,000	By Sales	2,89,600	
To Purchases	1,71,000		Less : Returns	(600)	2,89,000
Less : Returns	(4,000)	1,67,000	By Stock Destroyed by fire		20,000
To Carriage Inwards		1,500	By Closing Stock		23,000
To Wages		23,000			
To Power		9,000			
To Gross Profit c/d		99,500			
		3,32,000			3,32,000
To Salaries		34,400	By Gross Profit b/d		99,500
To Rent and Insurance Paid	19,900		By Discount Received		1,800
–Prepaid 1,200 ·2/12	(200)	19,700	By Rent Received		600
To General Charges		8,600	By Net Loss C/d.		5,990
To Traveller's Commission		2,890			
To Travellers' Salaries		9,000			
To Discount Allowed		5,000			
To Loss on Stock Destroyed		20,000			
To Depreciation :					
Plant and Machinery	2,000				
Traveller's Samples	900	2,900			
To Provision for Bad Debts :					
New Provision	2,000				
– Old Provision	(600)	1,400			
To Advertisement Development Written off		4,000			
		1,07,890			1,07,890

Balance Sheet of Mr. A
as on 31st March, 2021

Liabilities		`	*Assets*		`
Creditors (Expenses)		6,800	Cash in Hand		210
Creditors Trade		30,000	Cash at Bank		2,000
Capital :			Debtors	14,600	
Opening	41,000		–New Prov. For Bad Debts	2,000	12,600
– Net Loss	(5,990)		Closing Stock		23,000
– Drawings	(5,000)	30,010	Traveller Samples	2,700	
			–Depreciation	900	1,800
			Plant and Machinery	20,000	
			–Depreciation	(2,000)	18,000
			Goodwill		5,000
			Advertisement Development (8,000–4,000)		4,000
			Prepaid Insurance		200
		66,810			66,810

Questions without solutions (to be tried by students themselves)

1. From the following balance extracted from the books of Sharma, prepare the Trading and Profit and Loss Account for the year ended 31st December, 2021 and a Balance Sheet as on that date after taking into consideration the adjustments given below.

Trial Balance
as on 31st December 2021

	Dr. *Rs.*	*Cr.* *Rs.*

Drawings and capital	7,500	50,000
Purchases and Sales	72,100	95,000
Returns	1,300	2,700
Sundry Debtors and Creditors	18,200	35,750
Stock (1-1-2009)	19,800	
Bad Debts	3,000	
Bills receivable and Payable	12,000	23,000
Cash in hand	300	
Office Expenses	6,210	
Sales Van	15,000	
Sales Van Expenses	1,400	
Discount		2,910
Rent and Taxes	10,700	
Telephone charges	1,050	
Postage and Telegram	950	
Furniture	5,000	
Printing and Stationery	2,750	
Commission	8,400	
Carriage Inward	3,200	
Salaries and Wages	20,500	
	2,09,360	2,09,360

Adjustments.

1. Closing Stock was valued at Rs. 61,700
2. Depreciate Furniture at 10% and Sales Van at 20%.
3. Outstanding Rent amounted to Rs. 900.
4. Bad Debts Rs. 200
5. Make a Provision for Bad and Doubtful Debts @5% Debtors.
6. Charges one-fourth of Salaries and Wages to Trading Account

[**Ans.** Gross Profit Rs. 57,875, Net Profit Rs. 5,450; B/s Rs. 1,07,600]

2. Following trial balance was prepared on March 31, 2021 from the books of Mr. A. Prepare final accounts after making necessary adjustments :—

	Dr. `		*Cr.* `
Wages	6,000	Sales-cash	8,000
Drawings	2,000	Sales-credit	18,000
Purchases	18,000	Capital	34,000
Sales returns	300	Discount	340
Office furniture	4,000	Purchase returns	460
Building	12,000	Provision for doubtful debts	1,500
Office expenses	800	Creditors	2,800
Advertisement	500	Bank overdraft	1,300
Opening stock	5,000	Income from investments	250
Rent & taxes	400		
Commission	200		
Bills receivable	800		
Travelling expenses	250		
Trade expenses	350		
Bad debts	190		
Cash	1,800		
Debtors	11,000		
Postage	50		
Freight on purchases	210		
Investments	2,000		
Fuel, power (factory)	800		
	66,650		66,650

(a) Depreciate building and furniture @ 10%.
(b) Rent outstanding Rs. 120.
(c) Provide for doubtful debts at 5% on sundry debtors
(d) Interest accrued due Rs. 50.
(e) Goods worth Rs. 100 given as samples.
(f) Closing stock valued at Rs. 8,200.
[**Ans.** Gross profit Rs. 4,450 ; Net profit Rs. 1,480 ; Balance sheet total Rs. 37,700].

3. On 31st March, 2021 the following trial balance was extracted from the books of Chatterji :

	Dr. (Rs.)	Cr. (Rs.)
Capital account		50,000
Plant and machinery	80,000	
Sales		1,77,000
Purchases	60,000	
Returns	1,000	750
Opening stock	30,000	
Discount	350	
Bank charges	75	
Sundry debtors	45,000	
Sundry creditors		25,000
Salaries	6,000	
Manufacturing wages	10,000	
Carriage inwards	750	
Carriage outwards		1,200
Bad debts provision		525
Rent, rates and taxes	10,000	
Advertisement	2,000	
Cash in hand	900	
Cash at bank	6,000	
	2,53,275	2,53,275

You are asked to prepare final accounts for the year ended 31st March, 2021 and the balance sheet as on that date.

The following adjustments are required :-

1. Closing stock Rs. 35,000
2. Depreciated plants and machinery at 6%.
3. Bad debts provision to be adjusted to Rs. 500.
4. Interest on capital to be allowed at 5% per annum.

[**Ans.** Gross profit Rs. 1,11,000 ; Net profit Rs. 84,100 ; Balance sheet total Rs. 1,61,600.]

4. From the following Trial Balance of Shubham as on March 31, 2021, prepare Trading & Profit & Loss A/c and Balance Sheet :

	Dr. Rs.	Cr. Rs.
Capital	—	1,00,000
Drawings	12,000	—
Creditors	—	40,000
10% Loan (taken on 1¯1¯2021)	—	10,000
Cash in hand	1,200	
Cash at Bank	11,400	
Sundry Debtors	50,500	
Provision for Doubtful Debts	—	4,000
Furniture	12,000	
Machinery	28,400	
Stock on 1st April, 2021	75,000	
Purchases	1,80,000	
Returns Inwards	2,000	
Rent and Taxes	6,800	

Salaries	18,000	
Wages	30,000	
Travelling Expenses	1,600	
Sales	—	2,80,800
Office Expenses	2,500	
Insurance (including premium of Rs. 600 p.a. paid upto 30-6-2021)	800	
Commission received	—	1,000
Discount	1,600	2,000
Carriage	4,000	.
Total	4,37,800	4,37,800

Following adjustments are required :

(*a*) Stock on 31¯3¯2021 is valued at Rs. 58,500. (*b*) Write off Rs. 500 as bad debts and maintain the provision for doubtful debts at 5% on debtors. (*c*) Make a provision of 2% for discount on debtors and creditors. (*d*) Wages include Rs. 1,600 for erection of new machinery purchased on 1-4-2020. (*e*) Depreciate machinery by 5% and furniture by 10%. (*f*) Commission earned but not received amounted to Rs. 500. (*g*) Goods in stock worth Rs. 10,000 are destroyed by fire. Insurance company accepts the claim for Rs. 8,000.

[**Ans.** Gross Profit – Rs. 59,900; Net Profit– Rs. 28,150 and Balance sheet Total – Rs. 1,65,600]

5. Sanjiv Sondhi starts business on 1st January, 2021 with a capital of Rs. 30,000. The following trial balance was drawn up from his books at the end of the year :

	Dr. Rs.	Cr. Rs.
Drawings	4,500	
Plant & fixtures	8,000	
Purchases	1,16,000	
Carriage inwards	2,000	
Returns inwards	4,000	
Wages	8,000	
Salaries	10,000	
Printing and stationery	800	
Advertisement	1,200	
Trade charges	600	
Rent and taxes	1,400	
Sundry debtors	25,000	
Bills receivable	5,000	
Investments	15,000	
Discount	500	
Cash at bank	16,000	
Cash in hand	3,000	
Capital		40,000
Sales	1,60,000	
Sundry creditors		12,000
Bills payable		9,000
	2,21,000	2,21,000

The value of stock as at December, 2021 was Rs. 26,000. You are required to prepare his trading and profit and loss account for the year ended 31st December, 2021 and a balance sheet as on that date after taking the following facts into account :-

(*a*) Interest on capital is to be provided @ 6% per annum.
(*b*) An additional capital of Rs. 10,000 was introduced by Sanjiv Sondhi on 1st July, 2021.
(*c*) Plants and fixtures are to be depreciated by 10%.
(*d*) Salaries outstanding on 31st December, 2021 amounted to Rs. 500.
(*e*) Accrued interest on investments amounted to Rs. 750.
(*f*) Rs. 500 are bad debts and a reserve for doubtful debts is to be created at 5% of the balance of debtors.

[**Ans.** Gross profit Rs. 56,000, Net profit Rs. 37,125. Total balance sheet Rs. 96,225.]

6. **(Without GST)** From the following trial balance of Rao as at March 31, 2021 and adjustments given there under prepare his final accounts :

	Dr. Rs.		*Cr. Rs.*
Drawings	6,000	Capital	80,000
Plant & machinery (1.4.20)	20,000	Sundry creditors	10,000
Plant added on 30.9.20.	5,000	Sales	1,20,000
Stock	15,000	Returns outwards	1,000
Purchases	82,000	Provision for doubtful debts	400
Returns inwards	2,000	Discount	800
Debtors	20,600	Rent (premises sub.	
Furniture & fixtures	5,000	let for one year upto	1,200
Freight & duty	2,000	September 30, 2021)	
Carriage outwards	500		
Rent, rates & taxes	4,600		
Printing & stationery	800		
Trade expenses	400		
Postage & telegrams	800		
Insurance	700		
Salaries & wages	21,300		
Cash	20,500		
Bank	6,200		
	2,13,400		2,13,400

Adjustments :

(1) Closing stock Rs. 14,600.
(2) Rs. 600 to be written off as bad.
(3) Provision for doubtful debts to be maintained @ 5%.
(4) Provision for discount on debtors and discount on creditors @ 2%.
(5) Depreciate furniture & fixtures and plant & machinery @ 5% p.a. and 20% p.a. respectively.
(6) Prepaid insurance Rs. 100.
(7) Stock of the value of Rs. 5,000 was destroyed in March and the insurance company had admitted the claim for Rs. 3,000.

[**Ans.** Gross Profit Rs. 39,600 ; Net Profit Rs. 3,870 ; B/S Rs. 88,270]

Unit 3

Cost Accounting

CONCEPTS OF COST ACCOUNTING

Cost: - The term ‘Cost’ has a variety of meanings according to its purpose and conditions. As per the definition by Institute of Cost and Management Accountants (I.C.M.A.), now known as Chartered Institute of Management Accountants (C.I.M.A.), London, “Cost“ us the amount of :

[a] actual expenditure incurred on a given thing ; and

[b] notional expenditure attributable to a given thing.

In simple words, cost may be described as the total to all expenses incurred, whether paid or outstanding, in the production and sale of a product, or in rendering a service.

Costing: The I.C.M.A., London has defined costing as the ascertainment of costs. “It refers to the techniques and processes of ascertaining costs and studies the principles and rules concerning the determination of cost of products and services”.

Cost Accounting: It is the method of accounting for cost. The process of recording and accounting for all the elements of cost is called cost accounting. I.C.M.A. has defined cost accounting as follows: “The process of accounting for cost from the point at which expenditure is incurred or committed to the establishment of its ultimate relationship with cost centers and cost units. In its widest usage it embraces the preparation of statistical data, the application of cost control methods and the ascertainment of the profitability of activities carried out or planned”.

Cost Accountancy:It is an aid to management for decision making. I.C.M.A., has defined cost accountancy as follows: “The application of costing and cost accounting principles, methods and techniques to the science, art and practice of cost control and the ascertainment of profitability. It includes the presentation of information derived therefrom for the purpose of managerial decision making”.

SCOPE OF COST ACCOUNTING

The term scope here refers to the field of activity. Cost accounting is concerned with ascertainment and control of costs. The information provided to the management is helpful for cost control and cost reduction through functions of planning, decision making and control.

In the initial stages of evolution, cost accounting confined itself to cost ascertainment and presentation of the same with the main objective of finding the product cost. With the development of business activity and introduction of large scale production, the scope of cost accounting was broadened and providing information for cost control and cost reduction has assumed equal significance along with finding out cost of production.

In addition to enlargement of scope, the area of application of cost accounting has also widened. Initially cost accounting was applied in manufacturing activities only. Now, it is applied in service organizations, government organizations, local authorities, farms, extractive industries, etc.

OBJECTIVES OF COST ACCOUNTING

1. Ascertainment of Cost

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

2. Fixation of Selling Price

Cost data are useful in the determination of selling price or quotations. Apart from cost ascertainment, the cost accountant analyses the total cost into fixed and variable costs. This will help the management to fix the selling price; sometimes, below the total cost but above the variable cost. This will increase the volume of sales- more sales than previously, thus leading to maximum profit.

3. Cost Control

The object is to minimize the cost of manufacturing. Comparison of actual cost with standards reveals the discrepancies- variances. If the variances are adverse, the management enters into investigation so as to adopt corrective action immediately.

4. Matching Cost with Revenue

The determination of profitability of each product, process, department etc. is the important object of costing.

5. Special Cost Studies and Investigations

It undertakes special cost studies and investigations and these are the basis for the management in decision-making or policies. This will also include pricing of new products, contraction or expansion programmes, closing down or continuing a department, product mix, price reduction in depression etc.

6. Preparation of Financial Statements, Profit and Loss Account, Balance Sheet

To prepare these statements, the value of stock, work-in-progress, finished goods etc., are essential; in the absence of the costing department, when we have to close the accounts it rather takes too much time. But a good system of costing facilitates the preparation of the statements, as the figures are easily available; they can be prepared monthly or even weekly.

FUNCTIONS OF COST ACCOUNTING

According to Blocker and Weltemer, “Cost Accounting is to serve management in the execution of policies and in comparison of actual and estimated results in order that the value of each policy may be appraised and changed to meet the future conditions' '. The main functions of cost accounting are:

i) To serve as a guide to price fixing of products.

ii) To disclose sources of wastage in the process of production.

iii) To reveal sources of economy in the production process.

iv) To provide for an effective system of stores, materials etc.

v) To exercise effective control on factors of production.

vi) To ascertain the profitability of each product.

vii) To suggest management of future expansion policies.

viii) To present and interpret data for management decisions.

ix) To organize cost reduction programmes.

x) To facilitate planning and control of business activity.

xi) To supply timely information for various decisions.

xii) To organize the internal audit systems etc.

ADVANTAGES OF COST ACCOUNTING

1. Helps in Decision Making

Cost accounting helps in decision making. It provides vital information necessary for decision making. For instance, cost accounting helps in deciding:

a. Whether to make a product or buy a product?

b. Whether to accept or reject an export order?

c. How to utilize the scarce materials profitably?

2. Helps in fixing prices

Cost accounting helps in fixing prices. It provides detailed cost data of each product (both on the aggregate and unit basis) which enables fixation of selling price. Cost accounting provides basic information for the preparation of tenders, estimates and quotations.

3. Formulation of future plans

Cost accounting is not a post-mortem examination. It is a system of foresight. On the basis of past experience, it helps in the formulation of definite future plans in quantitative terms. Budgets are prepared and they give direction to the enterprise.

4. Avoidance of wastage

Cost accounting reveals the sources of losses or inefficiencies such as spoilage, leakage, pilferage, inadequate utilization of plant etc. By appropriate control measures, these wastages can be avoided or minimized.

5. Highlights causes

The exact cause of an increase or decrease in profit or loss can be found with the aid of cost accounting. For instance, it is possible for the management to know whether the profits have decreased due to an increase in labour cost or material cost or both.

6. Reward to efficiency

Cost accounting introduces bonus plans and incentive wage systems to suit the needs of the organization. These plans and systems reward efficient workers and improve productivity as well as improve the morale of the work -force.

7. Prevention of frauds

Cost accounting envisages sound systems of inventory control, budgetary control and standard costing. Scope for manipulation and fraud is minimized.

8. Improvement in profitability

Cost accounting reveals unprofitable products and activities. Management can drop those products and eliminate unprofitable activities. The resources released from unprofitable products can be used to improve the profitability of the business.

9. Preparation of final accounts

Cost accounting provides for a perpetual inventory system. It helps in the preparation of an interim profit and loss account and balance sheet without physical stock verification.

10. Facilitates control

Cost accounting includes effective tools such as inventory control, budgetary control and variance analysis. By adopting them, the management can notice the deviation from the plans. Remedial action can be taken quickly.

RELATIONSHIP BETWEEN FINANCIAL ACCOUNTING AND COST ACCOUNTING

Both financial and cost accountings are the branches of accounting. They are aimed at providing financial information for interested parties. In both the systems of accounting, information is accumulated and presented to serve the needs of management, proprietors and the outsiders. The sources of the two systems for recording the transactions are the same. Double entry system of accounting is followed in both the systems of accounting. Both are in monetary terms. They are complementary to each other. But the two systems differ in their purpose and scope.

Difference between Financial accounting and Cost accounting

The main differences between Financial Accounting and cost accounting are given as under.

S.No	Point of difference	Financial accounting	Cost accounting
1	Object	Its main objective is to prepare final A/c to report to owner and outsiders.	It aims to provide cost information to management for decision making.
2	Legal requirement	Financial records are maintained as per the requirement of IT act and companies act	It is maintained to fulfill the internal requirement of the management.
3	Nature	It is maintained on the basis of his historical records	It is maintained on both historical and predetermined costs.
4	Stock evaluation	Stock are valued at cost market price which ever is less	Stocks are valued at cost.
5	Period	Transactions are recorded for a particular period (annually)	Transaction is identified with cost units it may be daily, weekly, monthly etc.
6	Information	Only monetary transactions are recorded	It deals with monetary as well as non monetary information.
7	Figure	It deals mainly with actual facts and figure	It deals partly with facts and figures and partly with estimates.

METHODS OF COSTING

The method of costing refers to a system of cost ascertainment and cost accounting. Industries differ in their nature, in the products they produce and the services they offer. Hence, different methods of costing are used by different industries. For example, the method of costing employed by a building contractor is different from that of a transport company.

Job costing and process costing are the two basic methods of costing. Job costing is suitable to industries which manufacture or execute the work according to the specifications of the customers. Process costing is suitable to industries where production is continuous and the units produced are identical.

All other methods are combinations, extensions or improvements of these basic methods. The methods of costing are explained in detail.

1. Job costing

It is also called specific order costing. It is adopted by industries where there is no standard product and each job or work order is different from the others. The job is done strictly according to the specifications given by the customer and usually the job takes only a short time for completion. The purpose of job costing is to ascertain the cost of each job separately. Job costing is used by printing presses, motor repair shops, automobile garages, film studios, engineering industries etc.

2. Contract costing

It is also known as terminal costing. Basically, this method is similar to job costing. However, it is used where the job is big and spread over a long period of time. The work is done according to the specifications of the customer. The purpose of contract costing is to ascertain the cost incurred on each contract separately. Hence a separate account is prepared for each contract. This method is used by firms engaged in ship building, construction of buildings, bridges, dams and roads.

3. Batch costing

It is an extension of job costing. A batch is a group of identical products. All the units in a particular batch are uniform in nature and size. Hence each batch is treated as a cost unit and cost separately. The total cost of a batch is ascertained and it is divided by the number of units in the batch to determine the cost per unit. Batch costing is adopted by manufacturers of biscuits, ready made garments, spare parts medicines etc.

4. Process costing

It is called continuous costing. In certain industries, the raw material passes through different processes before it takes the shape of a final product. In other words, the finished product of one process becomes the raw material for the subsequent process. Process costing is used in such industries.

A separate account is opened for each process to find out the total cost as well as cost per unit at the end of each process. Process costing is applied to continuous process industries such as chemicals, textiles, paper, soap, lather etc.

5. Unit costing

This method is also known as single or output costing. It is suitable to industries where production is continuous and units are identical. The objective of this method is to ascertain the total cost as well as the cost per unit. A cost sheet is prepared taking into account the cost of material, labour and overheads, Unit costing is applicable in the case of mines, oil drilling units, cement works, brick works and units manufacturing cycles, radios, washing machines etc.

6. Operating costing

This method is followed by industries which render services. To ascertain the cost of such services, composite units like passenger kilometers and tone kilometers are used for ascertaining costs. For example, in the case of a bus company, operating costing indicates the cost of carrying a passenger per kilometer. Operating costing is adopted by airways railways, road transport companies (goods as well as passengers) hotels, cinema halls, power houses etc.

7. Operation costing

This is a more detailed application of process costing. It involves costing by every operation. This method is used where there is mass production of repetitive nature involving a number of operations. The main purpose of this method is to ascertain the cost of each operation. For instance, the manufacture of handles for bi-cycles involves a number of operations such as cutting steel sheets into proper strips, moulding, machining and finally polishing. The cost of these operations may be found out separately. Operation costing provides a minute analysis of costs to achieve accuracy and it is applied in industries such as spare parts, toy making and engineering.

8. Multiple Costing

It is also known as composite costing. It refers to a combination of two or more of the above methods of costing. It is adopted in industries where several parts are produced separately and assembled to a single product.

TECHNIQUES OF COSTING

In addition to different methods of costing, the following techniques are used for the purpose of ascertaining costs.

1. Historical costing

In this, actual costs are ascertained after they have been incurred. This is a conventional method of cost ascertainment.

2. Direct costing

The ascertainment of direct costs in respect of department, product or process. This is the aggregate of marginal cost and a portion of fixed cost that are identifiable with the product or process. Direct costs are, therefore, traceable costs.

3. Absorption costing

It is also known as total cost approach. Under this technique, all costs, both fixed and variable are charged to product, process or operations. It is useful in submitting tenders, preparing job estimates etc.

4. Uniform costing

It is the use of some costing principles and methods by several concerns for common control or comparison of costs.

5. Marginal costing

It classifies cost into fixed and variable and only variable costs are charged to the product. This type of costing is useful in taking important decisions such as price decisions in time of competition make or buy decisions, selecting profitable product mix etc.

6. Standard costing

Standard cost is a predetermined cost. The costs are determined in advance of production. Standard performance is set in terms of costs. Actual costs are compared with the standards and variations are found. Then, reasons for variations are investigated and remedial actions are taken. This system enables control of costs and also measurement of efficiency of operations.

Cost Sheet

MEANING AND DEFINITION OF COST SHEET

The expenses of a product are analysed under different heads in the form of a statement. This statement is called a cost sheet. Walter & Bigg define, “The expenditure which has been incurred upon production for a period is extracted from the financial books and the store records, and set out in a memorandum or a statement. If this statement is confined to the disclosure of the cost of the units produced during the period, it is termed as a cost sheet”. In other words, a cost sheet is a statement showing the total cost under proper classification in a logical order.

PURPOSE OF COST SHEET

1. It provides details of total cost under logical classification.

2. It provides cost per unit in different stages.

3. It helps in comparison and control of cost.

4. Cost sheet is helpful in estimation of cost for preparation of tender and quotations.

5. It acts as the basis for fixation of selling price.

COST SHEET FOR THE PERIOD _____

Production _____ Units

		Total Cost Rs.	Cost per unit Rs.
	Direct Material Consumed:		
	Opening stock		
Add:	Purchases		
Less:	Closing Stock	—	
	Cost of drawing	—	
	Direct Expenses	—	
	Primary Packing materials	—	
	PRIME COST		
Add:	Works / Factory overheads:	—	—
	Indirect Materials	—	
	Indirect Wages	—	
	Factory Rent and Rates	—	
	Factory Lighting and Heading	—	
	Power and Fuel	—	
	Repairs and Maintenance	—	
	Drawing Office Expenses	—	

	Research and Experiment cost	—	
	Depreciation of Factory Plant	—	
	Works Stationery	—	
	Insurance of factory	—	
	Works Manager's salary	—	
	WORKS COST/FACTORY COST/ MANUFACTURING COST		
Add:	Office and Administrative Overheads:	—	
	Office salaries	—	
	Office Rent and Rates	—	
	Lighting and Heating	—	
	Cleaning	—	
	Telephone and Postages	—	
	Printing and Stationery	—	
	Depreciation of office Furniture	—	
	Depreciation of office Equipment	—	
	Insurance	—	
	Legal Expenses	—	
	COST OF PRODUCTION	—	—
Add:	Selling and Distribution Overhead:	—	
	Advertising	—	
	Salesmen Salaries	—	
	Samples and Free gifts	—	
	Sales Office Rent	—	
	Sales Promotion Expenses	—	
	Packing and Demonstration	—	
	Showroom Rent and Rates	—	
	Commission	—	
	Traveling Rent and Rates	—	
	Warehouse Rent and Rates	—	
	Repair of Delivery vans	—	
	Carriage freight Outwards etc.	—	
	COST OF SALES	—	—

Prime cost: This is also called direct cost. It is the aggregate of direct materials, direct labour and direct expenses, which are easily identifiable with the product.

Work cost: It consists of the total of all items of expenses incurred in the manufacturing of a product, viz., prime cost plus factory expenses. It is also known as factory cost or manufacturing cost.

Cost of Production: This includes work cost and administration expenses. Production is not deemed to be complete without the managerial and facilitating costs.

Cost of Sales: It represents cost of production plus selling and distribution cost incurred. Thus, the cost of sales is the aggregate of all the direct and indirect costs connected to the goods sold.

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

COST SHEET AND PRODUCTION ACCOUNT

Cost sheet is a statement of total cost under different classifications of costs. The classification of cost is done on the basis of elements of cost, functions and behaviour of cost. The total cost in the form of cost of sales and cost per unit is revealed.

On the other hand, the cost, sales, and profits presented in the form of a ledger account is known as a production account or manufacturing account. The debit side of the account is shown with opening stock, expenses and the credit side is shown with closing stock and sales. The balancing figure is either profit or loss.

COST SHEET AND PRODUCTION STATEMENT

The cost of output can be ascertained from the statement known as cost sheet. The items of various costs are extracted from financial books and presented in logical order. Thus, the total cost of a cost centre or cost unit is shown in the cost sheet.

When sales, stocks and profits are included in the cost sheet it is called a production statement. Bigg has defined it as “The expenditure which has been incurred upon production for a period is extracted from the financial books and stores records and set out in a memorandum statement. If the statement is confined in the disclosure of the cost of the units produced during the period it is termed as cost sheet, but where the statement records cost, sales and profit it is usually known as production or output statement or account”. However the modern practice is to extend the cost sheet to show profit and sales also and call it “statement of cost and profit”.

IMPORTANT POINTS TO BE REMEMBERED

1 Alternative terms are used for many items in cost sheet

The following are some of them:

a. Direct Labour - Direct wages, Production wages, Productive wages, Productive labour

b. Direct expenses - Chargeable expenses

c. Overhead - ‘On-cost’, ‘Burden’

d. Factory overhead - Works-overhead, production overhead, manufacturing overhead

e. Factory cost - Works cost, Manufacturing cost

f. Administrative overhead - Office overhead

2 Valuation of Stocks of Finished Goods

When details of units produced and sold are available, the closing stock of finished units can be valued at 'current cost of production'.

$$\text{Value of closing stock units} = \frac{\text{Cost of production}}{\text{Units produced}} \times \text{Closing stock units}$$

If the value of opening stock units is not given, they can also be valued on the current cost basis, assuming that costs in the previous period were similar to the current period.

3 Sale of Material Scrap

It can direct material scrap and can be shown as a deduction from direct material cost. It may also be indirect material scrap in which case it has to be reduced from the factory overhead cost. When there is no indication, either method can be followed by stating the assumption.

4 Items excluded from cost accounts

(a) Purely financial expenses and losses like interest on loans and debentures, loss on sale of investments and fixed assets, cash discount.(b) Provisions like provision for income tax, provision for doubtful debts.(c) Capital expenses and losses written off like goodwill, preliminary expenses, discount on issue of shares, etc.(d) Appropriations like dividends paid transfer to reserves.

5 Profit given as percentage of selling price

Usually profit is added to the cost of sales to ascertain the sale price. If profit

percentage is given on sales, it must be converted to percentage on cost.

For example if profit is 20% on sale.

Sales is 100; profit 20 Cost = 100-20 = 80

$$\text{Profit to cost} = \frac{20}{80} = \frac{1}{4} \quad \text{(or) } 25\%$$

6 Standard Assumptions

In the context of tenders or quotations, the following assumptions can be made if nothing contrary is given in the problem.

(a) Factory overhead to direct wages ratio of the previous period holds good for the current period also.

(b) Administrative overhead to work cost ratio of the previous period is applicable in the current period also.

Tender

Frequently the manufacturer of consumer's durables and capital goods are asked to quote the price at which they can supply their output. The price at which the items of output are offered for sale is known as 'tender' or 'quotation' price. The tender has to be prepared carefully since it may be accepted and goods have to be supplied in future at the quoted rate.

STEPS IN PREPARATION OF TENDER AND QUOTATIONS

Estimation of different elements of cost has to be made. The following are the accepted norms. Frequently a manufacturer of consumer durable goods and capital goods etc. is required to quote the price at which they can supply their output. The price at which the items of output are offered for sale is known as 'tender' or 'quotation'. A tender has to be prepared very carefully and it may be accepted and goods have to be supplied in future at the quoted price.

In order to prepare a tender the following details are to be analyzed.

1. Raw material

2. Direct labour ex.

3. Direct expenses (or) chargeable expenses

4. Factory/ work overheads

5. Office and administration overheads

6. Selling & Distribution overheads

7. Estimated profit

Estimation of different elements of cost has to be made. Direct material cost & direct labour cost is generally estimated on the basis of cost per unit of preceding period, subject to fluctuations is market price of material and labour rate.

Over heads are estimated on the basis of past experience as a percentage as given below.

1. Percentage of factory overheads to direct wages = $\frac{Factory\ overheads}{Direct\ wages} X100$

2. Percentage of office & administration overheads to works cost

$$= \frac{office\ and\ Ad\min inistration\ overheads}{work\cos t} X\,100$$

3. Percentage of selling and distribution overheads

$$= \frac{Selling\ \&\ Distribution\ overheads}{Work\cos t} X\,100$$

Estimation of profit:

Some times profit is given as percentage of cost (profit on cost). In that cost profit for the tender (or) question is ascertained as given below.

$$\text{Profit} = Cost\ of\ sales\ X\ \frac{Percentage\ of\ profit}{100}$$

when profit is to be determined as a percentage of selling piece (profit on selling piece) of the tender or quotation. The profit is to be calculated as given below.

$$\text{Profit} = \frac{Cost\ of\ sales\ X\ Rate\ of\ profit\ \ on\ \ sales}{100 - Rate\ percentage\ on\ sales}$$

Standard assumption:

In the context of tender or quotations, the following assumptions can be made if nothing contrary is given in the problem.

(a) Factory / work overheads to direct wages ratio of the preceding period holds good for current period also

(b) Office and Administrative overhead to work/ factory cost ratio of the previous period is applicable in the current period also.

MARGINAL COSTING

Marginal costing is a technique of costing. This technique of costing uses the concept `marginal cost‟. Marginal cost is the change in the total cost of production as a result of change in the production by one unit. Thus marginal cost is nothing but variable cost. In marginal costing technique only variable costs are considered while calculating the cost of the product, while fixed costs are charged against the revenue of the period. The revenue arising from the excess of sales over variable costs is known as `contribution‟. Using contribution as a vital tool, marginal costing helps to a great extent in the managerial decision making process. This unit deals with the various aspects of marginal costing.

Marginal Costing is a very important technique in solving managerial problems and contributing in various areas of decisions. In this context profitability of two or more alternative options is compared and such options are selected which offers maximum profitability along with fulfillment of objectives of the enterprise.

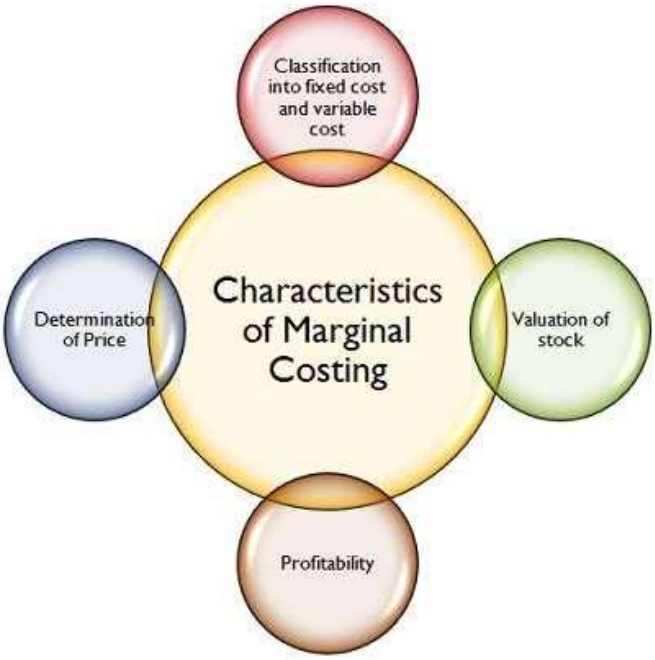
Marginal costing - definition

Marginal costing distinguishes between fixed costs and variable costs as conventionally classified.

The marginal cost of a product –"is its variable cost". This is normally taken to be; direct labor, direct material, direct expenses and the variable part of overheads.

Marginal costing is formally defined as: The accounting system in which variable costs are charged to cost units and the fixed costs of the period are written-off in full against the aggregate contribution. Its special value is in decision making". (Terminology.)

The term „contribution" mentioned in the formal definition is the term given to the difference between Sales and Marginal cost.



Thus, Marginal Cost = Direct Material + Direct Labor + Direct Expenses + Variable Overheads

Marginal Cost The term marginal cost sometimes refers to the marginal cost per unit and sometimes to the total marginal costs of a department or batch or operation. The meaning is usually clear from the context. Note- Alternative names for marginal costing are the contribution approach and direct costing. The difference between selling price and variable cost (or marginal cost) is

known as `contribution‟ or `gross margin‟. It may be considered as some sort of fund from out of which all fixed costs are met. The difference between contribution and fixed cost represents either profit or loss, as the case may be. Contribution is calculated thus: Contribution = Selling Price – Variable Cost = Fixed Cost + Profit or – Loss

It is clear from the above equation that profit arises only when contribution exceeds fixed costs. In other terms, the point of „no profit no loss‟ will be at a level where contribution is equal to fixed costs. Marginal cost equation The algebraic expression of contribution is known as marginal cost equation. It can be expressed thus:

S – V = F + P

S – V = C

C = F + P And In Case Of Loss

C = F – L

Where: S = Sales V = Variable Cost C = Contribution F = Fixed Cost = Profit = Loss

Profit Volume Ratio (P/V Ratio)

The profitability of business operations can be found out by calculating the p/v ratio. It shows the relationship between contribution and sales and is usually expressed in percentage. It is also known as „marginal-income ratio‟, „contribution-sales ratio‟ or `variable-profit ratio‟. P/v ratio thus is the ratio of contribution to sales, and is calculated thus:

thus is the ratio of contribution to sales, and is calculated thus:

$$\text{P/V Ratio} = \frac{\text{Contribution}}{\text{Sales}} \times 100$$

$$= \frac{C}{S} \text{ or } \frac{S - V}{S} \text{ or } \frac{F + P}{S}$$

$$= 1 - \frac{\text{Variable Costs}}{\text{Sales}}$$

The ratio can also be shown by comparing the change in contribution to change in sales, or change in profit to change in sales. Any increase in contribution, obviously, would mean an increase in profit, as fixed expenses are assumed to be constant at all levels of production.

$$\text{P/V Ratio} = \frac{\text{Change in Contribution}}{\text{Change in Sales}}$$

$$= \frac{\text{Change in Profit}}{\text{Change in Sales}}$$

The importance of p/v ratio lies in its use for evaluating the profitability of alternative products, proposals or schemes. A higher ratio shows greater profitability. Management should, therefore, try to increase p/v ratio by widening the gap between the selling price and the variable costs.

This can be achieved by increasing sale price, reducing variable costs or switching over to more profitable products.

Break-Even or Cost-Volume-Profit Analysis

Break-even analysis is a specific method of presenting and studying the inner relationship between costs, volume and profits. (Hence, the name c-v-p analysis). It is an important tool of financial analysis whereby the impact on profit of the changes in volume, price, costs and mix can be found out with a certain amount of accuracy. A business is said to break even when its total sales are equal to its total costs. It is a point of no profit or no loss. At this point contribution is equal to fixed costs. Break-even point, can be calculated thus:

$$\text{B.E.P. (In Units)} = \frac{\text{Fixed Cost}}{\text{Contribution Per Unit}}$$

$$= \frac{\text{Fixed Cost}}{\text{Selling Price/Unit} - \text{Marginal Cost/Unit}}$$

$$\text{B.E.P. (Sales)} = \frac{\text{Fixed Cost}}{\text{Contribution Per Unit}} \times \text{Selling Price/Unit}$$

$$= \frac{\text{Fixed Cost}}{\text{Total Contribution}} \times \text{Total Sales}$$

$$\text{Or} = \frac{F \times S}{S - V}$$

$$\text{Or} = \frac{\text{Fixed Cost}}{\text{Variable Cost Per Unit}}$$

$$1 - \frac{\text{Variable Cost Per Unit}}{\text{Selling Price Per Unit}}$$

$$\text{Or} = \frac{\text{Fixed Cost}}{\text{P/V Ratio}}$$

At break-even point the desired profit is zero. Where the volume of output or sales is to be calculated so as to earn a desired amount of profit, the amount of desired profits has to be added to the fixed cost given in the above formula.

$$\text{Units To Earn A Desired Profit} = \frac{\text{Fixed Cost + Desired Profit}}{\text{Contribution per Unit}}$$

$$\text{Sales to Earn a Desired Profit} = \frac{\text{Fixed Cost + Desired Profit}}{\text{P/V Ratio}}$$

Cash Break-Even Point

It is the level of output or sales where the cash inflow will be equivalent to cash needed to meet immediate cash liabilities. To this end, fixed costs have to be divided into two parts (i) fixed cost which do not need immediate cash outlay (depreciation etc.) And (ii) fixed cost which need immediate cash outlay (rent etc.). Cash break-even point can be calculated thus:

$$\text{Cash Break-Even Point (Of Output)} = \frac{\text{Cash Fixed Costs}}{\text{Cash Contribution per Unit}}$$

Composite Break-Even Point

Where a firm is dealing with several products, a composite breakeven point can be calculated using the following formula:

$$\text{Composite Break-Even Point (Sales)} = \frac{\text{Cash Fixed Costs}}{\text{Composite P/V Ratio}}$$

Margin of Safety

Total sales minus the sales at break-even point are known as the margin of safety. Lower breakeven point means a higher margin of safety. Margin of safety can also be expressed as a percentage of total sales. The formula is:

Margin of Safety = Total Sales – Sales at B.E.P.

$$\text{Or} = \frac{\text{Profit}}{\text{P/V Ratio}}$$

$$\text{Margin of Safety (\%)} = \frac{\text{Margin of Safety}}{} \times 100$$

Total Sales

Higher margin of safety shows that the business is sound and when sales substantially come down, (but not below break even sales) profit might be earned by the business. Lower margin of safety, as pointed out earlier, means that when sales come down slightly profit position might be affected adversely. Thus, margin of safety can be used to test the soundness of a business. In order to improve the margin of safety a business can increase selling prices (without affecting demand, of course) reducing fixed or variable costs and replacing unprofitable products with profitable one.

Theory of Marginal Costing

The theory of marginal costing as set out in "A report on Marginal Costing" published by CIMA, London is as follows:

In relation to a given volume of output, additional output can normally be obtained at less than proportionate cost because within limits, the aggregate of certain items of cost will tend to remain fixed and only the aggregate of the remainder will tend to rise proportionately with an increase in output. Conversely, a decrease in the volume of output will normally be accompanied by less than proportionate fall in the aggregate cost.

The theory of marginal costing may, therefore, by understood in the following two steps:

1. If the volume of output increases, the cost per unit in normal circumstances reduces. Conversely, if an output reduces, the cost per unit increases. If a factory produces 1000 units at a total cost of Rs.3,000 and if by increasing the output by one unit the cost goes up to Rs.3,100, the marginal cost of additional output will be Rs.100.

2. If an increase in output is more than one, the total increase in cost divided by the total increase in output will give the average marginal cost per unit. It can be described as follows:

The ascertainment of marginal cost is based on the classification and segregation of cost into fixed and variable cost. In order to understand the marginal costing technique, it is essential to understand the meaning of marginal cost.

Marginal cost means the cost of the marginal or last unit produced. It is also defined as the cost of one more or one less unit produced besides existing levels of production. In this connection, a unit may mean a single commodity, a dozen, and a gross or any other measure of goods.

Example, if a manufacturing firm produces X unit at a cost of Rs.300 and X+1 unit at a cost of Rs.320, the cost of an additional unit will be Rs.20 which is marginal cost. Similarly if the production of X-1 units comes down to Rs.280, the cost of marginal units will be Rs.20 (300–280).

The marginal cost varies directly with the volume of production and marginal cost per unit remains the same. It consists of prime cost, i.e. cost of direct materials, direct labor and all variable

overheads. It does not contain any element of fixed cost which is kept separate under marginal cost technique.

Marginal costing may be defined as the technique of presenting cost data wherein variable costs and fixed costs are shown separately for managerial decision-making. It should be clearly understood that marginal costing is not a method of costing like process costing or job costing.

Rather it is simply a method or technique of the analysis of cost information for the guidance of management which tries to find out an effect on profit due to changes in the volume of output.

There are different phrases being used for this technique of costing. In the UK, marginal costing is a popular phrase whereas in the US, it is known as direct costing and is used in place of marginal costing. Variable costing is another name of marginal costing.

Marginal costing technique has given birth to a very useful concept of contribution where contribution is given by: Sales revenue less variable cost (marginal cost)

Contribution may be defined as the profit before the recovery of fixed costs. Thus, contribution goes toward the recovery of fixed cost and profit, and is equal to fixed cost plus profit (C = F + P).

In case a firm neither makes profit nor suffers loss, contribution will be just equal to fixed cost (C = F). This is known as breakeven point.

The concept of contribution is very useful in marginal costing. It has a fixed relation with sales. The proportion of contribution to sales is known as P/V ratio which remains the same under given conditions of production and sales.

Definition: Marginal Costing is a costing technique wherein the marginal cost, i.e. variable cost is charged to units of cost, while the fixed cost for the period is completely written off against the contribution.

The term marginal cost implies the additional cost involved in producing an extra unit of output, which can be reckoned by the total variable cost assigned to one unit. It can be calculated as:

Classification into Fixed and Variable Cost: Costs are bifurcated, on the basis of variability into fixed cost and variable costs. In the same way, semi variable cost is separated.

Valuation of Stock: While valuing the finished goods and work in progress, only variable cost is taken into account. However, the variable selling and distribution overheads are not included in the valuation of inventory.

Limitations of Marginal Costing

Marginal costing has the following limitations:

1. Difficulty in classification: In marginal costing, costs are segregated into Fixed and variable. In actual practice, this classification scheme proves to be Superfluous in that, certain costs may be partly fixed and partly variable and certain other costs may have no relation to volume of output or even with the time. In short, the categorisation of costs into fixed and variable elements is a difficult and tedious job.

2. Difficulty in Application: The marginal costing technique cannot be applied in industries where large stocks in the form of work-in-progress (job and contracting firms) are maintained.

3. Defective Inventory Valuation: Under marginal costing, fixed costs are not included in the value of finished goods and work in progress. As fixed costs are also incurred, these should form part of the cost of the product. By eliminating fixed costs from finished stock and work-in progress, marginal costing techniques present stocks at less than their true value. Valuing stocks at marginal cost is objectionable because of other reasons also:

1. In case of loss by fire, full loss cannot be recovered from the insurance company.

2. Profits will be lower than that shown under absorption costing and hence may be objected to by tax authorities.

3. Circulating assets will be understated in the balance sheet.

4. Wrong Basis for Pricing: In marginal costing, sales prices are arrived at on the basis of contribution alone. This is an objectionable practice. For example, in the long run, the selling price should not be fixed on the basis of contribution alone as it may result in losses or low profits. Other important factors such as fixed costs, capital employed should also be taken into account while fixing selling prices. Further, it is also not correct to lay more stress on selling function, as is done in marginal costing, and relegate production function to the background.

5. Limited Scope: The utility of marginal costing is limited to short-run profit planning and decision-making. For decisions of far-reaching importance, one is interested in special purpose cost rather than variable cost. Important decisions on several occasions depend on non-cost considerations also, which are thoroughly discounted in marginal costing.

In view of these limitations, marginal costing needs to be applied with necessary care and caution. Fruitful results will emerge only when management tries to apply the technique in combination with other useful techniques such as budgetary control and standard costing.

Budgetary Control

According to CIMA, England, budgetary control is, "The establishment of budgets relating the responsibilities of executives to the requirements of a policy and the continuous comparison of actual with budgeted results, either to secure by individual action the objectives of that policy or to provide a basis for its revision".

According to J. Batty "budgetary control is a system which uses budgets as a means of planning and controlling all aspects of producing and /or selling commodities and services".

Thus, budgetary control is the process of determining various budgeted figures for the enterprise for the future period and then comparing the budgeted figures with the actual performance for calculating variances, if any. The budget is a means and budgetary control is the end result.

A sound Budgetary control system involves:

1) Establishment of budgets for each section of the organization.

2) Recording of actual performance.

3) Continuous comparison of the actual performance with the budget.

4) In case there is a difference between actual and budgeted performance, take suitable remedial action.

5) Revision of budgets if necessary.

OBJECTIVES OF BUDGETARY CONTROL

Budgetary control is inevitable for policy formulation, planning, control and coordination. The essence of budgeting is to plan and control. Following are the main objectives of budgetary control.

(i) To define the goal of the enterprise.

(ii) To provide long and short period plans for attaining these goals.

(iii) To coordinate the activities of different departments.

(iv) To operate various cost centres and departments with efficiency and economy.

(v) To eliminate waste and increase profitability.

(vi) To estimate capital expenditure requirements of the future.

(vii) To centralize the control system.

(viii) To correct deviations from established standards.

(ix) To fix the responsibility of various individuals in the organization.

(x) To ensure that adequate working capital is available for the efficient operation of the business.

(xi) To indicate to the management as to where action is needed to solve problems without delay.

MERITS AND LIMITATIONS OF BUDGETARY CONTROL

Advantages

The budgetary control system helps in fixing the total for the organization as a whole and concerted efforts are made for its achievement. Budgetary control has become an essential tool of the management for controlling costs and maximizing profits. It acts as a friend, philosopher, and guide to the management. Some of the advantages of budgetary control are:

1) Budgetary control defines the objectives and policies of the undertaking as a whole.

2) It is an effective method of controlling the activities of various departments of a business unit. It fixes targets and the departments have to work efficiently to reach the targets.

3) It secures proper coordination among the activities of various departments.

4) It helps the management to fix up responsibility in case the performance is below expectations.

5) It helps the management to reduce wasteful expenditure. This leads to reduction in the cost of production.

6) It brings in efficiency and economy by promoting cost consciousness among the employees.

7) It facilitates centralized control with decentralized activity.

8) It acts as an internal audit by a continuous evaluation of departmental results and costs.

9) It facilitates the introduction of standard costing.

10. It aids in obtaining bank credit.

11. It helps in estimating the financial needs of the concern. Hence the possibility of under or over capitalization is eliminated.

12. It provides a basis for introducing incentive remuneration plans based on performance.

13. It helps in the smooth running of the business unit. There will be no stoppage of production on account of shortage of raw materials or working capital. The reason is that everything is planned and provided in advance.

16. It indicates to the management as to where action is needed to solve problems without delay.

Limitation

Despite the many good points, the budgetary control system has some limitations. Some of the limitations are discussed as follows:

1. The preparation of a budget under inflationary conditions and changing government policies is really difficult. Thus, the accurate position of the business cannot be estimated.

2. Accuracy in budgeting comes through experience. Hence it should not be relied on too much in the initial stages.

3. Budget is only a management tool. It is not a substitute for management in decision making.

4. Budgeting involves heavy expenditure, which small concerns cannot afford.

5. There will be active and passive resistance to budgetary control as it points out the efficiency or inefficiency of individuals.

6. The success of budgetary control depends upon willing cooperation and teamwork. This is often lacking.

INSTALLATION OF BUDGETARY CONTROL SYSTEM

While installing budgetary control system, the following are the main steps should be taken in to account:

1. Organization chart

There should be a well-defined organization chart for budgetary control. This will show the authority and responsibility of each executive.

2. Budget centre

A budget centre is that part of the organization for which the budget is prepared. A budget centre may be a department, or a section of the department. (e.g., production department or purchase section). The establishment of a budget centre is essential for covering all parts of the organization. The budget centers are also necessary for cost control purposes. The evaluation of performance becomes easy when different centers are established.

3. Budget committee

In small companies, the budget is prepared by the cost accountant. But in big companies, the budget is prepared by the committee. The budget committee consists of the chief executive or managing director, budget officers and the managers of various departments. The managers of various departments prepare their budgets and submit them to this committee. The committee will make necessary adjustments, coordinate all the budgets and prepare a Master Budget.

The main functions of the committee are:

1. To receive and scrutinize all budgets.

2. To decide the policy to be followed.

3. To suggest revision of functional budgets wherever necessary.

4. To approve the finally revised budgets.

5. To prepare the Master Budget after functional budgets are approved.

6. To coordinate the budget programme.

7. To study variations of actual performance.

8. To recommend corrective action if and when required.

4. Budget Manual

Budget Manual is a look which contains the procedure to be followed by the executive's concerned with the budget. It guides the executives in preparing various budgets. It is the responsibility of the budget officer to prepare and maintain this manual.

The Budget Manual may contain the following particulars:

1. A brief explanation of the objectives and principles of budgetary control.

2. Duties and powers of the budget officer.

3. Functions and duties of the budget committee.

4. Budget period.

5. Accounts classification.

6. Reports, statements, forms and charts to be used.

7. Procedure to be followed for obtaining approval

5. Budget Period

The Budget Manual may contain the following particulars:

A budget period is the length of time for which a budget is prepared and employed. It may be different in the same industry or business. The budget period depends upon the following factors:

1. The type of budget-whether it is sales budget, production budget, raw material purchase budget, or capital expenditure budget. A capital budget may be for a longer period, i.e.3 to 5 year.

2. The nature of the demand for the product.

3. The timing for the availability of finance.

4. The length of the trade cycle.

All the above factors are taken into account while fixing the budget period.

6. Key Factor

It is also known as the limiting factor or governing factor or principal budget factor.

A key factor is one which restricts the volume of production. It may arise due to the shortage of material, labour, capital, plant capacity or sales. It is a factor which affects all other budgets. Therefore the budget relating to the key factor is prepared before other budgets are framed.

ESSENTIALS OF SOUND BUDGETARY CONTROL SYSTEM

The following are the requirements of a good budgetary control system.

1) Budgetary control system should have the whole-hearted support of the top management.

2) A budget committee should be established consisting of the budget director and the executives of various departments of the organization.

3) There should be proper fixation of authority and responsibility. The delegation of authority should be done in a proper way.

4) The budget figures should be realistic and easily attainable.

5) Variation between actual figures and budgeted figures should be reported promptly and clearly to the appropriate levels of management.

6) A good accounting system is essential to make budgeting successful.

7) The budget should not cost more to operate than is worth.

BUDGETARY CONTROL TECHNIQUES

The various types of budgets are as follows

i) Revenue and Expense Budgets:

The most common budgets spell out plans for revenues and operating expenses in rupee terms. The most basic of revenue budgets is the sales budget which is a formal and detailed expression of the sales forecast. The revenue from sales of products or services furnishes the principal income to pay operating expenses and yield profits. Expense budgets may deal with individual items of expense, such as travel, data processing, entertainment, advertising, telephone, and insurance.

ii) Time, Space, Material, and Product Budgets:

Many budgets are better expressed in quantities rather than in monetary terms. e.g. direct-labor-hours, machine-hours, units of materials, square feet allocated, and units produced. The Rupee cost would not accurately measure the resources used or the results intended.

iii) Capital Expenditure Budgets:

Capital expenditure budgets outline specifically capital expenditures for plant, machinery, equipment, inventories, and other items. These budgets require care because they give definite form to plans for spending the funds of an enterprise. Since a business takes a long time to recover its investment in plant and equipment, (Payback period or gestation period) capital expenditure budgets should usually be tied in with fairly long-range planning.

iv) Cash Budgets:

The cash budget is simply a forecast of cash receipts and disbursements against which actual cash "experience" is measured. The availability of cash to meet obligations as they fall due is the first requirement of existence, and handsome business profits do little good when tied up in inventory, machinery, or other noncash assets.

v) Variable Budget:

The variable budget is based on an analysis of expense items to determine how individual costs should vary with volume of output.

Some costs do not vary with volume, particularly in such a short period as 1 month, 6 months, or a year. Among these are depreciation, property taxes and insurance, maintenance of plant and equipment, and costs of keeping a minimum staff of supervisory and other key personnel. Costs that vary with volume of output range from those that are completely variable to those that are only slightly variable.

The task of variable budgeting involves selecting some unit of measure that reflects volume; inspecting the various categories of costs (usually by reference to the chart of accounts); and, by statistical studies, methods of engineering analyses, and other means, determining how these costs should vary with volume of output.

vi) Zero Based Budget:

The idea behind this technique is to divide enterprise programs into "packages" composed of goals, activities, and needed resources and then to calculate costs for each package from the ground up. By starting the budget of each package from base zero, budgeters calculate costs afresh for each budget period; thus they avoid the common tendency in budgeting of looking only at changes from a previous period.

CLASSIFICATION OF BUDGETS

Budgets may be classified on the following bases –

BASED ON TIME PERIOD:

Long Term Budget

Budgets which are prepared for periods longer than a year are called LongTerm Budgets. Such Budgets are helpful in business forecasting and forward planning. Eg: Capital Expenditure Budget and R&D Budget.

Short Term Budget

Budgets which are prepared for periods less than a year are known as ShortTerm Budgets. Such Budgets are prepared in cases where a specific action has to be immediately taken to bring any variation under control.
Eg: Cash Budget.

BASED ON CONDITION:

Basic Budget

A Budget, which remains unaltered over a long period of time, is called Basic Budget.

Current Budget

A Budget, which is established for use over a short period of time and is related to the current conditions, is called Current Budget.

BASED ON CAPACITY:

Fixed Budget

It is a Budget designed to remain unchanged irrespective of the level of activity actually attained. It operates on one level of activity and less than one set of conditions. It assumes that there will be no change in the prevailing conditions, which is unrealistic.

Flexible Budget

It is a Budget, which by recognizing the difference between fixed, semi variable and variable costs is designed to change in relation to the level of activity attained. It consists of various budgets for different levels of activity

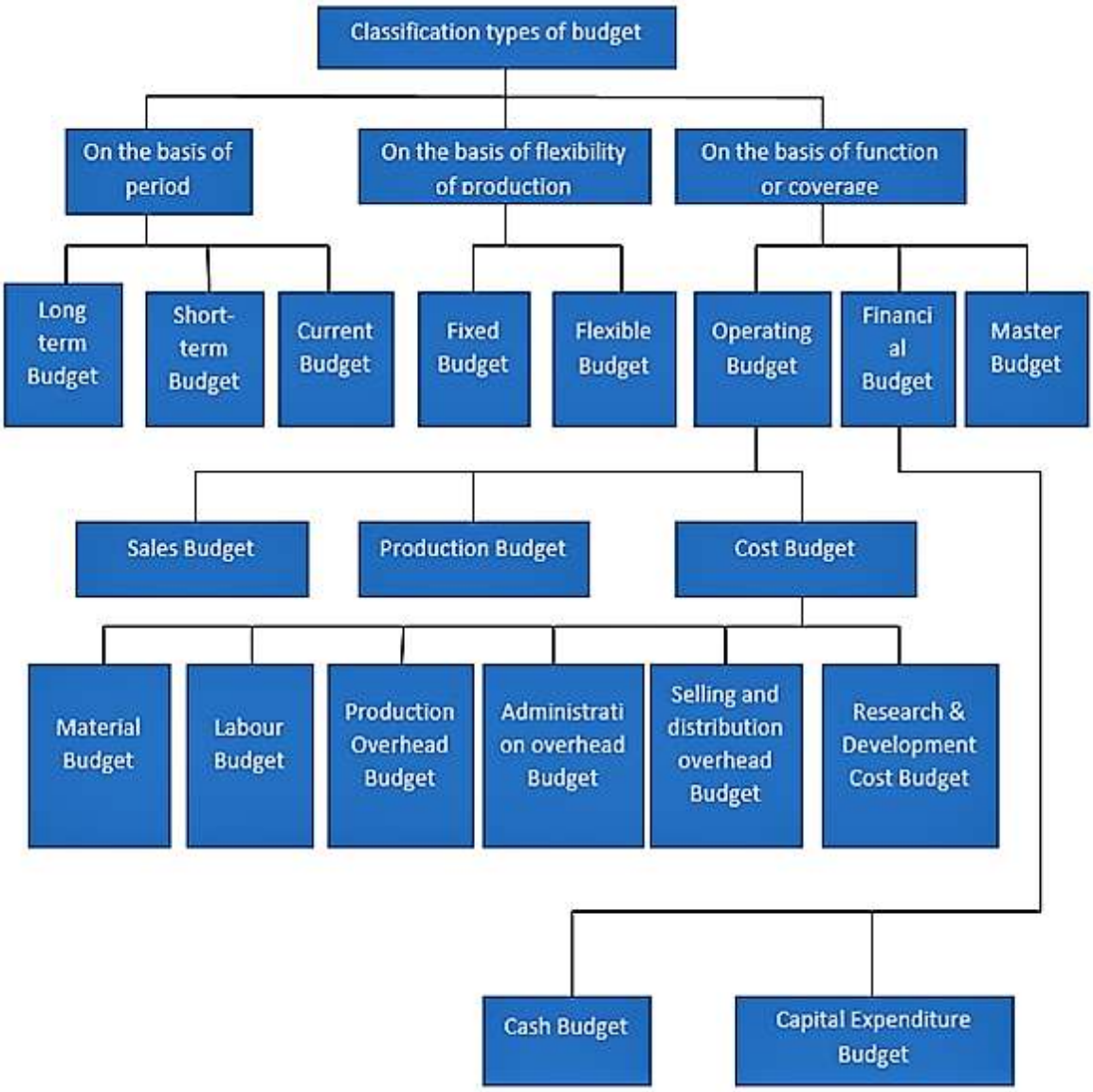
BASED ON COVERAGE:

Functional Budget

Budgets, which relate to the individual functions in an organization, are known as Functional Budgets, e.g. Purchase Budget, Sales Budget, Production Budget, Plant Utilization Budget and Cash Budget.

Master Budget

It is a consolidated summary of the various functional budgets. It serves as the basis upon which budgeted Profit & Loss Account and forecasted Balance Sheet are built up.


Classification types of budget
On the basis of period
On the basis of flexibility of production
On the basis of function or coverage
Long term Budget
Short-term Budget
Current Budget
Fixed Budget
Flexible Budget
Operating Budget
Financi al Budget
Master Budget
Sales Budget
Production Budget
Cost Budget
Material Budget
Labour Budget
Production Overhead Budget
Administrati on overhead Budget
Selling and distribution overhead Budget
Research & Development Cost Budget
Cash Budget
Capital Expenditure Budget

In the present era of competitive rivalry at global level with greater pressure to become cost-efficient, ever increasing expectations of customers for quality compelling company to innovate on continuous basis, and shifting of emphasis to sustainability in the light of justice with planet-companies have to rely upon cost accounting for identifying, measuring, communicating and focusing the attention on key areas of associated costs. Accountants have to collect, classify, measure and communicate costs not only for financial accounting purposes directed at reporting to external parties, but also have to supply information to management to identify the key areas of success which include following:

- *Cost efficiency* targeted at continuous reduction in cost of the products by identifying different activities of value-chain analysis like procurement, manufacturing, packaging, distribution, after sales services, advertising and customer relationship management.
- Customers' growing emphasis on *quality* i.s. conformance to customers' requirements that compel the company to integrate the whole seamless system in Total Quality Management.
- *Time to develop new products* in the light of fast changing technologies leading to shorter product life cycles and introduction of new product ranges; as well as *time to respond* to customers' requests at greater speed and ease.
- *Innovation and creativity* targeted at introduction of new product lines, new life to existing product life cycles, or reduction in associated costs as per the generic strategy of the company-both cost efficiency or differential product strategy.
- *Sustainability* because of increasing pressure to control environmental costs through energy conservatism, resource conservation, product recycling and control of pollution.

Aims of cost accounting

The aims of cost accounting can be stated as:

- A=Ascertainment of costs by appropriate identification and measurement.
- I=Inventory valuation to complete statutory or managerial requirements
- M=Matching costs with revenues
- S=Securing control over costs in the light of the company's generic strategy of either cost leadership (like that of Indigo) or differential strategies (like that of Apple).

Advantages of Cost Accounting

Cost accounting offers following advantages:

- Helpful in making decisions in a biased manner.
- Helpful in inventory valuation by identifying different costs to be reported.
- Helpful in transfer pricing problems related with multinational corporations to manage overall taxation.

- Focusing attention on key areas of success.
- Helpful in assessing projects
- Assessing performance of different product divisions, departments and individuals.
- Helpful to achieve the overall strategic goals of the organization.

Types of costs

A. On the basis of functions

Production costs: Costs related to the production process occurring in the factory that include direct raw material, direct labour and factory overheads.

Administration costs: Costs related to overall administration.

Selling costs: Costs associated with stimulation of sales e.g. advertisement,

Distribution costs: Costs associated with facilitating distribution of goods to suppliers, distributors and customers. For example: delivery van depreciation,

B. On the basis of variability

Fixed costs: Costs that remain fixed whatsoever is the level of activity.

Variable costs: Costs that vary with the level of production.

Semi-variable costs: Costs that are partly fixed and partly variable.

Step-up costs: Costs that remain fixed up to a certain level of activity and then suddenly jump up after that for a certain level of activity.

C. On the basis of association with Product

Product costs: Those costs that form part of inventory and are set off against revenues in the form of cost of goods sold. These costs usually include direct material, direct labour, direct expenses and factory overheads. Under marginal costing technique, all variable costs are product costs whereas under absorption costing both variable and fixed costs are product costs.

Period costs: Those costs that do not form part of product/inventory and are directly set off against the revenues of a period. The examples of such costs are selling and distribution overheads, rent of office, etc.

D. On the basis of traceability to product

Direct costs: Those costs that can be *easily and economically* identified with the product.

Indirect costs: Those costs that *can not* be easily and *economically identified with the product* and form part of overhead costs. These costs are systematically allocated, apportioned and absorbed.

E. For managerial decision purposes

Marginal cost: Cost of producing one extra unit.

Out of pocket costs: Those costs which involve payment to outsiders in the form of [present] cash outlays. Such costs are relevant for price fixation during recession or in the light of make or buy decisions.
Differential costs: The difference between costs of two alternatives whether different methods or different levels of activity.
Sunk costs: Those costs which have already been incurred and are redundant for taking particular decisions as they cannot be changed.
Imputed costs: Those costs which do not involve any outlay of costs, but are notional.
Opportunity costs: Those costs which are associated with benefits forgone by taking a particular decision.
Explicit costs: Costs involving immediate payment of cash to outsiders.
Conversion costs: Costs associated with converting raw material into finished goods.
Controllable costs: Those costs which can be controlled with the action of a particular responsibility centre manager.
Uncontrollable costs: Those costs which are out of control of the actions of a particular responsibility centre head.

Differences

Cost, Expenses and Expenditures

Cost is the amount of resources (both economic as well as non economic such as social, emotional and ecological) sacrificed to attain a particular object: such as goods, services, project, etc. [There was a time when emphasis was placed on economics i.e. scarce resources, but now costing literature focuses on all resources that may be accounted for in financial statements or not].
Expenses and losses are used up costs i.e. Those costs which have been matched with revenues of a particular period. Following matching concept, these costs are matched with revenues of a period:

a. Costs which are directly related with generation of revenues: cost of goods sold
b. Costs which are associated with revenue period: Period Costs such as rent of office, etc.
c. Costs which are not longer to benefit business in future: losses, selling and distribution, etc.
d. Systematic spreading or apportionment of costs over the period of revenues like depreciation (in case of assets), depletion of natural resources, writing off (amortization) miscellaneous expenses.

Expenditures involve present, past or future outflow of cash. Assets are costs expected to benefit in future. The expired/used up portions are shown as depreciation whereas the unused portion is shown as assets with WDV in the Balance Sheet.
We can also differentiate expenses and losses: expenses are the used up portion of costs that have benefited business whereas losses are the used up portion of costs which did not benefit business. Losses are used up costs that did not benefit business.
Product and period costs

Product costs are costs which form part of inventory. These are also called inventoriable costs. The period costs are directly matched with revenues of a period. In case of *product costs*, the expired portion is shown as the cost of goods sold whereas the unexpired portion is shown as inventory in the balance sheet.
On the other hand, period costs are directly matched with revenues of a period. They do not form part of the inventory.
Cost accounting , management accounting and financial accounting

Any system of accounting for costs is geared either towards reporting to external parties or to management for internal decision making. The system of accounting that is directed at reporting to external parties is called financial accounting and the system of accounting that is used for managerial decision making is called management accounting. Cost accounting is management accounting plus that portion of financial accounting that is concerned with inventory valuation.
Cost unit and cost driver

Cost unit is the smallest conveniently measurable quantity against which costs are measured. For example, per bag in case of cement, per job in case of advertising etc. are simple cost units; and tonnage-Km in transportation is an example of composite cost units.

Cost driver is any factor that influences the costs. A change in cost driver will lead to change in the total cost of a related cost object.
Main product and By Product
Because of the inherent nature of the production process involving chemical reactions, different products are produced from common mixtures. If the product is purposefully produced and has significant economic value, that is called the main product whereas if the product is of insignificant value, it is called by product as the organization does not intend to produce it. It was produced incidentally.
Allocation, apportionment and absorption of overheads

Allocation means charging the whole costs to cost centers, apportionment means assigning costs on a suitable basis and absorption means linking costs from cost centers to cost units on a suitable basis.

Cost Management, Cost control and cost reduction

Cost management refers to identification, information collection, measurement, classification and reporting useful information to management to determine the related costs of products, customers and suppliers as well as for planning purposes, control, continuous improvement and decision making (Hansen et al, 2007). It may also be defined as ``the cost of portfolio management and business activities that enable organizations to manage their costs and make cost management decisions." Thus cost management is a broad term that includes not only cost accounting, cost controls but also cost reduction techniques. Its useful tools are performance evaluation, budgetary control and standard costing, activity-based costing, target costing, quality management, balanced scorecard, etc.

Cost controls are concerned with setting parameters for different costs, and evaluating actual to ensure that costs may occur within defined limits. Cost reductions involve challenging the present predetermined costs on a continuous basis to achieve permanent reduction in costs.

Cost Sheet

Level of activity: …… Units

Particulars	Amount	Cost per unit
Direct Material	Xxxx	
Opening stock		
+ Purchases		
-closing stock		
Direct Labour	Xxxx	
Direct Expenses/Chargeable Expenses	Xxxx	
Prime Costs	Xxxx	
Factory Overheads		
Factory Rent, rates and taxes		
Factory lighting		
Factory supervision		
Foreman's salary		
Unproductive wages		
Estimating		
Drawing Office Salaries		
Loose tools written off		
Depreciation on machinery		
Repairs and maintenance	Xxxx	
Works Cost/Factory Cost/Production costs	Xxxxx	

Administration Overheads		
Office rent, rates, taxes		
Salaries		
Directors' fees		
Depreciation of furniture, computers, etc.		
Cost of Production	Xxxx	
Opening stock of finished goods		
Less: Closing stock of finished goods		
Cost of Goods sold	Xxxxx	
Selling and Distribution Overheads		
Salesmen commission		
Travelling expenses		
Carriage outward		
Depreciation on delivery van		
Royalty paid (on sales basis)		
Salesman salaries		
Advertisement		
Cost of Sales	Xxxx	
Profit	Xxxx	
Sales	xxxx	

Cost Sheet

1. From the following particulars, prepare a cost sheet showing the total cost per tonne for the period ended March 31, 2021: Rs.
   Rs.

Raw Materials	33,000	Rent and taxes(office)	500
Productive Wages	38,000	Water supply(works)	1,200
Unproductive wages	10,500	Factory insurance	1,100
Factory rent and taxes	7,500	Office insurance	500
Factory lighting	2,200	Legal expenses	400
Factory heating	1,500	Rent of warehouse	300
Motive power	4,400	Depreciation of:	
Haulages	3,000	Plant and machinery	2,000
Director' fees(works)	1,000	Office building	1,000
Director's fees(office)	2,000	Delivery van	200
Factory cleaning	500	Bad debts	100
Sundry office expenses	200	Advertising	300
Estimating expenses	800	Sales department's salaries	1,500
Factory stationery	750	Upkeep of delivery vans	700
Office stationery	900	Bank changes	50
Loose tools written off	600	Commission on sales	1,500

The total output of the period has been 14,775 tonnes.
Answer cost per tonne Rs. 8, Rs. 71,000; Rs. 1,08,050; Rs. 1,13,600; 1,18,200.

2. From the following data, prepare cost sheet for the year ended March, 2021:

Factory Office Salaries	6,500	Travelling Expenses	2,100
General Office Salaries	12,600	Traveller's Salaries and Comm.	7,700
Carriage Outward	4,300	Productive Wages	1,26,000
Carriage on purchases	7,150	Depreciation: Plant	6,500
Bad debts written off	6,500	Depreciation: furniture	300
Repairs of plant and	4,450	Directors' fees	6,000
machinery		Gas and water: Factory	1,200
Rent, rates and taxes:		Gas and water: Office	400
Factory	8,500	Manager's salaries:3/4factory,	10,000
Office	2,000	¼ office	
Sales	4,61,100	General Expenses	3,400
Stock of material:		Income tax	500
Opening	62,800	Dividend	1,000
Closing	48,000	Transfer to reserves	2,000
Material purchased	1,85,000		

Answer: Rs. 2,06,950; Rs. 3,32,950; Rs. 3,67,600; Rs. 3,94,800; Rs. 4,15,400. Profit: Rs. 45,700

3. From the following data, prepare a cost sheet for the year ended March. 2021:

Raw material used	3,20,000	Delivery van upkeep	7,000
Labour: productive	3,00,000	expenses	9,000
Labour: unproductive	8,000	Office salaries	7,000
Chargeable Expenses	30,000	Drawing office salaries	5,000
Bad debts	3,000	Income tax	4,000
Royalty (based on sales)	4,000	Dividend	23,000
Consumable stores	5,000	Interest on debentures	5,000
Estimating	6,000	Office rent and taxes	5,000
Depreciation:		Office stationery	6,000
Plant and machinery	5,000	Loss due to fire	7,000
Computers	6,000	Sales man's salaries	5,000
		Sales and VAT taxes	

During the year the output was 10,000 units and sales were of Rs. 10,00,000.

4. From the following data, prepare cost sheet for the year ended March, 2021:

Opening stock of raw material	30,000	Rent of showroom	1,200
Closing stock of raw material	35,000	Purchase of raw material	1,20,000
Opening stock of work-in-prog	15,000	Productive wages	90,000
Closing stock of work-in-prog.	20,000	Plant repairs	3,420
Opening stock of finished goods		Depreciation on plant	8,360

Closing stock of finished goods	43,700	Factory lighting	7,380
Indirect wages	54,000	Salesmen's salaries	7,650
Sales	9,720	Office salaries	15,030
Factory rent and rates	3,25,000	General expenses	13,500
Office rent	7,830	Income tax paid	3,000
	2,000		

5. From the following particulars, prepare cost statement for the year ended March, 2021:

Opening stock of raw material	40,000	Power expenses	9,500
Closing stock of raw material	50,000	Other production expenses	43,000
Opening stock of work-in-prog	15,000	General expenses	32,500
Closing stock of work-in-prog.	10,000	Income tax	500
Opening stock of finished goods	6,000	Dividend	3,000
Closing stock of finished goods	15,000	Debenture interest	5,000
Purchase of raw materials	4,75,000	Transfer to sinking fund	6,000
Carriage inwards	12,500	Goodwill written off	12,000
Wages	1,75,000	Payment of sales tax	45,000
Works managers' salaries	30,000	Selling expenses	16,000
Factory employees' salaries	60,000	Sales	8,60,000
Factory rent and rates	7,250	VAT taxes	6,000

6. In a factory, two types of radios are manufactured: Orient and Sujon models. From the following particulars prepare a statement showing cost and profit per radio sold. There is no opening and closing stock of goods.
   Material: Orient-Rs. 27,300, Sujon-Rs. 1,08,680; Labour-Orient: Rs. 15,600, Sujon-Rs. 62,920;
   Works overheads are charged @ 80% of labour cost and office overheads are taken at 15% of works cost. The selling price of both radios are Rs. 1,000. 78 Orient and 286 Sujon radios were produced and sold.

Statement of Cost and Profits

Particulars	Orient=78 Amount	Orient Per Unit	Sujon=286 Amount	Sujon Amount
Direct Material	27,300		1,08,680	
Direct Labour	15,600		62,920	
Prime Cost	42,900		1,71,600	
Factory Overheads: 80% of Labour				
Factory Cost				
Administration Cost: 15% of Works cost				
Cost of Production				
Profit				

Sales				

The accounts of x Limited for 2018 shows Material Rs. 3,50,000; Labour Rs. 2,70,000; Factory overheads Rs. 81,000; and administration overheads Rs. 56,080.

What price should the company quote for a refrigerator? It is estimated that Rs. 1,000 in material and Rs. 700 in labour will be required for one refrigerator. Absorb factory overheads on the basis of labour and administration overheads on the basis of work cost. A profit of 12.5% on selling price is required.

Statement of Cost and Profit

Particulars	Amount
Direct Material	3,50,00
Direct Labour	0
Prime Cost	2,70,00
Factory Overheads (30% of Wages)	0
Factory costs	**6,20,00**
Administration Overheads	**0**
(8% of Factory Costs)	81,000
Cost of Production	**7,01,00**
	0
	56,080
	7,57,08
	0

Note: Factory overheads are recovered on the basis of labour as there used to be a good relationship between factory overheads and wages.

Recovery rate: 81,000/270,000×100=30%

Administration overheads are recovered on the basis of factory costs.

Recovery rate: 56,080/7,01,000× 100= 8%

Statement Showing Price to be Tendered

Particulars	Amount
Direct Material	1,000
Direct Labour	700
Prime Cost	**1,700**
Factory Overheads (30% of Wages)	210
Factory costs	**1,910**

Administration Overheads	
(8% of Factory Costs)	153
Cost of Production	**2,063**
Profit 12.5/87.5	**295**
Selling Price to be quoted	**2,358**

Regarding percentage of profits, If selling price is Rs. 100, then profit equals Rs. 12.5
And cost equals Rs. 87.5
Rate of profit 12.5/87.5 (%)

A company has to file a tender and wants to earn profits of 20% on sales. During last year, its costs were Material Rs. 4,00,000, Labour Rs. 6,00,000, Factory Overheads Rs. 3,00,000 and Administration Overheads Rs. 2,60,000. The work under consideration shall cost the company Material Rs. 1,000; Labour Rs. 2,000. Prepare the statements

Statement of Cost and Profit

Particulars	Amount
Direct Material	4,00,000
Direct Labour	6,00,000
Prime Cost	**10,00,00**
Factory Overheads (50% of Wages)	**0**
Factory costs	3,00,000
Administration Overheads	**13,00,00**
(20% of Factory Costs)	**0**
Cost of Production	
	2,60,000
	15,60,00
	0

Recovery rates:

Factory overheads as % of labour costs: 3,00,000/6,00,000×100= 50%
Administration overheads as % of factory costs: 2,60,000/13,00,000×100=20%

Statement Showing Price to be Tendered

Particulars	Amount
Direct Material	1,000
Direct Labour	2,000
Prime Cost	**3,000**
Factory Overheads (50% of Wages)	1,000
Factory costs	**4,000**
Administration Overheads	

(20% of Factory Costs)	800
Cost of Production	**4,800**
Profit 20/80	**1,200**
Tender Price to be quoted	**6,000**

Statement of Cost and Profits

Particulars	Orient=78 Amount	Orient Per Unit	Sujon=286 Amount	Sujon Amount
Direct Material	27,300		1,08,680	
Direct Labour	15,600		62,920	
Prime Cost	42,900		1,71,600	
Factory Overheads: 80% of Labour				
Factory Cost				
Administration Cost: 15% of Works cost				
Cost of Production				
Profit				
Sales				

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Statement of Cost and Profit

Particulars	Amount
Direct Material	3,50,00
Direct Labour	0
Prime Cost	2,70,00
Factory Overheads (30% of Wages)	0
Factory costs	**6,20,00**
Administration Overheads	**0**
(8% of Factory Costs)	81,000
Cost of Production	**7,01,00**
	0

	56,080 7,57,080

Note: Factory overheads are recovered on the basis of labour as there used to be a good relationship between factory overheads and wages.
Recovery rate: 81,000/270,000×100=30%
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Statement of Cost and Profit

Particulars	Amount
Direct Material	4,00,000
Direct Labour	6,00,000
Prime Cost	**10,00,00**
Factory Overheads (50% of Wages)	**0**

Factory costs	3,00,000
Administration Overheads	**13,00,00**
(20% of Factory Costs)	**0**
Cost of Production	
	2,60,000
	15,60,00
	0

Recovery rates:
Factory overheads as % of labour costs: 3,00,000/6,00,000×100= 50%
Administration overheads as % of factory costs: 2,60,000/13,00,000×100=20%
Statement Showing Price to be Tendered

Particulars	Amount
Direct Material	1,000
Direct Labour	2,000
Prime Cost	**3,000**
Factory Overheads (50% of Wages)	1,000
Factory costs	**4,000**
Administration Overheads	
(20% of Factory Costs)	800
Cost of Production	**4,800**
Profit 20/80	**1,200**
Tender Price to be quoted	**6,000**

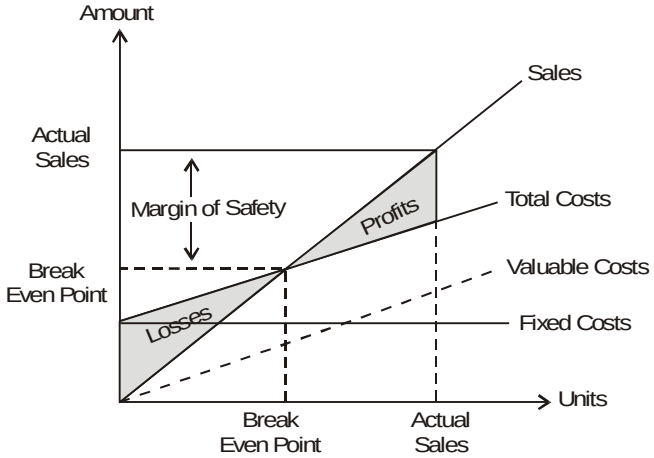
Marginal Costing

Marginal costing is a technique of costing in which all costs are divided into two categories: Fixed and variables, for the purpose of decision making and inventory valuation.

Fixed costs remain fixed, whatever the level of production, whereas variable costs vary with the level of activity.

As fixed costs are not recovered to a certain level of activity, business has to make losses, then there emerges a point where there is no profit no loss as total costs equal sales revenues. Such no profit and no loss point is called break even point. After that point, whatsoever are sales that contribute to profits. Those sales excess of break even sales are called as margin of safety.

Difference between sales and variable costs is called contribution. The ratio between contribution and sales is called Profit/Volume ratio. Higher the Profit volume ratio, higher is the possibility of generating profits.



Break even point is calculated as fixed costs over Profit/volume ratio or Fixed costs over contribution per unit.

Break even point= $\frac{Fixed\ Costs}{profit\ volume\ ratio}$

How has this happened?

We apply simple mathematics, let us say selling price per unit Rs. 10 and variable costs per unit Rs. 6. Fixed costs are Rs. 24,000. Then equation at no profit and no loss point shall be:

Profits= sales-total costs= sales- (fixed costs variable costs)

0 = 10x – (24,000+ 6x)

0= 10x -6x -24,000

24,000= 10x-6x

10x-6x=24,000

X= 24,000/(10-6)

10-6 is indicated as a contribution. So break even point in units = fixed costs/contribution per unit

If we want to calculate this in amount, then

Break even point = $\frac{24{,}000}{10-6} \times 10 = \frac{24{,}000}{\frac{10-6}{10}} = \frac{Fixed\ costs}{Profit\ volume\ ratio}$

Margin of Safety: sales-break even point sales.

This can also be calculated as profits/P/v ratio

Look at this example:

Statement of Cost and Profits

Level of activity: 10,000 units

Particulars	Amount	Per unit
1. Sales	1,00,000	10.00
2. Variable costs	(60,000)	(6.00)
3. Contribution	40,000	4.00
4. Fixed costs	(24,000)	
5. Profits	16,000	

1. Profit-Volume ratio= contribution/sales = 40,000/1,00,000× 100= 40%
2. Break even point= Fixed costs/Profit volume ratio= 24,000/.40= Rs. 60,000
3. Margin of safety= 16,000/.40= Rs. 40,000
4. If sales are Rs. 2,00,000
   Then contribution= 2,00,000×.40= 80,000
   Less: Fixed Costs = 24,000
   Profits= 56,000

Illustration :

1. A Company is showing the figures of following two years:

Particulars	**Year 1**	**Year 2**
Sales (Rs.)	2,00,000	4,00,000
Profits (Rs.)	20,000	80,000

You are required to calculate P/V ratio, Fixed costs, and profit and margin of safety when sales are Rs. 6,00,000. Also calculate the sales to generate profits of Rs. 1,00,000.

Here we find that because of an increase in sales from Rs. 2,00,000 to Rs. 4,00,000, there is an increase in profits from Rs. 20,000 to Rs. 80,000.
What so ever increase is there Rs. 60,000 that is due to increase in sales Rs. 2,00,000
So P/v Ratio = increase in profits/increase in sales
P/V ratio= 60,000/2,00,000 ×100= 30%
Then Profitability statement shall be:

Particulars	**Year 1**	**Year 2**
Sales (Rs.)	2,00,000	4,00,000
Contribution : Sales× P/V Ratio	60,000	1,20,000
Profits (Rs.)	20,000	80,000
Fixed costs	40,000	40,000

Break Even Point: Fixed Costs/P/V Ratio= 40,000/.30= Rs. 1,33,333
When sales are Rs. 6,00,000, Then Contribution: 6,00,000× .30= 1,80,000

Less: Fixed Costs Rs. 40,000
Profit= Rs. 1,40,000
Desired profit is Rs. 1,00,000
Then Desired sales: Desired Contribution/P/V ratio
= (1,00,000 +40,000)/.30= Rs. 4,66,667

2. A Rapid Meal has two restaurants that are open 24 hours a day. Fixed costs for two restaurants together total Rs. 45,00,000 per year. Service varies from a cup of coffee to full meals. The average sales charges for each customer is Rs. 80 and the average cost of food and other variable costs for each customer is Rs. 32. The income tax is 30% and target net income is Rs. 10,50,000. You are required to calculate the amount of sales and number of customers to break even as well as to earn the targeted income. Also compute the net income if the number of customers is 1,50,000.

Statement of Cost and Profitability

Particulars	Amount
Selling Price	80
Less: Variable Costs	(32)
Contribution Per unit	48
Profit/Volume Ratio	60%

Fixed Costs: Rs. 45,00,000

Break Even sales: 45,00,000/.60= Rs. 75,00,000

Target Net income Rs. 10,50,000

Profits after tax: 10,50,000

Profits before tax= 10,50,000(100/70)= Rs. 15,00,000

Desired Contribution: 45,00,000 + 15,00,000= Rs. 60,00,000

Desired Sales Volume: 60,00,000/.60= Rs. 1,00,00,000

Application of Marginal Costing Technique in Managerial decision making

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Profits before tax= 10,50,000(100/70)= Rs. 15,00,000

Desired Contribution: 45,00,000 + 15,00,000= Rs. 60,00,000

Desired Sales Volume: 60,00,000/.60= Rs. 1,00,00,000

Application of Marginal Costing Technique in Managerial decision making

The concept of marginal costing can be applied in following ways:

1. Deciding the suitable sales mix
2. Deciding the key factors that govern decisions
3. Make or buy decisions
4. Profit Planning

X Ltd. Produces and sells two products: Product A and Product B. Data regarding selling price and cost per units are given below:

	Product A	Product B
Selling Price Per unit (Rs.)	20	15
Direct Material Cost per unit (Rs.)	10	9
Direct Labour cost per unit (Rs.)	3	2
Variable expenses per unit(Rs.)	3	2

The fixed cost incurred was Rs. 600. You are required to recommend the most profitable sales mix out of the following:

(a) 100 units of Product A and 200 units of Product B,
(b) 150 units of Product a and 150 units of Product B and
(c) 200 units of Product A and 100 units of Product B.

Statement of Cost and Profits

	Product A	Product B
1. Selling Price Per unit (Rs.)	20	15
2. Variable costs		
Direct Material Cost per unit (Rs.)	10	9
Direct Labour cost per unit (Rs.)	3	2
Variable expenses per unit(Rs.)	3	2
	16	13
3. Contribution per unit Rs.	4	2

Statement showing Profitability of Mixes

Mix No	Products	Units	Contribution per unit	Contribution	Profits
a.	A B	100 200	4 2	400 400	200
b.	A B	150 150	4 2	600 300	300
c.	A B	200 100	4 2	800 200	400

Since Profitability of Mix no c is highest, this mix should be preferred.

3. The following data is given regarding two Products A and B:

	Product A	**Product B**
Selling Price Per Unit (Rs.)	400	500
Material Cost per unit (Rs. 50 per kg) (Rs.)	100	150
Labour Cost per unit (Rs. 15 per hour) (Rs.)	90	60
Variable Expenses per unit (Rs.)	110	170

(a)You are required to suggest which product is more profitable to sell, if (i) sales in units is the limiting factor, (ii) sales in amount is the limiting factor, (iii) material supply is the limiting factor, and (iv) labour hours is the limiting factor.

(b) Suppose 2,200 units of material are available to manufacture either of the products and the maximum demand of each product is 800 units, suggesting how many units of each product should be sold that profits of the company are maximum.

Profitability Statement

	Product A	**Product B**
1.**Selling Price** Per Unit (Rs.)	400	500
2. **Variable costs**		
Material Cost per unit (Rs. 50 per kg) (Rs.)	100	150
Labour Cost per unit (Rs. 15 per hour) (Rs.)	90	60
Variable Expenses per unit (Rs.)	110	170
	300	380
3.Contribution (Rs.)	100	120
4.P/V Ratio (contribution/sales)	25%	24%
5.Contribution Per Kg of Material (100/2, 120/3)	Rs. 50	Rs. 40
6.Contribution per labour hour (100/6, 120/4)	Rs. 16.666	Rs. 30

If 2,200 units of material are available, first Product A shall be utilized. And material used shall be 800×2=1,600 units. Remaining units are 600 units. Units produced = 600/3=200 units of Product B.

4. A part of the company used in the assembly of a product manufactured by the company has during the past three years been a bought out item. The current price of this part is Rs. 120. GST at 10 % is added to the invoice prince. That means it will cost Rs. 132 The company has been manufacturing this part earlier but decided subsequently to discontinue its own manufacture. There is sufficient unutilised capacity which can be used, if it is decided to manufacture this part again in its own plant. Annual requirements of this part are 6,000 units. The relevant manufacturing costs shall be:
   Variable costs:
   Material Rs. 40
   Labour Rs. 50
   VO Rs. 10
   Fixed overheads recovered Rs. 40 per unit
   Total cost Rs. 140
   Should we buy at Rs. 132 or produce at Rs. 140?
   This is a make or buy problem.
5. Two businesses A Ltd and B Ltd sell the same type of the product in the same type of market. Their budgeted profit and loss account for the year ended Dec 31,20.. are as follows:

	A Ltd. (Rs.)	**B Ltd. (Rs.)**
Sales	1,50,000	1,50,000
Variable Costs	(1,20,000)	(1,00,000)
Fixed Costs	(15,000)	(35,000)
Budgeted Profits	15,000	15,000

   Calculate P/V ratio and Break Even point of both businesses and suggest which business is more profitable under which conditions.

Statement of Profitability

	A Ltd. (Rs.)	**B Ltd. (Rs.)**
Sales	1,50,000	1,50,000
Variable Costs	(1,20,000)	(1,00,000)
Contribution	30,000	50,000
Fixed Costs	(15,000)	(35,000)
Budgeted Profits	15,000	15,000
P/V Ratio	20%	33.33%
Break even point	Rs. 75,000	Rs. 1,05,000

If sales are lesser than Rs. 1,50,000, A Ltd is better as it starts earning profits earlier due to lower break even point.

If sales are higher than Rs. 1,50,000 then B Ltd is better because its P/V ratio is high and it will fetch a good amount of profits.

6. A Company is showing the figures of following two years:

Particulars	Year 1	Year 2
Sales (Rs.)	3,00,000	4,00,000
Profits (Rs.)	60,000	80,000

You are required to calculate P/V ratio, Fixed costs, and profit and margin of safety when sales are Rs. 6,00,000. Also calculate the sales to generate profits of Rs. 2,00,000.

UNIT 4

Financial Management

What is Financial Management?

Financial management refers to the effective planning, organising, and controlling of monetary resources. Financial management primarily includes decisions and considerations regarding the size of investments, sources and range of use for capital, and the extent of profit earned from the same. It generally involves applying different management techniques to an enterprise's financial resources to maximise profits.

Financial management is an organic function of any business. Any organization needs finances to obtain physical resources, carry out the production activities and other business operations, pay compensation to the suppliers, etc. There are many theories around financial management:

Some experts believe that financial management is all about providing funds needed by a business on terms that are most favorable, keeping its objectives in mind. Therefore, this approach concerns primarily with the procurement of funds which may include instruments, institutions, and practices to raise funds. It also takes care of the legal and accounting relationship between an enterprise and its source of funds.

Another set of experts believe that finance is all about cash. Since all business transactions involve cash, directly or indirectly, finance is concerned with everything done by the business.

The third and more widely accepted point of view is that financial management includes the procurement of funds and their effective utilization. For example, in the case of a manufacturing company, financial management must ensure that funds are available for installing the production plant and machinery. Further, it must also ensure that the profits adequately compensate for the costs and risks borne by the business.

In a developed market, most businesses can raise capital easily. However, the real problem is the efficient utilization of the capital through effective financial planning and control.

Scope of Financial Management

Financial management helps a particular organisation to utilise their finances most profitably. This is achieved via the following three conducts.

1. **Investment decision** – Investment decision depicts investing in a fixed asset; it is also referred to as capital budgeting. Investment decisions can be of either long-term or short-term basis.
    - Long-term investment decisions allow committing funds towards resources like fixed assets. Long-term investment decisions determine the performance of a business and its ability to achieve financial goals over time.
    - Short-term investment decisions or working capital financing decisions mean committing funds towards resources like current assets. It occupies funds for a shorter period, including investments in inventory, liquid cash, etc. Short-term investment decisions directly affect the liquidity and performance of an organisation.
2. **Financing decision** – This scope of financial management indicates the possible sources of raising finances from various resources. They are of 2 different types –
    - Financial planning decisions attempt to estimate the sources and possible application of accumulated funds. A proper financial planning decision is crucial to ensure the availability of funds whenever required.
    - Capital structure decisions involve identifying various sources of funds. It facilitates the selection of the best external sources for short or long-term financial requirements.
3. **Dividend decision –** It involves decisions taken with regards to net profit distribution. It is divided into two categories –
    - Dividend for the shareholders.
    - Retained profits (usually depends on a particular company's expansion and diversification plans).

Liquidity Decision

Investment in current assets affects the firm's profitability and liquidity. Current assets should be managed efficiently for safeguarding the firm against the risk of illiquidity. Lack of liquidity in extreme situations can lead to the firm's insolvency. A conflict exists between profitability and liquidity while managing current assets. If the firm does not invest sufficient funds in current

assets, it may become illiquid and therefore, risky. But if the firm invests heavily in the current assets, then it would lose interest as idle current assets would not earn anything. Thus, a proper trade-off must be achieved between profitability and liquidity. The profitability-liquidity trade-off requires that the financial manager should develop sound techniques of managing current assets and make sure that funds would be made available when needed.

Objectives of Financial Management

Financial management definition indicates its primary objectives as procurement, allocation, and control of the financial resources of an organisation. The primary objectives are often defined as –

1. Ensuring a regular and suitable supply of funds for the organisation.
2. Allowing for optimum utilisation of funds.
3. Creation of a stable capital structure. The capital distribution should strike a steady balance between debt and equity.
4. Ensuring the safety of investments. The funds should be invested in safe ventures to guarantee adequate returns.
5. Ensuring adequate returns for the organisation and the shareholders.

There are objectives or reasons firms implement these management strategies to grow their business.

1. Profit Maximization

One of the reasons a company employs a financial manager is to maximize profit while managing the finance of the company.

The gain can be in the short or long-term. But the main focus is that the individual or department handling the financial issues of the company must ensure that the company in question is making sufficient profit.

2. Proper Mobilization of Finance

The collection of funds to run the business is also an integral part of financial management that the manager needs to handle appropriately.

Once the manager concludes the estimation of the amount needed for a business process, the required amount can then be requested from any legal sources such as debenture, shares, or even request for a bank loan. But the point is that there should be a proper balance between the money the firm has and the amount borrowed.

3. The Company’s Survival

The survival of the company is essential. That is one of the reasons the management considers hiring financial managers in the first place. The manager has to make adequate financial decisions to ensure the company is successful.

4. Proper Coordination
There must be a proper understanding and cooperation among the various departments. The finance department must understand and agree with other departments within the company for the business to function smoothly.

5. Lowers Cost of Capital
Financial managers also try their very best to reduce the cost of capital, which is something that is vital to the business. They ensure money borrowed attracts little interest rates so the company can maximize profit.

Features of Financial Management
The unique characteristics of financial management offer two different approaches to its functions.

1. **Traditional approach –**

Developed during the twentieth century, the traditional approach encourages the use of financial management only to secure financial assistance for that particular organisation. The utilisation of those funds was not on the cards.
Financial management is considered as corporate finance under this approach. Traditional approach depicts that funding is required only for infrequent events like liquidation, reorganisation, etc.
The following aspects were studied for the procurement of finance –

- Institutional sources of finance.
- The process of issuing financial instruments to collect funds.
- Legal and accounting relationship between businesses and sources of finance.

Limitations of the traditional approach
The traditional approach of finance can be considered somewhat narrow because of several reasons. Following are the primary drawbacks of this approach.

- One-sided approach –Traditional approach gives more attention to the system of procurement and the problems that might arise during that scenario. It does not offer a system for efficient utilisation of procured funds.
- More emphasis on large scale enterprises –The primary focus of the traditional approach is toward corporate entities. Non-corporate entities, i.e. partnership firms, remain outside its scope.
- Emphasis on sporadic events –Traditional approach considers fund allocation as contingencies for sporadic incidents, ignoring everyday financial problems that a business enterprise might face. Working capital financing decisions are also kept outside the scope of a traditional approach.

1. **Modern approach –**

The traditional approach became less effective in the changing business environment of the late '50s. A new approach was developed, keeping in mind a broad analytical viewpoint. It involved both acquisition of funds and their optimum utilisation.
The importance of financial management in a modern way considers both long and short-term financial shortcomings that an organisation might face. The modern approach also creates provision for various sporadic events as well. The primary components of this approach include -

- Financial planning.
- Perpetual functioning and proper capital budgeting evaluation.
- Provision to manage working capital in an optimal manner.
- A broad scope and capability to measure a company's performance

Functions of Financial Management

- **Estimation of capital requirements:** A finance manager has to make an estimation with regards to capital requirements of the company. This will depend upon expected costs and profits and future programmes and policies of a concern. Estimates have to be made in an adequate manner which increases the earning capacity of an enterprise.
- **Determination of capital composition**: Once the estimation has been made, the capital structure has to be decided. This involves short- term and long- term debt equity analysis. This will depend upon the proportion of equity capital a company is possessing and additional funds which have to be raised from outside parties.
- **Choice of sources of funds:** For additional funds to be procured, a company has many choices like-

  a) Issue of shares and debentures
  b) Loans to be taken from banks and financial institutions
  c) Public deposits to be drawn like in the form of bonds.

Choice of factor will depend on relative merits and demerits of each source and period of financing.

- **Investment of funds:** The finance manager has to decide to allocate funds into profitable ventures so that there is safety on investment and regular returns are possible.
- **Disposal of surplus:** The net profits decision has to be made by the finance manager. This can be done in two ways:

a) Dividend declaration - It includes identifying the rate of dividends and other benefits like bonus.
b) Retained profits - The volume has to be decided which will depend upon expansional, innovational, diversification plans of the company.

- **Management of cash:** Finance managers have to make decisions with regards to cash management. Cash is required for many purposes like payment of wages and salaries, payment of electricity and water bills, payment to creditors, meeting current liabilities, maintenance of enough stock, purchase of raw materials, etc.
- **Financial controls:** The finance manager has not only to plan, procure and utilize the funds but he also has to exercise control over finances. This can be done through many techniques like ratio analysis, financial forecasting, cost and profit control, etc.

Sources of Finance

1 Long-Term Sources of Finance

2 Medium Term Sources of Finance

3 Short Term Sources of Finance

4 Owned Capital

5 Borrowed Capital

6 Internal Sources

7 External Sources

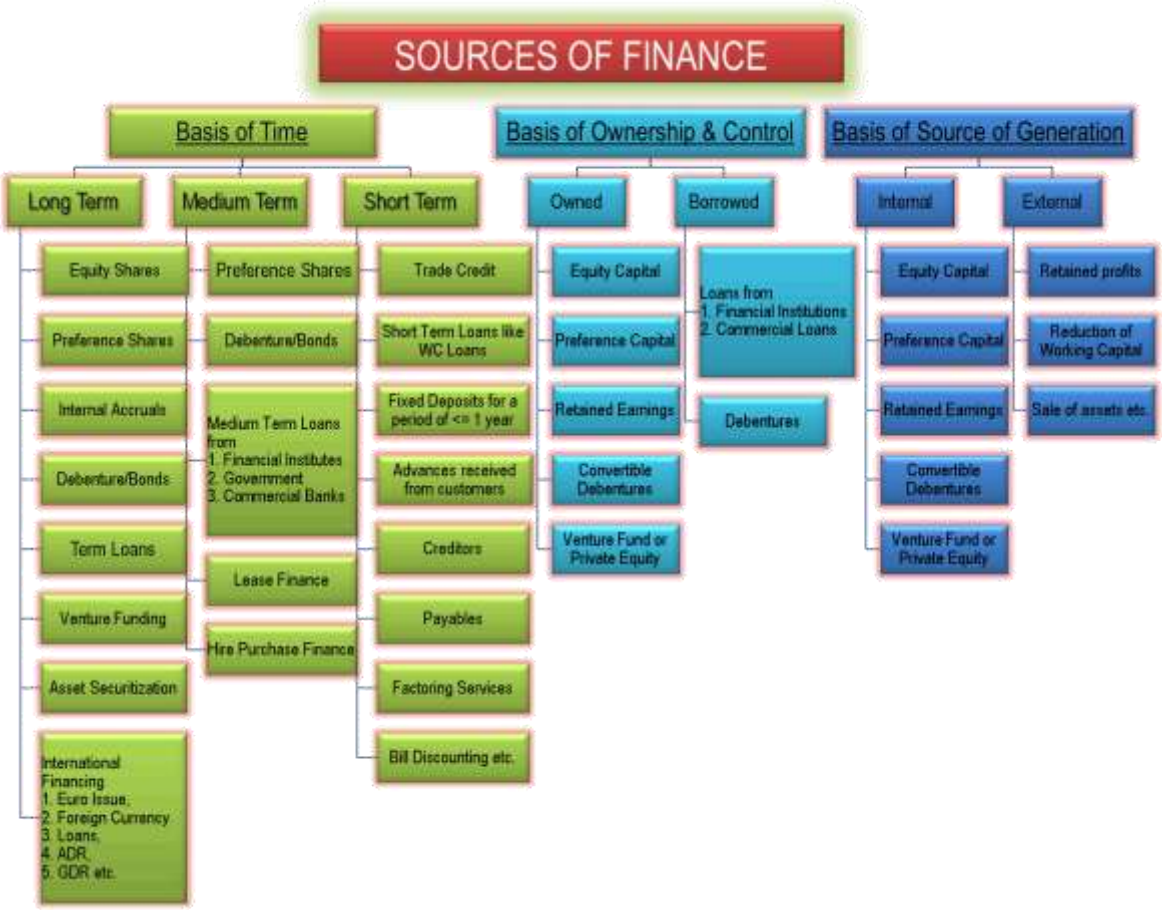
Sources of finance for business are equity, debt, debentures, retained earnings, term loans, working capital loans, letter of credit, euro issue, venture funding etc. These sources of funds are used in different situations. They are classified based on time period, ownership and control, and their source of generation. It is ideal to evaluate each source of capital before opting for it.

Sources of capital are the most explorable area especially for the entrepreneurs who are about to start a new business. It is perhaps the toughest part of all the efforts. There are various capital sources, we can classify on the basis of different parameters.

Having known that there are many alternatives to finance or capital, a company can choose from. Choosing the right source and the right mix of finance is a key challenge for every finance

manager. The process of selecting the right source of finance involves in-depth analysis of each and every source of fund. For analyzing and comparing the sources, it needs the understanding of all the characteristics of the financing sources. There are many characteristics on the basis of which sources of finance are classified.

On the basis of a time period, sources are classified as long-term, medium term, and short term. Ownership and control classify sources of finance into owned and borrowed capital. Internal sources and external sources are the two sources of generation of capital. All the sources have different characteristics to suit different types of requirements. Let's understand them in a little depth.



According to Time Period

Sources of financing a business are classified based on the time period for which the money is required. The time period is commonly classified into the following three:

LONG TERM SOURCES OF FINANCE / FUNDS	MEDIUM TERM SOURCES OF FINANCE / FUNDS	SHORT TERM SOURCES OF FINANCE / FUNDS
Share Capital or Equity Shares	Preference Capital or Preference Shares	Trade Credit
Preference Capital or Preference Shares	Debenture / Bonds	Factoring Services
Retained Earnings or Internal Accruals	Lease Finance	Bill Discounting etc.
Debenture / Bonds	Hire Purchase Finance	Advances received from customers
Term Loans from Financial Institutes, Government, and Commercial Banks	Medium Term Loans from Financial Institutes, Government, and Commercial Banks	Short Term Loans like Working Capital Loans from Commercial Banks
Venture Funding		Fixed Deposits (<1 Year)
Asset Securitization		Receivables and Payables
International Financing by way of Euro Issue, Foreign Currency Loans, ADR, GDR etc.		

Long-Term Sources of Finance

Long-term financing means capital requirements for a period of more than 5 years to 10, 15, 20 years or maybe more depending on other factors. Capital expenditures in fixed assets like plant and machinery, land and building, etc of business are funded using long-term sources of finance. Part of working capital which permanently stays with the business is also financed with long-term sources of funds. Long-term financing sources can be in the form of any of them:

- Share Capital or Equity Shares
- Preference Capital or Preference Shares

- Retained Earnings or Internal Accruals
- Debenture / Bonds
- Term Loans from Financial Institutes, Government, and Commercial Banks
- Venture Funding
- Asset Securitization
- International Financing by way of Euro Issue, Foreign Currency Loans, ADR, GDR, etc.

Medium Term Sources of Finance

Medium term financing means financing for a period of 3 to 5 years and is used generally for two reasons. One, when long-term capital is not available for the time being and second when deferred revenue expenditures like advertisements are made which are to be written off over a period of 3 to 5 years. Medium term financing sources can in the form of one of them:

- Preference Capital or Preference Shares
- Debenture / Bonds
- Medium Term Loans from
  - Financial Institutes
  - Government, and
  - Commercial Banks
- Lease Finance
- Hire Purchase Finance

Short Term Sources of Finance

Short term financing means financing for a period of less than 1 year. The need for short-term finance arises to finance the current assets of a business like an inventory of raw material and finished goods, debtors, minimum cash and bank balance etc. Short-term financing is also named as working capital financing. Short term finances are available in the form of:

- Trade Credit
- Short Term Loans like Working Capital Loans from Commercial Banks
- Fixed Deposits for a period of 1 year or less
- Advances received from customers
- Creditors
- Payables
- Factoring Services
- Bill Discounting etc.

According to Ownership and Control:

Sources of finances are classified based on ownership and control over the business. These two parameters are an important consideration while selecting a source of funds for the business. Whenever we bring in capital, there are two types of costs – one is the interest and another is sharing ownership and control. Some entrepreneurs may not like to dilute their ownership rights in the business and others may believe in sharing the risk.

OWNED CAPITAL	BORROWED CAPITAL
Equity	Financial institutions,
Preference	Commercial banks or
Retained Earnings	The general public in case of debentures.
Convertible Debentures	
Venture Fund or Private Equity	

Owned Capital

Owned capital also refers to equity. It is sourced from promoters of the company or from the general public by issuing new equity shares. Promoters start the business by bringing in the required money for a startup. Following are the sources of Owned Capital:

- Equity
- Preference
- Retained Earnings
- Convertible Debentures
- Venture Fund or Private Equity

Further, when the business grows and internal accruals like profits of the company are not enough to satisfy financing requirements, the promoters have a choice of selecting ownership capital or non-ownership capital. This decision is up to the promoters. Still, to discuss, certain advantages of equity capital are as follows:

- It is a long-term capital which means it stays permanently with the business.
- There is no burden of paying interest or installments like borrowed capital. So, the risk of bankruptcy also reduces. Businesses in infancy stages prefer equity for this reason.

Borrowed Capital

Borrowed or debt capital is the finance arranged from outside sources. These sources of debt financing include the following:

- Financial institutions,
- Commercial banks or
- The general public in case of debentures

In this type of capital, the borrower has a charge on the assets of the business which means the company will pay the borrower by selling the assets in case of liquidation. Another feature of the borrowed fund is a regular payment of fixed interest and repayment of capital. Certain advantages of borrowing are as follows:

- There is no dilution in ownership and control of the business.
- The cost of borrowed funds is low since it is a deductible expense for taxation purposes which ends up saving on taxes for the company.
- It gives the business the benefit of leverage.

ACCORDING TO SOURCE OF GENERATION:

Based on the source of generation, the following are the **internal and external sources of finance:**

INTERNAL SOURCES	EXTERNAL SOURCES
Retained profits	Equity
Reduction or controlling of working capital	Debt or Debt from Banks
Sale of assets etc.	All others except mentioned in Internal Sources

Internal Sources

The internal source of capital is the one which is generated internally by the business. These are as follows:

- Retained profits
- Reduction or controlling of working capital

- Sale of assets etc.

The internal source of funds has the same characteristics of owned capital. The best part of the internal sourcing of capital is that the business grows by itself and does not depend on outside parties. Disadvantages of both equity and debt are not present in this form of financing. Neither ownership dilutes nor fixed obligation/bankruptcy risk arises.

External Sources

An external source of finance is the capital generated from outside the business. Apart from the internal sources of funds, all the sources are external sources.

Deciding the right source of funds is a crucial business decision taken by top-level finance managers. The usage of the wrong source increases the cost of funds which in turn would have a direct impact on the feasibility of the project under concern. Improper match of the type of capital with business requirements may go against the smooth functioning of the business. For instance, if fixed assets, which derive benefits after 2 years, are financed through short-term finances will create cash flow mismatch after one year and the manager will again have to look for finances and pay the fee for raising capital again

Working capital refers to that part of the firm's capital which is required for financing short term or current assets such as cash, marketable securities, debtors, and inventories. Funds, thus, invested in current assets keep revolving fast and are being constantly converted into cash and this cash flow out again in exchange for other current assets. Thus, working capital is like a river which is always there but whose water level is constantly changing. Like that working capital will always be there, but the amount and items are constantly changing one. Hence, it is also known as revolving or circulating capital.

In the words of Shubin," Working capital is the amount of funds necessary to cover the cost of operating the enterprise."

According to Genestenberg, "Circulating capital means current assets of a company that are changed in the ordinary course of business from one form to another, as for example, for cash to inventories, inventories to receivables, receivable into cash."

Elements Included in Working Capital

The current assets and liabilities used to calculate working capital typically include the following items:

Current assets include cash and other liquid assets that can be converted into cash within one year of the balance sheet date, including:

- Cash, including money in bank accounts and undeposited checks from customers.
- Marketable securities, such as U.S. Treasury bills and money market funds.

- Short-term investments a company intends to sell within one year.
- Accounts receivable, minus any allowances for accounts that are unlikely to be paid.
- Notes receivable — such as short-term loans to customers or suppliers — maturing within one year.
- Other receivables, such as income tax refunds, cash advances to employees and insurance claims.
- Inventory including raw materials, work in process and finished goods.
- Prepaid expenses, such as insurance premiums.
- Advance payments on future purchases.

Current liabilities are all liabilities due within a year of the balance sheet date, including:

- Accounts payable.
- Notes payable due within one year.
- Wages payable.
- Taxes payable.
- Interest payable on loans.
- Any loan principal that must be paid within a year.
- Other accrued expenses payable.
- Deferred revenue, such as advance payments from customers for goods or services not yet delivered.

CONCEPT OF WORKING CAPITAL

There are two concepts of working capital:

[i] Gross Working Capital

[ii] Net Working capital.

In the broad sense, the term working capital refers to the Gross Working Capital and represents the amount of funds invested in current assets. Thus, the gross working capital is the capital invested in total current assets of the enterprise.

Current assets are those assets which in the ordinary course of business can be converted into cash within a short period of normally one accounting year.

1. Cash in hand and bank balance

2. Bills Receivables

3. Sundry Debtors [less provision for bad debts]

4. Short term loans and advances

5. Temporary Interments of surplus funds

6. Prepaid Expenses

7. Inventories of stock, as:

i. Raw materials

ii. Work-in-Progress

iii. Stores and spares

iv. Finished Goods

8. Accrued Incomes.

In a narrow sense, the term working capital refers to the net working capital. Net working capital is the excess of current assets over current liabilities or say:

Net Working Capital = Current Assets – Current Liabilities

Net working capital may be positive or negative. When the current assets exceed the current liabilities the working capital is positive and the negative working capital results when the current liabilities are more than the current assets.

Current liabilities are those liabilities which are intended to be paid in the ordinary course of business within a short period of normally one accounting year out of the current assets or the income of the business. Examples of the current liabilities are:

1. Bills Payable

2. Sundry Creditors or Accounts payable

3. Accrued or Outstanding Expenses

4. Short term loans, advances and deposits

5. Dividends Payable

6. Bank Overdraft

7. Provision for Taxation

The gross working capital concept is a financial or going concern concept whereas net working capital concept is an accounting concept of working capital. These two concepts of working capital are not exclusive; rather both have their own merits. The gross and net concepts of working capital are important aspects of working capital management. The net concept of working capital may be suitable only for proprietary forms of organization such as sole-trader or partnership firms. But the gross concept is very suitable to the company form of organization where there is a divorce between ownership, management and control.

However, it may be made clear that as per the general practice, net working capital is referred to simply as working capital. In the words of Hoagland,

"Working capital is descriptive of that capital which is not fixed. But the more common use of the working capital is to consider it as the difference between the book value of the current assets and current liabilities."

CLASSIFICATION OR KINDS OF WORKING CAPITAL

Working capital may be classified as under:

1. On the basis of concept

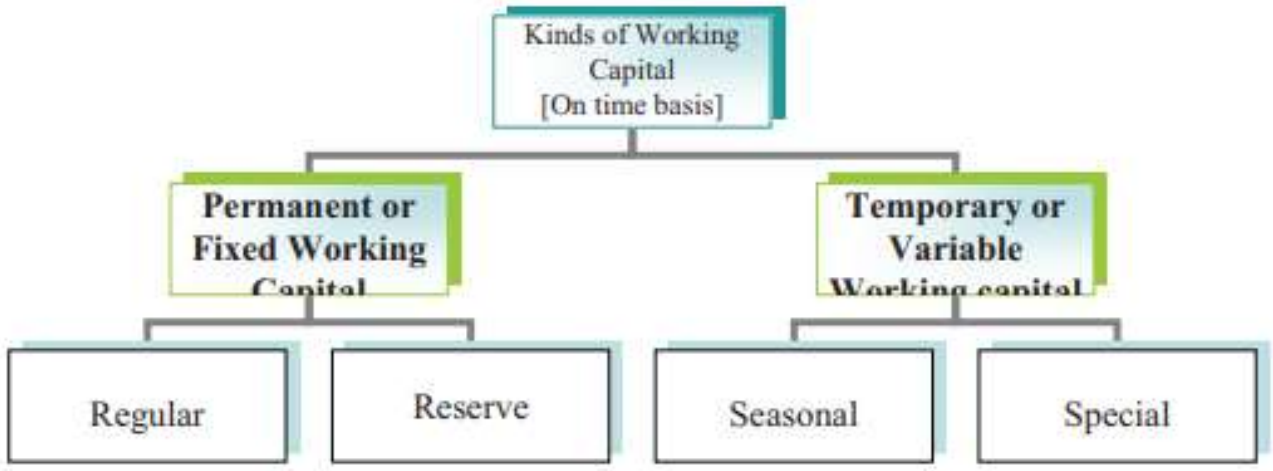
2. On the basis of time

On the basis of concept, working capital is classified as discussed earlier as

i. Gross Working capital; and

ii. Net Working Capital.

This definition is important from the finance manager's point of view. On the basis of time, working capital may be classified as:



A. Permanent or Fixed Working Capital

Permanent or fixed working capital is the minimum amount which is required to ensure effective utilization of fixed facilities and for maintaining the circulation of current assets. There is always a minimum level of current assets which is continuously required by the enterprise to carry out its normal business operations. For example, every firm has to maintain a minimum level of raw materials, work in progress, finished goods and cash balances. The minimum level of current assets is called permanent or fixed working capital as this part of capital is permanently blocked in current assets. As the business grows, the requirements of permanent working capital also increase due to increase in current assets.

The permanent working capital is also further classified as

a. Regular working capital

b. Reserve Working capital

a. Regular Working capital

Regular working capital is the minimum amount of working capital required to ensure circulation of current assets from cash to inventories, from inventories to receivables and from receivable to cash and so on.

b. Reserve Working capital

Reserve working capital is the excess amount over the requirements for regular working capital which may be provided for contingencies that may arise at unstated periods such as strikes, rise in prices, depression, etc.

B. Temporary or Variable Working Capital

Temporary or variable working capital is the amount of working capital which is required to meet the season's demands and some special necessities. Variable working capital can be further classified as

a. Seasonal Working Capital; and

b. Special Working capital.

a. Seasonal Working Capital

The capital required to meet the seasonal needs like festivals or rainy or summer seasons of the enterprise is called seasonal working capital.

b. Special Working Capital

Special working capital is that part of the working capital which is required to meet special exigencies such as launching extensive marketing campaigns, for conducting research etc.

Temporary working capital differs from permanent working capital in the sense that it is required for short periods and cannot be permanently employed gainfully in the business.

IMPORTANCE / ADVANTAGES OF ADEQUATE WORKING CAPITAL

Working capital is the life blood and nerve centre of a business. Just as circulation of blood is essential in the human body for maintaining life, working capital is very essential to maintain the smooth running of a business. No business can run successfully without an adequate amount of working capital.

The main advantages of maintaining adequate amount of working capital are as follows:

1. Solvency of the business

Adequate working capital helps in maintaining solvency of the business by providing uninterrupted flow of production.

2. Goodwill

Sufficient working capital enables a business concern to make prompt payments and hence helps in creating and maintaining goodwill.

3. Easy Loans

A concern having adequate working capital, high solvency and good credit standing can arrange loans from banks and others on easy and favourable terms.

4. Cash Discounts

Adequate working capital also enables a concern to avail cash discounts on the purchases and hence it reduces costs.

5. Regular supply of Raw Materials

Sufficient working capital ensures regular supply of raw materials and continuous production.

6. Regular payment of salaries, wages and other day to day commitments

A company which has ample working capital can make regular payment of salaries, wages and other day to day commitments, which raises the morale of its employees, increases their efficiency, reduces wastages and costs and enhances production and profits.

7. Exploitation of favourable market conditions

Only concerns with adequate working capital can exploit favourable market conditions such as purchasing its requirements in bulk when the prices are lower and by holding its inventories for higher prices.

8. Ability to Face Crisis

Adequate working capital enables a concern to face business crisis in emergencies such as depression because during such periods, generally, there is much pressure on working capital.

9. Quick and Regular Returns on Investments

Every investor wants a quick and regular return on his investments. Sufficiency of working capital enables a concern to pay quick and regular dividends to its investors as there may not be much pressure to plough back profits. This gains the confidence of its investors and creates a favourable market to raise additional funds in the future.

10. High morale

Adequacy of working capital creates an environment of security, conditions, high morale and creates overall efficiency in a business

DETERMINANTS/ FACTORS OF WORKING CAPITAL

The working capital requirements of a concern depend upon a large number of factors such as nature and size of business, the length of production cycle, the rate of stock turnover etc. It is not possible to rank them because all such factors are of different importance and the influence of individual factors changes for a firm over time and these factors affect different firms differently.

However, the following are important factors generally influencing the working capital requirements.

1. Nature of Business

Working capital depends upon the nature of business. Service oriented concerns like electricity; water suppliers need limited working capital whereas a manufacturing concern requires sufficient working capital, since they have to maintain stocks and debtors.

2. Credit Policies

A company that allows credit to its customers shall need more amount of working capital. Likewise, a company enjoying credit facilities from its suppliers will need a lower amount of working capital.

3. Manufacturing Process

Manufacturing process involves conversion of raw materials into finished products. Longer the process, higher the requirement of working capital, therefore length of manufacturing period is one of the factors which influence the working capital requirements.

4. Changes in Technology

Changes in technology affect the requirement of working capital. If the firm adopts a labour intensive process it requires more working capital. If it goes for automation, it improves the raw materials processing, reducing the wastages and making fast production. Hence, the requirement of working capital is less.

5. Rapidity of Turnover

High rates of turnover require a low amount of working capital and lower and slow moving stocks need a larger working capital. For example, slow moving jewelry shops have to maintain different types of jewelleries which require high working capital. But, high moving grocery shops require low working capital.

6. Business Cycle

Changes in the economy also influence the working capital. When a business is prosperous, it requires a huge amount of capital, and during the depression a huge amount of working capital is required for unsold stock, uncollected debts.

7. Seasonal Variations

Industries which are manufacturing and selling goods seasonally require a large amount of working capital during the season.

8. Fluctuation of Supply

Firms have to maintain large reserves of raw materials in stores, to avoid uninterrupted production requires a large amount of working capital.

9. Dividend Policy

If a conservative dividend policy is followed by the management, the need for working capital can be met with the retained earnings. It consequently drains off large amounts from the working capital pool.

10. Working Capital Cycle

In a manufacturing concern, the working capital cycle starts with the purchase of raw materials and ends with realization of cash from the sale of finished products. This cycle involves purchase

of raw materials and stores, its conversion into stock of finished goods through work-in-progress with progressive increment of labour and service costs, conversion of finished stock into sales, debtors and receivables and ultimately realization of cash and this cycle continues again from cash to purchase of raw materials and so on.

11. Price Level Changes

Changes in the price level also affect the working capital requirements. Generally, rising prices will require the firm to maintain a larger amount of working capital as more funds will be required to maintain the same current assets. The effect of rising prices may be different for different firms. Some firms may be affected much while some others may not be affected at all by the rise in prices.

12. Other Factors

Certain other factors such as operating efficiency, management ability, irregularities of supply, import policy, asset structure, importance of labour, banking facilities etc., also influence the requirements of working capital.

Working Capital Example

The following working capital example is based on the March 31, 2020, balance sheet of aluminum producer Alcoa Corp., as listed in its 10-Q SEC filing. All amounts are in millions.

Alcoa listed current assets of $3,333 million, and current liabilities of $2,223 million. Its working capital was therefore $3,333 million - $2,223 million = $1,110 million. That represented an increase of $143 million compared with three months earlier, on Dec. 31, 2019, when the company had $967 million in working capital.

	March 31, 2020	December 31, 2019
ASSETS		
Current assets:		

Cash and cash equivalents	$ 829	$ 879
Receivables from customers	570	546
Other receivables	95	114
Inventories	1,509	1,644
Fair value of derivative instruments	53	59
Prepaid expenses and other current assets	277	288
Total current assets	3,333	3,530
Properties, plants, and equipment	20,181	21,715
Less: accumulated depreciation, depletion, and amortization	13,021	13,799
Properties, plants, and equipment, net	7,160	7,916
Investments	1,059	1,113

Deferred income taxes	425	642
Fair value of derivative instruments	446	18
Other noncurrent assets	1,228	1,412
Total assets	$ 13,651	$ 14,631
LIABILITIES		
Current liabilities:		
Accounts payable, trade	$ 1,276	$ 1,484
Accrued compensation and retirement costs	353	413
Taxes, including income taxes	78	104
Fair value of derivative instruments	80	67
Other current liabilities	435	494
Long-term debt due within one year	1	1

Total current liabilities	2,223	2,563
Long-term debt, less amount due within one year	1,801	1,799
Accrued pension benefits	1,455	1,505
Accrued other postretirement benefits	729	749
Asset retirement obligations	548	606
Environmental remediation	289	296
Fair value of derivative instruments	164	581
Noncurrent income taxes	299	276
Other noncurrent liabilities and deferred credits	332	370
Total liabilities	7,840	8,745

How Working Capital Affects Cash Flow

Cash flow is the amount of cash and cash equivalents that moves in and out of the business during an accounting period. Cash flow is summarized in the company's cash flow statement.

A company's cash flow affects its amount of working capital. If revenue declines and the company experiences negative cash flow as a result, it will draw down its working capital. Investing in increased production may also result in a decrease in working capital.

Working Capital vs Net Working Capital

The terms "working capital" and "net working capital" are synonymous: Both refer to the difference between all current assets and all current liabilities.

However, some analysts define net working capital more narrowly than working capital.

One of these alternative formulas excludes cash and debt:

Net working capital = current assets (less cash) - current liabilities (less debt)

An even narrower definition excludes most types of asset, focusing only on accounts receivable, accounts payable and inventory:

Net working capital = accounts receivable + inventory - accounts payable

Working Capital vs. Fixed Assets/Capital

Working capital includes only current assets, which have a high degree of liquidity — they can be converted into cash relatively quickly. Fixed assets are not included in working capital because they are illiquid; that is, they cannot be easily converted to cash.

Fixed assets include real estate, facilities, equipment and other tangible assets, as well as intangible assets like patents and trademarks.

What Is Working Capital Management?

Working capital management is a financial strategy that involves optimizing the use of working capital to meet day-to-day operating expenses, while helping ensure the company invests its resources in productive ways. Effective working capital management enables the business to fund the cost of operations and pay short-term debt.

Several financial ratios are commonly used in working capital management to assess the company's working capital and related factors.

The **working capital ratio**, also known as the **current ratio**, is a measure of the company's ability to meet short-term obligations. It's calculated as current assets divided by current liabilities.

A working capital ratio of less than one means a company isn't generating enough cash to pay down the debts due in the coming year. Working capital ratios between 1.2 and 2.0 indicate a company is making effective use of its assets. Ratios greater than 2.0 indicate the company may not be making the best use of its assets; it is maintaining a large amount of short-term assets instead of reinvesting the funds to generate revenue.

The **average collection period** measures how efficiently a company manages accounts receivable, which directly affects its working capital. The ratio represents the average number of days it takes to receive payment after a sale on credit. It's calculated by dividing the average total accounts receivable during a period by the total net credit sales and multiplying the result by the number of days in the period.

The **inventory turnover ratio** is an indicator of how efficiently a company manages inventory to meet demand. Tracking this number helps companies ensure they have enough inventory on hand while avoiding tying up too much cash in inventory that sits unsold.

The inventory turnover ratio indicates how many times inventory is sold and replenished during a specific period. It's calculated as the cost of goods sold (COGS) divided by the average value of inventory during the period. A higher ratio indicates inventory turns over more frequently.

Sources of funds

A company might raise new funds from the following sources

The capital markets:

i) new share issues, for example, by companies acquiring a stock market listing for the first time

ii) rights issues

- Loan stock
- Retained earnings
- Bank borrowing
- Government sources
- Business expansion scheme funds
- Venture capital
- Franchising.

Ordinary (equity) shares

Ordinary shares are issued to the owners of a company. They have a nominal or 'face' value, typically of $1 or 50 cents. The market value of a quoted company's shares bears no relationship to their nominal value, except that when ordinary shares are issued for cash, the issue price must be equal to or be more than the nominal value of the shares.

Deferred ordinary shares

are a form of ordinary shares, which are entitled to a dividend only after a certain date or if profits rise above a certain amount. Voting rights might also differ from those attached to other ordinary shares.

Ordinary shareholders put funds into their company:

a) by paying for a new issue of shares
b) through retained profits.

Simply retaining profits, instead of paying them out in the form of dividends, offers an important, simple low-cost source of finance, although this method may not provide enough funds, for example, if the firm is seeking to grow.

A new issue of shares might be made in a variety of different circumstances:

a) The company might want to raise more cash. If it issues ordinary shares for cash, should the shares be issued pro rata to existing shareholders, so that control or ownership of the company is not affected? If, for example, a company with 200,000 ordinary shares in issue decides to issue 50,000 new shares to raise cash, should it offer the new shares to existing shareholders, or should it sell them to new shareholders instead?
i) If a company sells the new shares to existing shareholders in proportion to their existing shareholding in the company, we have a *rights issue.* In the example above, the 50,000 shares would be issued as a one-in-four rights issue, by offering shareholders one new share for every four shares they currently hold.

ii) If the number of new shares being issued is small compared to the number of shares already in issue, it might be decided instead to sell them to new shareholders, since ownership of the company would only be minimally affected.

b) The company might want to issue shares partly to raise cash, but more importantly to 'float' its shares on a stock exchange.

c) The company might issue new shares to the shareholders of another company, in order to take it over.

New shares issues

A company seeking to obtain additional equity funds may be:

a) an unquoted company wishing to obtain a Stock Exchange quotation

b) an unquoted company wishing to issue new shares, but without obtaining a Stock Exchange quotation

c) a company which is already listed on the Stock Exchange wishing to issue additional new shares.

The methods by which an unquoted company can obtain a quotation on the stock market are:

a) an offer for sale
b) a prospectus issue
c) a placing
d) an introduction.

Offers for sale:

An offer for sale is a means of selling the shares of a company to the public.

a) An unquoted company may issue shares, and then sell them on the Stock Exchange, to raise cash for the company. All the shares in the company, not just the new ones, would then become marketable.

b) Shareholders in an unquoted company may sell some of their existing shares to the general public. When this occurs, the company is not raising any new funds, but just providing a wider market for its existing shares (all of which would become marketable), and giving existing shareholders the chance to cash in some or all of their investment in their company.

When companies 'go public' for the first time, a 'large' issue will probably take the form of an offer for sale. A smaller issue is more likely to be a placing, since the amount to be raised can be obtained more cheaply if the issuing house or other sponsoring firm approaches selected institutional investors privately.

Rights issues

A rights issue provides a way of raising new share capital by means of an offer to existing shareholders, inviting them to subscribe cash for new shares in proportion to their existing holdings.

For example, a rights issue on a one-for-four basis at 280c per share would mean that a company is inviting its existing shareholders to subscribe for one new share for every four shares they hold, at a price of 280c per new share.

A company making a rights issue must set a price which is low enough to secure the acceptance of shareholders, who are being asked to provide extra funds, but not too low, so as to avoid excessive dilution of the earnings per share.

Preference shares

Preference shares have a fixed percentage dividend before any dividend is paid to the ordinary shareholders. As with ordinary shares a preference dividend can only be paid if sufficient distributable profits are available, although with 'cumulative' preference shares the right to an unpaid dividend is carried forward to later years. The arrears of dividend on cumulative preference shares must be paid before any dividend is paid to the ordinary shareholders.

From the company's point of view, preference shares are advantageous in that:

· Dividends do not have to be paid in a year in which profits are poor, while this is not the case with interest payments on long term debt (loans or debentures).

· Since they do not carry voting rights, preference shares avoid diluting the control of existing shareholders while an issue of equity shares would not.

· Unless they are redeemable, issuing preference shares will lower the company's gearing. Redeemable preference shares are normally treated as debt when gearing is calculated.

· The issue of preference shares does not restrict the company's borrowing power, at least in the sense that preference share capital is not secured against assets in the business.

· The non-payment of dividend does not give the preferred shareholders the right to appoint a receiver, a right which is normally given to debenture holders.

However, dividend payments on preference shares are not tax deductible in the way that interest payments on debt are. Furthermore, for preference shares to be attractive to investors, the level of payment needs to be higher than for interest on debt to compensate for the additional risks.

For the investor, preference shares are less attractive than loan stock because:

· they cannot be secured on the company's assets
· The dividend yield traditionally offered on preference dividends has been much too low to provide an attractive investment compared with the interest yields on loan stock in view of the additional risk involved.

Loan stock

Loan stock is long-term debt capital raised by a company for which interest is paid, usually half yearly and at a fixed rate. Holders of loan stock are therefore long-term creditors of the company.

Loan stock has a nominal value, which is the debt owed by the company, and interest is paid at a stated "coupon yield" on this amount. For example, if a company issues 10% loan stock, the coupon yield will be 10% of the nominal value of the stock, so that $100 of stock will receive $10 interest each year. The rate quoted is the gross rate, before tax.

Debentures are a form of loan stock, legally defined as the written acknowledgement of a debt incurred by a company, normally containing provisions about the payment of interest and the eventual repayment of capital.

Debentures with a floating rate of interest

These are debentures for which the coupon rate of interest can be changed by the issuer, in accordance with changes in market rates of interest. They may be attractive to both lenders and borrowers when interest rates are volatile.

Security

Loan stock and debentures will often be *secured.* Security may take the form of either a *fixed charge* or a *floating charge.*

a) **Fixed charge;** Security would be related to a specific asset or group of assets, typically land and buildings. The company would be unable to dispose of the asset without providing a substitute asset for security, or without the lender's consent.

b) **Floating charge;** With a floating charge on certain assets of the company (for example, stocks and debtors), the lender's security in the event of a default payment is whatever assets of the appropriate class the company then owns (provided that another lender does not have a prior charge on the assets). The company would be able, however, to dispose of its assets as it chose until a default took place. In the event of a default, the lender would probably appoint a receiver to run the company rather than lay claim to a particular asset.

The redemption of loan stock

Loan stock and debentures are usually redeemable. They are issued for a term of ten years or more, and perhaps 25 to 30 years. At the end of this period, they will "mature" and become redeemable (at par or possibly at a value above par).

Most redeemable stocks have an earliest and latest redemption date. For example, 18% Debenture Stock 2007/09 is redeemable, at any time between the earliest specified date (in 2007) and the latest date (in 2009). The issuing company can choose the date. The decision by a company when to redeem a debt will depend on:

a) how much cash is available to the company to repay the debt
b) the nominal rate of interest on the debt. If the debentures pay 18% nominal interest and the current rate of interest is lower, say 10%, the company may try to raise a new loan at 10% to redeem the debt which costs 18%. On the other hand, if current interest rates are 20%, the company is unlikely to redeem the debt until the latest date possible, because the debentures would be a cheap source of funds.

There is no guarantee that a company will be able to raise a new loan to pay off a maturing debt, and one item to look for in a company's balance sheet is the redemption date of current loans, to establish how much new finance is likely to be needed by the company, and when.

Mortgages are a specific type of secured loan. Companies place the title deeds of freehold or long leasehold property as security with an insurance company or mortgage broker and receive cash on loan, usually repayable over a specified period. Most organisations owning property which is unencumbered by any charge should be able to obtain a mortgage up to two thirds of the value of the property.

As far as companies are concerned, debt capital is a potentially attractive source of finance because interest charges reduce the profits chargeable to corporation tax.

Retained earnings

For any company, the amount of earnings retained within the business has a direct impact on the amount of dividends. Profit reinvested as retained earnings is profit that could have been paid as a dividend. The major reasons for using retained earnings to finance new investments, rather than to pay higher dividends and then raise new equity for the new investments, are as follows:

a) The management of many companies believes that retained earnings are funds which do not cost anything, although this is not true. However, it is true that the use of retained earnings as a source of funds does not lead to a payment of cash.

b) The dividend policy of the company is in practice determined by the directors. From their standpoint, retained earnings are an attractive source of finance because investment projects can be undertaken without involving either the shareholders or any outsiders.

c) The use of retained earnings as opposed to new shares or debentures avoids issue costs.

d) The use of retained earnings avoids the possibility of a change in control resulting from an issue of new shares.

Another factor that may be of importance is the financial and taxation position of the company's shareholders. If, for example, because of taxation considerations, they would rather make a capital profit (which will only be taxed when shares are sold) than receive current income, then finance through retained earnings would be preferred to other methods.

A company must restrict its self-financing through retained profits because shareholders should be paid a reasonable dividend, in line with realistic expectations, even if the directors would rather keep the funds for re-investing. At the same time, a company that is looking for extra funds will not be expected by investors (such as banks) to pay generous dividends, nor over-generous salaries to owner-directors.

Bank lending

Borrowings from banks are an important source of finance to companies. Bank lending is still mainly short term, although medium-term lending is quite common these days.

Short term lending may be in the form of:

a) an overdraft, which a company should keep within a limit set by the bank. Interest is charged (at a variable rate) on the amount by which the company is overdrawn from day to day;

b) a short-term loan, for up to three years.

Medium-term loans are loans for a period of from three to ten years. The rate of interest charged on medium-term bank lending to large companies will be a set margin, with the size of the margin depending on the credit standing and riskiness of the borrower. A loan may have a fixed rate of interest or a variable interest rate, so that the rate of interest charged will be adjusted every three, six, nine or twelve months in line with recent movements in the Base Lending Rate.

Lending to smaller companies will be at a margin above the bank's base rate and at either a variable or fixed rate of interest. Lending on overdraft is always at a variable rate. A loan at a variable rate of interest is sometimes referred to as a *floating rate loan.* Longer-term bank loans will sometimes be available, usually for the purchase of property, where the loan takes the form of a mortgage. When a banker is asked by a business customer for a loan or overdraft facility, he will consider several factors, known commonly by the mnemonic **PARTS.**

- **P**urpose
- **A**mount
- **R**epayment
- **T**erm
- **S**ecurity

P The purpose of the loan A loan request will be refused if the purpose of the loan is not acceptable to the bank.

A The amount of the loan. The customer must state exactly how much he wants to borrow. The banker must verify, as far as he is able to do so, that the amount required to make the proposed investment has been estimated correctly.

R How will the loan be repaid? Will the customer be able to obtain sufficient income to make the necessary repayments?

T What would be the duration of the loan? Traditionally, banks have offered short-term loans and overdrafts, although medium-term loans are now quite common.

S Does the loan require security? If so, is the proposed security adequate?

Leasing

A lease is an agreement between two parties, the "lessor" and the "lessee". The lessor owns a capital asset, but allows the lessee to use it. The lessee makes payments under the terms of the lease to the lessor, for a specified period of time.

Leasing is, therefore, a form of rental. Leased assets have usually been plant and machinery, cars and commercial vehicles, but might also be computers and office equipment. There are two basic forms of lease: "operating leases" and "finance leases".

Operating leases

Operating leases are rental agreements between the lessor and the lessee whereby:

a) the lessor supplies the equipment to the lessee

b) the lessor is responsible for servicing and maintaining the leased equipment

c) the period of the lease is fairly short, less than the economic life of the asset, so that at the end of the lease agreement, the lessor can either

i) lease the equipment to someone else, and obtain a good rent for it, or
ii) sell the equipment secondhand.

Finance leases

Finance leases are lease agreements between the user of the leased asset (the lessee) and a provider of finance (the lessor) for most, or all, of the asset's expected useful life.

Suppose that a company decides to obtain a company car and finance the acquisition by means of a finance lease. A car dealer will supply the car. A finance house will agree to act as lessor in a finance

leasing arrangement, and so will purchase the car from the dealer and lease it to the company. The company will take possession of the car from the car dealer, and make regular payments (monthly, quarterly, six monthly or annually) to the finance house under the terms of the lease.

Other important characteristics of a finance lease:

a) The lessee is responsible for the upkeep, servicing and maintenance of the asset. The lessor is not involved in this at all.

b) The lease has a primary period, which covers all or most of the economic life of the asset. At the end of the lease, the lessor would not be able to lease the asset to someone else, as the asset would be worn out. The lessor must, therefore, ensure that the lease payments during the primary period pay for the full cost of the asset as well as providing the lessor with a suitable return on his investment.

c) It is usual at the end of the primary lease period to allow the lessee to continue to lease the asset for an indefinite secondary period, in return for a very low nominal rent. Alternatively, the lessee might be allowed to sell the asset on the lessor's behalf (since the lessor is the owner) and to keep most of the sale proceeds, paying only a small percentage (perhaps 10%) to the lessor.

Why might leasing be popular

The attractions of leases to the supplier of the equipment, the lessee and the lessor are as follows:

· The supplier of the equipment is paid in full at the beginning. The equipment is sold to the lessor, and apart from obligations under guarantees or warranties, the supplier has no further financial concern about the asset.

· The lessor invests finance by purchasing assets from suppliers and makes a return out of the lease payments from the lessee. Provided that a lessor can find lessees willing to pay the amounts he wants to make his return, the lessor can make good profits. He will also get capital allowances on his purchase of the equipment.

· Leasing might be attractive to the lessee:

i) if the lessee does not have enough cash to pay for the asset, and would have difficulty obtaining a bank loan to buy it, and so has to rent it in one way or another if he is to have the use of it at all; or

ii) if finance leasing is cheaper than a bank loan. The cost of payments under a loan might exceed the cost of a lease.

Operating leases have further advantages:

· The leased equipment does not need to be shown in the lessee's published balance sheet, and so the lessee's balance sheet shows no increase in its gearing ratio.

· The equipment is leased for a shorter period than its expected useful life. In the case of high-technology equipment, if the equipment becomes out-of-date before the end of its expected life, the lessee does not have to keep on using it, and it is the lessor who must bear the risk of having to sell obsolete equipment secondhand.

The lessee will be able to deduct the lease payments in computing his taxable profits.

Hire purchase

Hire purchase is a form of instalment credit. Hire purchase is similar to leasing, with the exception that ownership of the goods passes to the hire purchase customer on payment of the final credit instalment, whereas a lessee never becomes the owner of the goods.

Hire purchase agreements usually involve a finance house.

i) The supplier sells the goods to the finance house.
ii) The supplier delivers the goods to the customer who will eventually purchase them.
iii) The hire purchase arrangement exists between the finance house and the customer.

The finance house will always insist that the hirer should pay a deposit towards the purchase price. The size of the deposit will depend on the finance company's policy and its assessment of the hirer. This is in contrast to a finance lease, where the lessee might not be required to make any large initial payment.

An industrial or commercial business can use hire purchase as a source of finance. With industrial hire purchase, a business customer obtains hire purchase finance from a finance house in order to purchase the fixed asset. Goods bought by businesses on hire purchase include company vehicles, plant and machinery, office equipment and farming machinery.

Government assistance

The government provides finance to companies in cash grants and other forms of direct assistance, as part of its policy of helping to develop the national economy, especially in high technology industries and in areas of high unemployment. For example, the Indigenous Business Development Corporation of Zimbabwe (IBDC) was set up by the government to assist small indigenous businesses in that country.

Venture capital

Venture capital is money put into an enterprise which may all be lost if the enterprise fails. A businessman starting up a new business will invest venture capital of his own, but he will probably need extra funding from a source other than his own pocket. However, the term 'venture capital' is more specifically associated with putting money, usually in return for an equity stake, into a new business, a management buy-out or a major expansion scheme.

The institution that puts in the money recognises the gamble inherent in the funding. There is a serious risk of losing the entire investment, and it might take a long time before any profits and returns materialise. But there is also the prospect of very high profits and a substantial return on the investment. A venture capitalist will require a high expected rate of return on investments, to compensate for the high risk.

A venture capital organisation will not want to retain its investment in a business indefinitely, and when it considers putting money into a business venture, it will also consider its "exit", that is, how it will be able to pull out of the business eventually (after five to seven years, say) and realise its profits. Examples of venture capital organisations are: Merchant Bank of Central Africa Ltd and Anglo American Corporation Services Ltd.

When a company's directors look for help from a venture capital institution, they must recognise that:

· the institution will want an equity stake in the company
· it will need convincing that the company can be successful
· it may want to have a representative appointed to the company's board, to look after its interests.

The directors of the company must then contact venture capital organisations, to try and find one or more which would be willing to offer finance. A venture capital organisation will only give funds to a company that it believes can succeed, and before it will make any definite offer, it will want from the company management:

a) a business plan

b) details of how much finance is needed and how it will be used

c) the most recent trading figures of the company, a balance sheet, a cash flow forecast and a profit forecast

d) details of the management team, with evidence of a wide range of management skills

e) details of major shareholders

f) details of the company's current banking arrangements and any other sources of finance

g) any sales literature or publicity material that the company has issued.

A high percentage of requests for venture capital are rejected on an initial screening, and only a small percentage of all requests survive both this screening and further investigation and result in actual investments.

Franchising

Franchising is a method of expanding business on less capital than would otherwise be needed. For suitable businesses, it is an alternative to raising extra capital for growth. Franchisors include Budget Rent-a-Car, Wimpy, Nando's Chicken and Chicken Inn.

Under a franchising arrangement, a franchisee pays a franchisor for the right to operate a local business, under the franchisor's trade name. The franchisor must bear certain costs (possibly for architect's work, establishment costs, legal costs, marketing costs and the cost of other support services) and will charge the franchisee an initial franchise fee to cover set-up costs, relying on the subsequent regular payments by the franchisee for an operating profit. These regular payments will usually be a percentage of the franchisee's turnover.

Although the franchisor will probably pay a large part of the initial investment cost of a franchisee's outlet, the franchisee will be expected to contribute a share of the investment himself. The franchisor may well help the franchisee to obtain loan capital to provide his-share of the investment cost.

The advantages of franchises to the franchisor are as follows:

· The capital outlay needed to expand the business is reduced substantially.
· The image of the business is improved because the franchisees will be motivated to achieve good results and will have the authority to take whatever action they think fit to improve the results.

The advantage of a franchise to a franchisee is that he obtains ownership of a business for an agreed number of years (including stock and premises, although premises might be leased from the franchisor) together with the backing of a large organisation's marketing effort and experience. The franchisee is able to avoid some of the mistakes of many small businesses, because the franchisor has already learned from its own past mistakes and developed a scheme that works.