MEANING OF ACCOUNTING

Accounting is the recording of business transaction for getting final results i.e.. Profit or loss. It is the process recording all the financial transactions of the firm in order to find out profitability and financial position of the business organization.

DEFINITION

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

FEATURES OF ACCOUNTING

- Monetary transaction
- Historical nature
- Legal requirements
- External use
- Disclosure of financial status
- Interim reports

SCOPE OF FINANCIAL ACCOUNTING

- **Book keeping**- book keeping is concerned with recording of financial data relating to business operations in a systematic manner.
- **Financial statements**- financial statements includes profit & loss account and balance sheet. Profit & loss account is prepared to know the profitability and balance sheet is prepared to know the financial position of the business.
- **Analysis and interpretation of financial statements**- when we analyze the financial statements we get more information about the business. After analyzing the financial statements, conclusions are drawn. Drawing conclusions are known as interpretation of financial statements.
- **Financial reporting-** the ultimate object of financial accounting is provide information to internal & external users for decision making. For this purpose the results of analysis and interpretations are communicated. The information is communicated in the form of reports.
- **Segment reporting**- segment reporting refers to the reporting of financial information relation to different business activities of the firm.
- **Accounting principles-** financial accounting follows a set of principles. These principles are generally known as Generally Accepted Accounting Principles. These helps in preparation of financial statements.
- **Accounting standards**- the presentation, preparation and reporting of financial accounts have to be done according to certain standards. These standards are known as accounting standards. The main objective accounting standards is to bring about uniformity.

ACCOUNTING POLICIES

Accounting principles are the assumptions and rules of accounting and the application of these rules, methods will enable us to make perfection accounting system. It is the general rules and procedures followed by the accountant while recording transactions and preparing final accounts.

Accounting principles are generally divided in to two-

- Accounting concepts
- Accounting conventions

ACCOUNTING CONCEPTS- these are the assumptions and conditions that is to be adopted when an accountant record the financial transactions. The major accounting concepts are as follows.

- **Business entity concept-** according to this assumptions, a business is treated as separate entity from its owner. From this point of view of business, owner is a creditor for the capital
- **Money measurement concept-** according to this concept, only those transactions which can be measured in terms are to be recorded.
- **Going concern concept-** it is assumed that every business will continue for an indefinite period of time. It is with this assumption fixed assets are recorded at original cost less depreciation.
- **Accounting period concept-** the life of a business is divided in to different periods for preparing financial statements. Generally businesses adopts 12 months period for measuring the income of the concern.
- **Cost concept-** according to this concept, all transactions are recorded in the books of accounts at actual price involved not at market price.
- **Dual aspect concept-** according to this concept every transaction has two aspects. Receiving aspect & giving aspect, receiving aspect is called debit and giving aspect is called credit. Accounting equation is based on this concept.
- **Realization concept-** according to this concept, revenue is recognized when a sale is made or a service is rendered to customers, whether it is a cash sale, credit sale or as installment sale.
- **Matching concept-** according to this concept, cost or expenses of a business of particular period are matched or compared with the revenue of that period in order to ascertain profit or loss.
- **Objectivity concept-** this concept requires that accounting data should verifiable and free from personal bias of the accountant.

ACCOUNTING CONVENTIONS- accounting conventions are the customs or tradition which guide the accountant while preparing financial statements.

- **Convention of consistency-** this convention follows that the basis followed in several accounting period should be consistent. This means the methods adopted in one accounting year should not be changed in another year.
- **Convention of conservatism**- this is a convention of caution or playing safe which is followed while preparing the financial statements. This idea of this statement is to consider all possible losses and to ignore all probable profits.
- **Convention of materiality**- according to this convention, only the material or important fact about the business are to be disclosed through financial statements. All other unimportant information should either be totally ignored or recorded as foot note.
- **Convention of full disclosure**- the objective of accounting is to provide true and accurate information. Hence, accounting records and statements should be honest and informative. The convention of disclosure requires that all significant information should be disclosed in the financial statements.

ACCOUNTING STANDARDS

Accounting standards are a regulatory framework within which financial statements are prepared. They are the rules that ensure uniformity of preparation, presentation and reporting of accounting information

SINGLE ENTRY SYSTEM

Single entry system is a system of accounting which does not follow the double entry system. Under this system only the accounts relating debtors and creditors are maintained. Cash book is also maintained.

DOUBLE ENTRY SYSTEM

In this system every business transaction is having a twofold effect of benefits giving and benefit receiving aspects. The recording is made on the basis of both these aspects. Double Entry is an accounting system that records the effects of transactions and other events in at least two accounts with equal debits and credits.

MEANING OF DEBIT & CREDIT

Debit

The word debit is derived from latin word debitum. It means due for that. In short, receiving aspect of transaction.

Credit

The word credit is derived from the latin word creder, which means due to that. In short, the giving aspect

STEPS IN DOUBLE ENTRY SYSTEM

(a) Preparation of Journal
(b) Preparation of Ledger
(c) Trial Balance preparation:
(d) Preparation of Final Account

- Preparation of profit & loss a/c
- Preparation of balance sheet

ADVANTAGES OF DOUBLE ENTRY SYSTEM

i) Scientific system
ii) Complete record of transactions
iii) A check on the accuracy of accounts:
iv) Ascertainment of profit or loss
v) Knowledge of the financial position of the business
vi) Full details for purposes of control
vii) Comparative study is possible
viii) Helps management in decision making
ix) No scope for fraud

ACCOUNTING EQUATION

Assets = liabilities + capital
Capital = assets – liabilities
Liabilities = assets – capital

TRANSACTIONS

Transaction is an event which involves transfer of money or money's worth between the business and outsider including owner.

Types of business transactions

- Cash transaction
- Credit transactions
- Non cash transactions- depreciation

ACCOUNT

In accounting we keep a separate record of each and individual assets, liabilities, expenses, incomes, capital etc. these place where such a record is maintained is known as account.

CLASSIFICATION OR TYPES OF ACCOUNTS

- **Real accounts-** these are the accounts or properties of business. Eg- cash account.
- **Personal account-** these are the account relating to persons with whom business deals. Personal accounts may be of the following three types.
  - **Natural person's personal account-** accounts human being
  - **Artificial person's account-** accounts of artificial person created by law eg- company a/c, bank a/c
  - **Representative person's account-** indirectly representing a person. Eg- prepaid expenses
- **Nominal accounts-** accounts relating to income, expenses etc

RULES OF ACCOUNTING

- English approach
- American approach

ENGLISH APPROACH- this approach is based on types accounts are recorded. They are as follows.

Real accounts-

Debit what comes in
Credit what goes out

Personal account

Debit the receiver
Credit the giver

Nominal account-

Debit all expenses
Credit all incomes

AMERICAN APPROACH- according to this approach accounts are classified in to four – assets, liabilities, expenses and incomes

Assets-

Increase in asset – debit
Decrease in asset- credit

Liabilities-

Increase in liabilities- credit
Decrease in liabilities- debit

Expenses-

Increase in expenses – debit
Decrease in expenses – credit

Incomes-

Increase in incomes- credit
Decrease in incomes- debit

LIMITATIONS OF ACCOUNTING

- It provides only past data
- It does not show profit of each job or process
- It fails to measure control over resources
- It does not measure organizational efficiency
- It fails to provide adequate data for price fixation
- It does not provide data for comparison of costs
- It fails to take into account the price level changes
- It cannot disclose controllable & uncontrollable costs
- It provide only limited information for management for decision making

BRANCHES OF ACCOUNTING

- Financial accounting
- Management accounting
- Cost accounting

JOURNAL

When the business transactions take place, the first step is to record the same in the books of original entry or subsidiary books or books of prime or journal. Thus journal is a simple book of accounts in which all the business transactions are originally recorded in chronological order and from which they are posted to the ledger accounts at any convenient time. Journaling refers to the act of recording each transaction in the journal and the form in which it is recorded, is known as a journal entry.

SUB DIVISION OF JOURNAL

- **Sales Day Book**- to record all credit sales.
- **Purchases Day Book**- to record all credit purchases.
- **Cash Book-** to record all cash transactions of receipts as well as payments.
- **Sales Returns Day Book**- to record the return of goods sold to customers on credit. Purchases Returns Day Book- to record the return of goods purchased from suppliers on credit.
- **Bills Receivable Book-** to record the details of all the bills received.
- **Bills Payable Book**- to record the details of all the bills accepted.
- **Journal Proper-**to record all other items

LEDGER

Ledger is a main book of account in which various accounts of personal, real and nominal nature, are opened and maintained. I n journal, as all the business transactions are recorded chronologically, it is very difficult to obtain all the transactions pertaining to one head of account together at one place.

CASH BOOK

In every business concern generally there is large number of transactions. For the purpose of recording all such transactions a separate book is maintained. This is called cash book. Cash book may be four types

- **Simple or single column cash book**- it has only one cash column. On the debit side all receipts are recorded. On the credit side all payments are recorded
- **Two column cash book** –in the two column cash book one additional column for discount is provided on either side to record cash discount. Thus two column cash book has two columns on each side- cash column and discount column.
- **Three column cash book-** triple column cash book contains three columns both sides. These three columns are cash, bank and discount.
- **Petty cash book-** to avoid inconvenience to main cashier and to save time, a separate book is maintained to record small expenses. This book is known as petty cash book. Thus petty cash book is a subsidiary book maintained for recording minor expenses to be paid in cash.

IMPORTANT ACCOUNTING TERMS

transactions

Transaction means the exchange of money or money's worth from one account to another account Events like purchase and sale of goods, receipt and payment of cash for services or on personal accounts, loss or profit in dealings etc., are the transactions".

Debtor

A person who owes money to the firm mostly on account of credit sales of goods is called a debtor. For example, when goods are sold to a person on credit that person pays the price in future, he is called a debtor.

Creditor

A person to whom money owes by the firm is called creditor. For example, Madan is a creditor of the firm when goods are purchased on credit from him.

Capital

It means the amount which the proprietor has invested in the firm or can claim from the firm. It is also known as owner's equity or net worth. Owner's equity means owner's claim against the assets. It will always be equal to assets less liabilities, say:

Capital = Assets **-** Liabilities.

Liability

It means the amount which the firm owes to outsiders that is, excepting the proprietors.

Proprietor

The person who makes the investment and bears all the risks connected with the business is known as proprietor.

Account

It is a statement of the various dealings which occur between a customer and the firm.

Drawings

It is the amount of money or the value of goods which the proprietor takes for his domestic or personal use. It is usually subtracted from capital.

Revenue

It means the amount which, as a result of operations, is added to the capital. It is defined as the inflow of assets which result in an increase in the owner's equity. It includes all incomes like sales receipts, interest, commission, brokerage etc.,

Expense

The terms 'expense' refers to the amount incurred in the process of earning revenue. If the benefit of an expenditure is limited to one year, it is treated as an expense such as payment of salaries and rent.

Purchases

Buying of goods by the trader for selling them to his customers is known as purchases. Purchases can be of two types. Cash purchases and credit purchases.

sales

When the goods purchased are sold out, it is known as sales. Here, the possession and the ownership right over the goods are transferred to the buyer.

Stock

The goods purchased are for selling, if the goods are not sold out fully, a part of the total goods purchased is kept with the trader unlit it is sold out, it is said to be a stock. If there is stock at the end of the accounting year, it is said to be a closing stock.

This closing stock at the year-end will be the opening stock for the subsequent year.

Asset

Any physical thing or right owned that has a money value is an asset. In other words, an asset is that expenditure which results in acquiring of some property or benefits of a lasting nature. Assets may be fixed assets or current assets.

Goods

It is a general term used for the articles in which the business deals; that is, only those articles which are bought for resale for profit are known as Goods.

Trial balance

Trial balance is a statement of debit and credit balances extracted from all accounts in the ledger accounts for testing the arithmetical accuracy.

Final accounts

Final accounts are the accounts prepared at the final stage to judge the financial position and profitability of the business. The final account consists of trading profit & loss account and balance sheet.

Trading account

Trading account is prepared to show the result of buying and selling of goods during an accounting period. The result of trading may gross profit or gross loss.

Profit & loss account

The trading account show only gross result. It does not show final profit or loss. Hence it is necessary to prepare profit & loss account after preparing trading account. It is prepared to know the net profit or net loss of the business for an accounting period.

Balance sheet

To know the financial position of business, accountant prepares a separate statement known as balance sheet. It contains two sides that are asset side and liability side.

Difference between trial balance and balance sheet

Trial balance	Balance sheet
It consist of debit and credit side	It shows assets and liabilities
It is prepared to check arithmetical accuracy of ledger posting	Prepared to know the financial position of the business
It show the balance of all ledger accounts	It shows assets and liabilities
It is prepared from various ledger accounts	It is prepared from trial balance
It does not contain closing stock	It contains closing stock
It can be prepared at the end of each month	It is generally prepared at the end of an accounting period
It is not compulsory to prepare trial balance	It is compulsory to prepare a balance sheet

CLASSIFICATION OF ASSETS-

- **Fixed assets**-
  fixed assets are those which are of a permanent nature or are used of the operation of business and not for resale. These assets help in earning revenue. These cannot be easily converted into cash eg- machinery, land, building etc.

- **Intangible assets**-Intangible assets are those assets which cannot be seen or touched, but their benefits accrue to the business. Eg- patent, copy right etc
- **Current assets**-
  Current assets are those assets which are held temporarily in course of business and converted into cash easily. Eg cash, bank, Stock, Prepaid expenses, debtors, bills receivables.
- **Fictitious assets** –
  These are not real assets. They are represented by log tangible possession. Eg- preliminary expenses
- **Wasting assets-**
  These are those assets which are exhausted gradually in the process of their use. Eg- mines, oil wells etc.
- **Contingent assets-**
  Contingent assets are probable assets which may or may not become assets depending upon occurrence or non-occurrence of a specific event. Assets which are in a case is an example

CLASSIFICATION OF LIABILITIES

- **Long term liabilities**-
  Liabilities which are repayable after a long period of time are known as long term or fixed liabilities. Eg- debentures, long term loans etc.
- **Current liabilities-**
  Liabilities which are repayable within one year are known as current liabilities or short term liabilities eg . creditors, bills payable, outstanding expenses etc
- **Contingent liabilities**-
  Contingent liabilities are those liabilities which may or may not become actual liabilities in future. Liabilities which are in case are an example for contingent liability.

ADJUSTMENT ITEMS

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- **Accrued income** – it is also known as outstanding income. This is the income earned but not received by the end of the accounting year
- **Outstanding expenses** – outstanding expenses are those expenses which remain unpaid at the end of the accounting period. In order to arrive at true profit or loss, it is necessary to take into account the accrue or outstanding expenses
- **Prepaid expenses** – prepaid expenses are payment made in the current year relate to the next year. In short, prepaid expense is expense paid in advance.
- **Income received in advance** – sometime the whole amount of income received in an accounting year does not belong to the current year. A part of it may relate to the next year. such portion is called income received in advance.
- **Bad debt** – when the amount due from debtors is found irrecoverable, it is called bad debt. In short irrecoverable debt is known as bad debt.
- **Provision for bad debt** – a part of the debtors at the end of the year may be irrecoverable. This means some of the debtors are doubtful. A doubtful debt is the debt which may or may not be recovered. Hence all enterprise based on their past experience create a provision for bad debt to meet such a probable loss in case it happens.
- **Depreciation** – decrease in the value of fixed asset due to wear and tear or obsolescence etc is called depreciation.
- **Drawings in goods** – when goods are withdrawn by the proprietor for private use, it should be treated as drawings.
- **Interest on capital** – sometimes interest is allowed or charged on

capital. Interest on capital is an expenses for the business.

Management accounting

Management accounting is the accounting information that is useful to management for decision making.

It is the process of identifying, analyzing, interpreting and presenting financial and& non-financial information to be used by the management to plan & control activities.

Nature of management accounting

- Provides accounting information
- Decision making
- Studies cause & effect relationship
- Use special techniques
- Quantitative & qualitative information
- Accounting for future
- No fixed form allowed
- Assist management
- Increase efficiency

Importance or advantages of management accounting

- Proper planning
- Effective control
- Quick decision making
- Increased efficiency
- Measurement of performance
- Maximizing profitability
- Increase in production
- Improve standard of living of people
- Economic development

Limitation of management accounting

- Based on accounting information
- Lack of knowledge
- Not a substitute for management
- Personnel judgment
- Costly
- Evolutionary stage
- Resistance

Tools of management accounting

- Financial analysis
    - Comparative income statement
    - Comparative balance sheet
    - Common size income statement
    - Common size balance sheet
    - Ratio analysis
    - Fund flow analysis
    - Cash flow analysis
- Marginal costing
- Budgetary control
- Standard costing

Uses of financial analysis

- Importance to shareholders- return
- Importance to creditors – to know position of business
- Importance to management- decision making
- Importance to employees- profitability
- Importance to government- tax matter

Tools Of Financial Analysis

Comparative income statement

Under comparative income statement two years' expenses and incomes are compared by analyzing the increase or decrease in each item. It also discloses percentage of changes.

Comparative balance sheet

The CBS shows the different assets and liabilities of the firm on different dates to make comparisons of absolute balances and also of changes if any, from one date to another. The CBS may be helpful in analyzing and evaluating the financial position of the firm over a period of number of years.

Common Size Balance sheet

A statement in which balance sheet items are expressed as the ratio of each asset to total assets and the ratio of each liability is expressed as a ratio of total liabilities is called common-size balance sheet. The common size balance sheet can be used to compare companies of differing size.

Common size Income statement

The items in Income statement can be shown as percentages of sales to show the relation of each item to sales. A significant relationship can be established between items of income statement and volume of sales.

Ratio analysis

A ratio is a simple arithmetical expression of the relationship of one number to another. In simple language ratio is one number expressed in terms of another and can be worked out by dividing one number into the other. A ratio can be expressed in the form of a fraction, number of times, percentage or in proportion.

Importance or advantages of ratio analysis

{a} Managerial uses of Ratio analysis

- Helps in decision making
- Helps in financial forecasting and planning
- Helps in communicating
- Helps in co-ordination
- Helps in control

{b}Utility to Shareholders/ Investors

An investor is particularly interested to know about the Long term financial position and profitability position

{c}Utility to Creditors

The creditors or suppliers extend short term credit to the concern. They are interested to know whether financial position of the concern warrants their payments at a specified time or not.

{d}utility to the Employees

The employees are also interested in the financial position of the concern especially profitability because their wage increases and amount of fringe benefits are related to the volume of profits earned by the concern.

{e}Utility to government

Government is interested to know the overall strength of the industry.

limitations of ratio analysis

- Limited use of a single ratio.
- Lack of adequate standards
- Inherent limitations of accounting
- Change of accounting procedure
- Window dressing
- Personal bias
- Incomparable
- Price level changes.
- Ratios no substitutes.

Types of ratios

Liquidity ratios –

The term liquidity refers to the firm's ability to meet its current liabilities when they become due. Liquidity ratios are used to measure the liquidity position or short term financial position of the firm.

- **Current ratio** – it defined as the ratio of current assets to current liabilities. It shows the relationship between total current assets and current liabilities
- **Quick ratio / Liquid ratio**–liquid ratio is the ratio of liquid assets to current liabilities. It is the measure of the instant debt paying ability of the business.
- **Absolute quick ratio –**it is the ratio of absolute liquid asset to current liabiltities.it is uses to analyze cash position of business to meet its current liabilities.

Solvency ratios or Leverage ratios –

The term solvency refers to the ability of a firm to pay its outside liabilities(both long term and short term). Solvency ratios are used to analyze the long term financial position of a business.

- **Debt equity ratio-** This ratio indicates the relative proportion of debt and equity in financing the assets of a firm.it expresses the relationship between debt and equity.
- **Proprietary ratio** – proprietary ratio establishes the relationship between shareholders' fund and total asset. This shows how much fund have been contributed by the shareholders in the total assets of the firm.
- **Fixed asset ratio** – it is the ratio of fixed to long term fund or capital employed. The objective calculating this ratio is to ascertain the proportion of long term funds invested in fixed assets.

- **Total asset to total debt ratio** –

This ratio expresses the relationship between total asset and total liabilities. Total assets include total fixed and total current assets. Total liabilities include total outside liabilities. It measures the overall solvency of the firm.

Turnover ratios /activity ratios –

Turnover ratios show how efficiently a firm uses its available resources or assets. These ratios indicate efficiency in asset management.

- **Stock turnover ratio** –

Inventory or stock turnover ratio shows the relationship between costs of goods sold and average inventory or stock. It indicates the number of times the stock is converted in to sales.

  - **Stock velocity** – generally stock turnover ratio is expresses in times. It can also expressed in months or days. Then it is called stock velocity.

- **Debtors turnover ratio** –

Debtors turnover ratios explains the relationship between net credit sales and average debtors including bills receivables. This shows how quickly debtors are converted in to cash. It indicates how efficiently the firm collects cash from debtors.

  - **Average collection period** – it means the number of days or months for which debtors remain outstanding.

- **Creditors turnover ratio** –

Creditors turnover ratio shows the relationship between net credit purchase and average creditors including bills payable. It indicates the number of times the creditors are paid.

  - **Average payment period** -It means the credit period enjoyed by the firm in paying creditors.

Profitability ratios - the term profitability refers to the ability of a firm to earn maximum profit. Profitability ratio measure the ability of the firm to earn an adequate return on sales.

- **Gross profit ratio** - this is the ratio of gross profit to sales expressed in percentage. The main objective of computing this ratio is to determine the efficiency in trading or production activity.
- **Net profit ratio** – Net profit ratio is the ratio of net profit earned by a business and its net sales. The objective of calculating this ratio is to measure the overall profitability.
- **Operating ratio** – operating ratio express the relationship between operating cost and sales. It indicates the overall efficiency in operating the business.
- **Operating profit ratio** – operating profit ratio explains the relationship between operating profit and sales.

Fund flow statement

Fund = working capital

Working capital=Current assets – current liabilities

In a narrow sense it means cash and in a broader sense it is capital or all financial resources of a business. But the fund is commonly used in its popular sense as working capital or net current assets. Thus for accounting purpose and for preparing funds flow statements , the term fund means working capital of the excess of current assets over current liabilities.

meaning and concept of flow of funds

The term flow means movement and includes both inflow and outflow of fund. The term flow of funds means the transfer of economic values from one asset of equity to another.

Importance of fund flow statement

1.It helps in the analysis of financial operations

2.It gives answers to many questions like happening of N.P, proceeds of sale of F.A etc.

3. It helps in the proper allocation of resources
4. It acts as a guide for future to the management.
5. It helps in appraising the use of working capital
6. It helps in knowing the overall credit worthiness of the firm
7. It states how much funds has been generated from operations during the year
8. It helps the management in framing financial policies like dividend policies, issue of shares etc.
9.Creditors and financial institutions who have lend money to the firm can assess the financial strengths and repayment capacity based on funds.

Steps in preparing fund flow statement

1.Statement or schedule of changes in working capital

Working capital means the excess of current assets over current liabilities. Statement of changes in working capital is prepared to show the changes in the working capital between the two balance sheet dates.

Working capital = Current assets - Current liabilities

- An increase in current assets increases the working capital
- The decrease in current assets decreases the working capital
  An increase in current liabilities decreases the working capital
- A decrease in current liabilities increases working capital

1. **Preparation of ledger accounts to show hidden transactions**
2. **Preparation of fund from operation**
3. **Fund flow statement**

Cash flow statements

Cash flow statement is a statement which describes the inflows and outflows of cash and cash equivalents in an enterprise during a specified period of time. It explains the reasons for changes in a firm's cash position during an year.

classification of cash flows

- Cash flows from operating activities
- Cash flows from investing activities
- Cash flows from financing activities

cash flow statement & funds flow statement

1.CFSt is a statement which discloses the inflows and outflows of cash during a period, FFS is a statement which discloses the sources and uses of funds or working capital during a period
2. CFS is prepared on cash basis, FFS is prepared on working capital basis
3. CFS is mainly used for cash planning and managing liquidity, .FFS is mainly used for long term financial planning
4.CFS explains reasons for shortage or surplus of liquid cash at the end, FFS explains reasons for a net increase or decrease in working capital
5. it is presented in prescribed format as per AS-3, . Not presented in prescribed format.
6. In CFS a schedule of changes in working capital is not required. In FFS a schedule of changes in working capital is prepared to ascertain the net increase or decrease in working capital.

Difference between fund flow statement and balance sheet

Fund flow statement	**Balance sheet**
Statement of changes in assets and liabilities	It is the statement of assets and liabilities.
Prepared to show the sources and uses of fund during a period of time.	Prepared to ascertain financial position of the firm
Prepared after balance sheet is prepared	Prepared at the end of an accounting period
No legal compulsory	Required to prepare.
Useful to internal management	Useful to external parties
There is no prescribed format	There is prescribed format.

Marginal costing

It is the technique of costing in which only marginal costs or variable are charged to output or production. The cost of the output includes only variable costs .Fixed costs are not charged to output.

CVP analysis/Cost profit volume analysis

It is the study of relationship between cost, profit and volume of production.

Importance of CVP analysis

1. Profit Planning
2. Cost control
3. Decision making
4. Fixation of selling price

Tools of CVP analysis

1. **Break even analysis**

Every business is interested in ascertaining the breakeven point. It is the level of operation where total revenue or sales are equal to total cost. It is the point of no profit or no loss.

2. **Margin of safety**

Margin of safety represents the strength of the business to face an adverse market condition. It is the excess of actual sales over break even sales.

3. **Profit volume ratio [P/V ratio].**

Contribution is an absolute measure of profitability but it cannot be used for comparison of two products or departments. Therefore, the contribution is related to volume of sales.

Assumptions in CVP analysis

- Cost can be classified into fixed and variable components.
- Total fixed cost remain constant at all levels of output
- The variable cost change in direct proportion with the volume of output
- The selling price per unit remains the same at all the levels of sales
- There is synchronization of output and sales, i.e., whatever output is produced, the same is sold during that period.

Standard costing

Standard costing is a technique of cost control. The CIMA official terminology defines it as "a control technique which compares standard costs and revenues with actual results to obtain variances which are used to stimulated improved performance."

In standard costing the actual costs incurred are compared with the standard costs. The difference between the two is called variance.

Objectives of standard costing:

1. Performance measurement
2. Cost control
3. Stock valuation
4. Establishing selling prices
5. Profit planning and decision making
6. Basis of estimating
7. Assisting establishment of budgets

Steps involved in Standard Costing:-

- Establishment of cost centers
- Classification and codification of accounts:
- Establishment of standards
- Ascertainment of actual cost:
- Comparison of Standard cost and Actual
- Analysis of Variances
- Reporting of variance

TYPES OF VARIANCES

MATERIAL VARIANCE – material variances are popularly known as material cost variances. They are in three types:

- **Material cost variance** – material cost variance is the difference between standard cost of material specified and actual cost of material used.
- **Material price variance** – it is the part of material cost variance which is due to the difference between standard price and actual price paid.
- **Material usage variance** – it is the difference between standard quantity and actual quantity used.

LABOUR VARIANCE – it is also called wage variance. When standard cost of labour differs from actual wage cost, the labour variances arise.

- **labour cost variance** –it is the difference between standard cost of labour allowed and actual cost of labour.
- **labour rate variance** – it is the difference between standard rate of labour and actual rate paid.
- **labour efficiency variance** – it is also called labour usage variance. It is the difference between standard hours specified for the actual output and the actual hours spent.
- **idle time variance –** it is the portion of labour cost variance which arises due to the abnormal idle time of workers.

OVERHEAD VARIANCE – expense variance

Meaning of budget

A budget is a plan of action for a future period. It simply means a financial plan expressed in terms of money. The budget pertaining to any of the activities of business is always forward looking

Budgetary control

Budgeting simply means preparing budgets. It is a process of preparation, implementation and the operation of budget.

Types of budgets

(A) Classification on the basis of Time:

- **Long-term budgets** - this budget are related to planning the operation of a firm for a period of 5 to 10 years.
- **Short-term budgets** – these budgets are drawn usually for a period of one or two years.
- **Current budgets** – this budget cover a period of one month or so.

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(B) Classification according to functions:

It may be two types functional budget and master budget

Functional or subsidiary budgets

Functional budgets are those which are prepared by head of functional departments for their respective departments. The following are the functional budgets.

- **Production budget –** it is the forecast of the quantity of production for the budget period. It is expressed in physical quantity.
- **Purchase budget** – this shows the quantity of different type of materials to be purchased during a definite period of time.
- **Sales budget** – sales budget is a forecast of total sales expressed in quantities and money.
- **Material budget –** a material budget shows the estimated quantities as well as cost of raw material required for the production of different products during the budget period
- **Cash budget –** cash budget is the most important of all the functional budgets. It is also called financial budgets. It is the device to plan for and control the use of cash. It is the statement showing estimated cash inflows and cash outflows over the budget period.

2. Master budgets –

The managers of various departments prepare their budget and submit them to the budget committee. The committee will make necessary adjustments, incorporate the entire functional budget and prepare a master budget. So one can say it is the summary of all functional budgets

(C) Classification on the basis of capacity:

- **Fixed budgets.** – Fixed budget is a budget which is designed to remain unchanged irrespective of the level of activity attained. It does not change in the level of activity.
- **Flexible budgets** – flexible budget is a dynamic budget. A budget designed to change in accordance with the level of activity actually attained. It shows estimated costs and profits at different levels of output.

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LIQUIDITY RATIOS	
Current ratio	Current assets / current liabilities
Quick or liquid ratio	Liquid assets / current liabilities
Absolute liquid ratio	Absolute liquid asset / current liabilities
SOLVENCY RATIOS	
Debt equity ratio	Debt / equity
Proprietary ratio	Shareholders fund / total asset
Total asset to total debt ratio	Total assets / total debts
Fixed asset ratio	Fixed asset / shareholders fund
PROFITABILITY RATIOS	
Gross profit ratio	Gross profit x100 / net sales
Net profit ratio	Net profit x 100 / net sales
Operating ratio	(Cost of goods sold + operating expenses) x 100 / net sales
Operating profit ratio	Operating profit x 100 / net sales
TURNOVER RATIOS	
Stock turnover ratio	Cost of goods sold / average stock
Stock velocity	365 / stock turnover ratio
Debtors turnover ratio	Net credit sales / average debtors + bills receivables
Average collection period	365 / debtors turnover ratio
Creditors turnover ratio	Net credit purchases / average creditors + bills payable
Average payment period	365 / creditors turnover ratio
MARGINAL COSTING EQUATIONS	
B.E. P in units	Fixed expenses / contribution per unit
Contribution	Sales – variable cost
B. E. P in sales	Fixed expenses x sales / contribution Or fixed expenses x selling price per unit / contribution per unit Fixed expense / P/V ratio
P / V ratio	Contribution x 100 / net sales or Change profit x 100 / change in sales or Change in contribution x 100 / change in sales
Margin of safety	Actual sales - B.E.P sales

MATERIAL VARIANCES	
Material cost variance	Standard cost of materials for actual output – Actual cost of materials used
Standard cost of material	std qty x std price per unit
Actual cost of material	Actual qty x actual price
Material price variance	Actual qty x (std price – Actual price)
Material usage variance	Std price per unit (Std qty – Actual qty)
LABOUR VARIANCES	
Labour cost variance	Std cost of labour – Actual cost labour
Standard cost of labour	Standard rate x standard time
Actual cost of labour	Actual rate x actual time
Labour rate variance	Actual time x (Std rate – Actual rate)
Labour efficiency variance	Standard rate x (Standard time for actual output – Actual time
Idle time variance	Anormanl idle time x standard rate