Class: III. B.Com **Course Name: Management Accounting**

Course Code: 16CMU601A **Semester: VI** **Year: 2017-2020**

UNIT- I

Management Accounting – meaning, nature and Scope and functions of management accounting – relationship between management accounting, and financial accounting-role of management in decision making

Management accounting

Meaning: The term management accounting refers to accounting for the management, i.e. accounting which provides necessary information to the management for discharging its functions. The functions of the management are planning, organising, directing and controlling. Thus, management provides information to management so that planning, organising, directing and controlling of business operations can be done in an orderly manner.

Definition

The Chartered Institute of Management Accountants, London, defines- "The application of professional knowledge and skill in the preparation of accounting information in such a way to assist management in the formation of policies and in the planning and control of the operations of the undertaking."

American Accounting Association -"Management Accounting is the application of appropriate techniques and concepts in processing historical and projected economic data of an entity to assist management in establishing plans for reasonable economic objectives in the making of rational decisions with a view towards achieving these objectives."

Efficiency of the various phase of management is, as a matter of fact, the common thread which underlies all these definitions. However, it should be clearly understood that it does not supplant financial accounting but rather it supplements it in order to serve the diverse requirements of modern management.

Management accounting covers all rearrangement, combination or adjustment of the orthodox accounting figures which may be required the Chief

Executive with the information from which he can control the business. It comprises accounting methods, systems and techniques which coupled with special knowledge and ability, assist management in its task of maximising profits or minimising losses.

FUNCTIONS OF MANAGEMENT ACCOUNTING

The basis function of management accounting is to assist the management in performing its function effectively. The functions of the management are planning; organising, directing and controlling. Management accounting helps in the performance of each of these functions in the following ways:

1. Provides Data:

Management accounting serves as a vital source of data for management planning. The accounts and documents are a repository of a vast quantity of data about the past progress of the enterprise which are a must for making forecasts for the future.

2. Modifies data:

The accounting data required for managerial decisions are properly compiled and classified. For example, purchase figures or different months may be classified to know total purchases made during each period product-wise, supplier-wise and territory-wise.

3. Analyses and Interprets data: The accounting data is analysed meaningfully for effective planning and decision-making. For this purpose the data is presented in a comparative form. Ratios are calculated and likely trends are projected.

4. Serves as a means of communicating: Management accounting provides a means of communicating management plans upward, downward and outward through the organisation. Initially, it means identifying the feasibility and consistency of the various segments of the plan. At later stages it keeps all parties informed about the plans that have been agreed upon and their roles in these plans.

5. Facilitates Control: Management accounting helps in translating given objectives and strategy into specified goals for attainment by a specified time and secures effective accomplishment of these goals in an efficient manner. All this is made possible through budgetary control and standard costing which is an integral part of management accounting.

6. Uses also qualitative information: Management accounting is concerned with presentation of accounting information in the most useful way for the management. Its scope is, therefore, quite vast. It includes within its fold almost all aspects of business operations. However, the following areas can rightly be identified as falling within the ambit of management accounting

a) Financial Accounting: Management accounting is mainly concerned with the rearrangement of the information provided by financial accounting. Hence, management cannot obtain full control and coordination of operations without a properly designed financial accounting system.

b) Cost Accounting: Standard Costing, marginal costing, opportunity cost analysis, differential costing and other cost techniques plan a useful role in operation and control of the business undertaking.

c) Revaluation Accounting: This is concerned with the ensuring that capital is maintained intact in real terms and profit is calculated with this fact in mind.

d) Budgetary Control: This includes framing of budgets, comparison of actual performance with the budgeted performance, computation of variances, finding of their causes, etc.

e) Inventory Control: It includes control over inventory from the time it is acquired till its final disposal.

f) Statistical Method: Graphs, charts, pictorial presentation, index numbers and other statistical methods make the information more impressive intelligible.

g) Interim Reporting: This includes preparation of monthly, quarterly, half-yearly income statements and other related reports, cash flow and funds statements, scrap and reports, etc.

h) Taxation: This includes computation of income in accordance with the tax laws, filing of returns and making tax payments.

i) Office Services: This includes maintenance of proper data processing and other office management services, reporting on the best use of mechanical and electronic devices.

j) Internal Audit: Development of a suitable internal audit system for internal control.

FUNCTIONS OF THE MANAGEMENT ACCOUNTANT

It is the duty of the management accountant to keep all levels of the management informed of their real position. He has, therefore, varied function to perform. His important functions can be summarised as follows:

1. Planning: He has to establish, Coordinate and administer as an integral part of management, and adequate plan for the control of the operations.

Such a plan would include profit planning, programme of capital investment and financing, sales forecasts, expense budgets and cost standards.

2. Controlling: He has to compare actual performance with operating plans and standards and to report and interpret the result of operations to all levels of management and the owners of the business. This is done through the compilation of appropriate accounting and statistical records and reports.

3. Coordinating: He consults all segments of management responsible for policy or action. Such consultation might concern any phase of the operation of the business having to do with attainment of the objectives and the effectiveness of the organisation structures and policies.

ADVANTAGES OF MANAGEMENT ACCOUNTING

Management accounting provides invaluable services to management in the performance of its functions effectively as explained below:

1. Planning: It involves formulation of policies, setting up of goals and initiating necessary programmes for achievement of the goals.

Management accounting makes an important contribution in performance of this function. It makes available the relevant data after pruning and analysing them suitably by effective planning and decision-making.

2. Controlling

It involves evaluation of performance keeping in view that the actual performance coincides with the planned one, and remedial measures are taken in the event of variation between the two. The techniques of budgetary control, standard costing and departmental operating statements greatly help in performing this function. As a matter of fact the entire system of control is designed and operated by the management accountant designated as controller.

3. Coordinating:

It involves interlinking of different divisions of the business enterprise in a way so as to achieve the objectives of the organisation as a whole. Thus, perfect coordination is required among production, purchase, finance, personnel, sales, departments, etc. Effective coordination is achieved through departmental budgets and reports which from the nucleus of management accounting.

4. Organising:

It involves grouping of operative action in a way as to identify the authority and responsibility within the organisation. Management accounting, here also plays a prominent role. The whole organisation is divided into suitable profit or cost centres. A sound system of internal control and internal audit for each of the cost or profit centres helps in organising and establishing a sound business structure

5. Motivating:

It involves maintenance of a high degree of morale in the organisation.

Conditions should be such that each person gives his best to realise the goals of the enterprise. The superiors should be in a position to find out whom to demote or promote and to reward or penalise. Periodical department profit and loss accounts, budgets and reports go a long way in achieving this objective.

6. Communicating:

It involves transmission of data, result, etc. both to the insiders as well outsiders. The orders of the supervisors should be communicated to the subordinates while the results achieved by the subordinates should be reported to the, supervisors. Moreover, the management owes a duty to the creditors, prospective investors, shareholders, etc. to communicate to them about the progress, financial position, etc. of the enterprise; Management accounting helps the management in performance of this function by developing a suitable system of reporting which emphasis and highlights the relevant facts. Management accounting is thus helpful to the management in every field of activity. This is the reason why management accountant is considered not only a service is to management but also a part of management.

DIFFERENCE BETWEEN COST ACCOUNTING AND FINANCIAL ACCOUNTING

Relation Ship of Cost Accounting with Financial Accounting

Financial accounting is concerned with recording, classifying and summarizing financial transactions pertaining to an accounting period. The basic objective is to provide a commentary to the shareholders and outside parties on the financial status of an enterprise in the form of a profit and loss account and balance sheet. The profit or loss of business operations is revealed through these statements year after year, observing the statutory requirements of the Companies Act, 1956.

Cost accounting, on the other hand, aims a providing prompt cost data for managerial planning, controlling and decision making. It offers a complete explanation as to how the scarce inputs are put to use in business. The sources of efficiency or inefficiency are revealed through periodic reports. The profit or loss relating to each job, department or product can also be found out easily.

Basis of distinction	**Financial Accounting**	**Cost Accounting**
Statutory Requirements	These accounts have to be prepared pared according to the legal requirements of Companies Act and Income Tax Act	Maintenance of these accounts is voluntary except in certain industries where it has been made obligatory to keep cost records under the Companies Act.
Purpose	The main purpose of financial. accounting is to prepare profit and loss account and balance sheet for reporting to owners and outside agencies i.e., external users	The main purpose of cost accounting is to provide detailed cost information to management i.e., internal users.
Analysis of cost and Profit	Financial accounts reveal the profit or loss of the business as a whole during a particular period. It does not show the figures of cost and profit for individual	Cost accounts show the detailed Cost and profit data for each product line, department, process etc.

	products, departments and processes, etc.	
Periodicity of Reporting	Profit and Loss Account and Balance Sheet is prepared periodically, usually on an annual basis.	Cost reporting is a continuous process and may be daily, weekly, monthly, etc.
Classification of Records purpose	Financial accounting classifies records and analysis transactions in subjective manner i.e. according to nature of expenditure.	Cost accounting records and classifies expenditure according to the purpose for which cost is incurred.
Nature	It is concerned with historical records. The historical nature of financial accounting can be easily understood in the context of the purpose for which it was designed. General purpose statements like Profit and Loss Account and Balance sheet are prepared by it.	Cost accounting does not end with what has happened in the past. It extends to plans and policies to improve performance in the future
Nature of statements prepared	That is to say that financial accounting must produce information that is used by many classes of people none of whom have explicitly defined information needs.	It generates special purpose statements and reports like Report of Loss of Materials, Idle Times Report Variance Report etc. Cost accounting identifies the user, discusses his problems and needs and provides tailored information.

ROLE OF MANAGEMENT

Essentially, the role of managers is to guide the organizations toward goal accomplishment. All organizations exist for certain purposes or goals, and managers are responsible for combining and using organizational resources to ensure that their organizations achieve their purposes.

The role of the Management is to move an organization towards its purposes or goals by assigning activities that organization member perform.

If Management ensures that all the activities are designed effectively, the production of each individual worker will contribute to the attainment of the organizational goals.

Management strives to encourage individual activity that will lead to reaching organizational goals and to discourage individual activity that will hinder the accomplishment of the organization objectives.

There is no idea more important than managing the fulfilment of the organizational goals and objectives. The meaning of the Management is given by its goals and objectives. All managers must have a single minded focus on the fulfilment of the organizational goals.

DECISION MAKING

Decision making is a process of selecting the best among the different alternatives. It is the act of making a choice. There are so many alternatives found in the organization and departments. Decision making is defined as the selection of choice of one best alternative. Before making decisions all alternatives should be evaluated from which advantages and disadvantages are known. It helps to make the best decisions. It is also one of the important functions of management. Without other management functions such as planning, Organizing, directing, controlling, staffing can't be conducted because in this managerial function decision is very important. According to Stephen P. Robbins, "decision making is defines as the selection of a preferred course of action from two or more alternatives.

ROLE OF MANAGEMENT IN DECISION MAKING

1. **Implementation of managerial function**: Without decision making different managerial function such as planning, organizing, directing, controlling, staffing can’t be conducted. In other words, when an employee does, s/he does the work through decision making function. Therefore, we can say that decision is important element to implement the managerial function.

2. **Pervasiveness of decision making:** the decision is made in all managerial activities and in all functions of the organization. It must be taken by all staff. Without decision making any kinds of function is not possible. So it is pervasive.

3. **Evaluation of managerial performance:** Decisions can evaluate managerial performance. When decision is correct it is understood that the manager is qualified, able and efficient. When the decision is wrong, it is understood that the manager is disqualified. So decision making evaluate the managerial performance.

4. **Helpful in planning and policies:** Any policy or plan is established through decision making. Without decision making, no plans and policies are performed. In the process of making plans, appropriate decisions must be made from so many alternatives. Therefore decision making is an important process which is helpful in planning.

5. **Selecting the best alternatives:** Decision making is the process of selecting the best alternatives. It is necessary in every organization because there are many alternatives. So decision makers evaluate various advantages and disadvantages of every alternative and select the best alternative.

6. **Successful; operation of business:** Every individual, departments and organization make the decisions. In this competitive world; organization can exist when the correct and appropriate decisions are made. Therefore correct decisions help in successful operation of business.

Possible Questions (Unit-II)

1. What is mean by management accounting?
2. Explain the need and scope of management accounting?
3. Explain the relationship between cost accounting with financial accounting
4. Write any ten advantages of management accounting?
5. What is mean by decision making?
6. What is the role of manager in a firm?
7. Differentiate between cost accounting and management accounting?
8. Explain the decision making process.
9. How the management accounting helps in decision making process?

10. Explain the limitations of management accounting.

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Course Code: 16CMU601A **Semester: IV** **Year: 2017-2020**

UNIT- II

Budget, Budgeting and budgetary control – definition, importance, essentials, classification of budgets, master budgets, preparation of different budgets – steps in budgetary control.

Budget

The first important task in front of the management is to have clearly defined objectives. Objectives are short term as well as long term and they should be defined in clear terms. It is necessary to prepare a comprehensive plan to transform these objectives into reality and planning without controlling will not be effective and hence there is a need of effective control system. While planning helps an organization to work systematically towards achieving the objectives, controlling helps to review the progress made and to monitor whether the work is progressing as per the plan or not. Budgeting is one such technique hat helps in planning as well as controlling. It is a technique of cost accounting with the twin objectives of facilitating planning and ensuring controlling.

Definitions of Budget

A **Budget** is a plan that outlines an organization's financial and operational goals. So a budget may be thought of as an action plan; planning a budget helps a business allocate resources, evaluate performance, and formulate plans.

While planning a budget can occur at any time, for many businesses, planning a budget is an annual task, where the past year's budget is reviewed and budget projections are made for the next three or even five years.

Budget has been defined by CIMA U.K. as, 'A financial and/or quantitative statement prepared prior to a defined period of time, of the policy to be pursued during that period for the purpose of achieving a given objective.' If we analyse the definition, the following features of budget emerge.

A budget is a statement that is always prepared prior to a defined period of time. This means that budget is always prepared for future period and not for the past. For example, a budget for the year2008-09 regarding the sales will be prepared in the year 2007-08. Another important point is that the time for which it is prepared is certain. Thus a budget may be prepared for next 3 years/1 year/ 6months/1 month or even for a week, but the point is that the time frame for which it is prepared is certain. It cannot be prepared for indefinite period of time

Budget is prepared either in quantitative details or monetary details or both. This means that budget will show the planning in terms of rupees or in quantity or both. For example, a production budget will show the production target in number of units and when the target units are multiplied by the anticipated production cost, it will be a production cost budget that is expressed in terms of money. Similarly purchase budget is prepared in quantity to show the anticipated purchases in the next year and when the quantity is multiplied by the expected price per unit, it will become a purchase cost budget that is expressed in monetary terms. Some budgets are prepared only in monetary terms, for example, cash budget, capital expenditure budget etc.

Every organization has well defined objectives, which are to be achieved in a particular span of time. It is of paramount importance that there should be systematic efforts to bring them into reality. As apart of these efforts, it is necessary to formulate a policy and it is reflected in the budget. Thus if a firm has to launch a massive drive for recruitment of people, this policy will be reflected in the man power planning budget as well as other relevant budgets. Thus the policy to be pursued in future for the purpose of achieving well-defined objectives is reflected in the budget. Budgetary Control is actually a means of control in which the actual results are compared with the budgeted results so that appropriate action may be taken with

OBJECTIVES OF BUDGETING

1. To define the goal of the enterprises.
2. To provide long and short period for attaining these goals.
3. To co-ordinate the activities of different department.

Budgets have a key function in that they also serve a number of useful purposes which are key to an organisation’s success, i.e.

- ✓ Planning;
- ✓ Co-ordination;
- ✓ Communication;
- ✓ Motivation;
- ✓ Control;
- ✓ Evaluation.

Planning

Managers are required to produce detailed plans to enable the implementation of the long term or strategic plan. The annual budgeting process encourages managers to plan for future operations, refine existing strategic plans and consider how they can respond to changing circumstances. This encourages managers to anticipate problems before they arise and ensures reasoned decision making. Without this incentive the pressures of day to day operations may tempt managers not to plan for future operations and hasty decisions based on expediency rather than reasoned judgement will be minimised.

Co-ordination

Budgeting facilitates consolidation and co-ordination and allows the actions of the different parts of the organisation to be brought into a common plan. It also compels managers to examine the relationship between the different parts of an organisation when making decisions and in assists in identifying and resolving conflicts. Examples of the type of conflicts which could arise in a manufacturing setting for example would be between a purchasing manager who buys in bulk to obtain large discounts, a production manager who wishes to avoid large stock levels and an accountant who is concerned about the impact on the business’s cash resources. Budgeting aims to reconcile these differences.

Communication

All managers within the organisation must have a clear understanding of the role which they are required to play in ensuring budgetary compliance. This ensures that the most appropriate individuals are made accountable for budget implementation. Senior management can also use budgets to communicate corporate objectives downwards and ensure that other employees understand them and co-ordinate their activities to attain them. The act of preparation as well as the budget itself will also improve communication.

Participation in budget setting relates to the extent that subordinates are able to influence the figures incorporated in their targets. Participation is often referred to as bottom-up budget setting whereas a non participatory approach whereby subordinates have little influence on the target setting process is sometimes called top-down budget setting.

Motivation

Budgets can also provide a motivation for managers to perform in line with organisational objectives. It therefore sets a standard which under circumstances managers may be motivated to achieve. It is important, however, that managers are involved in the budget setting process and that budgets are used as a tool to assist them in managing their departments. With 'top-down' approaches there is a risk that dysfunctional motivational will occur.

Control

Managers can also use budgets to control the activities for which they are responsible. Analyses of variances allow managers to identify those costs which do not conform to the long term plan and therefore may require alteration. By investigating the reasons for budget deviations managers may also be able to identify inefficiencies.

The budget forms the basis of a controlling mechanism for the various resources of an organisation which is achieved by comparing the resource measured to the end of a given period with that which was expected. This approach can be used for all measurable resources and activities within the organisation – not just those which are directly financial.

Budgetary control highlights variations from the expected in order that management can take remedial action to ensure that the policy objectives set in the budget can be met. It is a constant monitoring process and requires continual updating and amendment of the budget through operational feedback. This also allows for performance against objectives or targets to be measured.

Evaluation

Budgeting can also be used as an effective management tool. It provides an important mechanism for informing managers as to how well they are performing in meeting targets they have previously helped to set and an employee's ability to meet agreed targets is used is many organisations to determine promotions and bonuses. In this circumstance budgets will therefore influence human behaviour.

Essentials of Effective Budgeting:

A budgetary control system can prove successful only when certain conditions and attitudes exist, absence of which will negate to a large extent the value of a budget system in any business. Such conditions and attitudes which are essential for effective budgeting are as follows:

1. **Support of Top Management:** If the budget system is to be successful, it must be fully supported by every member of the management and the impetus and direction must come from the very top management. No control system can be effective unless the organisation is convinced that the top management considers the system to be import.

2. **Participation by Responsible Executives:** Those entrusted with the performance of the budgets should participate in the process of setting the budget figures. This will ensure proper implementation of budget programmes.

3. **Reasonable Goals:** The budget figures should be realistic and represent reasonably attainable goals. The responsible executives should agree that the budget goals are reasonable and attainable.

4. **Clearly Defined Organisation:** In order to derive maximum benefits from the budget system, well defined responsibility centres should be built up within the organisation. The controllable costs for each responsibility centres should be separately shown.

5. **Continuous Budget Education:** The best way to ensure the active interest of the responsible supervisors is continuous budget education in respect of objectives, potentials & techniques of budgeting. This may be accomplished through written manuals, meetings etc., whereby preparation of budgets, actual results achieved etc., may be discussed.

6. **Adequate Accounting System:** There is close relationship between budgeting and accounting. For the preparation of budgets, one has to depend on the accounting department for reliable historical data which primarily forms the basis for many estimates. The accounting system should be so designed so as to set up accounts in terms of areas of managerial responsibility. In other words, responsibility accounting is essential for successful budgetary control.

7. **Constant Vigilance:** Reports comparing budget and actual results should be promptly prepared and special attention focused on significant exceptions i.e. figures that are significantly different from those expected.

8. **Maximum Profit:** The ultimate object of realizing the maximum profit should always be kept uppermost.

9. **Cost of the System:** The budget system should not cost more than it is worth. Since it is not practicable to calculate exactly what a budget system is worth, it only implies a caution against adding expensive refinements unless their value clearly justifies them.

10. **Integration with Standard Costing System:** Where standard costing system is also used, it should be completely integrated with the budget programme, in respect of both budget preparation and variance analysis.

Preparation of Different Budget

A standing budget committee will usually be responsible for overall policy matters relating to the budget program and for coordinating the preparation of the budget itself.

Classifications of Budget

Budget

Based on Functions

- Production Budget
- Production Cost Budget
- Materials Budget
- Materials Cost Budget
- Cash Budget
- Capital Budget
- Sales Budget
- Selling Cost Budget
- Plant Utilisation Budget
- Labour Budget

Based on Rigidity

- Fixed Budget
- Flexible Budget

➢ **Master Budget**

The master budget is a summary of company's plans that sets specific targets for sales, production, distribution and financing activities. It generally culminates in a cash budget, a budgeted income statement, and a budgeted balance sheet.

➢ **Sales Budget**

A sales budget is a detailed schedule showing the expected sales for the budget period; typically, it is expressed in both dollars and units of production. An accurate sales budget is the key to the entire budgeting in some way. If the sales budget is sloppily done then the rest of the budgeting process is largely a waste of time.

- **Production Budget**

The production budget is prepared after the sales budget. The production budget lists the number of units that must be produced during each budget period to meet sales needs and to provide for the desired ending inventory.

- **Inventory Purchases Budget For A Merchandising Firm**

Manufacturing firms prepare production budget but merchandising firms prepare merchandising purchase budget instead. Merchandising purchase budget shows the amount of goods to be purchased from its suppliers during the period.

- **Material Budgeting | Direct Materials Budget**

Direct materials budget is prepared after computing production requirements by preparing a production budget. Direct materials budget or materials budgeting details the raw materials that must be purchased to fulfill the production requirements and to provide for adequate inventories.

- **Labor Budget**

The direct labor budget is developed from the production budget. Direct labor requirements must be computed so that the company will know whether sufficient labor time is available to meet the budgeted production needs.

- **Manufacturing Overhead Budget**

The manufacturing overhead budget provides a schedule for all costs of production other than direct materials and direct labor.

- **Ending Finished Goods Inventory Budget**

After preparing sales budget, production budget, direct materials budget, direct labor budget, and manufacturing overhead budget the management has all the data needed to calculate unit product cost. This calculation is needed for two reasons: first, to determine cost of goods sold on the budgeted income statement; and second, to know what amount to put on the balance sheet inventory account for unsold units. The carrying cost of unsold units is calculated on the ending inventory finished goods budget.

- **Selling And Administrative Expense Budget**

Selling and administrative expense budget lists the budgeted expenses for areas other than manufacturing.

- **Cash Budget**

Cash budget is a detailed plan showing how cash resources will be acquired and used over some specific time period.

- **Budgeted Income Statement**

The budgeted income statement is one of the key schedules in the budget process. It shows the company's planned profit for the upcoming budget period, and it stands as a benchmark against which subsequent company performance can be measured.

- **Budgeted Balance Sheet**

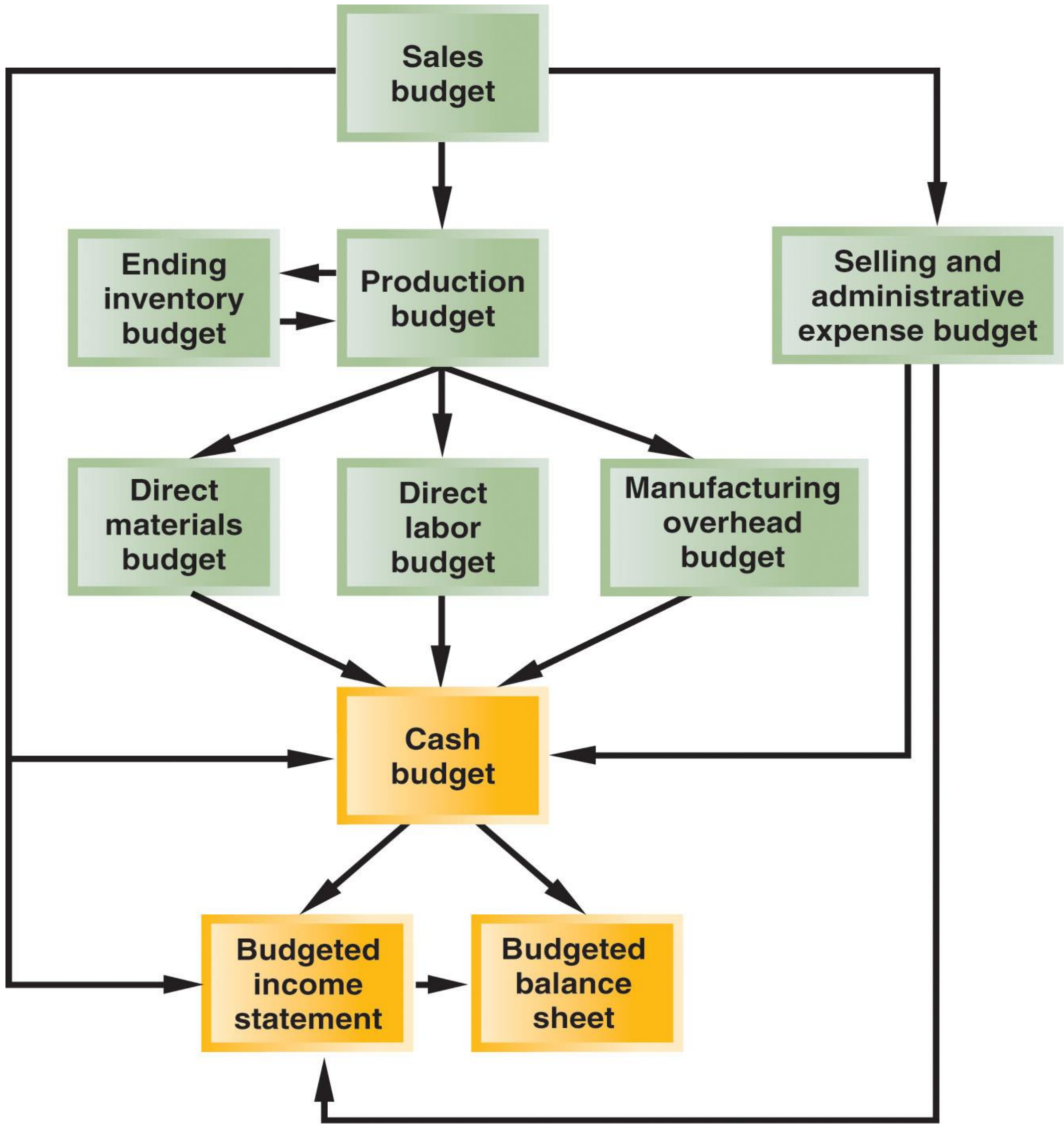
The budgeted balance sheet is developed by beginning with the current balance sheet and adjusting it for the data contained in other budgets.

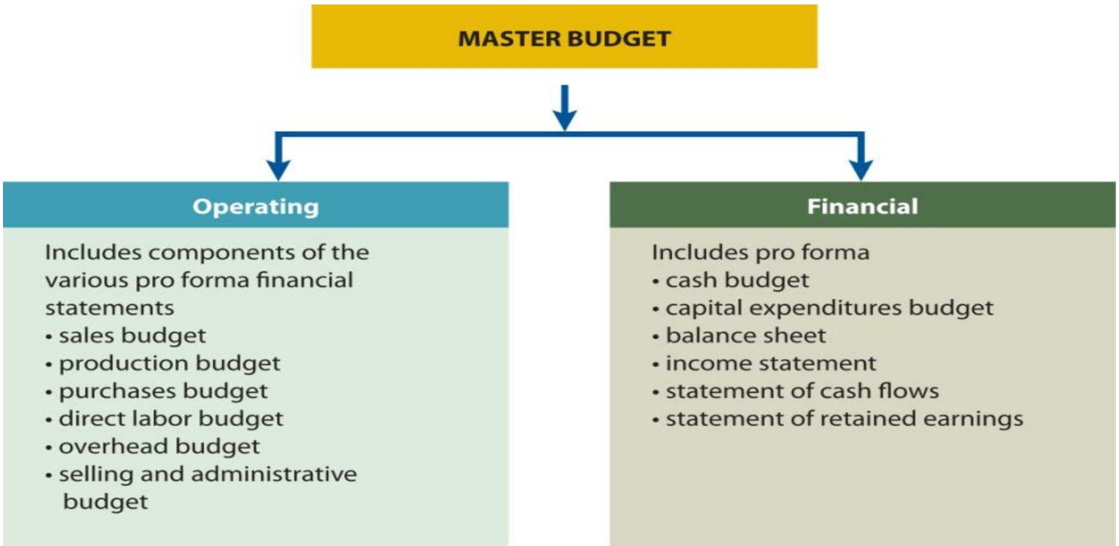
Master Budget:- It is a budget which summarises all the functional budgets.

According to **ICMA**, "A master budget is the summary budget incorporating its components functional budgets & which is finally approved, adapted & employed".

According to ICMA, "A budget which is designed to remain unchanged irrespective of the volume of output/turnover attained". – **Fixed Budget**.

According to ICMA, "A budget which, by recognising the difference in behaviour between fixed & variable cost in relation to fluctuations in output/turnover, is designed to change appropriately with such fluctuations".


Sales budget
Ending inventory budget
Production budget
Selling and administrative expense budget
Direct materials budget
Direct labor budget
Manufacturing overhead budget
Cash budget
Budgeted income statement
Budgeted balance sheet



BUDGETARY CONTROL

Budgetary Control – "It is the process of utilizing the various budgets like production budget, sales budget, etc,. for the purpose of internal control". This is done with intention of minimizing the wastage & maximizing the efficiency of various departments.

According to **ICMA** terminology budgetary control as "the establishment of budgets relating the responsibilities of executives to the requirements of the policy & the continuous comparison of actual with the budgeted results either to secure by individual actions the objective of that policy to provide basis for its revision".

Steps involved in the Budgetary Control Techniques:

1. Fise the objectives clearly.
2. Formulating the necessary plans to ensure that the desired objectives are achieved.
3. Translating the plans into budgets.
4. Relating the responsibilities of executives to the budgets.
5. Continuous comparison of the actual results with that of the budget & the ascertainment of deviations (Positive/negative).
6. Investigating into the deviations & establishing the causes.

7. Presentation of information to the management relating the variances to individual responsibilities.
8. Corrective action of the management to present recurrence of variance

Meaning of Budget:

According to Brown and Howard, "A budget is a pre-determined statement of management policy during a given period which provides a standard for comparison with the results actually achieved."

Budgeting:

The act of preparing budgets is called budgeting. In the words of Batty, "the entire process of preparing the budgets is known as budgeting.

Meaning of Budgetary Control:

Budgetary control is a system of controlling costs through preparation of budgets. Budgeting is thus only a part of budgetary control. According to CIMA, "Budgetary control is the establishment of budgets relating the responsibilities of executives of a policy & the continuous comparison of the actual with the budgeted results, either to secure by individual actions the objective of that policy to provide basis for its revision".

Forecast & Budget:

A forecast is a prediction of what may happen as a result of a given set of circumstances. It is an assessment of probable future events. A budget, on other hand, is a planned exercise to achieve a target. It is based on the pros and Cons of a forecast. Forecasting thus precedes the preparation of a budget.

Thus the main point of distinction between the two is that forecast is concerned with 'probable events' while budget relates to 'planned events'. Furthermore, forecast can be made by anybody, whereas a budget, being an enterprise objective, can be set only by the authorized management.

Steps in Budgetary Control

The following are the objectives of a budgetary control system:

1. **Planning:** A budget provides a detailed plan of action for a business over definite period of time. Detailed plans relating to production, sales, raw material requirements, labour needs, advertising and sales promotion performance, research and development activities, capital additions etc., are drawn up. By planning many problems are anticipated long before they arise and solutions can be sought through careful study. Thus most business emergencies can be avoided by planning. In brief, budgeting forces the management to think ahead, to anticipate and prepare for the anticipated conditions.

2. **Co-ordination:** Budgeting aids managers in co-ordinating their efforts so that objectives of the organisation as a whole harmonise with the objectives of its divisions. Effective planning and organisation contributes a lot in achieving coordination. There should be coordination in the budgets of various departments. For example, the budget of sales should be in coordination with the budget of production. Similarly, production budget should be prepared in co-ordination with the purchase budget, and so on.

3. **Communication:** A budget is a communication device. The approved budget copies are distributed to all management personnel which provides not only adequate understanding and knowledge of the programmes and policies to be followed but also gives knowledge about the restrictions to be adhered to. It is not the budget itself that facilitates communication, but the vital information is communicated in the act of preparing budgets and participation of all responsible individuals in this act.

4. **Motivation:** A budget is a useful device for motivating managers to perform in line with the company objectives. If individuals have actively participated in the preparation of budgets, it act as a strong motivating force to achieve the targets.

5. **Control:** Control is necessary to ensure that plans and objectives as laid down in the budgets are being achieved. Control, as applied to budgeting, is a systematized effort to keep the management informed of whether planned performance is being achieved or not. For this purpose, a comparison is made between plans and actual performance. The difference between the two is reported to the management for taking corrective action.

6. **Performance Evaluation:** A budget provides a useful means of informing managers how well they are performing in meeting targets they have previously helped to set. In many companies, there is a practice of rewarding employees on the basis of their achieving the budget targets or promotion of a manager may be linked to his budget achievement record.

Advantages of Budgetary Control:

Budgetary control provides the following advantages:

1. Budgeting compels managers to think ahead i.e. to anticipate and prepare for changing conditions.
2. Budgeting co-ordinates the activities of various departments and functions of the business.
3. It increase production efficiency, eliminates waste and controls the costs.
4. It pinpoints efficiency or lack of it.
5. Budgetary control aims at maximization of profits through careful planning and control.
6. It provides a yardstick against which actual results can be compared.
7. It shows management where action is needed to remedy a situation.
8. It ensures that working capital is available for the efficient operation of the business.
9. It directs capital expenditure in the most profitable direction.
10. It instills into all levels of management a timely, careful and adequate consideration of all factors before reaching important decisions.
11. A budget motivates executives to attain the given goals.

12. Budgetary also aids in obtaining bank credit.
13. Budgeting also aids in obtaining bank credit.
14. A budgetary control system assists in delegation of authority and assignment of responsibility.
15. Budgeting creates cost consciousness and introduces an attitude of mind in which waste and efficiency cannot thrive.

Limitations of Budgetary Control

The list of advantages given above is impressive, but a budget is not a cure all for organisational ills. Budgetary control system suffers from certain limitations and those using the system should be fully aware of them.

1. **The budget plan is based on estimates:** Budgets are based on forecasting cannot be an exact science. Absolute accuracy, therefore, is not possible in forecasting and budgeting. The strength or weakness of the budgetary control system depends to a large extent, on the accuracy with which estimates are made. Thus, while using the system, the fact that budget is based on estimates must be kept in view.
2. **Danger of rigidity:** A budget programme must be dynamic and continuously deal with the changing business conditions. Budgets will lose much of their usefulness if they acquire rigidity and are not revised with the changing circumstances.

3. **Budgeting is only a tool of management:** Budgeting cannot take the place of management but is only a tool of management. 'The budget should be regarded not as a master, but as a servant.' Sometimes it is believed that introduction of a budget programme alone is sufficient to ensure its success. Execution of a budget will not occur automatically. It is necessary that the entire organisation must participate enthusiastically in the programme for the realisation of the budgetary goals.

4. **Expensive Technique:** The installation and operation of a budgetary control system is a costly affair as it requires the employment of specialised staff and involves other

expenditure which small concerns may find difficult to incur. However, it is essential that the cost of introducing and operating a budgetary control system should not exceed the benefits derived therefrom.

Possible Questions (Unit-V)

1. What is mean by budget?
2. Define budget
3. What are the objectives of budget?
4. What is mean by planning?
5. What is mean by controlling and coordination?
6. What are the essentials of good budget

7. What are the classifications of budget?
8. Explain purchase budget
9. Explain the sales budget
10. What is mean by master budget?
11. How the cash budget is prepared?
12. Define budgetary control
13. What are the advantages of budgetary control?
14. What are the budgetary control techniques?
15. How the budget is forecasted?
16. What are the steps in budgetary control?
17. Explain the limitation of budgetary control?

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UNIT- III

Standard costing – Advantages and disadvantages- Difference between budgetary control and standard costing- Variance- Types of variance- material and labor variances only.

Standard Costing

The word 'standard' means a benchmark or gauge. The 'standard cost' is a predetermined cost which determines in advance what each product or service should cost under given circumstances. The technique of using standard costs for the purposes of cost control is known as standard costing.

Definitions of standard costing

Backer and Jacobsen define "Standard cost is the amount the firm thinks a product or the operation of a process for a period of time should cost, based upon certain assumed conditions of efficiency, economic conditions and other factors".

Chartered Institute of Management Accountants, London defines standard cost as "a predetermined cost which is calculated from management's standards of efficient operation and the relevant necessary expenditure". They are the predetermined costs based on technical estimate of material, labour and overhead for a selected period of time and for a prescribed set of working conditions.

Brown and Howard define "standard costing is a technique of cost accounting which compares the standard cost of each product or service with actual cost to determine the efficiency of the operation so that any remedial action may be taken immediately".

The terminology of Cost Accountancy defines standard costing as "the preparation and use of standard costs, their comparison with actual costs, and the analysis of variance to their causes, and points of incidence".

The London Institute of Cost and Works Accountants define it as "An estimate cost, prepared in advance of production or supply correlating a technical specification of material and labour to the price and wage rates estimated for a selected period of time, with an addition of the apportionment of overheads expenses estimated for the same period within a prescribed set of working conditions".

Further, it is a system of cost accounting which is designed to find out how much should be the cost of a product under the existing conditions. The actual cost can be ascertained only when production is undertaken. The predetermined cost is compared to the actual cost and a variance between the two enables the management to take necessary corrective measures.

STEPS INVOLVED IN STANDARD COSTING

The technique of standard costing involves the determination of cost before occurring. The standard cost is based on technical information after considering the impact of current conditions. With the change in condition, the cost also can be modified so as to make it more realistic. The standard cost is divided into standards for materials, labour and overheads. The actual cost is recorded when incurred. The standard cost is compared to the actual cost. The difference between the two costs is known as variance. The variances are calculated element wise. The management can take corrective measures to set the things right on the basis of different variances.

The basic purpose of standard costing is to determine efficiency or inefficiency in manufacturing a particular product. This will be possible only if both standard costs and actual costs are given side by side. Though standard costing system will be useful for all types of commercial and industrial undertakings but it will be more useful in those undertakings where production is standardized. It will be of less use in job costing system because every job has different specifications and it will' be difficult to determine standard costs for every job.

Advantages of Standard Costing

- **Measurement of Efficiency:** It is a tool for assessing the efficiency after comparing the actual costs with standard costs to enable the management to evaluate performance of various cost centres. By comparing actual costs with standard costs variances are determined and management is able to identify the place of inefficiencies. It can fix responsibility for deviation in performance. A regular check on various expenditures is also ensured by standard costing system. The standards are being constantly analysed and an effort is made to improve efficiency. Whenever a variance occurs the reasons are studied and immediate corrective measures are undertaken.

- **Production and Price Policy Formulation:** It becomes easy to formulate production plans by taking into account standard costs. It is also supportive for finding prices of various products. In case, tenders are to be submitted or prices are to be quoted in advance then standard costing produces necessary data for price fixation.

- **Reduction of Work:** In this system, management is supplied with useful information and necessary information is recorded and redundant data are avoided. The report presentation is simplified and only required information is presented in such a form that management is able to interpret the information easily and usefully. Therefore, standard costing reduces clerical work to a considerable extent

- **Management by Exception:** Management by exception means that everybody is given a target to be achieved and management need not supervise each and everything. The responsibilities are fixed and every body tries to achieve his targets. If the things are going as per targets then the management needs not to bother. Management devotes its time to other important things. So, management by exception is possible only when targets of work can be fixed. Standard costing enables the determination of targets.

Disadvantages of Standard Costing

- Standard costing cannot be used in those concerns where non-standard products are produced.
- The time and motion study is required to be undertaken for the process of setting up standards. These studies require a lot of time and money. Further, the process of setting up standards is a difficult task, as it requires technical skill.
- There are no inset circumstances to be considered for fixing standards. With the change in circumstances the standards are also to be revised. The revision of standard is a costly process.
- This system is expensive and small concerns may not afford to bear the cost. For small concerns the utility from this system may be less than the cost involved in it.
- The fixing of responsibility is not an easy task. The variances are to be classified into controllable and uncontrollable variances. The responsibility can be fixed only for controllable variances not in the case of uncontrollable.
- The industries liable for frequent technological changes will not be suitable for standard costing system. The change in production process will require a revision of standard. A frequent revision of standard will be costly. So this system will not be useful for industries where methods and techniques of production are fast changing

Standard Costing VS Budgetary Control

Standard costing and budgetary control have the common objective of cost control by establishing pre-determined targets. The actual performances are measured and compared with the pre-determined targets for control purposes. Both the techniques are of importance in their respective fields and are complementary to each other.

Points of Similarity:

There are certain basic principles which are common to both standard costing and budgetary control. These are:

1. The establishment of pre-determined targets of performance
2. The measurement of actual performance
3. The comparison of actual performance with the pre-determined targets.
4. The analysis of variances between the actual and the standard performance
5. To take corrective measures, where necessary.

Points of Difference:

In spite of so much similarity between standard costing and budgetary control, there are some important differences between the two, which are as follows:

	Standard Costing	**Budgetary Control**
Scope	Standard costs are developed mainly for the manufacturing function and sometimes also for making and administration functions	Budgets are compiled functions of the business such as sales, purchase, production, cash, capital expenditure, research & development, etc.,
Intensity	Standard costing is intensive in	Budgetary control is

	application as it calls for detailed analysis of variances	extensive in nature and the intensity of analysis tends to be much less than that in standard costing.
Relation to accounts	In standard costing, variances are usually revealed through accounts	In budgetary control, variances are normally not revealed through accounts and control is exercised by statistically putting budgets and actuals side by side.
Usefulness	Standard costs represent realistic yardsticks and, are therefore, more useful for controlling and reducing costs.	Budgets usually represent an upper limit on spending without considering the effectiveness of the expenditure in terms for output.
Basis	Standard cost are usually established after considering such vital matters as production capacity, methods employed and other factors which require attention when determining an acceptable level of efficiency.	Budgets may be based on previous year's costs without any attention being paid to efficiency.
Projection	Standard cost is a projection of cost	Budget is a projection of

	accounts	financial accounts.

Analysis of Variances

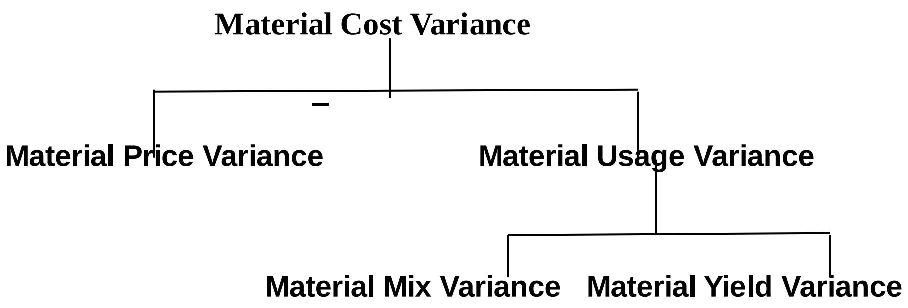
The divergence between standard costs, profits or sales and actual costs, profits or sales respectively will be known as variances. The variances may be favourable and unfavourable. If actual cost is less than the standard cost and actual profit and sales are more than the standard profits and sales, the variances will be favourable. On the contrary if actual cost is more than the standard cost and actual profit and sales are less than the standard profits and sales, the variances will be unfavourable. The variances are related to efficiency. If variances are favourable, it will show efficiency and if variances are unfavourable it will show inefficiency. The variances may be classified into four categories such as Direct Materials Variances, Direct Labour Variances, Overheads Cost Variances and Sales or Profit Variances.

Direct Material Variances

Direct material variances are also known as material cost variances. The material cost variance is the difference between the standard cost of materials that should have been incurred for manufacturing the actual output and the cost of materials that has been actually incurred. Material Cost Variance comprises of:

(i) Material Price Variance and

(ii) Material Usage Variance:



Material price variance

= (standard price – actual price)*actual quantity

Material usage variance

= (Standard quantity – actual quantity)* standard price

= (Standard quantity for actual production – actual quantity production) * standard price

Labour cost variance

Labour rate variance

= (standard price – actual price)*actual quantity

Labour efficiency variance

= (standard quantity – actual quantity)*standard price

= Standard quantity for actual production – actual quantity used) * standard price

Illustration: 1 ABC Ltd. makes and sells a single product. The company uses a Standard marginal costing system. It plans to produce and sell 1000 units in May 2005. A budget statement is produced as follow: Budgeted income statement for the month ended 31 May 2005

Sales (50*1000)		50000
Less: Variable cost of goods sold		
Direct materials (3*4000)	12000	
Direct labour (5*3000)	15000	

Variable overheads (2*3000)	6000	33000
Budget contribution		17000
Fixed overhead		3000
Budget profit		**14000**

The actual sales and production is 800 units. The actual income statement is shown as follows: Income statement for the month ended 31 May 2005

Sales ($60*800)		48000
Less: Variable cost of goods sold		
Direct materials ($3.2*2400)	12000	
Direct labour ($6*3200)	15000	
Actual Variable overheads	5500	32380
Contribution		15620
Fixed overhead		2600
Net profit		**13020**

Possible Questions (Unit-IV)

1. What is mean by standard costing?
2. Define standard costing
3. What are the steps involved in standard costing?
4. Explain the advantages of standard costing
5. What is mean by production and price policy formulation?
6. What is mean by reduction of work?
7. What are the disadvantages of standard costing?
8. Differentiate between standard costing and budgetary control
9. What is mean by variances?
10. How the variance is classified?
11. Explain about labour variance?
12. What is mean by material variance?
13. What is the formula for material price variance?

14. What is the formula for material usage variance?

15. What are the limitations of standard costing?

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UNIT -III

Working Capital- concepts, kinds, importance of working capital-working capital requirements and their computation- sources of working capital - forecasting of working capital requirements.

Meaning of Working Capital

Capital required for purchase of raw materials and for meeting day-to-day expenses like salaries, rent, advertising and etc., is called "working capital". In other words, working capital refers to that part of a firm's capital which is employed for short-term operations.

Need of Working Capital

Modern business enterprises produce goods in anticipation of demand. Goods produced are not sold immediately. Cash for sales is also not realized immediately.

From the time of purchase of raw material, to the realization of cash for sales made, an operating cycle is involved. The following stages are usually found in the operating cycle of a manufacturing firm.

- ✓ Conversion of cash into raw materials.
- ✓ Conversion of raw materials into work-in progress.
- ✓ Conversion of work-in-progress into finished goods.
- ✓ Conversion of finished goods into debtors through sales.
- ✓ Conversion of debtors into cash

There are time gap between purchase of raw materials and production; production and sales; and sales and realization of cash. Thus, the need for working capital arises due to the time gap between purchase of raw materials and realization of cash from sales.

Working capital is needed for the following purposes:

1. To purchase raw materials, spares and component parts.
2. To pay wages and salaries.
3. To incur day-to-day expenses.

4. To meet selling costs such as packing, advertising and etc.
5. To provide credit facilities to customers.
6. To maintain inventories of raw materials, work-in-progress and finished goods.

Advantages of working capital

1. Continuous production
2. Solvency and goodwill
3. Easy loans
4. Cash discount
5. Regular payment of expenses
6. Exploitation of market conditions
7. Ability to face crisis
8. High return on investments

Disadvantage of working capital

Excessive working capital

1. It means idle funds, which earn no profits for the business. Hence, the business cannot earn a proper rate of return on its investments.
2. Due to low rate of return on investments, the value of shares may also fall.
3. It leads to unnecessary purchasing and accumulation of inventories. As a result, chances of theft, waste and losses will increase.
4. It leads to overall inefficiency in the organization.

Inadequate working capital

1. It cannot pay its short-term liabilities in time. As a result, it losses its reputation and faces tight credit terms.
2. It cannot buy its requirements in bulk and take advantages of cash discounts.

3. It leads to increase in cost and reduction in profits.
4. It becomes difficult to exploit favorable market conditioned and undertake profitable projects due to lack of working capital.
5. Due to paucity of working capital, fixed assets are not effectively utilized. Thus, the rate of return on investment falls.

Concepts of working capital

Concept of working capital includes meaning of working capital and its nature. Working capital is the investment in current assets. Without this investment, we can not operate our fixed assets properly. For getting good profits from fixed assets, we need to buy some current assets or pay some expenses or invest our money in current assets. For example, we keep some of cash which is the one of major part of working capital.

At any time, machines may need repair. Repair is revenue expense but without cash, we can not repair machines and without machines, production may delay. Like this, we need inventory or to invest in debtors and other short term securities. On the basis of Concept, we can divide our working capital into two parts:

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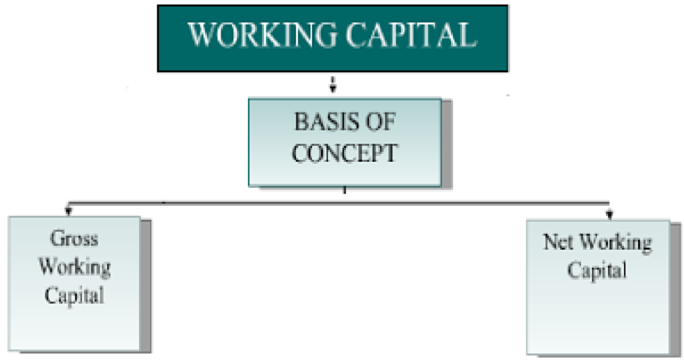
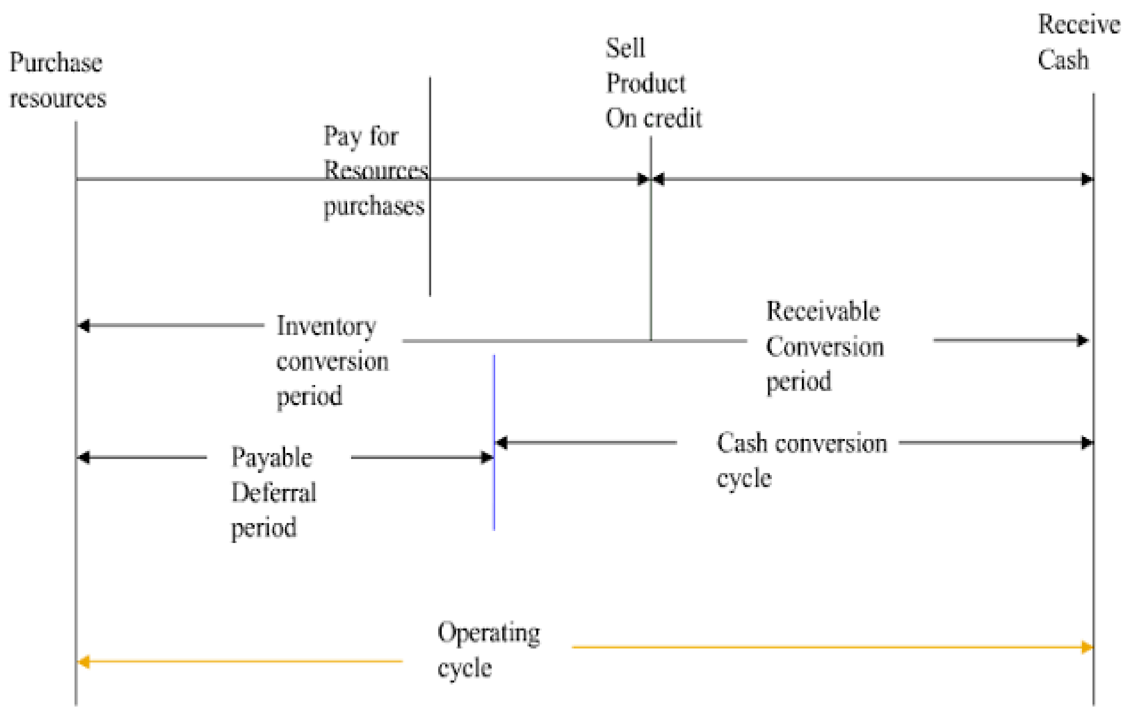




Kinds of Working Capital

1. Gross Working Capital

In this concept of working capital, we study gross working capital. We do not deduct current liabilities in this concept but we use current liabilities as source of fund. Suppose, if we buy goods on credit, it means save cash and can use this as working capital for paying other expenses.

2. Net Working Capital

Under this concept use net working capital. For this, first deduct all our current liabilities from our current assets. Excess of current assets over current liabilities will be current assets. We have to maintain minimum level of working capital in our business for operation of business activities. This concept is also used for preparation of balance sheet. In the vertical form of balance sheet, we show excess of current assets over current liabilities.

Operating Cycle Concept of Working Capital

In this concept of working capital, we make the operating cycle. In this cycle, we calculate inventory conversion period. To know this, we can estimate when we need cash for buying our inventory. We also calculate debtor or receivable conversion period. To know this, we can estimate when we receive cash from debtors. If inventory conversion period is less than debtor conversion period, we have to manage other sources for buying our inventories. If we buy good on credit, we also take care creditors' conversion period.

Types of Working Capital

The working capital can be classified on the basis of concept and on the basis of time.

Types of working capital On the basis of concept

Generally there are two concepts of working capital. They are gross working capital and net working capital. But they are defined by different names. They are explained below:

1) In broad sense: working capital refers to gross working capital. It is also defined as financial concept or going concern concept. It means the capital invested in the current assets of the firm. Current assets mean the assets which can be converted into cash easily or within one accounting period. It helps in determining the return on investment in working capital and providing correct amount of working capital at right time.

2) In narrow sense: working capital refers to net working capital. It is also defined as accounting concept. It means excess of current assets over current liabilities. It helps in finding out firm's capability to meet short term liabilities as well as indicates the financial soundness of the enterprise.

Net working capital = current assets – current liabilities

Net working capital can be + ve or – ve. When current assets are more than the current liabilities than working capital is + ve and when current assets are less than the current liabilities than working capital is – ve. At the end we can say, that both the working capital are important but according to the suitability gross working capital is suitable for companies having separate ownership or management while net working capital is suitable for sole trader companies or partnership firms.

Types of Working Capital on the Basis of Time

1) Permanent working capital: it is also called fixed working capital. It means to carry on the day to day expenses the firm is required to maintain the minimum amount of working capital. For example the firm is required to maintain the minimum level of raw material, finished goods or cash balance etc.

a) Regular working capital- it means the minimum amount which the firm has to keep with itself to carry on the day to day operation.

b) Reserve working capital- it means the excess amount over the regular working capital for uncertain circumstances like strike, lock out, depression etc.

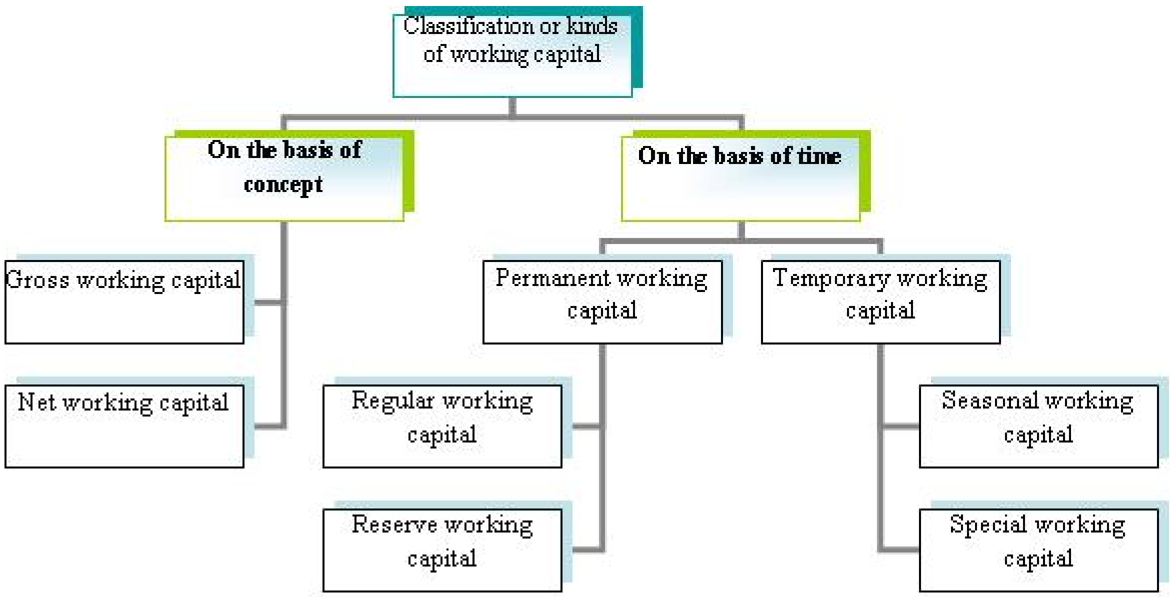
2) Temporary working capital: it is also called variable working capital, which is required to meet the seasonal demands as well as for special purposes.

a) Seasonal working capital- it is required to meet the seasonal needs of the enterprise.

b) Special working capital- it is required for some special purposes of the enterprise. For example advertising the product of the firm requires special working capital.

Temporary working capital is for short period and fluctuates while permanent working capital is stable and fixed.

These are the types or classification of working capital.



Sources of Working Capital

- **Short term sourcing**
- **Long term sourcing**

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Short Term Sources of Working Capital

Factoring	Instalment Credit	Invoice Discounting
Factoring is a traditional source of short term funding. Factoring facility arrangements tend to be restrictive and entering into a whole-turnover factoring facility can lead to aggressive chasing of outstanding invoices from clients, and a loss of control of a company's credit function.	Instalment credit is a form of finance to pay for goods or services over a period through the payment of principal and interest in regular payments.	Invoice Discounting is a form of asset based finance which enables a business to release cash tied up in an invoice and unlike factoring enables a client to retain control of the administration of its debtors.
Income received in advance	**Advances received from customers**	**Bank Overdraft**
Income received in advance is seen as a liability because it is money that does not correlate to that specific accounting or business year but rather for one that is still to come. The income account will then be credited to the income received in advance account and the income received in advance will be debited to the income account such as rent.	A liability account used to record an amount received from a customer before a service has been provided or before goods have been shipped.	A bank overdraft is when someone is able to spend more than what is actually in their bank account. The overdraft will be limited. A bank overdraft is also a type of loan as the money is technically borrowed.
Commercial Papers	**Trade Finance**	**Letter of Credit**
A commercial paper is an unsecured promissory note. Commercial paper is a money-market security issued by large corporations to get money to meet short term debt obligations e.g.payroll, and is	An exporter requires an importer to prepay for goods shipped. The importer naturally wants to reduce risk by asking the exporter to document that the goods have been shipped. The	A letter of credit is a document that a financial institution issues to a seller of goods or services which says that the issuer will pay the seller for goods/services the seller delivers to a third-party buyer.

only backed by an issuing bank or corporation's promise to pay the face amount on the maturity date specified on the note. Since it is not backed by collateral, only firms with excellent credit ratings will be able to sell their commercial paper at a reasonable price.	importer's bank assists by providing a letter of credit to the exporter (or the exporter's bank) providing for payment upon presentation of certain documents, such as a bill of lading. The exporter's bank may make a loan to the exporter on the basis of the export contract.	The issuer then seeks reimbursement from the buyer or from the buyer's bank. The document is essentially a guarantee to the seller that it will be paid by the issuer of the letter of credit regardless of whether the buyer ultimately fails to pay. In this way, the risk that the buyer will fail to pay is transferred from the seller to the letter of credit's issuer.

Long Sources of Working Capital

EQUITY CAPITAL

Equity capital refers to the portion of a company's equity that has been obtained (or will be obtained) by trading stock to a shareholder for cash or an equivalent item of capital value. Equity comprises the nominal values of all equity issued (that is, the sum of their "par values"). Share capital can simply be defined as the sum of capital (cash or other assets) the company has received from investors for its shares

LOANS

A loan is a type of debt which it entails the redistribution of financial assets over time, between the lender and the borrower. In a loan, the borrower initially receives or borrows an amount of money from the lender, and is obligated to pay back or repay an equal amount of money to the lender at a later time. Typically, the money is paid back in regular instalments, or partial repayments; in an annuity, each instalment is the same amount. Acting as a provider of loans is one of the principal tasks for financial institutions like banks. A secured loan is a loan in which the borrower pledges some asset (e.g. a car or property) as collateral. Unsecured loans are monetary loans that are not secured against the borrower's assets.

Factors Determination of Working Capital

- **Nature of the business**

  In case of public utility concern like railways, electricity etc., most of the transactions is on cash basis. Further, they do not require large inventories. Hence, their working capital requirements are low. On the other hand, manufacturing and trading concerns require more working capital since they have to invest heavily in inventories and debtors.

(Ex: Cotton mill)

- **Size of the business**

  Generally large business concerns are required to maintain huge inventories for the flow of business. Hence, bigger the size, the larger will be the working capital requirement

- **Time consumed in manufacture**

  To run a long production process more inventories is required. Hence, the longer the period of manufacture, the higher will be the requirements of working capital and vice-versa.

- **Seasonal fluctuations**

  A number of industries manufacture and sell goods only during certain seasons. For example, The Sugar industry produces practically all sugar between December and April. Their working capital requirement will be higher during this season. It is reduced as the sales are made and cash is realized.

- **Fluctuations in supply**

  If the supply of raw material is irregular, companies are forced to maintain huge stocks to avoid stoppage of production. In such case, working capital requirement will be high.

- **Speed of turnover**

A concern (hotel), which affects sales quickly, needs comparatively low working capital. This is because of the quick conversion of stock into cash. But if the sales are slow, more working capital will be required.

- **Terms of sales**

Liberal credit sales will result in locking up of funds in sundry debtors. Hence,a company which allows liberal credit will need more working capital than a company which observes strict credit norms.

- **Terms of purchase**

Working capital requirement are also affected by the credit facilities enjoyed by the company. A company enjoying liberal credit facilities from its suppliers will need lower amount of working capital (Ex: book shop) but a company which has to purchase only for cash will need more working capital.

- **Labour intensive Vs Capital intensive**

In labour intensive industries, larger working capital is required because of heavy wage bills and more time taken for production. But the capital-intensive industries require lesser amount of working capital because of the heavy investment in fixed assets and shorter time taken for production.

- **Growth and expansion of Business**

A growing concern needs more working capital to finance its increasing activities and expansion. But working capital requirements are low in the case of static concerns.

Funds Flow Statement

The funds flow statement is also referred as the "statement of changes in financial position" or "statement of sources and uses of funds". This statement depicts the sources of funds and application of funds during a period. Very broadly, funds are defined as total resources. Most commonly, however, funds are defined as working capital or cash.

The items of funds for statement of changes in financial position are as follows :

A). Long term sources:

1. Net profit after tax
2. Depreciation
3. Increase in capital
4. In crease in term liabilities.
5. Reduction in fixed assets or other non current assets.
6. Decrease in inter - corporate investments and advances.

B). Long term uses:

1. Net Loss
2. Decrease in Terms Liabilities
3. Increase in fixed assets or other non current assets
4. Dividend payments or drawings by partners or tax payments others

C). Short term sources:

1. Increase in short term bank borrowings.
2. Increase in other current liabilities.
3. Decrease in inventory.
4. Decrease in receivables
5. Decrease in other current assets

D). Short term uses:

1. Decrease in short term bank borrowings
2. Decrease in other current liabilities.
3. Increase in inventory.
4. Increase in receivables
5. Increase in other current assets.

Fund Flow Statement is studied particularly in reference not only to know the source and uses of fund but also to see whether short term sources are used to finance long term uses, which is technically known as diversion of fund

Difference between Fund Flow Statement and Cash Flow Statement

There are 3 basic financial statements that exist in the area of Financial Management.

1. Balance Sheet.

2. Income Statement.

3. Cash Flow Statement.

The first two statements measure one aspect of performance of the business over a period of time. Cash flow statements signify the changes in the cash and cash equivalents of the business due to the business operations in one time period. Funds flow statements report changes in a business's working capital from its operations in a single time period, but have largely been superseded by cash flow statements.

Cash Flow

Statement is a statement showing changes in cash position of the firm from one period to another. It explains the inflows (receipts) and outflows (disbursements) of cash over a period of time. The inflows of cash may occur from sale of goods, sale of assets, receipts from debtors, interest, dividend, rent, issue of new shares and debentures, raising of loans, short-term borrowing, etc. The cash outflows may occur on account of purchase of goods, purchase of assets, payment of loans loss on operations, payment of tax and dividend, etc.

A cash flow statement is different from a cash budget. A cash flow statement shows the cash inflows and outflows which have already taken place during a past time period. On the other hand a cash budget shows cash inflows and outflows which are expected to take place during a future time period. In other words, a cash budget is a projected cash flow statement.

Funds Flow

Statements state the changes in the working capital of the business in relation to the operations in one time period. For example, if the inventory of the business increased from Rs 1, 40,000 to Rs 1, 60,000, then this increase of Rs 20,000 is the increase in the working capital for the corresponding period and will be mentioned on the funds flow statement. Net working capital is the total change in the business's working capital, calculated as total change in current assets minus total change in current liabilities.

Cash flow statements have largely superseded funds flow statements as measurements of a business's liquidity because cash and cash equivalents are more liquid than all other current assets included in working capital's calculation.

Cash Flow Statement

The statement of cash flows uses information from the other two statements (Income Statement and Balance Sheet) to indicate cash inflows and outflows.

A Cash Flow Statement comprises information on following 3 activities:

1. Operating Activities
2. Investing Activities
3. Financing Activities

- **Operating Activities**

Operating activities include cash flows from all standard business operations. Cash receipts from selling goods and services represent the inflows. The revenues from interest and dividends are also included here. The operational expenditures are considered as outflows for this section. Although interest expenses fall under this section but the dividends are not included .Dividends are considered as a part of financing activity in financial accounting terms.

- **Investing Activities**

Investing activities include transactions with assets, marketable securities and credit instruments. The sale of property, plant and equipment or marketable securities is a cash inflow. Purchasing property, plant and equipment or marketable securities are considered as cash outflows. Loans made to borrowers for long-term use is another cash outflow. Collections from these loans, however, are cash inflows.

- **Financing Activities**

Financing activities on the statement of cash flows are much more defined in nature. The receipts come from borrowing money or issuing stock. The outflows occur when a company repays loans, purchases treasury stock or pays dividends to stockholders. As the case with other activities on the statement of cash flows depend on activities rather than actual general ledger accounts.

Difference between Funds Flow Statement and Cash Flow Statement

s.no	Basis of Difference	Funds Flow Statement	Cash Flow Statement
1.	**Basis of Analysis**	Funds flow statement is based on broader concept i.e. working capital.	Cash flow statement is based on narrow concept i.e. cash, which is only one of the elements of working capital.
2.	**Source**	Funds flow statement tells about the various sources from where the funds generated with various uses	Cash flow statement stars with the opening balance of cash and reaches to the closing balance of cash by proceeding through

		to which they are put.	sources and uses.
3.	**Usage**	Funds flow statement is more useful in assessing the long-range financial strategy.	Cash flow statement is useful in understanding the short-term phenomena affecting the liquidity of the business.
4.	**Schedule of Changes in Working Capital**	In funds flow statement changes in current assets and current liabilities are shown through the schedule of changes in working capital.	In cash flow statement changes in current assets and current liabilities are shown in the cash flow statement itself.
5.	**End Result**	Funds flow statement shows the causes of changes in net working capital.	Cash flow statement shows the causes the changes in cash.
6.	**Principal of Accounting**	Funds flow statement is in alignment with the accrual basis of accounting.	In cash flow statement data obtained on accrual basis are converted into cash basis.

Cash Flow Statement:

Cash Flow Statement depicts changes in cash position from one period to another. This Statement shows how the company is paying for its operations and future growth, by detailing the "flow" of cash between the company and the outside world. The positive numbers shows that cash is flowing in, whereas negative numbers show that cash is flowing out.

Cash flow shows the steady flow of money in and out of an organization, or the amount of cash that a business enterprise earns and holds during the financial period. However, Cash Flow doesn't report the profit & loss of the company and is merely an indicator on the movement of cash in an organization and it helps in maintenance of day-to-day accounts.

Two major fields of Cash Flow are 'Cash Inflow' and 'Cash Outflow', which refers to the following: -

a) **Cash Inflow** refers to the money that flows in to the organization in the shape of sales, investments, borrowings and advances.

b) **Cash outflow** refers to all the money that is paid out in the shape of of procurement costs, operation costs, staff salaries and other miscellaneous expenses

Cash generated from Business operations and Cash generated from investments are shown separately and these two terms refers to the following Cash from Business Operations: Revenue that is generated from the sale of company's products or usage of its service on a day-to-day basis makes up for cash from Business operations in the Cash flow statement. Basically it's the cash that end consumer gives to the company in return of its product or service.

Cash from Investments: Organizations also invest in equity shares and various other investment instruments. Cash generated from these activities and also from acquisition of other companies refer to cash from Investments. Some of these activities are also posted as negative cash outflow as to make investments, money flows out of the organization. Cash Flow Statement is considered as a tool to plan the short term liquidity position. The cash flow statement actually helps the management of the business to ascertain as to how much cash is needed to meet its due obligations and when it will be available. This also helps the entity in investing the surplus cash in profitable business.

Sources of cash:

The sources are generally grouped into categories, namely

(a) **Internal Source of Cash** e.g , net profit, depreciation, writing of the assets, gain or loss from sale of fixed asset and transfer to reserves;

(b) **External Source of Cash** : e.g., increase in capital, increase in term liabilities, reduction in fixed assets or othe(non current assets, decrease in inter corporate investments and advances, increase in short term bank borrowings, increase in other current liabilities, decrease in inventory and receivables and decrease in other current assets.

Uses of cash:

1. Net loss.
2. Decrease in term liabilities.
3. Increase in fixed assets or other non - current assets.
4. Increase in inter - corporate investment or advances.
5. Dividend payments or drawings or tax payments.
6. Decrease in short term bank borrowings.
7. Decrease in other current liabilities.
8. Increase in inventory and receivables.
9. Increase in other current assets

Forecasting of Working capital

If the working capital is to be estimated for the ensuring year, then the current requirements of the assets and cash flow for that period are to be estimated. The study of cash flow will reveal how much cash is available to meet the current assets requirements.

The basic object of forecasting working capital needs is either to measure the cash position of the enterprise or to exercise control over the liquidity position of the concern. But, the circular flow of working capital does not occur automatically and it is the essential responsibility of management to guide it in proper proportions through the production machine.

There are three popular methods available for forecasting working capital requirements:

(a) **Cash Forecasting Method** – In this method the position of cash at the end of the period is shown after considering the receipts and payments to be made during that period. It forms assuring more or less a summary of cashbook. This shows the deficiency or surplus of cash at the definite point of time.

(b) **The Balance Sheet Method** – In the balance sheet method of forecasting, a forecast it made of the various assets and liabilities of the business. Afterwards, the difference between the two is taken which will indicate either cash surplus or cash deficiency.

(c) **Profit and Loss Adjustment Method** – Under this method the forecasted profits are adjusted after adding the cash inflow and deducting the cash outflows. The basic idea under method is to adjust the estimated profits on cash basis.

A forecast of working capital requirements can also be called a working capital budget. The main object of preparing a working capital budget is to source an effective utilization of the investment in current assets. It shows the behaviour of working capital with the volume of output or estimated sales.

Class: III. B.Com **Course Name: Management Accounting**

Course Code: 16CMU601A **Semester: VI** **Year: 2017-2020**

Possible Questions (Unit-III)

1. What is mean by working capital?
2. Define working capital
3. Explain the need of working capital?
4. What are the advantages of working capital?
5. What are the limitations of working capital?
6. Explain the concept of working capital?
7. How the working capital is classified?
8. Explain the sources of working capital.
9. What are the long term sources of working capital?
10. What are the short term sources of working capital?
11. Explain the factors determining the working capital
12. What is mean by forecasting?
13. How the working capital needs are forecasted?
14. What is mean by gross working capital?
15. What is mean by net working capital?

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Course Code: 16CMU601A **Semester: IV** **Year: 2017-2020**

UNIT- I

Cost Accounting – Definition, meaning and scope – Relationship of Cost accounting with financial accounting and management accounting – Methods of costing – cost analysis – concepts and classifications – Elements of cost – preparation of cost sheet and tender — limitations of cost accounting.

COST ACCOUNTING

In the initial stages cost accounting was merely considered to be a technique for ascertainment of cost of products or services on the basis of historical data. In course of time due to competitive nature of the market, it was realized that ascertainment of cost is not as important as controlling costs. Hence, cost accounting started to be considered more as a technique for cost control compared to cost ascertainment.

Due to technological development in all fields, now cost reduction has also come within the ambit of cost accounting. Cost accounting is thus concerned with recording, classifying and summarizing costs for determination of costs of products or services, planning, controlling and reducing such costs and furnishing of information to management for decision making.

Meaning and Definitions of Cost Accounting

Cost accounting is a quantitative method that accumulates, classifies, summarizes and interprets information for three major purposes:

(i) Operational planning and control

(ii) Special decision and

(iii) Product decision **-Charles T. Horngren**

"Cost accounting is the process of accounting for costs from the point at which the expenditure is incurred of committed to the establishment of its ultimate relationship with cost units.

In its widest sense, it embraces the preparation of statistical data, the application of cost control methods and the ascertainment of the profitability of the activities carried out or planned is defined as the application of accounting and costing principles, methods and techniques in the ascertainment of costs and the analysis of saving and/or excess as compared with previous experience or with standards." **– Institute of Cost and Management Accountants of London**

"Cost accounting is defined as 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 therefore for the purposes of managerial decision making". **–Wheldon**

Cost accounting thus provides information to the management for decision of all sorts. It serves multiple purposes on account of which it is generally indistinguishable from management accounting or so-called internal accounting. Wilmot has summarized the nature of cost accounting as "the analysing, recording, standardizing, forecasting, comparing, reporting and recommending" and the role of a cost account as that of "a historian, news agent and rophet".

Scope of cost accounting

Cost accounting is a practice of cost control which is as follows:-

(a) Cost accounting is a branch of systematic knowledge that is a discipline by itself. It consist its own principles, concepts and conventions which may vary from industry to industry.

(b) Cost accounting is a science and arts both. It is science because it is a body of systematic knowledge relating to a wide variety of subject and an art because without the efficiency and experience of cost auditor it is not possible to use costing techniques efficiently.

Advantages of cost accounting

A good system of costing is the technique of controlling the expenditure and helps bringing economy in production, so it serves the needs of a large section of people in the following ways.

(a) Benefits to the Management: The information revealed by cost accounting aims at mainly assisting the management in decision making and optimizing profits. Besides this there are certain advantages of cost accounting to the management i.e. it helps in price fixation, in revealing profitable and unprofitable activities, idle capacity, in controlling cost and also helps in inventory control

(b) Benefits to the Employees: Cost accounting introduces wage scheme, bonus to the efficient &sincere employees which in turn increasing productivity, profitability and lowering cost.

(c) Benefits to Creditors: The better management of finance through cost accounting leads to timely debt servicing by company in the form of repayment of loan and payment of interest. To stay and grow in competition and for judging soundness of present and perspective borrower and cost reports give better picture of efficiency profit prospectus and capacity.

(d) Benefits to the Government: Cost accounting enables the Govt. to prepare plans for economic development of the country, to make policies regarding taxation, excise duty, export, price, ceiling, granting subsidy etc.

(e) Benefits to Consumers/Public: Cost accounting helps consumers in getting goods of better quality at reasonable price.

DIFFERENCE BETWEEN FINANCIAL ACCOUNTING AND MANAGEMENT ACCOUNTING

- ✓ Necessity
  - Financial Accounting (FA): SEC (or banks or suppliers) requires publicly traded companies to publish financial statements according to GAAP.
  - Management accounting (MA) is optional.
- ✓ Purpose.
  - FA: Produce financial statements for outside users.
  - MA: Help managers plan, implement and control.

- ✓ Users.
  - FA: faceless group, external users, present or potential shareholders.
  - MA: Known managers who influence what information is needed.
- ✓ Underlying structure.
  - FA: built around: Assets = Liabilities + Stockholders' Equity.
  - MA: purposes each with its own set of concepts and constructs
- ✓ Information content.
  - FA: financial statements are the end product and include primarily financial info.
  - MA: non-monetary as well as monetary info.
- ✓ Information precision.
  - FA: Uses approximations but as a generalization is more precise than MA.
  - MA: Management needs info rapidly to be useful in decision making and therefore precision is sometimes sacrificed.
- ✓ Report entity.
  - FA: Organization as a whole.
  - MA: Relatively small parts (responsibilities centers such as departments, product lines, divisions, subsidiaries as well as organization as a whole.)

Relation Ship of Cost Accounting with Financial Accounting

- ✓ Financial accounting is concerned with recording, classifying and summarizing financial transactions pertaining to an accounting period. The basic objective is to provide a commentary to the shareholders and outside parties on the financial status of an enterprise in the form of a profit and loss account and balance sheet. The profit or loss of business operations is revealed through these statements year after year, observing the statutory requirements of the Companies Act, 1956.
- ✓ Cost accounting, on the other hand, aims a providing prompt cost data for managerial

planning, controlling and decision making. It offers a complete explanation as to how the scarce inputs are put to use in business. The sources of efficiency or inefficiency are revealed through periodic reports. The profit or loss relating to each job, department or product can also be found out easily.

DIFFERENCE BETWEEN FINANCIAL ACCOUNTING COST ACCOUNTING AND

Basis of distinction	Financial Accounting	Cost Accounting
Statutory Requirements	These accounts have to be prepared pared according to the legal requirements of Companies Act and Income Tax Act	Maintenance of these accounts is voluntary except in certain industries where it has been made obligatory to keep cost records under the Companies Act.
Purpose	The main purpose of financial. accounting is to prepare profit and loss account and balance sheet for reporting to owners and outside agencies i.e., external users	The main purpose of cost accounting is to provide detailed cost information to management i.e., internal users.

Analysis of cost and Profit	Financial accounts reveal the profit or loss of the business as a whole during a particular period. It does not show the figures of cost and profit for individual products, departments and processes, etc.	Cost accounts show the detailed Cost and profit data for each product line, department, process etc.
Periodicity of Reporting	Profit and Loss Account and Balance Sheet is prepared periodically, usually on an annual basis.	Cost reporting is a continuous process and may be daily, weekly, monthly, etc.
Classification of Records purpose	Financial accounting classifies records and analysis transactions in subjective manner i.e. according to nature of expenditure.	Cost accounting records and classifies expenditure according to the purpose for which cost is incurred.
Nature	It is concerned with historical records. The historical nature of financial accounting can be easily understood in the context of the purpose for which it was designed. General purpose statements like Profit and Loss Account and Balance sheet are prepared by it.	Cost accounting does not end with what has happened in the past. It extends to plans and policies to improve performance in the future
Nature of statements prepared	That is to say that financial accounting must produce information that is used by many classes of people none of whom have explicitly defined information needs.	It generates special purpose statements and reports like Report of Loss of Materials, Idle Times Report Variance Report etc. Cost accounting identifies the user, discusses his problems and needs and provides tailored information.

COST

Generally cost may be explained as the amount of expenditure, actual or notional, relating to a specific thing or activity such as product, job, service, process etc. It may also be expressed as a sacrifice which may be defined in the terms of money means it is the amount of resources given up in exchange for some goods and services. Cost and expenses are different but relative terms.

Where 'costs' includes the cost of material and labour in addition to expenses, the term expenses is widely applied in financial accounts for various types of historical cost. In cost accounting, it is used for costs other than cost of raw material and wages. To understand the meaning of cost, it is necessary to define the meaning of expenses.

Expenses:

Generally expenses are called expired costs means those costs which have been used up totally in generating revenue. They are not capitalised but only shown as expenses in income statement. There are so many examples of expenses such as costs of goods sold expenses, selling expenses and administrative expenses.

For expenses, there is no need to be paid in cash immediately; even a promise to pay could be made for the profits received. The manufacturing costs are capitalised in the form of finished goods inventory and when a sale is incurred, they expire becoming expenses. The cost of unsold stock which was an asset prior, now converts expenses of cost of goods sold as it has contributed to the generation of revenue.

Manufacturing expenses may be expressed as cost because this is included in the cost of fished goods stock which is an asset unless sale is made.

For example, depreciation of a factory machine increases the utility of goods manufactured which are therefore included in work-in-progress and finished goods inventory.

Selling and administrative expenses, when not included in the cost of finished goods stock, are deemed only as expenses, not cost (asset) and are deducted from revenues whenever obtained. Similarly, depreciation of a factory building is a cost but depreciation of an office building is an expense.

The term cost itself is without any significant meaning and therefore, it is always advisable to use it with an adjective or phrase that will convey the meaning intended such as prime, direct, indirect, fixed, variable, controllable, opportunity, imputed, sunk, differential, marginal, replacement and the like. Future costs are also considered in cost accounting but not in financial accounting.

Loss:

To understand the concept of cost, the term ‘losses should be defined.

Loss is lost cost. It is applied to define two accounting events. In financial accounting, it is used to describe a circumstance where expenses exceed revenues for an accounting period, that is, the reverse of net income (earnings) for the accounting period. On the other hand, a loss arises due to the cost of an asset being more than the sale proceeds when the asset is sold. This unfavourable event does not arise from a normal business activity but from non-operating transactions or events.

Methods of costing

Depending upon the nature of the business and the types of its products, numbers of methods of cost ascertainment are used in practice. The methods of costing are as follows:

a) Job Costing: In this system the cost of each job is ascertained separately which is suitable in all cases where work is undertaken on receiving a customer’s order. Like a printing press, motor workshop etc.

b) Batch Costing: It is considered as the extension of job costing. It represents a number of small orders passed through the factory in batch. Each batch here is treated as a separate unit of cost.

c) Contract Costing: It is suitable for the firms which are engaged in the work of construction of bridges, roads, buildings etc.

d) Single or Output Costing: It is used in the business where a standard production is turned out and it is desired to find the cost of a basic unit of production.

e) Process Costing: It is a method of costing used to ascertain the cost of a product which may passes through various processes before completion.

f) Operating Costing: The cost of providing a service is known as operating cost and the methods to ascertain the cost of such services is known as operating costing.

g) Multiple Costing: In multiple costing, a combination of two or more methods of costing is used in conjunction to determine the cost of final product. This method is used by the industries where different components are separately manufactured and subsequently assembled into the finished product. For e.g.: Motor car, Television, Ships etc.

Cost Concepts

There are six basic cost concepts on which cost classification and various cost terms are based, which are as follows:

1. Concept of Objectivity: This concept helps to give direction to the operations referred to cost finding, cost analysing, cost recording and cost reporting. This concept requires goal congruence i.e. cost exercises have to be in harmony with the objectives. Objectives influence cost treatments and cost strategies which may include internal reporting for operational, external and specific non repetitive decisions.

2. Concept of Materiality: This concept that forces exactness must be tempered by good judgement, if no misrepresentation of product cost is likely to result. For example, overhead may include few items of direct cost, which may not be as material as to justify tracing them to particular unit of production. A specific decision may be helpful, but benefits may not be materially sufficient to implement it. Materiality is determined with reference to nature of firm's affairs, managerial policies and competitors' practices.

3. Concept of Time Span: All assumptions relating to various cost exercises remain valid only during related specific time span. The fixed cost statement is relied upon a time span under consideration. No costs will remain fixed for the whole time. Time span choose by a firm should be more enough to permit the procedures to record the related cost, output, labour hours and other factors required in the interpretation or analysts. If time span is too less, leads and lags in recording the cost data may be quite hassle. If cost associating to a specific time span activity is recorded to another time span activity, cost result may turn out to be quite wrong.

4. Concept of Relevant Range of Activity: Relevant range of activity reveals the span of volume over which the cost behaviour is expected to remain valid. Various cost activities are relied upon on specific assumptions relating to cost behaviour patterns, which are valid only within the related range of cost exercise. A fixed cost is fixed only in relation to the relevant range of activity during the time span.

5. Concept of Relevant Cost and Benefit: This concept is for decision-making objectives. In appraising alternative courses of action, management should consider only relevant cost and relevant profits relating to alternatives under consideration. Irrelevant cost and benefits are ignored. The affects of this concept on operating or cost range capacity decisions are as follows:

(a) Relevant Cost and Profit for Operating Decisions: In operating decisions concentration is on optimum application of existing capacity. Increment analysis based on differential cost and differential revenue is based directly on the concept of relevant cost and profit.

(b) Relevant Cost and Profit for Capacity Decisions: Relevant cost and profits to a capacity decision are varied from the cost and profits relevant to an operating decision. In the long-term, the concepts of fixed and variable cost are meaningless. In long-term decisions, cost and profits are evaluated in relation of their influence on cost. A long-term decision must consider time value of money, the timing of the investment and recovery of cost. The terms out-of-pocket cost and sunk cost are also considered from this perspective.

6. Concept of Normal and Abnormal Cost: The term normal refers for cost or circumstances which are in agreement with what is representative, usual or regular. The term abnormal refers for cost or circumstances which are varied from what is normal, expected or ordinary. Various cost accounting treatments and strategies are laid down for normal and abnormal cost and circumstances.

Generally these terms are used in reference to normal or abnormal working situations in cost accounting discussions.

CLASSIFICATION OF COST

1. Normal Classification of Cost

A) Direct Material cost: Material means those items which are applied for manufacturing of a product and direct material is directly related to production. For example, raw cotton in textiles, crude oil to make diesel etc. There are so many names of direct materials such as process material, prime cost material, stores material and construction materials.

Main points for direct material can be summarized as follows:

- Direct material specially acquired for a particular Job, order, process or product.
- It is integrated part of manufacturing unit.
- Value of direct material is comparatively higher than that of other materials.
- Material passing from one process to another process.
- It Increases in the same ratio as the increase in production

B) Indirect Material Cost: In the words of **C.I.MA., London**, "indirect material cost is the material cost which cannot be allocated but which can be apportioned to or absorbed by cost centres or cost units''.

Thus it may be said that indirect cost is the cost which cannot be directly identified to the unit of output or to the segment of a business activity e.g. oil, grease, consumable stores etc.

C) Direct Labour Cost: Direct labour is known as the wage of those workers who are involved in the production process whose time can be efficiently and economically traceable to units of products e.g. wages paid to compositors in a printing press, labour of machine operators and assemblers. It may also be defined as prime labour cost, process labour cost, operating labour cost, manufacturing wages, Direct wages and productive labour cost. In the words of **C.I.MA., London**, "direct wages is that wages which can be allocated to cost centres or cost units."

D) Indirect Labour Cost: Some workers do not engage directly in conversion of output but contribute indirectly. Labour is paid for the objective of carrying tasks incidental to goods or service provided.

It cannot be practically traced to particular units of output e.g. wages of store-keepers, foremen, time-keepers, supervisors, Inspectors etc. In the words of **C.I.M.A., London**, "Wages which cannot be allocated but which can be apportioned or absorbed by cost centres or cost units is indirect wages."

E) Direct Expenses Cost: It is also defined as chargeable expenses. These direct expenses are incurred directly on a particular product, Job or cost units and recognizable with the cost units. According to C.I.M.A., London, "Direct expenses means, expenses which can be allocated to cost centres or cost units." For example, -

(1) Hiring of a particular tool plant or equipment for job.

(2) Cost of special moulds, designs and patterns.

(3) Fees paid to architects, surveyors and consultants.

(4) Insurance charges on special materials chargeable to a job.

F) Indirect Expenses Cost: Those expenses which cannot be directly, conveniently and fully charged to cost units are known as indirect expenses In the words of **C.I.M.A.**, London, "Indirect expenses are expenses which cannot be allocated but which can be apportioned to or absorbed by cost centres or cost unit" For example, insurance, power, lighting and heating, rent, rates and taxes, depreciation etc.

2. According to Variation in Production Activity and Quantity:

Costs can be divided into (i) fixed, (ii) variable, and (iii) mixed costs, in terms of their changes in cost behaviour in relation to variation in output, or activity or volume. Activity can be expressed in any form such as units of output, hours worked, sales, etc.

A) Fixed Cost: Fixed cost is a cost which does not vary in total for a given time period in spite of wide fluctuation in production or volume of activity. These costs are also termed as standby costs, capacity costs or period costs. Few examples explaining the nature of fixed costs are rent, property taxes, supervising salaries, depreciation on office facilities, advertising, Insurance, etc. Fixed costs are incurred with the passage of time and not with the production of the product or the job.

Hence, fixed costs are defined in terms of time, such as per day, per month or per year and not in terms of unit. It is totally illogical to say that remuneration of supervisor in the form of salary and perquisites are so much per unit but, it can be said that supervisor's salary and perquisites are so much per month.

Fixed costs can be further classified in the following categories

a. Committed costs: Those costs are unavoidable in short-term if the concern has to function. Such costs are basically incurred to maintain the company's benefits and physical existence, and over which management has little or no discretion. Few examples of committed costs are plant and equipment depreciation, taxes, insurance premium, rate and rent charges.

b. Managed costs: Managed costs are related to current activities which must continue to be incurred to ensure the operating existence of the company e.g., management and staff salaries.

c. Discretionary costs: They are also identified as programmed costs. Discretionary costs result from special policy decisions, management programmes, new researches etc. Few examples of such costs are research and development costs, marketing programmes, new system development costs.

The difference between committed and discretionary costs is that it is hard to eliminate or neglect committed costs in times of low production or decline in business activity, whereas discretionary costs such as research and development could be reduced to a desirable level.

d. Step costs: A step cost is fixed for a given amount of production and then rises in a constant amount at a higher production level. For example, in a manufacturing concern, one supervisor is needed at a salary of Rs 20,000 p.m. for every 50 workers. So long as 50 workers or less than that are working, the supervision costs will be Rs. 20,000 p.m. But, as soon as the 51st worker is employed, the cost of supervision rises by Rs. 20,000 p.m. and will be Rs. 40,000.Up to 100 workers the cost of supervision remains fixed at Rs. 40,000. But, if more than 100 workers are employed the cost of supervision will go up further. The following figure can be used to explain this concept:

B) Variable Cost: Variable Cost is those costs that change directly and accordingly with the production.

There is a fixed ratio between the variation in the cost and variation in the level of output. Direct materials cost and direct labour cost is the costs which are generally variable costs. For example, if direct material cost is Rs. 50 per unit, then for producing each extra unit, a direct material cost of Rs. 50 per unit will be incurred. That is, the total direct material cost increases in direct proportion to increase in units manufactured. However, it should be highlighted that it is only the total variable costs that vary as more units are produced; the per unit variable cost remains fixed. Variable overheads like factory supplies, indirect materials, sales commission, office supplies are some other examples of variable costs. If the factory is shut down, variable costs are eliminated. Variable cost is always revealed in terms of units or percentage of volume; it cannot be stated in terms of time. For every increase in the units produced there is a proportionate increase in the cost. When production increases to 3,000 units from a level of 2,000 units, the cost of direct materials increases in direct proportion at the fixed rate of Rs. 50 per unit. The line of variable cost is shown as linear rather than curvilinear

C) Semi-variable/Fixed Cost (Mixed Cost): Mixed costs are costs made up of fixed and variable items. They are a combination of semi-variable costs and semi-fixed costs. Because of the variable element, they vary with volume; because of the fixed element, they do not fluctuate in direct proportion to output. Semi-fixed costs are those costs which remain fixed up to a certain level of production after which they become variable.

3. Degree of Changeability to the Product

According to this basis, cost may be divided into direct and indirect cost.

A) Direct Cost: it may be defined as the term of direct materials, direct labour and direct overheads.

That means it is a cost which can be directly identified to a unit of output or the segment of a business operation. It output units are the objects of costing, then direct cost represent cost and resources that can be traced to or identified with the finished product .

B) Indirect Cost: Indirect costs are those costs which cannot be associated with or chargeable to a single product because they are incurred for more products. The examples of indirect costs are: indirect materials (lubricants and scrap materials), salary of factory supervisors (indirect labour), rent, rates and depreciation (indirect expenses). Indirect costs, often related to as overheads, have to be apportioned to various products.

Costs also may be direct or indirect with respect to particular firm segments or divisions. That is some cost which are indirect for a product, may be charged to a segment or department and thus, will be direct costs for that department. A segment may mean any one of a number of things, viz. department, division, specific activity, sales territory etc.

Before classifying the cost into direct and indirect, it is necessary to know whether it is being related with a product, sales area, department or some other activity. For example, if a salesman simultaneously handles several products, his salary is an indirect cost for each product, but a direct cost to his sales area or department.

4. Degree of Relation with the Product

Cost may be divided into product costs and period costs in terms of relation with the product.

A) Product Cost: Generally product costs are identified with the product and merged in inventory values. In other words, product costs are those costs that are included in the cost of manufacturing a product. In a manufacturing firm, it is the combination of four elements: (i) direct materials, (ii) direct labour, (iii) direct expenses, and (iv) manufacturing overhead. Thus, product cost is a complete factory cost. Prior to sale, product costs are deferred as inventories and until the goods are sold, are shown on the balance sheet as assets. As finished inventory goods is sold, product costs are transferred from the inventory accounts to the cost of goods sold account thus becoming expenses and part of the period costs at the time revenue is realised.

B) Period Cost: Period costs are those costs which are not identified with product or activity during the period in which they are evolved. They are not carried forward as a part of value of stock to the next accounting period.

These costs are required to generate revenues but they cannot be directly related with units of product. Difference of opinion exists regarding whether certain costs should be considered as product or period costs.

5. Functional Classification of Costs

Functional classification of costs defines how the cost was applied (manufacturing, administration or selling).

A functional classification expresses that the business performs various functions for which costs are incurred.

In measuring net income, expenses are usually classified by function and grouped under the headings of manufacture, selling and administrative costs. Manufacturing costs are all production cost incurred to manufacture the products and to bring them to a saleable condition, including direct materials, direct labour and indirect manufacturing (or factory overhead) costs. Selling and administrative charges may be assumed as expenses when incurred or charged to prepaid expense accounts such as prepaid insurance. Functional classification is also important because it gives an opportunity to the management to calculate the efficiency of departments performing various functions in the firm.

6. Association with Accounting Period

Costs can also be classified into two major classes on the basis of the accounting period to which they relate:

- Capital expenditures, and
- Revenue expenditures

A capital expenditure provides benefit to future periods and is classified as an asset; revenue expenditure is treated to benefit the current period and is classified as an expense; a capital expenditure will flow into the cost stream as an expense when the asset is applied up or written off. The difference between capital and revenue expenditures is vital to the accurate matching of costs and revenue and to the right measurement of periodic net income.

7. Costs for Decision-Making and Planning

A) Opportunity Cost: opportunity cost is the cost of opportunity lost. Opportunity cost is the cost of choosing one item of action in terms of the opportunities which are given up to carry out that course of action. Opportunity cost is the profit lost by avoiding the best competing alternative to the one chosen. The benefit lost is normally the net earnings or profits that might have been earned from the rejected alternative.

For example, assume that a manufacturer can sell a semi-finished product to a customer for Rs. 5, 00,000. He decides, however, to keep it and eliminate it. The opportunity cost of the semi finished product is Rs. 5, 00,000 because this is the amount of economic resources rejected by the manufacturer to complete the product. Simultaneously, capital which is invested in plant and inventories cannot now be invested in shares and debentures that will earn interest and dividends.

The loss of interest and dividend that would be earned is the opportunity cost. Other examples of opportunity cost are when the owner of a business foregoes the opportunity to employ himself elsewhere; or a machine used to make Product X is said to have an opportunity cost if the machine can be sold or if it can also make Product Y.

Opportunity costs help in decision-making and selecting alternatives. Decision-making is selecting the best alternative which is adopted with the help of opportunity costs. But opportunity costs are not recorded in an accounting system as they relate to opportunities lost.

B) Sunk Cost: Sunk cost is past or historical cost which has already been incurred. It may be known as unavoidable cost, it refers to all past costs since these amounts cannot be changed once the cost is incurred. They are the costs which have been created by a decision in the past and cannot be altered or neglected by any decision that is made in the future. Examples of sunk costs are the book values of existing assets, such as plant and equipment, inventory, investment in securities, etc. Except the possible benefits or losses on sales of any of such assets, the book value is not relevant for decisions regarding whether to use them or dispose them off.

Some accountants make discussion and argument that the total cost of a fixed asset is not the sunk cost, but sunk cost is the difference between the purchase price of a fixed asset and the net amount that could be realised from its sale. For example, if a plant has a book value of Rs 10,00,000 and a scrap value of Rs. 60,000 then the sunk cost is Rs. 9,40,000 (Rs 10,00,000 - 60,000) and not Rs. 10,00,000 That is, the sunk cost is the difference between book value and scrap value.

C) Relevant Cost: Relevant costs are related to future, which differ between alternatives. Relevant costs may also be termed as the costs which are influenced and changed by a decision. On the other hand, irrelevant costs are not influenced by the decision, whatever alternative is selected. The features of relevant cost are as follows

(i) Relevant costs are basically future costs, i.e. those costs which are, expected to be charged in future. Relevant costs therefore, are not past (sunk) costs which have already been incurred and cannot be altered by a decision.

(ii) Relevant costs are only incremental (additional) or avoidable costs. Incremental costs refer to an increase in cost between two options. Avoidable costs are those which are not incurred from one alternative to another.

Components of Total Cost

1. Prime Cost: It consist costs of direct material, direct labour and direct expenses. It is also known as basic, first or flat cost.

2. Factory Cost: It comprises of prime cost and in addition, works or factory overheads which include costs of indirect labour and indirect expenses. This cost is also known as works cost, production or manufacturing cost.

3. Office Cost: If office and administration overheads are added to factory cost office cost is arrived at. This is also termed as administration cost or total cost of production.

4. Total Cost: Selling and distribution overheads are added to the total cost of production to get the cost of sales.

Cost Sheet

Cost sheet is an analytical statement of expenses relating to production of an article which informs regarding total cost, per unit cost and quantity of production.

According to **Wheldon**, "Cost sheets are prepared for the use of management and consequently, they mustinclude all the essential details which will assist the manager in checking the efficiency of production."

In the words of **C.I.M.A., London**, "Cost sheet is a cost schedule or document which provides for the assembly of the estimated detailed cost in respect of a cost centre or cost unit"

When cost per unit of production is not necessary to calculate then a statement of cost is prepared to ascertain total cost and profit or loss on production.

COST SHEET – FORMAT

Particulars	Amount	Amount
Opening Stock of Raw Material	***	
Add: Purchase of Raw materials	***	
Add: Purchase Expenses	***	
Less: Closing stock of Raw Materials	***	
Raw Materials Consumed	***	
Direct Wages (Labour)	***	
Direct Charges	***	
Prime cost (1)		***
Add :- Factory Over Heads:		
Factory Rent	***	
Factory Power	***	
Indirect Material	***	
Indirect Wages	***	
Supervisor Salary	***	
Drawing Office Salary	***	
Factory Insurance	***	
Factory Asset Depreciation		

	***	
Works cost Incurred		***
Add: Opening Stock of WIP Less: Closing Stock of WIP ____	*** ***	
Works cost (2)		***
Add:- Administration Over Heads:- Office Rent Asset Depreciation General Charges Audit Fees Bank Charges Counting house Salary Other Office Expenses	 *** *** *** *** *** *** ***	
Cost of Production (3)		***
Add: Opening stock of Finished Goods Less: Closing stock of Finished Goods ____	*** ***	
Cost of Goods Sold		***
Add:- Selling and Distribution OH:- Sales man Commission Sales man salary Traveling Expenses Advertisement Delivery man expenses	 *** *** *** *** ***	

Sales Tax Bad Debts	*** ***	
Cost of Sales (5)		***
Profit (balancing figure)		***
Sales		***

Notes:-

1) Factory Over Heads are recovered as a percentage of direct wages

2) Administration Over Heads, Selling and Distribution Overheads are recovered as a percentage of works cost.

1.12 Limitations of Cost Accounting

These are the following reasons for which cost accounting is criticized by the different sections of society:

a) Not Reliable: Cost Accounting is based on estimates and so it is not reliable.

b) Failure of the System: Cost Accounting system has failed to produce desired results in many concerns. Thus it could be said that this system is at fault.

c) Unnecessary: it is not necessary in Business concern as it involves duplication of work.

d) Inapplicability: Modern methods of cost accounting are not applicable to every type of industries.

e) Expenses: It is expensive because double set of account books has to be maintained and its introduction involves considerable amount of expenditure. Element is an important area of a product. To estimate correct cost accounting, cost classification and analysis is being done. This is also necessary to control the cost. In other words elements of cost means expenditure or cost incurred on resources which are helpful in produce an item, for example material, labour and expenses. To understand the cost one should know what is expenses and loss.

POSSIBLE QUESTIONS (UNIT-I)

1. From the following particulars prepare the statement showing

(a). Raw materials consumed

(b). Prime cost

(c). Work cost

(d). Cost of production

(e). Profit

Particulars	1-1-2009	31-1-2009
Raw materials	20000	32000
Work-in-progress	26500	14000
Purchase of raw materials	----	90000
Carriage inwards	----	2000

Chargeable expenses	----	15000
Direct wages	----	40000
Work over heads	----	22500
Administrative over heads	----	10000
Selling and distribution over heads	----	14000
Sales	----	220000

2. From the following particulars you are require to prepare cost sheet for the month ending march-31

Particulars	March-1	March-31
Raw materials	20000	----
Finished goods	14300	80400
Work in progress	6200	6900
Purchase of raw materials	17600	----
Direct wages	14000	----
Indirect wages	500	----
Work expenses	7400	----
Office expenses	2600	----
Selling expenses	3000	----
sales	56800	----

3. Draw a statement of cost from the following particulars

1. Opening stock

Materials	200000
Work in progress	60000
Finished goods	5000

2. Closing stock

Materials	180000
Work in progress	50000
Finished goods	15000
Material purchased	500000

Direct wages	150000
Office expenses	100000
Selling and distribution expenses	20000
Sales	800000

4.from the following particulars you are require to prepare statement showing cost of materials consumed, prime cost, work cost, cost of sales and profit.

Stock of finished goods on 31-12-2009 Rs.73000

Stock of raw materials on 31-12-2009 Rs.35000

Purchase of raw materials Rs.760000

Productive wages (direct wages) Rs.520000

Stock of finished goods on 31-12-2010 Rs.82500

Stock of raw materials on 31-12-2010 Rs.37500

Sale of finished goods (sales) Rs.1545800

Work overhead charges Rs.130200

Office and general charges Rs.6970

5. The following data related to a manufacturing company during the month of January

Raw materials Rs.80000

Direct wages Rs.48000

Machine hours Rs.8000

Machine hour rate Rs.4

Office overhead 10% of work cost

Selling overhead Rs.1.50 per unit

Units produced 4000

Unit sold 3600 at Rs.50 each

6. From the following particulars prepare a statement showing the competence of total sales and profit for the year ended Dec-31.

Stock of finished goods Jan-1 Rs.6000

Stock of raw material Jan-1 Rs.40000

Work in progress Jan-1 Rs.15000

Purchase of raw material Rs.475000

Carriage inwards Rs.12500

Factory, rent, taxes Rs.7250

Other production expenses Rs.43000

Stock of finished goods on Dec-31 Rs.15000

Wages Rs.175000

Work manager salary Rs.30000

Factory employees salary Rs.60000

Power expenses Rs.9500

General expenses(administrative overheads) Rs.32500

Sales Rs.860000

Stock of raw material Rs.50000

Work in progress Rs.10000.

7. What is mean by cost accounting?

8. Differentiate between cost accounting and management accounting ?

9. Explain the features of cost accounting

10. Explain the classifications of cost?

11. Write format of cost sheet.

12. What is mean by elements of cost?

13.Explain the limitations of cost accounting ?