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ACCOUNTING FOR HOSPITALS

MASTER OF BUSINESS ADMINISTRATION
(HOSPITAL ADMINISTRATION)

FIRST YEAR, SEMESTER-I, PAPER-V



7

DIRECTOR, I/c.

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FOREWORD

Since its establishment in 1976, Acharya Nagarjuna University has been forging ahead in the path of progress and dynamism, offering a variety of courses and research contributions. I am extremely happy that by gaining 'A+' grade from the NAAC in the year 2024, Acharya Nagarjuna University is offering educational opportunities at the UG, PG levels apart from research degrees to students from over 221 affiliated colleges spread over the two districts of Guntur and Prakasam.

The University has also started the Centre for Distance Education in 2003-04 with the aim of taking higher education to the door step of all the sectors of the society. The centre will be a great help to those who cannot join in colleges, those who cannot afford the exorbitant fees as regular students, and even to housewives desirous of pursuing higher studies. Acharya Nagarjuna University has started offering B.Sc., B.A., B.B.A., and B.Com courses at the Degree level and M.A., M.Com., M.Sc., M.B.A., and L.L.M., courses at the PG level from the academic year 2003-2004 onwards.

To facilitate easier understanding by students studying through the distance mode, these self-instruction materials have been prepared by eminent and experienced teachers. The lessons have been drafted with great care and expertise in the stipulated time by these teachers. Constructive ideas and scholarly suggestions are welcome from students and teachers involved respectively. Such ideas will be incorporated for the greater efficacy of this distance mode of education. For clarification of doubts and feedback, weekly classes and contact classes will be arranged at the UG and PG levels respectively.

It is my aim that students getting higher education through the Centre for Distance Education should improve their qualification, have better employment opportunities and in turn be part of country's progress. It is my fond desire that in the years to come, the Centre for Distance Education will go from strength to strength in the form of new courses and by catering to larger number of people. My congratulations to all the Directors, Academic Coordinators, Editors and Lesson-writers of the Centre who have helped in these endeavors.

Prof. K. Gangadhara Rao
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Vice-Chancellor I/c
Acharya Nagarjuna University.

**MASTER OF BUSINESS ADMINISTRATION
(HOSPITAL ADMINISTRATION)**

Programme Code: 197

PROGRAMME SYLLABUS

1st YEA ~~12~~ 2nd SEMESTER SYLLABUS

202HA26: ACCOUNTING FOR HOSPITALS

Unit – I: Financial Accounting: Meaning and Objectives and Functions of Accounting; Principles of Accounting – GAAP – Journals, Ledgers and Trail Balance for Hospitals; Subsidiary Books – Cash Book

Unit – II Financial Statements: Profit and Loss Account – Balance Sheet (**Problems**) – Accounts of Non-profit organizations. Depreciation Methods to be used for the Hospital Equipment

Unit – III: Costing: Fundamentals of Cost Accounting; Costing of Service Departments and Other Related Areas: Estimation of Cost-of-Service Departments – Allocation and Apportionment of costs to various departments – Service departments to be covered are: CSSD, laundry, compressors, water supply, oxygen, nitrous oxide, food & beverage, housekeeping – Activity Based Costing (ABC) in a Corporate Hospital. (Theory Only)

Unit – IV: Management Accounting: Nature and Scope; – Management Accounting Vs Financial Accounting – Management Accounting Vs Cost Accounting – Functions and Duties of Management Accountant in Hospitals.

Unit – V Marginal Costing: Definition, Marginal Costing Vs. Absorption Costing, CVP /BEP Analysis, Managerial Decision-Making Areas – Make or Buy.

Reference Books

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4. A.Murthy, T.S. Reddy “Financial Accounting” Margham Publications, 2017
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11. Steven A. Finkler, David M. Ward, Steve A. Finkler, Essentials of Cost Accounting for Healthcare Organizations, Aspen Publishers, Inc.; ISBN: 0834210118: 2nd edition.
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LESSON -1**MEANING, OBJECTIVES AND FUNCTIONS OF ACCOUNTING****1.1 Introduction:**

Accounting is an ancient art as old as money itself; however, the role of accounting has been changing with the economic and social developments. The traditional view of accounting as a historical description of financial activities is no longer acceptable. Over a period of time new dimensions have been added to the discipline of accounting. Until recently accounting was regarded merely as an art of recording, classifying and summarising transactions and event which are of a financial character. Later on, accounting was regarded as, “the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information.” Accounting is now regarded as a service activity the function of which is to provide quantitative information about economic activities. The information is primarily financial in nature and is intended to be useful in making economic decisions. Thus accounting can be rightly termed as a service activity, ‘a descriptive, analytical discipline and an information system’. It includes several branches, for example, financial accounting, cost accounting and management accounting.

1.2 Meaning and Definitions of Accounting:

Meaning: Accounting is the art and science of recording, classifying and summarising of financial transactions and interpreting the results there of. The need for recording such transactions arises because it is not possible to remember all transactions taking place during a period of time. The main purpose of accounting is to keep systematic record of financial transactions so as to ascertain the profit earned or loss incurred on account of carrying the business during a special period and to show the financial position of a business on a particular time. It also aims to protect firm’s properties from unjustified and unwarranted use.

Definitions:

Accounting involves the collection, recording, classification and presentation of financial data for the benefit of management and stakeholders such as shareholders, creditors, bankers

and government. The below are the famous definitions of accounting given by many professionally expertise stalwarts and concern accounting associations.

Eric L. Kohler defines accounting as “the procedure of analysing, classifying and recording transactions in accordance with a pre-conceived plan for the benefit of (a) providing a means by which an enterprise can be conducted in orderly fashion, and (b) establishing a basis for reporting the financial condition of enterprise and the results of its operations.” According to this definition, accounting is the recording of business transactions with the purpose of managing the concerns in a better way and also reporting the true financial position of operations.

American Institute of Certified Public Accountants defined as Accounting is the art of recording, classifying and summarising in a significant manner and in terms of money, transactions and event, which are in part at least, of a financial character, and interpreting the results there of.”

Smith and Ashburne describe it as, “Accounting is the science of recording and classifying business transactions and events, primarily of a financial character and the art of making significant summaries, analysis and interpretation of those transactions and events and communicating the results to persons who must make decisions or form judgements.

From the above definitions the following attributes or characteristics of accounting emerge.

- i. It is the art of recording business transactions
- ii. It is the art of classifying business transactions
- iii. The transactions or events of an enterprise must be recorded in monetary terms
- iv. It is the art of summarising financial transactions
- v. It is an art of analysing and interpretation of these transactions
- vi. The result of such analysis must be communicated to the persons who are able to make decisions or form judgements.

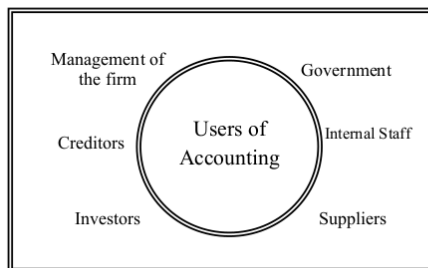
1.3 Objectives of Accounting

There is a specific purpose behind preparing the accounts for business concerns. Most of the objectives are relating to the financial status of the firm and some of the objectives of the accounting is to help the stake holders of the firm. The main objectives of accounting are:

1. *To Ascertain whether the business operations have been profitable or not.* Accounting helps us to know whether a business has earned profit or suffered loss during the accounting period. It will give us an idea of efficiency of the business. To determine profit or loss of the accounting period, a trading and profit and loss account or an income statement is prepared by matching revenues and expired costs incurred for earning the revenues.
2. *To ascertain the financial position of the business.* Balance sheet or position statement is prepared to give an idea of the financial position of the business on a particular date. The financial position of an enterprise is indicated by its assets on a given date and its liabilities on that date. Excess of assets over liabilities represent the capital and is indicative of the financial soundness of an enterprise.
3. *To generate* such information from accounting records which may be helpful to various persons in planning, control, evaluation of performances and decision-making.
4. *To report to the top management.* One of the important objectives of Accounting is to prepare the financial reports and to communicate them to the top management for making necessary decision. The primary requisite for any crucial decision in the organisation is appropriate information. Good and apt information always results in sound decisions otherwise the decisions will be poor. Likewise, the financial decisions in the firm need appropriate information which is provided by the accounting.

1.4 Functions of Accounting

Accounting is useful to management as well as to external users such as potential owners, creditors, government agencies and other interested persons. It provides information regarding the status of the business and results of its operations. The main functions of accounting are as follows:



1. **Recording of Information:** Accounting is an art of recording of all the financial transactions of a firm. It is not possible to remember each and every transaction of the business. Accounting is necessary to supplement human memory. The

information is recorded in journal and other subsidiary books. The subsidiary books to be used may be Purchases Book, Sales Book, Returns Outwards and Inwards Book, Journal Proper, Cash Book, etc. These books are used to record various transactions in such a way that the information is properly classified and analysed so that management may make use of that information.

2. **Classification of Data:** The classification of information means that data of one nature is placed at one place. This is done in the book called 'Ledger'. The entries relating to different items are brought at one place so that full information of these items may be collected under different heads. For example, we may have accounts called, Salaries, Rent, Interest, Advertisement etc. These accounts will be opened in the ledger under their heads and all entries relating to these accounts will be posted into these accounts.
3. **Making Summaries.** Another function of financial accounting is to make summaries of recorded and classified data. The classified data is used to prepare final accounts, i.e. profit and Loss Account and Balance Sheet. The Profit and Loss account is prepared from various revenue items for a given period. The balance sheet is a summary of various assets and liabilities. The final accounts are prepared to find out operational efficiency and financial strength of the business.
4. **Dealing with Financial Transactions.** Only those transactions are recorded which are measurable in terms of money. Money is taken as a common medium and all economic transactions are expressed to monetary terms. Anything which cannot be expressed in monetary terms does not form a part of financial accounting even though it has a significant bearing on the working of the business. The good behaviour of Production Manager might have encouraged workers to work more but this vital factor will not be a part of financial accounting because quality of an individual is not measurable in terms of money.
5. **Interpreting Financial Information.** Accounting information is modified in such a way that it is interpreted by the management for drawing conclusions. The interpretation part is very important for decision-making. The outsiders such as creditors, investors, bankers, shareholders are able to form an opinion about the profitability and overall financial position of the firm.
6. **Communicating Results.** Financial accounting is not only concerned with the recording of facts and figures but it is also connected with the communication of results. The profitability and financial position of the business are communicated

through profit and loss account and balance sheet. The persons interested in knowing the results of the business can make their own conclusions from financial statements. The information is supplied at regular intervals.

7. **Making Information more Reliable.** Another important function of financial accounting is to make the information more useful and reliable. This is done by the use of Internationally Accepted Accounting Standards for preparing accounts. The same accounting principle should be consistently used otherwise the reliability of accounts will not be possible. If we change method of charging depreciation and valuation of stock every year then reliability of accounts will be adversely affected. An effort is made to make the information useful and reliable.

LESSON -2**PRINCIPLES OF ACCOUNTING – GAAP****2.1 Introduction**

The development of accounting principles has been closely associated with the growth of business. When the business was small and exclusively a proprietary concern, the accounting was needed only for the owner. With the increase in size of business, the ownership and management have gone into two different hands. The complexities of business have increased the importance of accounting. Accounting is now required by management, shareholders, investors, bankers, creditors, government departments and many other authorities.

Accounting is an art and science of recording business transactions in a systematic manner. To convey the language of business, certain principle are required to be followed for maintaining business transactions. In the absence of common principles, there will be a chaotic situation and every accountant will have his own principles. Not only the utility of accounts will be less but these will not be comparable even in the same business. It becomes essential that common principles should be followed for measuring business revenues and expenses.

2.2 Accounting Principles

Accounting principle are men made. Unlike th principles of Physics, Chemistry and other natural sciences, accounting principles were not deduced from basis axioms, nor their validity is verifiable through observations or experiments. These principles are drawn from practical practice of accounting, no list of universally accepted principles can be prepared but still certain principles are drawn which are accepted by most of the accountants.

According to **Terminology Committee of AICPA**, “The word principles is used to mean a general law or rule adopted or preferred as a guide to action; a settled ground or basis or conduct or practice.”

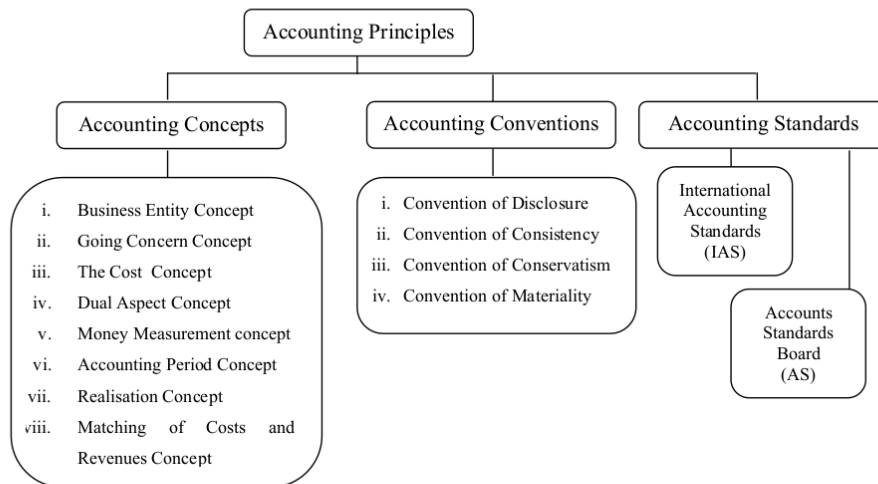
A.W. Johnson describes accounting principles as “Broadly speaking, these principles are the assumptions and rules of accounting, the methods and procedure of accounting and the application of these rules, methods and procedures to the actual practice of accounting.”

2.3 Essential Features of Accounting Principles

Accounting principles are acceptable if they satisfy the following norms:

1. **Relevance or Usefulness.** A Principle will be relevant only if it satisfies the needs of those who use it. The accounting principles should be able to provide useful information to its users otherwise it will not serve the purpose.
2. **Objectivity.** A principle will be said to be objective if it is based on facts and figures. There should not be a scope for personal bias. If a principle can be influenced by the personal bias and whims of users, it will not be an objective principle and its usefulness will be limited. The cost principle will be more useful than the value principle because value will be based on market prices and personal judgement will differ in finding out value.
3. **Feasibility.** The accounting principle should be practicable. The principles should be easy to use otherwise their utility will be limited. While showing fixed assets in the balance sheet, it will be more feasible to take cost less depreciation. If the assets are shown on market value or replacement cost basis then it will involve difficulties and different persons will take different values because market prices go on changing every time.

2.4 Classification of Accounting Principles



Accounting principles are classified into two categories. They are:

- (a) Accounting Concepts
- (b) Accounting Conventions

Accounting Concepts: The term concept is used to connote basis accounting postulates i.e. necessary assumptions and conditions upon which accounting is based. It refers to accounting propositions under which accounting works. 'Postulates are the basic assumptions on which principle rest. They are derived from the economic and political environment and from the modes of thoughts and customs of all segments of the business community.'

Though many accounting concepts are used but there is a general agreement on the following concepts:

- i. Business Entity Concept
- ii. Going Concern Concept
- iii. The Cost Concept
- iv. Dual Aspect Concept
- v. Money Measurement concept
- vi. Accounting Period Concept
- vii. Realisation Concept
- viii. Matching of Costs and Revenues Concept

Accounting Conventions: Certain accounting conventions are followed by the accountants, while they preparing financial records. These conventions are not only useful to the business but also to those who want to deal with the business. Some of the conventions are:

- i. Convention of Disclosure
- ii. Convention of Consistency
- iii. Convention of Conservatism
- iv. Convention of Materiality

2.5 Accounting Standards

Generally Accepted Accounting Principles (GAAPs)

With the liberalisation and globalisation of business in recent years and opening up of markets to international investors, huge amounts of capital have been flowing across the national boundaries. Much of this cross-border flow has been in the form of easily tradable securities, bonds, equities or other negotiable instruments. Indeed, as business ruthlessly transcends geographical barriers, it needs to speak the same language. Accounting is the language of business, but every country has its own language which is called as Generally Accepted Accounting Principles (GAAPs). As such, there is a need to harmonise national standards with international standards. Accounting standards would yield financial standards that could be effortlessly interpreted by any user around the world.

LESSON- 3

JOURNALS, LEDGES AND TRAIL BALANCE FOR HOSPITALS

Introduction

Double Entry Book-Keeping System: Double entry System was originated in 1444 by Fra Luca Pacioli, an Italian, who wrote the first known work on book-keeping entitled 'De Computis et Scripturis'. The book dealt with the use of Memorial or Memorandum Book, Journal and Ledger. This book was translated and published in English by Hugh Old Castle in 1943. The double entry system of book-keeping is the orderly recording of financial transactions of a business in a systematic manner.

We know that every business transaction involves exchange of value for value, or exchange of goods or services for money or money's worth. For example, when 'A' purchases goods for Rs.1000 from 'B' for cash, he exchanges cash for goods. He receives goods and parts with money. On the other hand, 'B' receives money and parts with goods. Similarly when 'A' pays salary of Rs.500 to his manager for the services rendered, he gives money and receives services. Thus, every business transaction involves receiving something having value and giving of something having value called two aspects of the transaction. The double entry system recognises that every transaction has two aspects and method of recording both the aspects of a transaction is known as Double Entry System of Book-keeping. Technically speaking, it can be said that every transaction involves two accounts out of which one account is debited and the other is credited with an equal amount. Thus, the totals of all the debits must equal to the total of all the credits. This is the fundamental principle of double entry system of book-keeping.

Principle of Double Entry Book-keeping System

The transactions of a business can be broadly classified into three categories.

- i. Transactions relating to persons – **Personal Account**
- ii. Transactions relating to property and assets – **Real Account**
- iii. Transactions relating to expenses and incomes – **Nominal Account**

Thus, it becomes necessary for a business to keep a separate account of each person or firm with whom it deals, each property or asset which it owns and each item of expenses or incomes.

1. **Personal Accounts:** Personal accounts include the accounts of persons, firms, institutions, organisations, companies and corporations. The main purpose of maintaining personal account is to determine the amount due to or due from various persons, firms etc. For Ex. Mr.Ganesh Chaturvedhi's A/c, Mr.Kiran Kumar A/c., M/s Gayatri Enterprises, Reliance Industries Ltd. Etc

Rule or Principle – **Debit the Receiver**

Credit the Giver

2. **Real Account.** All accounts related to assets, properties and possessions are called real accounts. For example, land A/c, Building A/c, Furniture A/c, Machinery A/c, Cash A/c etc.

Rule or Principle – **Debit the What Comes In**

Credit the What Goes Out

3. **Nominal Account.** Accounts relating to expenses, losses, incomes, gains or profits are called nominal accounts. Examples of such accounts are Rent A/c., Discount Received A/c, Commission A/c, Carriage A/c, Bad Debts A/c, Discount Paid A/c, Dividend Received A/c etc.

Rule or Principle – **Debit the All Expenses and Losses**

Credit the All Incomes and Profits

JOURNAL

We studied in Lesson 1 that Accounting is the art and science of recording, classifying and summarising of financial transactions and interpreting the results thereof. Thus, the Accounting Process is also called Accounting Cycle involves the following stages:

1. Recording: The transactions are primarily recorded in a book called **Journal**.
2. Classifying: All transactions recorded in the journal are classified account-wise and posted in the **Ledger**
3. Summarising: After the preparation of ledger, a summary of ledger accounts is prepared in the form of Trial balance and then Profit and Loss Account and Balance Sheet are prepared to ascertain the net effect of business transactions on the profitability and financial position of the business.

4. Interpreting: The financial statements so prepared are further analysed and interpreted to determine financial strengths and weaknesses of the firm. A number of devices such as comparative statements, trend analysis, ratio analysis, fund flow analysis, cash flow analysis etc are used for this purpose.

Meaning:

Journal is a book of original or prime entry where transactions are recorded in the order in which they occur, i.e. in chronological order. It is the basic book of accounting in which all business transactions are recorded at the first instance and that is why it is called the book of original entries. Journal is called the book of prime entry or the primary book of accounts because after recording the transaction in the journal it is finally posted in the ledger, called the book of final entry.

The process of recording or entering a transaction in the journal is called **Journalising** and the record of each transaction in the journal is called **Journal Entry**.

Date	Particulars	L.F	Debit Rs.	Credit Rs.

- In date column, the date of the transaction is written.
- In the Particulars column is to furnish the transaction details. It should be write in the three lines. Every entry should be write in three lines i) debit line – what comes in according to the nature of the transaction, ii) credit line – what goes out basing on the nature of the transaction and the iii) narration line – brief explanation about the transaction.
- Ledger Folio (L.F) Column – the page number of the ledger where the account is opened and posting is made is written for the purpose of reference.
- Debit Column – the amount to be debited (incoming aspect) is entered in this column
- Credit Column – the amount to be credited (outgoing aspect) is entered in this column.

Example 1. Analyse the following transactions and show how these will be recorded in journal:

Date	Particulars
2025 July 1	Vasu Started business with a capital of Rs.50,000
July 2	He Purchased furniture for Rs.1500
July 3	He opened an account with a bank depositing Rs.5000
July 5	He purchased goods for Rs.20000
July 8	He sold goods for Rs.8000
July 12	Purchased goods from Sunil on credit for Rs.12000
July 18	Paid Rs.7000 to Sunil on account
July 20	Purchased stationary for Rs.200 and used it for business
July 25	Paid rent for the shop Rs.800
July 28	Paid salary of clerk Rs.500

Sol.

July 1 – Vasu Started business with a capital of Rs.50,000

The two accounts involved in this transaction are (i) Cash A/c and (ii) Vasu's Capital A/c. Cash a/c is a real account and cash comes into the business, hence cash a/c shall be debited. Vasu's Capital A/c is a personal account and Vasu is the giver of the benefit, hence Vasu's Capital A/c shall be credited. The transaction will be recorded in journal as below:

Date	Particulars	L.F	Debit Rs.	Credit Rs.
2025, July 1	Cash A/c Dr		50,000	
	To Vasu's Capital A/c			50,000
	(Being business started with Rs.50,000 by Vasu)			

July 2 - He purchased furniture for Rs.1500

The two accounts involved in this transaction are (i) furniture a/c and (ii) Cash A/c. Both furniture and cash accounts are real accounts. Furniture comes into the business, it shall be debited while cash goes out of business, hence it shall be credited. The transaction shall be recorded in journal as follows:

Date	Particulars	L.F	Debit Rs.	Credit Rs.
2 July, 2025	Furniture A/c Dr		1,500	
	To Cash A/c			1,500
	(Being furniture purchased with cash Rs.1500)			

July 3 – He opened an account with a bank depositing Rs. 5,000

The two accounts involved in this transaction are (i) Bank A/c and (ii) Cash A/c. Bank a/c is a personal account and cash account is real account. Bank receives the money and therefore Bank A/c should be debited. Cash goes out of business and hence cash a/c should be credited. The journal entry shall be as follows:

Date	Particulars	L.F	Debit Rs.	Credit Rs.
3 July, 2025	Bank A/c Dr		5000	
	To Cash A/c			5000
	(Being cash deposited into bank)			

July 5 – He purchased goods for Rs.20,000

The two accounts involved in the transaction are (i) Purchases A/c and (i) Cash A/c. Both accounts are real accounts. Goods are coming into the business and cash is going out, therefore, Purchases A/c shall be debited and Cash A/c shall be credited.

Date	Particulars	L.F	Debit Rs.	Credit Rs.
2 July, 2025	Purchases A/c Dr		20,000	
	To Cash A/c			20,000
	(Being goods purchased with cash Rs. 20,000)			

July 8 – He sold goods for Rs.8000

The two accounts involved in the transaction are (i) Sales A/c and (i) Cash A/c. Both accounts are real accounts. The effect of this transaction is that cash comes into the business and goods (sales) go out of the business, therefore, Cash A/c shall be debited and Sales A/c shall be credited.

Date	Particulars	L.F	Debit Rs.	Credit Rs.
8 July, 2025	Cash A/c Dr		8,000	
	To Sales A/c			8,000
	(Being goods sold for cash Rs. 8,000)			

July 12 – Purchased goods from Sunil on Credit for Rs.12,000

The two accounts involved in this transaction are purchases a/c and Sunil's A/c. The Purchases A/c is a real account and the goods are coming into the business, therefore, it should be debited. Sunil's A/c is a personal account and Sunil is the giver of the benefit, therefore, his account should be credited.

Date	Particulars	L.F	Debit Rs.	Credit Rs.
12 July, 2025	Purchases A/c Dr		12,000	
	To Sunil's A/c			12,000
	(Being goods purchased from Sunil on credit Rs.12,000)			

July 18 - Paid Rs. 7,000 to Sunil to account

The two accounts involved in this transaction are (i) Sunil A/c and (ii) Cash A/c. Sunil a/c is a personal account and he is the receiver of the benefit, therefore, his account shall be debited. Cash A/c is a real account and cash goes out, therefore, it should be credited.

Date	Particulars	L.F	Debit Rs.	Credit Rs.
18 July, 2025	Sunil's A/c Dr		7,000	
	To Cash A/c			7,000
	(Being cash paid to Sunil Rs. 7,000)			

July 20 – Purchased stationary for Rs.200 and used it for business

The two accounts involved in the transaction are (i) Stationary a/c and (ii) Cash A/c. Stationary used in the business is an expenses and a nominal account, therefore, it should be credited.

Date	Particulars	L.F	Debit Rs.	Credit Rs.
20 July, 2025	Stationary A/c Dr		200	
	To Cash A/c			200
	(Being stationary purchased for Rs. 200)			

July 25 – Paid rent for the shop Rs.800

The two accounts involved in this transaction are Rent A/c and Cash A/c. Rent A/c is a nominal account, it is an expense, and therefore, it should be debited. Cash A/c is a real account, it goes out of the business, therefore it should be credited.

Date	Particulars	L.F	Debit Rs.	Credit Rs.
25 July, 2025	Rent A/c Dr		800	
	To Cash A/c			800
	(Being rent paid Rs. 800)			

July 28 – Paid salary to clerk Rs.500

The two accounts involve in this transaction are Salary A/c which is Nominal Account and Cash A/c is a Real Account. The Salaries A/c should be debited (because it is expenditure – all expenses are debit balance) and Cash A/c should be credited (because cash is going out of the business).

Date	Particulars	L.F	Debit Rs.	Credit Rs.
28 July, 2025	Salary A/c Dr		500	
	To Cash A/c			500
	(Being salary paid to Rs. 500)			

Important Points to Note

1. **Capital Account:** the amount invested by the owner in the business whether in the form of money or money's worth i.e. cash, goods or property is called capital. It should, therefore debit to cash/stock/property account and credited to capital account.
2. **Drawings Account:** any amount of cash or value of goods withdrawn by the owner of the business for his domestic or personal use is called drawings. The drawings account is a personal account and it should, therefore, be debited and cash/purchases account should be credited. The following are some of the transactions to be treated as drawings:
 - a. Goods withdrawn for personal use
 - b. Cash withdrawn for personal use
 - c. Income tax paid by the proprietor
 - d. Paid life insurance premium
 - e. Paid rent for the residential accommodation of the proprietor
3. **Goods Account:** The term 'goods' means the articles, commodities or merchandise in which the business deals. The Goods Account is a real account. For the purpose of accounting it is classified as:
 - a. Purchases A/c
 - b. Sales A/c
 - c. Purchase Returns or Returns Outwards A/c
 - d. Sales Returns or Returns Inwards A/c
 - e. Stock A/c
4. **Cash/Credit Transactions:** one must read the transaction carefully to ascertain whether the transaction is for cash or credit. Let us consider the following transactions:

- a. Sold goods for cash Rs1000
- b. Sold goods for Rs.1000
- c. Sold goods for Rs.1000 to Salman
- d. Sold goods for Rs.1000 to Salman for cash

In the transaction (d) it is clearly given that the sales have been made for cash. Transaction (b) it is also for cash. In transaction (c), it is not stated that whether the transaction is for cash or credit, but the name of the person to whom goods have been sold is given, therefore, it is a credit transaction. In transaction (d) the name of the person is stated but it is clearly mentioned that sales have been made for cash. So it must be treated as cash transaction.

- 5. **Payment of expenses to some persons:** When payment of an expenses like rent or salary is made to some person, then the particular expense account should be debited and not the personal account. For example, if salary is paid to Mohan, Salary Account shall be debited and not Mohan's Account
- 6. **Receipt of Income from a Person:** When an amount is received from a person which is an income of the business, then the particular income account should be credited and not the personal account of the giver. For example, if interest is received from Anush, Interest Account should be credited and not Anush's account.
- 7. **Payment/receipt on behalf of another:** When payment is made on behalf of another person, the account of the person on whose behalf the payment is made should be debited and not the person to whom payment is made. For example, if payment is made to Naresh on behalf of Suresh. then Suresh Account should be debited. Similarly, if freight is paid on behalf of the customer, then customer's account should be debited and the freight account.
- 8. **Trade Discount:** Trade discount is the discount allowed to customers from the gross or catalogue price without reference to the time factor within which the seller expects to receive the payment. It is allowed to promote sales. The amount of trade discount is deducted in the invoice and the transaction is recorded in the books of accounts for the net amount. No journal entry is made for trade discount.
- 9. **Cash Discount:** It is allowed to customer to attract prompt payment and is recorded in the books of accounts. When cash discount is allowed to a customer, it is an expense and thus, it should be debited. Similarly when cash discount is received from

the supplier while making him payment, discount received account should be credited.

- 10. Bad Debts:** When a customer/debtor who owes money fails to pay the amount on account of his insolvency or for any other reasons, the amount is termed as bad debts. It is a loss and, thus this amount should be debited to Bad Debts Account. For example, Mr. X who owed us Rs.2000 is declared and only 60% paid in rupees is received as final dividend from his estate. The Journal entry shall be

Date	Particulars	L.F	Debit Rs.	Credit Rs.
28 July, 2025	Cash A/c Dr		1200	
	Bad Debts A/c Dr.		800	
	To X's A/c			2000

- 11. Bad Debts Recovered:** When the Bad Debts is written off, the personal account of the debtor is closed and the amount irrecoverable is treated as loss. Sometimes, the amount may be received at a later date from the person whose account had been written off earlier, then Bad Debts Recovered Account should be credited as it is a gain and not the personal account of the debtor.
- 12. Expenses on Acquiring/Installation, etc of Fixed Assets:** when some fixed assets like plant, machinery etc. is purchased and any expenses are incurred for bringing that asset like freight, carriage etc or amount is paid for installation of that asset, the amount should be debited to the particular Fixed Asset Account and not to the expenses account. Similarly, if wages are paid for erection of buildings, then, Buildings Account should be debited.
- 13. Goods distributed as free samples, charity etc.** When goods are distributed as charity or free samples etc to promote sales, the particular expenses i.e. Charity Account or Advertisement Account should be debited and the Purchases Account should be credited.
- 14. Depreciation of Fixed Assets:** Depreciation is the gradual decrease in the value of an asset due to wear and tear and passage of time. It is an expense/loss for the business. Thus, Depreciation Account should be debited and particular Asset Account should be credited as the value of the asset decreased/goes out.
- 15. Bank Charges:** These are the expenses charged by bank from its customers for providing various services. Bank charges should be treated as business expenses and thus, Bank Charges Account should be debited and Bank Account should be credited.

16. Interest on Capital/Drawings: Interest on Capital is an expense of the business and thus, should be debited while the capital account of the proprietor should be credited because it is not paid in cash. Similarly, interest on drawings is an income of the business. Interest on Drawings Account should be credited and Drawings Account should be debited.

17. Goods lost by fire etc.: Some goods may be lost by fire, theft etc. It is a loss to the business and the Stock of goods decreases. Thus, Loss by Fire Account should be debited and the Purchases Account should be credited. However, if the amount of loss is recoverable from insurance company either wholly or partially, then Insurance Claim/Company Account should be debited and the Loss by Fire Account should be credited.

LEDGER

The transactions are primarily recorded in a book called Journal. We have explained the process of recording transactions in journal in the above. You must have noted that various transactions of differing nature are recorded in journal, at different places, date wise. If a person wants to know the net impact of all the transactions recorded in journal, he cannot do so merely by looking at the journal. For example, if one wants to know the net amount due to a supplier or due from a customer or the net cash position etc., he cannot do so through journal since the transactions are scattered.

Thus, all the transactions of a similar nature or relating to a particular person or thing, entered into the books of original entry during a given period of time, must be sorted out and consolidated at one place to ascertain their net effect. This sort of processing called classifying is done in the Ledger. In ledger, all transactions relating to a particular person, thing expense or income are grouped or summarised under a common head known as 'Account'.

Ledger is the principal book of accounts. It contains all the accounts of a business whether real, personal or nominal. The transactions recorded in the journal are finally carried to the ledger, and thus, it is also called the book of final entry.

Nature and Form of Ledger

Ledger may be kept in any of the following two forms:

- i. Bound Ledger, and
- ii. Loose Leaf Ledger

The old method of maintain a ledger is in the form of abound book or register containing a number of pages serially numbered. But the present practice is to use loose leaf forms printed on paper or cards. The bound ledger is inflexible in nature as new pages cannot be added to it. The loose leaf ledger is flexible in nature as the new account/pages can be place at the desired place. Loose leaf ledger also helps in posting transactions especially when mechanised system of accounting is used. In a ledger, usually, one page is allotted to one account. If an account is very long and it exceed one page, a new page is allotted to it and the number of the new page is indicated at the end of the old page.

Every ledger contains an index of various accounts at the beginning. It is generally in the nature of alphabetical index and one page is allotted to each alphabet. The names of all accounts beginning with that alphabet are written on the page allotted to that alphabet, and against the name of each account, the page number on which the account appears is indicated.

Ledger Account

Date	Particulars	LF	Amount Rs.	Date	Particulars	LF	Amount Rs.

Ledger Posting: posting is the process of transferring entries from journal or the book of original entry to the respective accounts in the ledger. Thus, entries recorded in the journal or other books of original entry from the basis of entries in the ledger. It should be remembered that every business transaction has two aspects and involves two accounts. As such, each transaction recorded in journal is posted in the ledger in two accounts: in one account it is debited and in the other account it is credited. The concerned account which is debited in the journal should also be debited in the ledger, and the account which is credited in the journal is also credited in the ledger. For example, if goods are sold for cash Rs.2,000, Cash Account will be debited and Sales Account will be Credited in the ledger. Posting is completed only when both debit and credit aspects of the transaction are recorded in the ledger. Separate accounts should be opened for posting various transactions recorded in the journal. The names of the accounts should be exactly the same as given in the journal.

LESSON -5**PREPARATION OF PROFIT & LOSS ACCOUNT
AND BALANCE SHEET****Introduction:**

Final accounts give an idea about the profitability and financial position of a business to its management, owners, and other interested parties. All business transactions are first recorded in a journal. They are then transferred to a ledger and balanced. These final tallies are prepared for a specific period. The preparation of a final accounting is the last stage of the accounting cycle. It determines the financial position of the business. Under this it is compulsory to make trading account, the profit and loss account and balance sheet.

The term "final accounts" includes the trading account, the profit and loss account, and the balance sheet.

Legal Provisions

Sections 209 to 220 of the Indian Companies Act 2013 deal with legal provisions relating to preparation and presentation of final accounts by companies. Section 210 deals with preparation of final accounts by companies, while section 211 deals with the form and contents of the balance sheet and the profit and loss account.

Trading Account

A trading account shows the results of the buying and selling of goods. This sheet is prepared to demonstrate the difference between selling price and cost price. The trading account is prepared to show the trading results of the business, e.g. gross profit earned or gross loss sustained by the business. It records the direct expenses of a business firm. According to J.R.Batliboi- "The Trading Account shows the result of buying and selling goods. In preparing this account, the general establishment charges are ignored and only the transactions in goods are included."

What is a Profit and Loss Statement (P&L)?

The profit and loss (P&L) statement is a financial statement that summarizes the revenues, costs, and expenses incurred during a specified period, usually a fiscal quarter or year. The

P&L statement is synonymous with the income statement. These records provide information about a company's ability or inability to generate profit by increasing revenue, reducing costs, or both. Some refer to the P&L statement as a statement of profit and loss, income statement, statement of operations, statement of financial results or income, earnings statement or expense statement.

P&L management refers to how a company handles its P&L statement through revenue and cost management.

The P&L statement is a financial statement that summarizes the revenues, costs, and expenses incurred during a specified period.

The P&L statement is one of three financial statements every public company issues quarterly and annually, along with the balance sheet and the cash flow statement.

It is important to compare P&L statements from different accounting periods, as the changes in revenues, operating costs, R&D spending, and net earnings over time are more meaningful than the numbers themselves.

Together with the balance sheet and cash flow statement, the P&L statement provides an in-depth look at a company's financial performance.

Difference Between Profit and Loss & Profit and Loss Appropriation Account

Profit and loss appropriation account is an extension of the profit and loss account itself; however, there is a fundamental difference between profit and loss & profit and loss appropriation account.

By definition, a P&L account or Income statement is one of the three financial statements of an organization which summarizes revenues and expenses to ascertain net profit or a net loss of the organization for a specific time period.

By definition, a P&L appropriation account is used to demonstrate division or allocation of profit/losses among the owners.

Definition of Balance Sheet

The balance sheet is prepared in order to report an organization's financial position at the end of an accounting period, such as midnight on March 31.

A corporation's balance sheet reports its:

- Assets (resources that were acquired in past transactions)
- Liabilities (obligations and customer deposits)
- Stockholders' equity (the difference between the amount of assets and liabilities)

You can view the balance sheet as reporting the assets and the claims against those assets (liabilities and stockholders' equity). You can also view the balance sheet as reporting a corporation's assets and the amounts that were provided by creditors (the liabilities) and the amounts provided by the owners (the stockholders' equity).

A classified balance sheet reports the current assets in a section that is separate from the longterm assets. Similarly, current liabilities are reported in a section that is separate from longterm liabilities. This allows bankers, owners, and others to easily compute the amount of an organization's working capital and current ratio.

The balance sheet has some limitations. For example, the property, plant and equipment are reported at cost minus the accumulated depreciation (except land). If these assets have increased in value, the fair value is not reported because of the cost principle. Also, brand names and trademarks may have significant value, but cannot be reported on the balance sheet unless they were acquired in a business transaction.

Points to remembered while preparing Balance sheet

1. Calls in arrears: It refers to the amount not paid by the shareholders on the calls made on them by the company. This item is usually given in the trial balance. It should be deducted from the called up capital on the liabilities side of the balance sheet to find paid up capital. If the trial balance shows only the paid up capital and the calls in arrear is given in the adjustment, the amount is first added to the added to the paid up capital to show the called up capital and then deducted again so that the paid up capital can be shown in the outer column.
2. Unclaimed dividend: It refers to the amount of dividend not collected by the shareholders from the company. This item is always shown on the credit side of trial balance. It is shown on the liabilities side of the balance sheet under the heading – current liabilities.
3. Forfeited shares account: This item appears as a credit item in the trial balance and is shown on the liabilities side of the balance sheet by adding it to the paid up capital.

4. Securities premium account: This item is shown on the liabilities side of the balance sheet under the heading „Reserves and surplus” ¹⁵ The profit & loss account provides information about an enterprise's income and expenses which result in net profit or net loss. It helps a businessman to evaluate the performance of an enterprise and provides a basis for forecasting future performance. It also provides valuable information required by a banker while sanctioning a loan.

The Profit & Loss account describes different business activities such as revenues and expenses, particularly useful in assessing the risk of not achieving certain level of income in the future.

¹⁴

Assets

Within the assets segment, accounts are listed from top to bottom in order of their liquidity – that is, the ease with which they can be converted into cash. They are divided into current assets, which can be converted to cash in one year or less; and non-current or longterm assets, which cannot. Here is the general order of accounts within current assets: **Cash and cash equivalents** are the most liquid assets and can include Treasury bills and short-term certificates of deposit, as well as hard currency.

Marketable securities are equity and debt securities for which there is a liquid market.

Accounts receivable refers to money that customers owe the company, perhaps including an allowance for doubtful accounts since a certain proportion of customers can be expected not to pay.

Inventory is goods available for sale, valued at the lower of the cost or market price.

Prepaid expenses represent the value that has already been paid for, such as insurance, advertising contracts or rent. Long-term assets include the following:

Long-term investments are securities that will not or cannot be liquidated in the next year.

Fixed assets include land, machinery, equipment, buildings and other durable, generally capital-intensive assets.

Intangible assets include non-physical (but still valuable) assets such as intellectual property and goodwill. In general, intangible assets are only listed on the balance sheet if they are acquired, rather than developed in-house. Their value may thus be

wildly understated – by not including a globally recognized logo, for example – or just as wildly overstated.

Liabilities

Liabilities are the money that a company owes to outside parties, from bills it has to pay to suppliers to interest on bonds it has issued to creditors to rent, utilities and salaries. Current liabilities are those that are due within one year and are listed in order of their due date. Long-term liabilities are due at any point after one year.

Current liabilities accounts might include:

Current portion of long-term debt

Bank indebtedness

Interest payable

Rent, tax, utilities

Wages payable

Customer prepayments

Dividends payable and others

Earned and unearned premiums

Long-term liabilities can include: Long-term debt: interest and principal on bonds issued

Pension fund liability: the money a company is required to pay into its employees' retirement accounts

Deferred tax liability: taxes that have been accrued but will not be paid for another year (Besides timing, this figure reconciles differences between requirements for financial reporting and the way tax is assessed, such as depreciation calculations.)

Some liabilities are considered off the balance sheet, meaning that they will not appear on the balance sheet.

Shareholders' Equity

Shareholders' equity is the money attributable to a business' owners, meaning its shareholders. It is also known as "net assets," since it is equivalent to the total assets of a company minus its liabilities, that is, the debt it owes to non-shareholders. Retained earnings are the net earnings a company either reinvests in the business or use to pay off debt; the rest is distributed to shareholders in the form of dividends. Treasury stock is the stock a company has either repurchased or never issued in the

first place. It can be sold at a later date to raise cash or reserved to repel a hostile takeover.

Some companies issue preferred stock, which will be listed separately from common stock under shareholders' equity. Preferred stock is assigned an arbitrary par value – as is common stock, in some cases – that has no bearing on the market value of the shares

The "common stock" and "preferred stock" accounts are calculated by multiplying the par value by the number of shares issued. Additional paid-in capital or capital surplus represents the amount shareholders have invested in excess of the "common stock" or "preferred stock" accounts, which are based on par value rather than market price. Shareholders' equity is not directly related to a company's market capitalization: the latter is based on the current price of a stock, while paid-in capital is the sum of the equity that has been purchased at any price.

Limitations of Balance Sheets

The balance sheet is an invaluable piece of information for investors and analysts; however, it does have some drawbacks. Since it is just a snapshot in time, it can only use the difference between this point in time and another single point in time in the past. Because it is static, many financial ratios draw on data included in both the balance sheet and the more dynamic income statement and statement of cash flows to paint a fuller picture of what's going on with a company's business.

Different accounting systems and ways of dealing with depreciation and inventories will also change the figures posted to a balance sheet. Because of this, managers have some ability to game the numbers to look more favorable. Pay attention to the balance sheet's footnotes in order to determine which systems are being used in their accounting and to look out for red flags.

Illustration 1 Show the following items in the balance sheet of Amba Ltd. as per revised schedule

16	
March 31, 2013:	Rs. 8%
Debentures	10,00,000
Equity share capital	50,00,000
Securities premium	20,000
Preliminary expenses	40,000 .
Statement of Profit & Loss (cr.)	1,50,000

Discount on issue of 8% debentures	40,000
(Amount to be written in next 4 years approx.)	
Loose tools	20,000
Bank balance	60,000
Cash in hand	38,000

LESSON -6

ACCOUNTS FOR NON-PROFIT ORGANISATIONS

3 There are certain organisations which are set up for providing service to its members and the public in general. Such organisations include clubs, charitable institutions, schools, religious organisations, trade unions, welfare societies and societies for the promotion of art and culture. These organisations have service as the main objective and not the profit as is the case of organisations in business. Normally, these organisations do not undertake any business activity, and are managed by trustees who are fully accountable to their members and the society for the utilization of the funds raised for meeting the objectives of the organisation. Hence, they also have to maintain proper accounts and prepare the financial statement which take the form of Receipt and Payment Account; Income and Expenditure Account; and Balance Sheet. at the end of for every accounting period (normally a financial year).

This is also a legal requirement and helps them to keep track of their income and expenditure, the nature of which is different from those of the business organisations. In this chapter we shall learn about the accounting aspects relating to not-for-profit organisation.

Meaning and Characteristics of Not-for-Profit Organisation: Not-for -Profit Organisations refer to the organisations that are for used for the welfare of the society and are set up as charitable institutions 5 which function without any profit motive. Their main aim is to provide service to a specific group or the public at large. Normally, they do not manufacture, purchase or sell goods and may not have credit transactions. Hence they need not maintain many books of account (as the trading concerns do) and Trading and Profit and Loss Account. The funds raised by such organisations are credited to capital fund or general fund. The major sources of their income usually are subscriptions from their members donations, grants-in-aid, income from investments, etc. The main objective of keeping records in such organisations is to meet the statutory requirement and help them in exercising control over utilisation of their funds. They also have to prepare the financial statements at the end of each

accounting period (usually a financial year) and ascertain their income and expenditure and the financial position, and submit them to the statutory authority called Registrar of Societies.

The main characteristics of such organisations are:

1. Such organisations are formed for providing service to a specific group or public at large such as education, health care, recreation, sports and so on without any consideration of caste, creed and colour. Its sole aim is to provide service either free of cost or at nominal cost, and not to earn profit.
2. These are organised as charitable trusts/societies and subscribers to such organisation are called members.
3. Their affairs are usually managed by a managing/executive committee elected by its members.
4. The main sources of income of such organisations are: (i) subscriptions from members, (ii) donations, (iii) legacies, (iv) grant-in-aid, (v) income from investments, etc.
5. The funds raised by such organisations through various sources are credited to capital fund or general fund. 6. The surplus generated in the form of excess of income over expenditure is not distributed amongst the members. It is simply added in the capital fund. 7. The Not-for-Profit Organisations earn their reputation on the basis of their contributions to the welfare of the society rather than on the customers' or owners' satisfaction. 8. The accounting information provided by such organisations is meant for the present and potential contributors and to meet the statutory requirement.

Accounting Records of Not-for-Profit Organisations: ⁵ As stated earlier, normally such organisations are not engaged in any trading or business activities. The main sources of their income are subscriptions from members, donations, financial assistance from government and income from investments. Most of their transactions are in cash or through the bank. These institutions are required by law to keep proper accounting records and keep proper control over the utilization of their funds. This is why they usually keep a cash book in which all receipts and payments are duly recorded. They also maintain a ledger containing the accounts of all incomes, expenses, assets and liabilities which facilitates the preparation of financial

statements at the end of the accounting period. In addition, they are required to maintain a stock register to keep complete record of all fixed assets and the consumables.

They do not maintain any capital account. Instead they maintain capital fund which is also called general fund that goes on accumulating due to surpluses generated, life membership fee, donation, legacies, etc. received from year to year. In fact, a proper system of accounting is desirable to avoid or minimise the chances of misappropriations or embezzlement of the funds contributed by the members and other donors.

Final Accounts or Financial Statements: The Not-for-Profit Organisations are also required to prepare financial statements at the end of the each accounting period. Although these organisations are non-profit making entities and they are not required to make Trading and Profit & Loss Account but it is necessary to know whether the income during the year was sufficient to meet the expenses or not. Not only that they have to provide the necessary financial information to members, donors, and contributors and also to the Registrar of Societies. For this purpose, they have to prepare their final accounts at the end of the accounting period and the general principles of accounting are fully applicable in their preparation as stated earlier, the final accounts of a 'not-for-profit organisation' consist of the following:

- (i) Receipt and Payment Account
- (ii) Income and Expenditure Account, and
- (iii) Balance Sheet.

The Receipt and Payment Account is the summary of cash and bank transactions which helps in the preparation of Income and Expenditure Account and the Balance Sheet. Besides, it is a legal requirement as the Receipts and Payments Account has also to be submitted to the Registrar of Societies along with the Income and Expenditure Account, and the Balance Sheet. Income and Expenditure Account is akin to Profit and Loss Account. The Not-for-Profit Organisations usually prepare the Income and Expenditure Account and a Balance Sheet with the help of Receipt and Payment Account. However, this does not imply that they do not make a trial balance. In order to check the accuracy of the ledger accounts, they also prepare a trial balance which facilitates the preparation of accurate Receipt and Payment Account as well as the Income and Expenditure Account and the Balance Sheet.

In fact, if an organisation has followed the double entry system they must prepare a trial balance for checking the accuracy of the ledger accounts and it will also facilitate the preparation of Receipt and Payment account. Income and Expenditure Account and the Balance Sheet.

Receipt and Payment Account

It is prepared at the end of the accounting year on the basis of cash receipts and cash payments recorded in the cash book. It is a summary of cash and bank transactions under various heads. For example, subscriptions received from the members on different dates which appear on the debit side of the cash book, shall be shown on the receipts side of the Receipt and Payment Account as one item with its total amount. Similarly, salary, rent, electricity charges paid from time to time as recorded on the credit side of the cash book but the total salary paid, total rent paid, total electricity charges paid during the year appear on the payment side of the Receipt and Payment Account. Thus, Receipt and Payment Account gives summarised picture of various receipts and payments, irrespective of whether they pertain to the current period, previous period or succeeding period or whether they are of capital or revenue nature. It may be noted that this account does not show any non cash item like depreciation. The opening balance in Receipt and Payment Account represents cash in hand/cash at bank which is shown on its receipts side and the closing balance of this account represents cash in hand and bank balance as at the end of the year, which appear on the credit side of the Receipt and Payment Account. However, if it is bank overdraft at the end it shall be shown on its debit side as the last item. Let us look at the cash book of Golden Cricket Club given in the example to show how the total amount of each item of receipt and payment has been worked out.

5

Salient Features

1. It is a summary of the cash book. Its form is identical with that of simple cash book (without discount and bank columns) with debit and credit sides. Receipts are recorded on the debit side while payments are entered on the credit side.

2. It shows the total amounts of all receipts and payments irrespective of the period to which they pertain. For example, in the Receipt and Payment account for the year ending on March 31, 2016, we record the total subscriptions received during 2015–16 including the

amounts related to the years 2014–2015 and 2016–2017. Similarly, taxes paid during 2015–16 even if they relate to the years 2014–15 and 2016–2017.

3. It includes all receipts and payments whether they are of capital nature or of revenue nature.

4. No distinction is made in receipts/payments made in cash or through bank. With the exception of the opening and closing balances, the total amount of each receipt and payment is shown in this account.

5. No non-cash items such as depreciation outstanding expenses accrued income, etc. are shown in this account.

6. It begins with opening balance of cash in hand and cash at bank (or bank overdraft) and closes with the year end balance of cash in hand/ cash at bank or bank overdraft. In fact, the closing balance in this account (difference between the total amount of receipts and payments) which is usually a debit balance reflects cash in hand and cash at bank unless there is a bank overdraft.

Steps in the Preparation of Receipt and Payment Account

1. Take the opening balances of cash in hand and cash at bank and enter them on the debit side. In case there is bank overdraft at the beginning of the year, enter the same on the credit side of this account.

2. Show the total amounts of all receipts on its debit side irrespective of their nature (whether capital or revenue) and whether they pertain to past, current and future periods.

3. Show the total amounts of all payments on its credit side irrespective of their nature (whether capital or revenue) and whether they pertain to past, current and future periods.

4. None of the receivable income and payable expense is to be entered in this account as they do not involve inflow or outflow of cash.

5. Find out the difference between the total of debit side and the total of credit side of the account and enter the same on the credit side as the closing balance of cash/bank. In case, however, the total of the credit side is more than that of the total of the debit side, show the difference on the debit as bank overdraft and close the account

3

Income and Expenditure Account

It is the summary of income and expenditure for the accounting year. It is just like a profit and loss account prepared on accrual basis in case of the business organisations. It includes only revenue items and the balance at the end represents surplus or deficit. The Income and Expenditure Account serves the same purpose as the profit and loss account of a business organisation does. All the revenue items relating to the current period are shown in this account, the expenses and losses on the expenditure side and incomes and gains on the income side of the account. It shows the net operating result in the form of surplus (i.e. excess of income over expenditure) or deficit (i.e. excess of expenditure over income), which is transferred to the capital fund shown in the balance sheet.

The Income and Expenditure Account is prepared on accrual basis with the help of Receipts and Payments Account along with additional information regarding outstanding and prepaid expenses and depreciation etc. Hence, many items appearing in the Receipts and Payments need to be adjusted. For example, as shown in Example 1, (Page No. 10) subscription amount of Rs.2, 65,000 received during the year 2014-15 appearing on the receipts side of the Receipt and Payment Account includes receipts for the periods other than the current period. But the subscription amount of Rs. 2,25,000 pertaining to the current year only will be shown as income in Income and Expenditure Account for the year 2014-15.

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Steps in the Preparation of Income and Expenditure Account

Following steps may be helpful in preparing an Income and Expenditure Account from a given Receipt and Payment Account:

1. Pursue the Receipt and Payment Account thoroughly.
2. Exclude the opening and closing balances of cash and bank as they are not an income.
3. Exclude the capital receipts and capital payments as these are to be shown in the Balance Sheet.
4. Consider only the revenue receipts to be shown on the income side of Income and Expenditure Account. Some of these need to be adjusted by excluding the amounts relating to the preceding and the succeeding periods and including the amounts relating to the current year not yet received.

5. Take the revenue expenses to the expenditure side of the Income and Expenditure Account with due adjustments as per the additional information provided relating to the amounts received in advance and those not yet received.

6. Consider the following items not appearing in the Receipt and Payment Account that need to be taken into account for determining the surplus/ deficit for the current year : (a) Depreciation of fixed assets. (b) Provision for doubtful debts, if required. (c) Profit or loss on sale of fixed assets.

3 **Balance Sheet**

'Not-for-Profit' Organisations prepare Balance Sheet for ascertaining the financial position of the organisation. The preparation of their Balance Sheet is on the same pattern as that of the business entities. It shows assets and liabilities as at the end of the year. Assets are shown on the right hand side and the liabilities on the left hand side. However, there will be a Capital Fund or General Fund in place of the Capital and the surplus or deficit as per Income and Expenditure Account which is either added to/deducted from the capital fund, as the case may be. It is also a common practice to add some of the capitalised items like legacies, entrance fees and life membership fees directly in the capital fund. Besides the Capital or General Fund, there may be other funds created for specific purposes or to meet the requirements of the contributors/donors such as building fund, sports fund, etc. Such funds are shown separately in the liabilities side of the balance sheet. Some times it becomes necessary to prepare Balance Sheet as at the beginning of the year in order to find out the opening balance of the capital/general fund.

Preparation of Balance Sheet The following procedure is adopted to prepare the Balance Sheet:

1. Take the Capital/General Fund as per the opening balance sheet and add surplus from the Income and Expenditure Account. Further, add entrance fees, legacies, life membership fees, etc. received during the year.

2. Take all the fixed assets (not sold/discarded/or destroyed during the year) with additions (from the Receipts and Payments account) after charging depreciation (as per Income and Expenditure account) and show them on the assets side.

3. Compare items on the receipts side of the Receipts and Payments Account with income side of the Income and Expenditure Account. This is to ascertain the amounts of: (a) subscriptions due but not yet received; (b) incomes received in advance; (c) sale of fixed assets made during the year; (d) items to be capitalised (i.e. taken directly to the Balance Sheet) e.g. legacies, interest on specific fund investment and so on. 4. Similarly compare, items on the payments side of the Receipt and Payment Account with expenditure side of the Income and Expenditure Account. This is to ascertain the amounts if: (a) outstanding expenses; (b) prepaid expenses; (c) purchase of a fixed asset during the year; (d) depreciation on fixed assets; (e) stock of consumable items like stationery in hand; (f) Closing balance of cash in hand and cash at bank as, and so on.

LESSON -7

DEPRECIATION METHODS

8

Introduction:

Every concern or business house requires various types of fixed assets/tangible assets like property, plant, equipment etc. for performing regular business operations to earn revenues and these assets are used throughout its useful life. But the cost of fixed asset is recorded in books of accounts in the year of acquisition, instead of dividing or splitting its cost over the periods of its benefits enjoyed from it. In simple word depreciation is the splitting or allocation of the acquisition cost of fixed asset in every accounting year in which asset is utilized.

As per Schedule-II under the Companies Act, 2013, "Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. The depreciable amount of an asset is the cost of an asset or other amount substituted for cost, less its residual value. The useful life of an asset is the period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by the entity".

Accounting Standard for Depreciation: Previously, there was a separate standard on Depreciation (AS 6) and AS 10 on Fixed Asset. Now, AS 10 (revised), Property, Plant & Equipments (PPE) deals with all aspects of fixed assets including depreciation. Ind AS 16, PPE is introduced in line with International Financial Reporting Standards (IFRS).

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NEED FOR PROVIDING DEPRECIATION

The need for providing depreciation arises on account of the following points:

1. **To Ascertain the Profits or Losses:** The true profits or losses could be ascertained when all costs of earning revenues have been properly charged against them. Fixed assets like building, plant and machinery, furniture, motor vehicles etc are important tool in earning business income. But the cost of the fixed asset is not charged to profit and loss of the accounting period in which the asset is purchased. Therefore, the cost of the fixed asset less its salvage value must be allocated rationally to the periods that receive benefit from

the use of the asset. Thus, depreciation is an item of business expense and must be provided for a proper matching of costs with the revenue

2. **To show the Asset at its Reasonable Value:** The assets decrease in their value over a period of time on account of various reasons such as passage of time, constant use, accidents, etc. Therefore, if the depreciation is not charged then the asset will appear in the balance sheet at the over stated value. This practice is unfair as the balance sheet would fail to present the true financial position.
3. **Replacement of assets:** Business assets become useless at the expiry of their life and, therefore, need replacement. The cash resources of the concern are saved from being distributed by way of dividend by providing for depreciation. The resources so saved, if set aside in each year, may be adequate to replace it at the end of life of the asset.
4. **To Reduce Income Tax:** If tax is paid on the business income without providing for depreciation then it will be in excess to the actual income tax. This is a loss to the business. Thus, for calculating tax, depreciation should be deducted from income similar to the other expenses as depreciation is a chargeable expense and results in tax benefit.

FACTORS AFFECTING DEPRECIATION

In order to assess depreciation amount to be charged in respect of an asset in an accounting period the following three important factors should be considered:

1. **Cost of the asset:** The knowledge about the cost of the asset is very essential for determining the amount of depreciation to be charged to the profit and loss account. The cost of the asset includes the invoice price of the asset less any trade discount plus all costs essential to make the asset usable. Cost of transportation and transit insurance are included in acquisition cost. However, the financial charges such as interest on money borrowed for the purchase for the purchase of the asset should not be included in the cost of the asset.

2. **Estimated life of the asset:** Estimated life generally means that for how many years an asset could be used in business with ordinary repairs for generating revenues. For estimating useful life of an asset one must begin with the consideration of its physical life and the modifications, if any, made, factors of obsolescence and experience with similar assets. In fact, the economic life of an asset is shorter than its physical life. The physical life is based mostly on internal policies such as intensity of use, repairs, maintenance and replacements. The economic life, on the other hand, is based mostly on external factors such as obsolescence from technological changes.

3. Scrap Value of the Asset: The salvage value of the asset is that value which is estimated to be realized on account of the sale of the asset at the end of its useful life. This value should be calculated after deducting the disposal costs from the sale value of the asset. If the scrap value is considered as insignificant, it is normally regarded as nil.

Basis of Difference	Straight Line Method	Written Down Value Method
Basis for calculation	Depreciation is calculated on the original cost of an asset.	Depreciation is calculated on the reducing balance, i.e., the book value of an asset.
Amount of depreciation	Equal amount is charged each year over the effective life of the asset.	Diminishing amount of depreciation (on the written down value of asset) is charged each year over the effective life of the asset.
Book value of asset	Book value of the asset becomes zero at the end of its effective life.	Book value of the asset can never be zero.
Book value of the asset can never be zero.	It is suitable for the assets like patents, copyright, land and buildings, etc., which have lesser possibility of obsolescence and lesser repair charges.	It is suitable for assets that needs more repair in the later years like, plant and machinery, car, etc.
Effect of depreciation and repair on profit and loss account	Unequal effect over the life of the asset, as depreciation remains same over the years but repair cost increases in the later years.	Equal effect over the life of the asset, as depreciation cost is high and repairs are less in the initial years but in the latter years the repair costs increase and depreciation cost decreases.
Recognition under Income Tax Act	It is not recognised under the income tax act.	It is recognised under the income tax act.

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Key points of Ind AS 16:

- a. As per Ind AS, Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.
- b. As per Ind AS 16 Property, Plant and Equipment are tangible in nature that is held by an entity for use in the production or supply of goods or services throughout its useful life.
- c. As per Ind AS 16 "Property, Plant and Equipment", each part of fixed assets (Property, Plant and Equipment) with a cost is a significant part of the total cost of the item should be depreciated separately. Therefore depreciation on components of assets is necessary.
- d. As per Ind AS 16, the useful life and estimated residual value of an asset should be reviewed at the end of each accounting year before calculation of depreciation.
- e. As per Ind AS 16, change in method of depreciation should be treated as change in accounting estimate.

Difference between Depreciation, Amortization and Depletion:

Depreciation	Amortization	Depletion
Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life	It means deterioration in the value of an tangible asset due to efflux or passage of time or expiry of the legal life of an asset	It means drop in the value of a tangible asset due to exhaustion.

Causes of Depreciation:

Value of assets decreases mainly due to following reasons

- a. Wear and tears due to use in business entity ∅ Efflux or passage time even when an asset is not in regular use ∅ Deterioration in market value
- b. Obsolescence due to technological advancement, invention of new assets for better process or other changes

Objectives of providing Depreciation:

The objectives of providing depreciation are:

- a. To determine correct income
- b. To disclose true financial position statement
- c. To ascertain true cost of production
- d. To provide funds for replacement

Factors for the Measurement of Depreciation:

- a. Cost of asset (including installation & assemble cost and others admissible expenses, such as commission etc.)
- b. Estimated useful life of the asset
- c. Estimated Residual or scrap value of the asset
- d. Depreciable amount

Methods of Depreciation: A number of methods are available for calculating the amount of depreciation, these are:

1. Straight Line Method (SLM)
2. Written Down Value Method/Reducing Balance Method/Diminishing Balance Method
3. Production Unit Method
4. Annuity Method
5. Depletion Method
6. Sum-of-the-Years' Digit Method
7. Machine Hour Method
8. Depreciation Fund/Sinking Fund Method

1. Straight Line Method (SLM)/Fixed Instalment Method:

- Under this method an equal amount of depreciation is written off in every accounting year over the useful life of the asset.
- According to this method, written down value of the asset is reduced to nil or to its residual value.
- Formula

$$\text{Depreciation p.a.} = \frac{\text{Cost of Asset} + \text{Other Capital Expenses} - \text{Scrap Value}}{\text{Useful Life of Asset}}$$

$$\text{Rate of Depreciation} = \text{Depreciation p.a.} \times 100 / \text{Original Cost}$$

Written Down Value Method / Diminishing Balance Method:

- Under this method a fixed percentage of the diminishing value of the asset is written off in every accounting year and the value of the asset is reduced to its residual value
- The amount of depreciation decreasing
- Rate of depreciation remain constant
- Formula

Depreciation p.a. = For new asset: $\text{Original Cost} \times \text{Rate of Depreciation}$

For existing asset: $\text{Opening WDV} \times \text{Rate of Depreciation}$

Residual Value Cost of asset

LESSON -8

12

**FUNDAMENTALS OF COST ACCOUNTING,
COSTING OF SERVICE DEPARTMENTS****Introduction:**

1 All types of businesses, whether service, manufacturing or trading, require cost accounting to track their activities. Cost accounting has long been used to help managers understand the costs of running a business. Modern cost accounting originated during the industrial revolution, when the complexities of running a large scale business led to the development of systems for recording and tracking costs to help business owners and managers make decisions.

In the early industrial age, most of the costs incurred by a business were what modern accountants call "variable costs" because they varied directly with the amount of production.[citation needed] Money was spent on labor, raw materials, power to run a factory, etc. in direct proportion to production. Managers could simply total the variable costs for a product and use this as a rough guide for decision-making processes.

Some costs tend to remain the same even during busy periods, unlike variable costs, which rise and fall with volume of work. Over time, these "fixed costs" have become more important to managers. Examples of fixed costs include the depreciation of plant and equipment, and the cost of departments such as maintenance, tooling, production control, purchasing, quality control, storage and handling, plant supervision and engineering.[2] In the early nineteenth century, these costs were of little importance to most businesses. However, with the growth of railroads, steel and large scale manufacturing, by the late nineteenth century these costs were often more important than the variable cost of a product, and allocating them to a broad range of products led to bad decision making. Managers must understand fixed costs in order to make decisions about products and pricing.

For example: A company produced railway coaches and had only one product. To make each coach, the company needed to purchase ₹60 of raw materials and components, and pay 6 laborers ₹40 each. Therefore, total variable cost for each coach was ₹300. Knowing that making a coach required spending ₹300, managers knew they couldn't sell below that price

without losing money on each coach. Any price above ₹300 became a contribution to the fixed costs of the company. If the fixed costs were, say, ₹1000 per month for rent, insurance and owner's salary, the company could therefore sell 5 coaches per month for a total of ₹3000 (priced at ₹600 each), or 10 coaches for a total of ₹4500 (priced at ₹450 each), and make a profit of ₹500 in both cases.

Evolution of Cost Accounting:

Every modern business has to make its way through keen competition, uncertainty and risks. Quick changes in social and economic environment also create impact upon the businesses. Changes in political outlook of the government of the country also require adjustment in the business policies. Thus, a modern business becomes more and more complex in nature.

In old times the business concerns were small in size; there was no keen competition; necessity of adjustment in business outlook due to changes in social, economic and political outlook was rare and the owner/ owners of the business could maintain personal contact with the business and gather all information relating to the business whenever necessary. The present-day business is big in size and complex in character and is under keen competition. So, information relating to the business in detail, appropriate management policy on the basis of detailed information and proper execution of such policies can only bring about success.

As the successful treatment of a sick person often requires various pathological information, the successful management of a modern business requires various information regarding the business. The traditional financial Accounting fails to furnish all information necessary for managing a modern business successfully. Thus, as a branch of Financial Accounting, cost accounting has evolved and made rapid progress during the last few decades. This branch of accounting, with its developing techniques and procedures, has been rapidly expanding in the fields of its application. In recent years, another aspect of accounting, called Management accounting, has been developed and is being employed in many concerns.

1**Meaning of Cost:**

It is the amount of resources given up in exchange for some goods or services. The resources given up are expressed in monetary terms. Cost is defined as the amount of expenditure (actual or notional) incurred on or attributable to a given thing or to ascertain the cost of a given thing. The cost of an article consists of actual outgoings or ascertained charges incurred in its production and sale. Cost is a generic term and it is always advisable to qualify the

word cost to show exactly what it means e.g., prime cost, factory cost, sunk cost etc., cost is also different from value as cost is measured in terms of money whereas value is measured in terms of usefulness or utility of an article.

Meaning of Costing: Costing is a technique and process of ascertaining costs. This technique consists of principles and rules which govern the procedure of ascertaining the cost of products/services. The process of costing includes routines of ascertaining costs by historical or conventional costing, standard costing or marginal costing.

Meaning of cost accounting: Cost Accounting is the classifying, recording and appropriate allocation of expenditure for the determination of the costs of products or services, and for the presentation of suitable arranged data for purposes of control and guidance of management. It includes the ascertainment of the cost of every order, job contract, process, service or unit as may be appropriate. It deals with the cost of production, selling and distribution. It is thus the provision of such analysis and classification of expenditure as will enable the total cost of any particular unit of production or service to be ascertained with reasonable degree of accuracy and at the same time to disclose exactly how such total cost is constituted (i.e., the value of material used, the amount of labour and other expenses incurred) so as to control and reduce its cost. Thus, cost accounting relates to the collection, classification, ascertainment of cost and its accounting and control relating to the various elements of cost. It establishes budgets and standard costs and actual cost of operations, processes, departments or products and the analysis of the variance, profitability and social use of funds. Accounting to Kohler, "Cost Accounting is the branch of accounting dealing with the classification, recording, allocation, summarizing and reporting of current and prospective costs."

Meanings of cost accountancy:

Cost Accountancy is 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 there from for purposes of managerial decision making. Thus, cost accountancy is the science, art and practice of a cost accountant. It is science because it is a body of systematic knowledge having certain principles which a cost accountant should possess for proper discharge of his responsibilities,. It is an art as it requires the ability and skill with which a cost accountant is able to apply the principles of cost accountancy to various managerial problems. Practice includes the

continuous efforts of a cost accountant in the field of cost accountancy. Such efforts also include the presentation of information for the purpose of managerial decision making and keeping statistical records.

Importance of Cost Accounting

Importance of Cost Accounting may be considered under the following headings:

(A) Importance to Management: A good Cost Accounting system serves the management in the following ways:

(i) Classification and sub-division of costs: Costs are collected and classified by various ways in order to provide information to the management for control purposes and to ascertain the profitability of each area of activity. It enables the concern to measure the efficiency and then to maintain and improve it.

(ii) Control of material, labour and overhead costs: Various inventory control techniques or methods of costing are used to control the material cost. For example fixation of maximum level helps the management to reduce the over-stocking; use of EOQ helps the Purchase Department to order right quantity. An efficient check on labour and machines is provided by giving detailed information about availability of machine and labour capacity. The work is so planned that no section is overworked and no section remains idle. By classifying the overheads into controllable and uncontrollable or fixed and variable, helps to control the overhead costs. Thus cost accounting provides a detailed control of material, labour and overhead costs.

(iii) Price determination: Cost Accounting helps the management to fix the remunerative selling prices of various items of goods under different circumstances. During the period of depression a businessman has to become very watchful and vigilant in tracking down the concealed inefficiencies and sources of wastage, so that he may reduce the cost of production to the minimum. During depression the businessman has to cut the price to such an extent so as to recover the variable costs. Cost accounting makes the distinction between fixed and variable costs and helps the management in determination of prices. If prices are fixed without cost information, it is possible that prices quoted may be too high or too low.

(iv) Business Policy: Business policy may require consideration of alternative methods and procedures and this is facilitated by cost information correctly presented. Cost accounting

helps the management to take vital decisions such as introduction of new product, selection of optimum product mix, utilization of spare capacity, replacement of existing assets, etc.

(v) **Standards for measuring efficiency:** It provides the use of standards to assist management in making estimates and plans for future and to provide the basis for measuring of efficiency. Actual are compared with standards to determine the operating efficiency.

(vi) **Best use of limited resources:** Cost accounting provides the reliable data of costs with regard to materials, wages and other expenses. This helps the management to get maximum output at the minimum cost, by indicating where economies may be affected, waste eliminated and efficiency increased.

(vii) **Special factors:** Cost accounting informs the management about the special factors such as optimum profitability, seasonal variations in volume and costs. Idle time of labour and idle capacity of the machine, etc. It also helps to curtail the losses during the off season.

(B) Importance to Workers: Cost accounting discloses the relative efficiencies of different workers and thereby facilitates the introduction of suitable plans of wage payment to reward efficiency and to provide adequate incentive to the less efficient workers. A good system of costing promotes prosperity of the business and thus ensures greater security of service and adequate reward to workers.

(C) Importance to Creditors and Investors: It enables the creditors and investors to judge the financial strength and credit worthiness of the business. A sound business concern with a good system of costing can attract more investors than a similar concern without an adequate system of costing.

(D) Importance to Government: It facilitates the assessment of excise duty and income tax and the formulation of policies regarding industry, export, import, taxation, etc. It also facilitates the preparation of national plans for economic development. It provides ready figures for use by government by application to problems like price fixation, price control, tariff protection, and wage level fixation, payment of dividends or settlement of disputes.

(E) Importance to General Public: The ultimate aim of costing is to reduce cost of production to the minimum and maximize the profits of the business. A part of the benefit resulting from the reduction of the cost is usually passed on to the consumers in the form of lower prices. Besides the installation of a costing system will infuse confidence in the minds of the public about the fairness of the prices charged.

Differences between Financial Accounting and Cost Accounting: Main difference between financial accounting and cost accounting are given as under:

Point of distinction	Financial Accounting	Cost Accounting
1. Purpose	It provides information about the business in a general way. It tells about the profit and loss and financial position of the business to owners and other outside parties	It provides information to the management for proper planning, operation, control and decision making.
2. Form of accounts	These accounts are kept in such a way as to meet the requirements of companies Act and Income Tax Act.	These accounts are generally kept voluntarily to meet the requirements of the management. But now companies Act has made it obligatory to keep cost records in some manufacturing industries.
3. Recording	It classifies, records and analyses the transactions in a subjective manner i.e. according to the nature of expenses.	It records the expenditure in an objective manner i.e., according to the purposes for which the costs are incurred.
4. Control	It lays emphasis on the recording aspect without attaching any importance of control	It provides a detailed system of control for materials, labour and overhead costs with the help of standard costing and budgetary control.
5. Periodicity of reporting	It reports operating results and financial position usually at the end of the year.	It gives information through cost reports to management as and when desired
6. Analysis of profit	Financial accounts are the accounts of the whole business. They are independent in nature and disclose the net profit or loss of the business as a whole.	Cost Accounting is only a part of the financial accounts and discloses profit or loss of each product, job or service.
7. Reporting of costs	The costs are reported in	The costs are broken down on a

	aggregate in financial accounts	unit basis in cost accounts.
8. Nature of transactions	Financial accounts relate to commercial transactions of the business and include all expenses viz., manufacturing office, selling and distribution etc.	Cost accounts relate to transactions connected with the manufacture of goods and services and include only those expenses which enter in to production.
9. Information	Monetary information is only used (i.e. only monetary transactions are recorded).	Non-monetary information like units is also used (i.e., it deals with monetary as well as nonmonetary information).
10. Figures	Financial accounts deal mainly with actual facts and figures	Cost accounts deal partly with facts and figures and partly with estimates
11. Reference	In devising or operating a system of financial accounting reference can be made in case of difficulty to the company law, case decisions and to the canons of sound professional practice.	No such reference is possible. Guidance can be had only from a body of convention followed by cost accountants.
12. relative efficiency	Financial accounts do not provide information on the relative efficiencies of various workers, plants and machinery.	Cost accounts provide valuable information on the relative efficiencies of various plants and machinery.
13. Stock valuation	Stock are valued at cost or market price whichever is less	Stock are valued at cost
14. Type of science	Financial accounting is a positive science because it is subject to legal rigidity with regard to the preparation of the financial statements	Cost accounting is not only a positive science but also a normative science because it includes techniques of budgetary control and standard costing

The scope of cost accountancy is very wide and includes the following:

- (i) **Cost Ascertainment:** It deals with the collection and analysis of expenses, the measurement of production of the different product at the different stages of manufacture and the linking up of production with the expenses. In fact, the varying procedures for the collection of expenses give rise to the different systems of costing as Historical or Actual costs, Estimated costs, standard costs etc. Again the varying procedures for the measurement of production have resulted in different methods of costing such as specific order costing operation costing etc. For linking up of production with the expenses the different techniques of costing such as marginal cost technique, the total cost technique, direct cost technique etc., have been evolved. All the three i.e. system, methods and techniques can be used in one concern simultaneously.
- (ii) **Cost Accounting:** It is the process of accounting for cost which begins with recording of expenditure and ends with the preparation of statistical data. It is formal mechanism by means of which costs of products or services are ascertained and controlled. Cost accounting is helpful to the management in decision making. Decision making requires, apart from other information, cost information which is provided by cost accounting. Cost can be ascertained either by following the historical or predetermined system of costing. Cost can be predetermined either by standard costing or estimated costing. If the cost and financial accounts are kept separately then their reconciliation is also to be done in order to verify the accuracy of both sets of accounts.
- (iii) **Cost control:** Cost control is the guidance and regulation by executive action of the costs of operating an undertaking. It aims at guiding the actual towards the line of targets: regulates the actual if they deviate or vary from the targets: this guidance and regulation is done by an executive action. The cost can be controlled by standard costing, budgetary control, proper presentation and reporting of cost data and cost audit.

Objectives of Cost Accounting: The objectives of cost accounting are ascertainment of cost, fixation of selling price, proper recording and presentation of cost data to management for measuring efficiency and for cost control. The aim is to know the methods by which expenditure on materials, wages and overhead is recorded, classified and allocated so that the cost of products and services may be accurately ascertained; these costs may be related to sales and profitability may be determined. Yet with the development of business and

industry, its objectives are changing day by day. Following are the main objectives of cost accounting:

- (a) To ascertain the cost per unit of the different products manufactured by a business concern.
- (b) To provide a correct analysis of cost both the process or operations and by different elements of cost.
- (c) To disclose sources for wastage whether of material, time or expenses or in the use of machinery, equipment and tools and to prepare such reports which may be necessary to control such wastage.
- (d) To provide requisite data and serve as a guide to price fixing of products manufactured or services rendered.
- (e) To ascertain the profitability of each of the products and advise management as to how these profits can be maximized.
- (f) To exercise effective control of stocks of raw material, work-in-progress, consumable stores and finished goods in order to minimize the capital locked up in these stocks.
- (g) To reveal sources of economy by installing and implementing a system of cost control for materials, labour and overheads.
- (h) To advise management on future expansion policies and proposed capital projects. 9i) To present and interpret data for management planning, decision-making and control.
- (i) To help in the preparation of budgets and implementation of budgetary control.
- (k) To organize an effective information system so that different levels of management may get the required information at the right time in right form for carrying out their individual responsibilities in an efficient manner.
- (l) To guide management in the formulation and implementation of incentive bonus plans based on productivity and cost savings.
- (m) To supply useful data to management for taking various financial decisions such as introduction of new products, replacement of labour by machine etc.

(n) To help in supervising the working of punched card accounting or data processing through computers.

(o) To organize the internal audit system to ensure effective working of different departments.

(p) To organize cost reduction, programmers with the help of different departmental managers.

(q) To provide specialized services of cost audit in order to prevent the errors and frauds and to facilitate prompt and reliable information to management.

(r) To find out costing profit or loss by identifying with revenues the costs of those products or services by selling which the revenues have resulted.

Broadly speaking, the above objectives can be re-grouped under the following three heads:

(a) Ascertainment and analysis of cost and income by product, function and responsibility.

(b) Accumulation and utilization of cost data for control purposes to have the minimum possible cost consistent with maintenance of quality. This objective is achieved through fixation of targets, ascertainment of actual, comparison of actual with targets, analysis of reasons of deviations between actual and targets and reporting deviations to management for taking corrective action. (c) Providing useful data to management for taking decisions.

Advantages of Cost Accounting

The main advantages of cost accounting are given below:

1. Profitable and unprofitable activities are disclosed and steps can be taken to eliminate or reduce those activities from which little or no benefit is obtained or to change the method of production in order to make such activities more profitable.

2. It enables a concern to measure the efficiency and then to maintain and improve it. This is done with the help of valuable data made available for the purpose of comparison. For example, if material spent upon a pair of shoes in 2015 comes to ` 560 and for a similar pair of shoes the amount is ` 600 in 2016, the increase may be due to increase in prices of material or more wastage in the use of materials or inefficiency at the time of buying or unnecessarily high prices paid.

3. It provides information upon which estimates and tenders are based. In case of big contracts or jobs, quotations cannot be given unless the cost of completing the contracts can be found out.
4. It guides future production policies. It explains the cost incurred and profit made in various lines of business and processes and thereby provides data on the basis of which production can be appropriately planned.
5. It helps in increasing profits by disclosing the sources of loss or waste and by suggesting such controls so that wastages, leakages and inefficiencies of all departments may be detected and prevented.
6. It enables a periodical determination of profits or losses without resort to stock taking.
7. It furnishes reliable data for comparing costs in different periods, for different volumes of output, in different departments and processes and in different establishments, this helps in maintaining costs at the lowest point consistent with the most efficient operating conditions.
8. The exact cause of a decrease or an increase in profit or loss can be detected. A concern may suffer not because the cost of production is high or prices are low but also because the output is much below the capacity of the concern. This fact is revealed by cost accounts only.
9. Cost Accounting discloses the relative efficiencies of different workers and thereby facilitates the introduction of suitable plans of wage payment to reward efficiency and to provide adequate incentive to the less efficient worker. A goods system of costing promotes propriety of the business and thus ensures greater security of service and adequate reward to workers.
10. It enables the creditors and investors to judge the financial strength and credit worthiness of the business. A sound business concern with a goods system of costing can attract more investors than a similar concern without an adequate system of costing.
11. Helpful to the Government. It facilitates the assessment of exercise duty and income tax and the formulation of policies regarding industry, export, import, taxation etc. It also facilitates the preparation of national plans for economic development. It provides ready figures for use by the Government for application to problems like price fixation, price control, and tariff protection wage level fixation, payment of dividends or settlement of disputes.

12. Helpful to consumers. The ultimate aim of costing is to reduce cost of production to the minimum and maximize the profits of the business. A part of the benefit resulting from the reduction of the cost is usually passed on to consumers in the form of lower prices. Besides, the installation of a costing system will infuse confidence in the minds of the public about the fairness of the prices charged.

Characteristics of an Ideal Costing System:

An ideal system of costing is that which achieves the objectives of a costing system and brings all advantages of costing to the business. Following are the main characteristics which an ideal system of costing should possess or the points which should be taken into consideration before installing costing system.

- i) **Suitability to the business:** A costing system must be devised according to the nature, conditions, requirements and size of the business. Any system which serves the purposes of the business and supplies necessary information for running the business efficiently is an ideal system.
- ii) **Simplicity:** the system of costing should be simple and plain so that it may be easily understood even by a person of average intelligence. The facts, figures and other information provided by cost accounting must be presented in the right form at the right time to the right person in order to make it more meaningful.
- iii) **Flexibility:** the system of costing must be flexible so that it may be changed according to change conditions and circumstances. The system without such flexibility will be outmoded because of fast changes in business and industry. Thus, the system must have the capacity of expansion or contraction without much change.
- iv) **Economical:** A costing system is like other economic goods. It costs money just like economic goods. If the system is too expensive, the management may be unwilling to pay as buyers are not willing to pay for the goods if these are expensive as compared to their utility. A costing system should not be expensive and must be adapted according to the financial capacity of the business. The benefits to be derived from the system must be more than its costs as management will be willing to install the system when its perceived expected benefits exceed its perceived expected costs. In short, the system must be economical taking into consideration the requirements of the business.

- v) **Comparability:** The costing system must be such so that it may provide facts and figures necessary to the management for evaluating the performance by comparing it with the past figures, or figures of other concern or against the industry as a whole or other department of the same concern.
- vi) **Capability of presenting information at the desired time:** The system must provide accurate and timely information so that it may be helpful to the management for taking decisions and suitable action for the purpose of cost control.
- vii) **Minimum changes in the existing setup:** The existing system of delegation and division of authority and responsibility must not be disturbed with the costing system. As far as possible the system must be such so that it may least disturb the existing organizational set up.
- viii) **Uniformity of forms:** All forms and Performa's etc. necessary to the system should be uniform in size and quality of paper. Higher efficiency can be obtained by using colour of the paper to distinguish different forms. Printed forms should contain instructions as to their use and disposal.
- ix) **Maximum clerical work:** The filling of the forms by foremen and workers should involve little clerical work as possible as most of workers are not well educated. To ensure reliable statistics, every original entry should be supported by an examiner's signatures.
- x) **Efficient system of material control:** there should be an efficient system of stores and stock control as materials usually account for a greater proportion of the total cost.
- xi) **Adequate wage procedure:** There should be a well defined wage procedure for recording the time spent by workers on different jobs, for preparing the wage sheets and for the payment of wages, thus the introduction of well defined wage system will help to control the cost of labour.
- xii) **Departmentalization of expenses:** A sound plan should be devised for the collection, allocation, apportionment and absorption of overheads in order to ascertain the cost accurately.
- xiii) **Reconciliation of cost and financial accounts:** If possible the cost and financial accounts should be interlocked into one integral accounting scheme. If this is not possible the systems should be so devised that the two sets of accounts are capable of easy reconciliation.

- xiv) Duties and responsibilities of the cost accountant: Under a good system of cost accounting the duties and responsibilities of the cost accountant should be clearly defined. The cost accountant should have access to all works and departments.

CLASSIFICATION OF COST

1. By nature or element

- Materials
- Labour
- Expenses

2. By Functions

- Manufacturing and Product Cost
- Commercial Cost

3. By Degree of traceability to product

- Direct Cost
- Indirect Cost

4. By changes in Activity or volume

- Fixed Cost
- Variable Cost
- Semi Variable Cost

5. By controllability

- Controllable Cost
- Un controllable Cost

6. By Normality

- Normal Cost
- Abnormal Cost

7. By Relationship with accounting period

- Capital Cost
- Revenue Cost

8. By Time

- Historical Cost
- Pre-determined Cost

9. According to planning

- Budgeted Cost
- Standard Cost

10. By Association with the product

- Product Costs
- Period Costs

11. For Managerial decisions

- Marginal Cost
- Out of pocket Cost
- Differential Cost
- Sunk Cost
- Imputed or Notional Cost
- Opportunity Cost
- Replacement Cost

4

Technique of costing:-

As mentioned above, costing methods are for computation of the total cost of production/services offered by a firm. On the other hand, costing technique help to present the data in a particular format so that decision making becomes easy. Costing techniques also help for controlling and reducing the costs. The following are the techniques of costing.

- I. Marginal costing:-** This technique is based on the assumption that the total cost of production can be divided into fixed and variable. Fixed costs remain same irrespective of the changes in the volume of production while the variable costs vary with the level of production, i.e. they will increase if the production increases and decrease if the production decreases. Variable cost per unit always remains the same. In this technique, only variable costs are taken into account while calculating production cost. Fixed costs are not absorbed in the production units. They are written off to the costing profit and loss account. The reason behind this is that the fixed costs are period costs and hence should not be absorbed in the production. Secondly they are variable on per unit basis and hence there is not equitable basis of charging them to products. This technique is effectively used for decision making in the areas like make or buy decisions, optimizing of product mix, key factor analysis, fixation of selling price, accepting or rejecting an export offer, and several other areas.
- II. Standard costing:-** Standard costs are predetermined costs relating to material, labour and overheads. Though they are predetermined, they are worked out on scientific basis by conducting technical analysis. They are computed for all elements of costs such as material, labour and overheads. The main objective of fixation of standard

cost is to have benchmark against which the actual performance can be compared. This means that the actual costs are compared with the standards. The difference is called as 'variance'. If actual costs are more than the standard, the variance is adverse which if actual costs are less than the standard, the variance is favorable. The adverse variances are analyzed and reasons for the same are found out. Favorable variances may also be analyzed to find out the reasons behind the same standard costing, thus is an important technique of cost control and reduction.

III. Budget and Budgetary control:- Budget is defined as a quantitative and/ or a monetary statement prepared to prior to a defined period of time for the policies during that period for the purpose of achieving a given objective. If we analyze this definition, it will be clear that a budget is a statement, which may be either in monetary form or quantitative form or both. For example, a production budget can be prepared in quantitative form showing the target production, it can also be prepared in monetary terms showing the expected cost of production. Some budgets can be prepared only in monetary terms, e.g., cash budget showing the estimated receipts and payments in a particular period can be prepared in monetary terms only. Another feature of budget is that it is also ways prepared prior to a defined period of time which means that budget is always prepared for future and that to a defined future. For example, a budget may be prepared for next 12 months or 6 months or even for 1 month, but the time period must be certain and not vague. One of the important aspects of budgeting is that it lays down the objective to be achieved during the defined period of time and for achieving the objectives, whatever policies are to be pursued are reflected in the budget.

Budgetary control involves preparation of budgets and continuous comparison of actual with budgets so that necessary corrective action can be taken. For example, when a production budget is prepared, the production targets are laid down in the same for a particular period. After the period is over, the actual production is compared with the budget and the deviation is found out so that necessary corrective action can be taken. Budget and budgetary control is one of the important techniques of costing used for cost control and also for performance evaluation. The success of the technique depends upon several factors such as support from top management, involvement of employees and coordination within the organization.

Cost Unit

It is a device for the purpose of breaking up or separating cost into smaller sub-divisions attributable to products and services. It is the unit of product, service or time in relation to which costs may be ascertained, e.g. tone in case of coal. It must be clearly defined and selected before the process of cost finding can be started. It must not be too big or too small and must be so selected that expenditure can be associated with it and is appropriate to the needs of the business. In case of industries rendering service usually the unit is a compound of two measures since the single measure may be meaningless.

Name of the industry	Suitable cost unit
1. Steel making (or) cement industry	Cost pr tone
2. Sugar industry	Cost per quintal/tone
3. Textile industry	Cost per meter
4. Cycle industry	Cost per cycle
5. Hospital/nursing home	Cost per bed per patient per days
6. Timber industry	Cost per foot
7. Pharmaceutical	Cost per strip/bottles of diff sizes
8. Brick manufacturing	Cost per 1000 bricks
9. Chemical	Cost per kg/ tone
10. Soft drinks	Cost per case (24)/bottle of diff sizes
11. Aerated water (beer)	Cost per liter/barrel
12. Furniture manufacturing	Cost per article
13. Coal industry	Cost per tonne
14. Confectionary	Cost per kg
15. Good carrier/passenger	Cost per passenger per km/
16. Hotel	Cost per tonne per km
17. Canteen	Cost per meal

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