UNIT – I

MANAGEMENT ACCOUNTING-I

INTRODUCTION:

A business enterprise must keep a systematic record of what happens from daytot-day events so that it can know its position clearly. Most of the business enterprises are run by the corporate sector. These business houses are required by law to prepare periodical statements in proper form showing the state of financial affairs. The systematic record of the daily events of a business leading to presentation of a complete financial picture is known as accounting. Thus, Accounting is the language of business. A business enterprise speaks through accounting. It reveals the position, especially the financial position through the language called accounting.

MEANING OF ACCOUNTING:

Accounting is the process of recording, classifying, summarizing, analyzing and interpreting the financial transactions of the business for the benefit of management and those parties who are interested in business such as shareholders, creditors, bankers, customers, employees and government. Thus, it is concerned with financial reporting and decision making aspects of the business. The American Institute of Certified Public Accountants Committee on Terminology proposed in 1941 that accounting may be defined as, "The art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character and interpreting the results thereof".

Management accounting is not a specific system of accounting. It could be any form of accounting which enables a business to be conducted more effectively and efficiently. It is largely concerned with providing economic information to mangers for achieving organizational goals. It is an extension of the horizon of cost accounting towards newer areas of management. Much management accounting information is financial in nature but has been organized in a manner relating directly to the decision on hand.

Management Accounting is comprised of two words „Management‟ and „Accounting‟. It means the study of managerial aspect of accounting. The emphasis of management accounting is to redesign accounting in such a way that it is helpful to the management in formation of policy, control of execution and appreciation of effectiveness.

Definition: Anglo-American Council on Productivity defines Management Accounting as, "the presentation of accounting information in such a way as to assist management to the creation of policy and the day to day operation of an undertaking"

The ***American Accounting Association defines Management Accounting*** as "the methods and concepts necessary for effective planning for choosing among alternative business actions and for control through the evaluation and interpretation of performances".

OBJECTIVES OF MANAGEMENT ACCOUNTING:

The fundamental objective of management accounting is to enable the management to maximize profits or minimize losses. The evolution of management accounting has given a new approach to the function of accounting. The main objectives of management accounting are as follows:

1. Planning and policy formulation:

Planning involves forecasting on the basis of available information, setting goals; framing polices determining the alternative courses of action and deciding on the programme of activities. Management accounting can help greatly in this direction. It facilitates the preparation of statements in the light of past results and gives estimation for the future.

2. Interpretation process:

Management accounting is to present financial information to the management. Financial information is technical in nature. Therefore, it must be presented in such a way that it is easily understood. It presents accounting information with the help of statistical devices like charts, diagrams, graphs, etc.

3. Assists in Decision-making process:

With the help of various modern techniques management accounting makes decision-making process more scientific. Data relating to cost, price, profit and savings for each of the available alternatives are collected and analyzed and provides a base for taking sound decisions.

4. Controlling:

Management accounting is a useful for managerial control. Management accounting tools like standard costing and budgetary control are helpful in controlling performance. Cost control is effected through the use of standard costing and departmental control is made possible through the use of budgets. Performance of each and every individual is controlled with the help of management accounting.

5. Reporting:

Management accounting keeps the management fully informed about the latest position of the concern through reporting. It helps management to take proper and quick decisions. The performance of various departments is regularly reported to the top management.

6. Facilitates Organizing:

"Return on Capital Employed" is one of the tools of management accounting. Since management accounting stresses more on Responsibility Centres with a view to control costs and responsibilities, it also facilitates decentralization to a greater extent. Thus, it is helpful in setting up effective and efficiently organization framework.

7. Facilitates Coordination of Operations:

Management accounting provides tools for overall control and coordination of business operations. Budgets are important means of coordination.

NATURE AND SCOPE OF MANAGEMENT ACCOUNTING:

Management accounting involves furnishing of accounting data to the management for basing its decisions. It helps in improving efficiency and achieving the organizational goals. The following paragraphs discuss about the nature of management accounting.

1. Provides accounting information:

Management accounting is based on accounting information. Management accounting is a service function and it provides necessary information to different levels of management. Management accounting involves the presentation of information in a way it suits managerial needs. The accounting data collected by accounting department is used for reviewing various policy decisions.

2. Cause and effect analysis.

The role of financial accounting is limited to find out the ultimate result, i.e., profit and loss; management accounting goes a step further. Management accounting discusses the cause and effect relationship. The reasons for the loss are probed and the factors directly influencing the profitability are also studied. Profits are compared to sales, different expenditures, current assets, interest payables, share capital, etc.

3. Use of special techniques and concepts.

Management accounting uses special techniques and concepts according to necessity to make accounting data more useful. The techniques usually used include financial planning and analyses, standard costing, budgetary control, marginal costing, project appraisal, control accounting, etc.

4. Taking important decisions.

It supplies necessary information to the management which may be useful for its decisions. The historical data is studied to see its possible impact on future decisions. The implications of various decisions are also taken into account.

5. Achieving of objectives.

Management accounting uses the accounting information in such a way that it helps in formatting plans and setting up objectives. Comparing actual performance with targeted figures will give an idea to the management about the performance of various departments. When there are deviations, corrective measures can be taken at once with the help of budgetary control and standard costing.

6. No fixed norms.

No specific rules are followed in management accounting as that of financial accounting. Though the tools are the same, their use differs from concern to concern. The deriving of conclusions also depends upon the intelligence of the management accountant. The presentation will be in the way which suits the concern most.

7. Increase in efficiency.

The purpose of using accounting information is to increase efficiency of the concern. The performance appraisal will enable the management to pin-point efficient and inefficient spots. Effort is made to take corrective measures so that efficiency is improved. The constant review will make the staff cost – conscious.

8. Supplies information and not decision.

Management accountant is only to guide and not to supply decisions. The data is to be used by the management for taking various decisions. „How is the data to be utilized‟ will depend upon the caliber and efficiency of the management.

9. Concerned with forecasting.

The management accounting is concerned with the future. It helps the management in planning and forecasting. The historical information is used to plan future course of action. The information is supplied with the object to guide management for taking future decisions.

LIMITATIONS OF MANAGEMENT ACCOUNTING:

Management Accounting is in the process of development. Hence, it suffers form all the limitations of a new discipline. Some of these limitations are:

1. Limitations of Accounting Records:

Management accounting derives its information from financial accounting, cost accounting and other records. It is concerned with the rearrangement or modification of data. The correctness or otherwise of the management accounting depends upon the correctness of these basic records. The limitations of these records are also the limitations of management accounting.

2. It is only a Tool:

Management accounting is not an alternate or substitute for management. It is a mere tool for management. Ultimate decisions are being taken by management and not by management accounting.

3. Heavy Cost of Installation:

The installation of management accounting system needs a very elaborate organization. This results in heavy investment which can be afforded only by big concerns.

4. Personal Bias:

The interpretation of financial information depends upon the capacity of interpreter as one has to make a personal judgment. Personal prejudices and bias affect the objectivity of decisions.

5. Psychological Resistance:

The installation of management accounting involves basic change in organization set up. New rules and regulations are also required to be framed which affect a number of personnel and hence there is a possibility of resistance form some or the other.

6. Evolutionary stage:

Management accounting is only in a developmental stage. Its concepts and conventions are not as exact and established as that of other branches of accounting. Therefore, its results depend to a very great extent upon the intelligent interpretation of the data of managerial use.

7. Provides only Data:

Management accounting provides data and not decisions. It only informs, not prescribes. This limitation should also be kept in mind while using the techniques of management accounting.

8. Broad-based Scope:

The scope of management accounting is wide and this creates many difficulties in the implementations process. Management requires information from both accounting as well as non-accounting sources. It leads to inexactness and subjectivity in the conclusion obtained through it.

Chapter 1: Exhibit 1-1

	Financial Accounting	Managerial Accounting
1. Users	External persons who make financial decisions	Managers who plan for & control an organization
2. Time focus	Historical perspective	Future emphasis
3. Verifiability vs. relevance	Emphasis on objectivity & source documents	Emphasis on satisifying management needs
4. Precision vs. timeliness	Emphasis on "fair" report of operations and financial position	Emphasis on getting information to managers when they need it
5. Subject	Primary focus is on companywide reports	Primary focus is on segment reports
6. Rules	Must follow GAAP / IFRS and prescribed formats	Not bound by outside rules
7. Requirement	Mandatory for external reports	Not mandatory

FINANCIAL STATEMENTS

Financial statements, as used in corporate business houses, refer to a set of reports and schedules which an accountant prepares at the end of a period of time for a business enterprise. The financial statements are the means with the help of which the accounting system performs its main function of providing summarised information about the financial affairs of the business. These statements comprise Balance Sheet or Position Statement and Statement of Profit & Loss or Income Statement. Of course to give a full view of the financial affairs of an undertaking, in addition to the above, the business may also prepare a Statement of Retained Earnings and a Cash Flow Statement. In India, every company has to present its financial statements in the form and contents as prescribed under Section 2(2), 129 & 133 of the Companies Act 2013. The significance of these statements are given below:

(i) Balance Sheet or Position Statement: Balance sheet is a statement showing the nature and amount of a company's assets on one side and liabilities and capital on the other. In other words, the balance sheet shows the financial position on a particular date usually at the end of one year period. Balance sheet shows how the money has been made available to the business of the company and how the money is employed in the business.

(ii) (ii) Statement of Profit & Loss or Income Statement: Earning profit is the principal objective of all business enterprises and Statement of Profit & Loss or Income Statement is the document which indicates the extent of success achieved by a business in meeting this objective. Profits are of primary importance to the Board of directors in evaluating the management of a company, to shareholders or potential shareholders in making investment decisions and to banks and other creditors in judging the loan repayment capacities and abilities of the company. It is because of this that the profit and loss or income statement is regarded as the primary statement and commands a careful scrutiny by all interested parties. It is prepared for a particular period which is mentioned alongwith the title of these statements, which includes the name of the business firm also.

(iii) (iii) Cash Flow Statement: This is a statement which summarises for the period, the cash available to finance the activities of an organisation and the uses to which such cash have been put. A statement of cash flow reports cash receipts and payments classified according to the organisation's major activities i.e., operating activities, investing activities and financing activities. This statement reports the net cash inflow or outflow for each activity and for the overall business. The cash flow statement is to be prepared according to the Accounting Standard 3 (Revised) "Cash Flow Statement". The details of this statement have been discussed in a separate study.

NATURE OF FINANCIAL STATEMENTS

Financial statements are prepared for the purpose of presenting a periodical review or report on the progress by the management and deal with the *(a) status of the investments in the business and*

(b) results achieved during the period under review.

The data exhibited in these financial statements are the result of the combined effect of

- recorded facts;
- accounting conventions;
- postulates or assumptions made to implement conventional procedures;
- personal judgements used in the applications of conventions and postulates and
- accounting standards and guidance notes.

The objectives of financial statements

- To provide reliable financial information about economic resources and obligations of a business enterprise.
- To provide reliable information about the net resources (resources less obligations) of an enterprise that results from its activities.
- To provide financial information that assists in estimating the earning potentials of a business.
- To provide other needed information about changes in economic resources or obligation.
- To disclose, to the extent possible, other information related to the financial statements that is relevant to the needs of the users of these statements.

IMPORTANCE OF FINANCIAL STATEMENTS

1. The Management: The scope of modern business and the multiplicity of factors affecting the business operations call for an increasingly scientific and analytical approach in the management of such businesses. This is possible only when up-to-date, accurate and systematic financial records are available to the management team. Financial accounts and statements are of a very great help in understanding the progress, position and prospects of the business vis-a-vis the industry. Financial statements, by helping the management to be acquainted with the causes of the business results, enable them to formulate appropriate policies and courses of action for the future. Not only such financial statements - which are generally made public, but unpublished subsidiary accounts and statements also play an important role in policy-making and planning. Such subsidiary records provide more detailed, frank and revealing information than the financial statements. A comparative analysis of financial statements should enable management to see the trends in the progress and position of the enterprise and make suitable modifications in policies to avert unfavourable situations. It is through the release of such financial statements that the managements communicate their performance to various parties and justify their existence, and activities.

2. The Public: Business is a social entity. Various groups of the society, though not directly connected with business, are interested in the progress, position and prospects of a business enterprise. These groups are financial analysts, lawyers, trade associations, labour unions, financial press, students and teachers, etc. It is only through the published financial statements that these people can analyse, judge and comment upon the business enterprise. It should be noted that these financial statements are available to the public in case of joint stock companies. In case of proprietorships or partnerships, and other form of ownership no such statements are published or made available to the public.

3. The Shareholders and the Lenders: The financial statements serve as a useful guide for the shareholders and probable shareholders, the suppliers, and the lenders and probable lenders of a company. It is through a critical examination of the financial statements that these groups can come to know about the efficiency and effectiveness of the management and position, progress and prospects of the company. For this purpose, it is necessary that the financial statements should contain accurate, complete and systematic facts and figures so that these people can get a full and accurate idea regarding the present position and future of the company. Since published financial statements are the main bases available to such group of people to judge the affairs of the company, it has been found that some managements have been resorting to 'window dressing' in the presentation of these statements, to project a "better" than "what is" the position of the company.

4. The Labour and Trade Unions: In India, workers are entitled to bonus under the Payment of Bonus Act, depending upon the size of the profit as disclosed by audited Statement of Profit & Loss. Thus, Statement of Profit & Loss becomes greatly important to the workers. In wage negotiations also, the size of profits and the profitability achieved are greatly relevant.

5. The Country and Economy: Economic progress of country is to a great extent, associated with the rise and growth of joint stock companies. But unscrupulous acts affect the industry and people in the region in which the company operates, to a significant extent. Such fraudulent activities impair the confidence of the general public in joint stock companies as forerunner of economic progress, and thus retard economic growth of the country.

LIMITATIONS OF FINANCIAL STATEMENTS

(i) Financial statements are essentially interim reports and therefore, cannot be final because the final gain or loss can be computed only at the termination of the business. Financial statements only reflect the progress and position of the business at frequent intervals during its life. The decision regarding the period of these statements is a matter of personal judgement and it gives rise to the problem of allocating expenditures over various periods. Again the existence of contingent liabilities, deferred revenue expenditure make them more imprecise.

(ii) (ii) Financial statements though expressed in exact monetary terms, are not absolutely final and accurate. As the balance sheet is prepared on the basis of a going concern asset valuation represents neither the realisable value nor replacement costs. Further, they depend on the judgement of the management in respect of various accounting policies.

(iii) (iii) The values ascribed to the assets presented in the statements depend upon the standards of the persons dealing with them. For instance, the method of depreciation, mode of amortisation of fixed assets, treatment of deferred revenue expenditure, all depend on the personal judgement of the accountant. The soundness of such judgement will necessarily depend upon his competence and integrity.

(iv) Financial statements take into consideration only the financial factors. They fail to bring out the significance of non-financial factors which may have considerable bearing on the operating results and financial conditions of an enterprise. For example, public image of the enterprise, the calibre of its management, efficiency and loyalty of its workers etc.

(v) It is not always possible to discover false figures in financial statements. Unscrupulous managements generally resort to ‘window dressing’ in the preparation of such statements.

(vi) Financial statements are prepared primarily for shareholders. Other interested parties have to generally make many adjustments before they use them profitably.

(vii) Quite often, financial statements do not disclose current worth of the business. Only historical facts are presented and the true current worth is not reflected.

(viii) Owing to the fact that financial statements are compiled, on the basis of historical costs, while there is a marked decline in the value of the monetary unit and resultant rise in prices, the balance sheet losses its function as an index on current economic realities. Again the financial statements contain both historical and current costs items, hence figures are distorted. It is seen that holding gains and operating gains are added together, no differentiation is made between these two.

ANALYSIS OF FINANCIAL STATEMENTS

Published financial statements are the only source of information about the activities and affairs of a business entity available to the public, shareholders, investors and creditors, and the governments. These various groups are interested in the progress, position and prospects of such entity in various ways. But these statements howsoever, correctly and objectively prepared, by themselves do not reveal the significance, meaning and relationship of the information contained therein. For this purpose, financial statements have to be carefully studied, dispassionately analysed and intelligently interpreted. This enables a forecasting of the prospects for future earnings, ability to pay interest, debt maturities both current as well as long-term, and probability of sound financial and dividend policies. According to Myers, “financial statement analysis is largely a study of relationship among the various financial factors in business as disclosed by a single set of statements and a study of the trend of these fac

OBJECTIVES OF FINANCIAL STATEMENT ANALYSIS

Financial statement analysis is very much helpful in assessing the financial position and profitability of a concern. The main objectives of analyzing the financial statements are as follows:

- The analysis would enable the present and the future earning capacity and the profitability of the concern.
- The operational efficiency of the concern as a whole as well as department wise can be assessed.Hence the management can easily locate the areas of efficiency and inefficiency.
- The solvency of the firm, both short-term and long-term, can be determined with the help of financial statement analysis which is beneficial to trade creditors and debenture holders.

- ❖ The comparative study in regard to one firm with another firm or one department with another department is possible by the analysis of financial statements.
- ❖ Analysis of past results in respects of earning and financial position of the enterprise is of great help in forecasting the future results. Hence it helps in preparing budgets.
- ❖ It facilitates the assessments of financial stability of the concern.
- ❖ The long-term liquidity position of funds can be assessed by the analysis of **financial statements. tors as shown in a series of statements".**

LIMITATIONS OF FINANCIAL STATEMENT ANALYSIS

1. Owing to the fact that financial statements are compiled on the basis of historical costs, while there is a market decline in the value of the monetary unit and resultant rise in prices, the figures in the financial statement loses its functions as an index on current economic realities. Again the financial statements contain both items. So an analysis of financial statements can not be taken as an indicator for future forecasting and planning.
2. Analysis of financial statements is a tool which can be used profitably by an expert analyst but may lead to faulty conclusions if used by unskilled analyst. So the result can not be taken as judgements or conclusions.
3. Financial statements are interim reports and therefore can not be final because the final gain or loss can be computed only at the termination of the business. Financial statement reflects the progress of the position of the business so analysis of these statements will not be a conclusive evidence ofthe performance of the business.
4. Financial statements though expressed in exact monetary terms are not absolutely final and accurate and it depends upon the judgement of the management in respect of various accounting
5. methods. If there is change in accounting methods, the analysis may have no comparable basis and the result will be biased.
6. The reliability of analysis depends on the accuracy of the figures used in the financial statements.The analysis will be vitiated by manipulations in the income statement or balance sheet and accounting procedure adopted by the accountant for recording.
7. The results for indications derived from analysis of financial statements may be differently interpreted by different users.

8. The analysis of financial statement relating to a single year only will have limited use. Hence the analysis may be extended over a number of years so that results may be compared to arrive at ameaningful conclusion.
9. When different firms are adopting different accounting procedures, records, policies and different items under similar headings in the financial statements, the comparison will be more difficult. It will not provide reliable basis to access the performance, efficiency, profitability and financial conditionof the firm as compared to industry as a whole.
10. There are different tool of analysis available for the analyst. However, which tool is to be used in a particular situation depends on the skill, training, and expertise of the analyst and the result will vary accordingly.

TYPES OF FINANCIAL STATEMENT ANALYSIS

1. According to Nature of the Analyst

1.1. **External Analysi**s: It is made by those who do not have access to the detailed records of thecompany. This group, which has to depend almost entirely on published financial statements, includes investors, credit agencies and governmental agencies regulating a business in nominal way. The position of the external analyst has been improved in recent times owing to the governmental regulations requiring business undertaking to make available detailed information tothe public through audited accounts.

1.2. Internal Analysis: The internal analysis is accomplished by those who have access to the books of accounts and all other information related to business. While conducting this analysis, the analyst is a part of the enterprise he is analysing. Analysis for managerial purposes is an internal type of analysis and is conducted by executives and employees of the enterprise as well as governmental and court agencies which may have regulatory and other jurisdiction over the business.

2. According to Modus Operandi of Analysis

2.1. **Horizontal Analysis:** When financial statements for a number of years are reviewed and analysed, the analysis is called ‘horizontal analysis’. As it is based on data from year to year rather than on one date or period of time as a whole, this is also known as ‘dynamic analysis’. This is very useful for long term trend analysis and planning.

2.2. **Vertical Analysis:** It is frequently used for referring to ratios developed for one date or for one accounting period. Vertical analysis is also called 'Static Analysis'. This is not very conducive to proper analysis of the firm's financial position and its interpretation as it does not enable to study data in perspective. This can only be provided by a study conducted over a number of years so that comparisons can be effected. Therefore, vertical analysis is not very useful.

3. According to the Objective of the Analysis

On this basis the analysis can be long-term and short-term analysis:

3.1. **Long-term Analysis**: This analysis is made in order to study the long-term financial stability,solvency and liquidity as well as profitability and earning capacity of a business. The objective of making such an analysts is to know whether in the long-term the concern will be able to earna minimum amount which will be sufficient to maintain a reasonable rate of return on the investment so as to provide the funds required for modernisation, growth and development of the business.

3.2. **Short-term Analysis**: This analysis is made to determine the short-term solvency, stability, liquidity and earning capacity of the business. The objective is to know whether in the short-run a business enterprise will have adequate funds readily available to meet its short-term requirements and sufficient borrowing capacity to meet contingencies in the near future.

METHODS OF ANALYSING FINANCIAL STATEMENTS

The analysis of financial statements consists of a study of relationship and trends, to determine whether ornot the financial position and results of operations as well as the financial progress of the company are satisfactory or unsatisfactory. The analytical methods or devices, listed below, are used to ascertain ormeasure the relationships among the financial statements items of a single set of statements and thechanges that have taken place in these items as reflected in successive financial statements. Thefundamental objective of any analytical method is to simplify or reduce the data under review to moreunderstandable terms.

Analytical methods and devices used in analysing financial statements are as follows:

1. Comparative Statements
2. Common Size Statements
3. Trend Ratios
4. Ratio Analysis
5. Cash Flow Statements
6. Fund Flow Statement.

1. Comparative Statements

These financial statements are so designed as to provide time perspective to the various elements of financial position contained therein. These statements give the data for all the periods stated so as to show:

(a) Absolute money values of each item separately for each of the periods stated.

(b) Increase and decrease in absolute data in terms of money values.

(c) Increase and decrease in terms of percentages.

(d) Comparison expressed in ratios.

(e) Percentages of totals.

Such comparative statements are necessary for the study of trends and direction of movement in the financial position and operating results. This calls for a consistency in the practice of preparing these statements, otherwise comparability may be distorted. Comparative statements enable horizontal analysis of figures.

2. **Comparative Balance Sheet**: A comparative balance sheet shows the balance of accounts of assets and liabilities on different dates and also the extent of their increases or decreases between these dates throwing light on the trends and direction of changes in the position over the periods. This helps in predicting about the position of the business in future. A specimen of the comparative balance sheet is given below:

2. **Common-Size Statements** In the comparative financial statements it is difficult to comprehend the changes over the years in relation to total assets, total liabilities and capital or total net sales. This limitation of comparative statements make comparison between two or more firms of an industry impossible because there is no common base of comparison for absolute

figures. Again, for an interpretation of underlying causes of changes over time period a vertical analysis is required and this is not possible with comparative statements.

Common size financial statements are those in which figures reported are converted into percentages to some common base. For this, items in the financial statements are presented as percentages or ratios to total of the items and a common base for comparison is provided. Each percentage shows the relation of the individual item to its respective total.

(a) Common-size Income Statement: In a common size income statement the sales figure is assumed to be equal to 100 and all other figures of costs or expenses are expressed as percentages of sales. A comparative income statement for different periods helps to reveal the efficiency or otherwise of incurring any cost or expense. If it is being prepared for two firms, it shows the relative efficiency of each cost item for the two firms.

(b) Common-size Balance Sheet: In a common size balance sheet, total of assets or liabilities is taken as 100 and all the figures are expressed as percentage of the total. Comparative common size balance sheets for different periods help to highlight the trends in different items. If it is prepared for different firms in an industry, it facilitates to judge the relative soundness and helps in understanding their financial strategy.

3**. Trend Ratios** Trend ratios can be defined as index numbers of the movements of the various financial items in the financial statements for a number of periods. It is a statistical device applied in the analysis of financial statements to reveal the trend of the items with the passage of time. Trend ratios show the nature and rate of movements in various financial factors. They provide a horizontal analysis of comparative statements and reflect the behaviour of various items with the passage of time. Trend ratios can be graphically presented for a better understanding by the management. They are very useful in predicting the behaviour of the various financial factors in future. However, it should be noted that conclusions should not be drawn on the basis of a single trend. Trends of related items should be carefully studied, before any meaningful conclusion is arrived at. Since trends are sometimes significantly affected by externalities, i.e. reasons extraneous to the organisations, the analyst must give due weightage to such extraneous factors like government policies, economic conditions, changes in income and its distribution, etc.