6. MANAGEMENT ACCOUNTING

This chapter covers the following topics:

- Characteristics of Management Accounting
- Objectives of Management Accounting
- Comparison with Financial Accounting
- Comparison with Cost Accounting
- Ratio Analysis

Definition

Institute of Chartered Accountants of England and Wales defines management accounting as:

> *Any worm of accounting which enables a business to conduct more efficiently can be regarded as Management Accounting.*

American Accounting Association defines management accounting as:

> *Management Accounting includes the methods and concepts necessary for effective planning, for choosing among alternative business actions, and for control through the evaluation and interpretation of performance.*

Characteristics of Management Accounting

Management accounting provides data to the management on the basis of which they take decisions to achieve organizational goals and improve their efficiency. In this section, we will discuss the main characteristics of management accounting.

To Provide Accounting Information

Information is collected and classified by the financial accounting department, and presented in a way that suits managerial needs to review the various policy decisions of an organization.

Cause and Effect Analysis

One step further from financial accounting, management accounting works to know the reasons of profit or loss of an organization. It works to find out the causes for loss and also study the factors which influence the profitability. Therefore, cause and effect is a feature of management accounting.

Special Technique and Concepts

Budgetary control, marginal costing, standard costing are main techniques used in financial accounting for successful financial planning and analysis, and to make financial data more useful.

Decision Making

Studying various alternative decisions, studying impact of financial data on future, supplying useful data to management, helping management to take decisions is a part of management accounting.

Achieving Tasks

Financial data is used to set targets of the company and to achieve them. Corrective measures are used if there is any deviation in actual and targeted task. This all is done through management accounting with the help of budgetary control and standard costing.

No Fixed Norms

No doubt, tools of management accounting are same, but at the same time; uses of these tools depend upon need, size, and structure of any organization. Thus, no fix norms are used in application of management accounting. On the other hand, financial accounting totally depends on certain rules and principals. Therefore, presentation and analysis of accounting data may vary from one organization to another.

Increasing Efficiency

While evaluating the performance of each department of an organization, management accounting can spot the efficient and inefficient sections of an organization. With the help of that, corrective step can be taken to rectify the inefficient part for better performance. Hence, we can say that efficiency of a concern can increase using accounting information.

Informative Instead of Decision Making

Decisions are taken only by top management using information provided by management accountant as classified in a manner which is useful in decision making. Decision making does not come under preview of accountant, it is only the top management, who can take decision. Thus, decision of an organization depends on caliber and efficiency of the management.

Forecasting

Management accountant helps management in future planning and forecasting using historical accounting data.

Objectives of Management Accounting

Let us go through the objectives of management accounting:

Planning and Formulating Policies

In the process of planning and formulating policies, a management accountant provides necessary and relevant information to achieve the targets of the company. Management accounting uses regression analysis and time series analysis as forecasting techniques.

Controlling Performance

In order to assure effective control, various techniques are used by a management accountant such as budgetary control, standard costing, management audit, etc. Management accounting provides a proper managerial control system to the management. Reports are provided to the management regarding the effective and efficient use of resources.

Interpreting Financial Statement

Collecting accounting data and analyzing the same is a key role of management accounting. Management accounting provides relevant information in a systematic way that can be used by the management in planning and decision-making. Cash flow, fund flow, ratio analysis, trend analysis, and comparative financial statements are the tools normally used in management accounting to interpret and analyze accounting data.

Motivating Employees

Management accounting provides a selection of best alternative methods of doing things. It motivates employees to improve their performance by setting targets and starting incentive schemes.

Making Decisions

Success of any organization depends upon accurate decision-making and effective decision-making is based on informational network as provided by management accounting. Applying techniques of differential costing, absorption costing, marginal costing, and management accounting provides useful data to the management to aid in their decision-making.

Reporting to Management

It is the primary role of management accounting to inform and advice the management about the latest position of the company. It covers information about the performance of various departments on regular basis to the management which is helpful in taking timely decisions.

A management accountant also works in the capacity of an advisory to overcome any existing financial or other problems of an organization.

Coordinating among Departments

Management accounting is helpful in coordinating the departments of an organization by applying thorough functional budgeting and providing reports for the same to the management on a regular basis.

Administrating Tax

Any organization must comply with the tax systems prevailing in the country they are operating from. It is a challenge due to the ever-increasing complexity of the tax structure. Organization need to file various kinds of returns with different tax authorities. They need to calculate the correct amount of tax and assure timely deposit of tax. Therefore, the management takes guidance from management accountants to comply with the law of the land.

Management Accounting Versus Financial Accounting

All monetary transactions are recorded in the books of accounts on historical cost basis. Financial statements are prepared to ascertain the actual profit or loss of the firm and to know the financial position of the firm of every accounting period.

Management accounting collects data from financial statements, analyzes, and then provides this data to the management.

S.no.	Financial Accounting	Management Accounting
1	Monitory transactions are the base of financial accounting.	Data as obtained from financial accounting is the base of management accounting.
2	Recognition, classification, recording of financial transactions on actual basis, and preparation of financial statement are the main functions of financial accounting.	Collection of data from financial accounting, provision of necessary information to the management for planning, decision-making, and evaluation are the main functions of management accounting.
3	Support of relevant figures is required in preparing the financial reports.	Subjective and objective, both figures may be present in the management accounting report.
4	Success of financial accounting does not depend on sound management accounting system.	Success of management accounting depends on sound financial accounting system of a concern.
5	Financial reports are used by the management of a company,	Financial reports are exclusively used by the management only.

	shareholders, creditors, and financial institutions.	
6	Statutory audit of financial statements of concerns is required as per applicable law.	No statutory requirement of audit for reports prepared by management accountants.
7	Financial statements of a concern are prepared at the end of every accounting period.	The reports are prepared as and when required by management of the concern.
8	To ascertain profit or loss of a concern on actual basis and to know financial position of a concern financial accounting is used.	Thorough management accounting evaluation of performance is done department and section-wise, as well as whole concern-wise.

Management Accounting versus Cost Accounting

Management accounting collects data from cost accounting and financial accounting. Thereafter, it analyzes and interprets the data to prepare reports and provide necessary information to the management.

On the other hand, cost books are prepared in cost accounting system from data as received from financial accounting at the end of each accounting period.

The difference between management and cost accounting are as follows:

S. No.	Cost Accounting	Management Accounting
1	The main objective of cost accounting is to assist the management in cost control and decision-making.	The primary objective of management accounting is to provide necessary information to the management in the process of its planning, controlling, and performance evaluation, and decision-making.
2	Cost accounting system uses quantitative cost data that can be measured in monitory terms.	Management accounting uses both quantitative and qualitative data. It also uses those data that cannot be measured in terms of money.
3	Determination of cost and cost control are the primary roles of cost accounting.	Efficient and effective performance of a concern is the primary role of management accounting.

4	Success of cost accounting does not depend upon management accounting system.	Success of management accounting depends on sound financial accounting system and cost accounting systems of a concern.
5	Cost-related data as obtained from financial accounting is the base of cost accounting.	Management accounting is based on the data as received from financial accounting and cost accounting.
6	Provides future cost-related decisions based on the historical cost information.	Provides historical and predictive information for future decision-making.
7	Cost accounting reports are useful to the management as well as the shareholders and creditors of a concern.	Management accounting prepares reports exclusively meant for the management.
8	Only cost accounting principles are used in it.	Principals of cost accounting and financial accounting are used in management accounting.
9	Statutory audit of cost accounting reports are necessary in some cases, especially big business houses.	No statutory requirement of audit for reports.
10	Cost accounting is restricted to cost-related data.	Management accounting uses financial accounting data as well as cost accounting data.

Cash Flow

It is very important for a business to keep adequate cash in hand to meet day-to-day expenditures and to invest as and when required in business. Thus, cash plays a very vital role to run a business successfully. Sometimes it has been observed that in spite of adequate profit in business, they are unable to meet their taxes and dividends, just because of shortage of cash flow.

We have read about two very important financial statements: first, revenue statement and second, balance sheet. Revenue statements provide provide essential information about the operating activities of a concern, and balance sheets show the financial position of a firm. But, both are unable to convey anything about the generation of cash out of all business activities.

Keeping in view the above limitation, the financial accounting board, U.S.A., has emphasized on the need for a cash flow statement as:

> "Financial reporting should provide information to help potential investors and creditors and other users in assessing the amounts, timing and uncertainty of prospective cash receipts from dividends or interest and proceeds from the sales, redemption or maturity of securities or loans. The prospects for those cash receipts of effected by an enterprises ability to generate enough cash to meet the obligation when due and its others operating needs to re-invest in operations and to pay cash dividends."

In June 1995, the Securities and Exchange Board of India "SEBI" amended Clause 32 of the listing agreement requiring every listed companies to give along with the balance sheet and profit & loss account, a cash flow statement prepared in the prescribed format, showing cash flows from operating activities, investing activities and financing activities, separately. Recognizing the importance of cash flow statement, The Institute of Chartered Accountants of India (ICAI) issued AS-3 revised: Cash flow statements in March 1997. The revised accounting standards supersede AS-3 changes in financial position, issued in June 1981. The objectives of cash flow statement given in AS-3 (Revised) are as under:

> "Information about the cash flows of an enterprise is useful in providing users of financial statements with a basis to assess the ability of the enterprises to generate cash and cash equivalents and the needs of the enterprises to utilize those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generations.
>
> The statement deals with the provision of information about the historical changes in cash and cash equivalents of an enterprise by mean of cash flow the statement which classified cash flow during the period from operating, investing and financing activities."

During a specified period of time, a cash flow statement describes the inflows and outflows of the cash and cash equivalents in an enterprise. A cash flow statement shows the net effect of various business transactions on cash and cash equivalents and consideration of receipts and payments of cash. Cash flow is a summary of change in cash position in between the dates of two balance sheets and revenue statements. The important terms used in a cash flow statement are as follows:

Cash

The meaning of cash is cash in hand and cash at bank including deposits.

Cash and Cash Equivalents

Here, cash and cash equivalents imply readily convertible, highly liquid investments, the value of which in cash is well-known to us without risk of change in its realization amount. The purpose of keeping cash equivalents is to meet our current and short-term commitment rather than for investments. Only those investments having short maturity terms qualify as cash equivalents. Short maturity means maturity within three months.

Cash Flows

There are two types of flows: inflows and outflows. If the increase in cash is the effect of transactions, it is called inflows of cash; and if the result of transactions is decrease in cash, it is called outflows of cash.

Note: If decrease in cash is due to cash management rather than its operating, investing, and financing activities, it will be excluded from cash outflows. Cash management means investment of cash in cash equivalents.

Classification of Cash Flows

According to AS-3 (Revised), cash flows should be classified in three main categories:

- Cash Flow from operating activities
- Cash Flow from investing activities
- Cash Flow from financing activities

Cash flow from operating activities

Inflow of cash from operating activities represents the level of sufficient cash generation necessary to maintain operating capability without recourse to external resource of financing.

In other words, operating activities mean principal revenue-producing activities of a firm. It represents the transactions those determine the profit or loss of a firm.

Examples of cash Flows from operating activities:

- Cash sale (goods or services)
- Cash receipts from commission, fees and royalties income etc.
- Cash payments to workers or employees in form of salary or wages.
- Cash payments to supplier of goods or services.
- Cash receipt on account of insurance premium by insurance companies.
- Cash payments in form of claims, annuity and other benefits.
- Cash payments or refund of income tax in case not included in investing or financing activities.
- Cash payments on account of current and future contracts.

Note: Cash receipt on sale of plant and machinery comes under category of investing activities.

Cash flow from investing activities

Assets and long-term investments that do not come under cash equivalents are known as investing activities. Investing activity represents how much investment in long-term assets has been made to earn profit in future.

Examples of Cash Flows from investing activities:

- Cash payments to acquire tangibles and intangibles assets including construction of assets and capitalization of research and development cost.
- Cash receipts from sale of investments and disposal of fixed assets.
- Cash payment for investments in shares, warrants and debentures of other companies etc. excluding those which are covered under cash equivalents or purchased for trading purpose. If so, those come under operating activities.
- Cash received from disposal of or sale of shares, warrants or redemption of funds other than those which are kept for trading purpose.
- Advances or loan made to third party other than by financing companies.
- Cash payment for future contracts other than trading purpose.
- Cash received from future contracts other than trading purpose.

Cash flow from financing activities

The activities which may result in change in size and composition of owner's capital including preference shares are called financing activities. Separate disclosure is important for financing activities.

Examples of Cash flows from financing activities include cash received on issue of shares, debentures, loans, bonds and other short- or long-term borrowings.

Cash payments on redemption of debentures bonds, preference shares etc.

Treatment of Some Typical Items

The treatment of some typical cash flow items is discussed below.

Extraordinary Items

Inflow or outflow of cash is classified according to the nature of activities that may be operating, investing, or financing activities. Cash flow due to extraordinary items should be shown separately in the cash flow statement to enable users to understand its nature and effect on the cash flow statement.

Interest and Dividends

If cash flow arises due to interest paid or interest and dividend received, then that should be classified as operating activities in case of "financial enterprises". In case of "other than financial organizations", the interest paid should be classified as financing activity, and the interest and dividends received should be classified as investing activity.

Note: Dividend paid should be classified as financing activity in both the above cases.

Taxes on Income

Taxes on income should be separately disclosed and should be classified under operating activities in most of the cases except where we can easily identify the taxes according to nature of income but if total amount of tax is given, then it should be classified as operating activities.

Note: Dividend distribution tax will be classified as financing activities.

Cash flows from acquisition and disposal of subsidiaries and other business units:

Cash flow arises due to acquisition or disposal of subsidiary should be shown separately and classified as investing activities. This transaction should be easily identifiable in cash flow statement to enable users to understand the effect of it. The case flow of disposal is not deducted from cash flow of acquisition.

Foreign Currency

Items appearing in a cash flow statement should be shown in local currency value, applying actual foreign currency rate of the particular day on which cash flow statement is going to be prepared. Effect on value of cash and cash equivalents as reflected in the cash flow statement due to change in rate of foreign currency should be shown separately as a reconciliation of changes.

Due to change in foreign currency rate, unrealized gains and losses are not cash flows. However, effect on cash and cash equivalents held or due in foreign currency are reported in cash flow statement in order to reconcile the cash and cash equivalents at the beginning and at the end of the period.

Non-Cash Transactions

Some investing and financing activities do not have any direct impact on cash flows. For example, conversion of debt to equity, acquisition of an enterprise by means of issuance of share, etc.

Those transactions should be excluded from cash flow statements, in which there are no use of cash or cash equivalents. There are other financial statements in which those investing and financing activities appear separately.

Format: (Direct Method)

M/s ABC LIMITED

Cash flow Statement for the year ended 31 March 2014

Particulars		Amount
Cash Flows from Operating Activities	(Schedule- 1)	XX
Cash Flows from Investing Activities	(Schedule- 2)	XX
Cash Flows from Financing Activities	(Schedule-3)	XX
Extraordinary Items		XX
Net Profit before Tax		XX
Income Tax Paid		XX
Net Increase or Decrease in cash or cash Equivalents		XX
Add: Cash & Cash Equivalents at the beginning of the period		XX
Cash and Cash Equivalents at the end of the period		XXX

Schedule - 1

Cash flow from operating activities

Particulars		Amount
Cash received from customers		XXX
Cash Paid for:		
- Suppliers for Purchases	XX	
- Wages & Salary	XX	
- Operating and General administrative expenses	XX	XX
Net Profit before Taxes →		**XX**
Income Tax Paid →		**XX**
Cash flow From Operating Activities →		**XXX**

Schedule-2

Cash flow from investing activities

Particulars		Amount
Cash received for:		
- Sale of Fixed Assets	XX	
- Sale of Investment	XX	
- Interest received	XX	
- Dividend received	XX	XXX
Cash paid for:		
- Purchase of Fixed Assets	XX	
- Purchase of Investments	XX	XX
Net Cash Flow from Investing Activities →		**XX**

Schedule-3

Cash flow from financing activity

Particulars		Amount
Cash received for:		
- Issue of Equity Shares	XX	
- Issue of Preference Share	XX	
- Long term borrowings	XX	
		XXX
Cash paid for:	XX	
- Interest paid	XX	
- Redemption of Preference shares	XX	
- Repayment of Loans	XX	
- Dividend paid	XX	XX
- Purchase of Investments		XX
Net Cash Flow from Financing Activities →		

Cash Flow Indirect Method

- Two Balance Sheet requires
- No need of Profit & Loss account in Indirect Method
- Non Cash Item require.
- We need change in current Assets & Current Liabilities account.
- No need to open, Opening current assets and current Liabilities accounts

Format: (Indirect Method): Given by AS-3

M/s XYZ LIMITED

Cash flow Statement for the year ended 31 March 2014

Particulars	**Amount**
Cash Flows from Operating Activities (Schedule- 1)	XX
Cash Flows from Investing Activities (Schedule- 2)	XX
Cash Flows from Financing Activities (Schedule-3)	XX
Extraordinary Items	XX
Net Profit before Tax →	XX
Income Tax Paid →	XX
Net Increase or Decrease in cash or cash Equivalents →	XX
Add: Cash & Cash Equivalents at the beginning of the period →	XX
Cash and Cash Equivalents at the end of the period →	XXX

Schedule-1

Cash flow from operating activities

Particulars	Amount
Changes in Profit & Loss account	XX
Changes in Reserve (Any)	XX
(+) Interim Dividend	XX
Net Profit →	XXX
Non Cash Items:	
(+) Depreciation	XX
(+) Loss on Sale of Fixed Assets	XX
(+) Goodwill Amortization	XX
(+) Preliminary Expenses written off	XX
Non Cash Incomes:	
(-) Gain on Sale of Fixed Assets	XX
Operating Profit before working Capital changes →	XXX
± Changes in Current Assets & Current liabilities	XX
Cash operating Expenses before Tax	**XXX**
Tax Paid	**X**
Cash Flow from Operating Activities →	**XXX**

Schedule-2

Cash flow from investing activities

Particulars		Amount
Cash received for:		
- Sale of Fixed Assets	XX	
- Sale of Investment	XX	
- Interest received	XX	
- Dividend received	XX	XXX
Cash paid for:		
- Purchase of Fixed Assets	XX	
- Purchase of Investments	XX	XX
Net Cash Flow from Investing Activities →		XX

Schedule-3

Cash flow from financing activity

Particulars		Amount
Cash received for:		
- Issue of Equity Shares	XX	
- Issue of Preference Share	XX	
- Long-term borrowings	XX	
		XXX
Cash paid for:		
- Interest paid	XX	
- Redemption of Preference shares	XX	
- Repayment of Loans	XX	
- Dividend paid	XX	
- Purchase of Investments	XX	XX
Net Cash Flow from Financing Activities →		XX