Course No.: 503 **MANAGEMENT ACCOUNTING (MAAC XIX)**

(For B.Com General and Accounting & Finance)

Marks: 80 **Hours: 40**

Objective: This course provides the students an understanding of the application of accounting techniques for management.

Course Contents

UNIT-I: Management Accounting: Meaning, nature, scope, and functions of Management accounting in decision making; Tools and Techniques of Management accounting.
20: 10 hrs

UNIT-II: Cash flow Statements as per Indian Accounting Standard 3 (revised), fund flow statement.
20: 10 hrs

UNIT-III: Absorption & Marginal Costing: Marginal & differential costing as a tool for decision making –making or buy; change of product mix; Pricing; Break-even analysis; Exploring new markets; Shutdown decisions.
20: 10 hrs

UNIT-IV: Budgeting for profit Planning and Control: Meaning of budget and budgetary control; Objectives; Types of budgets; Fixed and flexible budgeting, Functional budgeting; Control ratios; Zero base budgeting; Responsibility accounting; Performance budgeting.
20: 10 hrs

Text and references:

1. Arora M.N.: Cost Accounting-Principles and Practices; Vikas, New Delhi.
2. Jain S.P. & Narang K.L: Cost Accounting; Kalyani, New Delhi
3. Anthony, Robert & Reece, et al: Principles of Management Accounting; Richard Irwin Inc.
4. Horngren, Charles, Forest and Datar et al: Cost Accounting- A Managerial Emphasis; Prentice Hall, New Delhi.
5. Sriram: Management Accounting and Financial Analysis, New Central Book Agency, Hyderabad.
6. Paul: Practical Cost and Management Accounting, New Central Book Agency, Hyderabad.

Unit – 2: Funds Flow and Cash Flow Statement

Meaning of funds flow statement:

The financial statement of the business indicates assets, liabilities and capital on a particular date and also the profit or loss during a period. But it is possible that there is enough profit in the business and the financial position is also good and still there may be deficiency of cash or of working capital in business. Financial statements are not helpful in analysing such situation. Therefore, a statement of the sources and applications of funds is prepared which indicates the utilisation of working capital during an accounting period. This statement is called Funds Flow statement.

In popular sense the term 'fund' is used to denote excess of current assets over current liabilities.

According to R.N. Anthony, "Fund Flow is a statement prepared to indicate the increase in cash resources and the utilization of such resources of a business during the accounting period."

According to Smith Brown, "Fund Flow is prepared in summary form to indicate changes occurring in items of financial condition between two different balance sheet dates."

From the above discussion, it is clear that the fund flow statement is statement summarising the significant financial change which have occurred between the beginning and the end of a company's accounting period.

Meaning of Flow of Funds

The term flow means movement and includes both inflow and outflow of fund. The term flow of funds means the transfer of economic values from one asset of equity to another. Flow of funds is said to have taken place when any transaction makes changes in the amount of funds available before happening of the transaction. In effect, transaction results in increase of funds are called inflow of funds and transaction which decreases funds are called outflow of funds. Further if a transaction does not changes the funds , it is said to have no flow of funds. According to working capital concept of fund, the term flow of funds means movement of funds in the working capital. A transaction which increases the working capital is called inflow of funds and which decreases working capital is called outflow of funds.

Rule of flow of funds: The flow of fund occurs when a transaction changes on the one hand a non current account and on the other hand a current account and vice versa It means that a change in non current account followed by a change in another non current account or a change in a current account followed by a change in another current account will not result in the flow of fund.

Current and non current accounts

Current accounts are accounts of current assets and current liabilities. Current assets are those assets which are in the ordinary course of business can be or will be converted into cash within a short period of normally one accounting year E.g. Cash in hand and at bank, Bills receivable, sundry debtors, short term loans and advances inventories, prepaid expenses and accrued incomes Current liabilities are those liabilities which are intended to be paid within the ordinary course of business within a short period of normally one accounting year out of the current assets or the income of the business. It includes sundry creditors, bills payable outstanding expenses bank overdraft etc.

Noncurrent assets are assets other than current assets and include goodwill land, plant and machinery furniture trademarks etc. Noncurrent liabilities are liabilities other than current liabilities and include all other long term liabilities such as equity share capital debentures , long term loans etc.

To know whether a transaction results in flow of funds the following procedure can be applied

1. Analyze the transaction and find out the accounts involved
2. Make journal entry of the transaction
3. Determine whether the accounts involved in the transaction are current or non current
4. If both accounts are current, either current assets or liabilities, it doesn't result in flow of funds
5. If both accounts are noncurrent, either noncurrent assets or noncurrent liabilities, it doesn't result in flow of funds.
6. If accounts involved are such that one is a current account while the other is a non current account, it results in flow of funds

E.g.1.cash collected from debtors

Cash A/c……………….Dr

To Debtors A/c

Both cash and debtors a/c are current accounts and hence do not result in flow of funds. The transaction results in increase in cash and at the same time an equal decrease in debtors and thus do not result in change in working capital or funds.

E.g.2.purchase of new machinery in exchange of old machinery. Here also both the accounts involved are non current accounts and do not result in flow of funds

Eg.3.issue of shares for cash

Cash A/c……………….Dr

To share capital

Here one account is current and the other is non current and results in flow of funds. Here cash increases without any increase in current liability and results in increase in working capital and thus results in flow of funds.

In simple language funds move when a transaction affects:

Ø a current asset and a Non-current asset,

Ø a current asset and a Non-current liability, or

Ø a Non-current and a current liability, or

Ø a fixed liability and current liability; and

Funds do not move when the transaction affects:

Ø a current asset and a current liabilities, or

Ø a Non-current asset and a Non-current liability, or

Ø only noncurrent liabilities

Importance of Funds Flow Statement

A funds flow statement is an essential tool for the financial analysis and is of primary importance to the financial management. The basis purpose of funds flow statement is to reveal the changes in the working capital on two balance sheet dates. It also describes the source from which additional working capital has been financed and the uses to which working capital has been applied. By making use of projected funds flow statement the management can come to know the adequacy or inadequacy of working capital even in advance. One can plan the intermediate and long term financing of the firm, repayment of long term debts, expansion of the business, allocation of resources etc.

The significance of funds flow statement are explained as follows:

(1) Analysis of Financial Position: Funds flow statement is useful for long term financial analysis. Such analysis is of great help to management, shareholders, creditors, brokers etc. It helps in answering the following questions:

(i) Where have the profits gone?

(ii) How was it possible to distribute dividends in absence of or in excess of current income for the period?

(iii) How was the sale proceeds of plant and machinery used?

(iv) How was the sale proceeds of plant and machinery used?

(v) How were the debts retired?

(vi) What became to the proceeds of share issue or debenture issue?

(vii) How was the increase in working capital financed?

(viii) Where did the profits go?

Though it is not easy to find the definite answers to such questions because funds derived from a particular source are rarely used for a particular purpose. However, certain useful assumptions can often be made and reasonable conclusions are usually not difficult to arrive at.

(2) Evaluation of the Firm's Financing: One of the important use of this statement is that it evaluates the firm' financing capacity. The analysis of sources of funds reveals how the firm's financed its development projects in the past i.e., from internal sources or from external sources. It also reveals the rate of growth of the firm.

(3) Test of Adequacy: The funds flow statement analysis helps the management to test whether the working capital has been effectively used on not and whether the working capital level is adequate or inadequate for the requirement of business.

(4) An Instrument for Allocation of Resources: In modern large scale business, available funds are always short for expansion programmes and there is always a problem of allocation of resources. Funds flow statement helps management to take policy decisions and to decide about the financing policies and capital expenditure programmes for future.

(5) Guide for investors: The funds flow statement analysis helps the investors to decide whether the company has managed funds properly or not. It indicates the financial soundness of a company which helps the investor to decide whether to invest money in the company or not.

(6) A tool for Measuring credit worthiness: Funds flow statement indicates the credit worthiness of a company which helps the lenders to decide whether to lend money to the company or not.

(7) Future Guide: A projected funds flow statement can be prepared and resources can be properly allocated after an analysis of the present state of affairs. The optimal utilisation of available funds is necessary for the overall growth of the enterprise. A projected funds flow statement gives a clear cut direction to the management in this regard.

(8) It helps in lending or borrowing operations and policies: Lending institution, such as Banks, IFS, IDBI etc. also requires the funds flow statement besides the financial statements in order to know the credit worthiness of the concern and also its ability to convert assets into cash for making the payments at the scheduled time.

Limitations of Funds Flow Statement

In spite of various uses of funds flow statement, it has the following limitations

1) Historical : This statement only shows how the company has performed in the previous year and does not give much clarity of current and future costs of the company. Hence, realistic comparison of the profit position of the company is not shown. Also, projected fund flow statement is also not very accurate.

2) Static: A fund flow statement takes into consideration two particular time periods for the purpose of analysis of working capital. Hence, it cannot depict continuous changes. Also, it does not take into consideration noncash items in the company which, in actual accounting, play an important role in many companies.

3) Incomplete statement : This statement does not show the reasons behind changes in working capital. It only presents the changes in working capital in the form of statement.

4) Non original statement: It is not an original statement but simply re-arrangement of financial data over two accounting periods. It is due to this reason many companies avoid preparation of funds flow statement.

5) Not a substitute: Since this statement only gives an idea of changes in working capital of the company, it cannot be used as a substitute of income statement or a balance sheet. It is only a supplement to them.

6) Cash flow statement is preferred over funds flow statement: Cash Flow Statement, i.e. changes in cash position, is more important or more informative than the changes in working capital which is presented by a Funds Flow Statement.

7) Not a forecast: Fund flow statement does not forecast a firm's future performance. Its indication is related to the performance of the previous year.

8) Does not show constant change: It cannot show any constant changes. The reason revolves around the fact that only two specific years can be taken for the purpose of analysis.

Cash Flow Statement:

A Cash Flow Statement is similar to the Funds Flow Statement, but while preparing funds flow statement all the current assets and current liabilities are taken into consideration. But in a cash flow statement only sources and applications of cash are taken into consideration, even liquid asset like Debtors and Bills Receivables are ignored.

A Cash Flow Statement is a statement, which summarises the resources of cash available to finance the activities of a business enterprise and the uses for which such resources have been used during a particular period of time. Any transaction, which increases the amount of cash, is a source of cash and any transaction, which decreases the amount of cash, is an application of cash.

Simply, Cash Flow is a statement which analyses the reasons for changes in balance of cash in hand and at bank between two accounting period. It shows the inflows and outflows of cash.

Objectives of Cash Flow Statement

The Cash Flow Statement is prepared because of number of merits, which are offered by it. Such merits are also termed as its objectives. The important objectives are as follows:

1) To Help the Management in Making Future Financial Policies: Cash Flow statement is very helpful to the management. The management can make its future financial policies and is in a position to know about surplus or deficit of cash.

2) Helpful in Declaring Dividends etc.: Cash Flow Statement is very helpful in declaring dividends etc. This statement can supply necessary information to understand the liquidity.

3) Cash Flow Statement is Different than Cash Budget: Cash budget is prepared with the help of inflow and outflow of cash. If there is any variation, the same can be corrected.

4) Helpful in devising the cash requirement: Cash flow statement is helpful in devising the cash requirement for repayment of liabilities and replacement of fixed assets.

5) Helpful in finding reasons for the difference: Cash Flow Statement is also helpful in finding reasons for the difference between profits/losses earned during the period and the availability of cash whether cash is in surplus or deficit.

6) Helpful in predicting sickness of the business: Cash flow is helpful in predicting sickness of the business. A sound cash position is a true indicator of sound financial position.

7) Supply Necessary Information to the Users: A Cash Flow Statement supplies various information relating to inflows and outflows of cash to the users of accounting information in the following ways:

(i) To assess the ability of a firm to pay its obligations as soon as it becomes due;

(ii) To analyze and interpret the various transactions for future courses of action;

(iii) To see the cash generation ability of a firm;

(iv) To ascertain the cash and cash equivalent at the end of the period.

8) Helps the Management to Ascertain Cash Planning: No doubt a cash flow statement helps the management to prepare its cash planning for the future and thereby avoid any unnecessary trouble.

Importance of Cash Flow statement:

Cash flow statement is very useful to the management for short-term planning due to the following reasons:

(i) Show the relationship of net income to changes in the business cash: Generally there is direct relation between net income and cash. High net income leads to increase in cash and vice versa. But there may be a situation where a company's net income is high but decrease in cash balance and increase in cash balance when net income is low. Every user is interested to know the reasons or difference between the net income and net cash provided by operations.

(ii) Helpful in preparing Cash Budget: A Cash Budget is an estimate of cash receipts and disbursement for a future period of time. Cash Flow Statement provides help to the management to prepare Cash Budget. A comparison of cash budget and cash flow statement reveals the extent to which the sources of the business were generated and used as per the plans of the business.

(iii) Measurement of Liquidity: Liquidity means ability of a business enterprise to pay off its liabilities when due. Cash Flow Statement helps to know about the sources where from the cash will be available to pay off the liabilities.

(iv) Dividend Decisions: The Capacity of the firm to pay dividends to shareholders depends on the generation of cash flows. Cash flow statement helps the management to know about the sources of cash to pay off dividend.

(v) Prediction of sickness: With the help of preparing cash from operation a business enterprise may come to know about cash losses in operation. It helps to predict this type of sickness.

(vi) Future Guide: Most of the users are interested to assess the ability of the firm in generating future cash flows, its timing and certainty. These questions can be answered by analysing the cash flow statement.

(vii) The use of cash in investing and financing Transaction: Information in cash flow statement would be useful to find out as to how cash has been obtained from investing and financing activities and how cash has been used to invest and repay borrowings etc.

The statement would be useful to users to ascertain the following:

a) The change in the net assets of the business.

b) The change in the financial structure.

c) The financing of expansion.

d) The utilisation of finance obtained by the enterprise.

e) The impact of investing and financing activities on the cash balance of the enterprise.

(viii) Enhances the Comparability of report: It enhances the comparability of the reporting of operating performance by different enterprises, because it eliminates the effect of using different accounting treatments for the same transactions and events.

Limitations of Cash Flow Statement

Though the Cash Flow Statement is a very useful tool of financial analysis, it has its limitations which must be kept in mind at the time of its use. These limitations are:

1) Non-cash Transactions are ignored: The Cash Flow Statement shows only inflows and outflows of cash. It does not show non-cash transactions like the purchase of buildings by the issue of shares or debentures to the vendors or issue of bonus shares.

2) Not a substitute for an Income Statement: An income statement shows both cash and non-cash items. The income statement shows the net income of the firm whereas the Cash Flow Statement shows only the net cash inflows or outflows which do not represent the net profits or losses of the enterprise.

3) Historical in Nature: It rearranges the existing information available in the income statement and the balance sheet. It will become more useful if it is accompanied by the projected Cash Flow Statement.

4) Ignorance: It ignores basic accounting concept, i.e., accrual concept.

5) What is Cash: It is difficult to precisely define the term 'cash'. There are controversies over a number of items like cheques, stamps, postal orders, etc. to be included in cash.

6) Does not reveal true liquidity position: A Cash flow statement reveals the inflow and outflow of cash but the exclusion of near cash items from cash obscures the true reporting of the firm's liquidity position.

7) Working Capital ignored: Working Capital being a wider concept of funds, a funds flow statement presents a more complete picture than cash flow statement.

8) Not a substitute of funds flow statement: It cannot replace funds flow statement as it cannot show the financial position of the concern in totality.

CLASSIFICATION OF CASH FLOWS

The revised Accounting Standard [AS-3] has made the following classification in respect of cash flows.

1. Cash flows from operating activities
2. Cash flows from investing activities
3. Cash flows from financing activities

1. Cash flow from operating activities: These are cash flows from regular course of operations. The operations of a firm include manufacturing, trading, rendering of services etc. Examples of cash flows from operating activities are:

a. Cash sales

b. Cash received from debtors on account of credit sales

c. Cash purchase of goods

d. Cash paid to suppliers on account of credit purchases

e. Wages paid to employees and staff

f. Cash operating expenses

g. Income from investing activities

2. Cash from investing activities: The investing activities of a business include purchase and sale of fixed assets like land buildings, equipments, machinery etc. Acquisition or disposal of companies also comes under investing activities. These are separately discloses in cash flow statement. E.g.

a. Cash payments to acquire fixed assets

b. Cash receipts from disposal of fixed assets

c. Cash payments to acquire shares, debt instruments or warrants

d. Cash receipts from disposal of shares

e. Cash advances and loans made to third parties

3. Cash flows from financing activities: The financing activities of a firm include issuing or redemption of share capital, issue and redemption of debentures , raising and repayment of long term loans etc. these are items changing the owners equity and debt capital during an accounting year. Dividends paid to shareholders also come under financing activities. E.g.

a. Cash proceeds from issuing shares or other similar instruments

b. Cash proceeds from issuing debentures, loans, notes , bonds and other short or long term borrowings and

c. Cash repayments of amounts borrowed such as redemption of debentures, bonds, preference shares.

Distinguish between:

(a) Funds flow statement and Balance sheet

(b) Funds flow statement and cash flow statement

(c) Funds flow statement and Income statement

(d) Cash Flow Statement and Cash Budget

(a) Difference between Funds flow statement and Balance sheet:

Balance sheet:	**Funds flow statement**
(i) Balance sheet is a statement showing the financial position of the concern on a particular date. It shows all assets and liabilities whether current or fixed, tangible or intangible etc.,	While Funds Flow Statement shows the changes in current assets an current liabilities during a particular period of time.
(ii) Balance Sheet shows the total financial position on a particular date and its utility is very limited for the management.	On the other hand, Funds Flow Statement is a comparative statement of assets and liabilities and depicts the changes in working capital during the period of two Balance sheets.
(iii). Balance Sheet represents the balance of various assets and liabilities and does not present analysis of any kind.	Funds Flow Statement is an analysis and control device for the management. It is a modern technique of knowing the inflows and outflows of funds during a particular period
(iv) while on the other hand, long-term financial position means future financial structure of the firm. Both are inter-relate but there is a differences in their analysis. The short-term view of the financial position of the firm cannot be had from the Balance Sheet.	There are two views of the financial position of the firm-long term and short-term. Short-term financial position means the solvency of the firm in the near future

(b) Difference between Funds Flow Statement and Cash Flow Statement

Basis of Difference	Funds Flow Statement	Cash Flow Statement
Basis of Analysis	Funds flow statement is based on broader concept i.e. working capital.	Cash flow statement is based on narrow concept i.e. cash, which is only one of the elements of working capital.
Objective	The object funds flow statement is to disclose the magnitude, direction and causes of changes in working capital.	The object of cash flow is to disclose the magnitude, direction and causes of changes in cash and cash equivalents.
Source	Funds flow statement tells about the various sources from where the funds generated with various uses to which they are put.	Cash flow statement starts with the opening balance of cash and reaches to the closing balance of cash by proceeding through sources and uses.
Usefulness	Funds flow statement is more useful in assessing the long-term financial position.	Cash flow statement is more useful in assessing the short-term financial position of the business.
Schedule of Changes in Working Capital	In funds flow statement changes in current assets and current liabilities are shown through the schedule of changes in working capital.	In cash flow statement changes in current assets and current liabilities are shown in the cash flow statement.
Causes	Funds flow statement shows the causes of changes in net working capital.	Cash flow statement shows the causes of changes in cash.
Principal of Accounting	Funds flow statement is based on the accrual basis of accounting.	In cash flow statement, data are obtained on accrual basis which are converted into cash basis.
Compulsion	There is no prescribed form for preparation of Funds flow statement.	Cash flow statement is compulsory to be prepared in prescribed proforma as given in AS – 3.

Basis of Difference	Funds Flow Statement	Cash Flow Statement
Relationship	Funds flow statement can be prepared from the cash flow statement under indirect method.	But a cash flow statement cannot be prepared from funds flow statement.
Financial Health	Sound fund position does not necessarily mean sound cash position.	But sound cash position is always followed by sound fund position.

(c) Difference between Income Statement and Funds Flow Statement

Basis	**Income Statement**	**Funds Flow Statement**
Meaning	Income statement is a summary of total income and total expenses and losses of a particular period.	Funds flow statement is the statement of changes in financial position
Objectives	Income statement is prepared to ascertain the profit earn or loss suffered by a firm.	Funds Flow Statement is prepared to identify how the profit has been utilized.
Preparation	Income statement is prepared on the basis of nominal accounts.	Funds flow statement is prepared on the basis of balance sheet.
Measurement	Income statement is helpful in measuring the profitability of a firm.	Funds flow statement is helpful in determining the net changes in working capital.
Period	It is usually prepared after six months or a year.	It is usually prepared every month.
Matching	This matches the cost of goods sold with the revenue in order to know the profit or loss.	This statement matches the funds raised with funds applied without making any distinction between capital and revenue items.
Scope	It presents the result of all financial transactions of the business during a specified period.	It presents information only relating to working capital and thus its scope is limited.
Reliability	It is not very reliable as items shown in profit or loss account	It is more reliable as items shown in this statement cannot be easily

Basis	Income Statement	Funds Flow Statement
	can be easily manipulated by the management.	manipulated by the management.

(d) Difference between Cash flow statement and Cash Budget:

Basis	Cash Flow Statement	Cash Budget
Objective	It is prepared to explain to management the sources of cash and its uses during a particular period of time.	It is prepared to show the probable cash position at a planned operation.
Technique of analysis	It is a technique of past analysis.	It is a technique of future financial forecasting.
Emphasis of source	It does not emphasise on a particular source and use.	It emphasises on the financial pattern to meet seasonal or temporary cash needs.
Coverage	It summarises effect of specific cash transactions into three categories operating, investing and financing activities of an enterprise during a period in prescribed format.	It can also be coordinated in relation to total working capital, sales, investments and debts.
Meaning	It means inflows and outflows of cash and cash equivalents.	It is estimated receipts and payments of cash over a period of time.
Period	It covers a period of one year.	It is broken into monthly, weekly segments