**Shri sangameshwar shikshan samstha’s**

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**Department of commerce**

**MANAGEMENT ACCOUNTING.**

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Unit – 1

**Nature and scope of Management accounting.**

**Meaning of Management Accounting**

Management Accounting is the presentation of accounting information to management in order to formulate the policies and assist in its day-to-day activities . In other words, it help the management to perform all its functions including planning, organizing, staffing, directing and control.

**Definition of Management Accounting**

The Institute of cost and Management Accountants, London, has defined Management Accounting as, "the application of professional knowledge and skill in the preparation of accounting information in such a way as to assist management in the formulation of policies and in planning and control of the operation of the undertaking."

According to R.N Anthony, “Management Accounting is concerned with accounting information that is useful to management

**Objectives of Management Accounting**

The objectives of management accounting are as follows:

1. To present financial information to the management in a way that is easily understandable
2. To supply necessary data to the management for formulating future plans. The data includes statements pertaining to past results and estimates for the future.
3. To help in keeping the actual performance as per the plans made by the management.
4. To establish a strong, working relationship amongst different individuals pertaining to different departments, of the same organization.
5. To maximize the wealth of the organization

(Vi) To motivate the employees, by fixing targets and providing incentives“ (Vii) To keep the tax burden of the organization minimum

(viii) To keep the management fully informed about the latest position of the organisation

**Nature of Management Accounting**

1. Mainly concerned with future : Planning is the process of looking ahead by taking the reference of the past. The process of management accounting is driven towards the future course of action with proper planning based on the analytical financial details other past. It considers the budgets to forecast the future revenue and expenditure and inflow and out follow of funds.
2. Recent origin: Management accounting has been well recognized in the modern business houses due to increasing customer base and market complexity. Modern managerial decisions need much quantitative organized information rather traditional form of financial statements for making effective decisions.
3. Management need oriented: Management Accounting is highly personalized service and Subjective in nature. It is basically intended for the use of internal managerial decisions. It provides necessary information as per the need of the management in therequired format and ensures that the information’s are sufficient to make effective decisions.
4. Information as per Management need: There is no hard and fast rule in the preparation of management reports and statement, it always as per the situationalrequirement of the management and based on the availability of the data for analysis and interpretation.
5. Provides data and not the decisions: Management accounting discipline is not an replacement of management. It provides just information to the managerial decisions. It facilitates decisions since majority of the decisions are made considering the facts and figures provided by the management accountants. But at the same time these data itself cannot form the decisions of the management.
6. Objective oriented: Management accounting present data in such a way that it enables the management to formulate policies and programme so as to achieve the managerial or organizational goals in most efficient and effective manner.
7. Financial and cost accounting information: Management accounting is all about the analysis

and interpretation of financial and cost accounting data, to generate such reports and statements which can prove useful to management in decision making.

1. Increases efficiency: Management accounting is concerned with providing, the needed information to the Management in the proper manner and assisting in the policy formulation and managerial control. This enables the management to increase efficiency of its operation and ensures the optimum profits with minimum operational risk

Apart from the above unique features Management Accounting is also characterized by the following:

1. It does not follow any fixed norms or formats.
2. Basically concerned with forecasting
3. Mainly used for Internal purpose.
4. Useful in managerial decision making.
5. It is not compulsory as the any other disciplines like financial accounting and cost accounting. It is purely optical to the management .
6. It is an interdisciplinary subject since it mainly depends on the financial and cost accounting

**Scope of Management Accounting**

1. **Financial Accounting** : Accounting is the process of systematic recording of financial transactions so as to determine the true and fair financial position of a concern.

Management accounting derives the necessary data from the financial accounting. For instance when fund flow statement or Ratio statement are to be prepared, financial statements are very essential without which the preparation and decision about fund flow and ratios are not possible.

1. **Cost Accounting**: Management accounting uses certain technique and tools of cost accounting as well. Cost accounting provides the various techniques of costing, viz, Marginal Costing, Standard Costing, Differential Cost Analysis etc. which plays significant role in the operation and control of the enterprise It assists management in measuring the operational efficiency of the management and achieving managerial goals.
2. **Budgetary Control**: Budgetary control is a system of controlling Costs thorough establishment of standards. It controls the activities of the business and measures the variance by comparing the actual with the budgeted figures and enquires into the reasonsof such variance at each and every step, so that the adverse variance may not be repeated in future.
3. **Tax Planning**: It is concerned with the computation of taxable income according to Income- Tax Act, and filing of returns and the payment of tax. It is one of the core functions of the modern management accountant, facilitating management in proper tax planning and accounting.
4. **Analysis and Interpretation of Accounts**: Financial statement can be better understood through comparative study. The primary duty of the managementaccountant is to explain the data relating to the management and assist management in taking decisions.
5. **Reporting:** Management accounting uses the technique of statistics wherever necessary for effective analysis and interpretation. Sometimes reports on various aspects of the business are to be submitted by the management accountants. At the time of preparation of the statement or Repots, they use different statistical techniques, viz, Line Chart, Pie Chart, Index Numbers etc. in order to be more attractive and intelligible.
6. **Internal audit and control**: Management accountants depend on the internal audit and use that for generating reports on various financial issues for decision making.
7. Budgetary Control: Budgetary control is a system of controlling costs thorough establishment of standards. It controls the activities of the business and measures the variance by comparing the actual with the budgeted figures and enquires into the reasons of such variance at each and every step, so that the adverse variance may not be repeated in future.
8. **Tax Accounting**: It is concerned with the computation of taxable income as per Income Tax Act, and filing of returns and the payment of tax. It is one of the core functions of the modern management accountant, facilitating management in proper tax planning and accounting.
9. **Analysis and Interpretation of Accounts**: Financial statement can be better understood through comparative study. The primary duty of the management accountant is to explain the data relating to the management and assist management in taking decisions.
10. **Management Information System**: It is very difficult to imagine organisations without computers in the globalized corporate environment. Information’s are stored and supplied to

the management with the help of computers for managerial decisions. The advancement in the technology has made management accountants job much easier and effective and has made more depended on the technology from time to time.

**The important tools and techniques are briefly explained below.**

1. **Financial Planning**

The main objective of any business organization is maximization of profits. This objective is achieved by making proper or sound financial planning. Hence, financial planning is considered as best tool for achievingbusiness objectives.

1. **Financial Statement Analysis**

Profit and Loss account and Balance Sheet are important financial statements. These statements are analyzed for different period. This type of analysis helps the management to know the rate of growth of business concern. This analysis is done through comparative financial statements, common size statements and ratio analysis.

1. **Cost Accounting**

Cost accounting presents cost data in product wise, process wise, department Wise branch wise and the like. These cost data are compared with predetermined one. This comparison of two costs enables the management to decide the reasons responsible for the difference between these costs.

1. **Fund Flow Analysis**

This analysis find out the movement of fund from one period to another. Moreover, this analysis is very useful to know whether the fund is properly used or not in a year When compared to the previous year. The working capital changes and funds from operation are also find out through this analysis.

1. **Cash Flow Analysis**

The movement of cash from one period to another can be find out through this analysis. Besides, the reasons for cash balance and changes between two periods are also find out. It studies the cash from operation and the movement of cash in a period.

1. **Standard Costing**

Standard costing is predetermined cost. It provides a yard stick for measuring actual performance. It is used to find the reasons for the deviations if any.

1. **Marginal Costing**

Marginal costing technique is used to fix the selling price, selection of best sales mix, best use of scarce raw materials or resources, to take make or buy decision, acceptance or rejection of bulk

order and foreign order and the like. This is based on the fixed cost, variable cost and contribution.

1. **Budgetary Control**

Under Budgetary control techniques, future financial needs are estimated and arranged according to an orderly basis. It is used to control the financial performances of business concern. Business operations are directed in a desired direction.

1. **Ratio Analysis**

It is used to management in the discharge of its basic functions of forecasting, planning, coordination, communication and control. It paves the way for effective control 0f business operations by undertaking an appraisal of both the physical and monetary targets

1. **Revaluation Accounting**

The fixed assets are revalued as per the revaluation accounting method so that the capital is properly represented with the assets value. It helps to find out the fair return On capital employed.

1. **Decision-making Accounting**

A business problem can be solved by choosing any one of the best and most profitable alternative. To select such alternative, the relevant costs are compared. Thus, accounting information are used to solve the business problem which are arising out of increasing complexity of nature of business.

1. **Management Information System**

The free flow communication within the organization is essential for effective functioning of business. Hence, the management can design the system through which every employee of an organization can assess the information and used for discharging theirduties and taking quality decision

**Difference between Financial Accounting and Management Accounting**

|  |  |  |
| --- | --- | --- |
| Basis | Financial accounting | Management Accounting |
| Users | Mainly intended to serve external users like share holders, bankers, creditors and  government. | Mainly intended to serve internal users like management |
| Legality | Statutorily compulsory as per different acts such as companies act of 1956 income tax act of 1961etc. | Not compulsory |
| Development | It is well developed and very old system in practice | It is of recent development |

|  |  |  |
| --- | --- | --- |
| Subject matter | It deals With preparation of financial statements through systematic recording and determines the financial position of a  concern. | It deals with presentation of needed information for management for effective decisions. |
| Standard | There is specific standard for Preparation as per the act and reports are practice. | Preparation of statements and reports are not standardized |
| Dependency | It is an independent discipline . discipline. | It is an inter dependent. |
| Publications | It is compulsory to publish the financial reports of the concern. | It is not compulsory. |
| Statement and report prepared | Generally Trading and profit and loss account and balance sheet areprepared | It prepares the funds and cash flow statement, budgetary reports, ratio statements etc, |
| Consideration | It considers only monetary transactions. | It sometime considers non monetary aspect also like quality, machine  hours, number of people working etc. |
| Auditing | Audit of books of accounts by a qualified charted accountant iscompulsory | It is not necessary to getaudited the records of management accounting, |

**Difference between Cost Accounting and Management Accounting**

|  |  |  |
| --- | --- | --- |
| Basis | Cost Accounting | Management Accounting |
| Functions | Basically executes the function of identification and recording of cost and cost control in the operation. | It basically assists management in decision making through providing necessary information. |
| Statutory compulsions . | It is necessary to maintain cost records in a systematic way in certain manufacturing industries asper the notification of the notification | It is purely optional to management |
| Focus | It is focused on cost identificationand cost control. | It is focused on the effective decisions for optimum managerial efficiency and objective attainment. |
| Users of the information | It is used by both internal as well as external parties. | Used by only internal parties. |
| Data used | It derives certain data from financial records. | It derives data from financial books, cost books as well as certain other sources. |
| Scope and coverage | The scope of this discipline is limited to the extent of cost recording and  reporting | The scope of this discipline is broader and covers various aspects  like finance, costing, taxation, audit |

|  |  |  |
| --- | --- | --- |
|  |  | and investments |
| Tools and techniques used | It follows well developed tools and techniques for identification and  recording of cost. | It doesn’t have well developed tools or technique. |

**Differences between Financial Accounting and Cost Accounting**

|  |  |  |
| --- | --- | --- |
| Basis | Financial accounting | Cost accounting |
| 1. Purpose | It serves the interest of business and other interested parties by Providing suitable information in the financial  statements. | It renders information for the guidance of the management for the proper planning control and decision  making. |
| 2. Options | F A is required to be kept as per the requirements Of the company act and income tax act. | CA is voluntarily kept to serve the management in the discharge of management functions. |
| 3. Analysis | FA reveal the profit of the business as a whole. | CA shows the profit result of each business as a whole operations  process and product |
| 4. Recording | It consists of classification recording and analysis of transaction in a subjective manner i.e., according to  the nature of expenditure. | It records in an objective manner i.e., according to which cost are incurred |
| 5. Control | It lays emphasis on the recording aspect, no consideration is given to control aspect. | It provides for a detailed system of control with the help of standard costing and budgetary control. |
| 6. Reporting | It involves reporting of  business performance at the end of  the accounting year. | There is a continuous flow of data information of cost report to  management. |
| 7. Obligation | This is to be maintained compulsory. | This is to be maintainedvoluntarily. |
| 8.Audit | Audit of FA is statutory | Audit of CA is not compulsory. |
| 9. Duration of | FA provides financial information once a year. | CA furnishes reporting cost data at frequent intervals. |
| 10. Pricing | It fails to guide the formulation of pricing policy. | It provides adequate data for formulating pricing policy. |
| 11. Valuation of Stock | Stock is valued at cost or marked rice whichever is less. | Stock is always valued at cost price. |

**Limitations of Management Accounting**

1. **Data Dependency**

Management accounting derives information from Financial accounting, Cost accounting and other sources. So, the conclusions arrived at by management accountants depend to a large extent on the accuracy of these two (Financial accounting and Cost accounting) records.

Therefore, if the past data which are collected from the financial and cost records are found inaccurate, the decisions suggested by the management accountants, on the basis of the above, also will be inaccurate.

1. **Does not give the decision**

Management accounting cannot replace the decisions. It can just assist the management in its operations through providing necessary analytical statements and advises management for better and efficient managerial functions.

1. **Costly affair**

Installation and maintenance of Management accounting system is suitable for those concerns which has significant amount of transactions generally large establishments. before, small concerns cannot afford to adopt this system.

1. **No standardization as other disciplines**

Management accounting is still in the development stage. So it has to face the problems fluidity of concepts, improvement of techniques etc. It does not have any strong principles like financial accounting and cost accounting. It does not follow any set rule and hence differs in its practices.

1. **Danger of misleading**

The information Provided by Management accountants cannot be taken as full proof information for making any managerial decisions. Because the data used by management accountants itself may have window dressed data due to which the management accounts may mislead the management.

1. Needs human involvement for interpretation Management accounting involves people to make final reports or interpretations, due to which the interpretation may be of the personal opinion of the person Who has prepared it.

It creates differences in the interpretations and becomes more subjective rather than objective in the analysis

**Unit - 2**

**FINANCIAL STATEMENT ANALYSIS**

**Meaning of Financial Statement**

Financial statements are the essential documents of business. They are the outputs of financial accounting. They are the final products of the accounting process. They are statements containing financial information of a business enterprise. They convey certain message to feel financial pulse of an organization. The basic purpose of preparing financial statements is to convey information about financial position of the enterprise to owners, creditors and the investors.

**Objectives of Financial Statements**

Financial statements serve as a horoscope of a business. This is so because they enable readers to measure financial position of a concern. The main objective of financial statements is to provide information about the financial position and performance of an enterprise that is useful to users in making decisions. The other objectives are summarized below:

1. To provide information about assets and liabilities of a firm.
2. To provide useful information to various parties interested in financial statements 3 To present true and fair view of the business.

4. To estimate the earning capacity of the enterprise.

5 To determine the debt capacity of the concern.

6. To decide about the future prospects of the business.

Thus, the ultimate Objective of financial statements is to get better insight about the financial strengths and weakness of the firm.

**Nature of Financial Statement**

The following characteristics of financial statements indicate their nature:

1. **Recorded Facts**

The term recorded facts refers to the data drawn from accounting records. Only those facts which have been recorded in the books are shown in the financial statements.

1. **Accounting Principles**

In the preparation of financial statements, certain accounting principles, concepts and conventions are followed. For example: The principle of cost price or market price whichever is less is followed for valuation of stock.

1. **Assumptions**

Business transactions are recorded on certain assumptions. For example: In preparing financial statements, the accountants make many assumptions like that the value of money remains constant, going concern concept etc.

1. **Personal Judgment**

The financial statements are affected by the personal judgment of accountants. For example: The method of stock valuation, method of depreciation etc. depend on the personal judgment of the accountant. The accountant can select one of the available methods of stock valuation, depreciation etc.

**Essential of Financial Statements**

The financial statements should possess the following essential qualities:

1. **Understandability**

Financial statements should be easily understandable by users. For this, the information contained in these statements should be clear and simple.

1. **Relevance**

The financial statements must contain only relevant information. Then only the users can evaluate past, present and future events and can take wise decisions.

1. **Reliability and Accuracy**

Financial statement should disclose information in such a way that the users can compare the current year’s progress with that of previous year. Users must also be able to compare the financial performance of reporting company with that of other companies.

1. **Comparability**

Financial statements should disclose information in such a way that the users can compare the current year’s progress with that of previous year. Users must also be able to comparethe financial performance of reporting company with that of other companies.

1. **completeness**

the information contained in the financial statements should be complete in all respects. This means all information should be shown in these statements. It further means that the information shown in the financial statements should not mislead creditors, investors and other users.

1. **Timeliness**

The financial statements should be prepared within a reasonable time after the accounting period is over. If the statement are not prepared and presented in time, they cannot be properly used. Beside, the firm cannot formulate plans for future.

**\*Meaning of Analysis and Interpretation of Financial Statement**

The term "analysis" can be understood as the process of splitting the facts or data found in the financial statements into simple elements. The term "interpretation" can be understood as the explanation of the meaning and significance of the financial data, so simplified with a view to throw light on the profitability and financial position of an enterprise.

*In the word of Myers,* "Financial statement analysis is largely a study of relationship among the various financial factors in a business as disclosed by a single set of statements, and a study of the trend of these factors as shown in a series of statements".

**Types of Financial Statement Analysis**

1. **on the basis of modes operating**
2. ***Horizontal Analysis***: Financial analysis is done for number of years, it is known as horizontal analysis. Such analysis set a trend wherein the figures of various years are compared with base year. Decision based on the trend percentage example: Trend percentage and Comparative financial statement.

It is also known as dynamic analysis as it measures the change of position of the business over a number of years.

1. ***Vertical Analysis***: Analysis is made for data covering one year’s periods it is known vertical

analysis. Example: Ratios and Common size financial statement

It is also known as static analysis as it measures the statement of affairs of the business as on given period of time.

1. **On the basis of material used**
2. ***External Analysis***: Financial statements analysis is made by outsiders who have no access to the books of accounts they have depend on the published accounts. Example: Shareholders, Creditors, Government agencies etc.
3. ***Internal Analysis:*** Financial statements analysis is made by internal parties who have access to the books of accounts such as management, employees etc.

**Types of Analysis and Interpretation of Financial Statements**

**Financial Statements can be analyzed by using the any one of the following method.**

1. Comparative financial statement analysis.
2. Common-size statement analysis.
3. Trend analysis
4. Ratio analysis.
5. Fund flow analysis.
6. Cash flow analysis.
7. **comparative Financial Statements.**

Under this method the financial statements of the different period of the same concern will be compared in order to derive significant change in the financial and profitability position of the concern. It denotes the changes (i.e increase or decrease) in the financial figures between two or more years, in terms of money value and as well as in term of percentages. In other words, they are those financial statements which summarizes and present relative accounting data for a number of years, incorporating therein the changes in individual items of accounting figures.

**Comparative Statement Analysis can be :**

1. Comparative Income Statement Analysis
2. Comparative Balance Sheet Analysis

**Objectives or Purposes of Comparative Financial Statements**

1. To make the data simpler and more understandable.
2. To ascertain the changes occurring year by year in financial position and performance of the enterprise.
3. To find out the strength and weakness of liquidity, solvency and profitability.
4. To help the management in forecasting and planning.
5. .**common-size Financial Statements Analysis**

In Common-size financial statements the data or figures presented in the statements are converted into percentages, taking some common base. The total of Assets or, Liabilities and capital is taken as 100% and all the items in the balance sheet are expressed as a percentage of this total. In case of the common size income statement, the Net sales figure is taken as 100% and all other items of the income statement are expressed as a percentage of Net Sales.

**common-size financial statements mainly include;**

1. Common-Size Income Statement and
2. Common-Size Balance Sheet

***Common-size Income Statement***

In case of common size income statement, the net sales figure is taken as 100% and all other items of the income statement are expressed as a percentage of Net Sales. It enables to know relative contribution of each element of the income statement on sales and profit of the concern. It also facilitates for the effective controlling of the operations so as optimize thereturn on investments.

**Trend Analysis**

Sometimes, it becomes necessary to known the trend changes in the financial position of the concern When a concern needs to know the profitability trend of the organization only profit and loss account independently may not serve the purpose. In such case, it is necessary to prepare a statement of the profit or loss or Balance sheet for many years and taking any previous year as base the trend or changes in the financial position can be prepared. When the financial statements of a number of years are analyzed, the analysis is called trend analysis

It is also called as horizontal analysis since it is prepared for many years taking any previous year as base year. In other words, horizontal analysis is a type of analysis in whichthere is comparison of the trend of each item in the financial statements over a number of years.

**Trend analysis as a tool of Decision-making**

Statement of trend analysis helps in many managerial decisions. It enables to find Out the growth or decline percentage or the pattern of changes that are taking place in an organization. It enables managers to take necessary measures to curb the unhealthy trends in the organizations. It is also useful to investors, Bankers and creditors to make effective financial decisions on the company. Its uses is outlined below:

1. Sales trend in the organization can reflect on the efficiency of the sales department.
2. Sales trend enables management to take necessary steps wherever required to improve the overall operational efficiency.
3. Trend on cost of operation facilitates to take decisions on cost control and improving profitability.
4. Trend in the profitability reflects the overall efficiency of the organization in utilizing its resources and optimizing the return on investments.

**Unit 3 Ratio analysis**

# Meaning of ratio analysis

Ratio analysis is one of the important technique of financial analysis where ratios are used as a yard stick for evaluating the financial condition and performance of a firm.

According to accountants hand book by Winson Kenn and Bed Ford “A ratio is an expression of the quantitative relationship between two numbers”

# Uses or advantages of ratios

1. It simplifies the financial statement.
2. It facilitates inter firm comparison.
3. It helps in planning.
4. It makes intra firm comparison possible.
5. The ratios can assist the management in its basic functions of planning, forecasting, co- ordination, control and communication.

# Classification of ratios

Various Accounting ratios can be classified as follows

1. Traditional ratios
2. Functional ratios
3. **Traditional ratios:** It consists of
   1. Balance sheet ratios
   2. Revenue sheet ratios or P&L A/c ratios
   3. Composite or inter statement ratios
4. **Balance sheet ratios:** ratios calculate on the basis of the figures or information’s of balance sheet only are known as balance sheet ratios. Example: current ratio, liquid ratio, debt equity ratio etc.
5. **Revenue sheet ratios or P&L A/c ratios:** ratios calculated on the basis of the

information’s or the figures of profit and loss account are called revenue ratios or profit and loss account ratios. Example: gross profit ratio, net profit ratio, stock turnover ratio etc.

1. **Composite or inter statement ratio**: ratios based on the figures of balance sheet as well as the profit and loss account are known as composite ratio. Example: return on

proprietor’s fund, earning per share etc.

1. **Functional ratios:** on the basis of function or tests accounting ratios are broadly classified as under.
   1. **Liquid ratios:** It includes
      * Short term solvency ratios
      * Long term solvency and leverage ratio
      * Activity ratio
      * Profitability ratio etc.

Liquidity ratio refers to the ability of the concern to meet its current obligation as when they arrives liquidity ratios are the ratios which measures the short term solvency of the firm.

The sufficiency or insufficiency of the current asset should be assessed by comparing them with short term liquidity.

# Significance of ratio analysis

1. It is an useful and important technique to check upon the efficiency with which working capital is being used in the enterprise.
2. It helps in cost control.
3. It is a medium of communication of financial position of a concern.
4. It is very helpful in financial forecasting.
5. It facilitates for comparison.
6. Financial ratios are very helpful in the diagnosis and financial health of a firm.

# Limitations of ratios

1. Ratios are based on many assumptions and hence these may mislead the decision makers.
2. Ratios are meaningful only when they are studied with other ratios. A ratio alone cannot be meaningless by itself.
3. Understanding of ratios needs professional knowledge. Hence, it cannot be used by common people.
4. Ratios alone are not adequate for judging the financial position of a business.
5. Ratios will not give decisions: It is just information to make effective decisions.
6. There is no standardization in ratios.
7. Does not reflect the qualitative aspects.
8. It is based on financial statements.

# Unit 4

**Fund flow statement**

# Meaning of fund

The term fund can be used in three different ways. They are:

In narrow sense: It means cash or money.

In broad sense: It means all financial resources.

In popular sense: In the context of funds flow statement, the term fund means working capital. It is the excess of current assets over current liabilities.

# Meaning of Fund Flow Statement

Fund flow statement is a statement in a summary form depicting the changes in the items of financial position between two balance sheet dates and showing sources and application of funds.

# Objectives or purposes of Fund Flow Statement

* To know the changes in working capital during the period.
* To understand the working capital position of the firm.
* To assess the financial condition of the firm.
* To anticipate the working capital position.
* To reveal the most important changes those have taken place during a particular period.
* To provide a basis for budgeting.

# Importance or uses or benefits of fund flow statement

1. **Useful to share holders**
   1. It provides information regarding the availability of funds in the business.
   2. It indicates the earning capacity of the business.
   3. It enables to know the ability of the company to pay the dividend.

# Useful to long term creditors and debenture holders

* 1. It helps to understand whether the money borrowed is utilized or not.
  2. It enables to judge the capacity of the company to repay the loan or debentures.

# Useful to short term creditors, banks and financial institutions

* 1. It helps to know whether the money borrowed is utilized or not.
  2. It helps to know whether the company can pay interest and to repay the principal in time.

# Useful to management

* 1. Planning temporary investment of funds.
  2. Evaluating proper utilization of funds.
  3. Formulating sound dividend policy.
  4. Estimating future working capital requirement.
  5. Testing whether working capital is effectively utilized.
  6. Taking appropriate decisions regarding purchase of assets.
  7. Identifying any necessary investment in fixed assets.
  8. Understanding the reason for financial difficulties, if any.
  9. Planning for redemption of long term debts.
  10. Ascertaining funds from operation.

# Limitations of fund flow statement

1. It shows what happened in the past. Hence, it is historical in nature.
2. It is only a rearrangement of data given in financial statements. Hence, it is not original.
3. It cannot reveal continuous changes.
4. It does not take into account those transactions which do not affect the working capital.
5. It is not as useful as cash flow statement.
6. It does not reveal the cash position of a firm.

# Steps involved in preparation of Fund flow statements

Step -1 preparation of schedule of changes in working capital.

Step -2 prepare necessary ledger accounts to identify the hidden transactions from the non- current assets and non-current liabilities.

Step-3 compute funds from operations from revenue expenses and incomes. Step-4 preparation of Fund Floe Statement.

# Treatment of special items

**Proposed dividend**It may be treated as non-current liability .the proposed dividend for the current year should be debited to Adjusted P&L A/c in order to find out funds from operation. The dividend paid will be shown as application in fund flow statement. Dividend proposed in last year is assumed to have been paid during the year.

**Dividend paid** –Sometimes proposed dividend is not given in the balance sheet. But dividend paid is given under adjustment. In such cases, it is added back to net profit while calculating fund from operation. It should also be taken the fund flow statement as an application.

**Interim dividend** –It is always as additional information. It should be added back to net profit while calculating fund from operation. It should also be taken as application in fund flow statement.

**Provision for taxation** –It is treated as non-current liability. In this case, a ledger account is prepared for this item in the work sheet, the closing balance figure (on credit side) being the provision made during the year, should be taken to the debit side of ‘Adjusted P&L A/c’ for calculating funds from operation. The amount of tax paid will be shown as application in the Fund Flow Statement.

# Unit 5

**Cash Flow Statement**

# Introduction

A cash flow statement is a statement which shows the change in cash position from one period to other. This statement helps in short term financial planning.

# Definition of cash fund Cash

Cash comprises cash on hand and demand deposits with banks.

# Cash equivalents

There are short term, highly liquid investments which can be readily converted into cash without a decline in their value. Examples of cash equivalents are treasury bill, commercial paper, short term deposits, marketable securities etc.

# Cash flows

Cash flows are inflows and outflows of cash and cash equivalents. When there is a change in any transaction, there will be flow of cash. If the effect of transaction results in increase of cash and its equivalents, it is called an inflow. If it results in decrease of cash, it is called outflow.

# Meaning of Cash Flow Statement

In the cash flow statement the term fund is used to mean cash only and does not include even most liquid current assets. A cash flow statement shows the impact of transactions on cash position of the firm and includes all transactions having a direct impact upon cash. It explain the changes in cash position between two periods

**Note:** According to AS 3 (revised) all manufacturing and finance companies which are listed in a stock exchange or all commercial or industrial and business enterprise whose sales are more than 50 crores per year, must prepare and publish CFS by indirect method. This is made compulsory from April 1, 2001 onwards.

# Objectives of cash flow statement

1. **Useful in cash planning:** It is very useful to management by providing a basis to evaluate ability of a company to generate cash. A cash flow statement prepared on an estimated basis for the next accounting period enables the management to know how much cash

can be generated internally and how much it should arrange from outside. Such estimated amounts are used for preparing cash budget.

1. **Assess cash flow from operating activities:** It provides information about cash generated from operating activities. It provides explanation for the difference net profit and cash from operations. Cash provided by operating activities is very important to assess the cash generated by internal sources.
2. **Payment of dividends:** Decisions to pay dividends cannot be based on net profit only. Availability of profit in the form of cash is also important for dividend disbursement.
3. **Cash from investing and financing activities:** It provides information not only about cash provides by operating activities but also by non-operating activities under two heads, namely investing activities and financing activities. This helps to explain the overall liquidity position of the enterprises and its ability to meet its cash commitments.
4. **Explain reasons for shortage or surplus of cash:** A business may have made profit and yet running short of cash. Similarly a business may have suffered a loss and still has sufficient cash at bank. A cash flow statement discloses reasons for such increase or decreases of cash balance.

# Advantages or importance of Cash Flow Statement

1. **Planning and co-ordination of financial operations:** It is useful in evaluating financial policies and current cash position. Since cash is the basis for carrying operations, the cash flow statement will enable the management to plan and co-ordinate the financial operations probably.
2. **A control device:** It is also a control devise for the management. A comparison of cash flow statement for previous year with the budget for the year would indicate to what extent the resources of the enterprise were according to plan.
3. **Useful to internal financial management:** Since it gives a clear picture of cash inflow from operations it is therefore, very useful to internal financial management in considering the possibility of retiring long term debts, in planning replacement of plant facilities or in formulating dividend policies.
4. **Profit and cash position:** It enables the management to account for situation when business has earned huge profits yet run without money or when it has suffered a loss and still has plenty of money at the bank.
5. **Short term finance position:** It helps the management in taking short term financial decisions.

# Differences between Fund Flow Statement and Cash Flow Statement

|  |  |
| --- | --- |
| **Fund Flow Statement** | **Cash Flow Statement** |
| Fund means working capital | Fund refers to actual cash or cash inflow |
| It is concerned with all items constituting funds | It deals with cash transaction only |
| It shows the causes for changes in working capital | It shows the causes for the change in cash |
| FFS is for a long term planning | CFS is a tool for short term financial planning |
| There are no opening or closing balances in FFS | CFS starts with the operating cash balance and ends with closing cash balance |
| Schedule of changes in working capital is prepared | Calculations of cash from operations is prepared |

**Limitations of CFS**

1. As the enterprise shifts form strictly cash basis, enters into credit transactions as well takes into account prepared and accrued items, the net income no doubt would generally represent an increase in working capital, yet equating net income to cash flow for such enterprise would be inaccurate and misleading since a number of non-cash items affect the net income of the firm.
2. The cash balance too easily influenced by postponing purchase and other payment.

# Classification of cash flow

Cash flow from operating activities Cash flow from investing activities Cash flow from financing activities